UNIVERSITY OF ZAGREB

Faculty of Economics & Business

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2nd International Conference

LEGAL AND ECONOMIC ASPECTS OF CORPORATE GOVERNANCE – MARKET TRANSPARENCY AND DICLOSURE IN PRIVATE AND PUBLIC COMPANIES

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Jean Monnet Chair

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Foreword

Dear readers,

The 2nd International Conference "Legal and Economic Aspects of Corporate Governance - Market Transparency and Disclosure in Private and Public Companies" was held on 3rd and 4th May 2013 in organization of the Jean Monnet Chair/Department of Law Faculty of Economics and Business, University of Zagreb and the Judicial Academy of the Republic of Croatia. The conference was organized under the high patronage of the President of the Republic of Croatia prof. dr. sc. Ivo Josipović. Professor Hana Horak, the President of the Organizing Committee, assembled a number of participants, researchers and practitioners, from Croatia and other Member States of the European Union (Bulgaria, Italy, Slovenia, Germany, France, Poland, UK, the Netherlands).

The goal of the 2nd International Conference "Legal and Economic Aspects of Corporate Governance - Market Transparency and Disclosure in Private and Public Companies" was to discuss market transparency and disclosure in order to increase number of investments and make proper market playing field for the private and public companies while operating on the EU Internal Market and nationally.

Conference participants were numerous experts in law and economics, attorneys, civil servants from the state administration bodies, judges and members of judicial authorities, representatives of independent agencies, representatives of private and public companies, undergraduate and postgraduate students. At the opening of the conference Professor Jurica Pavičić, Vice-Dean of the Faculty of Economics and Business, addressed the participants on behalf of the host, followed by Professor Boris Cota on behalf of the President of the Republic of Croatia.

In her presentation Professor Horak pointed out that the transparency and disclosure are key elements for companies and markets and also stressed the importance of transparency and disclosure for better corporate governance and for the protection of all stakeholders. Professor Horak also accentuated how the ongoing financial crisis has shown that non transparent operations under the weak corporate governance can affect not only the company by itself but the entire economy.

During the first day of the conference an overview was given of importance of transparency and disclosure for investors, of board efficiency and gender diversity, of issues of board structure including employees' participation and gender discrimination and also an overview of the

importance of accounting and auditing as instruments of transparency and disclosure. After introductory remarks delivered by Professor Hana Horak and Senior Assistant Kosjenka Dumančić, the presentations of the European corporate governance experts took place.

All these topics are the subject of numerous studies and contribute to the development of corporate governance not only in the Republic of Croatia but also in the other EU Member States.

When the corporate governance becomes transparent it helps in preventing corruption, attracts investors and enhances company's competitiveness and accountability. Successful corporate governance in the private and public companies is an essential precondition for the creation of business-friendly economy. This conference has sent a message about the importance of transparency and disclosure as preconditions for strengthening the economy and preventing illicit conduct. It should be noted that the core values of good corporate governance are the same as the core values of democratic society.

This conference proceedings are an important contribution to the development of corporate governance in the Republic of Croatia and in the other EU Member States and also the opportunity for implementation of the new experiences and harmonization of the best practices in corporate governance.

In the end, we wish to express our gratitude to our respected sponsors who enabled this conference to be organized.

Professor Tonći Lazibat, Ph. D.

Dean

Professor Hana Horak, Ph. D.

Jean Monnet Chair

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Hana Horak, Kosjenka Dumančić

TRANSPARENCY AND DICLOSURE AS KEY ELEMENTS FOR COMPANIES AND MARKETS

Introduction

Democratic society has been characterized with synergy of three sectors: public (state), private (market) and citizens (civil society). The core values of good corporate governance are the same core values of democracy.[1] The corporate governance is one of the key elements that can improve development of democratic society. Better transparency and disclosure can lead to the better corporate governance. Economy relies on the success of companies either state owned or private. The financial crisis has shown how non transparent operations under the weak corporate governance can affect not only the company by itself but the entire economy,[2] even on the global level. The definition of the corporate governance includes the relationship between shareholders, creditors and corporations; between financial markets, institutions and corporations; and between employees and corporations.[3] To enable all the above mentioned relations it is necessary to have a framework of laws, rules and institutions which differs from country to country or we can say they are affected by country institutional set up. Also there is a matter of ownership structure in a country, especially in the developing countries and also influence of the government policy. There are numerous researches that prove that countries legal framework can improve financial investments.[4] As it is in literature stated and proved in a practice objectives of the good corporate governance practice would be to maximize the contribution of companies to the overall economy.

[1] At www.democracythatdelivers.org.

[2] About the relationship between these factors see more in Hopt, K, Wymeersch, E., Kanda, H., Baum, H. (ed.): Corporate Governance in Context: Corporations, States and Markets in Europe, Japan and the US, Oxford, Oxford University Press, 2005.

[3] Classens, S., Yurtoglu, B: Corporate governance in emerging markets: A Survey, 2012, available at http://ssrn.com/abstract=1988880, p. 4. When we define corporate governance there is a set of definitions. One of the most used is one given in OECD Principles of Corporate Governance first realised in 1998 and last time revised in 2004. Available at http://www.oecd.org/daf/ca/corporategovernanceprinciples/31557724.pdf. For other definitions see also Zingales, L., Corporate Governance. The New Palgrave Dictionary of Economics and the Law, 1998. Available at SSRN: http://ssrn.com/abstract=46906 or http://dx.doi.org/10.2139/ssrn.46906; Shleifer, A., Vishny, R.W.: A Survey of Corporate Governance, The Journal of Finance, Vol. 52, No. 2 (Jun., 1997), pp. 737-783, available http://www.jstor.org/stable/2329497 . See also Hopt, K. J., Leyens, P.C.: Board models in Europe. Recent developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy, Law working paper No. 18/2004, January 2004, p.3 available at http://ssrn.com/abstract=487944; Becht, M., Bolton, P., Roell, A.: Corporate Governance and Control, ECGI Working paper no.02/2002.

