Setting the global standard for investment professionals

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Interest Representative
Register ID:
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Brussels, 22 July 2011

Re: Green Paper: The EU Corporate Governance Framework

Dear Mr. Delsaux,

CFA Institute[1] is pleased to comment on the green paper: *The EU Corporate Governance Framework* (the "Framework") issued by the European Commission (the "Commission"). CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency and integrity of global financial markets.

Executive Summary

CFA Institute supports the Commission's efforts to assess the effectiveness of the current corporate governance structure for European companies, and to offer solutions to current gaps in corporate governance best practices in this framework.

CFA Institute believes that investor interests are best served by a board with a diversity of experience and expertise that has adequate time to devote to its oversight of management. We also feel that a board is responsible for understanding and managing the risk inherent in a company's line of business. We believe that remuneration disclosures should be as clear, succinct and transparent as possible, and that allowing shareowners a non-binding vote on executive compensation will help focus boards on creating remuneration packages with better links to performance.

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[1][1] CFA Institute is a global, not-for-profit professional association of over 105,000 investment analysts, advisers, portfolio managers, and other investment professionals in 137 countries, of whom more than 93,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

CFA Institute believes that compensation for senior company executives and incentive structures for asset managers should be explicitly linked to long-term financial and operating performance. Potential concerns about conflicts of interest among proxy advisory firms who may provide more than one service to their clients should be addressed through thorough and timely disclosures to all proxy advisory firm clients. CFA Institute also believes that improving minority shareowner representation on boards may be accomplished by lowering the threshold of percentage holdings to nominate directors for election, and by allowing cumulative voting in the election of directors.

Finally, CFA Institute feels that companies that choose to depart from a corporate governance code recommendation should be required to provide detailed explanations for such departures and describe the alternative solutions adopted, why they were chosen, and how they will achieve the same goals of the rules with which they have failed to comply.

CFA Institute has written often on many of the subjects addressed in the Commission's consultation paper, including but not limited to; *Breaking the Short-Term Cycle (2006), Environmental, Social, and Governance Factors at Listed Companies (2009), Asset Manager Code of Professional Conduct (2009,2010), The Corporate Governance of Listed Companies: A Manual for Investors, Second Edition (2009) and Shareowner Rights across the Markets: A Manual for Investors (2009).*

General Comments

Based on our communications with the Commission regarding past company law considerations, we recognize that the phrasing of some of these questions may suggest consideration of a European corporate governance code. We recognize that this would be a departure from the neutral approach previously taken on such matters. To date, the Commission had decided to leave company law issues to the Member States to decide, rather than creating a European code.

In general, we are neutral as to whether or not such a code is needed. In this perspective, our comments with regard to such questions should be read as neither an endorsement nor rejection of such a code. Rather, our comments are based on the perspective of whether the proposals as stated are appropriate.

Comments on Specific Questions

(1) *Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.*

CFA Institute feels that relevant national authorities should help create a set of consistent and universal corporate governance principles and rules for use by all listed companies within their jurisdictions, and enforce those principles and rules. We believe that investors would benefit from a consistent approach among regulators, self-regulatory bodies, and exchanges. We therefore discourage the Commission from setting different rules for different size companies. Establishing different rules for different size companies can only add to the

confusion among investors as to what transparency and shareowner rights they can expect from the companies in which they invest.

We recognize that some EU member states have specific corporate governance codes tailored to small and medium-sized listed companies where the controlling shareowner may also be the manager. Those codes include recommendations that reflect company size and structure, which are therefore less complex for small businesses to implement. In other Member States, codes designed for all listed companies contain certain provisions tailored to smaller companies.

We do not favour separate governance codes for different sized companies. Our concern is that investors may not be able to distinguish between those companies that are operating under one code from those that are operating under a code with lower standards. We also believe that good corporate governance principles are applicable to all listed companies, regardless of size or industry.

(2) Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?

In general, this is not a matter of concern to investors in listed companies, but one that is relevant to those financial institutions that invest and/or lend to these types of companies. Consequently, we do not have an opinion on this matter. Nevertheless, we encourage unlisted companies to adopt high corporate governance standards as a means of improving their performance and value.

