Corporate governance in a changing financial and regulatory landscape

Report on the findings of the 17th European Corporate Governance Conference that took place in Luxembourg on 15 December 2015

Presidency of the Council of the European Union

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Contents

- Introduction 02
- Influence of new forms of financing on governance 04
- Governance of subsidiaries in multinational groups 10
- Role of the board of directors (credit institutions and investment firms) 14
- Remuneration in financial-sector institutions 18
- Principal conclusions 23

Introduction

The importance of corporate governance – and the political focus on it – seems only to increase with every month that passes. That is because well-governed companies are essential to creating economic growth – in the EU and in every other region of the world.

Corporate governance aims to enhance transparency around a company's operations so that shareholders and other stakeholders feel both informed and empowered. With this in mind, the EU is revising its Shareholder Rights Directive to improve the overall quality of corporate governance within the region. The proposed revised directive includes new measures that give shareholders the right to vote on the remuneration of executives as well as better oversight of related party transactions and the activities of proxy advisers.

Yet, as we all know, there are other reasons for the persistent focus on corporate governance besides its positive influence on economic competitiveness. The financial crisis sent corporate governance rocketing to the top of the regulatory agenda, particularly with respect to the financial sector. So with the 17th European Corporate Governance Conference taking place in the financial center of Luxembourg, it made sense that many of our discussions were focused on this sector, which is so critical to the stability of the EU.

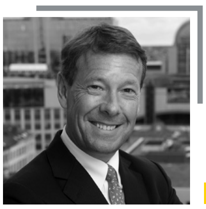
Over 200 people attended the conference and among them were some of the most influential people in the world of European corporate governance – CEOs, directors, regulators, legislators and shareholders. Together, we debated some new topics, such as the impact of the Capital Requirements Directive IV (CRD IV) on remuneration in financial institutions, along with more long-standing concerns, such as the effective governance of subsidiaries.

Inevitably, the role of regulation was a common thread in every discussion that we had. We pondered whether it would aid the development of the venture capital industry – should there be a framework to support crowdfunding, for example? – and whether it should be used to ensure that the interests of the group are recognized by the boards of subsidiaries.

We were also given some fascinating insight into how the regulator's remit can encompass the supervision of behaviour in a case study provided by De Nederlandsche Bank. Finally, in light of CRD IV, we reflected on whether bonuses do lead to bankers taking excessive risks and whether it is really the role of the regulator to determine pay structures in financial institutions.

Our panelists, who came from across Europe and beyond, engaged in intense debate and shared their own personal perspectives on the topics that were up for discussion. Regulators inevitably put forward the case for more rules while directors were more inclined to embrace principles. During the conference, we also polled the audience to get their views. You will be able to see the results of these polls as you read through the report.

I hope you find this report interesting and informative and that it provides some useful takeaways for you to take back to your own organization.



Jeremy Jennings

Regulatory & Public Policy Leader, EY, EMEIA

Foreword

As a holder of the Presidency of the Council of the European Union for the 12th time in the second semester of 2015, Luxembourg had the great honor and pleasure to host the 17th European Corporate Governance Conference, in cooperation with the European Commission, the University of Luxembourg, the Institut Luxembourgeois des Administrateurs (ILA), the Commission de Surveillance du Secteur Financier (CSSF) and the Academy of European Law (ERA), as well as with the support of the Luxembourg Stock Exchange and EY.

With a strategic location at the heart of Europe and its traditional openness towards the world, Luxembourg has not only positioned itself on the international financial market by offering a diverse range of financial services with its dynamic banking and insurance sector, including high performing investment funds, but has also proved itself to be a competitive intercontinental logistics hub and a key location for information and communication technology (ICT), as well as other high tech sectors, such as Eco-Innovative technologies, Health sciences and technologies, not to mention our space industry, which encompasses the world's leading satellite group.

The Luxembourg financial and business center is shaped by a modern legal framework which is characterized by a strong investor protection and corporate governance best practices.

Since the second edition of the European Corporate Governance Conference that was held in Luxembourg in 2005, major developments have occurred in the corporate world, and we all have been witnesses of the subsequent fundamental changes in the world of corporate governance.

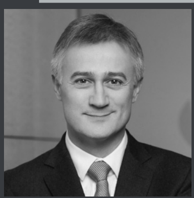
Whereas some of these changes have been the normal course of events, others are the reflection of the global financial crisis which has led to major landscape changes.

As a major financial player in the European Union, it is the ambition of the Luxembourg Government to contribute to the creation of a solid corporate governance system that fosters performance, as well as compliance.

Good corporate governance is key to achieve our objectives and to master our future challenges, as growth and progress must always be underpinned by trust and responsibility.

In this context, the actions undertaken by the European Union are of major importance, as they reflect the European and global perspective of our businesses. As such, they can provide significant added value regarding the development and implementation of corporate governance principles worldwide.

The 17th European Corporate Governance Conference was an important forum for national and international leaders from the private and public sector, as well as for academics, to engage in a fruitful debate about the current and future challenges of corporate governance. Their findings can be found hereafter and I very much hope that you enjoy a stimulating read and some new food for thought.



Félix Braz

Minister of Justice of Luxembourg

01

Influence of new forms of financing on governance

The wide-ranging implications of newer forms of financing on corporate governance were debated in the opening panel discussion, which particularly focused on venture capital and crowdfunding.

Moderator: Prof. André Prüm, Chair in Financial and Business Law, University of Luxembourg, Luxembourg

Panelists: Prof. Jesse Fried, Dane Professor of Law, Harvard Law School, USA

Jérôme Zois, Asset Manager, Mojo Capital

Prof. Dr. Erik Vermeulen, Professor of Business and Financial Law, Tilburg Law School, The Netherlands

Claude Kremer, Avocat à la Cour, Arendt & Medernach, Luxembourg

> "Governance is different depending on whether the enterprise that the fund is investing in is in an early-stage phase or whether it is in a more evolved phase."
>
> **Claude Kremer**
>
> Avocat à la Cour, Arendt & Medernach, Luxembourg

Prof. André Prüm, Chair in Financial and Business Law at the University of Luxembourg, moderated the opening session on the influence of new forms of financing, such as venture capital and crowdfunding, on corporate governance.