[4] The last research was done by Classens, S., Yurtoglu, B. and Study Doing business in a more transparent world by IFC and The World Bank. Older researches were done by Charles P. Himmelberg, C. P., R. Glenn Hubbard, R. G., Palia, D.: Understanding the determinants of managerial ownership and the link between ownership and performance, Journal of Financial Economics 53 (1999) p. 353-384, available at http://people.stern.nyu.edu/eofek/PhD/papers/HHP_Understanding_JFE.pdf; Adams, R., Ferreira, D.: One Share-One Vote: The Empirical Evidence, Review of Finance (2008) 12 (1): 51-91, available at http://rof.oxfordjournals.org/content/12/1/51.short; Roberts, M.R., Whited, T.M.: Endogeneity in Empirical Corporate Finance (October 5, 2012). Simon School Working Paper No. FR 11-29. Available at SSRN: http://ssrn.com/abstract=1748604 or http://dx.doi.org/10.2139/ssrn.1748604.

Classens and Yurtoglu[5] base their research and synthesize the results according to the conclusions that the corporate governance can increase the external financing and lead to higher investment, growth and employment creation. It can also lower the cost of capital and associated higher firm valuation which makes more investments attractive to investors. Corporate governance leads to better operational performance through better allocation of resources and better management. It is also connected with a reduced risk of financial crises and means in general better relationship with all stakeholders which help to improve social and labour relationship.

Operating on the market, there are state owned companies that are actively engaged on the market (not always transparently visible that they are state owned).[6] Secondly, there are private companies that go public (on the stock exchange) where the issues of transparency and disclosure are also extremely important. In both companies there are stakeholders what combines shareholders, suppliers, all interested (engaged) contractual parties, workers and society as a whole. Taking into the consideration privately owned and state owned companies while operating at the market there must be assured the same market position. Question is: "Is it really possible?" The possibility of the same market position can be achieved through the transparency and disclosure or in the other words from the institutional and legal framework under the same discipline for all the market players.

One of the crucial issues for the corporate governance and financial market development are properly functioning of legal and judicial systems. This involves a number of dimensions: the general definition and protection in laws of property rights; the formal definition and protection of creditor and shareholder rights specifically, the enforcement of legal rights in the judicial system (disclosure, accounting, regulation, supervision), the lack of corruption in general and the overall disclosure regime. Most of these aspects are of a qualitative nature and consequently not as easily captured and codified.[7] Legal foundations matter crucially for variety of factors that lead to higher growth including financial market development, external financing and the quality of investments.

From the law perspective both private and public law rules should insure effective regulatory framework. From the corporate governance perspective, beside the hard law rules, the self discipline within the company and board has been achieved through the set of soft law rules according to the documents and studies[8] more or less successfully.

According to the new European Commission Action plan[9] there is a need for modern set of binding rules bearing in mind that soft-law rules[10] in the form of recommendations haven´t efficiently

[5] Classens, S. et al.: Corporate governance…, p. 11. The analysis given by Classens, S. and Yurtoglu, B. is made by systematization of the literature throughout what channels it has identified that corporate governance impact companies and countries.

[6] See OECD Guidelines on corporate governance in State owned enterprises, 2005, available at http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/34803211.pdf.

[7] Ibidem, p. 6.

[8] Study on monitoring and enforcement pracitces in Corporate Governance in the Member States, RiskMetrics Group, September 2009., available at www.riskmetrics.com; EcoDa „Comply or explain" Preserving governance flexibility with quality explanations, Report, EcoDa annual conference, 2012, available at http://www.ecoda.org/docs%20-%20OK/Conferences/2012_03_27%20Comply%20or%20Explain/2012AnnualConf-ecoDa-CoEreport.pdf.

[9] Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, COM (2012) 740/2.

[10] About soft law see more in Bodiroga Vukobrat, N., Horak, H.: Kodeksi korporativnog upravljanja-instrument socijalno odgovornog gospodarenja (Corporate Governance Codes – an instrument of the social responsible

achieved certain goals.[11] But on the other hand it must be born in mind that mandatory rules can reduce the focus on the substance of good governance and they can remove the key responsibility of boards and shareholders for the quality of corporate governance and reduce the governance to the compliance debate with the regulators. Formalistic "comply or explain"[12] approach leads to a legalistic board approach with no in-depth board discussion on the governance of firm but with lawyers and auditors that have to fulfil the necessary formalities.[13]

Corporate governance has helped in last decade to redefine the powers within the corporation (such as role of the shareholders and board). It is important that shareholders have the right to the fair return in addition to full and fair information through transparent accounts.[14] Through that information the shareholders are given more information and possibilities to oversee remuneration policy and related party transactions and their cooperation is made easier that way.[15] The economic damage can be caused by breach of trust in the private sector and it is just as serious as breach of trust in the public sector. It is important to point out that public corruption is well defined in national laws and international treaties beside the fact that is not always efficiently prevented.[16] For the companies, codes of corporate governance and codes of conduct should define all the necessary rules, treatments and actions within the company. Bearing in mind what should be necessary to regulate beside the hard law regulations. Since the codes of corporate governance are form of soft-law, which means that they are applied voluntarily, there is always question of how they will be really applied in practice. In the practice[17] the corporate governance code can have the same authority for the company as a whole as a regulations and laws when there is real management

governance), Socijalno odgovorno gospodarenje, Zbornik radova, Tim press i Pravni fakultet Sveučilišta u Rijeci, Zagreb, 2008., p. 201. See also Wymeersch,E.: Implementation of the Corporate governance Codes in Hopt, K, Wymeersch, E., Kanda, H. i Baum, H. (ed.) Corporate Governance in Context: Corporations, States and Markets in Europe, Japan and the US, Oxford, Oxford University Press, 2005.