1. Board of Directors

(3) Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?

CFA Institute believes that combining the two positions may give undue influence to executive board members and impair the ability and willingness of non-executive board members to exercise independent judgment. Several national corporate governance codes require the separation of these two positions, while many jurisdictions consider separation as a best practice that ensures board agendas are set by board members who are independent of the CEO. We therefore advocate separation of the Chairman and CEO positions as a best practice, while giving companies the option to explain why they chose to combine the positions if they decide not to comply with a separation of the Chairman and CEO positions.

If a company decides to combine the role of Chairman and CEO, we would advocate for the mandatory naming of a lead independent director whose role is to chair separate meetings of independent directors and address other issues that may involve conflicts with management. This approach strikes an appropriate balance for ensuring the continued independence of board deliberation and decision-making processes.

1.1. Board composition

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(4) Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance, i.e. at national, EU or international level?

The interests of shareowners are best served by a board with members who have the diversity of talent, knowledge, and relevant expertise to oversee the workings of the company, and the commitment to act on behalf of shareowners. These qualifications will help ensure that the board is not only qualified but recognizes the interests of those it serves.

However, the needs of each company will be different and based on their particular circumstances such as their product mix, balance sheet liquidity and leverage, and stage in their corporate life cycle, among other things. Consequently, we do not believe the Commission should be specific about the profile of directors as such descriptions may impede, rather than enhance an individual company's development.

Nevertheless, we do encourage the Commission to require disclosure of board member qualifications. Such transparency will enable investors to judge for themselves whether a board or individual board members are qualified to oversee a company, and if not, to work with the company to fill any experience or expertise gaps in the board.

(5) Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?

(6) Should listed companies be required to ensure a better gender balance on boards? If so, how?

CFA Institute agrees that including women and individuals with different backgrounds on the board would enrich the board and potentially could improve its functioning and efficiency. However, we believe that the skills and competencies of the individuals should be the decisive factors for service on corporate boards, not gender or ethnicity.

On the larger question of diversity of the board, diversity concerns may differ from company to company and from industry to industry. Diversity can also mean different things to different stakeholders. CFA Institute believes that a board should strive for a diversity of backgrounds, expertise, and perspectives, including an increased investor focus, in a manner that enhances board performance.

Board composition with these attributes will:

- Improve the likelihood that the board will act independently of management and in the best interests of shareowners;
- Reduce the influence of board members who are executive officers of other companies who might have a natural inclination to support management's perspectives;
- Ensure board members are able to understand complicated financial transactions and activities;
- Ensure that company activities are presented properly in the financial statements; and
- Ensure that shareowner and investor views are considered by the boards.

We therefore encourage the Commission to require companies to discuss the diversity of their boards, but to define that diversity for themselves, and let investors judge whether the diversity of a board serves their interests.

1.2. Availability and time commitment

(7) Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?

The role of board members at listed companies is demanding and time consuming, and may include hours dedicated to research, training, travel and meetings. CFA Institute therefore does support limits on the number of mandates a non-executive director may hold. We encourage the Commission to work in concert with institutional shareowners and corporate issuers to determine a number that works best for all parties.

1.3. Board evaluation

(8) Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

We agree with the Commission that a regular use of an external facilitator (e.g. every third year) could improve board evaluations by bringing an objective perspective and sharing best practices from other companies. As noted by the commission, currently there seems to be a limited number of service providers in some domestic markets, though greater demand could encourage new entrants.

We therefore agree that companies should be encouraged to conduct external evaluations at regular intervals (every 3 – 5 years, perhaps), and communicate the general findings of these reviews to shareowners. Nevertheless, we do not believe that companies should have to disclose every detail of such evaluations, but should communicate to shareowners constructive changes or reaffirmations of policies that result from such endeavours.

1.4. Directors' remuneration

(9) Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors, be mandatory?