The advance of venture capital

Introducing the discussion, Prüm said that new corporate governance guidelines for the venture capital industry had been presented when Luxembourg last hosted the Corporate Governance Conference back in 2005.

Since then, the alternative finance industry had changed significantly, he said, noting that equity crowdfunding had barely existed 10 years ago. "Today, Europe has hundreds of venture capital funds," Prüm explained. "Most are still really small. Approximately 75% of the funds raised in Europe are smaller than €70bn, which is a modest size for a venture capital fund."

He said that venture capital fundraising had hit €4bn a year on average, but this was still five to six times less than in the US. "This means that venture capital fundraising only represents a tiny part of European GDP – 0.03%."

Yet despite its modest size, venture capital funding is gaining in importance, Prüm noted. Several larger companies in Europe have benefited from venture capital. "There is Silicon Valley air blowing in Europe today," he said. "A series of start-ups have reached the magic €100bn valuation, which transformed them into so-called unicorns." Overall, 13 unicorns were born in Europe in the last year, in comparison with the US where 22 unicorns were born.

Venture capital has been strongly supported by national governments and the EU, Prüm said. In 2013, the EU developed a specific label for European venture capital funds. While the label has been modestly successful - 34 funds have been created under it - the European Commission is aware that the label needs to be enhanced. So it has launched a public consultation to improve the framework of the venture capital fund label in Europe.

The Commission has also made venture capital one of the leading tools to stimulate economic growth through innovation and - alongside national governments - it is trying to scale up the size of venture capital funds and support equity crowdfunding.

The main issue for venture capital in Europe today is the modest size of vehicles, explained Prüm. Larger investors tend to invest in vehicles that have gained a certain size – €150m-€200m – because entry tickets are around €20m. The investors want their investments in funds to be diversified so that each investment doesn't represent more than 10% of the fund.

Presently, venture capital funds depend on a considerable amount of public investment. Roughly 35% of committed capital each year comes from national governments and European institutions, notably the European Investment Fund. Therefore, private investors are key to scaling up venture capital in Europe, Prüm observed. They need to be encouraged to invest in both start-ups and later-stage enterprises, as well as to support SMEs in general. Private investment can be encouraged in different ways, for example, by the use of tax incentives, by creating a broader framework through the European Venture Capital Funds Regulation (which is currently under discussion) and by possibly creating a pan-European public-private, venture capital funds of funds.

Meanwhile, equity crowdfunding raises a series of legal issues in relation to securities law and the rules relating to issuing of securities. Equity crowdfunding initiatives have to find a way into the exceptions of EU prospectus regulations and registration requirements. The European Commission has produced a new draft regulation to push up the thresholds to allow equity crowdfunding to grow according to these exceptions. National governments have also taken their own initiatives to support the growth of equity crowdfunding, but they need to avoid taking actions that will hinder the general development of cross-border equity crowdfunding in Europe, Prüm said.

In the US, equity crowdfunding has grown modestly, but it should gain further impetus as a result of the Start-ups Act.

Concluding, Prüm stated that all of these developments in venture capital and equity crowdfunding had implications for corporate governance.

Carrots and sticks

Prof. Jesse Fried, Dane Professor of Law at Harvard Law School, shared the results of an empirical study he conducted, with Prof. Brian Broughman, of 50 Silicon Valley start-ups that were sold in private (trade) sales – the most common form of start-up exit for venture capitalists (VCs).

Fried emphasized that the participants in a start-up, including VCs holding convertible preferred shares, founders (who generally own large amounts of common stock, but may give up their position as CEO), and other executives, often have conflicting financial interests around a contemplated trade sale of the start-up. These conflicts are most acute around trade sales where the VCs exit as preferred shareholders and have aggregate liquidation preferences that are large relative to the sale price, leaving little (or nothing) for common shareholders. In such a setting, VCs often must use carrots or sticks to induce other participants in the start-up to go along with a trade sale.

When VCs invest in a start-up, Fried explained, they have three main fears about possible "misbehaviour" by the founder. In particular, the VCs fear that the founder will (1) misrepresent the quality of the start-up, (2) divert value from the VCs by making business decisions that favor the founder at the expense of the VCs, and (3) not perform well as CEO, for example, by making bad decisions or not exerting sufficient effort.

Fried said that VCs employ various strategies to reduce the risk from such potential misbehaviour. They use convertible preferred stock, whose liquidation preferences give them priority over common shareholders upon sale of the firm unless the VCs choose to convert their preferred shares to common stock; negotiate for "protective provisions" that give the VCs the right to block major financial transactions, such as debt issuances; and obtain several seats on the board.

Over time, the VCs' power in the start-up tends to increase. As the firm raises additional financing, and new VCs invest, the VCs as a group acquire more seats on the board. By the time of a trade sale, VCs will usually control a majority of the board, Fried explained. In addition, in most start-ups the founder loses his or her position as CEO and is replaced by a professional manager chosen by the VCs. The study by Fried and Broughman found that, by the time of the trade sale, 60% of the founders had been replaced as CEO. As a result, in the typical trade sale, the venture capitalists control the board, and the founder owns a considerable amount of common stock but no longer has a management position.

When the VCs seek to exit via a trade sale, they often face resistance from the founder and other common shareholders, as well as from the management team. If the sale price is not substantially higher than the aggregate liquidation preferences of the VCs, common shareholders will get little or no cash while giving up the possibility of a better exit in the future. The management team will have a new "boss" (the acquiring firm) and are more likely to be replaced than if the start-up remains independent. Common shareholders may thus seek to impede the sale by voting their shares against the deal or threatening to sue the VCs, and management may refuse to cooperate in selling the firm.