[11] In Introduction of the Action Plan accentuated are fields of "say on pay" and more sustainable companies, p.3.

[12] See more about "comply and explain" principle and the role of the corporate governance codes in: Horak, H., Bodiroga-Vukobrat, N.: EU Member States´ Experiences with the „Comply or explain" Principle in Corporate Governance, Croatian Yearbook of European Law and Policy, Vol. 7, Zagreb, 2011, p. 179-200. See also Seidl, D., Sanderson P.: Applying „Comply or explain": conformance with codes of corporate governance in the UK and Germany, Centre for Business Research, University of Cambridge Working Paper No. 389 **,** June 2009, p.5., available at http://www.cbr.cam.ac.uk/pdf/WP389.pdf.

[13] EcoDa „Comply or explain" Preserving governance flexibility with quality explanations, Report, EcoDa annual conference, 2012, available at http://www.ecoda.org/docs%20-%20OK/Conferences/2012_03_27%20Comply%20or%20Explain/2012AnnualConf-ecoDa-CoEreport.pdf, p. 7.

[14] Vincke, F., Heimann, F. (ed.): Fighting corruption A Corporate Practices Manual, ICC, 2003., p. 135.

[15] Action Plan (2012), p. 4.

[16] Vincke, F. et al.: Fighting corruption…, p. 135.

[17] See more about comply and explain principles and the role of the corporate governance codes in: Horak, H., Bodiroga-Vukobrat, N.: EU Member States´ Experiences with the „Comply or explain" Principle in Corporate Governance, Croatian Yearbook of European Law and Policy, Vol. 7, Zagreb, 2011, p. 179-200; Horak, H., Bodiroga-Vukobrat, N.: Kodeksi korporativnog upravljanja - instrument socijalno odgovornog gospodarenja (Corporate Governance Codes – an instrument of the social responsible governance), Socijalno odgovorno gospodaranje, Barić, S., Bodiroga-Vukobrat, N. (ed.), Faculty of Law Rijeka and TIM PRESS, Zagreb, 2008, , p. 187-212.

commitment. According to the research of Classens and Yurtoglu[18] the efficiency of enforcement is twice as high in advanced countries than in emerging markets and transition economies.[19]

The objective of good corporate governance would be to maximize the contribution of companies to the overall economy that includes all stakeholders. Corporate governance encompasses also the issues of corporate social responsibility including aspects of the dealings of the company with respect to culture and environment.[20]

Why disclosure and transparency matters?

Many empirical evidences indicate that high standards of transparency and disclosure have an impact to the cost of capital on the market. That is just one of the elements. Reliable and timely information can increase confidence among decision-makers within the organization and enable them to make good business decisions[21] directly affecting growth and profitability of their own market players. Information also affects decision makers outside the entity – shareholders, investors and lenders who must decide where and at what risk to place their money. The information that company provides should show decision-makers and outside interests whether and to what corporation extend meets legal requirements. Disclosure helps public understanding of company´s activities, policies and performance with regard to environmental and ethical standards, as well as its relationship with the communities where the company operates. Disclosure and transparency, as well as proper auditing, serve as a deterrent to fraud and corruption, allowing firms to compete on the basis of their best offerings and to differentiate themselves from companies who do not practice good corporate governance.[22]

The disclosure can be analyzed from two perspectives. The first perspective is for the market and the second perspective is for the company. In the terms of market disclosure it is stated[23] that strong transparent disclosure regime is pivotal for market-based monitoring of companies and central to shareholder ability to exercise ownership rights. The data disclosure can be powerful tool for influencing companies and protecting investors. It can help to attract capital and maintain confidence in the markets. Disclosure helps to prevent financial crime either on the market or in the company itself. Weak disclosure can contribute to unethical behaviour and loss of market integrity, costing not only company but economy as a whole. Insufficient or unclear information may hamper ability of markets to function, increase cost of capital and result in poor resource allocation.[24] The

[18] Classens, S. et al.: Corporate governance…, p. 7.

[19] This statement can be confirmed in Croatia when looking in HANFA Report, available at http://www.ripe.hanfa.hr/hr/publiciranje/izvjesca/ (unfortunately still not published in English).

[20] Classens, S. et al.: Corporate governance…, p. 4. See also Report on corporate social responsibility: accountable, transparent and responsible business behaviour and sustainable growth (2012/2098(INI)) 28.1.2013. p. 4: "Modern understanding of corporate social responsibility considers corporate governance, key element of corporate social responsibility..."

[21] Information is a key element for making good business decisions. See also Ribstein, L. E., Alces, K. A.: Directors´ duties in failing firms, University of Maryland Journal of Business & Technology Law, 1, 2007, p. 529-549.

