

**Corporate Governance Conference**

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**Important European governance initiatives  
and their relevance for Poland**

by

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**I. The importance of corporate governance for capital access and economic development**

- Companies that 'subscribe' to the governance pillars transparency and independence will enjoy a better standing with their shareholders and other stakeholders. The greater confidence created by these pillars leads to a perception of reduced risk whereby investors will accept lower investment returns that are reflected in higher share prices.
- The EU Commission under the direction of Frits Bolkestein has become a major driver of better governance across Europe. The new commissioner Charlie McCreevy from Ireland is also seen as a strong promoter of transparent and functioning global capital markets to improve competitiveness for Europe.
- Global influence of the OECD Corporate Governance Principles (revised in 2004):<sup>1</sup> promote market confidence, integrity and efficiency to enhance economic growth and financial stability
- Sufficiently good governance (including unrestricted ownership rights) is a decisive prerequisite for foreign investors
- Local governance standards must therefore converge towards international best practice

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<sup>1</sup> Available in the Internet at [www.oecd.org](http://www.oecd.org).

- Companies to benefit from better governance through a reduction in the cost of equity and debt capital
- Investors to benefit from higher returns for their retirement funds as the only remedy for declining state pensions
- Nearly all empirical research now confirms the value proposition of good governance (latest examples: 12 % p.a. return difference between the best and poorest governed German companies in the period 1998 – 2002,<sup>2</sup> 25% outperformance in share price (i.e. spread difference at the end of a three year period) of the top-10% with good vs. bottom-10% companies with poor governance for the UK FTSE 350 from 2001 till 2003,<sup>3</sup> and for all companies of the FTSE Eurotop 300 the portfolio with above-average governance ratings outperformed the below-average portfolio by 3 % p.a. between 1997 and 2002<sup>4</sup>). Although the valuation of Polish equities will have improved in general since 2002 it is still remarkable that the global McKinsey-Survey found that investors were then willing to pay a premium of 23% for well-governed companies in Poland.<sup>5</sup>

## II. Key features of the EU Action Plan and other EU initiatives

- Reasons of the EU Action Plan<sup>6</sup> of May 2003 – The three major objectives that have led to the development of the current EU governance initiatives are:<sup>7</sup>
  - restore and save investors' confidence in market integrity and fair corporate behaviour,
  - integration of European capital markets to ensure equivalent corporate governance frameworks across the EU, and
  - ease the rapid and full transition of the new member countries to become fully competitive modern market economies.

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<sup>2</sup> Drobetz / Schillhofer / Zimmermann: Corporate Governance and Expected Stock Returns: Evidence from Germany, in: European Financial Management, Vol. 10, No. 2, 2004, 267-293.

<sup>3</sup> Grant / Grandmont / Flavia: Beyond the numbers – Corporate Governance in the UK; Deutsche Bank AG (Ed.), Global Equity Research – Strategy Focus, 18 February 2004

<sup>4</sup> Bauer / Guenster / Otten: Empirical evidence on Corporate Governance in Europe – The effect on stock returns, firm value and performance, in: Journal of Asset Management, Vol. 5, Iss. 2, S. 91-104, August 2004.

<sup>5</sup> McKinsey & Co.: Global Investor Opinion Survey 2002. Internet: [www.mckinsey.com/governance](http://www.mckinsey.com/governance).

<sup>6</sup> Available in the Internet at [http://europa.eu.int/comm/internal\\_market/en/company/company/modern/index.htm](http://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm).

<sup>7</sup> All of the following EU documents are available at [http://europa.eu.int/comm/internal\\_market/index\\_en.htm](http://europa.eu.int/comm/internal_market/index_en.htm).

▪ Strengthening shareholders' rights (Consultation for a EU Directive until mid Dec 2004)

Major points of the consultation for a EU Directive on 'Fostering an appropriate regime for shareholder rights' are:

- establishment of full voting rights, especially for cross-border voting,
- unrestricted admission to and participation in shareholder meetings (AGM),
- timely communication of information for AGMs, and
- dissemination of meeting minutes and voting results.

