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**Corporate Governance in the EU and U.S.:
Comply-or-Explain Versus Rule**

Maria Elisabeth Sturm

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Abstract

A few years ago, the “Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States” was prepared on behalf of the European Commission. This study aimed to evaluate how different stakeholders perceived corporate governance codes within the EU. It especially emphasized the comply-or-explain principle, which has become an important feature of the EU approach to corporate governance. In contrast to the comply-or-explain approach, in the U.S. corporate governance is put into force mainly through rule, such as through the Sarbanes-Oxley-Act. Although the U.S. was considered to be the starting point of the financial crisis, even in Europe the call for more legislative action to address corporate governance problems has increased. Therefore, this doctoral thesis explains the comply-or-explain-principle and describes its development in the UK and Germany by examining the background of EU Law, the different corporate governance codes in the UK and Germany, and the results of the “Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States.” In a second step, this thesis examines and compares the corporate governance rules in the U.S. to the corporate governance rules and codes in the UK and Germany, particularly with regard to the acceptance of the rules by stakeholders and their effectiveness in the economy. In particular, a special emphasis has been placed on the following points: 1) the level of compliance of companies with the applicable codes and laws, 2) the availability and quality of explanations for deviation, 3) the perception of corporate governance codes and laws by directors on the one and by shareholders on the other hand, 4) the complementary aspects of legislation and corporate governance codes, 5) the level of activity of investors and how it could be increased, and 6) the effectiveness of the different monitoring and enforcement practices.

The aim of this paper is to examine how insights from the U.S. corporate governance system can be used to make corporate governance in Europe more effective and to improve the comply-or-explain-approach. Whenever a new rule for corporate governance is presented, the legislator must consider if it should become a law or not. And although there is a long-standing and on-going discussion about corporate governance, and stricter rules are often proposed by politicians and the media, the EU comply-or-explain-approach itself has never really been questioned. The “Comparative Study of Corporate Governance Codes relevant to the European Union and its Member States” (2002) by *Weil, Gotshal & Manges LLP* on behalf of the European Commission emphasizes the advantages of comply-or explain. In particular, the study emphasizes the flexibility, which, of course, is also preferred by the enterprises which have to apply the corporate-governance codes, but need not to comply with them. Furthermore, the comply-or-explain approach has advantages with regard to the reduced financial and bureaucratic burden, and the superior quality of information it provides to shareholders and investors. In addition, no disadvantage in terms of enforceability gaps can be observed. The comply-or-explain approach enjoys wide acceptance, in the EU and the U.S., and the deficiencies in its practical implementation could be eliminated by introducing a corporate governance code for institutional investors based on the example set by the UK Stewardship Code.

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List of Abbreviations

ACCG	Austrian Code of Corporate Governance
AER	The American Economic Review
AG	1. Aktiengesellschaft 2. Die Aktiengesellschaft (Law Journal)
AGM	Annual General Meeting
AIA	American Institute of Accountants
AICPA	American Institute of Certified Public Accountants
AKEIÜ	Arbeitskreis „Externe und Interne Überwachung der Unternehmung“
AKEU	Arbeitskreis Externe Unternehmensrechnung
AktG	Aktiengesetz
ALI	American Law Institute
Am. Bus. L.J.	American Business Law Journal
Am. Econ. Rev.	American Economic Review
Am. J. Comp. L.	American Journal of Comparative Law
APB	Accounting Principles Board
BB	Betriebsberater (Law Journal)
BGH	Bundesgerichtshof
BörsG	Börsengesetz
BT-Drs.	Bundestagsdrucksache
B.Y.U.L.Rev.	Brigham Young University Law Review
CalPERS	California Public Employees' Retirement System
CAP	Committee on Accounting Procedure
CEO	Chief Executive Officer

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CFO	Chief Financial Officer
CLR	Consumer Law Review
COM	Commission document (Proposed legislation and other Commission communications to the Council and/or other institutions, and their preparatory papers Commission documents for the other institutions.)
Currents: Int'l Trade L. J.	Currents: International Trade Law Journal
DAX	Deutscher Aktienindex
DB	Der Betrieb
DG (Internal Market)	Directorate General
DIHK	Deutsche Industrie- und Handelskammer
DSF	Duisenberg School of Finance
Duke L.J.	Duke Law Journal
EC	European Commission
ECFR	European Company and Financial Law Review
ECGF	European Corporate Governance Forum
ECJ	European Court of Justice
ed.	editor
eg.	exempli gratia
EEC	European Economic Community
esp.	especially
et seq/et seqq	et sequens
EU	European Union
FAF	Financial Accounting Foundation
FASB	Financial Accounting Standards Board

FS	Festschrift
FSA	Financial Services Authority
GAAP	General Accepted Accounting Principles
GCCG	German Code of Corporate Governance
GES	Zeitschrift für Gesellschaftsrecht und angrenzendes Steuerrecht
GesRZ	Der Gesellschafter
GmbH	Gesellschaft mit beschränkter Haftung
HGB	Handelsgesetzbuch
Hous. J. Int'l. L.	Houston Journal of International Law
ICGN	International Corporate Governance Network
i.e.	id est
J.Corp.L.	Journal of Corporation Law
J. Fin. Econ.	Journal of Financial Economies
KG	Kammergericht
KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich
Loy.U.Chi.L.J.	Loyola University Chicago Law Journal
M&A	Mergers & Acquisitions
MD&A	Management Discussion and Analysis of Financial Conditions and Results of Operations

MitBestG	Gesetz über die Mitbestimmung der Arbeitnehmer
MontanMitBestG	Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie
NJW	Neue Juristische Wochenschrift (Law Journal)
NYSE	New York Stock Exchange
NZG	Neue Zeitschrift für Gesellschaftsrecht
OECD	Organisation for Economic Co-Operation and Development
öAktG	österreichisches Aktiengesetz
QLCC	qualified legal compliance committee
RWZ	Zeitschrift für Recht und Rechnungswesen
SE	Societas Europaea
SEC	1. Securities Exchange Commissio 2. Staff and joint staff working documents (impact assessments, summaries of impact assessments, staff working papers). Staff working documents had the identifier SEC prior to 2012. SEC will not be used anymore in the future.
SEV	Hellenic Federation of Enterprises

SFAS	statements of financial accounting standards
SFAC	statements of financial accounting concepts
SOX	Sarbanes-Oxley Act of 2002
Stan. J. L. Bus.&Fin.	Stanford Journal of Law, Business & Finance
TransPuG	Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität
Vic. U. Wellington L. Rev.	Victoria University of Wellington Law Review
Vol.	Volume
VorstAG	Gesetz zur Angemessenheit der Vorstandsvergütung
VorstOG	Gesetz über die Offenlegung der Vorstandsvergütungen
vs.	versus
VWL	Volkswirtschaftslehre
Wash. U. Global Stud. L. Rev.	Washington University Global Studies Law Review
Wm. Mitchell L. Rev.	William Mitchell Law Review
WpHG	Gesetz über den Wertpapierhandel
WTR Law & Contemp. Probs.	Winter Law & Contemporary Problems
UGB	Unternehmensgesetzbuch
UK	United Kingdom of Great Britain and Northern Ireland
U.S./USA	United States of America

ZGR	Zeitschrift für Unternehmens- und Gesellschaftsrecht
ZIB	Zeitschrift für Internationale Beziehun- gen
ZIP	Zeitschrift für Wirtschaftsrecht

A. Introduction

“Different countries’ economies are organized in very different ways, and corporate governance – that is, decisions about how capital is allocated, both across and within firms – is entrusted to very different sorts of people and constrained by very different institutions.”¹

Studies of the history and development of corporate governance have found that modern corporate structures are the result of legal systems dating back to preindustrial times². But if we understand how the differences we see today developed, we can better predict how to feasibly transfer regulations from one jurisdiction to another. The increase in cross-border activity has globalized not only the economy, but also the law. The internationalization of transactions and the increasing applicability of foreign law make comparative law an indispensable tool for the legal practitioner³.

The aim of this thesis is to gain a deeper insight into the U.S. corporate governance system and to find out how this understanding could be used to make corporate governance in Europe more effective. To this end, this thesis will unfold as follows. First, the concept of corporate governance will be defined, thereby illuminating its history and the underlying economic theories. One chapter will be dedicated to explaining the comply-or-explain approach, an idea that represents the most important differences between the European and the U.S. corporate governance systems. Second, the corporate governance systems in Europe and the U.S. will be characterized; a special emphasis will be put on some European Union Member States in order to gain deeper insights to the differences within the EU. Finally, the divergences and

¹ *Morck/Steier*, Global History of Corporate Governance, NBER Working Paper Series 1 (1).

² *Morck/Steier*, Global History of Corporate Governance, NBER Working Paper Series 1 (1).

³ *Lomio/Spang-Hanssen*, *Legal Research Methods*² (2009) 276.

convergences of comply-or-explain approach, both within the EU, and also in the U.S system, will be examined. The last step will be to summarize the advantages and disadvantages of both systems and to use this knowledge to create a proposal to improve the Corporate Governance system in the European Union.

B. The Concept of Corporate Governance

I. Meaning of “Corporate Governance”

Although “Corporate Governance” nowadays is used frequently in political and scientific discussions, it is helpful to define it more clearly. While corporate governance has existed for as long as entities have been incorporated, the term itself is rather new⁴. It began appearing frequently in legal and economic contexts in the mid 1990s⁵. Before a final definition is decided upon, a range of important definitions will first be examined.

1. Definitions

The UK Corporate Governance Code gives a very short definition, taken from the Cadbury Report:

“Corporate governance is the system by which companies are directed and controlled.”⁶

It is followed by an explication of the responsibilities of the different parties involved, showing that corporate governance is about the exercise of power over corporate entities⁷:

⁴ *Tricker, Corporate Governance (2009) 7, 12.*

⁵ *Hopt, GesRZ 2002, 4 (4).*

⁶ *Financial Reporting Council, UK Corporate Governance Code 1.*

⁷ *Tricker, Corporate Governance (2009) 7.*

“Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board’s actions are subject to laws, regulations and the shareholders in general meeting.”⁸

Monks/Minow already added the relationship of the participants to their definition:

“Corporate Governance is the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management (led by the chief executive officer), and (3) the board of directors.”⁹

Another important feature of this definition is the fact that it mentions “performance”. This shows the economic dimension of corporate governance and underscores the shareholder value, which has special importance for U.S. corporations, as compared to continental European countries that tend to follow the stakeholder value principle¹⁰.

Nevertheless, performance also plays an important role in Europe¹¹. This is demonstrated in the definition given in the Comparative Study of Corporate Governance Codes relevant to the EU Member States, which combines the function of control with the aim of performance:

⁸ *Financial Reporting Council*, UK Corporate Governance Code 1.

⁹ *Monks/Minow*, Corporate Governance (1995) 1; adopted also by *CalPERS*, Global Principles 5.

¹⁰ *Nagel*, NZG 2007, 166 (168); see also the foreword of the German Corporate Governance Code, which stresses the principles of the social market economy; *Krackhardt*, *Vict. U. Wellington L. Rev.* 2005, 319 (321, 353).

¹¹ As well as in other continents, e.g. Australia, where the corporate governance report „Strictly board-room“, issued by the Committee on corporate governance (1993), chaired by *Prof. Fred Hilmer* of the Australian Graduate School of Management, states that governance is about performance as well as about conformance (*Tricker*, Corporate Governance (2009) 14).

“Although corporate governance can be defined in a variety of ways, generally it involves the mechanism by which a business enterprise, organized in a limited liability corporate form, is directed and controlled. It usually concerns mechanisms by which corporate managers are held accountable for corporate conduct and performance. Corporate governance is distinct from – and should not be confused with – the topics of business management and corporate responsibility, although they are related.”¹²

The OECD introduces its definition with the goals that should be attained by implementing good corporate governance: improving economic efficiency and growth and enhancing investor confidence:

“Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”¹³

Thus, this definition highlights that investor confidence is crucial for successful performance¹⁴ and that the recent corporate governance discussion is also about the legitimacy and effectiveness of the exercise of power over companies¹⁵.

One last definition should be added because it combines some of the most important elements:

“Good corporate governance means good leading of a company, thus (...) the legal rules of organization that guarantee best that all entities within a corporation help enforcing the interest of the corporation. Good corporate governance requires more than just rules of organization, it wants to set quality standards (...). With regard to contents one can differ between rules for leading the company and rules for controlling it. Good corporate governance is realized by rules that enable an effective leading of the company without hindering an effective control.”¹⁶

¹² *Weil, Gotshal & Manges LLP, Comparative Study (2002) 1.*

¹³ *OECD, Principles of Corporate Governance 11.*

¹⁴ *Haberer, Corporate Governance (2001) 7.*

¹⁵ *Tricker, Corporate Governance (2009) 8.*

¹⁶ *Lange, NZG 2004, 265 (266).*

First of all, this definition says that corporate governance describes “legal rules”. This is important because whenever one talks about corporate governance, one must keep in mind that corporate governance consists of a set of regulations that combines laws and private codes of conduct. Thus, there are rules addressing corporations, and rules addressing the legislator, e.g. the OECD principles of corporate governance or the EU Commission recommendations. Secondly, this definition mentions the demand for setting quality standards above the legally required minimum. And finally, the aim of good corporate governance is explained: effective leading together with effective control.

2. Conclusion

To summarize the quintessential elements of these definitions, corporate governance is the internal structure of a company that takes into account the interests of all different parties involved, and distributes responsibilities and control accordingly, with the aim to improve the performance of the corporation and enhance the investor confidence. Many key forces exist within a corporation: the management, the shareholders, and the employees, which must be directed by institutions with the capacity to manage and control¹⁷. Good corporate governance solves internal company problems by 1) giving incentives, 2) controlling the internal decision-making process, and 3) managing the company with the intention to minimize risks and maximize the return on investment for investors. Thus, good corporate governance distributes power and responsibilities and tries to prevent the abuse of corporate power¹⁸. In other

¹⁷ *Schewe*, Unternehmensverfassung (2005) 9.

¹⁸ *Tricker*, Corporate Governance (2009) 13.

words, one can say that management runs the business, but an established corporate governance system is what ensures that the business is being run well and in the right direction¹⁹.

¹⁹ *Tricker, Corporate Governance (2009) 36.*

II. History and Development of Corporate Governance

When we talk about corporate governance we are talking about control. The key questions are: why control is necessary? And which forms of control are possible? The history of corporate governance began at the end of the 19th century. At that time, the first stock exchanges opened. Before, shares were not traded publicly. In most cases, a company was owned by its managers and thus managed by its owners. Ownership was not dispersed, but shared only between friends and family members. Control was executed by voice rather than by exit²⁰. With the opening of stock exchanges, dispersed forms of ownership emerged and control by exit became much easier.

1. The New Institutional Economics (NIE)

This development resulted in the separation of ownership and control, which sparked the beginning of the discussion of corporate governance²¹. From this conversation came the identification of the principal-agent-problem, which was first described by *Adam Smith*²². However, *Smith* concluded (incorrectly) that because of the principal-agent-problem, the shareholder company would not last²³. It was only later that *Berle/Means*²⁴ first intensively discussed the issue. By broadly presenting the issue,

²⁰ *Brändle*, Corporate Governance (2004) 4 et seq.

²¹ *Banzhaf*, Die Entsprechenserklärung der SE (2009) 19.

²² *O'Rourke*, Adam Smith (2008) 77 et seq.

²³ *Smith*, Wealth of Nations²⁶ (1984) 323 et seq.

²⁴ *Berle/Means*, The modern corporation and private property² (1997); see also: *Johnston*, EC Regulation of Corporate Governance (2009) 28 et seq.

Berle/Means gave the foundation for the development of a new economic science, the “New Institutional Economics (NIE)”²⁵. This theory provides a framework for the economic analysis of the institutional environment of the economy²⁶. It is new, as it sacrifices the clearness of the neo-classical model in favor of more difficult, but more realistic, assumptions²⁷. Every economic theory necessarily works with models; reality is simply too complex and it is not possible to reach a deeper insight into the co-dependencies without using a model²⁸. The problem hereby is to find the proper degree of abstraction²⁹. While classical theory emphasizes only price and sees subjective demand as irrelevant, neo-classical theory recognizes that prices are highly influenced by the expected utility of a good³⁰. The NIE now accepts neo-classical theory, but refines its image of the market participant. The homo oeconomicus still is only interested in maximizing his own utility³¹, but he or she no longer has all available information and is not perfect in processing the little information he has³². For that reason, the market participant is incapable of optimizing every decision. He or she is self-interested and rational, but not efficient. Moreover, human beings tend to behave opportunistically, which means that they are prepared to pursue their own interests, even through fraud. All market participants try to maximize their advantage as much

²⁵ *Banzhaf*, Die Entsprechenserklärung der SE (2009) 20; *Johnston*, EC Regulation of Corporate Governance (2009) 65 et seqq.

²⁶ *Richter/Furubotn*, Neue Institutionenökonomik (1996) 42.

²⁷ *Johnston* says, the NIE „simply fills in the gaps where neoclassical analysis operates at too high a level of abstraction“, EC Regulation of Corporate Governance (2009) 68; see also *Williamson*, Markets and Hierarchies⁴ (1983) 1; *Banzhaf*, Die Entsprechenserklärung der SE (2009) 21.

²⁸ *Heine/Herr*, VWL³ (2003) 1.

²⁹ *Heine/Herr*, VWL³ (2003) 3.

³⁰ *Heine/Herr*, VWL³ (2003) 12.

³¹ *Johnston*, EC Regulation of Corporate Governance (2009) 67.

³² *Bofinger*, Grundzüge der Volkswirtschaftslehre² (2007) 112; *Johnston*, EC Regulation of Corporate Governance (2009) 66.

as possible under the established institutional order³³. They create institutions³⁴ to regulate life within this imperfect, inefficient framework. In a perfect society with only efficient, utility-maximizing *homines oeconomici*, institutions, like e.g. courts and court procedures, would not be necessary, as every participant would understand the conditions of the system and act entirely rationally. Everyone would know in advance how a lawsuit would end, and therefore would not need to bring his or her case to court³⁵. But the NIE, with its assumption of imperfection, requires institutions. *North* says:

“Institutions are the humanly devised constraints that structure human interactions. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies.”³⁶

Institutions therefore are rules and organizations that compensate for the insecurity resulting from market imperfections by creating proper incentives. Institutions create costs, so-called “transaction costs”³⁷. There are three types of transaction costs: 1) information costs, which are incurred in the process of finding out with whom it is possible to make a contract; 2) negotiation and decision costs, which occur in the process of finalizing a contract; and finally, 3) control and enforcement costs, which include all investments that have to be made to make the contract work as it was negotiated. Institutions should be set up to minimize such costs as much as possible.

³³ *Richter/Furubotn*, *Neue Institutionenökonomik* (1996) 3 et seqq.

³⁴ A term originally introduced by *Thorstein Bunde Veblen*, though now defined slightly different, see *Wesch* in: *Herz*, *ZEIT-Bibliothek der Ökonomie* (2002) 55.

³⁵ *Richter/Furubotn*, *Neue Institutionenökonomik* (1996) 17.

³⁶ *North*, *Economic Performance through Time*, *Am. Econ. Rev.* 1994, 360 (360).

³⁷ *Richter/Furubotn*, *Neue Institutionenökonomik* (1996) 9; *Banzhaf*, *Die Entsprechenserklärung der SE* (2009) 25.

The introduction of transactions costs is one of the important characteristics that makes the NIE different from neo-classical theory, as the latter regards those costs as insignificant and negligible. However, the existence of those costs and the effort to minimize them has a strong influence on the behavior of the market participants.

2. Market vs. Hierarchy

“The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism.”³⁸ With this simple statement, Coase discovered that a market necessarily entails transaction costs, and asserts that this reality is the reason for the existence of firms. He describes the conflict between the two basic principles of coordinating processes of production: market dynamics and hierarchical order. The market organization works with short-term contracts based on current needs. Everybody buys just what he or she needs; the price is made by offer and demand. In contrast, in the hierarchical structure, long-term contracts are formed. As long as the contract lasts, a leader, e.g. the owner of a company, or the management, must decide what will be produced, how and how much, and through what instructions. The most important difference between the two systems lies in the transaction costs. While the market has advantages in processing information, as it brings all offers and all demands together in the fastest and most efficient way, the hierarchy has advantages with regard to negotiation and decision costs. With long-term contracts fewer contracts have to be formed. There is not a continuous search for new contract partners. Thus, firms are established to minimize negotiation costs by using the hierarchical system. This theory forms the basis of the U.S. model of

³⁸ Coase, *The Nature of the Firm*, 390; see also: *Johnston*, *EC Regulation of Corporate Governance* (2009) 26 et seqq, 222.

corporations called the “Nexus of Contractual Relationships”. In contrary to e.g. Germany, where a legal person still has its own legal personality, in the U.S. a corporation is regarded as center of a network of various contracts³⁹.

The crucial question is now: “Why, if by organizing one can eliminate certain costs and in fact reduce the cost of production, are there any markets at all?”⁴⁰ The bigger a firm grows, the higher the information processing costs are. At a certain point the savings from negotiation costs are overrun by the costs of processing information; the hierarchical structure becomes too big and the market is again the more efficient option.

3. The Principal-Agent-Problem⁴¹

Within a hierarchy another type of costs emerges, caused by the above-mentioned principal-agent-problem⁴². This problem always appears when one person, the principal, gives orders to another person, the agent, and the agent has various possibilities how to fulfill the orders. As the agent is a homo oeconomicus, he or she will try to pursue his or her own interests while fulfilling the order. Simultaneously, he or she is acting as an agent; and his or her actions also influence the interests of the principal, compared to whom he or she has an information advantage. This causes a need for monitoring the agent from the point of view of the principal. The costs for organizing

³⁹ *Banzhaf*, Die Entsprechenserklärung der SE (2009) 21.

⁴⁰ *Coase*, The Nature of the Firm, 394.

⁴¹ *Tricker*, Corporate Governance (2009) 217 et seqq; *Brändle*, Corporate Governance (2004) 9 et seqq.

⁴² B. II.1.; *Jensen/Meckling*, Theory of the Firm, J. Fin. Econ. 1976, 304 (305 et seqq).

the monitoring are “motivation costs,” which are part of the transaction costs⁴³. The relationship between management and shareholders in a corporation forms a classic principal-agent-relationship⁴⁴, which follows from the separation of ownership and control⁴⁵. Corporate governance codes are largely created to address this agency dilemma⁴⁶. The shareholders provide capital which can only be raised by a large number of investors. Yet, they are not involved in leading the company and cannot influence the day-to-day business which are run by management. The managers are not owners of the company; they only provide the management know-how. While corporations are considered to be the product of their shareholders’ wishes, in fact they are more likely to reflect the efforts of their senior executives⁴⁷. The reason for this separation is that shareholders often do not have the capability or time to manage the company in a reasonable way. On the other hand, the managers have great deal of discretion to use— as *homines oeconomici* – to their own advantage, even if that may be a disadvantage for the shareholders⁴⁸, e.g. by re-investing earnings in a not cost-effective but prestigious project, instead of disbursing earnings to the shareholders. According to *Schumpeter*, industrial property is no longer personal; managers therefore tend to adopt a mindset similar to those of civil servants⁴⁹. This causes additional transaction costs in form of “agency-costs”, the price one has to pay to ac-

⁴³ *Bofinger*, Grundzüge der VWL² (2007) 81 et seqq, *Kalss*, in *Kalss/Nowotny/Schauer*, Österreichisches Gesellschaftsrecht (2008) para 3/14.

⁴⁴ *Kalss*, in *Kalss/Nowotny/Schauer*, Österreichisches Gesellschaftsrecht (2008) para 3/ 14; *Tricker*, Corporate Governance (2009) 8, 18, 219; *Westbrook*, Between Citizen and State (2007) 19 et seqq.

⁴⁵ *Jensen/Meckling*, Theory of the Firm, J. Fin. Econ. 1976, 304 (309).

⁴⁶ *Tricker*, Corporate Governance (2009) 218.

⁴⁷ *Holt*, Sarbanes-Oxley Act (2009) 3.

⁴⁸ *Schewe*, Unternehmensverfassung (2005) 32 et seq; *Banzhaf*, Die Entsprechenserklärung der SE (2009) 23 et seq; *Merkt/Göthel*, US-amerikanisches Gesellschaftsrecht² (2006) para 69.

⁴⁹ *Geißler*, in *Herz*, ZEIT-Bibliothek der Ökonomie (2002) 93.

cess the advantages of the separation of ownership and control⁵⁰. The task of effective corporate governance is to motivate the agent to act in the interest of the principal and to control him or her efficiently. Rules that attempt to solve this conflict can be found in different laws, e.g. company laws or laws concerning the capital market, but also in so-called corporate governance codes based on the principle of comply-or-explain. Details regarding those types of rules will be discussed later⁵¹.

Another problem connected to the principal-agent-problem is the “free-rider”-problem, in which persons take advantage of the actions of others without being active themselves. This leads to a passivity of the whole group as all group members just wait for the others to become active. In a stock company this problem often occurs when minor shareholders do not execute their duty to supervise the company they hold stocks of, but trust in institutional investors⁵² to do so⁵³.

Therefore, the principal-agent-problem requires closer supervision of the management, but this does not happen, or at least not as much as needed, due to the free-rider problem. Minor shareholders do not have the time nor the resources, and so they rely on the institutional investors. We will see later if and to what extent institutional investors can fill in the gap.

III. Economic Theories

⁵⁰ *Haberer*, Corporate Governance (2001) 11 et seq.

⁵¹ See B.V.

⁵² For this work, for the term „institutional investor“ the following definition will be used: „The definition of „institutional investor“ has been widely framed and – apart from the usual pension funds – includes insurance companies, investment funds and companies, and credit institutions or banks that have been allowed to hold shares either in their trading or in their investment portfolio.“, *Wymeersch*, in *Hopt/Kanada/Roe/Wymeersch/Prigge*, Comparative Corporate Governance (1998) 1179.

⁵³ *Banzhaf*, Die Entsprechenserklärung der SE (2009) 23.

To be able to comprehensively understand systems of corporate governance, one must understand two other economic theories that explain how different interest groups act with regard to a company, the shareholder value model, and the stakeholder value model⁵⁴.

1. Shareholder value approach⁵⁵

Corporate governance rules are like the constitution of a company. They comprise rules for the company's behavior in relation to relevant interest groups. From a shareholder perspective, a company should primarily fulfill the owner's expectations. Its central goal is – pursuing a typical economic approach – the realization of profits. Therefore, this theory measures long-term efficiency by looking at the increase in shareholder value⁵⁶. The optimal use of the company's resources is to create more wealth and, consequently, to pay out to shareholders a risk adequate interest rate for their investment⁵⁷. This approach is typical for Anglo-American corporations⁵⁸.

2. Stakeholder value approach⁵⁹

⁵⁴ *Salacuse*, in *Norton/Rickford/Kleineman*, Corporate Governance Post-Enron (2006) 433 (450 et seq) also refers to them as the culture of individualism, only concentrating on the individual shareholder, versus the culture of communitarianism, also including rights of the affected community.

⁵⁵ *Johnston*, EC Regulation of Corporate Governance (2009) 21 et seqq; *Smerdon*, A Practical Guide to Corporate Governance (2004) para 1.013 et seqq; *Brändle*, Corporate Governance (2004) 5 et seqq; *Hopt*, Am. J. Comp. L. 2011, 1 (28).

⁵⁶ *Schewe*, Unternehmensverfassung (2005) 22.

⁵⁷ *Fichtinger/Hrebicek*, in *Hrebicek/Fichtinger*, Handbuch Corporate Governance (2003) 29.

⁵⁸ *Monks/Minow*, Corporate Governance (1995) 269; *Bieling/Steinhilber*, ZIB 2002, 39 (40).

⁵⁹ *Nobel* in *Tison/de Wulf/van der Elst/Steennot*, Company Law and Financial Regulation (2009) 165 et seqq; *Hopt*, Am. J. Comp. L. 2011, 1 (82).

In contrast⁶⁰, the stakeholder value approach, which is more common in Germany for example⁶¹, does not only take into account the shareholder interests, but also the interests of other groups connected with the company and seeks to maximize their benefits, too. Stakeholders are groups within the society that have a special interest regarding a company whose acting affects them and which they thus try to influence⁶². Examples of stakeholders are banks, employees, or suppliers. This concept sees the task of a company not only in maximizing the shareholder interest, but also the stakeholder value, while accepting that no group can enforce its interests completely and sustainably⁶³. Within a company many different stakeholder groups can run into conflict with each other, but all groups have to enforce their interests through collective negotiation. Different levels and potentials of power can lead to economically inefficient solutions⁶⁴, which create the need for control.

⁶⁰ *Hopt*, *GesRZ* 2002, 4 (4 et seq); *Hopt*, *Am. J. Comp. L.* 2001, 1 (9).

⁶¹ *Monks/Minow*, *Corporate Governance* (1995) 269; German Corporate Governance Code, 1; *Müller*, Ausführungen anlässlich der 8. Konferenz Deutscher Corporate Governance Kodex, 5; *Hommelhoff*, in *Tison/de Wulf/van der Elst/Steennot*, *Company Law and Financial Regulation* (2009) 268.

⁶² *Rauter*, *Stakeholder*, in *Straube*, *Fachwörterbuch zum Handels- und Gesellschaftsrecht* (2005) 292; § 70 I Austrian AktG.

⁶³ *Schewe*, *Unternehmensverfassung* (2005) 24.

⁶⁴ *Schewe*, *Unternehmensverfassung* (2005) 46.

IV. Forms of control

In the field of corporate governance two important forms of control are distinguished: internal and external control⁶⁵. Internal control establishes a system of checks and balances within the company based on the national companies' actions, while external control creates control over management through the influence of actors outside the company.

1. Internal control

Internal control is executed primarily by the board as the central body for management and control⁶⁶. In a two-tier system these tasks are split up. This leads to more transparency, as it is obvious that the "management board" is in charge of management and is controlled by the "control board" with regard to its economic performance, integrity, and compliance with the law⁶⁷. The control board can be internally broken up into different committees with distinct tasks, such as nomination, remuneration, and auditing. Through this division these important areas can be treated more efficiently and effectively. The two-tier board is a typical structure for Austrian and German boards because it is required by the stock companies act in each respective country⁶⁸. Internationally it is seen as a unique structure⁶⁹. In most countries, stock

⁶⁵ *Hopt*, *GesRZ* 2002, 4 (5); *Banzhaf*, *Die Entsprechenserklärung der SE* (2009) 18; *Hopt*, *Am. J. Comp. L.* 2011, 1 (8).

⁶⁶ *Hopt*, *GesRZ* 2002, 4 (5); *Brändle*, *Corporate Governance* (2004) 20; *Owen/Kirchmaier/Grant*, in *Owen/Kirchmaier/Grant*, *Corporate Governance in the US and Europe* (2006) 2, 11.

⁶⁷ *Davis*, *U.S. Corporate Governance*, *FS Raiser* (2005) 49 (50).

⁶⁸ §§ 70 et seqq, Austrian AktG, §§ 76 et seqq, German AktG.

⁶⁹ *Hopt*, *GesRZ* 2002, 4 (5 et seq).

companies have a one-tier board. Within this board the directors control themselves. This happens by distinguishing between executive and non-executive directors and creating committees – normally for approximately the same subject areas as in the control board of a two-tier system – that are often required to be filled only with non-executive or independent directors. The question of directors' independence forms an important part of the corporate governance discussion and is tackled intensively in Recommendation 2005/162/EC on the role of non-executive or supervisory directors of listed companies and on the committees of (supervisory) boards, which will be discussed later⁷⁰.

The work of auditors forms part of the internal control, too, and therefore is dealt with by Directive 2006/43/EC on statutory audits of annual accounts⁷¹. They are even seen as partners of the control board⁷².

2. External control⁷³

In contrast, external control is not regulated, but is executed by (institutional) investors, banks, and other external monitors through their decisions to invest or not. In terms of external control, good corporate governance is a question of competition of

⁷⁰ See C.I.2.b).

⁷¹ See C.I.3.c).

⁷² *Hopt*, GesRZ 2002, 4 (7).

⁷³ *Johnston*, EC Regulation of Corporate Governance (2009) 46 et seqq; *Brändle*, Corporate Governance (2004) 20 et seqq.

the corporate governance systems. The better the corporate governance, the more investors will be enticed to invest,⁷⁴ and the higher a company will be valued⁷⁵.

While in the USA external control is exerted through the capital markets, as well as through institutional investors and hostile takeovers⁷⁶, in Germany for example, hostile takeovers are rare. This is due to concentrated ownership⁷⁷ and the fact that external control is a task relegated to the big banks, which tend to have a strong influence on listed companies⁷⁸. Within the EU, a similar ownership structure and thus a similar form of external control to the USA can be found in the UK⁷⁹.

V. The idea of “Comply-or-explain”

As an artificial, legal person, every company needs a constitution⁸⁰. If every firm had to create and institute its own unique corporate governance structure, this would create unreasonably large transaction costs. Inventing a new corporate constitution for every single firm would require unnecessary work. These costs can be easily re-

⁷⁴ Hopt, *GesRZ* 2002, 4 (5); *Monks/Minow*, *Corporate Governance* (1995) 271.

⁷⁵ Hopt, *GesRZ* 2002 4 (7).

⁷⁶ *Tricker*, *Corporate Governance* (2009) 12, 47; *Owen/Kirchmaier/Grant*, in *Owen/Kirchmaier/Grant: Corporate Governance in the US and Europe* (2006) 14.

⁷⁷ *Owen/Kirchmaier/Grant*, in *Owen/Kirchmaier/Grant*, *Corporate Governance in the US and Europe* (2006) 8.

⁷⁸ Hopt, *GesRZ* 2002, 4 (5 et seqq); *Monks/Minow*, *Corporate Governance* (1995) 268 et seq; *Tricker*, *Corporate Governance* (2009) 47.

⁷⁹ *Bieling/Steinhilber*, *ZIB* 2002, 39 (56f); *Davies*, *GesRZ* 2002, 14 (15, 18); *Wymeersch*, in *Hopt/Kanada/Roe/Wymeersch/Prigge*, *Comparative Corporate Governance* (1998) 1189 et seqq.

⁸⁰ *Tricker*, *Corporate Governance* (2009) 25.

duced by providing generic, default solutions which suit the needs of most firms⁸¹. Those solutions can be provided either by law or by corporate governance codes.

As stated above, corporate governance is the internal structure of a company that takes into account the interests of all different parties involved (internal as well as external parties), and distributes responsibilities and control accordingly, with the aim of improving the performance of the corporation and enhancing investor confidence. This internal structure is only partly given by national legislation in most E.U. Member States. The legislation tries to save transaction costs, to counter market failure, and to enforce political aims. However, strict rules are sometimes not flexible enough⁸² to meet all situations. Therefore, corporate governance codes emerged to fill in gaps⁸³. This chapter will explain what a corporate governance code is, what its legal nature is, and how the comply-or-explain system, one of its typical characteristics, works.

„A corporate governance code would be defined (...) as a systematically arranged set of principles, standards, best practices and/ or recommendations, precatory in nature, that is neither legally nor contractually binding, relating to the internal governance of corporations (covering topics such as the treatment of shareholders, the organisation and practices of (supervisory) boards and corporate transparency) and issued by a collective body.“⁸⁴

A code is a set of rules, normally based on a private initiative, that creates a new regulatory framework in addition to already existing, mandatory regulations. Companies that adopt a code voluntarily subject themselves to these rules by declaring pub-

⁸¹ *Johnston*, EC Regulation of Corporate Governance (2009) 83, 85.

⁸² *Birkner/Löffler*, Corporate Governance in Österreich (2004) 33 et seq.

⁸³ *Lutter*, ZGR 2001, 224 (227); *Johnston*, EC Regulation of Corporate Governance (2009) 1 et seq; *Fleischer*, NZG 2004, 1129 (1135); *Banzhaf*, Die Entsprechenserklärung der SE (2009) 17.

⁸⁴ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) 11.

licly that they regard these rules as binding⁸⁵. Corporate governance codes reflect an ideal situation by articulating what good corporate governance should be. They are not legally binding and are often called “soft law”⁸⁶, which may be confusing since codes are not actually law. That is why a code only comes to effect if it is applied in practice. Of special importance here is the principle of comply-or-explain, which gives companies certain discretion in applying these rules⁸⁷.

“The existence of corporate governance codes may not be enough to improve the companies’ governance. The “comply or explain” principle should also work in practice. The success of the “comply or explain” principle will depend largely on the quality of the information provided in the corporate governance statement. Companies need to provide extensive, good quality information to the market for investors to take appropriate investment decisions and hence contribute to a better allocation of capital and higher economic efficiency.”⁸⁸

The implementation of corporate governance rules through codes is quite flexible: it takes into account the decision-making authority of the management⁸⁹ and is “(more or less) based on the commitment”⁹⁰ of the companies. Management that does not comply with the code does not automatically violate its obligations⁹¹. In fact, the management has to comply with the code only insofar as the code is 1) useful and

⁸⁵ *Kalss*, in *Kalss/Nowotny/Schauer*, Österreichisches Gesellschaftsrecht (2008) para 3/242.

⁸⁶ *Petersen*, Unternehmensführung (2006) 62; *Claussen/Bröcker*, DB 2002, 1199 (1199); *Semler/Wagner*, NZG 2003, 553 (554); *Kort*, AG 2008, 137 (138), who speaks of „pluralization of sources of law“, as company law is supplemented by a means of self-regulation; concerning the term „soft law“ in general. See also: *Krejci*, in *Lang/Schuch/Staringer*, Soft Law in der Praxis (2005) 53 (63 et seqq).

⁸⁷ SEC (2007) 1022, 3: „Comply or explain gives flexibility to companies. Some companies may find that a certain recommendation is ill suited to their specific characteristics and/or compliance with this standard would be excessively burdensome or difficult. These companies are not required to comply with this specific principle as long as they disclose these deviations and provide an explanation to the market.”

⁸⁸ SEC (2007) 1021, 9.

⁸⁹ *Petersen*, Unternehmensführung (2006) 70.

⁹⁰ *v. Werder*, in *Ringleb/Kremer/Lutter/v. Werder*, Deutscher Corporate Governance Kodex³ (2003) para 5.

⁹¹ *Ringleb*, in *Ringleb/Kremer/Lutter/v. Werder*, Deutscher Corporate Governance Kodex³ (2003) para 51 et seqq.

sensible for the interests of the company⁹² and 2) reflects sector and enterprise-specific requirements⁹³.

At this point, no final decision about the legal nature of corporate governance code exists. This type of regulation is still new, and therefore is a collection of rules and recommendations created “sui generis”⁹⁴. The only unquestionable characteristic of codes is that they are not legally binding⁹⁵.

However, the codes nonetheless have had a concrete impact on the practice of management and corporate governance. They are more than mere declarations of intent and are an important part of the mosaic of corporate governance⁹⁶. The effect occurs on three levels:

1. Law-describing parts of the code

Partly, corporate governance codes also cover topics that are already covered by the national company acts. What is regarded as good corporate governance within one jurisdiction can only be understood completely by reading the national company acts and the corporate governance codes together, as they refer to each other. This relationship caused some codes to add to their recommendations rules which are mandatory by law. These additions give a more complete overview (the so-called “com-

⁹² Kort, AG 2008, 137 (138).

⁹³ German Code of Corporate Governance (as of May 26, 2010) 2.

⁹⁴ Petersen, Unternehmensführung (2006) 65; Peltzer, NZG 2002, 10 (10).