CFA Institute believes that compensation for senior company executives (as well as incentive structures for asset managers) should be explicitly linked to long-term financial and operating performance. Creating links between compensation and fundamental performance for company executives and for asset managers will better serve investors' long-term interests.

It is imperative that investors have information that allows them to determine whether their interests are aligned with those of management. We therefore support efforts to require disclosure of remuneration policies, methods, and amounts paid to the highest-paid senior executives and board members of listed companies in annual remuneration reports. Please

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consult our recently published *Compensation Discussion and Analysis Template (2011[2])* for the mechanics behind such a document.

(10) Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

CFA Institute believes that companies and their boards of directors should permit shareowners to cast non-binding votes on the compensation packages awarded to companies' named executive officers in the past year.

Non-binding votes on compensation, or "say-on-pay" votes, permitted either through national company law structures or by companies on their own, give shareowners an opportunity to respond to company boards about the compensation policies and practices they helped create. Such votes also give boards the time they need to proactively work with investors to institute desired changes to compensation policies. Where implemented, such policies have led to more communication between shareowners and boards about appropriate compensation strategies and the amounts paid to senior executives.

1.5. Risk management

(11) Do you agree that the board should approve and take responsibility for the company's 'risk appetite' and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?

(12) Do you agree that the board should ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

Boards are ultimately responsible for ensuring that companies establish effective risk management processes that identify, monitor, and analyze the risk profile, including the sources, nature, and degree of their companies' risk exposures. A transparent, robust framework for managing risk and for effective reporting of those risks is key to protecting investors' interests by helping them make informed investment decisions.

We agree with the Commission that a "one-size-fits-all" risk reporting framework is not desirable due to the great diversity in size, industry and circumstances among EU companies that would be covered by such a framework. However, we do encourage the Commission to work with investors and issuers to develop a framework of risk reporting that requires boards to enumerate the risks they face and disclose to investors an explanation of how those risks are being addressed.

2. SHAREHOLDERS

2.1. Lack of appropriate shareholder engagement

2.2. Short-termism of capital markets

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[2] See: http://www.cfapubs.org/toc/ccb/2011/2011/1.

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(13) Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.

CFA Institute has worked with a number of organizations to help combat the issue of short-termism, among both corporate executives and investors. These reports, available on the website of CFA Institute[3], describe a number of proposals to reduce the likelihood of short-termism, including the following:

- Reconsideration and reform of earnings guidance practices;
- Application of long-term compensation structures for corporate and investment managers;
- Demonstration of leadership in shifting the focus to long-term value creation;
- Improvements in communications and disclosures about company strategies; and
- Promotion of broad educational efforts for all market participants about the benefits of long-term thinking and the costs of short-term thinking.

Nevertheless, we are concerned about the potential for defining "inappropriate short-termism" in a way that may impair the ability of investors to protect their clients' portfolios and/or to improve their returns. For example, if short-termism were defined to include buying and selling of securities within one week or one day, it could impair the ability of investment advisers to respond to changing market conditions immediately after taking an investment action.

Consequently, we urge caution in the use and definition of what is appropriate and inappropriate short-termism.

2.3. The agency relationship between institutional investors and asset managers

(14) Are there measures to be taken, and if so, which ones, as regards the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

As we stated in our comments concerning question (9) above, CFA Institute believes that compensation for senior company executives (**as well as incentive structures for asset managers**) should be explicitly linked to long-term financial and operating performance. Creating links between compensation and fundamental performance for both company executives and asset managers will better serve investors' interests.

In addition to this recommendation to lengthen the term-structure of some asset manager pay, in our paper, "Breaking the Short-term Cycle (2006)," we recommended improved disclosure of asset managers' incentive metrics, fee structures, and personal ownership of funds they manage. We therefore believe the Commission should call for better disclosure of these items by asset managers. We also encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.

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[3]See "Breaking the Short-Term Cycle, available at: http://www.cfapubs.org/toc/ccb/2006/2006/1. Also, see "Apples to Apples: A Template for Reporting Quarterly Earnings," available at http://www.cfapubs.org/toc/ccb/2007/2007/1.