To induce common shareholders and managers to go along with a trade sale, Fried and Broughman find that venture capitalists often use "carrots" to make the trade sale more palatable to these constituencies. In particular, the VCs will often "carve out" part of their liquidation preferences for common shareholders and provide sale-related bonuses to management. In a number of cases, VCs also used "sticks" (explicit coercion) to get founders to go along with sales. For example, in several cases the VCs threatened to blacklist the founder and prevent the founder from ever raising money again in Silicon Valley if the founder did not support a sale. The VCs' heavy reliance on carrots and infrequent use of sticks, Fried conjectured, is likely due to the VCs' fear of litigation and the adverse reputational consequences of overly aggressive behaviour.

Fried concluded by noting that the VCs' apparent reluctance to act heavy-handedly toward founders may make founders more willing to agree to arrangements that make them vulnerable to replacement by the VCs. The willingness of founders to possibly give up the CEO position, in turn, may make VCs willing to invest in a wider range of start-ups than they would be comfortable funding if the founders could not be displaced from the CEO position.

The power of private

Jérôme Zois, Asset Manager at collaborative investment platform Mojo Capital, observed that there were currently interesting dynamics at play in the public markets. In particular, value investors had been demanding buy-backs and dividend pay-outs with the result that buy-backs and dividends had topped $1 trillion on public-listed equities in 2015 – 20 times the amount invested in technology deals.

"There is a structural shift in terms of how public-company CEOs are expected to behave and how private-company CEOs are expected to behave," he commented. "When you're a public-company CEO, you're working by the quarter and you have to deliver on that. When you're a private-company CEO, you can go for 10 years on investors' money."

The interesting question, he said, is where does the value creation lie – on the public side or on the private side? "On the one hand, you can argue that a lot of value is being created on the private side because those companies aren't forced to distribute cash as fast as public companies and can therefore invest more heavily in R&D and position themselves to win in markets. On the other hand, if you believe those private companies have only a single product cycle, there are some issues around valuation."

Emphasizing the appeal of the private market at present, Zois highlighted that IPO lead times had been increasing and that IPO activity had actually fallen in 2015. Yet the funding rounds on the private market are getting larger and larger – for example, Uber recently raised $1bn and BlaBlaCar raised $200m. These are the kinds of sums that had been traditionally raised in IPO environments.

Alongside these developments in the private markets, some investors were demanding greater protection, Zois explained. In particular, ratchets are being more commonly used. A ratchet is where the investor gives money at a certain valuation and says that if there is a liquidity event in the future that comes at a lower valuation, they must be compensated in shares for the difference between the two values. While this is good for preferred stock holders, noted Zois, it's obviously not so good for employees and founders who have common stock and will feed that common stock up for the preferred shareholders to exercise their option on.

"Ultimately the robust private market has risen out of a potentially overregulated public market," Zois said. "That doesn't mean that private markets are immune to calamity themselves. At some point, there will be a correction and at some point talk around liquidity preferences is going to increase. The question is, whether the public markets are going to adjust first or whether private markets are going to fall in line with public markets and valuations."

Corporations as risk capital providers

Large and often multinational corporations are potentially a good source of venture capital funding in Europe, said Prof. Dr. Erik Vermeulen, Professor of Business and Financial Law at Tilburg Law School in the Netherlands. Unfortunately, however, they are often hampered in this respect by their own corporate governance structures (and the existing regulatory corporate governance framework in Europe).

Vermeulen said that while Europe could not replicate Silicon Valley, it has succeeded in developing its own local ecosystems. Amsterdam, Berlin, London and Paris are clear examples. He also observed that funding was not so much an issue at the start-up stage; it is more of an issue at the later stages. “We don’t have a start-up problem; we have a scale-up problem,” he explained. “We desperately need to focus on scaling up innovative companies in Europe.”

There is a key role for corporations to play in terms of helping start-ups to scale up, Vermeulen said. He pointed out that certain US companies, such as Google, invest heavily in start-ups because they recognize that becoming part of the global innovation and start-up ecosystem helps them to get a good perspective on new developments in the marketplace (it basically offers them a window to the market), enabling them to react and innovate faster. Not only do US corporations invest more money in “venture capital” than their European peers, they also participate in more late-stage deals, Vermeulen added.

How then can we make European corporations more active not only as risk-capital providers, but also as acquirers of younger companies (offering liquidity to founders and other investors), asked Vermeulen. He suggested that Europe could learn from the examples offered by large US corporations that have built quite a reputation in the industry. Of course, because these corporations were once venture capital-backed themselves, they have “innovation and venture capital” in their DNA. However, they also have other traits, such as flat organizational structures, open communication (e.g., this becomes clear when you look at their investor relations strategies and the personalized letters to investors) and inclusiveness (e.g., in these companies being a board member is less about monitoring and more about adding value and contributing to innovation).

The three principles – namely, flat-hierarchy, open communication and inclusiveness – operate together to create value in what Vermeulen termed as a "new generation firm." Unfortunately, the current regulatory focus on investor protection (which is hierarchical in nature) seems to neglect the more participatory-oriented relationships and governance structures that play a central role in successfully working together with start-up and scale-up companies.

Governance of funds

Luxembourg has a history in the fund industry that dates back to the 1950s, but knowledge of corporate governance was fairly limited until recently, said Claude Kremer, Avocat à la Cour at Luxembourg law firm Arendt & Medernach.

In 2004, the SICAR Law was the first initiative in Luxembourg to recognize risk capital. This was a milestone in the Grand Duchy because it was the start of outside players coming to Luxembourg to use the structure for their own investment vehicles.

While understanding of corporate governance has grown over the past decade, there is not a one-size-fits-all system of corporate governance that suits funds, noted Kremer. "It depends on the stage of evolution that the fund is at. The value chain goes from seed to early stage, to development, to growth, to turnaround or buy-out. That is a series of consecutive phases in the value chain. Venture capitalism is only a tiny part of that chain – seeds and early development. So the remaining portion will be in the larger phase of private equity."

He continued: "Governance is different depending on whether the enterprise that the fund is investing in is in an early-stage phase or whether it is in a more evolved phase. Nevertheless, the objective is always to create value for investors. The main difference is that in an early-stage situation, investors have an acceptance and expectation for failure. The higher you go up the value chain, however, the appetite for failure reduces dramatically."