[22] Available at http://www.iccwbo.org/corporate-governance/id3081/index.html.

[23] Smith, R.B.: Role of disclosure in Corporate Governance „Disclosure, again disclosure and still more disclosure", US SEC Commission, presentation.

[24] Ibidem.

need of the minimum rules that the information gathered and assessed must be made public and accessible in order to affect interest of the local community where the investment will be located under publicly available criteria that give the possibility to the society as a whole to answer if needed. Especially important role is the role of the anti-corruption measures that ensure that investors shall not be, prior or after the placement of their investment, asked, offered, promised or given any undue pecuniary or other advantage or opposite.[25]

When the information that should be disclosed is discussed, the distinction between financial and non-financial information that have to be disclosed at the market should be made. The financial disclosure is probably the most important issue for the market, but also there are growing initiatives regarding the non-financial disclosure.[26] The financial information that should be disclosed is the information that shows financial and operating result of the company in its annual reports and in accounting records.

According to the Action plan[27] there will be a modification of current Accounting Directive[28] with changes in disclosure of non-financial information. The non-financial disclosure[29] encompasses disclosure by companies of their policies in the field of social rights, environment, human rights or corruption, disclosure of the board diversity policy in terms of gender, age, nationality, educational and professional background and disclosure on "comply or explain" basis.[30]

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[25] See also Mann, H., Von Motke, K., Peterson, L.E., Cosbey, A.: IISD Model International Agreement on Investment for Sustainable development, Negotiatiors´Handbook, Second Edition, IISD, 2005 (2006), p. 24.

[26] As a result of consultation of stakeholders and interested parties on non-financial information an overall majority of stakeholders supported the need to improve the current legislative framework. Article 46 (1) of Proposal in fact contains „comply or explain" principle also for non-financial information. Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups COM (2013) 207 final, 16.4.2013., p. 4

[27] Action Plan (2012), p.6.

[28] Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L 222, 14.8.1978; amended by Seventh Council Directive 83/349/EEC of 13 June 1983, OJ L 193, 18.7.1983.; Eleventh Council Directive 89/666/EEC of 21 December 1989, OJ L 395, 30.12.1989; Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001, OJ L 283, 27.10.2001.; Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003, OJ L 178, 17.7.2003.; Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 OJ L 157, 9.6.2006; Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006, OJ L 224, 16.8.2006.; Directive 2009/49/EC of the European Parliament and of the Council of 18 June 2009 OJ L 164, 26.6.2009; Directive 2012/6/EU of the European Parliament and of the Council of 14 March 2012 OJ L 81, 21.3.2012. Proposal for Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups COM (2013) 207 final, 16.4.2013.

[29] See Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups COM (2013) 207 final, 16.4.2013., p. 4. See in Public consultations on "Disclosure of non-Financial information by companies" and on the "EU corporate governance framework".

[30] This approach allows companies to depart from particular recommendations on the applicable code, provided they explain the reasons for doing so. The explanations provided by the companies are often insufficient. They either simply state that they had departed form a recommendation without any further explanation, or provide only a general or limited explanation. See more in Action Plan, p. 6 and also in the Study on monitoring and Enforcement practices in Corporate Governance in the Member states, available at http://ec.europa.eu/internal_market/company/ecgforum/studies_en.htm. See also EcoDa „Comply or explain" Preserving governance flexibility with quality explanations, Report, EcoDa annual conference, 2012.

In the terms of company reliable and timely information increases confidence among decision makers within the company (board members, shareholders) and enables them to make good business decisions[31] directly affecting growth and profitability. Information also affects decision makers outside the entity-shareholders, investors and lenders, who must decide where and with what risk to place their money. The information provided, show the decision-makers and outside interests whether and to what extent corporations meet legal requirements. Disclosure helps public understanding of company´s activities, policies and performance with regard to environmental and ethical standards, as well as its relationship with the communities where the company operates (relations with stakeholders). Disclosure and transparency as well as proper auditing serves as a deterrent to fraud and corruption, allowing firms to compete on the basis of their best offerings and to differentiate themselves from firms who do not practice good governance.[32] In accordance transparency and accountancy standards and the character of investment should meet or exceed national and internationally accepted standards of corporate governance for sector involved. Investors should make public all investment contracts. That rules also comply to the principle of achieving corporate social responsibility when we speak about importance of disclosure for the market.[33] But also an effective corporate policy would require that all favours (above certain amount should be defined) and disclosed within the corporation. Because corporate governance rules are voluntarily applied there are some critics that there is a need of sanctioning the breach of them, that lacks. The most important is implementation of the rules in practice. The corporate rules can have, for the company and its employees, just the same authority as the national laws have for the citizens of a country.[34]

Regulatory framework for disclosure is defined. At the market level it is defined by laws, codes and recommendations. At the company level regulatory framework is defined by the company strategy (its mission and vision) and by the statute, but also by the management and supervisory board decisions.

Transparency is defined as information available to any interested party. "Transparency means active disclosure". There is a need to enhance transparency while the companies need to provide better information about their corporate governance to their investors and society at large. At the same time companies should be allowed to know who their shareholders are and institutional investors should be more transparent about their voting policies so that a more fruitful dialogue on corporate governance can take a place.

Also according to the European Commission Action Plan one of the most important challenges of the Action Plan is engagement of the shareholders.[35] Since overall quality of corporate reporting has gone up, and the focus now should be on more improvement in the general quality of disclosure around corporate governance and a clear articulation by each company of how its governance

[31] See more on business judgement rule in Horak, H., Dumančić, K.: Pravilo poslovne prosudbe u hrvatskom i američkom pravu (Business judgment rule in Croatian and American Law), Zbornik Pravnog fakulteta u Rijeci, Vol. 29, no. 2, 2009.