⁹⁵ Petersen, Unternehmensführung (2006) 65; Claussen/Bröcker, DB 2002, 1199 (1199); Seibt, AG 2003, 465 (470); Weber-Rey/Buckel, NZG 2010, 761 (765).

⁹⁶ Arlt/Bervoets/Grechenig/Kalss, GesRZ 2002, 64 (80).

munication function” of a code⁹⁷). For example, section II of the German code of corporate governance (GCGK), explains the content of §§ 118 ff. German stock companies act (German AktG)⁹⁸. These parts of the code describe what the law is⁹⁹. One should not forget that the code does not replace the law, but only describes it (sometimes only partially) and gives an interpretation¹⁰⁰. Only the law itself is binding. The code is just an additional, often helpful, source of information¹⁰¹.

2. De-facto binding effect

A de-facto binding effect can occur when companies accept the code and declare which rules they will comply with and which rules they will deviate from (and why). A deviation from the recommendations is possible (but not for the law-describing parts, of course), but this requires an explanation of deviation according to the principle of comply-or-explain. Companies might feel forced adhere to the code to a greater extent than they would without it. They may fear that the fact that they deviated might be regarded as a problem in their corporate governance structure by potential investors¹⁰². The fact alone, that a set of rules describing what is regarded as good corporate governance exists, creates social pressure to comply with those recommendations for which the effort to justify the deviation is higher than the advantage of devi-

⁹⁷ *Brändle*, Corporate Governance (2004) 107.

⁹⁸ *Petersen*, Unternehmensführung (2006) 80.

⁹⁹ *Haberer*, Corporate Governance (2001) 127.

¹⁰⁰ Austrian Code of Corporate Governance (ACCG) Preamble, footnote 1.

¹⁰¹ *Ringleb*, in *Ringleb/Kremer/Lutter/v. Werder*, Deutscher Corporate Governance Kodex³ (2003) para 35.

¹⁰² *Ringleb*, in *Ringleb/Kremer/Lutter/v. Werder*, Deutscher Corporate Governance Kodex³ (2003) para 45; *Petersen*, Unternehmensführung (2006) 69; this assumption is supported by the Code-Report 2009 of the Berlin Center of Corporate Governance which shows that the interviewed DAX-30 companies at an average comply with 95 % of the recommendations.

ating. *Roth/Büchele* call this effect the “indirect force of the capital market and public pressure”¹⁰³, while *Gerhard Cromme*¹⁰⁴ simply says: “What can’t be explained publicly with good reasons shouldn’t be done at all.”¹⁰⁵ The corporate governance codes are therefore already enforced before any legal duty exists, entirely through the power of the market, which works in tandem with the media, analysts, and the behavior of the investors¹⁰⁶ as external control¹⁰⁷. Although these codes are not legally binding, they may be enforced through reputational mechanisms¹⁰⁸, the so-called “tacit or implicit understandings”¹⁰⁹. To be able to attract more investors, it is important for a company to maintain its reputation as well-governed¹¹⁰. The desire to maintain this reputation means that managers will apply the principles laid down in the code even when its application might not be optimal in the short run, but demonstrates the reliability of the company in the long run¹¹¹. Reputation is a strong factor supporting the self-enforcing powers of codes of conduct. But there are some voices that doubt the power of reputation. The first argument against reputation is that it only works where a good reputation exists, which might not be the case in a declining industry or when

¹⁰³ *Roth/Büchele*, in *Büchele/Mildner/Murschitz/Roth/Wörle*, Corporate Governance (2006) 11.

¹⁰⁴ Chairman of the German Corporate Governance Code Government Commission until June 30, 2008.

¹⁰⁵ *Cromme*, Ausführungen anlässlich der 7. Konferenz Deutscher Corporate Governance Kodex 4.

¹⁰⁶ *Eberhartinger*, in *Haller*, Wirtschaftsprüfung und Corporate Governance (2005) 74; *Longin* in *Hrebicek/Fichtinger*, Handbuch Corporate Governance (2003) preamble, 13; *Eberhartinger/Schenk*, in *Hrebicek/Fichtinger*, Handbuch Corporate Governance (2003) 129; *Guggenberger/Hasch/Janezic*, in *Hrebicek/Fichtinger*, Handbuch Corporate Governance (2003) 196; *Nowotny*, in *Hrebicek/Fichtinger*, Handbuch Corporate Governance (2003) 172; *Claussen/Bröcker*, DB 2002, 1199 (1204); *Brändle*, Corporate Governance (2004) 107; *Hopt*, Am. J. Comp. L. 2011, 1 (64 et seq).

¹⁰⁷ *Habersack*, NZG 2004, 1 (3).

¹⁰⁸ *Kreps*, Mikroökonomische Theorie (1994) 479 et seqq, 690 et seqq; *Johnston*, EC Regulation of Corporate Governance (2009) 85 et seqq; *Krejci*, in *Lang/Schuch/Staringer*, Soft Law (2005) 53 (60).

¹⁰⁹ *Johnston*, EC Regulation of Corporate Governance (2009) 71 et seqq.

¹¹⁰ *Tricker*, Corporate Governance (2009) 15.

¹¹¹ *Johnston*, EC Regulation of Corporate Governance (2009) 86.

firm identities are subject to dramatic alterations¹¹². Moreover, there are informational asymmetries. Capital markets cannot reliably distinguish when investments are economical for a specific firm from cases in which the management is involved in unprofitable empire-building. This makes reputation harder to observe and thus less effective¹¹³. However, the biggest players in each national economy, as well as ambitious and rising ones, depend on their reputation to attract investors. They will therefore try to comply with relevant codes, especially, as media show increasing interest in corporate activities¹¹⁴. The second argument against the utility of reputation looks at the practical implementation of codes and the transaction costs incurred by investors to monitor firms. Recent facts and figures concerning this issue will be introduced below in the section, “Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States”¹¹⁵. Code enforcement can be left to market forces, but it can also be done by stock exchanges and even be legally backed by national stock corporation acts¹¹⁶.

3. Declaration of compliance and corporate governance reports

The third pillar of effective corporate governance codes is the listing rules of stock exchanges¹¹⁷ and the stock companies act rules, which require companies to declare

¹¹² Blair, *Ownership and Control* (1995) 259.

¹¹³ Johnston, *EC Regulation of Corporate Governance* (2009) 87 et seq: Johnston writes here about reputation of companies with regard to employees and the possibility to attract the best employees, but some of the arguments and mechanisms may be as well applied on the relationship between companies and investors.

¹¹⁴ Tricker, *Corporate Governance* (2009) 45, 321 et seqq.

¹¹⁵ See C.I.4.b).

¹¹⁶ See B.V.3.; Hopt, *GesRZ* 2002, 4 (11); Davies, *GesRZ* 2002, 14 (14).

¹¹⁷ Tricker, *Corporate Governance* (2009) 41.

their compliance with the law and/or a corporate governance report. These requirements thus link the code with the company law¹¹⁸. For example, to be listed on the Vienna stock exchange, a declaration concerning the Austrian Code of Corporate Governance is necessary¹¹⁹, as well as the German Code of Corporate Governance is standard for the Deutsche Börse Group¹²⁰. In the U.S., the New York Stock Exchange requires the company to abide by specified corporate governance rules for listed companies¹²¹. In addition, the stock companies acts require supervisory and management boards¹²² to execute a declaration of compliance, e.g. in Germany (§ 161 German AktG), or create a duty to set up a corporate governance report, e.g. in Austria (§§ 222, 243b Austrian UGB, § 127 Austrian AktG), the so-called “legal-backing of self-regulation”. As the declaration of compliance and the corporate governance report are based on federal laws, they are not just de-facto binding, but quasi-legal¹²³. This was demonstrated in the decision of the German Federal Court of Justice of February 16, 2009¹²⁴. The second senate held that an incorrect declaration executed in compliance with § 161 German AktG makes the exculpatory decision of the general stockholders’ meeting regarding the management subject to appeal, since the board has violated its institutional obligations if the board members knew or had to know about the incorrectness. If a company complies actually with the code

¹¹⁸ Hommelhoff, in *Tison/de Wulf/van der Elst/Steennot*, Company Law and Financial Regulation (2009) 267.

¹¹⁹ *Wiener Börse AG*, Regelwerk Prime Market, 7.

¹²⁰ *Deutsche Börse AG*, Listing Guide Deutsche Börse AG, 6.1.1.9., though only applicable to German issuers.

¹²¹ NYSE, Final NYSE Corporate Governance Rules, available at <nyse.com/pdfs/finalcorpgovrules.pdf>.

¹²² Peltzer, NZG 2002, 593 (595).

¹²³ Werder, DB 2011, 49 (49); Kort, AG 2008, 137 (138); Johnston, EC Regulation of Corporate Governance (2009) 343.

¹²⁴ BGH 16.02.2009, II ZR 185/07.

does not matter, at least not to the law, but the declaration of compliance must be accurate¹²⁵. The declaration gives information about the past and the future. The first must be in accordance with the facts; the second must be an honest declaration of intent¹²⁶. This declaration has a durable character and the management needs to adapt it if a deviation or change of the company's practice occurs¹²⁷.

According to the Austrian AktG, the enforcement of the corporate governance report can even be enforced against board members by fines imposed against the company register, pursuant to § 258 I Austrian AktG. Moreover, the company can sue the managers for damages and fire them. Finally, issuing a wrong corporate governance report can be considered a crime under § 255 I n° 5 Austrian AktG.

¹²⁵ *Semler/Wagner*, NZG 2003, 553 (553); *Vetter*, NZG 2009, 561 (566).

¹²⁶ *Semler/Wagner*, NZG 2003, 553 (554); *Peltzer*, NZG 2009, 1336 (1336); *Banzhaf*, Die Entsprechenserklärung der SE (2009) 79 et seq; see also KG 26.5.2008, 23 U 88/07, where the court held that § 161 German stock corporation act is only violated if the defendant already when issuing the declaration regarding its future behavior had decided to act contrarily and BGH 21.09.2009, II ZR 174/08 (KG), where the court held that a declaration according to § 161 German stock corporation act needs to be adapted immediately if the a violation of the code happens after the original declaraiion.

¹²⁷ *Vetter*, NZG 2009, 561 (562); *Semler/Wagner*, NZG 2003, 553 (556); *Schanz*, Börseneinführung³ (2007) § 3 para 14.

C. Corporate Governance in the European Union

I. EU Legal and other Acts concerning Corporate Governance

1. Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward

On May 21, 2003 the Commission issued a communication with the title “Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward”¹²⁸ to the Council and the European Parliament. This communication sought to outline the approach followed by the Commission up until that point, concerning company law and corporate governance, and which one it intended to follow in the future.

a) Reasons¹²⁹

Good corporate governance is a key element for a prospering real economy¹³⁰. It fosters efficiency and competitiveness of businesses and helps to strengthen shareholder’s rights¹³¹. If approached EU-wide, it helps to fulfill the aims of the TFEU, particularly Article 49, since it can facilitate the freedom of establishment of companies

¹²⁸ COM (2003) 284 final; *Smerdon*, Corporate Governance (2004) para 22.002 et seq; *Birkner/Löffler*, Corporate Governance in Österreich (2004) 23 et seqq.

¹²⁹ COM (2003) 284 final, 6 et seq.

¹³⁰ *Hopt*, GesRZ 2002, 4 (5).

¹³¹ COM (2003) 284 final 3.

and guarantee legal certainty in intra-EU operations¹³². Therefore, the plan lists five particular reasons for an approach to develop EU company law concerning corporate governance.

(1) Deepening of the Internal European Market

First, the internal market should be deepened and an integrated European capital market should be created¹³³. This would be ideal since more and more companies operate cross-border and the internal market is affected by the development of the four fundamental freedoms, from a prohibition of discrimination to a general prohibition of restrictions¹³⁴.

(2) Creation of an Integrated European Capital Market

Second, capital markets, as important parts of the Internal Market¹³⁵ should be integrated. Both, issuers and investors have more confidence in a European market that offers equivalent corporate governance frameworks in all Member States.

¹³² COM (2003) 284 final 6.

¹³³ *Bieling/Steinhilber*, ZIB 2002, 39 (40).

¹³⁴ ECJ, Case C-55/94 (*Gebhard*), ECR 1995, I-4165: the “Gebhard-test” requires that restrictive national rules not only be applied in a non-discriminatory manner, but also they must be justified by imperative requirements in the general interest, must be suitable for securing the attainment of the objective which they pursue, and must not go beyond what is necessary in order to attain it; see also *Johnston*, EC Regulation of Corporate Governance (2009) 155; *Huber*, *Recht der Europäischen Integration*² (2002) § 17 para 47 et seqq; *Foster*, EU Law (2006) 365; *Deards/Hargreaves*, European Union Law (2004) 242.

¹³⁵ *Pache*, in *Schulze/Zuleeg*, *Europarecht*¹ (2006) § 10 para 199.

(3) Maximization of the Benefits of Modern Technologies

Third, the benefits of modern technologies should be maximized. Information and transparency are crucial elements of effective corporate governance. New information and communication technologies, especially the Internet, can help to support them, e.g. through virtual general meetings or cross-border voting rights.

(4) Coping with EU Enlargement Challenges

Fourth, the enlargement of the EU poses new challenges due to an increasingly diverse set of national regulatory frameworks. An EU-wide approach to corporate governance, although not necessarily including setting up a European corporate governance code¹³⁶ and a modernized EU Acquis, will become more and more important to creating a competitive, modern market economy across the entire EU.

(5) Addressing recent Corporate Scandals

Finally, recent scandals should be addressed in order to restore confidence in capital markets¹³⁷. In particular, the Enron case gained notoriety by giving a name to the “disease” of lost investor confidence¹³⁸. The plan was set up ten years ago, and yet still new scandals emerge, which indicates that the corporate governance discussion

¹³⁶ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) 81; *Habersack*, NZG 2004, 1 (3).

¹³⁷ COM (2003) 284 final 7.

¹³⁸ Wikipedia, available at <de.wikipedia.org/wiki/Enronitis>.

has not reached its end point yet. Often changes have been made in response to critical situations, not theoretical concepts¹³⁹.

b) Objectives¹⁴⁰

The “Plan to Move Forward” pursues two main objectives: 1) strengthening shareholders’ rights and third parties’ protection and 2) fostering the efficiency and competitiveness EU-founded businesses¹⁴¹. These aims are linked: to be competitive, companies need to have the chance to raise cheap capital, but to raise cheap capital, the management must be more strongly shareholder-value orientated¹⁴², and shareholders’ rights and the investors’ confidence in the capital markets must be strengthened¹⁴³. Capital markets must work to build investor confidence with integrity¹⁴⁴, as higher confidence generates more market volume¹⁴⁵. This is the starting point for good corporate governance that aims to reduce transaction costs and solve the principal-agent-conflict between management and shareholders.

c) Actions to take

¹³⁹ *Tricker*, Corporate Governance (2009) 8.

¹⁴⁰ COM (2003) 284 final 7 et seqq.

¹⁴¹ *Habersack*, NZG 2004, 1 (1).

¹⁴² *Bieling/Steinhilber*, ZIB 2002, 39 (52).

¹⁴³ *Hopt*, GesRZ 2002, 4 (5).

¹⁴⁴ *Mansfeld*, Kreditwesen 2009, 29 (30); *Grundsatzkommission Corporate Governance*, DB 2000, 238 (238).

¹⁴⁵ *Poppmeier-Reisinger*, Handbuch Börsegang (2002) 25.

The guiding criteria for any regulation based on this action plan are: subsidiarity, proportionality, and flexibility¹⁴⁶. The principle of subsidiarity is also laid down in Article 5 I 1, III TEU and solves the conflict between unity and diversity, inherent in a federal system¹⁴⁷. It means that the EU only takes such measures that cannot be undertaken by a single state, but can be done by the EU itself¹⁴⁸. While the principle of subsidiarity tells us when the EU can act, the principle of proportionality shows how it should act¹⁴⁹. Article 5 IV TEU says that the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties. Therefore, EU-wide applicable rules should address only those problems with cross-boarder impact and should also be flexible enough to take national idiosyncrasies into account. That is why the legal act “recommendation” according to Article 288 V TFEU is helpful in this context¹⁵⁰; it has no binding force, but leads to de facto harmonization when it is followed. So it often is used as a first step to a binding rule¹⁵¹. The desired flexibility is continued during the implementation of EU recommendations through national corporate governance codes that follow the principle of comply-or-explain, as described above¹⁵². The acceptance of this principle, as well as the already high degree of conformity of corporate governance rules in the different Member States, disposed the EU commission to choose coordination instead of setting up its own EU corporate

¹⁴⁶ COM (2003) 284 final 4.

¹⁴⁷ *Langguth* in *Lenz/Borchardt*, EU-Verträge⁵ (2009) Article 5 para 6.

¹⁴⁸ *Huber*, Europäische Integration² (2002) § 16 para 28.

¹⁴⁹ *Langguth* in *Lenz/Borchardt*, EU-Verträge⁵ (2009) Article 5 para 36; *Johnston*, EC Regulation of Corporate Governance (2009) 149 et seq, calls them the “twin principles”.

¹⁵⁰ *Habersack*, NZG 2004, 1 (2).

¹⁵¹ *Remien*, in *Schulze/Zuleeg* Europarecht¹ (2006) § 14 para 17.

¹⁵² See chapter B. IV.

governance code¹⁵³. Such code would only create a new level between international principles and national rules. Nonetheless, a certain level of uniformity is required to deepen the European integration which leads to a more efficient allocation of resources, better competitiveness, and a more flexible European economy¹⁵⁴. Not full harmonization, but only timely, specific measures are sufficient to help corporate function owners act efficiently and in line with the corporation's interests, while offering corporations a helpful framework for cross-border trade¹⁵⁵. The integration is enforced by different legal acts of the EU, so investors can rely on an EU-wide uniform level of protection and transparency. Beyond that, the EU counts on regulatory competition between the national legislatures. This makes centralized control superfluous, and creates a baseline regulatory framework only to prevent or supersede regulatory competition where it is likely to produce inefficient outcomes¹⁵⁶.

Moreover, all measures should support the European tradition of entrepreneurship¹⁵⁷, while integrating it in the international framework¹⁵⁸. The action plan names in particular the Sarbanes-Oxley-Act, which was enacted in the U.S. in 2002. The content of this internationally considered law will be described later¹⁵⁹.

¹⁵³ COM (2003) 284 final 13 et seq; *Habersack*, NZG 2004, 1 (3).

¹⁵⁴ *Bieling/Steinhilber*, ZIB 2002, 39 (49).

¹⁵⁵ *Habersack*, NZG 2004, 1 (3).

¹⁵⁶ *Johnston*, EC Regulation of Corporate Governance (2009) 165 et seqq.

¹⁵⁷ *Habersack*, NZG 2004, 1 (3).

¹⁵⁸ COM (2003) 284 final, 5; *Habersack*, NZG 2004, 1 (2); *Wohlmannstetter*, ZGR 2010, 472 (475).

¹⁵⁹ See D. I. 4.

Annex I of the action plan¹⁶⁰ gives a concrete list of measures to take, broken down by short-term, medium-term, and long-term measures¹⁶¹. The most important measures already taken will be discussed in the following chapter.

2. Recommendations

According to Art 288 V TFEU, recommendations “shall have no binding force” and are chosen as legal instrument when more flexibility is needed to adapt its proposed rules to national peculiarities¹⁶². Nevertheless, they have a political impact and should be taken into account by national courts when applying national law.¹⁶³

The EU commission issued two important recommendations, one concerning the remuneration of directors, one concerning non-executive directors and supervisory boards. Both are only applicable for listed companies¹⁶⁴ that have their registered office in the territory of a Member State¹⁶⁵. If a company has not been incorporated in one of the Member States, the recommendations are applicable for those companies that are primarily listed in the territory of a Member State¹⁶⁶. “Listed companies” means companies whose securities are admitted to trading on a regulated market, within the meaning of Directive 2004/39/EC, in one or more Member States¹⁶⁷. The

¹⁶⁰ COM (2003) 284 final 24 et seqq.

¹⁶¹ *Habersack*, NZG 2004, 1 (2).

¹⁶² *Kort*, AG 2008, 137 (142).

¹⁶³ *Streinz*, *Europarecht*⁹ (2012) 186.

¹⁶⁴ Re (COM) 2004/913/EC 1.1.; Re (COM) 2005/162/EC 1.1.

¹⁶⁵ Re (COM) 2004/913/EC 1.1.

¹⁶⁶ Re (COM) 2004/913/EC 1.2.; Re (COM) 2005/162/EC 1.4.

¹⁶⁷ Re (COM) 2004/913/EC 2.1.; Re (COM) 2005/162/EC 2.1.

concentration on listed companies leads to a stronger linkage between corporate and capital market law¹⁶⁸.

a) Recommendation 2004/913/EC – fostering an appropriate regime for the remuneration of directors of listed companies¹⁶⁹

Directors' remuneration offers a wide range of potential conflicts. On the one hand it is important for companies to offer adequate pay, especially for managers, in order to attract qualified candidates. Managers must be highly qualified, capable of handling a big workload and a high degree of responsibility. All these factors are reflected in their remuneration. Otherwise, nobody who fulfills these requirements would do the job¹⁷⁰. On the other hand, remuneration must be transparent and checkable in order to protect shareholders and foster sustainable investor confidence¹⁷¹. High remuneration is only considered fair, if it can be justified through adequate performance, which is primarily measured by the overall success of the company. Finally, one should not forget that remuneration for single managers consists of individual and private data which are worth of protection¹⁷². Therefore, the recommendation tries to give guidance as to how the Member States can balance these competing interests. It comprises three different areas of remuneration: the remuneration policy in general, the individual remuneration, and the share-based remuneration.

¹⁶⁸ *Habersack*, NZG 2004, 1 (1).

¹⁶⁹ *Johnston*, EC Regulation of Corporate Governance (2009) 352 et seq.

¹⁷⁰ *Mutter*, AG report 2009 R130 (R130).

¹⁷¹ Re (COM) 2004/913/EC, recital 3; *Haberer/Kraus*, GES 2010, 10 (11).

¹⁷² See also DIHK-Stellungnahme zum Entwurf eines Gesetzes zur Angemessenheit der Vorstandsvergütung (VorstAG), BT-Dr 16/12278, NZG 2009, 538 (540).

(1) Remuneration Policy in general

The remuneration policy in general should consist of a remuneration statement (3.1.)¹⁷³ explaining the company's policy on directors' remuneration (3.2.). It should cover variable, non-variable, and non-cash components, the linkage between remuneration and performance, performance criteria, supplementary pensions and retirement schemes (3.3). But the recommendation covers not only the contents of the remuneration, but also requires information concerning terms of contracts, duration, notice periods, and provisions for termination payments (3.4), as well as concerning mandate and composition of a remuneration committee and role of the shareholders' general annual meeting (3.5) to be disclosed. The remuneration statement should contain information about future and previous years (3.2). Combining the past and the future perspective helps to define significant changes. The commission recommends, moreover, a transparent remuneration statement for the shareholders, and their participation on the directors' remuneration through the general annual meeting. The remuneration policy should be an explicit item on the agenda (4.1) so that shareholders can influence it effectively without having to bring their own petition. Finally, the remuneration statement should be submitted to a vote which can be either mandatory or advisory or can be held only if shareholders representing at least 25% request it (4.2)¹⁷⁴.

(2) Remuneration of Individual Directors

¹⁷³ *Haberer/Kraus*, GES 2010, 10 (11); *Lutter in Tison/de Wulf/van der Elst/Steennot*, Company Law and Financial Regulation (2009) 134.

¹⁷⁴ *Haberer/Kraus*, GES 2010, 10 (11).

The information concerning the remuneration of individual directors should include remuneration and emoluments (5.3), share-incentive schemes (5.4) and supplementary pension schemes (5.5). With regard to the first category, information should be given about the total amount of salary (a), remuneration received from any undertaking belonging to the same group (b), profit sharing, bonus payments (and reasons for them) (c), additional remuneration (d), compensation in connection with the termination of his or her activities (e), and the total value of non-cash benefits (f). With regard to the second category, information is required about the number of share options and conditions of application (a), the number of share options exercised, number of shares involved and the exercise price (b), the number of share options unexercised (c,) and any changes in terms and conditions of existing share options (d). As for the third, information should be presented about changes in the director's accrued benefits if it is a defined benefit scheme (a) and about contributions paid or payable if it is a defined-contribution scheme (b).

(3) Share-based Remunerations

Section IV contains recommendations concerning the shareholders' approval of share-based remunerations¹⁷⁵. It leads to an alignment of shareholders' and directors' interests and is therefore a typical instrument to solve the principal-agent problem¹⁷⁶. But this kind of remuneration causes a special problem; it can also tempt directors to concentrate on short-term profits, as their contracts and remuneration conditions have a time limit, by taking measures that might disadvantage the company in

¹⁷⁵ Re (COM) 2004/913/EC, Section III, 5.4.

¹⁷⁶ *Homann/Wolff*, ZGR 2010, 959 (971); *Haberer/Kraus*, GES 2010, 10 (18); *Fleischer*, NZG 2004, 1129 (1131); *Kaplan*, in *Owen/Kirchmaier/Grant*, Corporate Governance in the US and Europe (2006) 38 et seq.

the long-run¹⁷⁷. Because of this inherent risk, this sort of remuneration should be approved by the shareholders' general annual meeting (6.2). In particular, the grant (a), the determination of the maximum number and main conditions of the granting process (b), the term (c), the conditions for subsequent changes (d), long-term incentive schemes (e), a deadline to award these types of compensation (6.3), substantial changes (6.4), and rights to subscribe to shares at a price lower than the market value (6.5) should be discussed by shareholders.

Moreover, section V requires that shareholders receive information prior to the general annual meeting. Specifically, shareholders should receive the full text of the share-based remuneration schemes (7.1), information about how the company intends to provide for the shares needed (7.2), and an overview of the costs (7.3).

b) Recommendation 2005/162/EC – on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board¹⁷⁸

This recommendation only covers the supervisory body of a stock company which can be a supervisory board in dual board systems or the non-executive directors within the board of a unitary board system. The main task of the supervisory body is, as its name suggests, to supervise and control the management and the executive directors¹⁷⁹, and to represent the company vis-à-vis the executive directors and managers¹⁸⁰. To be able to fulfill this controlling function, its structure, as well as its man-

¹⁷⁷ *Rasinger*, in *Hrebicek/Fichtinger*, *Handbuch Corporate Governance* (2003) 136; *Johnston*, *EC Regulation of Corporate Governance* (2009) 44 et seqq; *Brändle*, *Corporate Governance* (2004) 36.

¹⁷⁸ *Johnston*, *EC Regulation of Corporate Governance* (2009) 350 et seq.

¹⁷⁹ § 111 I German AktG; § 95 I Austrian AktG; *Grunewald Gesellschaftsrecht*⁴ (2000) 2.C.V.2.a).

¹⁸⁰ § 112 German AktG; § 97 Austrian AktG; *Grunewald Gesellschaftsrecht*⁴ (2000) 2.C.V.2.b).

ning must be designed accordingly. The effectiveness of the supervision is not only a questions of formal structures, but also of practical application¹⁸¹. The recommendation aims to avoid conflicts of interests and to secure the independence of non-executive and supervisory directors¹⁸². Only independent control can ensure that an account is given in due form and that minority shareholders are protected. And this is indispensable to restore and maintain investor confidence in the capital market, the recommendation aims to foster access to capital and support the competitiveness of companies. Therefore, the commission recommendation covers presence and role of non-executive or supervisory directors on (supervisory) boards (section II) and the profile of non-executive or supervisory directors (section III).

(1) Formation of Committees

The recommendation proposes to form **committees**¹⁸³, especially for those areas where the potential for conflicts of interests between management and company is particularly high. Therefore, a nomination, remuneration, and an audit committee should be established (5.). Establishing a committee, staffing it with independent members, and introducing a particularly objective and professional mode of operation helps to support the crucial supervisory function of control¹⁸⁴. Indeed, committees should only make preparatory recommendations. Yet with proper preparation, efficiency can be increased significantly (6.1). The recommendation leaves it up to the

¹⁸¹ *Schoenfeld*, RWZ 2008, 193 (196); *Kort*, AG 2008, 137 (142 et seq).

¹⁸² Re (COM) 2005/162/EC recitals 2 and 7.

¹⁸³ *Kort*, AG 2008, 137 (143).

¹⁸⁴ Re (COM) 2005/162/EC recitals 9, 11.

companies if they form committees or not, but if they do not, they must explain why, and how they can nevertheless achieve the objectives of the recommendation, which are the avoidance of conflicts of interest and an objective mode of operation (7.1). Moreover, a self-evaluation of the (supervisory) board¹⁸⁵ (8.) and a report on its internal organization and procedure (9.1) are required, which offers more transparency. These duties put pressure on the companies to clearly define the work of their (supervisory) boards and to explain to their (potential) investors how they implement the recommendation (which especially serves the interests of the investors).

(2) General Rules for Committees

The recommendation is completed by **annex I, which** sets up rules for committees in general and for the three recommended committees in particular. Committees should be formed with a minimum of three members (1.1). This small number makes meetings fast and efficient¹⁸⁶, but it is big enough to ensure discussions and to hinder one person from taking over the committee. Regular contact between chair and members to update information is recommended (1.2). An exact description of each mandate is required (1.3), to ensure efficient work and to avoid duplication of assignments. The committees should be provided with sufficient resources from the company (1.4). Specifically, they should be able to access to expert knowledge and to make recommendations based on that information. Meetings should be attended only by committee members, but other board members may attend if they are invited (1.5). This helps to avoid undesirable influences. After all, committees are created in order to

¹⁸⁵ *Hopt*, Am. J. Comp. L.2011, 1 (35).

¹⁸⁶ *Peltzer*, NZG 2002, 593 (596 et seq), who also recommends not to form too many committees as this could lead to a fragmentation of responsibilities.

avoid conflicts of interest which could be caused by the presence of other people. Finally, the recommendation requires committees to report its work and make public its mandates (1.6) in order to fulfill transparency requirements and offer informational access to investors.

(3) The Nomination committee

The **nomination committee** should have the following tasks (2.2): it should regularly monitor the composition of the (supervisory) board with regard to skills, knowledge, and experience, and use this information to set up a candidate profile for vacant positions. The information gained through this monitoring should be the basis for recommending any change to personnel planning, to plan succession, and to consider proposals made by relevant parties (2.3.1).

(4) The Remuneration Committee

The **remuneration committee** should establish a comprehensive concept for the remuneration policy. That entails making proposals for a remuneration system in general and for specific individuals, creating general ideas for fixed and performance-related schemes, objectives and evaluation criteria, and generating a plan for termination payments. It should also provide suitable forms of contracts. To fulfill these tasks, the remuneration committee should have access to all information about the existing remuneration system. This is necessary as the committee is charged with controlling the disclosure of the payment system (3.2.1). With regard to senior management, the committee should make general recommendations to level and struc-

ture of the remuneration (3.2.2) and concerning share-based incentives it should make proposals on the general policy (3.2.3).

(5) The Audit Committee

The **audit committee**'s tasks are as follows: it should monitor the integrity of the financial information provided by the company, review the internal control and risk management systems, and ensure the effectiveness of the internal audit system (4.2.1). Furthermore, it must monitor and ensure the external auditor's independence and objectivity. In particular, the non-audit services paid for by the company should be reviewed in order to avoid conflicts of interest (4.2.2). As to the mode of operation, the recommendation requires that new committee members should take part in an induction program and subsequent training. They should also receive full information relating to the company's specific accounting, financial, and operating features (4.3). This information is essential for effective monitoring and control.

(6) Profile of (supervisory) Board Members

Non-executive or supervisory board members should be appointed for specified terms, with the possibility of prolonging the contract or removing them from office at the end of their terms. This way supervisory board members have enough time to develop expertise and can be reconfirmed if they perform well, or removed if they do not (10.).

The **profile of (supervisory) board members**¹⁸⁷ requires three important characteristics: the proper qualifications¹⁸⁸, commitment to the organization, and independence. When assessing the qualifications of potential member of the board, one must keep in mind the qualifications of the other members. New appointees should be chosen so as to close existing gaps so that the board contains all necessary qualifications (11.1). Members of the audit committee in particular should have recent and relevant expertise in accounting (11.2). Moreover, all new members should receive orientation programs and the board should review regularly its skills and knowledge, so that they are up to date (11.3). In this regard, it is important that qualifications are branch-specific. A board position is time-consuming. To fulfill his or her duties, a non-executive or supervisory director must have enough time and therefore should not hold too many other professional commitments. A company needs to check this when appointing a new director and therefore potential candidates must disclose all commitments (12.). Finally, directors should be independent. This is the case “if he [or she] is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgment” (13.1). Conflicts can emerge from such a wide variety of circumstances such that it is not possible to list all possible conflicts.

Annex II gives some guidance in this respect¹⁸⁹, although, of course, it is not binding and responsibility of enforcement lies with the Member States¹⁹⁰. First, if a non-

¹⁸⁷ *Kort*, AG 2008, 137 (143).

¹⁸⁸ The latest Green Paper on the EU corporate governance framework (COM (2011) 164 final 5 et seq.) discusses with regard to this topic not only the professional qualification, but also diversity – professional, international and gender diversity – to improve decisions; see also: *Peltzer*, NZG 2002, 10 (12).

¹⁸⁹ *Nagel*, NZG 2007, 166 (166 et seq).

¹⁹⁰ *Jaspers*, AG 2009, 607 (610).

executive director is or has been an executive director of the same company within the last five years, that is particularly relevant. Since non-executive or supervisory directors should control the executive directors and managers, overlapping personnel is counterproductive. Dual board systems already try to avoid intimate contacts from developing by separating the managing board from the supervisory board¹⁹¹. Even then, a former executive director may be in the position of reviewing his own earlier decisions if he later becomes a non-executive director. Such a development may delay necessary strategy changes or the realization of damage claims against former members of the management board¹⁹². Therefore, the recommendation requires a cooling-off period of five years before being a former executive director may be appointed as a non-executive director. This requirement reflects the policy judgment that the negative effects of such a situation outweigh the possible advantages, such as personnel continuity or maintenance of know-how and contacts¹⁹³. Based on these recommendation guidelines, different criteria should be established in EU Member States. These criteria should focus on defining and implementing independence practically, not formally. The principal issue is that the (supervisory) board monitors the independence of its members, discloses the result of such monitoring, and explains, if conflicts occur, why such conflicts do not hinder the board's work.

c) Reports on the application

¹⁹¹ See e.g. §105 German AktG, § 90 Austrian AktG.

¹⁹² *Lange*, NZG 2004, 265 (267).

¹⁹³ *Lange*, NZG 2004, 265 (266, 268); *Jaspers*, AG 2009, 607 (607); different view: *Sünner*, AG 2010, 111 (111 et seq); *Nagel*, NZG 2007, 166 (168).

In July 2007 the European Commission issued two reports on the application of the recommendations by the Member States.

(1) Report on director's remuneration

The **first** report¹⁹⁴ on director's remuneration, states that the recommendations regarding transparency of general and individual director's remuneration have been implemented EU-wide to a certain degree, but not yet to the extent expected¹⁹⁵. In particular, member states had not yet fully implemented the recommendation to eliminate certain areas of conflict and to strengthen shareholders' ability to exert a real influence on the company's remuneration policy¹⁹⁶. More transparency should motivate the investors and shareholders to get involved in the remuneration discussion and to win back and maintain investor confidence¹⁹⁷.

(2) Report on the role of non-executive or supervisory directors

The **second report**¹⁹⁸ on the role of non-executive or supervisory directors was much more critical of the state of supervisory directors. Although it states there is an observable improvement in corporate governance standards within the European

¹⁹⁴ Commission Staff Working Document: Report on the application by Member States of the EU of the Commission Recommendation on director's remuneration, SEC (2007) 1022.

¹⁹⁵ SEC (2007) 1022, 4.

¹⁹⁶ SEC (2007) 1022, 7.

¹⁹⁷ SEC (2007) 1022, 2.

¹⁹⁸ Commission Staff Working Document: Report on the application by the Member States of the EU of the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, SEC (2007) 1021.

Union¹⁹⁹, and the “comply-or-explain” principle has become a typical feature in Europe’s approach to corporate governance^{200 201}, the report criticizes that non-executive and supervisory directors still are not as independent as expected. Definitions of independence differ within the EU, which leads to different standards²⁰². And in some countries, it is also still possible for a former CEO to become part of the supervisory board, and even its chairperson. As discussed, this is contrary to the commission recommendation which requires the strict separation of the role of chief executive director and (supervisory) board chairperson. At the very least, the recommendation requires a cooling-off period²⁰³.

d) Recommendation 2009/385/EC – completing recommendations

2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies

On February 23, 2004, the Services of the Internal Market Directorates launched a public consultation on a document “Fostering an Appropriate Regime for the Remuneration of Directors”. The results were summarized in a working document:

“A majority of respondents considered that it was preferable to deal with the issues of directors’ remuneration in codes of corporate governance rather than by introducing regulatory measures, since these would make it very difficult to make practice-oriented adjustments or take account of sector-specific factors. “Comply or explain” rules would allow capital markets and investors to sanction non-compliance

¹⁹⁹ SEC (2007) 1021, 3.

²⁰⁰ Statement of the European Corporate Governance Forum on the comply-or-explain principle, 1, available at: <ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-comply-explain_en.pdf> (last accessed: 08.04.2014).

²⁰¹ SEC (2007) 1021, 3.

²⁰² SEC (2007) 1021, 3, 7.

²⁰³ SEC (2007) 1021, 3 et seq, 6 et seq.

and/or failures in management or supervision. Pressure of this kind was likely to be just as effective in terms of discouraging excess as legal compulsion, particularly if the company's auditor was required to play a part in monitoring compliance with the guidance."²⁰⁴

Those expectations were not fulfilled. The recommendation concerning directors' remuneration was implemented in national corporate governance codes, but not to the extent expected. Since 2004, the discussion of excessive directors' remuneration has moved on and the commission felt forced to issue a recommendation complementing the recommendations 2004/913/EC and 2005/162/EC. It comprises three sections:

(1) Section I

Section I introduces two new definitions for the terms "variable components of remuneration" (2.1) and "termination payments" (2.2). The terms were already used in the first two recommendations, but not defined. However, these two kinds of payments for directors were particularly criticized and the new definitions demonstrate which points the commission saw as necessary for subsequent improvement. Variable remuneration was determined to lead directors to make decisions based on short-term payouts, instead of promoting long-term sustainability²⁰⁵. Common termination payments often seemed to be rewards for failure²⁰⁶. Therefore, they should be limited.

²⁰⁴ DG Internal Market: Synthesis of the comments on the consultation Document of the Services of the Internal Market Directorate General "Fostering an Appropriate Regime for the Remuneration of Directors", 4, available at: <ec.europa.eu/internal_market/company/docs/directors-remun/synthesis2505_en.pdf> (last accessed: 08.04.2014).

²⁰⁵ Re (COM) 2009/385/EC, recital 6; GmbH-Report 2009 R 169; see also *Kocher/Bednarz*, Der Konzern 2011, 77 concerning the German Act on the Appropriateness of Management Board Remuneration.

²⁰⁶ Re (COM) 2009/385/EC, recital 7; GmbH-Report 2009 R 170; see also: *ICGN*, Second Statement on the Global Financial Crisis, 5.1.5: "...[Shareholders] can ensure that boards develop policies that reward sustained performance, ... It is very important not to pay reward for failure."