In an early-stage situation, investors would be more likely to have smaller, non-controlling stakes in a diverse range of investments, Kremer explained. Yet when an enterprise was in a more mature, private equity phase, investors would look to take more controlling stakes, they would expect their investments to mature-and they would not anticipate the failure of the enterprise.

Kremer said that funds apply two levels of corporate governance: internal and external. Internal governance relates to ensuring that there is good conduct within the fund itself and that interests are aligned between the fund's board, shareholders and other stakeholders.

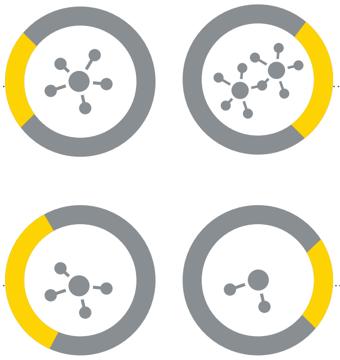
External governance is about the relationship between the fund and the portfolio companies in which it invests. That governance will vary according to whether the portfolio company is in a venture capital situation or a buy-out situation. In a venture capital situation, the fund is likely to send an observer to the portfolio company for the purpose of identifying risks, but it will not necessarily look to take control. In a later-stage, private-equity situation, the fund is more likely to want to become actively involved with the portfolio company.

Kremer supported the concept of a "fund of funds," saying it was a developing area of the Luxembourg fund industry. In the context of venture capital or private equity, the fund of funds would effectively be the venture capital fund selector, which creates opportunities for funds to invest in. It would combine the resources of sovereign funds, pension funds, insurers and private investors. Nevertheless, Kremer warned that a fund of funds raised the potential for conflict, since pension funds and insurers may have different objectives from sovereign funds.

Turning to crowdfunding, Kremer said that this financing method is a way for a broad range of people to participate in the financing of the real economy. He added that there should be a European framework to support crowdfunding, which applies across borders and creates a level playing field for all participants.

Audience poll*

Q1. To what extent should the method of financing dictate the company's governance structure?



- 2.4 Completely
- 3.6 To a greater extent
- 4 To a lesser extent
- 2 Not at all

Q2. How can governments and the EU stimulate the growth of venture capital?

- 4 Create regulated structures for funds
- 2.9 Sponsor venture capital funds
- 7 Offer incentives to investors
- 2.8 Invest in third-party funds

*Polling was done on a scale of 1-10

02

Governance of subsidiaries in multinational groups

The second panel discussion debated the governance of subsidiaries in multinational groups, focusing particularly on the role of independent directors on subsidiary boards.

Moderator: Michael Schweiger, Head, Investor & Treasury Services Legal, Continental Europe, Royal Bank of Canada

Panellists: Tom Loesch, Avocat à la Cour and member of the ILA Working Group on Internal Governance

Prof. Pierre-Henri Conac, Professor of Commercial Law, University of Luxembourg and Research Associate at the European Corporate Governance Institute (ECGI)

Paul Mousel, Banking & Financial Services Partner, Arendt & Medernach, Luxembourg

Marie-Jeanne Chevremont-Lorenzini, Independent Director and former Chair of ILA

Alexis Kyprianou, Founder and Managing Director Concordia, ILA & IFA Certified Director

"We should make life easier for groups that are active cross-border."

Prof. Pierre-Henri Conac

The challenges that come with balancing group interests with subsidiary interests and the role of independent directors on a subsidiary board were examined in a lively panel session moderated by Michael Schweiger, Head, Investor & Treasury Services Legal, Continental Europe, Royal Bank of Canada. Subsidiaries are a topical issue in Luxembourg since the Grand Duchy is home to a large number of them, particularly in the financial services sector.

Luxembourg perspective

Tom Loesch, Avocat à la Cour and member of the Institut Luxembourgeois des Administrateurs (ILA), opened the session with an overview of the findings from ILA's report, *Group interest and subsidiary governance in Luxembourg*, which was published in June 2015. The report explores how companies manage situations where the interests of the group and the interests of subsidiaries are in conflict with each other. It also provides best-practice recommendations that can help to lessen the potential for conflict between Luxembourg-based subsidiaries and the groups of which they form part.

Loesch highlighted that it is important for directors of subsidiary companies to be able to anticipate and manage conflicts of interest with the parents.

He also emphasized that there could not be a "one-size-fits-all" model for addressing conflict, since not all subsidiaries are alike. The nature of subsidiaries can vary significantly from full operational business units through to legal constructs, including special purpose vehicles. Some subsidiaries will be 100% controlled by the parents; others may be joint ventures or have a strong minority interest. As a result, they need to be approached on a "case-by-case" basis.

Among the recommendations outlined in the report are basing the organizational structure of groups on economical and business considerations; induction and regular information sessions for directors so that they understand the purpose of the subsidiary; and the adoption of a rule book for dealing with conflict of interest situations.

The report also advised that there should be a good balance of directors on the subsidiary board, with the board containing both directors originating from the group and independent directors. It said that at least two of the directors should be independent and it called for the board composition to be adequate and diverse in terms of personality, professional skills and technical background.

Group interest within the EU

Not all countries in the EU give recognition to the interest of the group, explained Pierre-Henri Conac, Professor of Commercial Law, University of Luxembourg, and Research Associate at the European Corporate Governance Institute (ECGI).

He highlighted that while many EU Member States, such as France, do recognize group interests, there is still a significant minority of others, such as Germany, who do not. Nevertheless, over the past 15 years, legal developments in all Member States have tended to go in the direction of recognizing the interest of the group.

The academic and business communities are also increasingly demanding a flexible, EU-wide approach to the management of subsidiaries. A group of academics and legal practitioners from 22 European Member States have been developing the European Model Company Act (EMCA) since 2007. The Act, which is inspired by the US Model Business Corporation Act, has a specific chapter on groups, which balances the French approach of recognizing the group's interests and the more rigid German approach.

Another group of experts, the Forum Europaeum on Company Groups (FECG), has recently called for the European Commission to introduce a directive that would require the recognition of the group interest at EU level. The FECG notes the difference between service and non-service companies, arguing that the interests of fully owned service companies will inevitably be closely aligned with the parent – meaning that the group interests should be easily recognized in this situation.