A sensible approach to enhanced shareholder rights – as currently under review for a EU Directive – must provide comprehensive shareholder access to all relevant financial and non-financial information including the AGM agenda and counter motions. This information should be available to all shareholders well before an AGM, also via electronic communication means, i.e. the Internet. The company's management should answer multiple shareholder questions in writing prior to the AGM to focus the meeting on the important agenda items. As Polish companies nowadays seldom publish the candidate names for election to the supervisory board in due time before the AGM, this will certainly be changed by future EU regulations unless implemented before by a code or other listing requirement.

Voting procedures should allow electronic proxy voting and facilitate cross-border voting without unnecessary blocking periods that deter international institutional shareholders from voting their shares. The introduction of a 'record date' instead of a five day share blocking requirement as it currently applies in Poland is an important catalyst for increased institutional investor participation. In Germany this law change will be introduced in 2005; this is quite necessary in view of shareholder representation of only 30 – 40 % in most DAX30 companies.

Other changes to improve the efficiency of the AGM in Poland should include that comprehensive shareholder information is given at least four weeks before the AGM (instead of 15 days as currently stipulated by law) and the introduction of voting by mail or via Internet.

▪ Improving the supervisory board (Draft EU Recommendations Oct 2004)

Major points of the draft EU Recommendation for the role of supervisory board members and their committees are:

- stipulate sufficient number of independent directors,
- define and disclose profile of the supervisory board members regarding qualification, commitment and independence,
- create audit, nomination, and remuneration committees, where a majority of their members should be independent,
- evaluate board performance by an annual review procedure, and
- ensure transparency and communication of supervisory board organisation and shareholder information regarding general company affairs.

EU member states have to take appropriate measures until 30 June 2006.

Central for the effectiveness and the quality of the board is a sufficiently high number of independent supervisory board members. The EU Action Plan stresses the importance of independent board members to improve board practices. Not only for investors it is paramount that independence does not only exist formally (with the absence of material company relationships), but even more in reality: Only supervisory board members with sufficient stature that stand firm by well reasoned positions can be credible business supervisors. Institutional investors therefore want to see a sufficient number of truly independent directors. The EU Commission unfortunately changed its original proposal that contained broad mandatory independence criteria into a loose and self-governed determination process. The code requirement of the Warsaw Stock Exchange (WSE Code<sup>8</sup>) for a majority of independent directors – that even exceeds the EU Recommendation – is very good. Unfortunately, its implementation deadline has just been postponed another six months until June 2005. Nevertheless, guidelines for independence should be developed according to the criteria available in the appendix of the EU recommendation. The independence rules should also apply in full for listed companies still under State control as the minority shareholders need particular protection from undue influence of the public sector.

Until the acceptance of the WSE Code's majority requirement is fully satisfactory, the alternative proposal of the Gdansk Institute for Market

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<sup>8</sup> The WSE Code of July 2002 is available at [www.wse.com.pl/zrodla/gpw/pdf/bestpract.pdf](http://www.wse.com.pl/zrodla/gpw/pdf/bestpract.pdf).

Economics (GIME<sup>9</sup>) and the Polish Forum for Corporate Governance (PFCG) in their Code<sup>10</sup> is a good solution to secure the acceptance of independent board members by the controlling shareholders. This is achieved with the stipulation that two independent board members must be elected without the votes of the controlling shareholders. To strengthen their influence certain veto rights are provided for. On balance, an early implementation of the WSE Code of a board with a majority of independents would, however, be the preferable outcome even now that the refined WSE Code provides the exemption for companies with a shareholder controlling more than 50% of the voting rights. This new stipulation is understandable but makes a minimum number of independent directors (e.g. one third) even more necessary.

The need to enhance the qualification of board members seems to be evident. Not surprisingly, the EU Action Plan calls for minimum standards for director independence, a limitation of the total number of directorships, and minimum standards for committees.

Board committees – especially audit, nomination, and remuneration committees – are best practice standard and also proposed by the current EU Recommendations. They enable intensive discussions and ensure quality decision making. In Poland, board committees can rarely be found leaving ample room for improvement. It can therefore be welcomed that the WSE Code now contains a provision requiring board committees. From a German point of view, committees are particularly necessary to achieve board effectiveness due to the negative effects of co-determination that gives employee representatives half of the board seats in large companies. Polish company boards regularly have smaller board sizes and should therefore see more open board discussions – an advantage that should not be given up. Important employee interests should be pursued in the relevant workers council by the management board instead of stifling the supervisory board with mandatory co-determination.