(2) Section II

Section II covers first the structure of the policy on directors' remuneration in general. While the first recommendation only required the disclosure of the components of variable remuneration, more detailed specifications are now in place. Limits should be set (3.1) and the remuneration should be subject to predetermined and measurable performance criteria (3.2)²⁰⁷. Previously, it was recommended to disclose sufficient information concerning performance criteria. However, if such criteria do not exist, they cannot be disclosed. Moreover, where a variable component of remuneration is awarded, a major part of it should be deferred for a minimum period of time (3.3) and – if awarded on the basis of misstated data – it should be possible to reclaim that remuneration (3.4). These contractual clauses create incentives for the directors to concentrate more on long-term development of the company and to produce sustainable, instead of short-term, success²⁰⁸. Additionally, termination payments should not exceed a fixed amount and should not be paid if the termination is due to inadequate performance (3.5). This establishes a stronger link between remuneration and performance, especially in terms of the middle- and long-term sustainability of the company²⁰⁹. In comparison, the first recommendation also only required disclosure of termination payments.

²⁰⁷ *GmbH-Report Redaktion*, GmbH-Report 2009 R 170 (R170).

²⁰⁸ Re (COM) 2009/385/EC, recital 2; see also *Kocher/Bednarz*, *Der Konzern* 2011, 77 concerning the German Act on the Appropriateness of Management Board Remuneration.

²⁰⁹ Communication from the Commission accompanying Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector, COM (2009) 211 final 3.

Not only disclosure, but also requirements regarding the content are part of the rules for share-based remuneration schemes. Under these content rules, shares should not vest for at least three years after they are awarded(4.1), and directors should retain a fixed number of shares until the end of their mandate (4.3). Predetermined and measurable performance criteria are also required (4.2). The idea is that these requirement will encourage management to be to long-term orientated and to avoid unnecessary risk taking²¹⁰. Of course, all new requirements should be part of the remuneration statement (5.2), which should be clear and easily understandable (5.1) since disclosure is only effective when information is presented in a clear and understandable manner. Finally, shareholders should be motivated to assert their rights (6.), a goal already mentioned in Recommendation 2004/913/EC²¹¹. Thus, share-based remuneration schemes require approval at the annual general meeting (2004/913/EC, 6.), and companies bear comprehensive duties to inform shareholders (2004/913/EC, 7.). It is unclear how successful the new “encouraging clause” in Recommendation 2009/385/EC is in furthering the first recommendations.

(3) Section III

Section III covers the remuneration committee²¹². The remuneration committee (7.1) requires at least one member to have prior experience in the field of remuneration policy. Because the recommendation assumes that at least one member will be knowledgeable and competent in this field, the rule specifies only general requirements and gives leeway for directors to fulfill those tasks as they see best. This free-

²¹⁰ COM (2009) 211 final 2.

²¹¹ Re (COM) 2004/913/EC, recitals 5 et seqq.

²¹² *GmbH-Report Redaktion*, GmbH-Report 2009 R 170 (R 170).

dom helps the remuneration committee to function with less reliance on external consultants, which therefore allows it to act more quickly and efficiently²¹³. The committee's tasks are broadened since it not only controls the disclosure of information, but should also review the remuneration policy and its implementation (8.1). This results in a strengthening of the review functions of the committees and enables the (supervisory) board to better fulfill their control function. Moreover, the independence of the committee members, already discussed comprehensively in Annex II of Recommendation 2005/162/EC, is further emphasized (9.1). As for external consultants, Section III makes recommendations for the remuneration committee similar to those made for the audit committee. Namely, it highlights that the audit committee is in danger of losing their independence if they rely on consultants who work or have previously worked for the human resources department or executive or managing directors of the company (9.2). In addition, the individual compensation of executive and managing directors must be in proportion to the salaries of other staff members of the company (9.3). This requirement helps to avoid inappropriate remuneration if some directors, but not all are affected. Finally, the members of the remuneration committee to report to shareholders at the annual general meeting (9.4), about their work, since they are tasked with defending the shareholders' interests.

3. Directives

According to Art 288 II TFEU, a directive "shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods". This creates a binding character only with regard to the goals, but not with regard to specific forms. This is a com-

²¹³ COM (2009) 211 final 4.

promise between the desirability of uniform law within the EU and the need to preserve national independence and specific characteristics as much as possible. The disadvantage of this approach is that Member States must translate these goals into specific rules and methods. This translation often is deficient or tardy²¹⁴. However, in certain fields the flexibility this approach provides is preferable.

a) Directive 2004/109/EC – on the harmonization of transparency requirements²¹⁵

Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, was a further step taken by the EU to improve corporate governance. This directive is a minimum harmonization measure that requires listed corporations to disclose acquisitions and disposals of substantial shareholdings, and prescribes the minimum content for management reports²¹⁶. As described in recital 1 of this directive, the “disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence,” which therefore enhances market efficiency. Furthermore, recital 5 states that “greater harmonization of provisions of national law on periodic and ongoing information requirements for security issuers should lead to a high level of investor protection”.

(1) Required Information

²¹⁴ *Streinz*, *Europarecht*⁹ (2012) 165.

²¹⁵ *Fleischer/Schmolke*, *NZG* 2010, 1241 (1241); *Möllers*, *ECFR* 2007, 173 (177).

²¹⁶ *Johnston*, *EC Regulation of Corporate Governance* (2009) 304.

Therefore, the directive regulates disclosure of periodic and ongoing information about issuers whose securities are admitted to trading on a regulated market²¹⁷. It requires the disclosure of periodic reports (chapter II), such as annual financial reports (Article 4), half-yearly financial reports (Article 5), and interim management statements (Article 6). The issuer or its administrative, management, or supervisory bodies shall be responsible and liable for these disclosures (Article 7). In addition, it requires ongoing information (chapter III) about major holdings (section I) to be publicized and for holders of securities admitted to trading on a regulated market (section II). Section I contains notification requirements for the acquisition or disposal of major holdings (Article 9) or major proportions of voting rights (Article 10). Section II contains information requirements for issuers whose shares (Article 17) and whose debt securities (Article 18) are admitted to trading on a regulated market.

(2) Establishment of Competent Authority

Moreover, the directive requires the establishment of a competent authority in each Member State. This authority is responsible for 1) carrying out the obligations provided for in the directive and ensuring that the provisions adopted pursuant to this directive are applied (Article 24), 2) establishing professional secrecy and cooperation between Member States (Article 25), and 3) imposing penalties against noncompliant companies (Article 28) to make the disclosure requirements more effective.

b) Directive 2006/46/EC on annual accounts

²¹⁷ Dir 2004/109/EC, Article 1 (1).

Directive 2006/46/EC amends four other directives in order to attain the goals of the action plan: to confirm the collective responsibility²¹⁸ of the board members, to increase transparency in transactions with related parties and off-balance-sheet arrangements, and to improve disclosure about corporate governance practices²¹⁹. Its most important new rule is point 7, which introduces Article 46a to the Directive EEC/78/660 on annual accounts. This article requires companies whose securities are admitted to trading on a regulated market to include a corporate governance statement in its annual report, with the aim of providing shareholders with easily accessible information about the company's corporate governance practice²²⁰. This statement should comprise information about the corporate governance code the company is subject to, the code it applies voluntarily, and the corporate governance practices applied beyond legal requirements (paragraph 1a). Moreover, the companies should give an explanation for the parts of the code from which they deviate and why (paragraph 1b). This rule represents the first time the comply-or-explain principle was introduced into European Union Law. Furthermore, it obligates members of the administrative, management, and supervisory bodies of the company to ensure that the report they provide are in accordance with the directive and international accounting standards (Article 50b)²²¹.

c) Directive 2006/43/EC on statutory audits of annual accounts²²²

²¹⁸ *Habersack*, NZG 2004, 1 (6); *Grimm*, Ein Sarbanes-Oxley-Act für Europa, available at: <di-epresse.com/home/recht/rechtswirtschaft/304051/print.do> (last accessed: 08.04.2014).

²¹⁹ Dir 2006/46/EC, recital 1.

²²⁰ Dir 2006/46/EC, recital 10; *Johnston*, EC Regulation of Corporate Governance (2009) 306 et seq.

²²¹ *Möllers*, ECFR 2007, 173 (187 et seq).

²²² *Schön* in *Tison/de Wulf/van der Elst/Steennot*, Company Law and Financial Regulation (2009) 231; *Merkt* in *Tison/de Wulf/van der Elst/Steennot*, Company Law and Financial Regulation (2009) 244 et seq; concerning its transposition into German national law see: *Habersack*, AG 2008, 98 et seqq.

This Directive also contains an article about audit committees. Since according to Article 53 I the directive needed to be transposed into national law²²³ by 2008/06/29, the European legislation goes beyond the recommendation²²⁴. The described tasks have more or less the same content and coverage, but more companies are affected. The directive covers “public-interest entities”, which are defined as listed companies (Article 2 Nr. 13) (just as in the Recommendation 2005/162/EC), but Member States are also free to designate other companies as being of public interest, e.g. because of their size or the number of employees.

Furthermore, the Directive requires the members of the audit committee (Article 41) to have competence in accounting or auditing and to be independent²²⁵. It describes more precisely the requirements already mentioned generally for non-executive and supervisory directors in Recommendation 2005/162/EC. In addition, the statutory auditors and the auditing firm must be independent and must disclose information about their independence (Articles 22, 24 and 42).

d) Directive 2007/36/EC – on shareholders’ rights

Enhancing shareholders’ rights in listed companies and solving problems relating to cross-boarder voting are two important issues already touched by the action plan,

²²³ *Huber*, Europäische Integration² (2002) §8 para 96 et seqq.

²²⁴ *Huber*, Europäische Integration² (2002) §8 para 111 et seq.

²²⁵ *Habersack*, AG 2008, 98 (103 et seq).

“Modernising Company Law and enhancing Corporate Governance in the EU”²²⁶. Recital 1 of Directive 2007/36/EC states those aims as the basis for the directive. Effective shareholder control is a prerequisite to sound corporate governance²²⁷. This directive therefore seeks to fully enforce the existing legislation on shareholder control, since this directive regulates only the disclosure requirements which act a baseline for executing voting rights²²⁸. In particular, this directive seeks to enforce Directive 2001/34/EC on the admission of securities to official stock exchange listing and on information to be published on those securities. The requirements established by this directive are only applicable to those companies with registered offices in EU Member States and whose shares are traded on a regulated market situated or operating in a Member State²²⁹. Additional obligations can be imposed by the Member States, as the directive only sets a minimum harmonization²³⁰. Chapter II requires: 1) the equal treatment of shareholders in terms of participation and exercise of voting rights in the general meeting (Article 4), 2) the issuance of certain information prior to the general meeting on a non-discriminatory basis (Article 5), 3) the right of shareholders to put items on the general meeting agenda and table draft resolutions (Article 6), 4) the delineation of requirements for participation and voting in the general meeting (Article 7), 5) the ability to participate in the general meeting through electronic means (Article 8), 6) the right to ask questions (Article 9), 7) the right to appoint any other natural or legal person as a proxy holder to attend and vote at the general meeting (Article 10), 8) the possibility to vote by correspondence (Article 12), 9) the

²²⁶ See C.I.1.

²²⁷ Dir 2007/36/EC, recital 3; *Johnston*, EC Regulation of Corporate Governance (2009) 307 et seq.

²²⁸ Dir 2007/36/EC, recital 4.

²²⁹ Dir 2007/36/EC, Article 1 (1).

²³⁰ Dir 2007/36/EC, Article 3.

removal of certain impediments to the effective exercise of voting rights (Article 13), and 10) the disclosure of voting results (Article 14).

4. Studies

a) Comparative Study of Corporate Governance Codes relevant to the European Union and its Member States²³¹

This Study from January 2002 identified all codes relevant to the EU at the moment of its publication and compared these codes with regard to ownership structure, stakeholder and shareholder interests, supervisory and managerial bodies, and enforcement. It found that corporate governance became increasingly important among EU Member States as equity investors more frequently consider the quality of corporate governance together with financial performance. Therefore, corporate governance is important to national economies and companies²³². Although over thirty-five codes were analyzed, the study concluded that their provisions are homogeneous; differences can mainly be traced back to differences in the legal framework of the different Member States. It seems that within the EU, a common view has developed of what good corporate governance is and how it can be achieved²³³. After a short introduction, the study summarized the identified codes and analyzed the differing definitions of corporate governance, culture, ownership concentrations and law, stakeholder and shareholder interests, and the supervisory and managerial bodies.

²³¹ Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States (On Behalf of the European Commission, Internal Market Directorate General), Final Report & Annexes I-III, Brussels 2002.

²³² *Weil, Gotshal & Manges LLP*, Comparative Study (2002) 2.

²³³ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) 3.

The fourth chapter covered enforcement and compliance, while the concluding chapter discussed divergences and – more frequently – convergences.

(1) Introduction

The **introduction** stated that across the EU, an increasing interest in improving corporate governance can be observed. This is due to the fact that a firm's ability to attract investment capital, which is internationally mobile, is related to the quality of its corporate governance. The starting point was the UK, where the Cadbury Report was issued in 1992 in response to financial scandals and related failures of listed companies²³⁴. From there, the interest in corporate governance expanded across the EU. The OECD named four basic principles of corporate governance: transparency, accountability, responsibility, and fair treatment of shareholders. However, no single system exists, since each country has its own corporate culture. The scope of the study was therefore limited to identifying existing codes and comparing them in order to find commonalities and differences²³⁵.

(2) Relevant Codes

Through **identifying relevant codes**, the study discovered that most countries have only one general code, although some have more. Certain governance topics are treated in some countries by code and in other countries by law. The bodies issuing corporate governance codes may be either governmental, committees appointed by

²³⁴ See also C.II.1.a).

²³⁵ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 8 et seqq.*

the government, stock-exchange related, investor-related, business/industry/academic associations, or hybrids of the aforementioned institutions. According to the issuing body, the codes may have different focal points. Although the codes are either voluntary or aspirational (for example, some already include the comply-or-explain system), they nonetheless can have a significant influence given the economic power of the issuing body. The four main objectives are improving 1) the quality of the (supervisory) board governance, 2) the accountability of the companies to their shareholders, 3) the companies' performance, and 4) the quality of governance-related information available to the capital market²³⁶. The German Code of Corporate Governance, for example, concentrates explicitly on the last issue; it states that its aims are to make the corporate governance system transparent and understandable and to promote the trust of shareholders, stakeholders, and national and international investors²³⁷ in corporations. However, it also implicitly covers other issues. Transparency is the baseline precondition for its other aims.

(3) Comparative Analysis

In the main part, the **comparative analysis**, the study concentrated on four areas:

(aa) Definition of Corporate Governance

First, it compared the various definitions of corporate governance. While there are broader and narrower definitions, all contain the terms "control" and "supervision".

²³⁶ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) 14 et seqq.

²³⁷ German Code of Corporate Governance (as amended on May 15, 2012) 1.

These terms seem to be essential to the concept of corporate governance, along with the relationship between shareholders, (supervisory) boards, and managers²³⁸.

(bb) Culture, Ownership, and Legal Framework

Second, the analysis examined culture, ownership concentration, and legal framework in different EU Member States. It looked to how these factors influence the corresponding corporate governance codes. The study found a rich diversity in corporate governance practices, structures, and participants, and attributed this diversity to differences in culture, traditional financing options (keyword bank lending vs. stock market), corporate ownership patterns, and legal origins and frameworks. Germany and the United Kingdom mark the two extremes within the EU: while in Germany cooperation and consensus are stressed²³⁹, and employee cooperation and work councils play an important role, in the UK competition and market process are more important. The problems addressed by corporate governance codes also correspond to the ownership patterns in each country. Countries with dispersed ownership models tend to have a “collective action” problem: smaller investors are not able to read the annual report and assess the information properly, and so small investors do not attempt to influence stock price. Instead, small investors free-ride on the price-setting of professional investors who have the knowledge and resources to evaluate the information issued by the companies²⁴⁰. This leads to supervisory bodies that are often strongly influenced by management and thus cannot monitor the management

²³⁸ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 28.*

²³⁹ *Monks/Minow, Corporate Governance (1995) 293; Tricker, Corporate Governance (2009) 187; Kort, AG 2008, 137 (141).*

²⁴⁰ *Steen, Stan. J. L. Bus.&Fin. 2006, 386 (399 et seq).*

properly. In this scenario, codes focus on supervisory body structure and practices. In contrast, for countries with highly concentrated ownership models, the code focuses on ensuring fair treatment of minority shareholders²⁴¹. Nevertheless, significant similarities can be observed since there is increasing reliance on equity financing and stock portfolios in Europe. Thus, a common understanding of the role of corporate governance in a modern European corporation has emerged.

(cc) Shareholder and Stakeholder Interests

Third, the study examined how shareholder and stakeholder interests are treated in the various codes. In all countries, firms are allowed to be organized as limited liability stock corporations, as this has proven to be an efficient means to serve the interests of the whole society by coordinating capital and human resources to produce goods and services. But corporations can only serve society if they are controlled. In all EU Member States this control is effected by a shareholder body, in the form of a general annual meeting, a supervisory body, and a management body. Yet there are differences in how certain resource providers are protected, for example, in terms of minimum capital requirements and the right to vote in selecting supervisory board members. Here a certain standardization can be seen. The remaining differences are the ones most deeply grounded in national attitudes and laws, and thus are the most difficult to change (for example, these deeply-held differences include the role of employees and their participation in supervisory boards). Codes widely recognize that corporate success and shareholder profit are intertwined and codependent with em-

²⁴¹ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 29 et seqq.*

ployee security and the interests of other stakeholders²⁴². Some of them address stakeholder interests through transparency. Furthermore, there is a growing interest in social responsibility rankings and indices, which leads to investor-related groups exerting stronger pressure on companies²⁴³. As for the rights of shareholders, the major difference among the EU Member States is, as mentioned above, the selection of the supervisory body. Generally, the supervisory body is selected by the general meeting of the shareholders, but in some countries the body is selected partly by the employees. In those countries, the ability of the shareholders to select and influence the supervisory body is reduced. Laws and regulations about participation in the general annual meeting and the procedures about proxy voting and shareholder resolutions vary significantly. These differences pose a great obstacle to cross-border investments. In particular, share blocking and registration requirements, which seek to ensure that voting is legitimately limited to the current owners, can have a negative effect. In these areas there is continued need for harmonization. The OECD requires that general meeting participation be not unduly difficult²⁴⁴ or expensive, while the ICGN supports the use of electronic channels to facilitate shareholder participation. Some codes also call for transparency for voting results: all votes must be counted and counted equally. In general, disclosure requirements are highly regulated by securities laws, and efforts are made to promote better regulations, especially by referring to International Accounting Standards which leads to further convergence. The existing codes favor increased, voluntary transparency for director compensation, share ownership, and corporate governance practices. The way that laws handle the equal treatment of shareholders vary significantly. The one-share/one-

²⁴² OECD, *Principles of Corporate Governance* (2004) 21, 46 et seqq.

²⁴³ *Weil, Gotshal & Manges LLP, Comparative Study* (2002) 33 et seqq.

²⁴⁴ OECD, *Principles of Corporate Governance* (2004) 18 et seqq, 32 et seqq.

vote concept is widely accepted in all Member States²⁴⁵, but there are some exceptions: multiple or no voting rights are accepted, so long as they are disclosed. Greater voting rights to long-term holders or voting right caps are seen as more controversial, as they enable minority shareholders to exert control. The codes generally support the one-share/one-vote principle, however, with some flexibility. The ICGN warns that inequality can lead to disadvantages in competing for capital and requires, and that differences should not exist within the same share class. Any differences should be disclosed, explained, and easy to understand. Codes issued by investor-related groups take a harder line on this issue²⁴⁶.

(dd) Supervisory and Managerial Bodies

Fourth, the study took a closer look at the supervisory and managerial bodies.

(i) Unitary and two-tier Boards

The main difference among board systems is the distinction between unitary and two-tier boards. This difference notwithstanding, considerable similarities can be observed: the members are elected by the shareholders, there is a distinction between a supervisory and a managerial function, the supervisory board usually appoints the members of the managerial body, both are responsible for the appropriate working of financial reporting and control systems, as well as for legal compliance in general for the whole company. Every system has its unique benefits and disadvantages. While the unitary system provides a closer relation between the directors and thus a better

²⁴⁵ E.g. GCCG as of May 13, 2013, 2.1.2.

²⁴⁶ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 37 et seqq.*

flow of information, it also creates a risk of corruption because of the concentration of corporate power²⁴⁷. In contrast, the two-tier system offers a clearer formal separation between supervisory board and supervised management²⁴⁸. As practices converge and most codes express support for enhancing the distinction between supervision and management, the respective benefits become less important. With the call for supervisory board independence, the separation of chairman and CEO, and the increased reliance on board committees, the systems become more and more similar²⁴⁹. Many codes emphasize that supervisory responsibilities, like monitoring and managerial responsibilities, and like day-to-day business, should be distinct. These codes differ in degree of emphasis, depending on in how the different responsibilities are already expressed in laws and/or listing standards. In Germany, for example, the supervisory board is seen as a counterweight to the management board²⁵⁰.

(ii) Transparency and Disclosure

Nearly all EU Member States hold supervisory and managerial bodies accountable for the activities of the corporation. These bodies are instructed to avoid conflicts of interest and to promote the company's interest without ignoring other stakeholder concerns. Transparency and disclosure are especially important here, which are highly regulated in the European Union by securities laws. As for supervisory board

²⁴⁷ *Monks/Minow*, *Corporate Governance* (1995) 316.

²⁴⁸ *Tricker*, *Corporate Governance* (2009) 38, 186; *Salacuse* in *Norton/Rickford/Kleinman*, *Corporate Governance Post-Enron* (2006) 433 (456).

²⁴⁹ *Weil, Gotshal & Manges LLP*, *Comparative Study* (2002) 43 et seq; *Cromme*, Ausführungen anlässlich der 7. Konferenz Deutscher Corporate Governance Kodex 1; *Hopt*, *Am. J. Comp. L.* 2011, 1 (22).

²⁵⁰ *Weil, Gotshal & Manges LLP*, *Comparative Study* (2002) 45; *Eisenhardt*, *Gesellschaftsrecht*¹⁰ (2002) 305.

compositions, a slow convergence can be observed. As to individual executive and director remuneration, a hardening of norms has taken place, which can be seen, for example, in Germany with the “Act on the Appropriateness of Executive Remuneration”²⁵¹. Many codes also endorse a voluntary disclosure of corporate activities and performance. The disclosure of financial performance is usually already required by law, but in most cases this disclosure is also mentioned in the codes because they want to emphasize the company’s responsibility for the accuracy of financial information and agenda items prior to the annual general meeting. There are significant differences between codes on the disclosure of remuneration for key individuals in the company. While shareholder groups are in favor of such disclosure, many EU Member States are reluctant to require that. However, new listing rules and/or legislation to enhance greater transparency can be seen in many countries. Some codes also require the compensation policy and the treatment of stakeholder and social issues to be disclosed.

(iii) Size and Composition

Nearly all codes cover the topics of size and composition of the supervisory and managerial bodies, the qualification of its members, their nomination, and independence of these bodies. The size of supervisory and managerial bodies is mainly controlled by laws or listing rules. In Europe the typical minimum is three members, while the average size is about twelve to thirteen members. Codes tend to recommend keeping bodies small so that they can be flexible and effective. Board members need certain qualifications to be able to perform their duties. Thus, codes require, though

²⁵¹ Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG), adopted on June 18th, 2009 and entered into force on August 5th, 2009.

to different degrees, experience, personal characteristics, independence, core competencies, and availability. With regard to director nomination, the codes stress the need for a formal and transparent process of appointing new directors. A nomination committee, composed of non-executive directors, should be installed; however, the board as a whole bears the ultimate responsibility for new members. The committee is tasked with studying the company's needs, suggesting a candidate profile, and recommending specific candidates. For boards in unitary systems it is especially important to consider the perfect mix of inside and outside directors, in order to bring different opinions to the discussions about company issues.

(iv) Conflicts of Interest and Director Independence

Conflicts of interest are another important topic pertaining to the accountability of supervisory and managerial bodies. Conflicts of interest are inherent to the conduct of companies, but should be avoided as far as possible. Where that is not possible, conflicts should be minimized and disclosed; to accomplish this, companies should set up formal procedures for managing conflicts. Many codes recommend director independence as means of reducing conflicts²⁵². All codes emphasize that a supervisory board should be sufficiently distinct from management, so that they can monitor objectively, ensure accountability, and provide strategic guidance. Two-tier systems already relegate distinct functions to distinct boards, which facilitates objectivity and helps to expose management to a variety of viewpoints. Two specific types of supervisory board members should be limited: retired members of the management board and executives from other entities with close relationships to the company, such as

²⁵² *Weil, Gotshal & Manges LLP, Comparative Study (2002) 46 et seqq.*

business relations or entities with cross-shareholdings. The varying definitions of independence are an interesting point of difference. Although the concept of director independence is similar in all countries, the definitions vary considerably. Some relationships often criticized are: being a present or former executive of the company or an associated company, a family member of an executive, a controlling or dominant shareholder or executive of an entity that is a controlling or dominant shareholder, having business, family or financial relationships with a controlling or dominant shareholder, or being an important supplier. Some codes have detailed lists of relationships that harm director independence, while others are less specific or express less concern, e.g. in the UK or Germany²⁵³, or recommend each board should define independence itself. Other codes do not only require the absence of certain relationships, but stress the general ability to fulfill one's responsibilities. The role of the chair of the supervisory board is similar in unitary and two-tier systems and consists primarily in leading and organizing the work of the supervisory body. While in two-tier systems each body has its own chair, in unitary systems this position is often combined, which can lead to significant conflicts of interest. Many codes thus state that these positions should be separated²⁵⁴.

(v) Working Methods of the board(s)

Codes often discuss the working methods of the board(s): the meeting frequency, the information flow, and the established committees. Codes underscore the need for regular meetings but the actual frequency varies significantly among EU Member

²⁵³ See below C. II.

²⁵⁴ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 50 et seqq.*

States, ranging from twelve to four times per year. It is the chair's responsibility to call and moderate meetings and to set the agenda, but all members should be able to add topics of interest. One of the key topics in most codes is how quickly comprehensive information can be obtained from the managerial body, as the supervisory body must to rely on the managerial body. Management has the primary responsibility to disclose information, since they have superior access, but the supervisory board should also exercise its right to access the information needed to fulfill its tasks. With regard to working methods, there is a clear trend among EU countries towards installing board committees. Board committees help to organize the board work, especially in areas where conflicts tend to arise, like auditing, remuneration, and nomination. Generally, codes recommend these board committees to be comprised of independent, non-executive directors who can provide an objective opinion. Special attention is paid to the audit committee's functioning and composition, since that is an important means of protecting shareholder interests and promoting investor confidence²⁵⁵. Decisions about executive remuneration are generally seen as a key supervisory function, so the principles and application behind executive remuneration should be transparent. Codes recognize the need to align executive remuneration with company performance, which they do by using share-option programs or performance related incentives²⁵⁶. The same principles apply to non-executive remuneration, excluding one major difference: most codes recommend against participation in stock option and pension plans for non-executives, as these schemes may create improper incentives. Many codes also recommend an evaluation of the managerial

²⁵⁵ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 59 et seqq.*

²⁵⁶ *Bieling/Steinhilber, ZIB 2002, 39 (57).*

body by the supervisory body, linked to remuneration decisions, as well as a voluntary self-evaluation of the supervisory body²⁵⁷.

(vi) Internal Control System

Another important aspect of corporate governance is the internal control system's organization and supervision. Financial reporting, risk assessment, and control have received a lot of attention in many codes across the European Union. A special emphasis has been put on the financial reporting obligation of the company and the complementary audit function of the board, as these obligations are critical to creating and maintaining investor confidence and market integrity. Many codes also encourage annual audits by independent auditors who can ensure the accuracy of financial reports and their disclosure²⁵⁸.

(4) Enforcement and Compliance

The fourth part of the study covered **code enforcement and compliance**. Here, it acknowledged that one code can never work for all types of companies. The applicable rules should vary according to company size, organizational complexity, shareholding structure, and corporate life cycle maturity. Furthermore, continual evolution and flexibility are needed to determine the appropriate governance practices within the legal framework. Corporate governance primarily seeks to achieve fair and equitable treatment of shareholders, managerial and supervisory body accountability, and

²⁵⁷ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 63 et seqq.*

²⁵⁸ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 66 et seq.*

transparency with regard to performance, ownership structure, and corporate responsibility.

(aa) Subsidiarity

The principle of subsidiarity, common to EU legislation, seems to provide an appropriate approach to corporate governance: laws should only set minimum standards, while codes should offer flexible rules that can be applied on a voluntary basis. The soft law of the codes seeks to establish standards for improved corporate governance through entreaty, and sees itself as complementary to laws and listing rules. However, soft law does not lack force and effect. Compliance pressure²⁵⁹ can emerge through reputational forces and more comprehensive disclosure, depending on the status of the code-issuing body and the degree of information in compliance available to the market. The codes can also draw investor and company attention to corporate governance issues. They can stimulate discussion of corporate governance topics, educate the general public and the investors about corporate governance related issues, set the stage for changes in securities and company laws²⁶⁰, and can serve as a benchmark for supervisory and management bodies.

(bb) Disclosure Systems

Two systems of disclosure exist: the totally voluntary disclosure system and the comply-or-explain disclosure system. Within the voluntary system, codes call for

²⁵⁹ See above B.V.2.

²⁶⁰ *Arlt/Bervoets/Grechenig/Kalss*, GesRZ 2002, 64 (66; 68); for Germany see: *Hopt*, GesRZ 2002, 4.

more voluntary disclosure of corporate governance practices and information about the extent of compliance with a certain code. These codes seek to provide the market with more information so that investors can assess the quality of corporate governance and apply these assessments in their investment decisions. Here, the codes rely on the market to encourage compliance. They assume that companies that do not comply with code recommendations become less attractive to investors. This works in theory and shows promise for working in practice as well. As the investor community or shareholder groups create more codes and rating agencies establish benchmarks for corporate governance practices of companies, companies have stronger incentives to comply with these recommendations. In the comply-or-explain system, codes are linked to listing rules. Listed companies therefore have to disclose whether they comply or not. If not, listed companies must explain why. This encourages the voluntary adoption of certain corporate governance practices and recognizes coercive effect of disclosure: companies tend to comply so that they can avoid lengthy explanations and they also consider to what extent markets will accept deviations²⁶¹. Companies comply with code recommendations to differing degrees, depending on if codes are mandatory or not, but, in general, companies tend to comply. In the UK, for example, the country with the longest experience with codes and mandatory disclosure, the Financial Services Authority views the quality of disclosure by companies as generally high. One must remember, however, that codes express an ideal. The translation into practice may be slow²⁶².

(5) Conclusions

²⁶¹ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 68 et seqq.*

²⁶² *Weil, Gotshal & Manges LLP, Comparative Study (2002) 70 et seqq.*

The **conclusions** of the study showed that there is a generally high interest in articulating accepted standards and best practice codes in all EU Member States. It can therefore be concluded that the quality of corporate governance is important to national economies. This reflects the understanding that equity investor's decisions may be determined by good corporate governance. Although codes emanate from countries with diverse cultures, financing traditions, ownership structures, and legal origins, they are remarkably similar²⁶³.

(aa) Divergences

Distinctions emerge primarily from laws, not from code recommendations. All Member States recognize that good corporate governance is beneficial for listed companies, markets, shareholders, and stakeholders. A strong trend towards convergence can be seen, which is further supported by the codes. One of the greatest remaining divergences is employee representation on supervisory boards. In some countries that structure, however, is embedded in law. Moreover, there are substantial differences in shareholder rights, such as minority rights in take-overs or squeeze-outs, general meeting participation, and procedures for proxy voting can hinder cross-border investments. Another major difference is the difference between unitary and two-tier board system, but here practical similarities lead to convergence.

(bb) Convergences

²⁶³ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 74.*

Convergence occurs with regard to social and stakeholder issues, which are increasingly seen as important corporate governance topics across the EU. Convergence has also occurred with supervisory board independence, where a consensus has been reached that supervisory and managerial bodies should be separate. While unitary boards should be staffed by a reasonable number of independent non-executives, two-tier systems, which already have two boards, concentrate on the director independence. Within the boards, a general trend towards reliance on committees can be observed. Although disclosure rules differ, there is a trend towards more similarity. The comply-or-explain approach in particular leads to significantly more information about corporate governance practices and structures. Consequently, across the European Union generally, greater transparency is emerging²⁶⁴.

(cc) Further Trends

Further trends and expected developments include: 1) an increasing ability to contest corporate controls, as boards become less hesitant to remove managers for poor performance, and 2) an increase in corporate governance information, as more information and analysis become available. Electronic shareholder communication will become increasingly important as new means of communication make it easier for different shareholder groups to communicate, coordinate their activities, and disseminate information. General meeting participation and voting through electronic means are enhanced by electronic breakthroughs and the removal of legal barriers, e.g. by introducing the NaStraG²⁶⁵ in Germany.

²⁶⁴ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 74 et seqq.*

²⁶⁵ Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung (Law about the name share and the facilitation of voting), BGBl. I, S. 123 as of January 18, 2001.

(dd) No Euro-Code reclaimed

Finally, shareholders have a more detailed and critical view on directors' remuneration as more information is available in this area too²⁶⁶. From the private sector's perspective, the most important differences emerge from company laws and securities regulations. The variations among soft law and codes are negligible, especially if one takes into account that they may be waived for non-domestic issuers and that codes tend to be flexible and non-binding. Therefore, no Euro-Code is claimed, but a further harmonization of laws and regulations²⁶⁷. Finally, the study concludes that the codes in the European Union Member States are fairly similar and support a continuing trend towards convergence. Thus, no single code for the whole European Union is necessary²⁶⁸. The existing codes provide sufficient flexibility for corporations to adjust to changing circumstances. In contrast, a single code agreed on by all Member States would only contain basic principles and no detailed recommendations on best practices. A single code would therefore function only as the lowest common denominator. Instead, further efforts should be undertaken to harmonize company laws and security regulations²⁶⁹.

b) Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States

²⁶⁶ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 79 et seq.*

²⁶⁷ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 81.*

²⁶⁸ *Arlt/Bervoets/Grechenig/Kalss, GesRZ 2002, 64 (65).*

²⁶⁹ *Weil, Gotshal & Manges LLP, Comparative Study (2002) 81 et seqq.*

On September 23, 2009, the EU Commission released a study on monitoring and enforcement practices in corporate governance in the Member States. The study aimed to evaluate the effectiveness of the different monitoring and enforcement systems and to provide recommendations to improve these systems²⁷⁰. This study gave a comprehensive overview of the corporate governance system in force in the Member States and therefore showed the differences, especially with regard to the European comply-or-explain approach. It was divided into five chapters: chapter one was a legal analysis of how corporate governance is regulated in the Member States, chapter two gave an analysis of company practices, chapter three covered company and director perception of corporate governance codes, chapter four described the investor perception, and chapter five concluded with some recommendations.

(1) General Background

Chapter 1 described the **general background** of corporate governance in the EU. It showed that corporate governance based on a code first appeared in the UK²⁷¹ and later spilled over to the continent, resulting corporate governance codes in nearly all EU Member States²⁷². However, the entity drafting the codes differ²⁷³; it can be either government-driven, a private initiative, or a combination of both. The application also varies²⁷⁴: while in some countries the application of comply-or-explain is laid down in the local listing rules, in other countries the code itself mentions this obliga-

²⁷⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 19.

²⁷¹ See C.II.1.

²⁷² *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 22.

²⁷³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 23.

²⁷⁴ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 24.

tion, or there is a combination of public and private regulation listing rules which refer to a code and the law imposes the comply-or-explain approach. Finally, some states decided to impose a system wherein the reference to the code and the application by comply-or-explain are imposed by law. In general, codes comprise three levels of guidelines²⁷⁵: general principles, recommendations, and suggestions. The implementation often depends on the size of the company or on its listing status on the highest segment of a stock exchange. Although nearly every state has a code, codes vary significantly in terms of level of detail. Codes must always be read within the context of their legal framework. Differences also emerge through the ownership structure²⁷⁶ in the different states, as it may be dispersed or concentrated. Block-holders may be individuals, public institutions, financial or non-financial institutions. Investors may be foreign or domestic, and all owners have a differing level influence on the corporate governance system. Due to all the differences the “Comparative Study of Corporate Governance Codes relevant to the European Union and its member states”²⁷⁷ came to the conclusion that a uniform code for the EU would not be useful. It is better to harmonize the enforcement mechanism instead of altering the substance. Therefore the comply-or-explain principle, as introduced by Directive 2006/46/EC²⁷⁸, which requires companies listed on a regulated market to publish a corporate governance statement, was seen as the most effective way forward for the EU.

(aa) Relation between Law and Code

²⁷⁵ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 25.

²⁷⁶ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 26.

²⁷⁷ See C.I.4.a).

²⁷⁸ See C.I.3.b).

This leads to a complex situation: the rules applying to a company are **legislation as well as codes**. The study examined their relation²⁷⁹.

(i) Composition and Functioning of the Board

Recommendation 2005/162/EC²⁸⁰ contains six main pillars aimed at eliminating and preventing conflicts with regard to the composition and the functioning of boards of directors and supervisory boards. These pillars include: 1) an appropriate balance of executive and non-executive directors, 2) a sufficient number of independent directors, 3) the creation of board committees, 4) a regular board evaluation, 5) enhanced transparency, and 6) the clarification of standards for qualification and competence. But the board structure and the election/dismissal of the board members are also deeply anchored in national law²⁸¹. Legislation typically requires a minimum of three members on a board, though maximum board size varies. Regulations on the presence of an adequate number of non-executive directors vary, but these differences are important only in countries where dual board structures are not allowed or are unusual²⁸².

(ii) Independence of the Board Members

²⁷⁹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 31; see also figure I-4-2 on page 53.

²⁸⁰ See C.I.2.b).

²⁸¹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 32.

²⁸² *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 32 et seq.

The independence of board members is mainly dealt with in codes, not law. Although this topic appears in all codes generally, the precise definition of independence can vary. Some countries refer to the Recommendation 2005/162/EC, which defines independence as a situation in which a board member is “free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgment.”, and its Annex II that gives some criteria as guidelines²⁸³. However, other countries have their own set of exclusionary criteria. Some countries only have a general definition of independence, without precise criteria. These countries therefore leave the definition of independence to the companies²⁸⁴.

(iii) Dual and Unitary Board Structures

The main distinction with boards is if they abide by a dual board structure or a unitary board structure. A dual structure has strictly defined functions for the supervisory and the management board. A unitary structure mixes the roles of supervisory and managerial tasks²⁸⁵. Codes are often used to fill the gaps left by law. Codes turn laws into practical guidelines and therefore have a strong legal backing in the national law. Genuine code issues include self-evaluation, third-party evaluation, and reporting of the board's activity²⁸⁶. The Recommendation 2005/162/EC recommends three committees²⁸⁷: an audit, nomination, and remuneration committee. However, this recom-

²⁸³ See C.I.2.b).

²⁸⁴ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 33.

²⁸⁵ *Tricker*, Corporate Governance (2009) 38.

²⁸⁶ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 37.