Meanwhile, the French think tank Club des Juristes has asked the Commission to adopt a recommendation recognizing also the interest of the group although it fell short of requiring fully owned companies (i.e., companies that have just one owner – the parent) to accept instructions from the parent. It also acknowledges, that circumstances will be different where minority shareholders exist. The Club des Juristes also suggested that there should be a white list of group practices that would be acceptable in law at the EU level – cash pooling, for example.

The argument of the Club des Juristes aligns with the so-called Rozenblum precedent – a decision made by the French Supreme Criminal Court in 1985 that recognized the interests of the group provided several conditions were satisfied. These conditions include the existence of capital/equity links between different companies in a group and of genuine business integration among companies within the group, allowing for a coherent group policy and a common interest. In addition, financial support should not be without contrepartie or break the balance between the respective commitments of the companies. Finally, the decision should not endanger the company and put it at risk of insolvency.

Following the 2011 Report of the Reflection Group on the Future of EU Company Law, the European Commission issued in 2012 a public consultation as to whether it should adopt a recommendation recognizing the interest of the group. There was strong support for the recommendation, Professor Conac explained, which came mainly from lawyers, some business associations and, from a geographic perspective, from Member States with rigid or unclear rules that want their companies to be able to manage their international subsidiaries in a more flexible way.

Recognizing group interests at EU level would have a number of advantages, Conac said. It would provide greater clarity for the directors of both subsidiaries and parent companies, reduce the cost of doing business cross-border (especially for SMEs), provide more protection for businesses in the financial services sector, because it would facilitate an integrated risk management, and facilitate the creation of intercompany loans to ensure the stability of financial groups.

The Informal Company Law Expert Group (ICLEG) is working with the Commission to explore the issue of group interests at EU level and is due to publish a report on the topic in the first half of 2016.

"We should make life easier for groups that are active cross-border," Conac concluded .

One size does not fit all

Turning to the panel, Schweiger queried whether there could be an optimal approach for the corporate governance of subsidiaries, given that groups are involved in different industries and their subsidiaries exist for different purposes.

Paul Mousel, Banking & Financial Services Partner at Luxembourg law firm Arendt & Medernach, observed that Luxembourg companies that want to do business outside of the Grand Duchy could choose to do it via a subsidiary or via a branch.

If they choose to do it via a subsidiary, he said, they would need to recognize the fact that the subsidiary is an autonomous legal entity. He also pointed out that in the financial sector, reporting often goes by business line while the concept of consolidation exists within both the fields of accounting and supervision. "Consolidation means clearly that the group exists and the group's interests must be taken into account," he said.

But he added that taking a one-size-fits-all approach was particularly unfeasible where companies are regulated, publicly listed or have minority interests, since these kinds of companies have different stakeholders to accommodate.

Marie-Jeanne Chevremont-Lorenzini, an independent director and the former Chair of ILA, noted that the size and complexity of both the group and its subsidiaries need to be taken into account. "The more complex the group is, the more important it is to have good corporate governance in the subsidiary in order to make sure that the subsidiary recognizes the interest of the group."

Chevremont-Lorenzini supported the idea of subsidiaries having at least two independent directors on the board, observing that it is very difficult for a single independent director to drive change when they are the only person on the board alongside the executive directors.

Alexis Kyprianou, Founder and Managing Director of Concordia, observed that the independence of independent directors is to some extent compromised. "Who nominates the board directors?" he asked. "The shareholders. So the dominant shareholder has the power to appoint you and remove you. Even if you are an independent director at the subsidiary level, realistically your independence is somewhat compromised because if you don't act to a certain extent in the interests of the majority shareholder, that majority shareholder can and may remove you."

He continued: "In the real world, you feel a little bit inhibited when you are up against a majority of directors nominated by the majority shareholder. That's the practical reality. There are numerous cases where a majority shareholder has removed an 'independent' director simply because that director was not toeing the group line. That shouldn't happen and we have to find ways to ensure that majority shareholders respect and understand the value of those independent directors at the subsidiary level.

Kyprianou highlighted that the value of independent directors is that they bring an outside view. He said that activities of a subsidiary are held in a separate legal entity to the parent company for a reason, usually because the subsidiary activity has a certain risk, operating, business or legal profile that is different from the parent company — otherwise the activity concerned would simply be a branch of the parent. Therefore, it is necessary to manage the subsidiary in a different way from the company, hence the value of independent directors. He said the amount of independent directors on a board should depend on the size of the board itself.

Resolving conflict

The panel explored how the boards of subsidiaries could best resolve conflict between the subsidiary and the group without evoking the resignation of directors.

Kyprianou suggested setting up a charter for each legal entity, which defines what the role of each board of directors is and how they should go about their business while promoting the interests of the company. The charter can outline the primary interests at a subsidiary level with consideration also given to group interests. In addition, it can include a system for dealing with conflicts of interest in a transparent and upfront manner. Furthermore, Kyprianou emphasized that having a chair who is also an executive of the company can result in a conflict of interest.

It is important to acknowledge that there could be a conflict of interest between the group and its subsidiary, said Chevremont-Lorenzini. She noted that both the chair of the group and subsidiary have an essential role to play in ensuring that good governance prevails. Concurring, Mousel said: "When the chair is an independent director, the atmosphere of the board is completely different. He can ask the right questions and he can challenge management more than if the chair comes from the group."