[32] Smith, R.B.: Role of disclosure in Corporate Governance „Disclosure, again disclosure and still more disclosure", US SEC Commission, presentation.

[33] Mann, H. et al.: IISD Model International Agreement …, p. 26.

[34] Vincke, F. et al.: Fighting corruption…, p. 137.

[35] Action Plan defines three important steps: main lines of action. One of them is enhancing transparency.

arrangement support its business model. The assumption that shareholders[36] are the monitors of companies´ governance presupposes their engagement. It must cover better oversight of remuneration policy, what is at the moment one of the hottest topics in the EU Member States.

Oversight of the related party transactions, regulating proxy advisor, clarification of the concept of "acting in concert" and employee share ownership, all this has been more or less regulated by the Shareholders directive,[37] but since 2007 the implementations in practice didn´t show any special improvements.

It is also important to mention concerning transparency strengthening disclosure on board policies on diversity and non-financial risk management, quality of explanations for non-compliance in corporate governance reports, shareholders´ identification and transparency of voting policies.

And last but not least transparency and disclosure should be improved through improving the framework for cross border operations of companies (cross border transfer of the companies' seat[38]/ cross border mergers and cross border divisions). New regulation on European SMEs and European Private Company and the merging and codifying the provisions of various company law directives in one code, but it is questionable is it possible to achieve this bearing in mind different national company law solutions.[39]

Implementation in Croatia

Transparency and disclosure in Croatia is defined by numerous rules incorporated in laws, regulation and Code of corporate governance.[40] As the authors stated before the transparency and disclosure are important from two perspectives. The first one is important for the market and the second one for the company. In that sense, analyzing the matters that concern company law it is necessary to follow the developments of the company law rules and that of the capital market rules since they are interconnected and complement. Accompanied with soft law rules, the disclosure and transparency of the information about the companies are important for both areas no matter that the aim of the regulation slightly defers. As authors in the literature explain[41] for the company law disclosure and transparency are instruments that are primary for protection of the shareholders and

[36] About Shareholders directive and shareholders rights see more in Horak, H., Dumančić, K.: Jačanje prava dioničara i pravo dioničara na informacije (Fostering the shareholders rights and shareholders right to information), Pravni vjesnik of the Faculty of Law University in Osijek, year 27, No. 3-4, Osijek, 2011, p. 191-217.

[37] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14. 7. 2007, str. 17-24.

[38] About cross border transfer of the companies seat see in Horak, H., Dumančić, K., Šafranko Z.: Sloboda poslovnog nastana trgovačkih društava – što donosi prijedlog četrnaeste direktive u pravu Europske unije? (The freedom of establishment – what does the Proposal of the Fourteen Company Law Directive bring into the European Union Law?), Zbornik Pravnog fakulteta Sveučilišta u Rijeci, vol. 33, br. 2, Rijeka, 2012.

[39] Horak, H.; Dumančić, K.: Harmonisation of the Croatian Company Law with Aquis Communitaire of the European Union, The Business Review, Cambridge, Vol. 18, No. 2, 2011.

[40] The Code of Corporate Governance, HANFA (Croatian financial services supervisory agency and Zagreb stock exchange), 2010.

[41] Ferarini, G., Enriques, L., Gatti, M.: EC reforms of Corporate Governance and Capial Markets Law: Do they Tackle Insiders Opportunism?; 2006, available at SSRN: http://ssrn.com/abstract=886345, p.13; Horak, H., Dumančić, K., Pecotić Kaufman, J.: Uvod u europsko pravo društava (Introduction into the European company law, Školska knjiga, Zagreb, 2010, str. 17.

as a control of the acting of the management and supervisory bodies. Within the capital market law, disclosure and transparency are used to provide accurate and reliable information for all the actors at the capital markets. Company law and corporate governance are developed in Croatia along parallel lines, as it is evidenced by the continuous adjustment of the Companies Act[42] with the latest achievements in the field of company law and corporate governance at the European Union level.[43] Also, the amendments on the Court Register Act,[44] the provisions of the Capital Market Act,[45] in particular those which enter into force on the date of the Croatian accession into the EU,[46] as that of the Takeovers of joint stock companies Act,[47] the Credit Institutions Act[48] which regulates transparency and disclosure of the data with credit institutions.

Bearing in mind financial institutions (and credit institutions)[49] it is clear that transparency and disclosure and issues of corporate governance have been under special treatment after crisis in 2008. According to the literature[50] corporate governance in financial institutions has been identified to differ from that of corporations but in which way is not yet clear.[51]

Considering the provisions that define corporate governance, authors have divided the definitions in the literature[52] in two categories. In a comparative review, the question arises how broadly to define the framework for corporate governance. Under a narrow definition, the focus would be only on the rules in capital markets governing equity investments in publicly listed firms. This would include listing requirements, insider dealing arrangements, disclosure and accounting rules, and protections of minority shareholder rights. A broader definition would define corporate governance as a set of mechanisms through which firms operate when ownership is separated from management. These definitions provide the application of different laws. In Croatia the regulation follows this model.