²⁸⁷ See C.I.2.b).

mentation is softened in some countries, in which it is a mere suggestion, or a recommendation to form committees where necessary, where necessity is determined by the company itself²⁸⁸. The EU Directive 2006/43/EC obliges listed companies to establish an audit committee staffed entirely by non-executives and with at least one independent financial expert²⁸⁹. Member States tend to minimize regulations by law and prefer to relegate the details to the codes²⁹⁰. Remuneration committees were mentioned already in Recommendation 2005/162/EC²⁹¹, but formally introduced only by Recommendation 2009/385/EC²⁹². The establishment of remuneration and nomination committees is not required by the Member States and so this regulation is still deeply rooted in codes²⁹³.

(iv) Executive Remuneration

Executive remuneration standards were one of the main policy objectives of the Company Law Action Plan of May 2003²⁹⁴ which led to the adoption of Recommendation 2004/913/EC²⁹⁵. This recommendation contains four main provisions²⁹⁶: the disclosure of the company remuneration policy, shareholders' vote on remuneration

²⁸⁸ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 37.

²⁸⁹ *Hommelhoff* in *Tison/de Wulf/van der Elst/Steennot*, Company Law and Financial Regulation (2009) 272.

²⁹⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 38.

²⁹¹ See C.I.2.b).

²⁹² See C.I.2.d).

²⁹³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 39.

²⁹⁴ COM (2003) 284 final, see also C.I.1.

²⁹⁵ See C.I.2.a).

²⁹⁶ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 39.

policy, the disclosure of individual directors' remuneration, and prior shareholder approval of share-based remuneration schemes. A report on the application of these principles²⁹⁷ showed that practices vary significantly across the EU, but that the level of application is nonetheless relatively high²⁹⁸. Some interesting aspects about the disclosure of the remuneration can be seen²⁹⁹: nearly all Member States require the disclosure of remuneration, which can be seen as an improvement in comparison to the report, and it is mostly ruled by codes. Most Member States also require disclosure on an individual basis, however, only half of them require this by law. Share-incentive schemes differ significantly in terms of regulated content, as these are governed by law and by codes. In some countries these regulations are highly detailed, while in others only aggregate information is required. In most Member States variable remuneration should be linked to identifiable performance criteria, but only half of the states require the disclosure of such criteria. The disclosure of other types of remuneration is handled quite differently from one state to another. With regard to shareholders' participation the following aspects are noteworthy³⁰⁰: only 11 Member States require a vote either on the remuneration policy or on the remuneration report, however, most of them require a binding vote, while in three states an advisory vote is possible. In most states this requirement is part of the code; only Germany has a special "Act on the Appropriateness of Executive remuneration"³⁰¹. The approval of share-based remuneration schemes by the general meeting is implemented by law in most states. EU legislation concerning remuneration was amended by Recommen-

²⁹⁷ SEC (2007) 1022, see also C.I.2.c).

²⁹⁸ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 40.

²⁹⁹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 40 et seq.

³⁰⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 41.

³⁰¹ Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG), adopted on June 18th, 2009 and entered into force on August 5th, 2009.

directive 2009/385/EC to complement Recommendations 2009/913/EC and 2005/162/EC. It now includes requirements to limit or ban severance payments, to balance fixed and variable payments, to predetermine measurable performance criteria, to promote long-term sustainability, to allow “claw-backs” (reclamation of remuneration based on wrong data), to extend disclosure requirements, to avoid share options for non-executive directors because of the risk of conflicts of interest, to strengthen role and operation of remuneration committees, and to enhance shareholder commitment, especially of institutional investors³⁰².

(v) Internal Control and Risk Management

Internal control and risk management are dealt with mainly by codes, with two exceptions: 1) Article 41 of Directive 2006/43/EC, which regulates the duty for audit committees to monitor its effectiveness, and 2) Article 7 of Directive 2006/46/EC, which requires a description of its main features in the corporate governance statement. In contrast, in the US internal control and risk management are dealt with in law and securities regulations³⁰³. In the EU, Member States have no definitions of internal control and risk management and there exist great differences in the scope and content of regulations. The responsible body may be the supervisory or the management body or both. Primarily, only an appropriate framework and periodic assessments are required³⁰⁴. The codes recommend a structured body within the company to carry out control of internal risk management. They also describe the functions and duties as

³⁰² See also C. I.2.d) and C.II.1.d).

³⁰³ Esp. the Securities Act of 1933 and the Securities Exchange Act of 1934 as amended by the Sarbanes-Oxley Act of 2002; see D.I.2. and 3.

³⁰⁴ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 43.

complementary to the EU legislation. In the UK, the Turnbull Guidance³⁰⁵, which covers the implementation of sound systems of internal control, gives some guidance. There are also as further guidelines published by the FRC³⁰⁶. Therefore, one can say that the EU directives only provide minimum requirements, while national codes and guidelines establish the details³⁰⁷.

(vi) Statutory Auditors

In contrast to internal control and risk management, the regulation of statutory auditors has a long history of harmonization in the EU. Directive 2006/43/EC³⁰⁸ requires auditors to be appointed by the general meeting, to report to the audit committee, to confirm their independence, to disclose additional services and discuss the threat to their independence, to rotate a least every seven years, to be dismissible only for justified reasons, and to take full responsibility for the consolidated accounts of a group of companies. The transposition of these measures is quite uniform in the Member States, and is primarily carried out through law³⁰⁹.

(vii) Shareholders' Rights

³⁰⁵ *Financial Reporting Council*, Internal Control, Revised Guidance for Directors on the Combined Code, dated October 2005, available at: <frc.org.uk/getattachment/5e4d12e4-a94f-4186-9d6f-19e17aeb5351/Turnbull-guidance-October-2005.aspx> (last accessed: 09.04.2014).

³⁰⁶ <frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code/Guidance-for-boards-and-board-committees.aspx>.

³⁰⁷ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 44.

³⁰⁸ See also C.I.3.c).

³⁰⁹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 45.

Shareholders' rights are predominately regulated by national rules. However, some rights are laid out in Directive 2007/36/EC³¹⁰, such as the equal treatment of shareholders, the right to information, the right to ask questions and introduce proposals at a general meeting, and the right to different options to cast a vote³¹¹. Shareholder responsibility is even less harmonized. Therefore, the High Level Group of Company Law Experts recommended in its 2002 Report, to obligate shareholders to disclose their voting policies and records, because shareholders, particularly institutional investors, were ideally placed to act as watchdogs of good governance³¹². Consequently, the EU Commission included recommendations in its 2003 Action Plan asking institutional investors to disclose their investments and their voting rights policies, as well how these rights have been used in a particular case. The Commission hoped to enhance the participation of institutional investors. However, the topic of shareholders' responsibility has been left to national initiatives until now. Institutional investors have an inherent obligation of due care and diligence according to national law. Only a few Member States, including the UK, have implemented duties for institutional investors aimed at generating more active participation³¹³. Here, the Combined Code recommends: 1) that institutional investors ensure that their voting intentions are actually being translated into practice, 2) that investors make information concerning their votes available to their clients, and 3) that investors attend general

³¹⁰ See also C.I.3.d).

³¹¹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 47.

³¹² Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, dated November 4th, 2002, available at: <ec.europa.eu/internal_market/company/docs/modern/report_en.pdf> (last accessed 08.04.2014).

³¹³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 47 et seq; see also C.II.1.d).

meetings where appropriate and practicable³¹⁴. However, these strictly voluntary principles have not proved efficient. The “Walker Review” recommended separate principles of stewardship of communication and engagement that were adopted in July 2010³¹⁵, along with the new UK Corporate Governance Code of June 2010³¹⁶. Some institutional investor associations have also issued recommendations concerning disclosure and engagement strategies. According to the “Principles on Institutional Shareholder Responsibilities” of the International Corporate Governance Network (ICGN)³¹⁷, institutional investors should develop a voting policy based on certain criteria, disclose their voting records, and explain deviations from their usual policy³¹⁸ to their clients. The European Fund and Asset Management Association (EFAMA) recommends in its “Code for External Governance”³¹⁹ that investment management companies should have a documented policy on the exercise of their ownership responsibilities available, monitor their investee companies, establish clear guidelines on when and how they will intervene with investee companies, cooperate with other investors, exercise their voting rights, and report on it. The compliance with these

³¹⁴ *Financial Reporting Council*, The Combined Code on Corporate Governance, June 2008, Section 2, Principle E.3, available at: <<https://www.frc.org.uk/getattachment/1a875db9-b06e-4453-8f65-358809084331/The-Combined-Code-on-Corporate-Governance.aspx>> (last accessed: 09.04.2014).

³¹⁵ *Financial Reporting Council*, The UK Stewardship Code, July 2010, available at: <<https://www.frc.org.uk/Our-Work/PUBlications/Corporate-Governance/The-UK-Stewardship-Code.pdf>> (last accessed: 09.04.2014).

³¹⁶ *Financial Reporting Council*, The UK Corporate Governance Code, June 2010, available at: <<https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Corporate-Governance-Code.pdf>> (last accessed: 09.04.2014).

³¹⁷ *ICGN*, Principles on Institutional Shareholder Responsibilities, 2007, available at: <https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/inst_share_responsibilities/2007_principles_on_institutional_shareholder_responsibilities.pdf> (last accessed: 09.04.2014).

³¹⁸ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 51.

³¹⁹ *EFAMA*, Code for External Governance, date April 6th 2011, available at: <ecgi.org/codes/documents/efama_code_external_governance_6apr2011_en.pdf> (last accessed: 08.04.2014).

principles should work as a “catalyst for engagement”³²⁰ between investors and investee companies.

(bb) Updating of Corporate Governance Codes

The key advantage of codes in contrast to laws is the flexibility that these corporate governance codes offer. This also means that codes have to be reviewed regularly and amended when necessary. This review can also give an impulse to new legislation if this is regarded as more efficient³²¹. On the other hand, a code is normally bound to its own legal framework and therefore needs to be changed when the law changes. Codes are **updated** in nearly all Member States on a regular basis. While some countries, such as Austria and Germany, have formal revisions systems where the code itself requires an annual review³²², other countries have no formal revision systems, but use informal ad-hoc arrangements³²³. In some cases, these reviews have brought about further legislation to improve the enforcement of certain requirements. In Germany, for example, persistent noncompliance led to the Acts on the Disclosure and Appropriateness of Directors’ remuneration³²⁴. But even with updated codes the comply-or-explain principle is only effective if there is a high level of transparency and monitoring.

³²⁰ *EFAMA*, Code for External Governance 2.

³²¹ *Arlt/Bervoets/Grechenig/Kalss*, *GesRZ* 2002, 64 (66, 68).

³²² Austrian Code of Corporate Governance (ACGC), Preamble 11; German Code of Corporate Governance (GCGC), Preamble 2.

³²³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 57 et seq.

³²⁴ *VorstOG*, BGBl. 2005, Teil I, Nr. 47, 2267; *VorstAG*, BGBl. 2009, Teil I, Nr. 50, 2509.

(cc) Monitoring Rules and Enforcement Sanctions

The EU tries to improve transparency by requiring listed companies to issue a corporate governance statement with a certain minimum content³²⁵. Due to agency problems³²⁶, either between management and shareholders in a company with dispersed ownership, or between majority and minority shareholders in a company with concentrated ownership, managers may be reluctant to implement corporate governance standards, which they regard as burdensome. Therefore, **monitoring rules and enforcement sanctions** may be necessary. Monitoring helps to collect information needed to take better investment decisions and simultaneously provides companies with an incentive to disclose information via public exposure and reputational cost³²⁷.

(i) Market-wide Monitors

Companies can be monitored by various bodies. On the one hand, there are the market-wide monitors³²⁸. They monitor individual companies, but focus on the market as whole and aggregate information about several companies to form an overall picture. While public monitors have legally determined authority and enforcement power, bodies with public interest mission and private monitors act informally and on a voluntary basis. Their enforcement instruments are mainly reputational sanctions. The market-wide public monitors have two main approaches: they check the availa-

³²⁵ Dir 2006/46/EC, L 224/1, recital 10, n°. 7; see also C.I. 2.b).

³²⁶ See also above B.II.3.

³²⁷ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 59.

³²⁸ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 59.

bility of information, i.e. they verify whether a corporate governance statement is published without assessing its quality³²⁹, and they assess the value of the disclosed information, i.e. they check if enough information was disclosed to make an informed judgment³³⁰, based on the disclosure requirements set by law and listing rules. As official sanctions, public monitors can issue public letters or impose fines, and stock exchanges can issue a reprimand, impose a fine, or delist the company. In the UK the FSA (Financial Services Authority) only carries out an availability check, but does not judge about accuracy or adequacy. In other countries, like Germany, financial market authorities, as market wide monitors, also check the informational value and publish results. However, they do not mention individual companies. These reports help to review company practices, make information more easily accessible, exemplify good practices, and support informal enforcement techniques³³¹. Market-wide private monitors, like professional organizations, business consultancy groups, or academic institutions (which are often the origin of corporate governance activities³³²), usually have limited powers and primarily use the “name and shame” strategy³³³.

(ii) Company specific Monitors

³²⁹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 60.

³³⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 60.

³³¹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 61 et seqq; see also above B.V.2.

³³² See e.g. C.II.2.a) for Germany.

³³³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 68; see also above B.V.2.

Additionally, there are company specific monitors³³⁴, which, as the name implies monitor only one company. This group of monitors includes auditors, boards, shareholders, and other groups of stakeholders. Boards ensure strategic guidance and effective monitoring. They remain accountable to the shareholders. Directive 2006/46/EC³³⁵ contains minimum requirements for the board's involvement in monitoring the disclosure of corporate governance practices. Because of its liability towards the company, the board is encouraged to monitor the company's disclosure in order to protect against loss of reputation, investor divestment, and the possible investigation by the securities regulator. However, boards often lack sufficient independence from controlling shareholders. If minority or dispersed shareholders are too passive, control may not be effective³³⁶. As for auditors, they have deep knowledge of companies' functioning and governance practices, but national regulations on auditors were quite diverse. This area of regulations have been only partly harmonized by Directive 2006/46/EC³³⁷. Under this directive, auditors only assess the availability of information, but do not regulate enforcement instruments. Accuracy and the value of the information disclosed therefore are not assessed³³⁸. Although shareholders are the main beneficiaries of good corporate governance, and consequently have a crucial interest in monitoring management, their action alone is often insufficient. Shareholders seeking to encourage good corporate governance have three options: divesting from the company, exercising their voting rights, and pursuing legal action. Divestment is mainly applicable to minor shareholders, for whom the cost of monitoring

³³⁴ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 60.

³³⁵ See also C.I.3.b).

³³⁶ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 69.

³³⁷ See also C.I.3.b).

³³⁸ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 69 et seq.

is higher than the cost of divestment³³⁹. Shareholders are entitled to appoint or remove directors, to set board/management remuneration, and to approve important transactions. But minority shareholders' stakes are too small to have a noticeable impact and they may be tempted to free-ride³⁴⁰ on others' active monitoring. Therefore, the major burden of enforcing good corporate governance lies with institutional investors, who have the resources and incentives to monitor. Their larger shares in the corporations allow their voices to be more influential. Some countries already encourage institutional investors to take an active role by implementing reporting obligations for institutional investors' voting policy and records³⁴¹.

(iii) Legal Action

Finally, legal action is seldom used, due to various reasons. With derivative actions, i.e. actions against directors on behalf of the company, only the company can be awarded damages, not the shareholder. Securities litigations are often difficult to win, since it can be difficult to prove a causal relationship between breach of disclosure duties and damage. Moreover, in some Member States, class actions are unavailable. National courts may also be inexperienced in hearing cases that involve listed companies, which makes it difficult for individual shareholders to pursue litigation³⁴². Thus, market wide monitors try to facilitate monitoring by shareholders by using standard forms for corporate governance reporting. A single, standardized form dis-

³³⁹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 70 et seq.

³⁴⁰ *Johnston*, EC Regulation of Corporate Governance (2009) 43 et seq.

³⁴¹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 71 et seq; see also C.II.1.d).

³⁴² *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 72 et seq.

closes all required information, which thereby reduces costs and complexity by making information easy to locate, compare, and assess. But these advantages are complicated by one considerable disadvantage: companies may be tempted to follow a box-ticking approach and disclose only boilerplate information³⁴³. Since every company and every branch of trade is different, there is no way to accomplish corporate governance monitoring.

(2) Company Practice

Chapter 2 analyzed **company practices** concerning corporate governance and information policy. When the study was published, Greece was the only EU Member State that had not adopted a corporate governance code. However, the SEV Hellenic Federation of Enterprises adopted such a code for listed Greek companies in March 2011³⁴⁴. Now all EU Member States have a code and 94% of the analyzed companies refer to at least one code in their annual report. This shows that referring to a corporate governance code has become common³⁴⁵. Additionally, 86% of the companies provide comply-or-explain information and 77% indicate at least one deviation³⁴⁶.

(aa) Areas of deviation and quality of explanations

³⁴³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 73 et seq.

³⁴⁴ *SEV Hellenic Federation of Enterprises*, SEV Corporate Governance Code For Listed Companies, March 2011, available at: <sev.org.gr/online/index.aspx?lang=en> (last accessed: 08.04.2014).

³⁴⁵ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 79.

³⁴⁶ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 80 et seq.

Deviation mainly occur in the following areas: the board of directors, remuneration, shareholder rights and duties, disclosure, and auditing³⁴⁷. Concerning the quality of these explanations, the study classified them into five categories: 1) invalid (deviations without explanation), 2) general (explanations that indicate disagreement, but without giving information about the company-specific situation), 3) limited (deviations that do not explain reasons, but give other additional information), 4) specific (explanations relating to a company-specific situation), and 5) transitional (those deviations that will be abolished at a later stage). Of all explanations analyzed, 34% were found to be specific, 5% transitional, 26% limited, 19% general and 16% invalid. Remarkably, in the UK no invalid explanations for deviation were given³⁴⁸. The quality of explanations was determined by different factors: if the code is detailed and prescriptive, if companies explain on a general or on a provision-per-provision basis, and if companies already had experience with the comply-or-explain system. Additionally, the underlying ownership structure was taken into account. The least informative explanations concerned remuneration, while the most informative concerned audit issues³⁴⁹. Companies that explain on a provision-per-provision basis tended to have a higher number of deviations, while companies disclosing on a general basis tended to have more informative explanations³⁵⁰. The existence of an important shareholder, i.e. a shareholder that holds 10% or more of a company's outstanding capital or any other special right that is not attributed to ordinary shareholders, gave rise to an interesting observation: 80% of companies have at least one important shareholder that

³⁴⁷ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 82 et seq.

³⁴⁸ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 83 et seq.

³⁴⁹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 85.

³⁵⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 86.

meets this definition³⁵¹. These shareholders are granted special rights, specific approval rights, and/or preferential dividends³⁵². As indicated above, differences in national corporate governance may be due to the ownership structure³⁵³. However, countries with very concentrated ownership do not always have a high number of explanations for deviation linked to the existence of such a shareholder. For example, of all companies analyzed in Germany, 13 have an important shareholder, but no explanation for deviation was linked to this shareholder³⁵⁴. The reason for this could either be 1) that the existence of important shareholders is so common that explanations seemed unnecessary, or 2) that the existence of important shareholders already influenced the draft of the corporate governance code. The study also describes country-specific observations. Three of which deserve mention here. First, in Germany all companies disclose comply-or-explain information and all do it on a general basis. Most of their explanations are specific, based on a specific company agreement, a company practice that has proven to be valuable, or the size of the company. Most of the explanations are linked to the board of directors or director remuneration³⁵⁵. Specific explanations for deviation are the most difficult to attack, as they do not question the rule itself, but refer to a special situation that makes the rule invalid specifically for this company. Second, in Hungary all companies disclose comply-or-explain information on a provision-per-provision basis. In Hungary, companies give by far the most explanations for deviation, but these explanations are also the least informative. One of the main characteristics of these explanations is

³⁵¹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 87.

³⁵² *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 88.

³⁵³ See above C.I.4.a) (3).; *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 87; *Hopt*, *GesRZ* 2002, 4 (6).

³⁵⁴ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 87.

³⁵⁵ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 91.

repetition; many of them are incomplete or unclear³⁵⁶. Finally, all companies in the UK disclose comply-or-explain information and most do so on a general basis. The majority of these explanations are specific, based on independence materiality assessments, ownership structure, and existing contracts³⁵⁷. Comparing these three countries, one can conclude that the comply-or-explain system and the flexibility it offers only comes into its own when explanations are disclosed on a general basis. Explanations on provision-per-provision basis lead exactly to undesirable box-ticking. In the following, explanations in three fields will be more closely examined: the board of directors, the audit committee, and the remuneration.

(bb) Board of Directors

With regard to the board of directors, this study examined two specific areas: independence and elections, which covered if shareholders could vote for single board members or only for entire lists. Market specific differences can be observed concerning powers, duties, and responsibilities, which stem partly from the difference between one-tier and two-tier systems, and partly from the way board composition is organized in some countries. Especially in Germany, legal rules allow employees' rights to elect their own representatives to the board without any input from the general meeting³⁵⁸. A tendency can be observed to abandon bundled elections and even

³⁵⁶ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 92.

³⁵⁷ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 97.

³⁵⁸ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 98; Gesetz über die Mitbestimmung der Arbeitnehmer – MitBestG (Employee Participation Act), BGBl. I, 1153; Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie – MontanMitbestG (Act about the co-determination of employees in boards of mining companies and iron and steel manufacturers), BGBl. I, 2407; Gesetz über die Drittelbeteiligung der Arbeitnehmer im Aufsichtsrat – DrittelbG (Act about the one-third co-determination of employees in boards, BGBl. I, 974.

if it is no market practice in Europe, the number of unbundled elections has risen³⁵⁹. Directors' independence is needed to challenge management decisions and to protect shareholders' interests. A majority of companies taking part in this study refer to a definition of independence. However, the board of directors is the most common area of deviation, with many companies referring to the directors' independence, which is often linked to tenure³⁶⁰.

(cc) Audit Committees

EU Directive 2006/43/EC³⁶¹ made audit committees obligatory for public companies. The audit committee's members should be non-executives and at least one should be independent and have competence in auditing, i.e. be a so-called "financial expert", which means that he or she must be competent in auditing. The study examines audit committees' existence and composition, functioning, and the disclosure of audit-related and non-audit-related fees³⁶². The majority of companies analyzed has set up an audit committee or attributed that function to the board. Nearly all large-cap companies have an extra audit committee and in Germany, for example, even all mid-cap companies have set up such committees³⁶³. However, in Germany the proportion of independent committee members is relatively low (just above 50%), while the majority of EU Member States committee members have an independence rate

³⁵⁹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 99 et seq.

³⁶⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 100 et seq.

³⁶¹ See also C.I.3.b).

³⁶² *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 103 et seqq.

³⁶³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 103.

of 70% or more³⁶⁴. For the functioning of the audit committee, the study scrutinized the disclosure on committee meetings, responsibilities to the external/ internal auditor, access to outside auditors and of charters, and activity reports. Disclosure standards are much higher here for large-cap companies, except a few countries, including the UK, where all companies disclose such information. The UK tends to have a relatively high level of disclosure within the EU³⁶⁵. The amended 7th Directive on consolidated accounts of companies with limited liability³⁶⁶ requires separate disclosure of the fee charged by statutory auditors/ auditing firms for the statutory audit of the consolidated accounts, the fee charged for other assurance services, the fee charged for tax advisory services, and the fee charged for other non-audit services. Remarkably, in this field, either all companies in a Member State disclose the required information, or very few do so³⁶⁷.

(dd) Remuneration

For remuneration, the study examined four fields: variable remuneration, other remuneration disclosure, determination of remuneration, and shareholder involvement. Recommendation 2004/913/EC³⁶⁸ recommends that companies explain the relative importance of variable and non-variable components of compensation and performance criteria. Recommendation 2009/385/EC³⁶⁹ even requires caps and variable

³⁶⁴ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 104.

³⁶⁵ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 105 et seqq.

³⁶⁶ Dir 83/349/EEC.

³⁶⁷ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 108 et seq.

³⁶⁸ See also C.I.2.a).

³⁶⁹ See also C.I.2.d).

components be subject to predetermined performance criteria³⁷⁰. In nearly all EU countries, companies indicated the existence of any variable remuneration component; however, only about half of the companies disclose information on the ratio of variable and fixed components. The highest level of disclosure (again) is in the UK³⁷¹. Short-term variable remuneration is normally an annual cash bonus, while long-term variable remuneration is typically an equity grant. The three main types of variable remuneration identified are annual bonus plans, stock option plans, and performance share plans³⁷². The performance criteria concentrate on the disclosure of performance measures, the performance period, the linkage of performance measures to the performance of a peer group of companies and the composition of that peer group, the vesting schedule of the awards, and the performance target to be achieved. The availability of such information is high in the UK and in Germany. In both countries these recommendations are also in the national corporate governance code³⁷³. With regard to other remuneration disclosures, Recommendation 2004/913/EC requires the description of supplementary pensions and early retirement schemes³⁷⁴. Furthermore, the total estimated value of non-cash benefits and the policy with regard to the contract terms of executive directors, including applicable notice periods and termination payments, should be disclosed. For pensions, a significant gap exists between countries. In some countries companies give hardly any information about pensions. In other countries – such as Germany and the UK – about 80% of companies disclose information. For other benefits, such as housing or

³⁷⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 110.

³⁷¹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 111.

³⁷² *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 111 et seq.

³⁷³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 113 et seq.

³⁷⁴ See C.I.2.a).

cars, almost half of companies indicate the monetary value of these benefits, but very few give complete information about what these benefits represent. Once again, the most informative disclosures are in Germany and the UK. For executive contracts, especially, length, notice periods and severance agreements, complete information is offered by nearly all UK companies, while companies in all other countries offer information only on one or two of the above-mentioned aspects, if at all³⁷⁵. Recommendation 2004/913/EC requires the disclosure of information on the preparation and decision-making process for determining a company's remuneration policy, including the mandate and composition of a remuneration committee, names of external consultants, and the role of the shareholders' annual general meeting. The creation of a remuneration committee was already recommended in 2005³⁷⁶, but only in 2009 were detailed proposals on the role, composition, and functions of this committee made³⁷⁷. About 70% of the companies polled for the study have established remuneration committees. All companies in Finland, Ireland, Portugal, and the UK have one. In Germany about 90% have one, but in some countries, like Bulgaria, only very few companies have installed a remuneration committee and they have not even attributed the function to the whole board. As for the independence of committee members, once again the UK companies stand out. While the EU average is 62%, German companies are even below this number. Only 20% of the companies use remuneration consultants as source of advice and information. These consultants are mainly used in Ireland and the UK, which are countries where companies also disclose names and types of services provided. In Germany, in contrast, no company

³⁷⁵ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 116 et seqq.

³⁷⁶ See C.I.2.b).

³⁷⁷ See C.I.2.d).

has contracted a consultant³⁷⁸. When it comes to shareholder involvement in approving executive remuneration, one must distinguish between approval of share-based plans and approval of the remuneration policy in general, either ex-ante or ex-post. Shareholder decisions can be either binding or non-binding. Recommendation 2004/913/EC proposed that the remuneration policy should be an item on the agenda of the annual general meeting and that share-based remuneration schemes should be subject to the approval of the shareholders through a prior separate resolution. Although in most EU countries few companies featuring votes on share-based remuneration, the number that do is increasing. When it comes to votes on remuneration reports or policies, in Sweden and the UK all companies make their shareholders vote. In stark contrast, in some other countries no companies require shareholders to vote. There is great gap within the EU. However, votes on (supervisory) board remuneration are more common in most EU countries³⁷⁹.

(3) Companies' and Directors' Perception

Chapter 3 examined the **perception** of corporate governance codes by **companies and directors** in order to identify their opinions on the effectiveness and the impact of national corporate governance codes across the EU.

(aa) Effectiveness

³⁷⁸ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 120 et seq.

³⁷⁹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 122 et seqq.

The national codes appear to be rather effective in reaching basic initial objectives, such as giving a reference tool for corporate governance practices, professionalizing corporate governance, and increasing awareness of corporate governance. Other objectives have only partially been reached, such as enhancing foreign investment or creating a better position in the market. This gap in achievement may be due to the fact that the introduction of corporate governance codes is quite new in most EU countries. This argument is supported by the finding that in the UK, the first country to adopt a code, respondents gave the highest assessments of the code. The influence of governance activities was rated as neutral, with the functioning of the board rated as the most positive, transparency rated as the most significant on the introduction of board committees, and risk management rated as the lowest. The effects on management are seen as positive, especially with regard to the relationship between the board/supervisory board and executive management/the management board. Positive effects are also seen on shareholders, whose confidence has increased; however, there are still defects in the awareness of the interests of potential shareholders. Finally, companies and directors rate the influence on the position of stakeholders as neutral to positive, since the awareness of the interests of stakeholders has not increased significantly³⁸⁰.

(bb) Structure, Content, and the Comply-or-Explain approach in general

Of the respondents, 92% considered the structure of their code adequate and 84% regarded their code as clear in its recommendations.

³⁸⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 131 et seqq.

With regard to the content, most directors regard the codes as complete and think that they deal with appropriate topics. The most important items then are regarded as overall well-treated in the EU. In Germany and the UK, among others, the comprehensiveness of the code has been rated above the EU median³⁸¹. The complementary attributes of legislation and codes, of hard and soft law, respectively, are considered to be appropriately balanced in most of the EU member states (58%) or are regarded as neutral (29%). Only 13% of companies and directors rate legislation and codes as unbalanced, although they do not indicate why, or what they think is lacking. In the UK especially, the balance is seen as helpful in creating wealth and high corporate governance standards. A shift towards more legislation is regarded negatively by most UK companies. The advantages of codes are that they provide a framework (as well as flexibility), they enhance the dialogue between shareholders and boards, they go beyond law, filling gaps and giving further explanations, they can work as an interpretation reference, and finally they do not prevent the adoption of further legislation. However, on an EU-wide, as well as on a Member State level, an increase in legislation is occurring. Most respondents think that certain topics are better dealt with through legislation. Those topics are, among others, the liability of directors, corporate transparency (i.e. reporting and disclosure duties), the definition of independent directors, and the delineation of director rights and responsibilities. Some 55% of respondents think that the adoption of a corporate governance code did not prevent the adoption of further legislation in this field³⁸². The comply-or-explain approach is viewed very positively. It is said to offer sufficient flexibility and to take into account specific situations. Shareholders seem to be willing to accept explanations for deviation, if convincing. The majority of companies think that the bene-

³⁸¹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 137 et seqq.

³⁸² *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 139 et seqq.

fits exceed the costs of compliance, as codes create valuable trust. In particular, companies thought that the benefits of transparency outweigh the costs of disclosure³⁸³.

(cc) Country-specific findings

The study also made some interesting country-specific observations. In the Czech Republic, the code is not assessed favorably and according to the respondents, the code needs to be amended according to European standards, since the code is not based on the comply-or-explain approach. At the time the study was conducted, Greece did not have a code³⁸⁴ and the law was regarded as insufficiently flexible. In Hungary, the comply-or-explain principle was regarded as lacking any real impact, since the quality of explanations for deviation is too low and explanations are unhelpful in every aspect. The German code is regarded as sufficiently flexible, has attained its initial objectives successfully, and has the potential for important consequences, as it influences court judgments as an interpretation guide. The perception of the code in the UK was the most positive; the code was seen as improving governance standards without creating too many costs³⁸⁵.

(4) Investor Perception

³⁸³ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 142 et seqq.

³⁸⁴ In March 2011 the *SEV Hellenic Federation of Entreprises* adopted such a code for listed Greek companies.

³⁸⁵ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 145 et seqq.

Chapter 4 described the **investor perception** of corporate governance codes.

(aa) Investors' Assessment of Companies' Disclosure

According to investors, the quality of disclosure with regard to explanations for deviation is poor, but has improved significantly over the past three years. The poorest quality has been observed in connection with risk and remuneration. There is great support for the comply-or-explain approach, and from an investor's point of view, a combination of code and law provides sufficient coverage of all important corporate governance issues³⁸⁶.

(bb) Investors' Corporate Governance Practices

Investors were also asked about their corporate governance practices, the extent to which they exercise their rights, and the extent to which they integrate this information into their investment management decision-making. A vast majority of investors have a voting policy, disclose this information publicly, and exercise their voting rights. Of investors, 78% percent have voted at least once against management in 2008 due to inadequate explanations. Hence, the respondents seem to be active. Among the engagement activities undertaken by the investors are letters to the board, ad hoc contact via phone or e-mail, attendance at general meetings and one-to-one meetings (which are reported via summary reports), and full voting records or detailed disclosure of each vote cast against the management to even parts. Howev-

³⁸⁶ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 155 et seqq.

er, one must take into account that of the over two thousand investor organizations invited to respond to this survey, only one hundred actually did. Thus, the results are probably biased in favor of the more active investors who already take on responsibility. The majority of investors are still is not as active as would be desirable for enhancing corporate governance standards³⁸⁷, since they play an important role in modern corporate governance as they hold a significant part of shares in many markets³⁸⁸. Investors perceive their own entitlement to exercise their rights as average and think shareholders' rights need to be enhanced with regard to voting on remuneration statements and corporate governance statements. Furthermore, not only the shareholders' rights, but also their responsibilities should be encouraged³⁸⁹. Finally, the influence of a controlling shareholder is regarded negatively for implementing corporate governance codes and for the effectiveness of the comply-or-explain mechanism³⁹⁰.

(5) Conclusions and Recommendations

Chapter 5 finally comprised **conclusions** and **recommendations**.

(aa) Broad Acceptance

³⁸⁷ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 159 et seqq.

³⁸⁸ *Tricker*, Corporate Governance (2009) 42.

³⁸⁹ See also C. II. 1. d).

³⁹⁰ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 163 et seq.

In sum, the study found that the comply-or-explain approach, the EU approach to corporate governance, has broad support by all market participants. The regulators, on an EU level, as well as on Member State level, favor this approach. Companies like it as well because of its flexibility, and investors prefer it, as long as legislation and comply-or-explain based codes are appropriately balanced, although they criticize the low quality of disclosures.

(bb) Deficiencies

However, some deficiencies are present: with regard to the companies, there is a lack of implementation, and with regard to the investors, there is a lack of diligent exercise of their monitoring and enforcement responsibilities. Information is disclosed, but the quality often is low. The two markets with a low presence of important shareholders – UK and the Netherlands – issue the most informative explanations. Explanations based on general information seem to be more valuable than explanations based on provision-per-provision systems, which seem to be overly detailed and prone to box-ticking behavior. However, the first mentioned system might lead to incomplete information³⁹¹. The study mentions three pillars to strengthen the comply-or-explain system: 1) there must be a real obligation to use the comply-or-explain principle, 2) there must be a high level of transparency, and 3) there must be a way for shareholders to hold company boards accountable.

(i) Genuine Duty to Use to the Comply-or-Explain Approach

³⁹¹ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 166 et seqq.

As for the first pillar, the study states that this goal has been mostly achieved. EU Directive 2006/46/EC³⁹² introduced the comply-or-explain based corporate governance statement and this system has been implemented in the Member States. What remains is the problem of complex listing situations, i.e. cases of cross-border listing situations where companies are confronted with different requirements. The idea of adopting a pan-European corporate governance code was not successful, as one code would not fit the different legal systems and ownership structures³⁹³. Thus, the ECGF proposed new rules³⁹⁴, which have not been implemented yet³⁹⁵.

(ii) Transparency

With regard to the second pillar, the study states boards and directors cannot be expected to disclose the required information voluntarily if there is no effective monitoring and enforcement system in force. The comply-or-explain approach was initially introduced in the UK, where dispersed ownership, strong financial markets, an influential financial press, and common law and self-regulation traditions supported this approach. However, as the model spread across the EU some issues appeared: the level and quality of explanations for deviations is quite poor, the agency problem persists, only very few shareholders really actively adopt their role as monitors, large shareholders have a negative influence, and, in Member States with limited institutional ownership, there is no counter-balance to block holders. Thus, the role of market-wide monitors should be enhanced by granting them more monitoring powers to

³⁹² See C.I.3.b).

³⁹³ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) 81; see also C.I.4.a).

³⁹⁴ ECGF, Statement on Cross-border issues, available at: <ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-crossborder_en.pdf> (last accessed: 08.04.2014).

³⁹⁵ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 177 et seq.

improve the availability and quality of the information provided. Qualitative and comprehensive information can help market players to make informed decisions. Therefore, a simple availability check is not sufficient. The content should be analyzed and published on a market-wide basis, so information is easily accessible, assessment of information is facilitated for shareholders, good practices are illustrated, and companies are encouraged to adopt a similar modes of conduct. The threat of negative publicity can also be a strong incentive for companies to disclose more valuable information. Furthermore, a standard and reliable framework for corporate governance reporting should be created so that information is easier to search, process, and compare. However, this standardized form should not encourage box-ticking, in which answers are also standardized, but should serve as a guide for companies to structure their corporate governance statement. Finally, the role of statutory auditors should also be extended, as Directive 2006/46/EC³⁹⁶ only provides for a minimal harmonization. Here too, a standardized methodology for auditors to perform their check of corporate governance statements could be helpful³⁹⁷.

(iii) Accountable Boards

As for the third pillar, one has to observe the existence of shareholders' rights on the one hand and the exercise of them on the other. Compared to the U.S., shareholders in EU-domiciled companies have a lot of rights, based on national laws and recently enhanced through EU legislation, e.g. via Directive 2007/36/EC which addressed

³⁹⁶ See C. I. 3.b).

³⁹⁷ *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 178 et seqq.

shareholders' rights in listed companies³⁹⁸. However, these rights could be strengthened if corporate governance issues were explicitly placed on the agenda of the general annual meeting and discussed systematically. In Member States for example, where advisory or mandatory votes on remuneration have been introduced, the potential rejection of proposals lead to a stronger willingness to discuss critical points and even change the company policy. But providing shareholders with more rights does not help, if they are not fully aware of their responsibilities³⁹⁹. Often a free-rider problem occurs: every investor dispenses with monitoring and engagement, relying instead upon the monitoring and engagement of other investors, which in turn leads to inefficiencies in the whole system⁴⁰⁰. Thus a new framework is needed to support investors, especially institutional ones, and to require them to disclose their policy with regard to corporate governance of the companies in which they invest, their voting policy, and their communication and engagement with those companies. For this purpose, codes of best practice for institutional investors can be helpful. The UK already issued a so-called "Stewardship Code" in July 2010⁴⁰¹, also based on the comply-or-explain principle⁴⁰².

Finally, the study concluded "that the comply-or-explain regime should not be abandoned. It should be strengthened" – according to the above mentioned proposals for

³⁹⁸ See C.I.3.d).

³⁹⁹ *Tricker*, Corporate Governance (2009) 46, 378.

⁴⁰⁰ *Banzhaf*, Die Entsprechenserklärung der SE (2009) 23; *Davies A.*, Best Practice in Corporate Governance (2007) 7.

⁴⁰¹ See C. II. 1.d).

⁴⁰² *RiskMetricsGroup*, Study on Monitoring and Enforcement Practices (2009) 183 et seqq.

improvement. This approach has been pursued with the Recommendation on the Quality of Corporate Governance Reporting (“Comply or Explain”)⁴⁰³.

II. Corporate Governance in the United Kingdom and Germany

After having examined the results of two important EU studies concerning corporate governance in its Member States, we will take a closer look at the corporate governance regulations of two countries in detail: the United Kingdom and Germany.