Circular resolutions

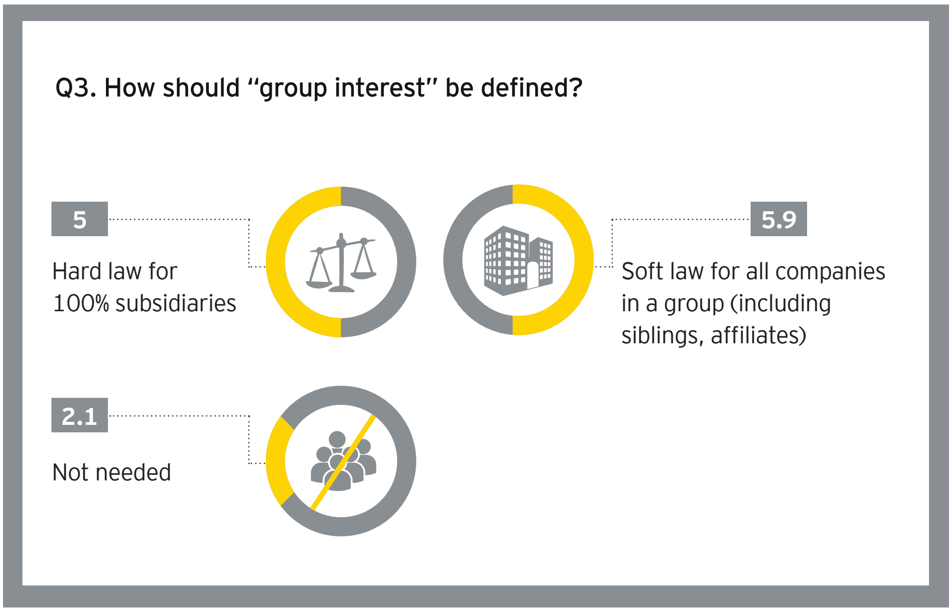
The panel concluded with a discussion about whether board members should be expected to approve circular written resolutions to make large dividend pay-outs, on say 30 December, — just one day before the end of the subsidiary's financial year.

"It is very bad corporate governance to use circular resolutions at all," observed Mousel. If, on 30 December, you receive a circular resolution to approve a written resolution and you are a responsible independent director, you should refuse to do so unless it has been discussed. If it comes out of the blue, you should say 'no.'"

Chevremont-Lorenzini agreed that written resolutions should be exceptional, but she noted: "Board members should be flexible and ready to jump and make the right decisions at the right time."

The real issue is not whether a discussion about the dividend took place in person or by circular resolution, said Kyprianou. "A material transaction coming out of the blue on 30 December suggests that there's a problem with cash planning. Most groups, at least in the industrial world, do cash pooling anyway. So a dividend is just one of several ways in which you can take cash from the subsidiary level upstairs to the mother company. If we get one day's notice to make a dividend, which is a material transaction, there is something bigger involved than just the governance between the mother company and the subsidiary company."

Audience poll*



*Polling was done on a scale of 1-10

03

Role of the board of directors (credit institutions and investment firms)

Should regulators be supervising the behaviour in financial institutions? If so, where do the board's responsibilities lie? This was the fascinating theme of the third panel discussion.

Moderator: Anthony Smith-Meyer, Independent Non-Executive Director and Editor in Chief of *The Journal of Business Compliance*, Netherlands/Luxembourg

Panellists: Ingeborg Rademakers, Examining Officer – Expert Centre Governance, Behaviour and Culture, De Nederlandsche Bank, Holland

Jeroen Hooijer, Head of Unit, Directorate General for Justice, European Commission

Thierry Schuman, Chief HR Officer and Member of the Management Board at BGL BNP Paribas, France

"It's very important that boards of institutions see behaviour and culture as a means to have sustainable performance and be competitive."

Ingeborg Rademakers

Examining Officer – Expert Centre Governance, Behaviour and Culture, De Nederlandsche Bank

The roles of the board of directors – and supervisors – in monitoring good and bad behaviour was examined in depth in this thought-provoking panel session moderated by Anthony Smith-Meyer, an independent non-executive director and Editor in Chief of *The Journal of Business Compliance*.

Supervising behaviour

Ingeborg Rademakers, Examining Officer – Expert Centre Governance, Behaviour and Culture, at De Nederlandsche Bank (DNB) in Holland, opened the session with a fascinating overview of how the bank is supervising behaviour in financial institutions.

The DNB started incorporating behaviour into supervision in 2010 because it strongly believes that behaviour drives company performance, Rademakers said.

The G30's recent report on conduct in banks also stated that banks should embrace the notion that behaviour and culture are very important for economic sustainability in general and for their own performance. She explained that the DNB did not think it should proscribe the kind of behaviour and culture that banks should have because there is no such thing as an ideal culture. Instead, it sees its role as being to address risks, make observations, confront boards and address behaviour and culture that are ineffective for performance while helping organizations to realize change.

Rademakers emphasized that the DNB's behavioural approach does not replace more traditional supervision - it is an additional approach. In the past, the DNB was more focused on finance and backward-looking reports. Now its approach is more forward-looking and preventive - for example, it watches out for behaviour that could lead to future problems. Its methodology is based on a range of regulatory guidelines, as well as scientific research and common sense.

The culture of an organization is like an iceberg, according to Rademakers. The tip of the iceberg is the physical behaviour demonstrated by certain groups, for example, the board, the compliance function or the trading room. The DNB looks at this behaviour, focusing particularly on communication, decision-making and leadership because these three behaviours particularly affect culture.

But what is more important - because it is the driver of behaviours - is what is beneath the surface of the water. This includes the group dynamics and how conflicts are resolved - both within and between groups. The DNB attends board meetings and meetings of the group risk committee and the asset/liability committee in order to learn more about group dynamics. It also interviews people and uses self-assessment and surveys to carry out its research.

After looking at the behavioural patterns within an organization, the DNB identifies which behaviours might be considered to be strong, effective and good for the performance of the company and which might be a risk and cause damage to the company's reputation.

"We discovered that behavioural patterns are often the root cause of many problems – financial problems, problems with solvency but also supervisory problems," Rademakers revealed.

She gave the example of an institution where her prudential colleagues were confronted with incorrect reporting on risk, compliance and solvency. The company addressed these issues, but nothing improved, so the DNB did a board effectiveness examination. It found that this board was very focused on results and solutions, but not on discussing the underlying problems. Furthermore, the chair didn't create opportunities for challenge. The same pattern occurred in the supervisory board.