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[42] The Companies Act (Official Gazette of the Republic of Croatia "Narodne Novine" of the Republic of Croatia Nos. 111/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09, 111/12)

[43] As an example see Companies Act, Art. 272. p. that introduces "Comply or explain" principle into Croatian company law. More about harmonization of the Croatian company law with European Company law see in Horak, H.; Dumančić, K.: Harmonisation of the Croatian Company Law with Aquis Communautaire of the European Union, The Business Review, Cambridge, Vol. 18, No. 2, 2011, p. 163-170; Horak,H., Dumančić, K.: Usklađivanje u području prava društava Republike Hrvatske s pravnom stečevinom EU, Pravo i porezi, br.5, 2011, ISSN 1331-2235 and in Horak, H., Dumančić, K.: Jačanje prava dioničara i pravo dioničara na informacije (Fostering the shareholders rights and shareholders right to information), Pravni vjesnik of the Faculty of Law University in Osijek, year 27, No. 3-4, Osijek, 2011, p. 191-217.

[44] The Court Register Act was also amended (Official Gazette of the Republic of Croatia "Narodne Novine" Nos. 1/95, 57/96, 1/98, 30/99, 45/99, 54/05, 40/07, 91/10, 90/11). For example Art. 36, 37, 39 and 40 of the Court Register Act.

[45] The Capital Market Act (Official Gazette of the Republic of Croatia "Narodne Novine" Nos. 88/08; 146/08; 74/09)

[46] For example Art. 335 (3) and Art.364 (2) of The Capital Market Act.

[47] The Takeovers of Joint Stock companies Act (Official Gazette of the Republic of Croatia "Narodne Novine" Nos. 109/07; 108/12).

[48] The Credit Institutions Act (Official Gazette of the Republic of Croatia "Narodne Novine" nos. 117/08; 74/09; 153/09; 108/12).

[49] Under the Credit Institutions Act under the credit institutions we understand different kind of banks and institutions for electronic money (Art. 2). The same Act in Art. 9 regulates financial institutions as is a legal entity that isn´t a credit institution and whose sole or main activity is to acquire holdings or to provide one or more basic financial services defined in Art 5 of the same Act.

[50] Classens, S. et al.: Corporate governance…, p. 30.

[51] See also The governance of banks in transition economies Croatia country report, European Bank for Reconstruction and Development, 2012. Financial institutions have their own rules on corporate governance. Croatian national bank has issued in 2007 its viewpoints on corporate governance in banks.

[52] Classens, S. et al.: Corporate governance…, p. 3.

In addition to the legal framework of the utmost importance are the Zagreb Stock Exchange Rules[53] and the Corporate Governance Code[54] (last time amended in 2010) that assure transparency and disclosure of information about the companies but also implementation of that rules in practice. Bearing in mind all the stakeholders, the special attention of the corporate governance regulation should be on employees participation that has been regulated with by the Labour Act[55] recently amended and harmonized with European regulatory framework, transparency and disclosure of the public registers[56] and issue of board diversity. All this cannot be completely achieved if there is no active, consistent and coherent oversight and performance role of regulatory and supervisory agencies,[57] especially in emerging market like Croatia is.

Bearing in mind that enforcement is a key to corporate reforms there is a lot of work to do in order to attract investments, growth of financial structure and to maximize the contribution of companies to the overall economy. In Croatia we have to establish independent corporate governance body[58] (example Germany, Belgium, France...) that would have advisory role and give the guidelines necessary to raise the issue of corporate governance as a whole.

[53] The Zagreb Stock Exchange Rules, available at http://www.zse.hr/UserDocsImages/legal/Pravila2011_engl.pdf.

[54] The Code of Corporate Governance, HANFA (Croatian Financial Services Supervisory Agency and Zagreb Stock Exchange, 2010.

[55] The Labour Act (Official Gazette of the Republic of Croatia "Narodne Novine" Nos. 149/09; 61/11).

[56] The Land Registry Act (Official Gazette of the Republic of Croatia "Narodne Novine" Nos. 91/96; 114/01; 100/04; 107/07; 152/08), The Court Registry Act (Official Gazette of the Republic of Croatia "Narodne Novine" Nos. 1/95; 57/96; 1/98; 30/99; 45/99; 54/05; 40/07; 91/10; 90/11), etc.

[57] In Croatia Agency for Supervision of Financial Services (HANFA), Government Asset Management Agency (AUDIO), State Agency for Deposit Insurance and Bank Rehabilitation (DAB).

[58] For example in Germany Government Commission for German Corporate Governance Code is established (Regierungskommission Deutscher Corporate Governance Kodeks), Belgian Commission Corporate Governance (http://www.corporategovernancecommittee.be/fr/commission/fonctionnement/default.aspx),French Commission Nationale de Gouvernance d'Entreprise, etc.

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Bistra Boeva

CORPORATE GOVERNANCE AND COMPANIES'S AND COUNTRY COMPETITIVENESS (THE CASE OF NEW MARKET ECONOMIES IN SE EUROPE)

Corporate Governance: Company and country competitiveness: theoretical observations and practical evidence

Abstract

The transition from a planned to a market economy is mainly about dismantling long-term structures and mechanisms and building (and rebuilding) new institutions from scratch. Corporate Governance is an integral part of these new institutions. The focus of the paper is to investigate the role of corporate governance from a different perspective: the objective is not about what is corporate governance in new market economy countries, but rather to trace the contribution of the corporate governance to the company's and country's competitiveness. *The paper embeds theoretical observations, results of research on corporate governance issues in a new EU member country - Bulgaria and results from a comparative analysis of corporate governance issues in two group of transition economies countries: Western Balkans countries and Euroasia countries. I used quantitative and qualitative methods to find the adequate information and arguments. I specially would like to mention the support: literature, first - hand information and encouragement for this research from the representatives of IFC team for ECA countries.*