- Appropriate remuneration issues for listed companies (Draft EU Recommendation October 2004)

Detailed information on directors' remuneration is highly relevant to judge particularly management board performance. The draft EU Re-

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<sup>9</sup> More information on GIME is available at [www.ibngr.edu.pl](http://www.ibngr.edu.pl).

<sup>10</sup> The Gdansk Code of June 2002 is available on the website of the Polish Corporate Governance Forum – [www.pfcg.org.pl](http://www.pfcg.org.pl).

commendation of October 2004 covers these issues in detail with the following major points:

- disclosure of the remuneration policy (remuneration structure, performance criteria, link between remuneration and performance, annual bonus and non-cash benefits, pension scheme, terms of contracts of executive directors),
- individual directors' remuneration (total fixed salary and bonus payments; total estimate of non-cash benefits; number of share options granted, exercised incl. exercise price, and unexercised incl. conditions; pension payments and loans),
- shareholder approval for share-based remuneration schemes required, and
- remuneration statement to become an AGM agenda subject to shareholders' vote.

Member states have to take appropriate measures until 30 June 2006.

In general, the board compensation structure should reflect the different functions and success factors to ensure that incentives are in line with shareholder interests. According to the PFCG rating analysis<sup>11</sup>, the lack of detailed information by Polish companies about the remuneration rules and policies seems especially worrying. This should therefore be addressed rather soon – not only to comply with the far reaching EU Recommendations.

▪ Enhancing corporate governance disclosure

Major points of the proposed EU Directive of October 2004 on company accounts are:

- establish collective board responsibility for financial statements,
- enhance transparency about related party-transactions and off-balance sheet arrangements, and
- introduce a corporate governance statement.

Shareholders and other stakeholders require sufficient information to evaluate the company-specific governance situation. Therefore, a corporate governance statement will become a specific part of the company's annual report according to the draft EU Directive of October

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<sup>11</sup> See Dzierżanowski / Przybyłowski / Tamowicz: A small step forward... Corporate Governance Rating 2003 for Polish Listed Companies, July 2004, available at [www.pfcg.org.pl](http://www.pfcg.org.pl).

2004. The statement should contain information on shareholder structure, the risk management system, operation of the AGM, the shareholder rights and operation of the board and its committees. Investors thus can assess the governance quality. This should help to exert market pressure and improve the quality of the discussion which can then be focused on the critical governance elements.

Increased transparency over related-party transactions and off-balance-sheet arrangements (including the use of Special Purpose Vehicles and offshore centres) should crucially improve governance practices also in Poland. The PFCG rating has shown that only seven of all analysed companies have sufficient internal control measures for related-party transactions. At least a supervisory board approval contained in the articles of association and a review by the auditor should be required. The recent Code improvement that at least half of the independent directors should vote for related-party transactions is certainly to be welcomed.

Important disclosure items already part of EU regulations via the EU Market Abuse Directive and the EU Takeover Directive of April 2004 are the shareholdings of the management and supervisory board members, directors' dealings and changes of share ownership. Equally important is timely and easy access to this information. Timely disclosure in this context means publication within three to five days of execution.

For Polish companies, disclosure of all relevant information – also via the Internet – is an area of major concern. According to a study for 2002 only 44% of the companies disclose their annual report on the company website, only 37% their ownership structure and only 29% a description of the company strategy.<sup>12</sup>

- Growing role of institutional investors: Not only the EU Action Plan but also the OECD Corporate Governance Principles (April 2004) underline the importance of enhanced participation by institutional investors in the affairs of the companies in which they invest. The respective legal action for improved disclosure requirements is planned for the medium-term by the EU Commission (2006 – 2008) but its importance rather suggests short-term implementation. In Poland, pension fund assets are growing at a rapid rate and by the end of the decade are projected to reach 10% of

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<sup>12</sup> Compare Dzierzanowski / Tamowicz: Setting standards for Corporate Governance, GIME Working Paper 2002, p. 16 (table 4).

GDP.<sup>13</sup> This development requires increased investor engagement: In addition to the voluntary obligation to vote at the AGM (which has to be regarded as a must based on the fiduciary duty to act in the sole interest of the clients), institutions should disclose their voting policy and their actual voting behaviour in aggregated form explaining critical decisions in detail.