The DNB challenged the board about its non-challenging behaviour and focus on "fixing," which led to a distorted picture of the effectiveness of the company. It asked them to take more ownership of the root causes of problems and to spend more time discussing them. It also shared its findings with the supervisory board, which became a more vigilant watchdog of the board.

The DNB has done examinations of 54 institutions so far, Rademakers explained. In 34 of those institutions, the risks that the DNB identified were serious and most institutions were willing to address those risks by implementing behavioral change. Among the actions they took were changes to their formal governance arrangements – for example, taking a different approach to decision-making and repositioning the first and second line of defense – and changes in attitude or behaviour e.g., changing the composition of the board, starting leadership development or organizing more opportunities for reflective challenge. In a minority of cases, the DNB still had to use legal enforcement to address the risks that it had identified, however.

Concluding, Rademakers said: "Behaviour and culture is not a soft topic. It's a tough topic. It's very important that boards of institutions see it as a means to have sustainable performance and to be competitive. We believe in cultural diversity and we also see that every culture has its merits but also its risks. We believe that we can add value by helping organizations to be robust."

Rules vs. responsibilities

It is the responsibility of an institution to do the right thing and to look after the culture in its organization, observed Jeroen Hooijer, Head of Unit, Directorate General for Justice at the European Commission. Yet it is still necessary to set certain rules and guidelines on corporate governance for institutions to abide by.

Although culture is the responsibility of the company, Hooijer noted that it is important to ensure there is high-level awareness of, and high-level training on, cultural issues. This does not necessarily happen automatically, he said, which is why it needs to be triggered at a high level or by a supervisor.

Thierry Schuman, Chief HR Officer and Member of the Management Board at BGL BNP Paribas, observed that a lot of board members do not schedule enough time for board meetings. He also queried whether the way that board members are currently chosen is appropriate and said that it was important to have a job description. He added that although he was very much in favor of diverse boards, it was also essential to ensure that they are technically competent.

Rademakers agreed that both competence and diversity were essential attributes of high performing boards, explaining that the Netherlands is very focused on "fit and proper" testing.

Schuman pointed out that often there is not a single culture within a company; instead there might be subcultures within different departments. He also emphasized the importance of a company's mission and values in terms of determining its culture. He noted that while companies tend to like having strong leaders as board chairs and CEOs, the best-performing companies often have "no name" CEOs. "A lack of mission or values, combined with a CEO who runs the company as if it were his own, may well be a recipe for disaster," he concluded.

Smith-Meyer asked the panel how much time boards would have for thought-through decision-making given the pressure on financial institutions to comply with all their obligations under the Capital Requirements Directive IV.

Rademakers responded that it was an enormous challenge for boards to find time to think about their companies' visions amid all the regulations that exist. She said that boards needed to find this time, however, or they would be confronted with ineffective behaviour in the lower echelons of their businesses.

Hooijer noted that CRD IV had tried to respect both the one-tier and two-tier board systems that exist within the EU, since the Commission does not have a preference for either system. He added that the role of independent directors or members of the supervisory board is an issue across sectors because it is difficult to find genuinely independent board members who will challenge the management and be critical and independently minded. He said that since substantial responsibilities and liabilities are given to independent board members, it is important to think about how to further professionalize them. "That will have a price," he said. "Independent board members are not always sufficiently remunerated, certainly in comparison with management."

The final word belonged to moderator Smith-Meyer who returned to the topic of values, saying: "To be successful in the longer term, we need to create the right kind of culture at head office and to have boards that are going to think deeply about the reasons why their organizations exist and determine values for those organizations that can be understood. And we need to combine these boards with subsidiaries where people are thinking about these values relative to the local market."

Audience poll*

Q4. Do you agree that "behaviour" is the cause of many issues of supervision?

Q5. To what extent should supervisors focus on behaviour as much as they do on financial issues?

*Polling was done on a scale of 1-10

Remuneration in financial-sector institutions

CRD IV turned the international principles on remuneration into rules and introduced a cap on variable pay for bankers. The final panel explored what this means for financial companies in the EU.

Moderator: Jeremy Jennings, Regulatory & Public Policy Leader, EY, EMEIA

Panellists: Guido Ferrarini, founding member of the European Corporate Governance Institute and Professor of Business Law at the University of Genoa, Italy

Thierry Schuman, Chief HR Officer and Member of the Management Board at BGL BNP Paribas, France

Anthony Smith-Meyer, Independent Non-Executive Director and Editor in Chief of *The Journal of Business Compliance*, Netherlands/Luxembourg

Nadia Manzari, Head of Innovation, Payments, Market Infrastructure and Governance at the Commission de Surveillance du Secteur Financier in Luxembourg; Luxembourg Member of EBA Sub Group on Governance and Remuneration; and Member of the Task Force on Corporate Governance of the Basel Committee on Banking Supervision

"Pay arrangements should be more flexible but should fully emphasise corporate governance functions."

Guido Ferrarini

Professor of Business Law at the University of Genoa

Capital Requirements Directive IV (CRD IV) and its impact on remuneration in European financial-sector institutions was debated in the closing panel session, moderated by Jeremy Jennings, Regulatory & Public Policy Leader, EY, EMEIA.

CRD IV and bankers' pay

The topic of bankers' remuneration is "at the border between corporate governance on one side and regulation on the other," Guido Ferrarini, founding member of the European Corporate Governance Institute and Professor of Business Law at the University of Genoa, told the conference.

Addressing the topic of how CRD IV will affect bankers' pay, he observed that regulating pay structures is controversial since there are disagreements as to whether the nature of bankers' remuneration did contribute to the excessive risk-taking that led to the financial crisis.

CRD IV includes very detailed rules on how banks should remunerate employees who are high earners and major risk takers, Ferrarini explained. The rules track the international principles set out by the Financial Stability Board with regard to matching pay to long-term performance and effective risk taking, but they also make those principles mandatory. Furthermore, the rules introduce a bonus cap in the form of a requirement that variable pay should not exceed 100% of fixed pay.