1. UK and Germany as countries of comparison

These two countries can serve as useful representatives and countries of comparison for several reasons. The United Kingdom was a pioneer in introducing the comply-or-explain system through a corporate governance code. Because of that, it not only has a long tradition and experience with this kind of regulation, but also has served as role model for the whole European Union. The system, invented in the UK, spilled over to the continent and now forms a typical trait of the EU corporate governance system. Furthermore, it has a common law system⁴⁰⁴, like the United States. Due to that fact, one would expect both countries to take a similar approach to legal problems, and in many cases this is true. However, in the case of corporate governance systems, these countries chose different solutions to these legal problems. Therefore, these countries form a useful pair for comparison. Germany serves as a civil law counterpart,⁴⁰⁵ with a similar approach to corporate governance as the UK

⁴⁰³ Rec 2014/7208/EU.

⁴⁰⁴ Byrd, *Introduction to Anglo-American Law & Language*² (2001) 4 et seq.

⁴⁰⁵ Byrd, *Introduction to Anglo-American Law & Language*² (2001) 3 et seq.

due to the spillover effect and the great influence of the UK within the European Union. Finally, Germany and the United Kingdom both are very influential countries within the EU, politically as well as economically, which makes them good comparison models for the purpose of this thesis. They have the most and respectively third-most number of inhabitants and accordingly, in 2013, they had the largest and respectively third-largest gross domestic product⁴⁰⁶.

2. UK

The United Kingdom will be analyzed first, as it was the first country to produce a corporate governance code. It therefore has the most developed corporate governance culture, the most comprehensive experience, and the greatest influence on the development of other countries in this field. The UK has gained a reputation as global leader in corporate governance reforms⁴⁰⁷.

a) The birth of the comply-or-explain approach

In 1992 the Cadbury Committee, named after its chair, Sir Adrian Cadbury, was convened by the Financial Reporting Council, the London Stock Exchange, and the accounting profession. It was tasked with tackling the scandals that hit the City in the late 1980s. Ultimately, it issued its report on the Financial Aspects of Corporate Governance. According to the committee, corporate governance was not a question of legislation. Therefore, it opted to produce a best practices code, which dealt with

⁴⁰⁶ Eurostat, <<http://de.statista.com/statistik/daten/studie/188776/umfrage/bruttoinlandsprodukt-bip-in-den-eu-laendern/>> (last accessed: 06.09.2014).

⁴⁰⁷ *Tricker*, Corporate Governance (2009) 146 et seqq; *Weil, Gotshal & Manges LLP*, Comparative Study (2002), Annex IV, 219; *Bieling/Steinhilber*, ZIB 2002, 39 (48).

board and committee structures, remuneration, financial reporting, and auditing. Furthermore, it emphasized the importance of independent non-executive directors⁴⁰⁸, an idea that was later also adopted by the EU recommendation 2005/162/EC⁴⁰⁹. The London Stock Exchange then changed its listing rules and required listed companies to state in their annual report if they complied with the code and, if they did not, to explain why they did not comply⁴¹⁰. This was the birth of the comply-or-explain principle in corporate governance. It is based on the principle of self-regulation, in which the regulator ensures that accurate information is available to investors and sanctions are imposed by the market⁴¹¹.

b) From the Greenbury Committee to the UK Corporate Governance Code 2010

The Cadbury Committee was followed by the Greenbury Committee⁴¹² on directors' remuneration in 1995, which especially recommended the use of a remuneration committee⁴¹³ and whose code was also included in the London Stock Exchange listing rules based on the comply-or-explain principle. As both committees recommended a comprehensive Committee on Corporate Governance, the Hampel Committee was convened in 1995 and issued its report in 1998⁴¹⁴. The first two codes were positive influences, but regarded as insufficient. A particular criticism was that compliance with the codes by some companies was conducted by mere box-ticking. On

⁴⁰⁸ *Tricker*, Corporate Governance (2009) 13.

⁴⁰⁹ See above C.I.2.b).

⁴¹⁰ *Smerdon*, Corporate Governance (2004) para 1.002.

⁴¹¹ *Tricker*, Corporate Governance (2009) 185.

⁴¹² *Schneider*, DB 2000, 2413 (2415 et seq).

⁴¹³ *Tricker*, Corporate Governance (2009) 14.

⁴¹⁴ *Smerdon*, Corporate Governance (2004) para 1.003.

the other hand, the institutional investors acted too passively. They did not make use of the influence they had or could have on the governance of the companies they invested in. Therefore, the Hampel report combined general principles and more detailed provisions. The companies now had to apply the principles and explain how they applied them. In addition, they had to explain if they complied with the provisions and if not, then why. The combination of principles and provisions gave the new code its name: “The Combined Code”⁴¹⁵. Thus the comply-or-explain system was maintained and extended. In 1998, plans to reform the company law led to the establishment of a steering group to oversee the project. This Company Law Review steering group issued a final report in July 2001 that included, among others, the following recommendations: simplifying the rules related to small companies, stressing the directors’ duty to take into account long-term consequences of their decisions, clarifying rules related to directors’ conflicts of interest, improving directors’ qualifications, improving company reporting, and requiring greater transparency of institutional investors’ exercise of their powers. The latter topic was also treated by the Myners Report, a report issued by a commission that was chaired by Paul Myners, which investigated institutional investing practices⁴¹⁶. These developments finally led to the adoption of the UK Stewardship Code⁴¹⁷.

c) The UK Corporate Governance Code⁴¹⁸

⁴¹⁵ *Smerdon*, Corporate Governance (2004) para 1.004; *Davies*, GesRZ 2002, 14.

⁴¹⁶ *Weil, Gotshal & Manges LLP*, Comparative Study (2002), Annex IV, 220.

⁴¹⁷ See C.II.1.d).

⁴¹⁸ *Financial Reporting Council*, The UK Corporate Governance Code, June 2010, available at: <<https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Corporate-Governance/The-UK-Corporate-Governance-Code.pdf>> (last accessed: 09.04.2014).

“The UK Corporate Governance Code” of September 2012 is the latest version of the Combined Code.

(1) Introduction

It begins with an **introduction** to governance and the code. Firstly, it contains a definition of corporate governance, taken from the Cadbury report, accompanied by the explanation that corporate governance has to be understood as a general organisational principle and must be distinguished from the day-to-day operational management. Secondly, it aims to facilitate effective entrepreneurial management and to strengthen key components of effective board practice, which are based on underlying principles of good governance, such as transparency and sustainable success. Thirdly, it recognizes that the permanently changing economy requires a regular evaluation process of the code itself, so that it is able to adapt to the changing economic environment⁴¹⁹.

Then the **preface** explains the general ideas behind the code: the code can be a guide only in general terms and requires that one take into account specific economic situations. The spirit and letter of the code should be followed, but following the code does not replace the requirement for boards to think deeply and thoroughly about their overall tasks. However, the code can help boards discharge their duties in the best interest of the company⁴²⁰. Finally, it stresses the impact of shareholders, which

⁴¹⁹ *Financial Reporting Council*, The UK Corporate Governance Code 1.

⁴²⁰ *Financial Reporting Council*, The UK Corporate Governance Code 2 et seq.

should be enhanced, especially by the new Stewardship Code⁴²¹. Subsequently, the comply-or-explain principle itself is set out: its flexibility, which is the foundation of the code, is supported by companies as well as by shareholders. Therefore, it is not challenged. The code functions through the interplay of general principles and more detailed provisions. Every alternative to following a provision may be justified, as long as the company explains its reasons clearly and follows the general principle. Here, companies' individual circumstances, size and complexity, the nature of differing risks, and challenges have to be taken into account. The codes appeals to shareholders not to treat departures from the code as breaches automatically, but to be prepared to discuss critical points with the companies. Especially for smaller listed companies, some provisions may be disproportionate or less relevant, but these companies should be encouraged to apply the code as well, even if they need to deviate occasionally. Finally, the impact of investors is stressed and the code explains that it is based on the responsibility of both boards and investors, and their mutual engagement⁴²².

The **main principles** are then explained in relation to five crucial areas of corporate governance: leadership (Section A), effectiveness (Section B), accountability (Section C), remuneration (Section D), and relations with shareholders (Section E). Each of these areas corresponds to one section in the code. Each subsection is comprised of one main principle, supporting principles (occasionally), and the code provisions itself, which can be interpreted according to the aims set out in the principles. This system helps to make the code easy to understand; by starting from the basic princi-

⁴²¹ See C.II.1.c).

⁴²² *Financial Reporting Council*, The UK Corporate Governance Code 4 et seq.

ple, the code makes it easier to understand deviations when the principle itself is obtained in another way.

(2) Section A

Section A encourages every company to be headed by a collectively responsible board that divides its responsibilities clearly. Therefore, this section covers the role of the board, the division of responsibilities, the chairman, and the non-executive directors. Here the code recommends that boards meet regularly (A.1.1) and divide responsibilities clearly between Chairman and CEO (A.2.1), so that each can act efficiently (A.1). The chairman should also be independent according to the criteria described in Section B and should not be a former CEO⁴²³ (A.3.1). One independent non-executive director should be appointed senior independent director and act as an intermediary for the other directors (A.4.1).

(3) Section B

Section B seeks to aggregate the appropriate balance of skills in the board. In support of this goal, it recommends a transparent appointment procedure, sufficient time, induction and information for the board members, and an evaluation of committee members. It covers the composition of the board, appointments to the board, commitment, development, information and support, evaluation and re-election. Every board needs a balance between executive and non-executive (especially independ-

⁴²³ *Davies, GesRZ 2002, 14 (16).*

ent) directors. Independence criteria can be found in code provision B.1.1, which adopts many of the criteria proposed in EU Recommendation 2005/162⁴²⁴. To reach a desirable combination of skills and experiences within the board, the nomination committee (B.2.1) should evaluate the existing skills of board members and prepare a description of skills needed (B.2.2). This will aid in the transparency in the appointment procedure. To be sure that all members will be able to dedicate sufficient time to the company, the description should also include the expected time commitment (B.3.1). Furthermore, the code values the development of directors: new directors should receive a comprehensive introduction and during their career on the board they should be trained according to their needs and the needs of the company (B.4.1). In addition, directors should receive all necessary information and should especially have access to independent professional advice⁴²⁵ (B.5.1). The board should also evaluate its own performance and that of its committees and individual directors. The code requires the board to describe in the annual report how the performance evaluation has been conducted (B.6.1). To support the requirement of satisfactory performance, directors should be subject to re-election at regular intervals and shareholders should receive comprehensive information, so that they can make an informed decision (B.7.1).

(4) Section C

Section C supports the principle of enhanced disclosure. It requires every board to determine its position, the risks it is willing to take, and the risk management and internal control system it wants to set up. It is therefore composed of financial and

⁴²⁴ See also C.1.2.b).

⁴²⁵ *Davies, GesRZ 2002, 14 (16).*

business reporting, risk management and internal control, and audit committees and auditors. The directors, as well as the auditor, should explain their responsibility concerning the annual report (C.1.1). In addition, the directors should explain their strategy for delivering long-term value (C.1.2). The risk management and internal control system should be reviewed at least annually by the board (C.2.1). An audit committee, consisting of independent, non-executive directors with relevant financial experience, should be installed (C.3.1), and its main responsibilities should be written down (C.3.2) and made available to the public (C.3.3). The code names six minimum tasks that should be performed by the audit committee: 1) monitoring the integrity of the financial statements, 2) reviewing the company's internal financial controls, 3) monitoring and reviewing the effectiveness of the company's internal audit function, 4) making recommendations to the board concerning the appointment and remuneration of the external auditor, 5) reviewing and monitoring the independence of the external auditor, and 6) implementing a policy on the engagement of the external auditor concerning non-audit services. The audit committee's responsibility lies primarily with appointing and removing the external auditor (C.3.6), whose independence should be safeguarded (C.3.7).

(5) Section D

Section D states that the remuneration should be high enough to attract, retain, and motivate directors, but excessive payments should be avoided. It deals with the level and components of remuneration and the procedure of payment. First, it refers to Schedule A of the code (D.1.1), which contains proposals concerning the design of performance-related remuneration for executive directors. The remuneration commit-

tee should be established (D.2.1) and should set up performance conditions like annual bonuses, upper limits to compensation, and significant holding periods for shares. These conditions will promote long-term success for the company. New long-term incentive schemes should replace old ones or form part of a well thought out overall plan. Any incentive scheme should be approved by shareholders. Grants should be phased and subject to challenging performance criteria that reflect the company's objectives. In cases of misstatement or misconduct, variable components should be reclaimed. Only the basic salary should be pensionable. Levels of remuneration should reflect the time commitment and responsibilities. Non-executive directors should not receive performance-related payment. But, if they do, it should be approved by shareholders in advance and should be held at least one year after the director leaves the company (D.1.3). The costs of potential early termination should be considered in order to carefully avoid rewarding poor performance (D.1.4). Longer notice or contract periods should be avoided (D.1.5). The remuneration committee should make an explanation of its role and the authority delegated available to shareholders (D.2.1). It should have the responsibility for setting remuneration for executive directors and the chairman. It should also be responsible for recommending and monitoring the level and structure of remuneration for senior management (D.2.2). The board itself or the shareholders should determine the remuneration of the non-executive directors (D.2.3). Shareholders should approve all new long-term incentive schemes and significant changes to existing schemes (D.2.4).

(6) Section E

Section E requires a dialogue⁴²⁶ with the shareholders and seeks to ensure that the annual general meeting is used as communication tool where active participation is encouraged. It has two main chapters: the dialogue with the shareholders and the constructive use of the AGM. Shareholder views should be communicated to the board, strategy and governance should be discussed with major shareholders, and scheduled meetings with shareholders should be attended by non-executive directors (E.1.1). The steps taken to have a dialogue with the shareholders should be published in the annual report (E.1.2)⁴²⁷. A separate resolution should be proposed for each substantially separate issue (E.2.1). The chairmen of the audit, remuneration, and nomination committees should answer questions at the AGM and all directors should be present (E.2.3).

d) The UK Stewardship Code⁴²⁸

In July 2010 the Financial Reporting Council issued “The UK Stewardship Code” to complement to the UK Corporate Governance Code for listed companies. The latest version is from September 2012. It aims to enhance the quality of engagement between institutional investors and companies, to create a stronger link between governance and the investment process, and to lend greater substance to the concept of “comply-or-explain”⁴²⁹. Given the increasing importance of institutional investors in

⁴²⁶ *Wilcox*, WTR Law & Contemp. Probs. 2011, 149 (155).

⁴²⁷ *Wilcox*, WTR Law & Contemp. Probs. 2011, 149 (156).

⁴²⁸ *Financial Reporting Council*, The UK Stewardship Code, July 2010, available at: <<https://www.frc.org.uk/Our-Work/PUBlications/Corporate-Governance/The-UK-Stewardship-Code.pdf>> (last accessed: 09.04.2014).

⁴²⁹ See C.I.4.b) (4).

modern corporate governance⁴³⁰, the Stewardship code applies the comply-or-explain system to these investors. This principle maintains that a company should disclose if they comply with the code provisions and, in case they do not, provide an explanation for their deviation⁴³¹. Institutional investors are defined as “firms who manage assets on behalf of institutional shareholders such as pension funds, insurance companies, investment trusts and other collective investment vehicles”⁴³². The code contains seven principles. Institutional investors should: 1) publicly disclose their policy on how they will discharge their stewardship responsibilities, 2) have a robust policy on managing conflicts of interest in relation to stewardship and publicly disclose this policy, 3) monitor their investee companies, 4) establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value, 5) be willing to act collectively with other investors where appropriate, 6) have a clear policy on voting and disclosure of voting activity, and 7) report periodically on their stewardship and voting activities⁴³³. Every principle is accompanied by a “guidance” paragraph which explains in detail what compliance with the principle should look like. This guidance therefore makes compliance easy to handle.

e) The Legal Framework

⁴³⁰ *Tricker*, Corporate Governance (2009) 42; *Bruner*, J. Corp. L. 2011, 309 (318).

⁴³¹ *Financial Reporting Council*, The UK Stewardship Code 1.

⁴³² *Financial Reporting Council*, The UK Stewardship Code 2.

⁴³³ *Financial Reporting Council*, The UK Stewardship Code 4.

With regard to corporate governance, the most important UK laws are the Companies Act of 2006 and the Company Directors Disqualification Act of 1986, for company law, and the Financial Services Act of 2010, for securities law⁴³⁴. The UK has a one-tier board system, meaning that a single board directs and monitors the company's activities. Management, understood as day-to-day business, is delegated to a board of senior officers and executives, who might also be members of the board of directors. The board of directors determines the general strategy, hires and dismisses the top management, ensures the company's compliance with all relevant laws and regulations, and ensures the integrity of the company's accounting, auditing, and financial reporting⁴³⁵.

3. Germany

Corporate governance in Germany is influenced by three general features. First, a co-operative relationship among banks, shareholders, boards, managers, and employees is emphasized in order to promote corporate efficiency and harmonious labor relationships. Second, Germany has a highly developed system of co-determination. Hence, employees have a significant voice in electing supervisory bodies. Third, the two-tier system leads to a formalized distinction between managing the company and supervising the management⁴³⁶. Furthermore, two important developments can be observed: a shift towards a stronger equity culture, especially through increased

⁴³⁴ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) Annex IV, 219.

⁴³⁵ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) Annex IV, 221 et seqq; *Dine/Koutsias*, Company Law⁶ (2007) 149 et seq, 158 et seq.

⁴³⁶ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) Annex IV, 89 et seq; *Schanz*, Börseneinführung³ (2007) § 3 para 9, 45; *Monks/Minow*, Corporate Governance (1995) 287 et seq; However, this distinction may not always be that strict in practise according to *Monks/Minow*, Corporate Governance (1995) 294 et seq.

cross-border M&A activity, and a growth in the number of shareholders caused by the privatization of large state-held companies and the maturing of family-owned companies⁴³⁷.

a) The development of the corporate governance discussion

The German Code of Corporate Governance as it exists today reflects the final point of a multi-stage development. At the beginning, there were two private initiatives aimed at setting up basic rules for good corporate governance. On one hand, there was the “Code of Best Practice” of the “Grundsatzkommission Corporate Governance (Commission for Corporate Governance principles)” for listed companies (the so-called “Frankfurt principles”)⁴³⁸. On the other hand, there was the code draft of the Berlin Initiative Circle German Code of Corporate Governance (GCCG)⁴³⁹. Both initiatives took different approaches to corporate governance. While the first code was legally oriented, the second was more economically orientated⁴⁴⁰. However, they both sparked a discussion about corporate governance, offered concrete proposals, and tried to fill the gaps left by corporate governance laws⁴⁴¹. The existence of two different groups dedicated to the same issue showed that in Germany the time had come for a corporate governance code. Yet, the existence of two different codes could be problematic, especially with regard to securing the cooperation with the EU

⁴³⁷ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) Annex IV, 90.

⁴³⁸ *Schneider/Strenger*, AG 2000, 106ff.; *Schneider*, DB 2000, 2413 (2414).

⁴³⁹ *Peltzer/v. Werder*, AG 2001, 1ff.; *Schneider*, DB 2000, 2413 (2414).

⁴⁴⁰ *Ringleb* in *Ringleb/Kremer/Lutter/v. Werder*, Deutscher Corporate Governance Kodex³ (2003) para 6; *Haberer*, Corporate Governance (2001) 95.

⁴⁴¹ *Schneider/Strenger*, AG 2000, 106 (108).

Commission⁴⁴². Therefore, the government decided to convoke a governmental commission chaired by Theodor Baums (the so-called “Baums-Kommission”), which recommended forming a new commission to create a uniform German Code of Corporate Governance. Such a commission was finally convoked by the German Ministry of Justice in September 2001. The members were elected from all possible interest groups, in order to ensure broad acceptance of the code⁴⁴³. On February 26, 2002 the German Code of Corporate Governance⁴⁴⁴ was adopted in its original version. Since then, it has already been revised several times. It is regularly reviewed by a standing commission⁴⁴⁵ that was created for that purpose. The commission reviews the code with regard to its effectiveness, practicability, and its relevance. Recent changes were made to adapt the code to the new law on the adequacy of directors’ remuneration (VorstAG; BT-Drs. 16/12278). This reaction of the code shows that corporate governance is not a question of code or law. Both must be taken into account to reach a comprehensive understanding.

b) Federal Legislation

The German legal framework that influences corporate governance is mainly the Stock Corporation Act (German AktG) and the Commercial Code (German HGB), with regard to Company Law, and the Exchange Act (German BörsG) and the Securities Trade Act (German WpHG), with regard to securities law. These main laws are

⁴⁴² *Schneider*, DB 2000, 2413 (2417).

⁴⁴³ *Ringleb* in *Ringleb/Kremer/Lutter/v. Werder*, Deutscher Corporate Governance Kodex³ (2003) para 10 et seq.

⁴⁴⁴ Available at <corporate-governance-code.de/ger/download/DCG_K_D20020223.pdf> (last accessed: 08.04.2014).

⁴⁴⁵ *Habersack*, NZG 2004, 1 (2).

completed by several other acts and regulations. Since stock corporations are created through the separation of ownership and control, laws require strong protection for the shareholders. Hence, large parts of the Stock Corporation Act are mandatory⁴⁴⁶.

(1) The supervisory board

According to the obligatory two-tier system⁴⁴⁷ for stock corporations, every corporation must have an extra supervisory body, a “**supervisory board**”. A supervisory board must be composed⁴⁴⁸ of at least three members (§ 95 German AktG). Its members should not serve on more than ten boards and these members should be independent (§ 100 German AktG). The last criterion is accomplished by forbidding board members from serving on the board of a controlled company and by requiring a cooling-off period of two years before management board members can to serve on the supervisory board⁴⁴⁹. This cool-off period is not as long as proposed by Recommendation 2005/162/EC⁴⁵⁰, but it at least tries to prevent self-evaluation and to foster objectivity⁴⁵¹. The supervisory board’s main responsibility⁴⁵² is to balance the requirements of shareholders, employees and public interest,⁴⁵³ and to control the management (§ 111 German AktG). The supervisory board appoints and dismisses

⁴⁴⁶ Schanz, Börseneinführung³ (2007) § 3 para 5.

⁴⁴⁷ Monks/Minow, Corporate Governance (1995) 287 et seq; Schanz, Börseneinführung³ (2007) § 3 para 9, 45.

⁴⁴⁸ Schanz, Börseneinführung³ (2007) § 3 para 51 et seqq.

⁴⁴⁹ Hoffmann-Becking/Krieger, NZG 2009, 1 (7 et seq).

⁴⁵⁰ See above C.I.2.b).

⁴⁵¹ Schulenberg/Brosius, BB 2010, 3039 (3039, 3040).

⁴⁵² Schanz, Börseneinführung³ (2007) § 3 para 46 et seqq.

⁴⁵³ Monks/Minow, Corporate Governance (1995) 288.

members of the management board (§ 84 German AktG)⁴⁵⁴, decides about the remuneration of the management (§ 87 German AktG)⁴⁵⁵, and represents the corporation vis-à-vis the management (§ 112 German AktG). Furthermore, it is in charge of the supervising the company's risk management⁴⁵⁶ and its risk monitoring system, which is established by the management board to ensure the integrity of accounting, auditing, and financial reporting (§§ 171, 172 German AktG). The supervisory board has approval authority for certain business decisions according to the company's by-laws (§ 111 German AktG)⁴⁵⁷. The supervisory board can form committees to prepare its work or follow up on previous decisions (§ 107 III 2 German AktG)⁴⁵⁸. In particular, an audit committee is encouraged to support the supervision of risk management⁴⁵⁹. Board member remuneration can only be determined by the general meeting or the by-laws (§ 113 German AktG). Share option programs are illegal according to §§ 71 I Nr. 8, 192 II Nr. 3, 193 II Nr. 4 German AktG. In order to avoid an alignment of interests between supervisory and management board members⁴⁶⁰, share options are only open to management board members. If a board member performs a service for the company based on a separate contract, the payment for this service must be authorized by the supervisory board (§ 114 German AktG). This is required

⁴⁵⁴ *Peltzer*, NZG 2002, 10 (12 et seq) and 593 (596); *Wohlmannstetter*, ZGR 2010, 472 (473 et seq); *Schanz*, Börseneinführung³ (2007) § 3 para 20.

⁴⁵⁵ *Hoffmann-Becking/Krieger*, NZG 2009, 1 (8 et seq).

⁴⁵⁶ *AKEU/AKEIÜ*, DB 2009, 1279 (1280).

⁴⁵⁷ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) Annex IV, 93ff.; *Klunzinger*, Grundzüge des Gesellschaftsrechts¹³ (2004) 173; *Eisenhardt*, Gesellschaftsrecht¹⁰ (2002) 309 et seq; *Hueck/Windbichler*, Gesellschaftsrecht² (2003) 323 et seq.

⁴⁵⁸ *Schanz*, Börseneinführung³ (2007) § 3 para 66 et seq.

⁴⁵⁹ *Kort*, ZGR 2010, 440 (449f); *Scheffler*, ZGR 2003, 236 (248).

⁴⁶⁰ BGH 16.02.2004, II ZR 316/02; see also: *Peltzer*, NZG 2002, 10 (16); *Schanz*, Börseneinführung³ (2007) § 3 para 68; *Lutter in Tison/de Wulf/van der Elst/Steennot*, Company Law and Financial Regulation (2009) 135.

even if the contract is not with the board member him-/herself, but only with a company he or she is involved with⁴⁶¹. This requirement seeks to safeguard the independence of the board members⁴⁶².

(2) The management board

Day-to-day business is run by the **management board**, which represents the company judicially and extrajudicially (§§ 76, 77 German AktG)⁴⁶³. The management board is responsible for corporate strategy and policy, for establishing a risk-monitoring system and for reporting to the supervisory board on finance, investment, personnel planning, and internal monitoring and control structures (§ 90 German AktG)⁴⁶⁴. This last reporting duty was introduced by the German Corporate Control and Transparency Act (German KonTraG⁴⁶⁵) in 1998, along with the duty to establish an internal monitoring and control system (§ 91 II German AktG)⁴⁶⁶. The Transparency and Disclosure Act (German TransPuG⁴⁶⁷) of 2002 amended the duty by adding that when actual developments deviate from former reports, that must be disclosed and justified (§ 90 I 1 Nr. 1 German AktG). Furthermore, the Transparency and Disclosure Act introduced a so-called “balance sheet oath (affidavit)” in §§ 37v II Nr. 3,

⁴⁶¹ BGH 20.11.2006, II ZR 279/05.

⁴⁶² BGH 20.11.2006, II ZR 279/05; *Schanz*, Börseneinführung³ (2007) § 3 para 70.

⁴⁶³ *Schanz*, Börseneinführung³ (2007) § 3 para 18.

⁴⁶⁴ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) Annex IV, 95 et seq; *Klunzinger*, Gesellschaftsrecht¹³ (2004) 169; *Eisenhardt*, Gesellschaftsrecht¹⁰ (2002) 305 et seq; *Hueck/Windbichler*, Gesellschaftsrecht²⁰ (2003) 288 et seqq.

⁴⁶⁵ BGBl. 1998 I, Nr. 24, 786.

⁴⁶⁶ *Kort*, ZGR 2010, 440 (442 et seq).

⁴⁶⁷ BGBl. 2002 I, Nr. 50, 2681.

37 w II Nr. 3 Securities Trade Act (German WpHG), § 264 II 3 Commercial Code (German HGB). This oath is based on Sec. 302 and 906 of the Sarbanes-Oxley Act⁴⁶⁸, which require judicial representatives from the share issuing company to confirm that the financial accounting is correct. A false oath may result in punitive consequences. Though these consequences are not as far-reaching as in the U.S.⁴⁶⁹

(3) The general meeting

The shareholders, united in the **general meeting**, have the power to elect and remove supervisory board members who represent the shareholders, to approve the annual financial statement, to discharge supervisory and management board members, to appoint the auditor, to make decisions about changes to the by-laws on capital procurement and reduction of the capital stock, and to liquidate of the corporation (§ 119 German AktG)⁴⁷⁰. Germany follows the “one-share/one-vote” principle⁴⁷¹, although proxy voting is possible⁴⁷². The German KonTraG changed § 125 German AktG, which covers communications with shareholders, by adding a duty to inform shareholders explicitly about the possibility to vote through an authorized proxy, which can be a shareholder association (§ 125 I 4 German AktG).

⁴⁶⁸ See also D.I.3; *Köhler/Schlereth/Schober*, Aufsichtsrat aktuell 2009, 4 (8).

⁴⁶⁹ *Hutter/Kaulamo*, NJW 2007, 550 (553).

⁴⁷⁰ *Klunzinger*, Gesellschaftsrecht¹³ (2004) 173 et seq; *Eisenhardt*, Gesellschaftsrecht¹⁰ (2002) 321 et seq; *Hueck/Windbichler*, Gesellschaftsrecht² (2003) 328 et seqq.

⁴⁷¹ *Eisenhardt*, Gesellschaftsrecht¹⁰ (2002) 295, 348 et seq; *Hueck/Windbichler*, Gesellschaftsrecht² (2003) 341.

⁴⁷² *Eisenhardt*, Gesellschaftsrecht¹⁰ (2002) 326 et seqq; *Klunzinger*, Gesellschaftsrecht¹³ (2004) 176; *Hueck/Windbichler*, Gesellschaftsrecht² (2003) 343 et seqq; *Weil, Gotshal & Manges LLP*, Comparative Study (2002) Annex IV, 96 et seqq.

(4) Director remuneration

The Commercial Code (HGB) contains several provisions on the remuneration of supervisory and management board members. § 285 Nr. 9 German HGB requires information on the notes on the financial statement. § 289 II Nr. 5 German HGB requires information about the overall remuneration system be included in the annual report. §§ 314 I Nr. 6, 315 II Nr. 4 German HGB require the same information for consolidated companies. Those provisions were changed by the Act on the Disclosure of Management Board Remuneration (German VorstOG⁴⁷³) of 2005 and the Act on the Appropriateness of Management Board Remuneration (German VorstAG⁴⁷⁴) of 2009. The VorstOG changed § 285 I Nr. 9a) German HGB and § 286 IV German HGB, § 286 V German HGB and § 289 II Nr. 5 German HGB were introduced. Accordingly, § 314 I Nr. 6a German HGB was changed and § 314 II 2 and § 315 II Nr. 4 German HGB were introduced. This means that share based remuneration now must be declared by quantity and current market value. Later changes in value based on changes in the exercise conditions must also be disclosed. In addition, listed companies must disclose individual remuneration⁴⁷⁵, divided into performance-related and non-performance-related remuneration, and remuneration with long-term incentives. Moreover, commitments concerning the termination of the function as board members and remuneration paid by third persons should be disclosed. The German VorstAG changed the aforementioned laws to that effect. It requires that disclosure be explicitly divided into 1) remuneration for ordinary termination, 2) changes in the

⁴⁷³ BGBl. 2005 I Nr. 47, 2267; *Haberer/Kraus*, GES 2010, 10 (12); *Lutter in Tison/de Wulf/van der Elst/Steennot*, Company Law and Financial Regulation (2009) 137 et seq.

⁴⁷⁴ BGBl. 2009 I Nr. 50, 2509; *Hirte*, DB 2009, 140; *Haberer/Kraus*, GES 2010, 10 (12).

⁴⁷⁵ *Hoffmann-Becking/Krieger*, NZG 2009, 1 (12).

commitment with regard to termination payments, and 3) remuneration for former management board members who have concluded their employment during the accounting year. Furthermore, the German *VorstAG* also amended the stock corporation act: the enumeration in § 87 I German *AktG* now contains performance-related incentives and share options. Director remuneration should not only depend on the director's tasks and the state of the company, but also on sustainable developments⁴⁷⁶, his/her performance, and common remuneration⁴⁷⁷. These criteria are controversial since they are difficult to define and can lead to an unstable situation which could harm the trust between the supervisory and management boards⁴⁷⁸. § 87 II German *AktG* even extends the possibilities for the supervisory boards to reduce the remuneration of management board members in case of a deterioration of the company's situation⁴⁷⁹. However, it could occur that a poor situation would actually require higher remuneration, since the manager's task could be more difficult⁴⁸⁰. Moreover, remuneration should incentivize long-term, sustainable company development, as well⁴⁸¹. § 116 German *AktG* says that awarding inappropriate remuneration can create liability for the supervisory board. § 193 German *AKtG* extends the waiting period for exercising buying options for the first time from two to four years as the original period was regarded as too short⁴⁸².

⁴⁷⁶ *Kocher/Bednarz*, *Der Konzern* 2011, 77.

⁴⁷⁷ *Spindler* in *Goette/Habersack/Kalss*: *MünchKomm AktG*³ (2008) Vol II, para 20 et seq.; *Mutter*, *AG report* 2009 R 130 (R 130); *Scheffler*, *AG report* 2009 R3 76 (R 376); *Hoffmann-Becking/Krieger*, *NZG* 2009, 1 (1 et seq).

⁴⁷⁸ *DIHK-Stellungnahme zum Entwurf eines Gesetzes zur Angemessenheit der Vorstandsvergütung (VorstAG)*, *BT-Dr* 16/12278, *NZG* 2009, 538 (538 et seq).

⁴⁷⁹ *Bosse*, *BB* 2009, 1650 (1651); *Hoffmann-Becking/Krieger*, *NZG* 2009, 1 (4 et seq).

⁴⁸⁰ *Diller*, *NZG* 2009, 1006 (1007); *Homann/Wolff*, *ZGR* 2010, 959 (971).

⁴⁸¹ *Bosse*, *BB* 2009, 1650 (1650 et seq).

⁴⁸² *Peltzer*, *NZG* 2002, 10 (16).

c) The German Code of Corporate Governance (GCCG)

The GCCG applies not only to listed companies, as defined in § 2 III German AktG, but addresses them mainly according its foreword⁴⁸³. Only corporations with headquarters in Germany are subject to the GCCG, regardless of if they are listed on a German stock exchange. Foreign companies are not subject to the GCCG, even if they are listed in Germany⁴⁸⁴. Such companies, or, more accurately, their boards⁴⁸⁵, are therefore not subject to the duty to disclose described in § 161 German AktG⁴⁸⁶.

The GCCG tries to make the German Corporate Governance System more transparent and understandable for foreign investors⁴⁸⁷. It thus contains rules which explain national laws, and rules which go beyond what is required by law, describing what is considered good national and international corporate governance⁴⁸⁸. Therefore within the GCCG there are three different categories of rules⁴⁸⁹: 1) the “shall”-rules, which only allow deviation with explanation (recommendations), 2) the “should/could”-rules, which allow deviations without explanation (suggestions), and 3) rules that reproduce obligatory national law.

⁴⁸³ GCCG, 2.

⁴⁸⁴ v. Werder in *Ringleb/Kremer/Lutter/v. Werder*, Deutscher Corporate Governance Kodex³ (2003), para 128.

⁴⁸⁵ *Banzhaf*, Die Entsprechenserklärung der SE (2009) 75.

⁴⁸⁶ *Hüffer*, Aktiengesetz⁸ (2008) §161 para 6; different opinion: *Claussen/Bröcker*, DB 2002, 1199 (1204).

⁴⁸⁷ *Wolff*, Wash.U. Global Stud. L. Rev. 2004, 115, 128; *Krackhardt*, Vict. U. Wellington L. Rev. 2005, 319 (325).

⁴⁸⁸ *Schanz*, Börseneinführung³ (2007) § 3 para 11.

⁴⁸⁹ GCCG, 2; *Schanz*, Börseneinführung³ (2007) § 3 para 13; *Wolff*, Wash.U. Global Stud. L. Rev. 2004, 115 (121 et seq).

The GCCG is divided into seven chapters⁴⁹⁰. First, there is a foreword, which is followed by chapters on shareholders and the general meeting, cooperation between management board and supervisory board, management board, supervisory board, transparency, reporting, and audit of the annual financial statements.

(1) Foreword

The **foreword** mainly states the aims of the GCCG: first, more transparency, and second, the creation of sustainable value to reach the confidence of national and international investors, clients, employees, and the public. The foreword thus stresses stakeholder value, not merely shareholder value⁴⁹¹. Furthermore, it explains the German dual board system, although that system is now converging with the single board system, since the code requires close cooperation between management and the supervisory board⁴⁹².

(2) General Meeting

The Code suggests that the **General Meeting** can authorize the remuneration system as decided by the supervisory board (2.2). Furthermore, it recommends 1) that the company shall facilitate the exercise of shareholders' voting rights, including

⁴⁹⁰ *Claussen/Bröcker*, DB 2002, 1199 (1201 et seqq).

⁴⁹¹ *Hecker*, BB 2009, 1654 (1654 et seq).

⁴⁹² GCCG, 1; see also 3.1, 5.2 and 7.1.2; *Banzhaf*, Die Entsprechenserklärung der SE (2009) 72 et seq.

through proxies (2.3.3), which are not only allowed, but also encouraged, and 2) that General Meetings should be available via modern communication media, especially the Internet (2.3.4).

(3) Cooperation between Management and Supervisory Board

The third chapter deals with the **cooperation between management and supervisory board** which should be close (3.1) so that managers and directors can lead efficiently and avoid asymmetries of knowledge⁴⁹³. This requirement is repeated in both paragraph 5.2, which covers the tasks of the supervisory board chairman, who should maintain regular contact with the management board, and in paragraph 7.1.2, which states that the supervisory board is asked to discuss financial statements with the management board. This close cooperation leads to the aforementioned convergence between one- and two-tier systems⁴⁹⁴. § 90 German AktG enumerates certain reporting duties that the management board has to towards the supervisory board. In addition, paragraph 3.4 asks the supervisory board to specify the information and reporting duties to make them clearer to the management.

(4) Management Board

Chapter 4, which concerns the **management board**, mainly concentrates on members' compensation. First, it explains the legal requirements of § 87 German AktG in detail, and second, it amends those requirements, as the code recommends explicitly

⁴⁹³ Peltzer, NZG 2002, 10 (14).

⁴⁹⁴ See above C.I.4.a)(5).

a combination of fixed and variable elements, a relation to comparison parameters and a cap for premature termination payments. Overall, compensation must not encourage taking unreasonable risks (4.2.3). Moreover, the compensation system should be described in an extra compensation report and should also include information on fringe benefits (4.2.5). The total compensation should be determined by the full supervisory board (4.2.2)⁴⁹⁵, not a committee⁴⁹⁶. Conflicts of interest should be disclosed by management board members to the supervisory board immediately. Sideline activities and important transactions should also be approved by the supervisory board (4.3.4, 4.3.5).

(5) Supervisory Board

The **supervisory board**, which is obligated to supervise management, should, according to the GCCG, also ensure long-term succession planning (5.1.2). Furthermore, it should form committees with sufficient expertise to work efficiently, and, in addition, it should evaluate its own efficiency on a regular basis (5.6). While the law merely allows for the formation of committees and mentions an audit committee as an example (§ 107 III 2 German AktG)⁴⁹⁷, the code explicitly recommends an audit committee and a nomination committee. The audit committee chair should be independent and should not be a former management board member (5.3.2). Furthermore, he or she should have specialist knowledge in accounting⁴⁹⁸, as the code requires the chairperson to possess a higher level of expertise than is required by law,

⁴⁹⁵ *Mutter*, AG report 2008 R 402 (R 402).

⁴⁹⁶ *Hecker*, BB 2009, 1654 (1656 et seq).

⁴⁹⁷ *AKEU/AKEIÜ*, DB 2009, 1279 (1279).