Keywords

Corporate governance, competitiveness; public and private institutions, Western Balkans, Euroasia, EU

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1. BACKGROUND OF THE PAPER

On my long journey of establishing and researching the best practices of corporate governance in transition economies I faced a lot of challenges, a lot of critics and a lot of questions concerning the rationale of these practices. The transition from a planned to a market economy is mainly about dismantling long-term structures and mechanisms and building (and rebuilding) new institutions from scratch. Corporate Governance is an integral part of these new institutions. During the transition period, aligned with voucher privatization and strategic M&A, a lot of time and effort was invested to make the recently privatized companies implement corporate governance as a set of feasible checks and balances.

The focus of my research is to investigate the role of corporate governance from a different perspective: the objective is not about what is corporate governance in new market economy countries but rather to trace the contribution of the corporate governance to the company's and country's competitiveness. *The research is about the developments of new EU member country- Bulgaria, on hand, and about the developments in two group of transition economies countries: Western Balkans (Albania, Bosna & Herzegovina - B&H, FYROM, Montenegro and Serbia) and Euroasia (Azerbaijan, Kazakhstan, Kyrgyz Republik - KR, Tajikistan). It goes about systems, where corporate governance likely differs between developed economy markets (Bebchuk and Hamdani, 2009). My point is to look not only for evidence that would prove the difference but to look for an answer how does CG contribute to the performance of these countries on the global market place. Likewise to the view that CG differs also between different emerging markets (Durnev and Fauver, 2007).*

The paper is structured as following:

- *The first part embeds the results of the literature survey on corporate governance (CG) and its contribution to the national and companies competitiveness*
- *The second part sheds light on the results of data analysis*
- *In the third part the results of the analysis are discussed and*
- *In the last part propositions for theory and practice are shared*

Part one: Corporate Governance phenomenon through the lens of competitiveness

The objective of this paper is to arise the issue about the similarities and differences in the practice of CG of emerging economies countries, on one hand, and to find rational arguments about the relationship between CG and the competitiveness – macro and micro levels.

In the course of my work on the paper I began with a comparatively new methodological platform and later I implemented another set of more traditional research methods. As my preliminary research revealed there is a limited number of publications that target the relationship between CG and international competitiveness (micro and macro level). At this stage I started to look for a different methodology and decided to employ the grounded theory. In literature ground theory is considered a theoretical framework that focuses on the role of field research and on qualitative methods. The theory is generated from the data collected by the researcher. I would like to point out that it was typical for the first stage of my research. During the second stage the methodological basis was expanded and some traditional tools that a researcher uses are followed - a survey of literature, data analysis and qualitative methods (interviews).

1.1 CG and economic development

The literature is dominated by the studies that prove the endogeneity between CG and companies performance. *At the same time the majority of authors on this subject are inclined to investigate the contribution of CG to the economic performance or, to put it another way, the point of view of most scholars is the perspective of the finance and capital markets.*

A *stream in the modern literature researches the impact of CG on the national economic development (Maher M. and Th. Andersson , 1999), Claessens St and B.Yourtoglu, 2012) and how this trajectory behaves in emerging markets (Ararat, M. and G. Dallas, 2010). It merits to underline the richness of arguments that the academia presents on the contribution of the institutions incl. the mechanics of CG to the development of the financial markets (Djankov, 2008) The endogeneity is proved via the analysis of the channels that link CG and economic development (Claessens St. and B. Yourtogly, 2012).*

Align with the objective of this paper it was found out that the competition is not a terra incognita in the studies on CG from the perspective of the economic development. The interest of the researches (B. Yourtogly) is directed to the real factor markets and the role of the competition in the relationship to CG. The relationship CG and competition is studied from the market-oriented and blockholder-based governance regimes (Koke).

1.2 . CG and competitiveness

The knowledge and the awareness that competitiveness matters on the global market place and there is no a final answer what is it (Garreli St), on one hand, and why phenomenon such as CG are sine qua non for the countries that moved from the planned towards the market economy require and additional answer. The question is how important is CG for the competitiveness of the respective country? In current theoretical studies two approaches are revealed that looks for evidence that CG matters for companies and countries competitiveness: corporate governance school of thought and competitiveness school of thought.

1.2.1 Corporate governance school of thought

So what is the theoretical framework of the research conducted to investigate the CG – company level competitiveness relationship? J. He and J. Mahoney are among the scholars that go beyond the paradigm of corporate governance and economic performance (J.He, J. Mahoney, 2006). They focus on the checks and balances of CG: special attention is paid to the role of the corporate boards. They tried to reconcile three theoretical concepts. More to the point, they started their research on a multi theoretic framework: CG, competitive dynamics and dynamic resource. They tried to justify that CG influences the competitive behavior of the company. It is important to underline that their theoretical framework and the respective literature survey are determined by their clear view about **the limitations of the agent-principal theory** to explain the relationship between CG and a companies' competitive behavior. In this regard, they employed **the resource based theory**, which provides an understanding about capability - in this case about the capability of the boards and the ways, in which they shape competitive behaviour. They also look into the motivation of board members, the number of the board members, the performance of the non-executive directors and independent directors, the existence of lack thereof of separation of the positions of the Chairman of the board and the CEO. It should be pointed out that they equated competitive behavior with the financial performance of the company and the behavior of the institutional investors. From the strategic management perspective and the concept about competitive advantages the research that J. He and J. Mahoney conducted is very compelling: they justified their preliminary views with clear theoretical arguments that CG principles and mechanics contributed to the competitive advantages of the company: cost leadership, differentiation or shared

value.[1] It is this research **that indicates the shift of the paradigm** about the role of the CG: **from pure financial indicators to competitive advantages**.