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(15) Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?

In general, we support the notion that institutional investors should carefully monitor the activities and performance of asset managers with regard to funds invested on behalf of their beneficiaries. We believe that more transparency about the strategies and performance of asset managers, including their investment strategies, the cost of portfolio turnover, whether the level of portfolio turnover is consistent with the agreed strategy, the cost and benefits of engagement, etc., could shed more light on whether or not asset managers' activities are beneficial for long-term institutional investors and long-term value creation on their behalf. To that end, CFA Institute has created its "Asset Manager Code of Professional Conduct[4]" as a means of helping institutional investors achieve this goal.

As an alternative to drafting a law, CFA Institute encourages the Commission to consider requiring institutional investors to require their asset managers to adhere to such a code of conduct in order to achieve the same purpose. We believe this type of structure would permit more flexibility in adjusting and evolving with changing market conditions and concerns.

2.4. Other possible obstacles to engagement by institutional investors

(16) Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

CFA Institute has advocated in the past for the independence of asset managers' governing bodies. In particular, we view such bodies as the watchdogs for investors' interests, and thus structures are needed to mitigate potential conflicts of interests between asset managers and members of the governing bodies. We also believe that governing body independence would help establish the appropriate environment within the board to address business issues that may affect investor interests.

(17) What would be the best way for the EU to facilitate shareholder cooperation?

CFA Institute does not have any suggestions beyond those offered in the consultation to offer with regard to this question.

2.5. Proxy advisors

(18) Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?

[4] See: http://www.cfapubs.org/toc/ccb/2009/2009/8.

(19) Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

There has been much concern in recent years about the perceived power that proxy advisory firms hold over the proxy process. Many are concerned that investors, and especially institutional investors who hold a greater concentration of shares than any other group, may be swayed by these entities' suggestions.

Our experience and interaction with these investment institutions tells us that this concern is exaggerated. Nevertheless, there may be steps institutional investors and others who vote proxies can develop to assure beneficiaries and issuers that proxies are being voted in a reasoned and conscientious manner. CFA Institute hopes the Commission will encourage these investor institutions and firms to develop policies to ensure that shareowner votes are handled properly, namely by;

- Developing guidelines for initial reviews of new or controversial proxy issues;
- Ensuring that proxy-voting decisions agree with the investment interests, objectives, and preferences of the investor, participants, or beneficiaries of an account;
- Creating a mechanism to review unusual proxy proposals;
- Having a process for deciding whether to communicate with a company's management or board of directors prior to, or following, a vote;
- Having a process for determining whether to join the proxy efforts of other concerned investors in taking specific actions with regard to a company;
- Having a process for determining when and how to report the proxy positions taken during the proxy season; and
- Having a process to identify and vote proxy issues by particular accounts considering the specific preferences of beneficiaries, participants, or other clients.

Such policies will help both shareowners and their advisers to not only vote the proxies, but also to do so in a manner consistent with clients' interests. Moreover, they will force clients to focus on whether investment firms' policies are acceptable.

Concerns about conflicts of interest among proxy advisory firms who may provide more than one service to their clients should be addressed through thorough and timely disclosures to all proxy advisory firm clients. We do not believe that proxy advisory firms should be required to disclose publicly their decision models for approval of executive compensation plans, as some groups have suggested.

In our view proxy advisory firms currently provide a sufficient level of information to both clients and others regarding their recommendations on proxy issues including compensation plans.

2.6. Shareholder identification

(20) Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

CFA Institute encourages the Commission to explore a means of allowing issuers the ability to contact their shareowners while preserving complete confidentiality for shareowners if such confidentiality is desired (unless certain ownership thresholds are met that require disclosure).

CFA Institute believes that giving individual investors the ability to access proxy materials and voting instruction information through the investor's account page on a broker's web site would be useful in generating more retail involvement. We understand that some organizations, including proxy advisory organizations, are considering a move in this direction. We believe the Commission should encourage the use of such technology to better educate about, and thus get investors more involved in, the proxy process.