▪ Ensure the credibility and reliability of companies' financial statements

Major points of the proposed EU Directive on statutory audit of March 2004 are:

- strengthen auditor independence and
- introduce a private accounting oversight board.

What are the new rules with respect to auditor independence? The EU Directive will bring significant change as it requires separate disclosure of fees charged for audit and audit-related services, tax advisory services and other non-audit services. According to the PFCG survey 2003 none of the analysed companies discloses the cost of the audit and non-audit services. Further EU requirements that should find more attention also in Poland are the rotation of the audit firm and/or its lead partner as well as auditor selection. This should be free from influence by the controlling shareholder and the management board – ideally decided by an audit committee that by the majority is independent.

In addition, a private accounting oversight board has to be implemented. The German two-step approach with a self-regulated body on the first level and the Securities Exchange Commission (BaFin) as second level for dealing with unresolved issues could serve also as a model for Poland.

The EU Directive on the implementation of International Accounting Standards (IAS) regulation published in July 2002 demands that European listed companies introduce international accounting standards for consolidated accounts beginning in 2005. The implementation process has already caused significant costs for many European companies. Nevertheless, to attract foreign investors, credible and reliable financial statements are a prerequisite. To fulfil this objective there is no alternative to harmonising national accounting standards according with international best practice. The need to align Polish accounting standards is evident as

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<sup>13</sup> See Institute of International Finance, Inc. (IIF): Corporate Governance in Poland – An Investor Perspective, Task Force Report, February 2003, p. 10.

they allow for example that group companies are excluded from consolidation if they are 'immaterial' (which is the case when the total assets of the subsidiary is less than 10% of the parent company or the total income does not exceed 20% of the parent company).<sup>14</sup>

▪ Unresolved governance issues

- Level playing field for takeovers: The unsatisfactory outcome of the protracted EU Takeover Directive (April 2004) requires individual action by member states and investors alike. The necessity for further change can exemplarily be demonstrated by the present German takeover law: Deficits in bid-price mechanisms as well as the possibility for the board to take decisive anti-takeover measures without shareholder consent are important violations of the investor's interest. In Poland, the PFCG survey results suggest similar improvement needs as existing anti-takeover-defences hinder the development of a functioning market for control. In particular, the current 50% threshold triggering a mandatory bid should be reduced to an internationally accepted level between 30% and 35%; shareholder approval of takeovers should be introduced as mandatory.
- One share-one vote: The EU Commission considers in its Action Plan that there is a strong medium to long term case for aiming to establish a real shareholder democracy in the EU. That means no deviations from the 'one share-one vote'-principle. In Poland, especially the right of the State Treasury to have five votes per share as stockholder in companies established between 2001 and 2004 does not comply with the EU objective. The elimination of the number of nonvoting and supervoting shares should therefore be pursued vigorously. State-owned firms should set the standard and enforce this fundamental governance principle. Without such a legal change, at least a recommendation in favour of equal shareholder rights should be added to the WSE Code requiring an explanation in case of non-compliance.

▪ Establishment of independent bodies for arbitration and improve enforcement mechanisms

Good governance will not be possible without sufficient enforcement as companies will not adhere to the quality aspects if they have nothing to fear from governance misdeeds. It is therefore vital to establish appropriate bodies and sanction mechanisms. This should include:

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<sup>14</sup> Example from IIF Task Force Report, February 2003, p. 8.

- Introduction of a private arbitration panel consisting of accepted market experts to resolve code-related issues and conflicts between minority and controlling shareholders. The panel should be able to decide within three months thus relieving the courts from unnecessary work that can be settled directly between the parties. According to the OECD Principles' commentary this has proven beneficial in many countries, at least at the first instance level.
- Centralize competencies of the market supervisory authority and concentrate courts in one authoritative place that can process all normal court issues within one year. This development has to be seconded by extensive training for enforcement authorities.

### III. The code compliance question: the German example

- Compliance by companies: the formal vs. the real picture

In the early development period before 2002, only a few companies were really interested to actively engage in the promotion of governance. Intensive resistance had to be overcome particularly by the chief lawyers who generally have a strong position in German companies and reacted negatively to new obligations of a non binding legal nature. More than two years after the introduction of the official Code in 2002, some major corporations are only willing to do the absolute necessary rather than seeing the opportunity to promote a good company image to all stakeholders.