⁴⁹⁸ *Kort*, AG 2008, 137 (145); *Peltzer*, NZG 2002, 593 (597)

which only requires expert knowledge (§ 100 V German AktG)⁴⁹⁹. Supervisory board members should be elected individually (5.4.3), they should have sufficient experience and expertise (5.4.1)⁵⁰⁰, and they should be independent⁵⁰¹. Therefore, they should not be former management board members. The code recommends a cooling-off period of two years (5.4.4)⁵⁰² and that the board be composed of an adequate number of independent members (5.4.2). In contrast to former versions, the latest version of the code defines independence by explaining when a board member is not independent. A board member is not independent when there is a personal or business relationship between the board member and either the company, its organs, a controlling shareholder, or a related company, and that relationship could cause a significant, non-temporary conflict of interest. Moreover, paragraph 5.5 enumerates some potential conflicts of interest and describes how they should be handled. Supervisory board members should receive a remuneration adequately related to the company's situation and the board members' tasks. Performance-related components, if utilized, should give incentives for sustainable long-term development (5.4.6).

(6) Transparency

With regard to **transparency** requirements, the code recommends treating all shareholders equally. All information known by financial analysts should be made available to shareholders as well (6.1). Furthermore, the excess or falling short of 3, 5, 10, 15,

⁴⁹⁹ *Habersack*, AG 2008, 98 (103).

⁵⁰⁰ *Scheffler*, ZGR 2003, 236 (258 et seq).

⁵⁰¹ *Scheffler*, ZGR 2003, 236 (259 et seq); *Nagel*, NZG 2007, 166 (166).

⁵⁰² See also § 104 II Nr. 4 German Stock Corporation Act, amended by the Act on the Appropriateness of Management Board Remuneration and *Bosse*, BB 2009, 1650 (1652 et seq).

20, 25, 30, 50 or 75% of the voting rights by one individual must be disclosed. This requirement is based on § 21 I 1 of the Securities Trade Act (German WpHG) which was amended by the Transparency and Disclosure Act (German TransPUG⁵⁰³) which transferred the Transparency Directive 2004/109/EC⁵⁰⁴ into German law⁵⁰⁵.

(7) Annual Financial Statements

In addition to the legal requirements to disclose **annual financial statements**, the code recommends a corporate governance report that contains information on stock option programs (7.1.3). The independence of the audit should be ensured by requiring a statement describing all relationships between the auditor and the company. The supervisory board should be informed about any new facts without delay (7.2.3).

4. Differences and Similarities between the UK and Germany

From a formal point of view, both the British and German codes have an introduction or foreword which explains the general aims and structures of the codes. The UK Corporate Governance Code is structured more clearly, with the strict system of main principle, supporting principle, and code provisions that is used throughout. The German Corporate Governance Code follows a similar system with legal provisions, recommendations, and suggestions, although the division between these categories is not as clear, since it must be deduced from the wording (“shall” vs. “should” or

⁵⁰³ BGBl. 2002 I, Nr. 50, 2681.

⁵⁰⁴ See above C.I.3.a).

⁵⁰⁵ *Hutter/Kaulamo*, NJW 2008, 471 (474).

“can”). As for content, both codes cover more or less the same areas, but while the UK Code is structured by guiding principles, the German Code is structured by entities and tasks. The main difference then is the dual board system in Germany, which is not only mentioned in the foreword, but also takes up an extra chapter on the cooperation of management and supervisory board. In contrast, the UK Code primarily addressed the clear division of responsibilities, which is more important if there is only one board. Both codes try to enhance shareholder participation: the German Code does this by requiring that relevant information be available for shareholders, by facilitating the exercise of voting rights, and by using modern communication tools. In comparison, the UK Code does this by requiring a dialogue between board and shareholders, so that there is mutual understanding. In this respect, the UK Code is already supported by the Stewardship Code for Investors. Furthermore, the ideal board composition is dealt with in both codes by seeking an appropriate balance of skills and by forming committees for special tasks. In this regard, there is no big difference between the codes. The provisions concerning remuneration also show some similarities: the UK Codes discuss a good balance between remuneration that is high enough to attract competent managers, but is not excessive, and the German Code requires remuneration that is orientated towards sustainable growth. Thus, the same principle underlies both codes: for sustainable growth, a company needs to pay its personnel decently, but not excessively. Then, both codes give guidelines for remuneration schemes. While the UK Code recommends a special remuneration committee, the German Code states that the decision on management remuneration must come from the full supervisory board.

D. Corporate Governance in the U.S.

U.S. corporate governance is characterized by a decentralized and fragmented system for making rules and setting standards⁵⁰⁶. While corporate law is state law⁵⁰⁷, capital market law is federal law⁵⁰⁸. Corporations are incorporated under the law of one state and no provisions exist for incorporating a company at federal level. However, the Securities and Exchange Commission (SEC) provides federal oversight of public companies listed on United States stock markets⁵⁰⁹. In addition, corporate governance is influenced by the listing standards of stock exchanges and private initiatives, e.g. from the American Law Institute (ALI)⁵¹⁰, or companies, such as CalPERS⁵¹¹. No national corporate governance code has been issued yet⁵¹². Therefore, the different influences and their interdependences of these standards will be described here.

I. Legal Acts concerning Corporate Governance

⁵⁰⁶ *Davis*, U.S. Corporate Governance, *FS Raiser* (2005) 49 (49); *Salacuse* in *Norton/Rickford/Kleineman*, Corporate Governance Post-Enron (2006) 433 (441 et seqq).

⁵⁰⁷ *Merkt/Göthel*, US-am. Gesellschaftsrecht² (2006) para 13; *Schoenfeld*, *RWZ* 2008, 193 (195).

⁵⁰⁸ *Birkner/Löffler*, Corporate Governance in Österreich (2004) 16 et seq; *Fisch* in *Macey*, The iconic cases in corporate law (2008) 46.

⁵⁰⁹ *Tricker*, Corporate Governance (2009) 27, 155.

⁵¹⁰ *American Law Institute (ALI)*, Principles of Corporate Governance: Analysis and Recommendations.

⁵¹¹ California Public Employees' Retirement Systems, one of the worlds biggest pension funds; *Banzhaf*, Die Entsprechenserklärung der SE (2009) 32.

⁵¹² *Banzhaf*, Die Entsprechenserklärung der SE (2009) 27, 31.

The comply-or-explain principle, which was first developed in the UK and is now the philosophical basis of most corporate governance codes around the world, is totally contrary to the approach applied in the U.S. In the U.S., legislation – especially the Sarbanes-Oxley-Act of 2002 – plays a major role⁵¹³. While the UK follows a non-prescriptive, principles based, and more self-regulatory approach⁵¹⁴, U.S. corporate governance is built on a prescriptive, rule-based legal approach⁵¹⁵. Or, as *Lander* puts it: since the introduction of SOX and the following new SEC rules and listing standards, the U.S. corporate governance is no longer market driven, but highly rule-driven⁵¹⁶.

1. US Corporate Law

U.S. corporate law is state, not federal law. Therefore, 50 U.S. corporate laws exist⁵¹⁷. The federal ability to regulate is based entirely on the Commerce Clause, which gives to Congress the power “to regulate commerce (...) among the several States”, the Necessary and Proper Clause (both Article 1 § 8 Fed. Const.), and the 10th Amendment. Consequently, every state has enacted its own corporate law, which companies must adhere to when they are founded. But, since Congress has exclusive jurisdiction in terms of interstate commerce, states are prevented from enjoining companies founded in other states from doing business in their state in cases

⁵¹³ *Tricker*, Corporate Governance (2009) 16, 148, 166; *Smerdon*, Corporate Governance (2004) para 1.009, 1.018.

⁵¹⁴ See above C. II. 1.

⁵¹⁵ *Tricker*, Corporate Governance (2009) 19, 184,

⁵¹⁶ *Lander*, What is Sarbanes-Oxley? (2004) XI.

⁵¹⁷ *Tricker*, Corporate Governance (2009) 183 et seq; *Schoenfeld*, RWZ 2008, 193 (195); *Banzhaf*, Die Entsprechenserklärung der SE (2009) 35.

of interstate commerce. For cases of interstate commerce⁵¹⁸, states are free to regulate as they will. This quirk of U.S. law has created competition between the states on the basis of corporate law: states compete to attract companies (and their tax dollars), and one major way that states seek to woo companies is with their corporate law. Since management typically makes the decision about where to incorporate, this means that corporations choose states that have a corporate law that provides many liberties for management and has few rules for the protection of investors⁵¹⁹. This leads to the so-called “Race of Laxity”⁵²⁰ or “Race to the bottom”⁵²¹. Most companies founded in the U.S. are now incorporated in certain states, such as Delaware, New York, or California. For example, 50% of the Fortune 500 business corporations are incorporated in Delaware.⁵²² These states are chosen primarily because they offer lax corporate law, with reduced protections for investors, and exclusion of director liability for fiduciary duty violations. These states also offer specialized jurisdiction as a result of the continuously high incorporation rates. Many corporations leads to many court decisions, and many court decisions leads to a high degree of predictability and security, especially in a common law system⁵²³. With the goal of avoiding

⁵¹⁸ Merkt/Göthel, US-am. Gesellschaftsrecht² (2006) para 18; Paul vs. Virginia, 75 U.S. (7 Wall.) 168 (1869); the term „interstate commerce“ is defined very wide and comprises not only commerce between two or more U.S. states, but also international commerce, Kersting, ZIP 2003, 233 (235).

⁵¹⁹ Eisenberg, Corporations and Other Business Organizations⁸ (2000) 101 et seq.

⁵²⁰ This phrase was first used by Justice Brandeis in *Liggett Co. vs. Lee*, 288 U.S. 517 (1933): „Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws the least restrictive. The states joined in advertising their wares. The race was one not of diligence but of laxity.“

⁵²¹ This opinion was criticized by *Ralph Winter*, who distinguished between attracting managers and unduly favoring managers. The latter would lead to lower returns, higher cost of capital und finally to a weaker position of the management. Thus managers wouldn't choose a state for incorporation where the corporate law unduly favors them, as this favor would harm them in the end; Eisenberg, Corporations and Other Business Organizations⁸ (2000) 102.

⁵²² Merkt/Göthel, US-am. Gesellschaftsrecht² (2006) para 207 et seq; see also para 25 et seq changes of the incorporation state and the relation between incorporation and seat.

⁵²³ Merkt/Göthel, US-am. Gesellschaftsrecht² (2006) para 206, 209; Eisenberg, Corporations⁸ (2000) 104.

misuse and the abuse of lax regulation, in 1928 the National Conference of Commissioners on Uniform State Laws issued the Uniform Business Corporation Act which was a model that was intended for adoption in all states⁵²⁴. However, the project was abandoned in 1958 and at that point only five states⁵²⁵ had adopted it. Later, federal measures were taken to regulate corporations via antitrust, labor, tax, and capital market law⁵²⁶, which are areas subject to federal, not state, legislation. The most important laws were the Federal Securities Act of 1933, The Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002⁵²⁷, which will be discussed in detail in the following paragraphs.

2. Securities Act of 1933/ Securities Exchange Act of 1934

After the stock market crash of 1929 and the Great Depression, many Americans lost their faith in the financial system, the free enterprise system, and capitalism itself. Therefore, Franklin D. Roosevelt's successful presidential campaign focused on reforming the financial system. The solution he offered was neither nationalizing key industries, nor leaving markets to their own devices, but establishing a federal bureaucracy to control the financial markets. Thus, the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted by Congress⁵²⁸. Since the stock market crash was assumed to be caused by manipulation, fraud, and a lack of reliable market information, those new laws required full and accurate disclosure of all rele-

⁵²⁴ *Merkt/Göthel*, US-am. Gesellschaftsrecht² (2006) para 20.

⁵²⁵ Michigan, California, Illinois, Minnesota, and Pennsylvania.

⁵²⁶ *Merkt/Göthel*, US-am. Gesellschaftsrecht² (2006) para 21.

⁵²⁷ *Merkt/Göthel*, US-am. Gesellschaftsrecht² (2006) para 29 et seq.

⁵²⁸ *Westbrook*, *Between Citizen and State* (2007) 149 et seq.

vant information. However, they left it up to the individual investor to evaluate the fairness of the offering by analyzing the disclosed information⁵²⁹, an approach similar to the comply-or-explain system recently installed in the European Union as explained above⁵³⁰. As Section 2 of the Securities Exchange Act of 1934 explains, there is a national public interest in securities transactions and therefore there is a need for regulation and control. Securities and exchange markets are susceptible to market manipulation, and this manipulation can intensify and prolong periods of unemployment, imbalance of trade, transportation and industry. To prevent manipulation, which is detrimental to society, several key steps should be taken. First, appropriate financial reports are necessary. Also, impediments to the healthy functioning of the national market system should be removed, and measures necessary to make regulation and control effective should be imposed. Further, the integrity of interstate commerce should be protected, and the fairness of securities markets maintained. Both of these statutes were federal acts, authorized by the Commerce Clause of the Constitution⁵³¹, and therefore immune from state laws that would seek to undermine their regulations. Further federal influence was effected through the exclusive or concurrent jurisdiction of the federal courts for suits premised on the violation of one of the laws⁵³². The Securities Exchange Act of 1934 also established the Securities Exchange Commission (SEC)⁵³³, which consists of five presidentially-appointed commissioners, five divisions (Corporate Finance, Trading and Markets, Investment Management, Enforcement, and Economic and Risk Analysis), and twenty-three of-

⁵²⁹ *Bost*, The Sarbanes-Oxley Act of 2002 (2003) 44.

⁵³⁰ See above C.

⁵³¹ Article I, Section 8, clause 3.

⁵³² *Merkt/Göthel*, US-am. Gesellschaftsrecht² (2006) para 29.

⁵³³ *Tricker*, Corporate Governance (2009) 43 et seq; *Davies A.*, Best Practice in Corporate Governance (2007) 19; see also: <sec.gov/> (last accessed: 08.04.2014).

fices. The SEC enforces the newly-passed securities laws, promotes stability in the markets, and protects investors⁵³⁴.

3. The Sarbanes-Oxley Act of 2002 (Public Company Accounting Reform and Investor Protection Act of 2002)⁵³⁵

The act “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws”, public law 107-204 of July 30, 2002, is better known as the “Sarbanes-Oxley-Act” (SOX). This act has had the most far-reaching influence on corporate governance in the U.S. since the Securities Act of 1933 and the Securities Exchange Act of 1934. It implements a new way of conducting business⁵³⁶. This part will now explain and examine SOX. The act amends certain sections of existing U.S. law⁵³⁷, and also establishes new important sections. After the Enron and WorldCom accounting scandals, the accepted legal approach towards corporate governance was seen as defunct and inadequate. Investors simply did not trust the information disclosed by companies anymore. Although the underlying accounting frauds were different, some similar facts predominated both scandals: accounting manipulation with outside director complicity, executive refusal to take responsibility for accurate financial reporting, insider sales of company stock shortly before the public announcement of financial restatements, and a neglectful and inat-

⁵³⁴ <sec.gov/about/whatwedo.shtml> (last accessed: 08.04.2014); *Tricker*, Corporate Governance (2009) 184; *Smerdon*, Corporate Governance (2004) para 22.014; *Eisenberg*, Corporations⁸ (2000) 282 et seq.

⁵³⁵ 15 U.S.C. 7201 (2002).

⁵³⁶ *Holt*, Sarbanes-Oxley Act (2009), 6; *Brändle*, Corporate Governance (2004) 44.

⁵³⁷ *Sheppey/McGill*, Sarbanes-Oxley (2007) 5.

tentive board⁵³⁸. Therefore, SOX aimed to eliminate accounting fraud and restore investor faith in company disclosures by heightening the disclosure standards and toughening the criminal penalties⁵³⁹. Three main goals can be distilled from the act: first, the quality of corporate disclosure and financial reporting should be improved; second, the independence of accounting firms should be strengthened; and third, the responsibility of corporate officers in financial statements and corporate disclosures should be increased⁵⁴⁰. These general goals can be split up in five concrete objectives, which make up the first five titles of the act: reforming public company accounting (titles I and II), reforming the governance of public companies (title III), increasing CEO and CFO responsibility for public company periodic reports and financial statements (title III), improving financial reporting and disclosure under the '34 Act (title IV), and enhancing objectivity of securities analysis (title V).

a) Public Company Accounting Oversight Board⁵⁴¹

Since at times financial statements have been inaccurate and auditors have not been independent, the SEC and the accounting industry are now supported by the Public Company Accounting Oversight Board⁵⁴². Established by Title I of the Sarbanes-Oxley Act, this board oversees the audit of public companies, protects investors' in-

⁵³⁸ *Bost*, The Sarbanes-Oxley Act (2003) 3; *AKEIÜ*, BB 2004, 2399 (2399).

⁵³⁹ *Bost*, The Sarbanes-Oxley Act (2003) 45; *Sheppey/McGill*, Sarbanes-Oxley (2007) 27.

⁵⁴⁰ *Bost*, The Sarbanes-Oxley Act (2003) 1.

⁵⁴¹ <pcaobus.org/Pages/default.aspx> as of October 23, 2013.

⁵⁴² *Tricker*, Corporate Governance (2009) 33; *Schoenfeld*, RWZ 2008, 193 (196); *Lander*, Sarbanes-Oxley (2004) 85 et seqq; *Shu-Acquaye*, Hous. J. Int'l L. 2007, 583 (594f); *Schaumann*, Wm. Mitchell L. Rev. 2004, 1315 (1318).

terests, and ensures that audit reports are informative and accurate⁵⁴³. The board is a non-profit, self-regulatory corporation that is entrusted with regulatory powers and is subject to SEC oversight. Accounting firms that audit public companies must be registered with the board⁵⁴⁴. Otherwise, accounting firms are not allowed to prepare or issue audit reports on the financial statements of SEC registrants, and will be inspected by the board periodically⁵⁴⁵, depending on the firm's size. This way, the firm-on-firm review system exercised before in the auditing branch was eliminated. If the standards for quality, ethics, and independence set by the board are not achieved, the board has the power to withdraw an auditing firm's registration, impose fines, and bar an individual person from further working with any registered auditing firm⁵⁴⁶. An oversight board with such independence was one of the most remarkable reforms in SOX.

b) Auditor Independence

Auditing companies often offer additional, more lucrative, services to their clients, such as bookkeeping or consulting⁵⁴⁷. This combination of audit and non-audit services offered by the same firm to the same client led to a relation of dependence and exposed auditors to several threats: 1) the self-interest threat, which refers to the fact that the auditor wants to keep a good contact with his or her client and therefore may

⁵⁴³ Kersting, ZIP 2003, 233 (234).

⁵⁴⁴ Sheppey/McGill, Sarbanes-Oxley (2007) 28 et seqq; Lander, Sarbanes-Oxley (2004) 86; Schumann, Wm. Mitchell L. Rev. 2004, 1315 (1320).

⁵⁴⁵ Sheppey/McGill, Sarbanes-Oxley (2007) 33 et seq; Lander, Sarbanes-Oxley (2004) 87 et seq; Schumann, Wm. Mitchell L. Rev. 2004, 1315 (1320 et seq).

⁵⁴⁶ Bost, The Sarbanes-Oxley Act (2003) 9 et seq.

⁵⁴⁷ E.g. Andersen Consulting, one of the big five auditing firms before going bankrupt after the Enron scandal, had in 1997 non-audit revenues of \$3.1 billion, but only audit revenues of \$1.8 billion (Boost, The Sarbanes-Oxley Act (2003) 11).

be less objective; 2) the advocacy threat, which is born of the contradiction between the trust in a consulting relationship and the critical distance in a oversight relationship; and 3) the self-review threat, which is the threat of the auditor being in the position to have to audit his or her own consulting work⁵⁴⁸. To tackle this problem, title II of SOX prohibits certain non-audit services from being provided by the auditing company⁵⁴⁹. These include: bookkeeping, financial information system design, valuation, actuarial, internal audit and investment banking services, and human resources and management functions. Other non-audit services may only be offered if the audit committee approves. Furthermore, the auditor must provide the audit committee with an annual report that covers critical accounting policies and offers alternative treatment for financial information within GAAP. SOX also prohibits an auditing firm from auditing a company whose CEO or CFO was employed by the auditing company and requires lead partners of the auditing firm to rotate every five years, with a five-year “time out” period⁵⁵⁰. This structure prevents the auditor from becoming too close with the company, and helps to maintain certain audit quality standards⁵⁵¹. SOX gives the SEC more power by granting it the right to censure someone’s right to appear and practice before the SEC. If a person is unqualified to represent others, lacks character or integrity, or has wilfully violated SEC rules, then they may be barred. This ability to ban persons from appearing before the SEC applies to auditors, outside lawyers, and in-house counsel. According to section 303 of SOX, it is now unlawful for

⁵⁴⁸ *Gelter*, Die Unabhängigkeit des Abschlussprüfers (2004) 248 et seq; *Schewe*, Unternehmensverfassung (2005) 193.

⁵⁴⁹ *Schoenfeld*, RWZ 2008, 193 (196 et seq); *Kersting*, ZIP 2003, 233 (234); *AKEIÜ*, BB 2004, 2399 (2401, 2404); *Owen/Kirchmaier/Grant* in *Owen/Kirchmaier/Grant*, Corporate Governance in the US and Europe (2006) 5; *Sheppey/McGill*, Sarbanes-Oxley (2007) 36; *Lander*, Sarbanes-Oxley (2004) 76ff; *Schaumann*, Wm. Mitchell L. Rev. 2004, 1315 (1322).

⁵⁵⁰ *Kersting*, ZIP 2003, 233 (234); *Sheppey/McGill*, Sarbanes-Oxley (2007) 36 et seq; *Lander*, Sarbanes-Oxley (2004) 75 et seq, 79 et seq.

⁵⁵¹ *Bost*, The Sarbanes-Oxley Act (2003) 12 et seq.

directors to fraudulently influence, coerce, manipulate, or mislead an auditor engaged in the performance of an audit. This prohibition supports the Exchange Act provisions that make it unlawful to give incomplete statements to auditors. The term “engaged in the performance of an audit” can also comprise a period before or after the actual auditing, if it is still possible at that time to influence the audit⁵⁵². Additionally, section 802 requires auditors to keep all records relevant to an audit or review of a company’s financial statements for five years⁵⁵³. Sections 802 and 1102 prohibit altering, destroying, or falsifying any documents related to comprehensive documentation duties. SOX specific software systems have been developed for this purpose⁵⁵⁴.

c) Audit committee⁵⁵⁵

SOX not only requires the establishment of an audit committee for listed companies, but also requires that the committee have more independence, authority, and responsibility⁵⁵⁶ to act as a neutral supervisory body for all business⁵⁵⁷. If no audit committee is established, the whole board is regarded as such. Additionally, since section 301 requires national securities exchanges to adopt listing standards that enhance audit committee independence and expertise, this means that all committee members must be independent. A committee member is regarded as independent if he or she does not receive any direct or indirect compensation from the company or

⁵⁵² *Lander*, *Sarbanes-Oxley* (2004) 2 et seq.

⁵⁵³ *Bost*, *The Sarbanes-Oxley Act* (2003) 14 et seq.

⁵⁵⁴ *Holt*, *Sarbanes-Oxley Act* (2009) 15; *Sheppey/McGill*, *Sarbanes-Oxley* (2007) 53, 109, 58.

⁵⁵⁵ *Smerdon*, *Corporate Governance* (2004) para 22.019; *Shu-Acquaye*, *Hous. J. Int’l L.* 2007, 583 (607 et seq).

⁵⁵⁶ *Kersting*, *ZIP* 2003, 233 (234).

⁵⁵⁷ *Scheffler*, *ZGR* 2003, 236 (242).

its subsidiaries aside from what he or she is paid for his or her service as a director, and if he or she is not otherwise affiliated with the company⁵⁵⁸. Securities exchanges are allowed to extend the independence criteria, as long as they do not violate SEC rules⁵⁵⁹. According to section 407, every committee should have at least one financial expert⁵⁶⁰. A financial expert is a person with education in and understanding of GAAP, experience in financial statement preparation and application, experience with internal accounting controls, and understanding of the proper functioning of an audit committee. A significant degree of technical financial and accounting knowledge is required, theoretical as well as practical⁵⁶¹. If the committee does not have a financial expert, the company must disclose this fact to its shareholders and give reasons for the omission⁵⁶². Here, a rules-based system includes one principle-based regulation. Interestingly, having a financial expert on the audit committee is obligatory in the EU, according to Article 41 Directive 2006/43/EC⁵⁶³. According to SOX, the audit committee is a powerful body. It is directly responsible for appointing, compensating, and overseeing the work of the auditor. Thus, auditors now work for the audit committee, not for the senior management. This change makes them more independent⁵⁶⁴. According to section 204, the registered public accounting firm must report directly to

⁵⁵⁸ *Nagel*, NZG 2007, 166 (167); *AKEIÜ*, BB 2004, 2399 (2402); *Scheffler*, ZGR 2003, 236 (244). *Lander*, *Sarbanes-Oxley* (2004) 54; *Schaumann*, Wm. Mitchell L. Rev. 2004, 1315 (1342 et seq).

⁵⁵⁹ See Section 303A, Final NYSE Corporate Governance Rules.

⁵⁶⁰ *Smerdon*, *Corporate Governance* (2004) para 22.020; *AKEIÜ*, BB 2004, 2399 (2402); *Scheffler*, ZGR 2003, 236 (244); *Sheppey/McGill*, *Sarbanes-Oxley* (2007) 49, 111; *Schaumann*, Wm. Mitchell L. Rev. 2004, 1315 (1341 et seq).

⁵⁶¹ *Lander*, *Sarbanes-Oxley* (2004) 57 et seq.

⁵⁶² *Bost*, *The Sarbanes-Oxley Act* (2003) 16 et seq; *Lander*, *Sarbanes-Oxley* (2004) 57.

⁵⁶³ See also C.I.3.c.); in Germany implemented by the „Bilanzrechtsmodernisierungsgesetz“ (accounting modernizing law) in § 100 V German AktG.

⁵⁶⁴ *Kaplan* in *Owen/Kirchmaier/Grant*, *Corporate Governance in the US and Europe* (2006) 40; *Banzhaf*, *Die Entsprechenserklärung der SE* (2009) 165 et seq; *Lander*, *Sarbanes-Oxley* (2004) 56.

the audit committee⁵⁶⁵. The committee not only monitors, but also controls the whole auditing process. It must approve in advance all auditing, reviewing, and attesting services, as well as all permitted non-audit services⁵⁶⁶. Furthermore, it is tasked with finding solutions for conflicts between management and the auditor on financial reporting issues, and establishing a procedure for handling complaints from employees about the auditing⁵⁶⁷. To be able to fulfil this obligation, the company must provide sufficient funds⁵⁶⁸. The audit committee report on their work must be included in the annual and proxy statements⁵⁶⁹. The company must also disclose the following information about its principal accountant: audit fees, audit-related fees, tax fees, other fees, pre-approval policies, and procedures⁵⁷⁰.

d) Corporate Counsel

SOX also modifies the responsibilities of corporate counsel, since they play an important role in effectively preventing corporate fraud. As corporate counsel were accused of shirking their due diligence and not offering a strong, objective voice supporting necessary public disclosure⁵⁷¹, section 307 now requires the SEC to set

⁵⁶⁵ *Sheppey/McGill*, *Sarbanes-Oxley* (2007) 37 et seq, 110 et seq; *Lander*, *Sarbanes-Oxley* (2004) 29f.

⁵⁶⁶ *Lander*, *Sarbanes-Oxley* (2004) 80 et seqq.

⁵⁶⁷ *Kersting*, *ZIP* 2003, 233 (234); *Sheppey/McGill*, *Sarbanes-Oxley* (2007) 110 et seq; *Scheffler*, *ZGR* 2003, 236 (243); *Lander*, *Sarbanes-Oxley* (2004) 55; *Schaumann*, *Wm. Mitchell L. Rev.* 2004, 1315 (1340 et seq).

⁵⁶⁸ *Bost*, *The Sarbanes-Oxley Act* (2003) 17.

⁵⁶⁹ *Smerdon*, *Corporate Governance* (2004) para 22.026.

⁵⁷⁰ *Lander*, *Sarbanes-Oxley* (2004) 83.

⁵⁷¹ *Grundfest*, *Stan. J.L. Bus.&Fin.* 2003, 1 (4 et seq).

standards of conduct for attorneys appearing and practicing before the SEC⁵⁷². Lawyers must report evidence of material violation⁵⁷³ of securities laws to the chief counsel and/or the CEO. If no remedial measures are taken, then corporate counsel must report directly to the audit committee or the full board. He or she must ensure that his/her cautionary advice is effectively communicated to the organization. This obligation ends only when the attorney believes that no material violation has occurred, the company has adopted appropriate measures, or the company has implemented the attorney's remedial recommendations. "Evidence of material violation" is defined as credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur⁵⁷⁴. Furthermore, the SEC encourages the establishment of a qualified legal compliance committee (QLCC)⁵⁷⁵, consisting of at least one audit committee member and two other independent directors, which is tasked with adopting written procedures for the confidential handling of a report of a material violation. It should have the authority to start investigations after receiving a report and decide on appropriate measures to take. If the company fails to take the necessary steps, the QLCC should be entitled to notify the SEC. The new reporting duties of corporate counsels have also been criticized: if the attorney has reported his or her doubts to all possible persons and institutions (chief counsel, CEO, audit committee, full board, QLCC) and no measures are taken, he or she must withdraw from representing the company and must inform

⁵⁷² *Shu-Acquaye*, Hous. J. Int'l L. 2007, 583 (610); *Schaumann*, Wm. Mitchell L. Rev. 2004, 1315 (1325).

⁵⁷³ *Smerdon*, Corporate Governance (2004) para 22.021; *Sheppey/McGill*, Sarbanes-Oxley (2007) 45; *Lander*, Sarbanes-Oxley (2004) 59, 90 et seqq.

⁵⁷⁴ *Schaumann*, Wm. Mitchell L. Rev. 2004, 1315 (1326).

⁵⁷⁵ *Lander*, Sarbanes-Oxley (2004) 59, 93f; *Schaumann*, Wm. Mitchell L. Rev. 2004, 1315 (1330 et seqq).

the company and SEC accordingly. This drastic requirement may damage the relationship of trust and confidence between the lawyer and the company. Additionally, this may implicate the disclosure of privileged client communications, which could violate state court ethics rules. The attorney could also be vulnerable to a malpractice action if his or her belief that a material violation occurred later proves to be unreasonable⁵⁷⁶.

e) Further corporate responsibility problems

Further problems are tackled by SOX, including measures such as prohibiting personal loans to executives, other than consumer credit arrangements made in the ordinary course of business (section 402)⁵⁷⁷, and barring unfit officers and directors from serving in public companies⁵⁷⁸.

(1) Unfitness to serve as an officer

Already the '33 and '34 acts empowered courts to prohibit a person who has violated securities laws from serving as an officer/director if his/her conduct demonstrates substantial unfitness to serve as an officer or director⁵⁷⁹. Substantial unfitness can be caused by the egregiousness of the violation, a repetition of the offense or the likelihood of a repeat offense, the position of the person, the criminal intent displayed, or

⁵⁷⁶ *Bost*, The Sarbanes-Oxley Act (2003) 18 et seqq.

⁵⁷⁷ *Bost*, The Sarbanes-Oxley Act (2003) 24 et seq; *Smerdon*, Corporate Governance (2004) para 22.023; *Kersting*, ZIP 2003, 233 (235); *AKEIÜ*, BB 2004, 2399 (2400); *Lander*, Sarbanes-Oxley (2004) 69; *Mossos*, Currents: Int'l Trade L.J. 2004, 9 (12).

⁵⁷⁸ *Bost*, The Sarbanes-Oxley Act (2003) 26; *AKEIÜ*, BB 2004, 2399 (2400 et seq).

⁵⁷⁹ Securities Exchange Act of 1934, Sec. 21(d)(2); Securities Act of 1933, Sec. 8A(f).

the economic consequences of the violation. Section 305 of SOX changed “substantial unfitness” to merely “unfitness”⁵⁸⁰.

(2) Pension Fund Blackout Periods

Furthermore, section 306 prohibits insider trading during pension fund blackout periods⁵⁸¹. Before, it was possible for top executives to exercise their stock options during a pension fund blackout period. A “blackout period” is defined as any period of more than three consecutive business days during which the ability of at least 50% of the participants or beneficiaries of all individual account plans of the company to purchase, sell, or otherwise acquire or transfer an interest in any equity security of the company held in such an individual account plan, is temporarily suspended by the company or by a fiduciary of the plan⁵⁸². In a case of violation, the company can now recover any profit realized or loss avoided.

(3) Whistleblower Provision

Finally, section 806 prohibits discrimination against employees who lawfully provide information to a federal agency, congress, or a supervisor about conduct that may reasonably be regarded as a violation of securities law⁵⁸³ and requires the appoint-

⁵⁸⁰ *Shu-Acquaye*, *Hous. J. Int'l L.* 2007, 583 (604).

⁵⁸¹ *Bost*, *The Sarbanes-Oxley Act* (2003) 27 et seqq.

⁵⁸² *Lander*, *Sarbanes-Oxley* (2004) 69 et seq.

⁵⁸³ *Bost*, *The Sarbanes-Oxley Act* (2003) 29 et seq; *Sheppey/McGill*, *Sarbanes-Oxley* (2007) 55; *Lander*, *Sarbanes-Oxley* (2004) 97 et seq.

ment of a contact person, e.g. a compliance officer to whom employees can direct their doubts. This “whistleblower provision” provides very broad protection⁵⁸⁴.

f) CEO and CFO Responsibility⁵⁸⁵

Section 302 seeks to counteract top executives’ disengagement from financial reporting. It seeks to remedy executive abandonment of personal responsibility to present the company’s true financial situation to shareholders.

(1) Signature of periodic reports

Although before SOX, laws already existed that tackled fraudulent or misleading company disclosures and other activities, it was difficult to prove fraud because fraudulent behaviour was often hidden by complex financial transactions and incomplete documentation. The goal of SOX was to make CEOs and CFOs responsible for archiving and disclosing accurate, comprehensive, and true information⁵⁸⁶. Thus now CEOs and CFOs are required to sign periodic reports, certifying that: 1) they have reviewed the report, 2) the report contains no misstatements or omissions, 3) it fairly presents the company’s financial condition, 4) disclosure controls and procedures have been established and maintained, 5) relevant information is made known to them, 6) the effectiveness of the process is evaluated, 7) any significant deficien-

⁵⁸⁴ *Holt*, Sarbanes-Oxley Act (2009) 54 et seqq; *AKEIÜ*, BB 2004, 2399 (2402).

⁵⁸⁵ *Smerdon*, Corporate Governance (2004) para 22.015; *Shu-Acquaye*, Hous. J. Int’l L. 2007, 583 (602 et seq).

⁵⁸⁶ *Holt*, Sarbanes-Oxley Act (2009) 67; *Schoenfeld*, RWZ 2008, 193 (197); *Sheppey/McGill*, Sarbanes-Oxley (2007) 40 et seqq., 81, 106, 111, 181 et seqq, 207; in the EU a similar, however less strict and extensive rule exists in Directive 2006/46/EC, see above C.I.3.b.

cies⁵⁸⁷ have been disclosed to the auditor and the audit committee, and 8) significant changes in the internal controls are indicated⁵⁸⁸. This means that CEOs/CFOs are responsible for providing assurance for the overall material accuracy and completeness of the information disclosed in annual reports⁵⁸⁹. “Fair presentation” is defined as the application of appropriate accounting policies, the disclosure of all relevant financial information, and the disclosure of additional information needed to have an accurate and complete picture of the company’s situation. The requirements are thus broader and more comprehensive than those of the GAAP. “Disclosure controls and procedures”, (i.e. controls and other procedures designed to ensure that information required to be disclosed in Exchange Act reports is recorded, processed, summarized, and reported within the required time periods⁵⁹⁰), must be established to ensure that all information required to be disclosed is recorded, processed, accumulated, and communicated to the management. The CEO is ultimately responsible for this process.

(2) Internal Control Reports

In addition, management is required to issue an “internal control report” (section 404)⁵⁹¹ which establishes that the management is responsible for the establishment

⁵⁸⁷ See definition of the SEC, 17 CFR Parts 210 and 240; Release Nos. 33-8829; 34-56203; File No. S7-24-06; RIN 3235-AJ58.

⁵⁸⁸ *Kersting*, ZIP 2003, 233 (233); *AKEIÜ*, BB 2004, 2399 (2400).

⁵⁸⁹ *Tricker*, *Corporate Governance* (2009) 156; *Martin*, NZG 2003, 948 (951); *Sheppey/McGill*, *Sarbanes-Oxley* (2007) 106.

⁵⁹⁰ *Lander*, *Sarbanes-Oxley* (2004) 10.

⁵⁹¹ *Smerdon*, *Corporate Governance* (2004) para 22.024; *AKEIÜ*, BB 2004, 2399 (2400); *Sheppey/McGill*, *Sarbanes-Oxley* (2007) 47 et seq, 98,107, 188 et seqq, 207, 256 et seq; *Stoltenberg/Lacey/George/Cuthbert*, *Am. J. Comp. L.* 2005, 457 (464).

and maintenance of internal controls and procedures. This means that management is responsible for every process that relates to the preparation of financial statements, that contains the management's conclusions on the effectiveness of the procedures and the auditor's approval of the management's evaluation⁵⁹², or that provides reasonable assurance for the reliability of financial reporting⁵⁹³. That includes maintaining records that do the following in reasonable detail: 1) accurately reflect the transactions and dispositions of the registrant's assets, providing reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and 2) attest that receipts and expenditures of the registrant are made only with authorization from management and the directors of the registrant, and 3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the registrant's assets that could have a material effect on the financial statements⁵⁹⁴. Here, there are no new requirements established, only new disclosure provisions. However, while setting up the report, companies may detect gaps in their internal control system and find themselves obliged to close those gaps.

(3) Evaluation

Furthermore, a company is required to evaluate the effectiveness of the design of its disclosure control procedures regularly, and must disclose its conclusions in a report⁵⁹⁵. The management's assessment of the efficacy of the control procedures must also be cross-checked by the company's auditor, who must also issue a report

⁵⁹² *Tricker*, Corporate Governance (2009) 157 et seq.

⁵⁹³ *Lander*, Sarbanes-Oxley (2004) 15.

⁵⁹⁴ *Stoltenberg/Lacey/George/Cuthbert*, Am. J. Comp. L. 2005, 457 (465 et seq).

⁵⁹⁵ *Lander*, Sarbanes-Oxley (2004) 11.

on it⁵⁹⁶. Each control should consist of five components: the control environment, i.e. the consciousness of the employees; the risk assessment, meaning the identification and analysis of relevant risks; the control activities; information and communication; and monitoring⁵⁹⁷. Each of these five components must be discussed in the report. The term “disclosure controls and procedures” is broader than the term “internal control over financial reporting”, since management may conclude that some parts of the information gained through internal control do not need to be disclosed in its Exchange Act reports.

(4) Criminal Statutes

Finally, the certification requirements are supported by criminal statutes. These statutes empower courts to impose fines or prison time for knowingly or wilfully disclosing information that does not fully comply with the reporting requirements of the 1934 Act as amended by SOX in section 906⁵⁹⁸. Additional modified criminal laws can be found in sections 807, for defrauding shareholders of publicly held companies, and in sections 901 to 904, for securities fraud and related crimes⁵⁹⁹. While before it often seemed that non-performance was rewarded by golden handshakes and bonuses, now, non-performance can lead to large fines and imprisonment⁶⁰⁰. Additionally, section 304 requires CEOs and CFOs to forfeit their bonuses and stock sale profits with-

⁵⁹⁶ *Lander*, Sarbanes-Oxley (2004) 19.