We encourage the Commission to further consider creating less-expensive or free proxy voting platforms that would provide retail investors with access to proxy research, vote recommendations, and vote execution. Likewise, advance voting instructions, much like those used by institutional investors, may be one way to increase voter participation, although controls must be used to guard against abuse. And investors should be allowed to, and perhaps required to, revisit these decisions on a periodic basis.

We are encouraged the initiatives by groups such as Euroshareholders, who aim to get investors more involved in the management of the companies they own. This initiative is meant to facilitate the involvement and proxy voting of retail investors in Europe (especially cross-border) by launching a EUROVOTE[5] proxy voting service on internet and EU-wide Voting Guidelines.

2.7. Minority shareholder protection

(21) Do you think that minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

As the Commission notes, minority shareowner engagement is difficult in companies with controlling shareowners. This remains the predominant governance model in European companies, and raises the question whether the 'comply-or-explain' system is viable in such companies, particularly where adequate protection of minority shareowners is not guaranteed.

Secondly, the question arises whether the existing EU rules are sufficient to protect minority shareowners' interests against potential abuse by a controlling shareowner (and/or management).

In order to enhance the rights of shareowners, certain Member States (e.g. Italy) reserve the appointment of some board seats to minority shareowners.

CFA Institute believes one method of improving minority shareowner representation on boards is to lower the threshold of percentage holdings to nominate directors for election. That way the nomination committee cannot fully control the list of directors to be elected.

We also recommend that cumulative voting be allowed in all EU jurisdictions. Such a system allows shareowners to accumulate their votes for one nominated candidate. For example, if a shareowner has 100 shares and there are five directors up for election, instead of casting 100

[5] See: http://www.euroshareholders.eu/eurovote_about.

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shares for each director, the shareowner could accumulate all 500 votes for one director; thus increasing the shareowner's chances of electing its desired candidate.

(22) Do you think that minority shareholders need more protection against related party transactions? If so, what measures could be taken?

Companies should have appropriate thresholds for determining when related-party transactions require board and/or shareowner approval. Investors need to ensure that there are systems in place that monitor the legitimacy of major transactions pursued by company management. Board approval makes management more accountable, and shareowner approval makes management, as well as the board, accountable.

When related-party transactions require board or shareowner approval, those board members or shareowners involved in the transactions should be required to abstain from voting. Related parties, be they "interested" shareowners or directors, should have to abstain from voting to avoid potential conflicts of interest which could impair the objectivity of the vote.

Companies should voluntarily disclose the identities and level of ownership of related parties who own a substantial amount of their shares, including subsidiaries and affiliated companies. Full disclosure makes it easier to identify related parties and exposes potential conflicts of interest between related parties with the board/management and shareowners.

2.8. Employee share ownership

(23) Are there measures to be taken, and if so, which ones, to promote at EU level employee share ownership?

3. THE 'COMPLY OR EXPLAIN' FRAMEWORK – MONITORING AND IMPLEMENTING CORPORATE GOVERNANCE CODES

3.1. Improving the quality of the explanations given in corporate governance statements

3.2. Better monitoring of corporate governance

(24) Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

CFA Institute agrees that companies that choose to depart from a corporate governance code recommendation should be required to provide detailed explanations for such departures and describe the alternative solutions adopted, why they were chosen, and how they will achieve the same goals of the rules with which they have failed to comply.

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(25) Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?

CFA Institute agrees that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary. The Commission should work with local regulators throughout the EU to establish uniform penalties for companies that do not adequately explain.

Concluding Comments

CFA Institute is pleased to submit its views on the Commission's *Green Paper: The EU Corporate Governance Framework.* If you or your staff have questions or seek clarification of our views, please feel free to contact either Nitin Mehta, CFA, at +44.0207.330.9595 or nitin.mehta@cfainstitute.org, Agnès Le Thiec, CFA at +32 2 401 6829 or agnes.lethiec@cfainstitute.org, or Matthew Orsagh, CFA, CIPM at +1.212.756.7108 or matt.orsagh@cfainstitute.org.

Sincerely,

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