As mandated by company law (§ 161 AktG), listed German companies have to explain deviations from the 'Shall Recommendations' of the Code at least annually. A recent survey<sup>15</sup> conducted by the University of Hamburg showed that for 2003 all analysed companies generally accept the Code as such. More interesting, however, is the extent of the acceptance in detail. The survey reveals that only few companies comply with all recommendations. Most reported deviations concern: disclosure of individual board member remuneration, board qualification, implementation of audit committees, deductibles for D&O insurance for board members, and timely financial reporting. More improvements are even required in terms of application of the voluntary 'Should Suggestions'

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<sup>15</sup> See Bassen / Kleinschmidt / Zoellner: Corporate Governance Quality Study 2004 - Analyse der Corporate Governance deutscher Unternehmen aus Investorenperspektive, in: Finanz Betrieb, Issue 7, July 2004, p. 527-533.

of the Code. Only close monitoring by investors, analysts and the media will ensure an ongoing improvement in quality terms.

The difference between formal compliance and real governance quality also became apparent in a recent survey conducted by a prominent investor magazine<sup>16</sup> that reflected the practical experience of major German and international capital market participants. The comparison of formal compliance versus the governance quality as perceived by the capital market produced significant differences. For example, Siemens AG ranked only 12th in formal Code compliance but was ranked first in governance quality by the capital market experts, whereas RWE AG as the only company that fully complies with all Code recommendations and suggestions was only ranked average by the capital market experts.

In Poland, the same discrepancy seems to exist: Many companies declare compliance with the WSE Code but deviate substantially in quality in critical recommendations.

- Monitoring and evaluating corporate governance practices
  - Governance scoring: As the best governance framework does not guarantee acceptance and implementation if the companies are not complying with the spirit of the code, practical ways of monitoring company governance are essential. One of the proven ways to achieve this is the systematic analysis and publication of the governance situation via a scorecard. Such a scorecard should provide full transparency of the evaluation process and involve no or only marginal cost for companies, investors and interested stakeholders. Furthermore, the user should be enabled to verify the score by conducting the process himself. The German Society of Investment Professionals (DVFA) devised such a scorecard upon the introduction of the official German Governance Code.<sup>17</sup>

While some companies have supported the German Scorecard, there are many companies that are reluctant to apply this tool. In particular, they insist that by fulfilling the mandatory 'Shall-Recommendations' of the German Code (but not the 'Should-Suggestions' and other good

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<sup>16</sup> See 'Euro Corporate Governance Quality Award 2004' at [http://ad04.vhb.de/dmwwwangebot/fn/dmo/sfn/load\\_bin/SH/0/pid/218903/index.pdf](http://ad04.vhb.de/dmwwwangebot/fn/dmo/sfn/load_bin/SH/0/pid/218903/index.pdf).

<sup>17</sup> The Scorecard is available in English at [www.dvfa.com](http://www.dvfa.com). The German Governance Code is also available in English at [www.corporate-governance-code.de](http://www.corporate-governance-code.de).

governance elements), they should reach a score of 100%. Furthermore, they are critical about the inclusion of other elements that reflect the OECD Principles and other international governance standards, like a level playing field approach for takeovers. In general, these companies ignore that the capital markets need analytic instruments to compare not only financial but also non-financial criteria due to the large number of potential investment candidates.

The rating effort by the PFCG and others is a critical success factor to advance good governance in Poland. It should therefore be continued and its results should be considered by policy makers.

- There is now a quickly growing supply of independent research initiatives (e.g. Deminor, GovernanceMetrics, ISS) that offer an alternative monitoring solution based on proprietary rating methods. They are especially valuable for investment institutions as a first step of a deeper governance analysis. However, these ratings are proprietary and rather costly (€ 20.000 - € 40.000 for annual subscription and solicited ratings that start at € 50.000 per company) thus not easily available for a broad application by all stakeholders. The rating methodology of the rating agencies and proxy services is not transparent ('black box'). Especially the use of a 'one-size-fits-all'-approach for international governance assessments risks either to be superficial or to ignore country-specific governance elements that might lead to biased results. Yet, national characteristics are important to consider especially in countries that have only recently entered the international corporate governance stage.