⁵⁹⁷ *Lander*, Sarbanes-Oxley (2004) 22; *Sheppey/McGill*, Sarbanes-Oxley (2007) 208.

⁵⁹⁸ *Lander*, Sarbanes-Oxley (2004) 100f; *Shu-Acquaye*, *Hous. J. Int'l L.* 2007, 583 (605).

⁵⁹⁹ *Bost*, *The Sarbanes-Oxley Act* (2003) 30 et seqq; *Sheppey/McGill*, Sarbanes-Oxley (2007) 55 et seqq.

⁶⁰⁰ *Sheppey/McGill*, Sarbanes-Oxley (2007) 107.

in twelve months after a material non-compliance with the reporting requirements. This non-compliance is the result of misconduct, but it does not have to be the misconduct of the CEO or CFO him-/herself. If any employee acts wrongly, management is ultimately held responsible⁶⁰¹.

As we can see here, the sections concerning CEO and CFO responsibility do not influence the composition of the board, but do affect how management behaves⁶⁰².

g) Financial Reporting and Disclosure

Financial reporting and disclosure under the 1934 act are improved via four changes.

(1) Off-Balance Sheet Arrangements

First, the disclosure of off-balance sheet arrangements must be more transparent. Originally, those structures were designed to comply with Financial Accounting Standards Board regulations. If a company had independent third party status, it was not seen as a subsidiary. Therefore, transactions between the first company and the second were seen as transactions between unrelated parties. The financial statements of the first company only showed the gains realized by selling assets to the second company, but not the losses and liabilities of the second company. This becomes problematic if the second company is not really independent, but is only con-

⁶⁰¹ *Bost*, The Sarbanes-Oxley Act (2003) 34f; *AKEIÜ*, BB 2004, 2399 (2400); *Lander*, Sarbanes-Oxley (2004) 72; *Mossos*, Currents: Int'l Trade L.J.2004, 9 (12); *Shu-Acquaye*, Hous. J. Int'l L. 2007, 583 (604).

⁶⁰² *AKEIÜ*, BB 2004, 2399 (2399).

structured to appear so. Now, the Management Discussion and Analysis of Financial Conditions and Results of Operations (MD&A) must contain information about those secondary companies, including: their business purpose, their importance to the company, the amount of revenues arising from those companies, the amount of indebtedness incurred by those companies, and any known event likely to reduce benefits. In short, the MD&A must include all information necessary to understand the off-balance sheet arrangements and their future effects on the company⁶⁰³. An off-balance sheet arrangement is defined:

“(…) to include a transaction, an agreement, or other contractual arrangement with an unconsolidated entity under which the company has 1) an obligation under certain guarantee contracts, 2) a retained or contingent interest in assets transferred to the entity as credit, liquidity, or market support (...), 3) an obligation, including a contingent obligation, under certain derivative instruments, and 4) an obligation, including a contingent obligation, arising out of a material variable interest in the entity if the entity provides financing, liquidity, market, or credit risk support to the company or engages in leasing, hedging, or research and development services with the company⁶⁰⁴.

The definition is intended to target the means through which companies typically incur a risk that is not transparent to investors⁶⁰⁵. The management needs to identify all off-balance sheet arrangements, analyze the likelihood of events that could affect these arrangements, and evaluate possible consequences from those arrangements. It must disclose the arrangement's nature and business purpose, its importance to the company's liquidity, and any other information necessary for understanding the arrangement. In short, the MD&A should provide investors with the management's insight into the potential risk of such arrangements⁶⁰⁶.

⁶⁰³ *Kersting*, ZIP 2003, 233 (235).

⁶⁰⁴ *Bost*, The Sarbanes-Oxley Act (2003) 37..

⁶⁰⁵ *Lander*, Sarbanes-Oxley (2004) 24.

⁶⁰⁶ *Lander*, Sarbanes-Oxley (2004) 25 et seqq.

(2) Pro Forma Figures

Second, the use of pro forma figures must be reformed. Here, the problem is that some expenses are excluded as “extra-ordinary”, because including them on financial statements would create an unrealistic picture of the company’s situation. But, by excluding those figures, that creates an overly-optimistic impression. Thus, section 401 does not forbid pro forma figures, but requires them to be not materially misleading, compared to GAAP. The public disclosure must be accompanied by a presentation of the most directly comparable measures, in accordance with GAAP, and an understandable reconciliation of the difference⁶⁰⁷.

(3) Ethics Codes for Senior Offices

Third, Ethics Codes for senior officers must be disclosed, too. There was a general impression that meaningful ethical standards were lacking among executives. Consequently, section 406 requires companies to disclose whether a code of ethics (including its amendments) was adopted by the company, and if not, then why⁶⁰⁸. Here, the Sarbanes-Oxley Act adopts the comply-or-explain approach⁶⁰⁹, although only for a specific area. A code of ethics is defined as a written standard that seeks to deter

⁶⁰⁷ *Bost*, The Sarbanes-Oxley Act (2003) 38 et seq; concerning pro forma figures also see: *Born*, Rechnungslegung international (1997) 211; *Sheppey/McGill*, Sarbanes-Oxley (2007) 46; *Lander*, Sarbanes-Oxley (2004) 35 et seqq.

⁶⁰⁸ *Smerdon*, Corporate Governance (2004) para 22.022; *AKEIÜ*, BB 2004, 2399 (2400); *Sheppey/McGill*, Sarbanes-Oxley (2007) 48 et seq, 108; *Lander*, Sarbanes-Oxley (2004) 58 et seq; *Mossos*, Currents: Int’l Trade L.J.2004 9 (11).

⁶⁰⁹ *Krackhardt*, Vict. U. Wellington L. Rev. 2005, 319 (333); *Shu-Acquaye*, Hous. J. Int’l L. 207, 583 (609).

wrongdoing and promote honest and ethical conduct; full, fair, accurate, understandable, and timely disclosures; compliance with the law; prompt reporting of violations; and accountability for adherence to the code⁶¹⁰.

(4) Disclosure of Material Changes

Finally, material changes and insider stock sales should be disclosed rapidly to promote faster communication to the investors. Section 409 encourages companies to disclose material changes in the company's financial conditions or operations rapidly, i.e. based on the "real-time concept"⁶¹¹, and in plain English. Therefore, by adopting shorter deadlines for filing annual and quarterly reports, the filing process is accelerated⁶¹². Section 403 requires that changes in ownership be disclosed before the end of the second business day after the change. This is a drastic shortening of the time frame for disclosure, which was ten days after the end of the months of the transaction⁶¹³.

h) Security Analysis⁶¹⁴

⁶¹⁰ *Bost*, The Sarbanes-Oxley Act (2003) 39 et seq; *Sheppey/McGill*, Sarbanes-Oxley (2007) 108; *Lander*, Sarbanes-Oxley (2004) 66.

⁶¹¹ *Sheppey/McGill*, Sarbanes-Oxley (2007) 50 et seq.

⁶¹² *Lander*, Sarbanes-Oxley (2004) 42 et seq.

⁶¹³ *Bost*, The Sarbanes-Oxley Act (2003) 41; *Sheppey/McGill*, Sarbanes-Oxley (2007) 47; *Lander*, Sarbanes-Oxley (2004) 69 et seq.

⁶¹⁴ *Schoenfeld*, RWZ 2008, 193 (197); *Schaumann*, Wm. Mitchell L. Rev. 2004, 1315 (1332 et seqq).

Securities analysts are exposed to a conflict of interest. On the one hand, they need to make an objective analysis, but, on the other hand, they (or their firm) want to stay in good contact with their corporate customers. This leads to overly optimistic ratings. Section 501 encourages registered securities associations and national securities exchanges to adopt rules to address conflicts of interest concerning securities analysts⁶¹⁵. These should foster public confidence and protect analysts' objectivity and independence⁶¹⁶. Within the firms, structures must be established to separate analysts and investment banking personnel, and to create a disclosure scheme for potential conflicts of interest⁶¹⁷.

II. Soft Law in the U.S.

Although the U.S. Corporate Governance system is mainly based on a legal approach, some forms of soft law do exist.

1. Global Principles of Accountable Corporate Governance (CaIPERS)

The California Public Employees' Retirement System⁶¹⁸, the largest U.S. pension fund⁶¹⁹ and thus an influential institutional investor, was one of the pioneers in setting

⁶¹⁵ „Securities Analysts“ are defined as any person working for a registered broker or dealer who prepares a research report, regardless of his or her actual job title., *Sheppey/McGill*, Sarbanes-Oxley (2007) 51; *Möllers*, ECFR 2007, 173 (179 et seq).

⁶¹⁶ *Kersting*, ZIP 2003, 233 (235).

⁶¹⁷ *Bost*, The Sarbanes-Oxley Act (2003) 41 et seqq.

⁶¹⁸ <calpers.ca.gov/> (last accessed: 08.04.2014).

⁶¹⁹ *CaIPERS*, Global Principles of Accountable Corporate Governance 5.

up principles for good corporate governance⁶²⁰. Its global principles, which were originally published in 1997 and last updated in 2011, have been a best practice guide for many. CalPERS issued these guidelines in order to create a framework for executing its proxy voting responsibilities. It speaks of “shareowners”, not “shareholders”, to stress the shareholder responsibility and to make clear that this responsibility requires more than a merely passive “holding” of shares. CalPERS holds that it is important for a shareowner to exercise its rights, to participate in voting, to make well informed decisions about its investments, and to motivate other investors to be active, too. CalPERS issued four different principles: 1) the core principles which are valid for all types of companies, 2) the domestic principles for companies based in the U.S. market, 3) the international principles for companies based abroad, and 4) the emerging market principles. Different principles exist for different needs and requirements, as they apply in specific markets⁶²¹. The core principles are principles that are regarded as elementary for establishing a foundation for achieving long-term sustainable investment returns through accountable corporate governance structures. According to CalPERS, accountable corporate governance structures are the most effective basis for producing the best returns to shareowners. Thus, they recommend first, that the board should always focus on optimizing the company’s performance and profitability, and thus the returns to shareowners. Second, managers should be accountable to directors and directors to shareholders. Being accountable also means being accessible. Third, all information about the company should be transparent, in order to allow accurate market comparisons. Fourth, the one-share/one-vote principle should apply. Fifth, proxy materials should contain all information necessary for making an informed decision. Furthermore, the information

⁶²⁰ Tricker, *Corporate Governance* (2009) 162.

⁶²¹ CalPERS, *Global Principles of Accountable Corporate Governance* 6.

should be provided in a way that encourages investor participation. Sixth, CalPERS recommends codes of best practices for each capital market, and, subsequently, an explanation of whether companies comply with those best practices or not. Seventh, directors and managers should run their company with an emphasis on long-term, sustainable value. This long-term strategy should be supported by the shareholders, who should resist short-term behavior. Here again, shareholder responsibility is stressed. Finally, CalPERS recommends that all shareholders have direct access to director nominations⁶²². Altogether, the CalPERS global principles of accountable corporate governance cover the most important issues in the international corporate governance discussion.

2. New York Stock Exchange (NYSE) Listed Company Manual⁶²³

The NYSE issued a listed companies' manual, which consists of nine sections that cover all topics relevant for a company that wants to be listed or already is listed on the NYSE: the listing process (section 1), disclosure and reporting material information (section 2), corporate responsibility (section 3), shareholders' meetings and proxies (section 4), certificates (section 5), agencies, depositories, trustees (section 6), listing applications (section 7), suspension and delisting (section 8) and exchange forums (section 9). Corporate Governance Standards are covered in Section 303A.00. The required standards are summarized in 12 recommendations, which are:

⁶²² CalPERS, Global Principles of Accountable Corporate Governance 7.

⁶²³ Available at: <nysemanual.nyse.com/lcm/> (last accessed: 08.04.2014).

a) Quality of Board Oversight

The quality of the board oversight should be increased. Thus, the majority of its members must be independent⁶²⁴.

b) Independence

Independence is defined as “no material relationship with the company”⁶²⁵. Due to the impossibility of explicitly mentioning all relevant situations, boards should consider broadly all relevant facts and circumstances that could possibly influence the independence of directors from the management. In the company’s annual proxy statement, a company must explain which relationships are defined as not material.⁶²⁶ Moreover, a director who is either A) an employee of the company, receives more than \$ 100,000 per year direct compensation from the company, is affiliated with a present or former internal or external auditor OR B) is an executive officer of a company that makes payments to, or receives payments from the listed company that exceed a certain threshold, is not independent until three years after the end of the respective situation⁶²⁷.

c) Promotion of open discussion

⁶²⁴ NYSE, Listed Company Manual, Section 303A.01; *Lander*, Sarbanes-Oxley (2004) 46 et seq.

⁶²⁵ *Lander*, Sarbanes-Oxley (2004) 48.

⁶²⁶ NYSE, Listed Company Manual, Section 303A.02(a).

⁶²⁷ NYSE, Listed Company Manual, Section 303A.02(b); *Lander*, Sarbanes-Oxley (2004) 49.

To promote open discussion, non-management directors are called to meet at regularly scheduled sessions without management.⁶²⁸

d) Nominating/ Corporate Governance Committee

Listed companies must have a nominating/corporate governance committee staffed only by independent directors. Its obligatory written charter must contain its purpose and responsibilities, which must reflect the board's criteria for selecting new directors, as well as an annual performance evaluation⁶²⁹. The charter should also contain: desired committee member qualifications, appointment and removal procedures, committee structure and operations, and any committee reporting to the board. As nominations are among the most important functions of the board, a committee is crucial for efficacy, independence, and quality.⁶³⁰

e) Compensation Committee

Furthermore, the manual requires that the compensation committee be composed of independent directors. Its obligatory written charter should again contain an annual performance evaluation and its purpose and responsibilities, which are: to review and approve corporate goals and objectives relevant to CEO compensation; to evaluate CEO performance and to determine CEO compensation based on this evaluation; to make recommendations with regard to non-CEO compensation, incentive compensa-

⁶²⁸ NYSE, Listed Company Manual, Section 303A.03.

⁶²⁹ Lander, Sarbanes-Oxley (2004) 50.

⁶³⁰ NYSE, Listed Company Manual, Section 303A.04.

tion, and equity-based plans; and to produce a committee report⁶³¹. Again, the charter should contain required committee member qualifications, appointment and removal procedures, committee structure and operations, and the schedule for committee reporting to the board. The long-term incentives for CEOs should be based on the company's performance, similar incentives awarded to CEOs at comparable companies, and awards given in the past.⁶³²

f) Audit Committee

The third required committee according to the Exchange Act is an audit committee⁶³³. It must have three members, all of them must be financially literate, and at least one must have accounting or related financial management expertise. Beyond the Exchange Act, the manual requires audit committee members to fulfill the independence requirements of Section 303A.02⁶³⁴. It must have a written charter that addresses its purpose⁶³⁵: oversight over 1) the integrity of the company's financial statements, 2) compliance with legal and regulatory requirements, 3) independent auditor's qualifications and independence, and 4) performance of the company's internal audit function. Furthermore, the written charter must contain chapters about the committee's annual performance evaluation and the committee's internal audit function for an ongoing assessment of the company's risk management process and system of internal control. The latter are explained in more detail and consist of: re-

⁶³¹ *Lander, Sarbanes-Oxley (2004)* 51.

⁶³² NYSE, Listed Company Manual, Section 303A.05.

⁶³³ NYSE, Listed Company Manual, Section 303A.06.

⁶³⁴ See above D.II.2.b).

⁶³⁵ *Lander, Sarbanes-Oxley (2004)* 60 et seq.

viewing the internal quality-control procedures by evaluating the auditor's qualifications, performance and independence; assuring the legally required lead audit partner rotation⁶³⁶; and, additionally, considering a rotation of the auditing firm itself. Conclusions should be presented to the full board. Annual and quarterly financial statements should be discussed with management and the independent auditor. Additionally, financial information, risk assessment, and management policies should be provided to analysts. The committee should provide management with guidelines to govern the assessment of risk exposure, as the board is responsible for understanding the risks to which the company is exposed and for ensuring that those risks are handled appropriately⁶³⁷. Separate, periodical sessions with management and internal auditors should take place. Audit problems or difficulties should be reviewed and discussed with the management. Hiring policies for (former) employees of independent auditors should be set up. These persons can be valuable managers due to their knowledge, but should not be exposed to any kind of pressure due to their decision to seek a job at the company they audited. The committee should report regularly to the full board of directors about the quality and integrity of the company's financial statements, its compliance with legal or regulatory requirements, the performance of the independent auditors, and of the internal audit function.⁶³⁸

g) Corporate Governance Guidelines

⁶³⁶ *Lander, Sarbanes-Oxley (2004) 79 et seq.*

⁶³⁷ *Tricker, Corporate Governance (2009) 19.*

⁶³⁸ *NYSE, Listed Company Manual, Section 303A.07.*

Companies are required to set up corporate governance guidelines⁶³⁹. These can vary, but should at least address some key areas, like director qualifications and responsibilities, board committees, and director compensation. The guidelines should be available online, along with the charters of the board committees. Seven subjects must be addressed: 1) director qualification standards, including independence requirements, tenure, retirement, and succession; 2) director responsibilities, including board meeting attendance; 3) director access to management, and independent advisors; 4) director compensation, including principles of form and amount; 5) director orientation and education; 6) management succession, comprising selection and performance review policies; and 7) annual performance evaluation of the board, a self-evaluation of the functioning of the board and its committees.⁶⁴⁰

h) Code of Business Conduct

Listed companies also must adopt and disclose a code of business conduct and ethics for directors, officers, and employees⁶⁴¹. It should concentrate on areas of ethical risk, should provide guidance, and should create mechanisms for reporting unethical conduct, in order to create a culture of honesty. Any waiver should be disclosed to the shareholders. Even if each company sets up its own policies, some minimum standards must be included: conflicts of interests (i.e. any interference of an individual's private interests with the interests of the corporation) should be avoided, and means of communicating potential conflicts of interest should be provided. Directors,

⁶³⁹ *Lander, Sarbanes-Oxley (2004) 67 et seq.*

⁶⁴⁰ *NYSE, Listed Company Manual, Section 303A.09.*

⁶⁴¹ *Lander, Sarbanes-Oxley (2004) 67.*

officers, and employees should be prohibited from taking personal advantage of corporate opportunities. Confidentiality should be maintained and fair dealing with all customers, suppliers, competitors and employees should be fostered. Company assets should be used properly and be protected. Compliance with laws, rules, and regulations should be actively promoted. And the reporting of illegal or unethical behaviour should be encouraged.⁶⁴²

i) Foreign Issuers

Listed foreign private issuers may stick to their home corporate governance rules. They are only asked to disclose a brief and general summary on the ways in which their practices differ from those followed by domestic issuers.⁶⁴³

j) CEO Certification

Each CEO must certify annually to the NYSE that he or she is not aware of any violation by his or her company, and, if he or she becomes aware of a violation, must attest that he or she will notify the NYSE.⁶⁴⁴

k) Public Reprimand

⁶⁴² NYSE, Listed Company Manual, Section 303A.10.

⁶⁴³ NYSE, Listed Company Manual, Section 303A.11.

⁶⁴⁴ NYSE, Listed Company Manual, Section 303A.12; *Lander, Sarbanes-Oxley (2004)* 103.

Before suspending trading or delisting a company, measures that may harm the very shareholders these standards seek to protect, the NYSE may issue a public reprimand letter.⁶⁴⁵

3. General accepted accounting principles (GAAP)

One of the main goals of financial accounting is to protect investors and to provide them with all information needed to make decisions about their investments⁶⁴⁶. Thus, GAAP form an important part of the corporate governance system. They are an important soft law reference since no accounting laws exist in the U.S.⁶⁴⁷

a) Development of GAAP

Until 1917, there were no binding principles for drawing up annual accounts because there was no legal foundation for such principles. In 1917, the American Institute of Accountants (AIA), a private association of accountants, developed the first accounting principles, and in 1929, after the stock market crash, they cooperated with the NYSE to improve the accounting and disclosure duties for publicly listed companies. At that time, only state securities laws existed. These laws offered limited investor protection, as securities deals that crossed state borders were not included. The situation changed in 1933 with the adaption of the Securities Act⁶⁴⁸, which dealt with

⁶⁴⁵ NYSE, Listed Company Manual, Section 303A.13.

⁶⁴⁶ *Buchholz*, Internationale Rechnungslegung³ (2003) 23.

⁶⁴⁷ *Buchholz*, Internationale Rechnungslegung³ (2003) 5.

⁶⁴⁸ See above D.I.2.

initial public offerings, and the Securities Exchange Act⁶⁴⁹, which dealt with securities deals after their stock issue⁶⁵⁰. The latter also established the Securities Exchange Commission as an independent federal agency with the authority to supervise compliance with the new laws. Its Division of Corporate Finance is especially important for corporate accounting⁶⁵¹. The adoption of generally accepted accounting principles, however, were assigned to the American Institute of Certified Public Accountants (AICPA), as the AIA was named now, and later to the Financial Accounting Standards Board (FASB)⁶⁵².

b) Standard Setters in the USA

Several institutions influenced the generally accepted accounting principles by issuing guidelines on various accounting topics. One thing all of these organizations have in common is that they are private and have no legislative organs⁶⁵³. First, the AICPA issues industry auditing and accounting guides that contain recommendations on accounting and auditing in specific branches and statements of position on topics that are not dealt with by the FASB and the SEC. Until 1959, accounting research bulletins were issued by the committee on accounting procedure (CAP) of the AICPA. The bulletins only cover special accounting problems, no general guidelines. However, they are the first documented generally accepted accounting principles. In 1959, the CAP was replaced by the accounting principles board (APB) of the AICPA.

⁶⁴⁹ See above D.I.2.

⁶⁵⁰ *Born*, Rechnungslegung international (1997) 185.

⁶⁵¹ *Born*, Rechnungslegung international (1997) 186.

⁶⁵² *Born*, Rechnungslegung international (1997) 187.

⁶⁵³ *Buchholz*, Internationale Rechnungslegung³ (2003) 9.

The APB issued several opinions which were officially proclaimed and are still valid today. Furthermore, some interpretations on current topics were given. However, these were only recommendations. It also published four statements as non-binding discussion proposals. Finally, 12 accounting research studies were issued with the intention of creating general principles. The APB was replaced too, because of the lack of independence, a criticism that already existed against the CAP. Thus the FASB was founded by an independent foundation, the financial accounting foundation (FAF)⁶⁵⁴. It issues detailed explanations of accounting principles, statements of financial accounting standards (SFAS), general accounting principles, statements of financial accounting concepts (SFAC), interpretations of SFAS and SFAC, technical bulletins concerning the accounting problems of special branches or certain companies, and other publications, such as research reports or discussion papers⁶⁵⁵.

c) The Conceptual Framework

While CAP and APB had no theoretical foundation, right after its creation the FASB started developing a conceptual framework that was intended to be a guideline for establishing standards, offering a framework for new issues, limiting the discretion for the drawing of annual accounts, fostering the comprehensibility of and the confidence in annual accounts, and increasing the comparability of annual accounts⁶⁵⁶. The conceptual framework of the FSAB consists of six statements⁶⁵⁷:

⁶⁵⁴ *Born*, Rechnungslegung international (1997) 188 et seqq.

⁶⁵⁵ *Born*, Rechnungslegung international (1997) 191.

⁶⁵⁶ *Born*, Rechnungslegung international (1997) 192.

⁶⁵⁷ *Buchholz*, Internationale Rechnungslegung³ (2003) 23.

(1) SFAC (statement of financial accounting concepts) 1 says that the objectives of financial reporting are conditioned by the expectations and needs of external readers. The reports should give sufficient information needed to make economic decisions and should be reasonably understandable⁶⁵⁸.

(2) SFAC 2 states the needed qualitative characteristics of accounting information. According to this statement, understandability is the basic principle that should always be followed. Additional important features include relevance and reliability. Relevance means that the information should be helpful for predicting future events and for evaluating former expectations, thus have a predictive, as well as a feedback value. Reliability means that the information must be verifiably neutral and representationally faithful. Furthermore, information must be available promptly and it should be consistently organized, so as to support the comparison of two or more companies. Those qualitative features are only limited by the demand for materiality and the considerations of cost effectiveness⁶⁵⁹.

(3) SFAC 3 was replaced by SFAC 6. SFAC 4 only treats non-business organizations and will therefore not be part of this work.

(4) While SFAC 1 and 2 cover the complete financial reporting of a company, SFAC 5 and 6 only cover the annual financial statements, which are comprised of statement of financial position, statement of earnings and comprehensive income, statement of cash flows and statement of investment by and distributions to owners. SFAC 5 sets

⁶⁵⁸ *Born*, Rechnungslegung international (1997) 193.

⁶⁵⁹ *Born*, Rechnungslegung international (1997) 193 et seq.

the recognition and measurement preconditions; SFAC 6 defines the components of the annual balance sheet⁶⁶⁰.

d) GAAP

Neither the legislator, nor the SEC define the term “generally accepted accounting principles”. According to the AICPA,

“The phrase >generally accepted accounting principles< is a technical accounting term that encompasses the conventions, rules, procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules and procedures provide a standard by which to measure financial presentations.”

Although not defined by law or issued by the legislature (neither the state nor the federal), the GAAP has gained quasi legal force through the acceptance by the SEC⁶⁶¹. Additionally, the NYSE also requires annual accounts according to US-GAAP⁶⁶². GAAP, therefore, are a mixture of principles and best practice⁶⁶³. They have a binding effect similar to corporate governance codes in Europe that are legally backed by listing rules⁶⁶⁴. Other sources of established accounting principles can be used too, but to what extent this is possible depends on each single case and the authority of its author⁶⁶⁵.

e) SEC Rules

⁶⁶⁰ *Born*, Rechnungslegung international (1997) 194 et seq.

⁶⁶¹ *Born*, Rechnungslegung international (1997) 198.

⁶⁶² *Buchholz*, Internationale Rechnungslegung (2003)³ 1, 17.

⁶⁶³ *Sheppey/McGill*, Sarbanes-Oxley (2007) 84 et seq.

⁶⁶⁴ See above B.V.2., 3.

⁶⁶⁵ *Born*, Rechnungslegung international (1997) 200.

The SEC requires certain information be handed in by securities issuers in registration statements and reports. The kind of information that is required depends on the forms and mode in which it is given, both of which depend on the regulations S-X and S-K⁶⁶⁶. S-X contains rules about form, content, audit, disclosure periods of annual and quarterly statements, and requirements concerning the qualifications and independence of the auditor. It contains no rules about recognition and measurement as those are left to the GAAP. S-X is valid for all financial statement required by the Securities Act and the Securities Exchange Act⁶⁶⁷. S-K is valid for disclosure duties apart from the annual account, such as financial information about the last five years or the management's discussion and analysis of financial condition and results of operations (MD&A)⁶⁶⁸.

f) Conclusion

In sum, when analyzing the accounting principles in the U.S. and comparing them to those in Europe, especially in Germany, one can say that the U.S. principles have a different addressee, a different aim, and a different legal approach. The US-GAAP is addressed to investors and wants to protect investors, as opposed to debtees, who are the main addressees of German law. As a consequence, the US-GAAP are intended more to provide information for investors, while the German rules are intended to calculate the capital gains as precisely as possible for distribution.⁶⁶⁹ Here, the

⁶⁶⁶ *Born*, Rechnungslegung international (1997) 208.

⁶⁶⁷ *Born*, Rechnungslegung international (1997) 208.

⁶⁶⁸ *Born*, Rechnungslegung international (1997) 211 et seq; *Buchholz*, Internationale Rechnungslegung³ (2003) 37.

⁶⁶⁹ *Buchholz*, Internationale Rechnungslegung³ (2003) 38.

U.S. approach is similar to the UK's approach, with its stewardship code. However, the legal approach to rule accounting and corporate governance is reversed: while in the U.S. the accounting rules are soft law and the corporate governance rules are hard law, in the EU the corporate governance rules are – mainly – soft law and the accounting rules hard law. Although, of course, there are differences between the different Member States.

E. Comparative Analysis and Evaluation of the Corporate Governance Concept

Company regulation traditionally consists of company laws, accounting standards, and – for listed companies – stock exchange rules, which have been amended recently by corporate governance codes⁶⁷⁰. In practice, there are differences between default rules, which can be contracted out of, and mandatory rules, which cannot⁶⁷¹. Together default and mandatory rules form the regulatory framework in which companies operate. The different countries' legislatures use varying combinations of these rules, based on the different legal, social, and economic systems, institutional conditions, and traditions⁶⁷² in each country, according to what seems best to them for their national economy. This way, different systems of corporate governance have emerged⁶⁷³. The question is: is one system better? And if so, should it be adopted in other countries? However, it is important to recognize that adopting an entire system of corporate governance would be nearly impossible. In any case, it would likely not be effective, as corporate governance standards have developed based on different cultural, political, and economic fundamentals that are specific to each country⁶⁷⁴. Reforms would be certain to fail if implemented without understanding the unique combination of economic, legal, and social determinants of corporate governance functions in each country⁶⁷⁵. Only specific parts of one system may fit another. The aim of

⁶⁷⁰ *Tricker*, Corporate Governance (2009) 145.

⁶⁷¹ *Johnston*, EC Regulation of Corporate Governance (2009) 37.

⁶⁷² *Grundsatzkommission Corporate Governance*, Code of Best Practice, DB 2000, 238; *Schneider*, DB 2000, 2413 (2415); *Wolff*, Wash.U. Global Stud. L. Rev. 2004, 115 (117).

⁶⁷³ *Tricker*, Corporate Governance (2009) 9.

⁶⁷⁴ *Monks/Minow*, Corporate Governance (1995) 270 et seq.

⁶⁷⁵ *Hopt*, Am. J. Comp. L. 2011, 1 (6).

comparative corporate governance is to determine which aspects of corporate governance are appropriate to export to other nations.

I. Differences

The Sarbanes-Oxley Act of 2002 reinforced the crucial distinction between the regulation of corporate governance in the U.S. and in most other countries. The European Union and its Member States tend to use the comply-or-explain principle, (in Australia also called the “if not, why not?”-approach), but SOX underlines the U.S. American mandatory rule approach⁶⁷⁶. Two primary influences can be found that account for those fundamental differences in corporate governance: context and culture⁶⁷⁷.

1. Patterns of Ownership

First, different patterns of ownership should be examined⁶⁷⁸. The following table shows a balance of listed company ownership⁶⁷⁹:

Country	Individuals	Institutional Investors	Banks and governments	Holding company	Foreign
Australia	20 %	34 %	4 %	11 %	31 %
Canada	15 %	38 %	8 %	14 %	25 %
France	23 %	12 %	14 %	14 %	37 %

⁶⁷⁶ *Tricker, Corporate Governance (2009) 158, 166.*

⁶⁷⁷ *Tricker, Corporate Governance (2009) 21, 181; Salacuse in Norton/Rickford/Kleineman, Corporate Governance Post-Enron (2006) 433 (434).*

⁶⁷⁸ *Banzhaf, Die Entsprechenserklärung der SE (2009) 28 et seq.*

⁶⁷⁹ *Tricker, Corporate Governance (2009) 182; see also Jungbluth, ZEIT 3.2.2011, 31.*

Germany	17 %	15 %	17 %	39 %	12 %
Italy	18 %	14 %	40 %	18 %	10 %
Japan	20 %	21 %	23 %	28 %	8 %
Sweden	23 %	30 %	8 %	9 %	30 %
Netherlands	14 %	21 %	1 %	23 %	41 %
UK	19 %	58 %	5 %	2 %	16 %
USA	51 %	41 %	3 %	0 %	5 %

The differences between the different markets are eye-catching: in the USA and the UK⁶⁸⁰ dispersed ownership, characterized by strong securities markets, rigorous disclosure standards, high share turnover, and high market transparency⁶⁸¹, is widespread. In other markets, like Germany, equity capitalization is comparatively low⁶⁸² and either the impact of foreign investors is much higher or companies tend to be dominated by block holders. Boards are therefore obliged to respond to different groups of shareholders when managing a company. A dominant shareholder may have different expectations than a small investor, and the communication between management and the shareholder may vary as a result. Shareholdings that are held for strategic reasons, e.g. by banks or insurance companies in Germany, are not intended to be traded. They therefore reduce the volume of shares available for trade⁶⁸³. In the case of strategic shareholding, influence is exercised by voice, rather than by exit. One must also remember, that banks that are shareholders, representa-

⁶⁸⁰ Or at least "semi-dispersed" ownership, as Davies puts it, meaning that there is neither complete dispersal, nor high concentration, *Davies*, *GesRZ* 2002, 14; *Brändle*, *Corporate Governance* (2004) 23ff, 86; *Wymeersch* in *Hopt/Kanada/Roe/Wymeersch/Prigge*, *Comparative Corporate Governance* (1998) 1170 et seqq, 1176; *Salacuse* in *Norton/Rickford/Kleineman*, *Corporate Governance Post-Enron* (2006) 433 (436).

⁶⁸¹ *Coffee* in *Norton/Rickford/Kleineman*, *Corporate Governance Post-Enron* (2006) 5.

⁶⁸² *Schanz*, *Börseneinführung*³ (2007) § 3 para 3; *Smerdon*, *Corporate Governance* (2004) para 22.005; *Davies A.*, *Best Practice in Corporate Governance* (2007) 82; *Wymeersch* in *Hopt/Kanada/Roe/Wymeersch/Prigge*, *Comparative Corporate Governance* (1998) 1168 et seq, 1176; *Stoltenberg/Lacey/George/Cuthbert*, *Am. J. Comp. L.* 2005, 457 (487).

⁶⁸³ *Monks/Minow*, *Corporate Governance* (1995) 291; *Krackhardt*, *Vict. U. Wellington L. Rev.* 2005, 319 (347).

tives of other shareholders, and creditors may have certain conflicts of interest⁶⁸⁴. Thus ownership patterns can have an essential influence on how a company is run and how powerful a board is⁶⁸⁵. In cases of concentrated ownership, the board must work as a counterpart to controlling shareholders. In cases of dispersed ownership, it must work as a counterpart to strong management⁶⁸⁶.

2. Markets of Corporate Control

A second contextual difference emerges from the existence (or non-existence) of active markets for corporate control⁶⁸⁷. In markets where merger and acquisition activity is widespread, boards are controlled by the threat of a hostile takeover bid, which could lead to a loss of control. In countries with a low proportion of external investors, M&A activities are rare and thus do not impose an effective form of external control that could influence the management of a company⁶⁸⁸. Although a hostile takeover could happen, its threat is not strong enough to effectively influence the behavior of management.

3. Financing

⁶⁸⁴ *Monks/Minow*, Corporate Governance (1995) 293.

⁶⁸⁵ *Tricker*, Corporate Governance (2009) 182.

⁶⁸⁶ *Owen/Kirchmaier/Grant* in *Owen/Kirchmaier/Grant*, Corporate Governance in the US and Europe (2006) 11; *Krackhardt*, Vict. U. Wellington L. Rev. 2005, 319 (321 et seq, 324); *Steen*, Stan. J. L. Bus.&Fin. 2006, 386 (404 et seq).

⁶⁸⁷ See above B.II.4.

⁶⁸⁸ *Tricker*, Corporate Governance (2009) 182 et seq.

Third, the financing of an enterprise⁶⁸⁹ can influence its management and governance system. The difference between market orientation and industry-bank-alliance, the so-called outsider/insider system, coins the corporate governance system⁶⁹⁰. Where large equity markets with high liquidity exist, shareholdings are widespread, and the power lies with the voting shareholders that flexibly invest in different companies. Where stock markets are small, companies tend to be financed by non-equity loan capital, which leads to a greater influence of the lender, often a bank⁶⁹¹, that might be more risk-averse than an investor with entrepreneurial spirit.

This point is also connected to the abovementioned ownership patterns. If shareholdings are widespread, and institutional investors have greater influence, there is a stronger demand for disclosure, as investors need more and better information to make their investment decision. Banks, in contrast, can receive the required information directly from the enterprise that applies for a loan, for example, and do not depend on mandatory disclosure. Thus, the optimal level of disclosure⁶⁹² would be higher in the USA, than, e.g. in Germany. From this fact, one could gather that rule-based mandatory disclosure is more important in the USA than in Germany, where disclosure based on a comply-or-explain code would be sufficient.

4. Behavior of Directors

⁶⁸⁹ *Banzhaf*, Die Entsprechenserklärung der SE (2009) 28.

⁶⁹⁰ *Hopt*, Am. J. Comp. L. 2011, 1 (9).

⁶⁹¹ *Tricker*, Corporate Governance (2009) 183.

⁶⁹² *Fox* in *Hopt/Kanada/Roe/Wymeersch/Prigge*, Comparative Corporate Governance (1998) 715 et seqq.

Finally, the cultural component of corporate governance comes from the behavior of the directors and their relationship to each other within the board. Culture is the socially transmitted behavior patterns, attitudes, norms, and values of a given community⁶⁹³. While in the U.S., the board is seen as a totally independent entity of control, which should have no interest in the company, the German board, for example, is designed as to have multiple interests. It is staffed by persons who have an interest in the company, e.g. employees. The idea is that differences and conflicts of interests are discussed by the board⁶⁹⁴. One can imagine, that discussion and problem-solving strategies will function differently if the board is less homogeneous, if more stakeholders take part in the process, and if more diverse viewpoints are presented.

Therefore, corporate governance rules need to address different problems⁶⁹⁵. Against this background, the possible advantages and disadvantages of the types of rules – strict and soft law – will now be discussed.

II. Advantages and disadvantages

1. Flexibility – Chance or Risk?

The comply-or-explain principle does not force companies to do something, but only recommends a course of action. This approach offers great flexibility. This advantage, which is highly appreciated by boards and investors⁶⁹⁶, leads to more infor-

⁶⁹³ *Salacuse* in *Norton/Rickford/Kleineman*, *Corporate Governance Post-Enron* (2006) 433 (444).

⁶⁹⁴ *Nagel*, *NZG* 2007, 166 (167).

⁶⁹⁵ *Micheler*, *GesRZ* 2002, 47 (50).

⁶⁹⁶ *Steen*, *Stan. J. L. Bus.&Fin.* 2006, 386 (391).

mation in the market, as companies need to decide A) whether to comply or not, and B) how to explain their decisions. Furthermore, it offers the possibility to adapt rules to the individual circumstances of each company⁶⁹⁷, while still responding to the demands of international investors⁶⁹⁸. Principles are more individualized, as they do not have to be applied in an undifferentiated manner, but are also more general, as they do not refer to a specific group at a certain point in time⁶⁹⁹. A “one-size-fits-all”-system does not work for many aspects of corporate governance, e.g. internal controls⁷⁰⁰. In addition, not only the adaption of principles by the companies, but also the process of making the principles is faster and more flexible than the regular legislative procedure⁷⁰¹. In contrast, the inflexible rules-based system leads to a high level of litigation, and directors face an ever-present threat of legal penalties for non-compliance⁷⁰². However, flexibility has been criticized too, since it may create uncertainty⁷⁰³ and may not stop companies from circumventing unpleasant rules⁷⁰⁴. Strict rules, in comparison, offer better comparability and standardization. Furthermore, flexibility is regarded as only theoretical, because market expectations create pressure to conform, and so there is no real decision. The only option is to comply. The powerful influence of the investment community codes, although voluntarily in nature,

⁶⁹⁷ *Tricker*, *Corporate Governance* (2009) 147 et seq; Hommelhoff in *Tison/de Wulf/van der Elst/Steennot*, *Company Law and Financial Regulation* (2009) 269; *Rickford* in *Owen/Kirchmaier/Grant*, *Corporate Governance in the US and Europe* (2006) 27; *Rapp/Schmid/Wolf*, *HHL Research Paper Series* 2011, 18 (18); *Steen*, *Stan. J. L. Bus.&Fin.* 2006, 386 (387).