There is considerable variation around the bonus cap, Ferrarini explained, since Member States can allow variable pay to go up to 200% of fixed pay subject to shareholder approval or, alternatively, they can set lower thresholds than even 100%. The UK and Italy have adopted the 200% threshold, for example, while Belgium has a 50% threshold and the Netherlands has a 20% threshold.

In response to the bonus cap, the UK had introduced the concept of role-based allowances, said Ferrarini. As there was a risk that these could be used to circumvent the bonus cap, the European Banking Authority has issued guidance to the effect that, in order to count as fixed pay, these payments must be pre-determined, transparent and permanent.

Ferrarini queried the logic behind the European approach to regulating pay, arguing that there was no certainty that remuneration structures generally contributed to excessive risk taking before the financial crisis. He said that traditional regulation – capital regulation and risk management regulation – could be better at curbing excessive risk taking and suggested that regulators may not be the most suitable parties for designing pay structures.

"Pay arrangements should be more flexible but should fully emphasise corporate governance functions," Ferrarini stated. "Competent authorities should supervise the institutions and therefore their governance in terms of how they react to flawed incentives. But authorities should not state what the pay structure should be."

Putting caps on variable remuneration can have negative consequences, Ferrarini explained. These include institutions increasing fixed pay for employees so that variable pay can also increase, a possibility that banks will be more prone to take on bad risks and shun good ones, and talented banking employees choosing to emigrate to other countries or work for non-bank organizations such as hedge funds or private equity. The bonus caps particularly affect investment banks, which rely on the use of variable pay to motivate employees, Ferrarini observed.

CRD IV applies on a consolidated basis, which means that it applies to all entities in the group – both banks and non-banks, whether they are located in Europe or in other countries. As a result, if an asset manager or an investment firm is included in a banking group, then both CRD IV and the cap on remuneration apply, not only to the remuneration of bankers but also to the remuneration of employees in other, non-banking subsidiaries.

Ferrarini suggested that a possible solution for investment banks that want to keep high, variable remuneration would be for them to separate from their banking parents so that they become autonomous investment funds and would therefore not be subject to a bonus cap.

Drivers of bad behaviour

Following Ferrarini's presentation, the panel debated the extent to which high variable remuneration encourages bad behaviour.

Variable remuneration only encourages bad behaviour if an organization's culture, processes and values are wrong, observed Thierry Schuman, Chief HR Officer and Member of the Management Board at BGL BNP Paribas. "The vast majority of people don't tend to gamble with what they've got or what they might get."

"We need a focus on getting the right kind of culture and the right kind of people," concurred Anthony Smith-Meyer, an independent non-executive director and Editor in Chief of The Journal of Business Compliance. "As long as incentives and variable pay arrangements are linked to sensible financial performance objectives, they do not drive people to behave badly. Role models and personal development drive people's behaviour. It's about setting goals, the mission statement and the vision."

Remuneration was highlighted as an issue due to the abuses that took place during the financial crisis, observed Nadia Manzari, Head of Innovation, Payments, Market Infrastructure and Governance at the Commission de Surveillance du Secteur Financier in Luxembourg.

She said that financial institutions had not responded adequately to the governance framework for remuneration that was set out in CRD III in 2010. This framework required banks to put remuneration policies in place and to consider the values that they wanted to reflect through their policies. CRD IV, which was adopted in 2013, was a reaction to CRD III not being applied correctly, Manzari stated. "There were three years between CRD III and CRD IV. Maybe not enough was done in that time."

Smith-Meyer suggested that CRD IV might be a disproportionate response to a number of high-profile severance packages made to senior personnel within the financial sector. He said that the focus should be on separating risk-taking activities from process banking and also on holding people to account for their actions.

Schuman observed that the remuneration rules under CRD IV raised real issues for financial groups that include both financial and nonfinancial entities – for example, they might consists of banks, investment companies, insurance companies and real estate companies. These issues include employees choosing to move business unit because they are not happy with the remuneration on offer where they are currently, businesses in non-European jurisdictions losing talented staff to local competitors who do not have to abide by the CRD IV remuneration rules, and the fact that bonuses are part-linked to share prices, even though share prices tend to be more strongly influenced by the market and the index in general than the performance of the company itself.

CRD IV is presenting problems to US institutions that are coming to London, Ferrarini said. "It has an impact on competition between banks and on competition between banking and non-banking institutions. This is serious because banks are already suffering a lot from competition with non-banking institutions."

Jennings raised the issue of proportionality and whether lighter rules could be applied to the remuneration policies of banks that are less of a risk to the financial system.

Manzari said that regulators were aware of the proportionality principle. "We have big banks and small banks. We have small institutions with high risks and big institutions with lower risks. So we have published guidelines on proportionality and published thresholds that banks can apply. Proportionality is an important issue, not only for remuneration but also for governance in the financial sector."

Audience poll*

Q6. Do you support the approach to regulating financial sector pay as set out in CRD IV?

Q7. What is the best way to exercise oversight of financial sector pay?

*Polling was done on a scale of 1-10

Principal conclusions

The conference reached a number of conclusions that can help to improve corporate governance within the EU. These, therefore, merit the consideration of policymakers:

Influence of new forms of financing on governance

- Change the composition of boards to include more product specialists and innovators. Having board members who are focused on adding value will encourage more large corporates to act as venture capitalists and invest in start-ups and later-stage enterprises.
- Create a European framework to support crowdfunding.

Governance of subsidiaries in multinational groups

- Give adequate legal recognition to the group's interests.
- Create charters for each legal entity within a group. These charters should define what the role of each board of directors is and how they should go about their business while promoting the interests of the group.
- Ensure that majority shareholders respect and understand the value of the independent directors at the subsidiary level.

Role of the board of directors

- Professionalize independent board members and remunerate them appropriately.
- Ask boards to consider whether the right behaviours, culture and values exist within their organization.

Remuneration in financial-sector institutions

- Review whether the rules relating to remuneration packages in the financial sector harm the competiveness of EU institutions.
- Consider the creation of autonomous investment funds that are separate from their banking parents and are therefore not subject to the remuneration rules under Capital Requirements Directive IV.
- Reflect on the need to return to a more principles-based approach to regulating financial sector remuneration.

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