⁶⁹⁸ *Krackhardt*, *Vict. U. Wellington L. Rev.* 2005, 319 (320).

⁶⁹⁹ *Davies A.*, *Best Practice in Corporate Governance* (2007) 27.

⁷⁰⁰ *Romano* in *Ménard/Ghertman*, *Regulation, Deregulation, Reregulation* (2009) 243 (246).

⁷⁰¹ *Schoenfeld*, *RWZ* 2008, 193 (193 et seq); *Davies A.*, *Best Practice in Corporate Governance* (2007) 16; *Steen*, *Stan. J. L. Bus.&Fin.* 2006, 386 (402).

⁷⁰² *Tricker*, *Corporate Governance* (2009) 184.

⁷⁰³ *Davies A.*, *Best Practice in Corporate Governance* (2007) 17.

⁷⁰⁴ *Krackhardt*, *Vict. U. Wellington L. Rev.* 2005, 319 (330).

could have a significant influence on corporate governance practices⁷⁰⁵. However, a strong culture of deviation could counteract this pressure, if justified non-compliance is a signal for even better corporate governance, since it shows that management thoroughly thought through its decision to deviate⁷⁰⁶. Comply-or-explain thus can encourage companies to take greater responsibility for their actions,⁷⁰⁷ and to take a closer look at possibly out-dated structures⁷⁰⁸. After all, good board performance depends more on personal skills and group dynamics than on formal governance arrangements, and strict laws only have a limited influence here⁷⁰⁹.

A study undertaken in the UK showed that companies that gave no explanations for deviation underperformed the market, while companies that provided detailed explanations for their deviations outperformed even those companies that fully complied with the code⁷¹⁰. Other studies have failed to find any link between independence and improved governance. This does not mean that companies should dispense with independent directors, but only indicates that formal criteria only have limited influence, since independence is an immeasurable state of mind. Thus, giving companies the option to have formally non-independent directors, which may be useful to the company for other reasons, actually helps to improve corporate governance more than a strict rule⁷¹¹.

⁷⁰⁵ *Weil, Gotshal & Manges LLP*, Comparative Study (2002) 2.

⁷⁰⁶ *Werder*, DB 2011, 49 (50); *Banzhaf*, Die Entsprechenserklärung der SE (2009) 89; *Steenot*, Stan. J. L. Bus.&Fin. 2006, 386 (404).

⁷⁰⁷ COM (2011) 164 final 18.

⁷⁰⁸ *Burger/Kalss*, GesRZ 2002, 51 (62).

⁷⁰⁹ *Winter*, The Financial Crisis, DSF Policy Paper 2011, 1 (6 et seq).

⁷¹⁰ *McCahery/ Vermeulen* in *Tison/de Wulf/van der Elst/Steenot*, Company Law and Financial Regulation (2009) 322 (330).

⁷¹¹ *Cosenza*, B.Y.U. L. Rev. 2007, 1 (14 et seqq).

Moreover, the comply-or-explain principle can only be effective, if its standards are accepted and not just box-ticked without real compliance⁷¹². The box-ticking effect was one of the points of critique of strict laws, and was also mentioned in connection with the Sarbanes-Oxley Act⁷¹³. This effect was meant to be avoided by the comply-or-explain approach. Pseudo-acceptance, meaning compliance under pressure without careful and sound application, can never lead to effective quality control⁷¹⁴ and might finally end up with a new law instead⁷¹⁵ and more bureaucracy.

The code system also needs the market to sanction bad corporate governance in order for the system to work. Therefore, transparency is crucial, and thus companies are called to pursue an active policy of communication. Especially soft code recommendations, which need interpretation, require not only the “comply” declaration, but also further explanation on how they are put into practice. Hence, the comply-or-explain system only works if the economic and political forces really support it. It must be accepted and exercised by a strong culture of deviation and an active communication policy. Only then can comply-or-explain offer great advantages for all sides⁷¹⁶.

⁷¹² *Tricker*, Corporate Governance (2009) 147; *Krejci*, in *Lang/Schuch/Staringer*, Soft Law (2005) 53 (57); *Davies A.*, Best Practice in Corporate Governance (2007) XIV, 27, 57, 94.

⁷¹³ SEC, SEC Staff Statement on Management’s Report on Internal Control over Financial Reporting, available at: <sec.gov/info/accountants/stafficreporting.htm>.

⁷¹⁴ *Werder*, DB 2011, 49 (49); *Smerdon*, Corporate Governance (2004) para 1.017.

⁷¹⁵ *Werder*, DB 2011, 49 (50).

⁷¹⁶ *Werder*, DB 2011, 49 (50); *Schneider*, DB 2000, 2413 (2416).

On the other hand, serious explanations from companies need serious action from investors, especially institutional investors. A rules-based approach lays the onus on the legislator, while a principles-based approach lays it on the investors. Shareholder rights and responsibilities are just the two sides of the same coin. Institutional investors in particular need to take their responsibilities seriously and hold boards accountable⁷¹⁷. To enforce the code more efficiently, the UK, for example, implemented a Stewardship Code, which required more action from institutional investors⁷¹⁸, while also placing more trust in shareholders and investors⁷¹⁹. This leads us to the question of the enforceability of these codes.

2. Enforceability

Another important question is: how can a country enforce corporate governance rules, if there is no legal duty to comply? Merely categorizing a certain behavior as desirable or non-desirable would be “platonic” and without “procreativity”. To become a real tool of justice, a code needs to be imperative, according to *Engisch*⁷²⁰.

Based on the assumption that voluntary codes are insufficient to deter those with access to company funds from abusing their position⁷²¹, SOX introduced high personal fines and imprisonment for directors who do not act as the law requires. Thus, SOX

⁷¹⁷ *ICGN*, Second Statement on the Global Financial Crisis, 1.4, 2.1, 4.6.

⁷¹⁸ See above C.II.1.d).

⁷¹⁹ *Anderson*, Duke L.J. 2008,1081 (1099).

⁷²⁰ *Engisch*, Einführung in das juristische Denken¹⁰ (2005) 28.

⁷²¹ *Sheppey/McGill*, Sarbanes-Oxley (2007) 7.

attracts the necessary attention⁷²². However, just because something is forbidden by law does not mean that people do not do it. But, on the other hand, even soft law in the form of corporate governance codes can have a strong practical impact, as described above⁷²³. Through de-facto binding effects, such as market pressure⁷²⁴, lower agency costs⁷²⁵, and legal backing, soft law can impact reality. Therefore, the question of enforceability is not the deciding issue with regard to assessing the comply-or-explain approach versus the rule approach.

3. Soft Law – compatible with Civil Law Systems?

The introduction of soft law via corporate governance codes has been criticized in continental Europe as being out of place in a civil law system. Here, all important rules concerning corporate governance could already be found in the company acts. Therefore, soft law rules would fit better in a common law system with a less restrictive understanding of rules⁷²⁶. However, this opinion was discredited by the Sarbanes-Oxley-Act, which showed that in common law systems, like the U.S., the understanding of rules can be just as strict as in a civil law system. On the other hand, corporate governance codes now exist in all European civil law countries, and their advantages are widely recognized. Their existence is not questioned. Only their arrangement and implementation is examined, as discussed in the previous paragraph.

⁷²² *Smerdon*, Corporate Governance (2004) para 1.018.

⁷²³ See B.V.

⁷²⁴ *Krackhardt*, *Vict. U. Wellington L. Rev.* 2005, 319 (331); *Steen*, *Stan. J. L. Bus.&Fin.* 2006, 386 (396); *Romano* in *Ménard/Ghertman*, *Regulation, Deregulation, Reregulation* (2009) 243 (250).

⁷²⁵ *Rapp/Schmid/Wolf*, HHL Research Paper Series 2001, 18 (18); *Steen*, *Stan. J. L. Bus.&Fin.* 2006, 386 (395); *Jahn/Rapp/Strenger/Wolff*, HHL Research Paper Series 2010, 7 (7).

⁷²⁶ *Birkner/Löffler*, *Corporate Governance in Österreich* (2004) 37.

4. Financial and bureaucratic burden

When SOX was enacted in the United States, it was soon criticized for making U.S. capital markets uncompetitive. The prior system seemed to balance transparency and disclosure against unnecessary and costly bureaucracy⁷²⁷. However, corporate governance scandals showed that this bureaucracy was actually necessary, and the system was not as balanced as it seemed. Still, SOX is criticized. On the one hand, there were huge compliance costs⁷²⁸. Not only were there start-up costs for establishing new procedures, but there were also on-going costs for maintaining those procedures. On the other hand, companies tried to avoid the new obligations, which was a route primarily possible for foreign companies which could simply delist from U.S. stock exchanges⁷²⁹. For the remaining companies, the benefits of the act came at a significant cost. SOX created massive bureaucratic procedures, especially for smaller companies⁷³⁰, which often valued form over substance⁷³¹. This forced boards to spend more time on process instead of business⁷³², and prevented managers from taking necessary risks⁷³³. Moreover, the expectation that corporate governance systems would converge internationally, and countries would be on an equal playing

⁷²⁷ *Tricker*, *Corporate Governance* (2009) 156.

⁷²⁸ *Brändle*, *Corporate Governance* (2004) 51 et seq; *Sheppey/McGill*, *Sarbanes-Oxley* (2007) 15, 93, 98.

⁷²⁹ *Tricker*, *Corporate Governance* (2009) 158; *Mossos*, *Currents: Int'l Trade L.J.* 2004, 9 (10); *Stoltenberg/Lacey/George/Cuthbert*, *Am. J. Comp. L.* 2005, 457 (470); *Möllers*, *ECFR* 2007, 173 (193); *Anderson*, *Duke L.J.* 2008, 1081 (1081); *Ford*, *Am. Bus. L.J.* 2008, 1 (1); *Romano* in *Mé-
nard/Ghertman*, *Regulation, Deregulation, Reregulation* (2009) 243 (244).

⁷³⁰ *Steen*, *Stan. J. L. Bus.&Fin.* 2006, 386 (392).

⁷³¹ *Bost*, *The Sarbanes-Oxley Act* (2003) 46.

⁷³² *Smerdon*, *Corporate Governance* (2004) para 1.018.

⁷³³ *Wade*, *Loy.U.Chi.L.J.* 2008, 595 (596).

field,⁷³⁴ was not fulfilled completely. As discussed, the EU retains the comply-or-explain principle, which is preferred by many companies⁷³⁵. The argument that better internal controls can positively effect the efficiency of operations and reduce the likelihood of theft and incompetence⁷³⁶ has not been born out, since those positive effects can be attained by a principles-based system, too. Some fear that the vitality of the U.S. financial system could be damaged by excessive regulation⁷³⁷, since SOX was not cost-effective⁷³⁸.

5. More Information or Better Information?

The starting point of the corporate governance discussion is the principal-agent-conflict, which is based on the information asymmetry between the principal (here: shareholders, investors) and the agent (here: management)⁷³⁹. An essential part of corporate governance rules – either laws or codes – is providing more information to capital markets. However, more information does not always mean better information. In this regard, codes have a serious advantage, since optional disclosure leads to higher quality of information than mandatory disclosure requirements.

If information disclosure is required by law, the provision can either generally state that all relevant information needs to be disclosed, which may lead to information

⁷³⁴ *Holt*, Sarbanes-Oxley Act (2009) 75.

⁷³⁵ *Holt*, Sarbanes-Oxley Act (2009) 83.

⁷³⁶ *Holt*, Sarbanes-Oxley Act (2009) 76.

⁷³⁷ *Owen/Kirchmaier/Grant* in *Owen/Kirchmaier/Grant*, Corporate Governance in the US and Europe (2006) 18; *Gilmore*, *Loy. CLR* 2011, 101 (114).

⁷³⁸ *Steen*, *Stan. J. L. Bus.&Fin.* 2006, 386 (386).

⁷³⁹ See B.II.3.

overload because companies might be tempted to disclose as much information as possible, just to be on the safe side. Or the law may list exactly what information has to be disclosed in an exhaustive list. This latter approach creates the risk that the list is not complete or does not comprise the information required by the capital market. These requirements may change and due to the lag in legislation procedures, a law might not be flexible enough to react promptly. Both alternatives lead to more, but not necessarily better, information⁷⁴⁰. The result is an information overload that foils the initial concept⁷⁴¹.

Optional disclosure, on the other hand, tends to result in the disclosure of required and necessary information, but it avoids the information dump. If disclosure is voluntary, then companies have an interest in disclosing the information required by the market instead of boiler-plate declarations⁷⁴², since investors would assume that non-disclosing companies are of lower quality than disclosing companies. Thus, the companies with the best information will not hesitate to disclose it, and thereby put pressure on its competitors to disclose the same information⁷⁴³. The disclosure process will continue until the optimal disclosure level is reached and the market has obtained exactly the appropriate kind and amount of information⁷⁴⁴. This is also important insofar as information not only has to be received by investors, but must be also processed by them. Too much information leads to unnecessary high processing costs, or to incomplete information processing. This overabundance could lead to unwise

⁷⁴⁰ *Brändle*, Corporate Governance (2004) 50.

⁷⁴¹ *Martin*, NZG 2003, 948 (952).

⁷⁴² *Ford*, Am. Bus. L.J. 2008, 1 (8, 19, 30).

⁷⁴³ *Ford*, Am. Bus. L.J. 2008, 1 (41).

⁷⁴⁴ *Brändle*, Corporate Governance (2004) 48 et seqq.

investment decisions⁷⁴⁵. This is because more information can improve the precision of estimations, but also may increase the rate of errors⁷⁴⁶ since people have limited cognitive abilities to process information⁷⁴⁷. This also applies to institutional investors, even if they might be in the position to process information more efficiently than small investors.

F. Conclusions and Proposals

I. Summary of the Corporate Governance Development

During the last decades, a strong, global discussion of corporate governance has emerged. This conversation has led to a change, on both sides of the Atlantic, from the Management Model to the Monitoring Model⁷⁴⁸. This means the focal point of discussion is no longer management itself, but how it is controlled. Due to a comprehensive process of globalization, corporate governance systems have converged too⁷⁴⁹. In Germany, for example, the level of ownership concentration has fallen over the last years, and cross-holdings have started to dissolve. Meanwhile, in the U.S., the separation of the roles of CEO and Chairman of the Board, the introduction of committees, and the increasing number of non-executive directors, has led to move-

⁷⁴⁵ *Brändle*, Corporate Governance (2004) 52.

⁷⁴⁶ *Brändle*, Corporate Governance (2004) 54.

⁷⁴⁷ *Brändle*, Corporate Governance (2004) 56.

⁷⁴⁸ *Davis*, U.S. Corporate Governance, FS *Raiser* 49 (50).

⁷⁴⁹ *Monks/Minow*, Corporate Governance (1995) 270 et seq; *Schoenfeld*, RWZ 2008, 193 (197); *Brändle*, Corporate Governance (2004) 88; *Tricker*, Corporate Governance (2009) 208 et seqq.

ment towards the two-tier system⁷⁵⁰. This convergence is driven by market forces, which react to the needs of large enterprises. The convergence of financial accounting standards and practices has facilitated cross-border activities, the continuing integration of financial markets and international mergers, and the growing influence of institutional investors on corporate governance standards on both sides of the Atlantic⁷⁵¹.

However, one must distinguish between the convergence of problems and the convergence of systems. The Cadbury Report of 1992, the first report on corporate governance, and thus the spark for the corporate governance discussion around the world, contained five important requests⁷⁵²:

- a wider use of independent non-executive directors
- the introduction of an audit committee on the board
- the division of responsibilities between chairman of the board and CEO
- the introduction of a remuneration committee of the board
- the introduction of a nomination committee

Although this report was issued over twenty years ago, its proposals still are relevant. These ideas form the core of the corporate governance discussion even today, no matter if that discussion occurs in a country ruled by code, or one ruled by law. These proposals arise in both systems, and therefore are discussed and tackled in

⁷⁵⁰ *Brändle*, Corporate Governance (2004) 89 et seq.

⁷⁵¹ *Brändle*, Corporate Governance (2004) 93 et seqq.

⁷⁵² *Tricker*, Corporate Governance (2009) 147.

both systems⁷⁵³. By now, the most economically significant countries have published some form of corporate governance guidelines, recommendations, or principles⁷⁵⁴. But nevertheless, one should not forget that we are still talking about two fundamentally different systems⁷⁵⁵. Different starting points have led to the development of different risks and different solutions⁷⁵⁶. One system cannot simply be implemented in another, due to potential compatibility barriers⁷⁵⁷. On the contrary: one could draw the conclusion that each system has its advantages and disadvantages, but nevertheless fits in its environment and has a right to exist, since after years of market competition, each system still exists⁷⁵⁸. Since no system can be regarded as perfect, and each system is equally valid in its context, mutual recognition is the best solution⁷⁵⁹. However, as shown above, the comply-or-explain system has some distinct advantages with regard to flexibility, cost effectiveness, and information quality. Furthermore, with codes, a juridification⁷⁶⁰ can take place: with codes, a kind of “parallel company law” developed, which often was later integrated into the company acts⁷⁶¹. Thus, soft law can also be a trial run and form the basis for future laws. Self-

⁷⁵³ *Owen/Kirchmaier/Grant* in *Owen/Kirchmaier/Grant*, *Corporate Governance in the US and Europe* (2006) 2; *Shu-Acquaye*, *Hous. J. Int'l L.* 2007, 583 (585 et seq).

⁷⁵⁴ *Tricker*, *Corporate Governance* (2009) 151 et seqq.

⁷⁵⁵ *Theisen*, *DB* 2011 M1 (M1).

⁷⁵⁶ *Owen/Kirchmaier/Grant* in *Owen/Kirchmaier/Grant*, *Corporate Governance in the US and Europe* (2006) 6; *Coffee* in *Norton/Rickford/Kleineman*, *Corporate Governance Post-Enron* (2006) 4, 18.

⁷⁵⁷ *Wolff*, *Wash.U. Global Stud. L. Rev.* 2004, 115, 124.

⁷⁵⁸ *Hansen* in *Tison/de Wulf/van der Elst/Steannot*, *Company Law and Financial Regulation* (2009) 150.

⁷⁵⁹ *Shu-Acquaye*, *Hous. J. Int'l L.* 2007, 583 (623); *Tricker*, *Corporate Governance* (2009) 374 et seq.

⁷⁶⁰ *Wymeersch* in *Hopt/Kanada/Roe/Wymeersch/Prigge*, *Comparative Corporate Governance* (1998) 1069.

⁷⁶¹ E.g. in Germany, where new Code of Corporate Governance also served as preparation for the stock corporation act reform in 2002, *Hopt*, *GesRZ* 2002, 4; for Germany or Spain see also: *Arlt/Bervoets/Grechenig/Kalss*, *GesRZ* 2002, 64 (66, 68); for the UK: *Owen/Kirchmaier/Grant* in *Owen/Kirchmaier/Grant*, *Corporate Governance in the US and Europe* (2006) 26 et seq; *Davies*, *GesRZ* 2002, 14 (18).

regulation can serve as an experiment for corporate governance solutions by supplementing existing laws or introducing new international standards⁷⁶². Codes and laws, private and governmental initiatives are intersecting and sometimes contradictory. There is always a need for further readjustment and combination⁷⁶³. In this regard, starting corporate governance from a soft law code can be advantageous. Of course, the system is not perfect. It has its deficiencies, as shown in the Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States⁷⁶⁴, and it needs further refinement, such as in the UK with the introduction of the Stewardship Code⁷⁶⁵. Also, the reforms which try to strengthen shareholder rights are meant to increase shareholder activism, which is the basis for the comply-or-explain principle and the information-based shareholder economy⁷⁶⁶. But as long as a corporate governance code fulfills four principles, it should be successful: it should be lean, clear, flexible, and differentiated, because those criteria give it its superiority over the law⁷⁶⁷. As described above, the U.S. system also includes some soft law features. As *Cheryl L. Wade* puts it: “The value of SOX lies in the principles underlying the Act rather than in the Act’s corporate governance details.”⁷⁶⁸

II. A Stewardship Code for Europe?

⁷⁶² *Hopt*, Am. J. Comp. L. 2011, 1 (66); *Burger/Kalss*, GesRZ 2002, 51 (62).

⁷⁶³ *Hopt*, Am. J. Comp. L. 2011, 1 (67); *Arlt/Bervoets/Grechenig/Kalss*, GesRZ 2002, 64 (80).

⁷⁶⁴ See C.I.4.b).

⁷⁶⁵ See C.II.1.b).

⁷⁶⁶ *Bieling/Steinhilber*, ZIB 2002, 39 (39, 60).

⁷⁶⁷ *Hopt*, GesRZ 2002, 4 (9 et seq).

⁷⁶⁸ *Wade*, Loy.U.Chi.L.J. 2008, 595 (606).

As we have seen, the comply-or-explain system as implemented within the European Union has remarkable advantages and has been widely accepted by politicians, companies, and investors. However, it also has its weaknesses, especially with regard to investors' engagement. This approach of information and transparency is strongly dependent on investors who participate actively and use the rights they have been awarded. However, not every investor, particularly not a small investor, has the capacity to act in this way, and those who have this capacity, often still do not engage as strongly as they could. Therefore, the comply-or-explain approach of requesting companies to refer to a code of best practices should be complemented by a code of best practices for institutional investors. The latter code should motivate those investors who have the resources to use their shareholders' rights to do so and should serve as a means of enforcement for company best practices. Again, the United Kingdom has pioneered this role⁷⁶⁹.

1. First initiatives

a) The EFAMA Code for external governance

In 2011, the European Fund and Asset Management Association (EFAMA)⁷⁷⁰ issued a "Code for external governance"⁷⁷¹ based on investor responsibility. As investors have the duty to act as fiduciaries for their clients in exercising their shareholders'

⁷⁶⁹ See above C.II.1.d).

⁷⁷⁰ See <efama.org>.

⁷⁷¹ Available at: <efama.org/Publications/Public/Corporate_Governance/11-4035%20EFAMA%20ECG_final_6%20April%202011%20v2.pdf>.

rights, they should be encouraged to have to have a policy on how they exercise those shareholders' rights⁷⁷². The purpose of this code is to act as a catalyst for the engagement of institutional investors with the companies they invest in, to support interaction between investors and companies, and to ensure a strong link between investment governance and investment process⁷⁷³. The code consists of six principles and is based on the comply-or-explain system and – according to its own words – “relies upon judgement rather than prescription” to give investors the possibility to apply the principles in a way that reflects their specific circumstances⁷⁷⁴.

These principles reflect the whole extent that comprises a responsible investment based on transparency and information, as required by the comply-or-explain approach to work:

First, investors should have a documented policy available to the public on whether, and if so how, they exercise their ownership responsibilities⁷⁷⁵. Second, investors should monitor their investee companies⁷⁷⁶. Third, they should establish clear guidelines on when and how they will intervene with investee companies to protect and enhance value⁷⁷⁷. Fourth, they should consider cooperating with other investors⁷⁷⁸. Fifth, they should exercise their voting rights according to an adequate and effective

⁷⁷² EFAMA, Code for external governance 2.

⁷⁷³ EFAMA, Code for external governance 2.

⁷⁷⁴ EFAMA, Code for external governance 2.

⁷⁷⁵ EFAMA, Code for external governance 3.

⁷⁷⁶ EFAMA, Code for external governance 4.

⁷⁷⁷ EFAMA, Code for external governance 5.

⁷⁷⁸ EFAMA, Code for external governance 6.

policy⁷⁷⁹, and finally, they should report on their exercise of ownership rights and voting activities⁷⁸⁰. Every principle is accompanied by a best practice recommendation, explaining how the principle can be implemented in a useful way.

These principles form a circle: investors need to set up guidelines on how to invest, act according to those principles, and then report on those actions. The application of the guidelines may show weaknesses which lead to an amendment of the guidelines and the circle can start again. This way, the investment governance will improve and will consequently improve the corporate governance of the investee companies too, as that is the final goal of the whole exercise.

b) The Action Plan on European Company Law and Corporate Governance – a modern legal framework for more engaged shareholders and sustainable companies⁷⁸¹

The action plan “Modernizing Company Law and Enhancing Corporate Governance in the EU”⁷⁸² of 2003 proposed several actions which have been implemented and applied. However, the EU seeks to further improve the business environment and detected some defects⁷⁸³:

“In particular, there is a perceived lack of shareholder interest in holding management accountable for their decisions and actions, compounded by the fact that many shareholders appear to hold their shares for only a short period of time.”

⁷⁷⁹ EFAMA, Code for external governance 6.

⁷⁸⁰ EFAMA, Code for external governance 7.

⁷⁸¹ COM(2012) 740 final.

⁷⁸² See C.I.1.

⁷⁸³ COM(2012) 740 final 3.

Thus, three main areas of action have been proposed: improving transparency, basing transparency on a stronger engagement of the shareholders, and, finally, supporting company growth and competitiveness in general. The first and second areas will be explained in more detail, as they are the most relevant for this thesis.

(1) Enhancing Transparency

Here especially, the transparency rules for institutional investors should be strengthened. They should publish their voting policies, in particular, information about voting and engagement. This could foster investor awareness, optimization of investment decisions, dialogue between investors and companies, and shareholder engagement. Transparency could thus finally lead to stronger accountability of companies to civil society⁷⁸⁴.

(2) Engaging Shareholders

A corporate governance system based on the comply-or-explain approach depends heavily on engaged shareholders. The companies – and institutional investors – are required to provide all necessary information, but that is only the first step to making shareholders more engaged. Here, the relationship between investor cooperation on corporate governance issues and the “acting in concert” concept should be clarified to make these concepts more accessible to shareholders⁷⁸⁵. Otherwise, cooperation

⁷⁸⁴ COM(2012) 740 final 8.

⁷⁸⁵ COM(2012) 740 final 11; for the problematic situation in Germany see § 30 II WpÜG and *Siller*, Kapitalmarktrecht (2006) 115 et seqq.

could be hindered, leading to free-rider behavior and short-term engagement, two behavior patterns that should be prevented.

c) The European Commission informal discussion concerning the initiative on shareholder engagement

Based on the Action Plan on European Company Law and Corporate Governance⁷⁸⁶, the European Commission undertook several measures. Furthermore, it encouraged an informal discussion with several stakeholders, such as asset owners, asset managers, consultants, stock exchanges, etc., to stimulate the reflection process on shareholder engagement. The outcomes concentrated around six focal points, of which the first three are of special interest for this work:

(1) Shareholder Engagement⁷⁸⁷

Nearly all involved stakeholders agreed that shareholder engagement often has been insufficient and should be further fostered. The following reasons were given for the lack of engagement: 1) the free rider problem; 2) strongly diversified portfolios of institutional investors which help to minimize risks, but make it more difficult to get engaged; 3) lack of financial literacy among institutional investors and increasing complexity of financial instruments, and 4) weak shareholder rights. The last aspect is where the leverage should be placed. However, it was recommended to subject shareholders to certain obligations, similar to the ones in the UK Stewardship Code,

⁷⁸⁶ See F.II.1.b).

⁷⁸⁷ *European Commission*, Summary of the informal discussion concerning the initiative on shareholder engagement 3.

in exchange for more rights. Such a code could also lead to competition between investors by setting up an acknowledged standard and thereby creating a certain demand by the market.

(2) “Long-term” Shareholder Engagement⁷⁸⁸

The discussion led to the conclusion that shareholder engagement should be assessed qualitatively, not quantitatively. However, the typical demand for concentration on long-term engagement was called into questions for two reasons: first, short-term investments might be in the interest of the clients of institutional investors. Thus, they were obliged to engage in short-term investments to fulfill their fiduciary duties. Second, the effectiveness of long-term engagement is difficult to prove, due to other influences. Therefore, a simple call for more long-term engagement is not regarded as constructive. Hence, the third point comes to the fore.

(3) Transparency of voting policies and engagement policies⁷⁸⁹

Institutional investors should not simply be required to engage in long-term investments, but they should make their investment decisions and voting policies transparent and understandable. A short-term investment, for example, could be useful, but investors should provide an explanation for it. Based on this consideration, the involved stakeholders proposed a disclosure on a comply-or-explain basis. Because

⁷⁸⁸ *European Commission*, Summary of the informal discussion concerning the initiative on shareholder engagement 4.

⁷⁸⁹ *European Commission*, Summary of the informal discussion concerning the initiative on shareholder engagement 4 et seq.

mandatory disclosure could have a negative impact by forcing investors to vote. Votes could therefore be cast without consideration, leading to a low quality decision. This could increase the influence of proxy advisors.

d) Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement⁷⁹⁰

The proposal forms part of a package of measures to improve corporate governance within the EU. It is accompanied by a commission recommendation on the quality of corporate governance reporting⁷⁹¹ and has the following content:

(1) Political and Economical Environment

According to the EU Commission, corporate governance in the EU has two main problems: insufficient integration of shareholders and scarce transparency. Thus, the directive on shareholders' rights should be revised to offer shareholders a longer perspective and therefore to improve working conditions for listed companies⁷⁹².

Aims to be achieved are:

- Stronger engagement of investors in the companies they invest in

⁷⁹⁰ COM(2014) 213 final.

⁷⁹¹ Rec 2014/208/EU.

⁷⁹² COM(2014) 213 final 2.

- Better connection between remuneration and performance of directors
- Higher transparency of transactions between associated companies and persons
- Reliability and quality of advice of proxy advisors
- Better transmission of cross-border information⁷⁹³

These aims and proposals are based on the knowledge that 44% of the shares of listed companies are held by foreign investors, mostly institutional ones. Consequently, measures have to take aim at these investors. Only common measures on EU level can ensure common standards⁷⁹⁴.

(2) Results of the Consultation

The Commission issued several Green Papers on the topic⁷⁹⁵, took advice from the European Corporate Governance Forum, and kept contact with all kinds of stakeholders. They all argued for more transparency and shareholder control regarding director remuneration, better control of asset managers, more transparency for proxy advisors, and stricter rules for related party transactions. Furthermore, according to the Commission, voting policies of institutional investors should be made public and

⁷⁹³ COM(2014) 213 final 2 et seq.

⁷⁹⁴ COM(2014) 213 final 3.

⁷⁹⁵ 2010 Green Paper on corporate governance in financial institutions and remuneration policies, COM(2010) 284 final; 2011 Green Paper on the EU corporate governance framework, COM(2011) 164 final; Green Paper on the long-term financing of the European economy, COM(2014) 150 final.

investments should be made more efficient by making information more easily available and by facilitating cross-border voting⁷⁹⁶.

Five main problems have crystallized during the consultation process:

First, institutional investors are accused of showing insufficient engagement. Companies are supervised suboptimally by institutional investors, who frequently base their investment decisions on short-term share price movements, in opposition of the long-term interest of their clients. This is often caused by quarterly evaluation of investments that lead asset managers to make short-term decisions.⁷⁹⁷

Second, remuneration and performance of directors are said to be linked insufficiently. Stronger shareholder control should hinder remuneration strategies that reward directors, but do not lead to long-term company performance. However, the information available in this context is mostly insufficient, unclear, or hardly comparable. Shareholders do not have the means to assess it.⁷⁹⁸

Third, shareholders have neither sufficient information, nor sufficient means of action to counteract related parties transactions.⁷⁹⁹

⁷⁹⁶ COM(2014) 213 final 4.

⁷⁹⁷ COM(2014) 213 final 5.

⁷⁹⁸ COM(2014) 213 final 5.

⁷⁹⁹ COM(2014) 213 final 5 et seq.

Fourth, despite their importance for cross-border transactions and their influence on the voting behavior of shareholders, proxy advisors do not make sufficiently clear how they base their advice and how independent and objective that advice is.⁸⁰⁰

Fifth, shareholders face severe difficulties in executing their rights, especially when it comes to intermediate holding chains. Here, systems often do not allow shareholders to identify the investors, forward information late, or price discriminate against investors at cross-border transactions.⁸⁰¹

(3) Content of the Proposal

Despite the principle of subsidiarity on which all EU measures are based, the commission proposes EU-wide measures, as the capital markets are no longer national, but European or even international. Institutional shareholders, asset managers, and proxy advisors work on an international basis. The above mentioned problems thus cannot be tackled effectively on a national basis. Different rules in the different Member States would lead to different levels of transparency and shareholder protection. Information asymmetries can affect shareholders and hinder cross-border transactions and investments. However, to offer the highest possible level of flexibility, for the Member States and for the undertakings, the commission proposes the directive as a legal means in this regard and to further employ the comply-or-explain approach. This offers a balance between flexibility and harmonization.⁸⁰²

⁸⁰⁰ COM(2014) 213 final 6.

⁸⁰¹ COM(2014) 213 final 6.

⁸⁰² COM(2014) 213 final 7 et seq.

The proposal tries to reach these aims without creating disproportionate burdens by using the following options:

First, institutional investors need to be more transparent with regard to their investment and voting policies. Articles 3 f-h of the proposal require institutional investors to elaborate on their policy on how they will integrate shareholders in their decision, to disclose how their strategy was adapted to profile and term of their investments, and to discuss how it contributed to the mid- and longterm development of their investments. Furthermore, asset managers will need to explain semi-annually if and how their strategy complies with the institutional investor's one.⁸⁰³ In particular, the elaboration of the engagement policy (Article 3f) will lead investors to reflect thoroughly on how they interact with the shareholders, and with the undertakings they invest in, since investors will need to explain how they supervise the target company and how they handle actual or potential conflicts of interest.

Second, the proposal aims at introducing more transparency with regard to the remuneration policy for directors⁸⁰⁴. More transparency and improved supervision should lead to a better link between pay and performance. Here, the amount of the remuneration is not regulated, only the way it is determined. According to articles 9a and 9b, shareholders should receive detailed and user-optimized information about remuneration schemes and policy. This creates the basis for the right to approve the remuneration policy and to vote on the remuneration report.⁸⁰⁵

⁸⁰³ COM(2014) 213 final 9, 22 et seqq.

⁸⁰⁴ *Zetsche*, NZG 2014, 1121 (1128).

⁸⁰⁵ COM(2014) 213 final 9 et seq, 25 et seqq.

Third, to counteract related parties transactions⁸⁰⁶ that might harm shareholders' interests, transactions with related parties that concern more than 5% of company assets or that might have serious effects on profits or sales, need to be approved by the shareholders. Smaller transactions, those that concern at least 1% of the company asset, need to be disclosed publicly. To hinder excessive administrative costs, exceptions are provided for transactions between companies and members of its group, and for recurrent transactions.⁸⁰⁷

Fourth, proxy advisors will need to take measures to make sure their advice is correct and reliable, and to avoid their advice from being improperly influenced by conflicts of interest. As proof, proxy advisors need to disclose relevant information on their webpage according to Article 3i.⁸⁰⁸

Finally, it should be easier for shareholders to execute their rights. Thus, it must be possible for companies to identify their shareholders via financial intermediaries⁸⁰⁹. The intermediaries need to disclose names and contact data of the shareholders immediately, and, in case of legal entities, they should also disclose the legal entity identifier. If a company does not communicate directly with its shareholders, the relevant information must be communicated to them by the intermediary. According to Article 3c, the intermediaries also need to facilitate the execution of shareholders

⁸⁰⁶ *Zetsche*, NZG 2014, 1121 (1126).

⁸⁰⁷ COM(2014) 213 final 10, 28 et seq.

⁸⁰⁸ COM(2014) 213 final 10, 25.

⁸⁰⁹ *Zetsche*, NZG 2014, 1121 (1122).

rights by making it possible for them to vote in person or via a third person during the general annual meeting or by voting for them according to their decision.⁸¹⁰

(4) Criticism

The proposal has been criticized by academia. The critiques concentrate on four areas:

First, the identification of shareholders via the “chain-model”, which requires all information and data to be sent from the issuer via the sub-custodian to the shareholder and back, is alleged to be error-prone. A “direct-model” that allows custodian banks to contact the issuer directly for the shareholders is regarded as more practicable. *Zetsche* proposes to include a “combination-model” in the recommendation, which would allow more flexibility to the Member States.⁸¹¹

Second, the alleged passivity of institutional investors that tend to act with short-term interest is based on the idea that the short-term interests of institutional investors are in conflict with the long-term interests of the companies. However, though investors need to keep their clients best interests in mind, which can be a short-term interest, an efficient financial market would show mid- and long-term expectations in the present price.⁸¹²

⁸¹⁰ COM(2014) 213 final 10 et seq, 20 et seqq.

⁸¹¹ *Zetsche*, NZG 2014, 1121 (1122).

⁸¹² *Zetsche*, NZG 2014, 1121 (1124).

Third, the rules for related party transactions are similar to rules that have already been implemented in other directives, e.g. Article 5 IV Directive 2004/109/EC or Article 17 I Directive 2013/34/EU. Thus, it might make more sense, to amend those rules instead of creating new ones.⁸¹³

However, this critique does not question the proposals in general, only some technical details. This leads to the conclusion that the proposal itself, based on the principles of transparency, more shareholder rights, and more investor engagement, is nonetheless a useful improvement to corporate governance in Europe.

2. Implementation

After all these initiatives, the next logical step would be to create a corporate governance code for institutional investors according to the UK model. However, we have learned that a corporate governance code for the whole EU is not sensible. It would not offer sufficient flexibility to adapt to the different company laws and corporate governance models within the different Member States and would violate the principle of subsidiarity. The same applies to a corporate governance code for institutional investors. Thus, EU recommendations and directives, which would only provide a framework that could be filled by the Member States by creating a corporate governance code for institutional investors that complements their existing corporate governance code and fits in their company law framework, would be the most efficient solution.

⁸¹³ Zetsche, NZG 2014, 1121 (1127).

III. Final Remarks

There are two important social needs: one for certainty, which can be achieved by rules, and one for flexibility for coping with the variety of life, which can be achieved by principles and standards. The combination of both within a jurisdiction is a compromise between those needs and an attempt to balance the tension between regulation and deregulation⁸¹⁴. Obviously every jurisdiction has found a different compromise based on its different legal and social backgrounds⁸¹⁵. And at the heart of the governance issue is the self-evident point that any process is only as good as the people operating it⁸¹⁶. Not form, but substance and quality should come first. From what we have seen in this thesis, two conclusions can be drawn:

First, the comply-or-explain approach as established and executed within the EU during recent years works for this supranational entity. It is well received by all market participants and there is no need to replace it by stricter rules similar to the ones applied in the U.S. Those stricter rules might work there, as it only refers to one nation, but for the several Member States of the EU with their different company law backgrounds, the more flexible approach of comply-or-explain fits better.

Second, the comply-or-explain approach as it is applied now, has certain weaknesses that need to be improved. One important step in this direction would be to set up a

⁸¹⁴ *Davies A.*, *Best Practice in Corporate Governance* (2007) 40.

⁸¹⁵ *Ferra*, in *Tison/de Wulf/van der Elst/Steennot*, *Company Law and Financial Regulation* (2009) 427 et seq.

⁸¹⁶ *Smerdon*, *Corporate Governance* (2004) para 1.019.

corporate governance code for institutional investors, similar to the Stewardship Code in the UK:

“It is a fine line between achieving reasonable standards to improve corporate governance and imposing unnecessary burdens on companies⁸¹⁷.”

⁸¹⁷ *Krackhardt*, *Vict. U. Wellington L. Rev.* 2005, 319 (321).

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