Another author that targets the topic under question is Chi-Kun Ho. He sticks to the understanding that CG matters for the company's competition on the international markets, on one hand, and through an empirical study he draws the conclusion that CG as a system adds value to the competitiveness on the micro level (Chi- Kun Ho, 2005). I strongly support the view that the system as a whole not a separate elements of Corporate Governance is among the driving forces that shape the competiveness. Koke, J. and L. Renneboog explored two groups of companies (market – oriented and block-holder-based governance regimes) to extract the endogeneity between the corporate governance regime and productivity.

The literature observation sheds light on role of the CG plays for national competitiveness and the investment attractiveness of the respective country. For years I have supported this view and some preliminary results of my research favour the above assumption. It is important to point out that this branch of academic studies is not yet well developed. From the perspective of the **neo-institutional school of thought, CG is considered as factor for the distribution of the resources and, namely, the distribution of international flows of capital.** This view is determined by the study of Linz, Leuz and Warnock (2008). They explored the data from 4409 companies in 29 countries. Another group of scholars focus on the same issue from the position of **applied oriented research.** The theoretical assumptions are supported by studies in some of the most dynamic regions: Middle East and North Africa (MENA) and Central and Latin America (2007 Saidi, 2004 A. Kapur)[i]. The results of the data processing enabled the authors to draw conclusions that support the thesis about the relationship between CG and the investment attractiveness on company and country levels. J. Köke and L. Renneboog (2003) take a different approach towards the phenomenon in question: they focused on the role of the market control on the productivity of the company.

Finally, the theoretical observation also sheds light on the **role of Corporate Governance for research activities (R&D) and research achievements of the companies (1999 Maher, M. J. Andersson, 2006; Goldberg, 2008; Goldberg). The theoretical framework** is an eclectic one: institutional school of thought, principal – agent relationship theory etc. The author's theses are proved by the results of the theoretical research on the impact of Corporate Governance for economic freedom, the chances that the agent has to take a foreseeable risk against the limits that traditional management sets within the company (2008, Goldberg). Unfortunately, as mentioned above, this new direction in the studies on the relationship between Corporate Governance and

[1] The research revealed that the studies on corporate governance focus on the Anglo- Saxon model . There are limited number of studies that focus on in the competitiveness in countries with two tier system corporate governance practices.

competitiveness is only theoretically supported. The lack of results of empirical surveys undermines these fresh and innovative conclusions. Despite certain criticisms on my part, I support the above conclusions. I think that for a country (I mean Bulgaria) that has re-established the market economy after a discontinuity of 45 years the above **theoretical paradigm is extremely useful as a guideline for the continuing successful R&D policy of both individual companies and for the State.**

In the course of the above survey some problems have been spotted:

- CG as a system. The more concrete and structured approach is needed. The academia researches on the relationship corporate governance - competitiveness do not follow the approach that is employed for the study of the relationship – economic performance of the company: various corporate governance components are examined. From this perspective the suggestion of Baines, Beiner, St. W., Drobetz, M. Schmidt and H. Zimmerman (2004) to move from the black box to a system of criteria in order to find out the level of quality of the performance of the firm is of importance.

- The publications are theoretical and the empirical evidence to support their conclusions is insufficient. The problem with endogeneity exists. The similar problem exists in some studies on the relationship between CG and performance (B. Yourtogly).
- Majority of the researches explored the competitiveness issue on the territory of the Anglo-Saxon (one-tier) model of CG and dispersed ownership. The practice in the countries with two tier block-holder ownership is not on the research agenda.
- my research also targets different models of Corporate Governance, such as the two-tier model. The reason for that composition is because in the countries under survey the legislation envisages both a one and two-tier systems of governance.

1.2.2. Strategic management school or competitiveness school of thought

The category competitiveness is studied by strategic management scholars. In the last three decades American academia has tabled a lot of research on competitive advantages and competitiveness. Michael Porter launched his concept regarding competitiveness on company level and competitiveness on a national level. Both theory and practice determined the key forces of the competitiveness. CG is considered by a limited number of researchers as a driving force for a

company's and country's competitiveness. M. Porter concept about the competiveness is embedded in the methodology that World Economic Forum (WEF) employed for the evaluation of the global competitiveness. According to the annual report of the WEF competitiveness is a "set of institutions, policies, and factors that determine the level of the productivity of the country" (Global Competitiveness Report WEF 2008/09). It merits to point out that according the above methodology the set of institutions includes a sub-set of private institutions: **governance, disclosure and transparency the competitiveness on a company (firm) level**. Similar views and understanding about the competitiveness are shared by the authors of World Competitiveness Yearbook (2011). According to one of them – prof. St. Garelli (2011) is process as "to investigate the "mechanisms" of competitiveness rather than the "results".

The concept of WEF **meets the objectives of the my research**. **The message is clear: corporate governance components are among the drivers that determine the countries competitiveness**.

I also believe that the views espoused by the strategic management school hold that competitiveness and competitive advantages are **broader categories** than financial performance. Another argument that justifies the theoretical and methodological platform of my research and paper is that the current view shared by academia and business (World Economic Forum 2011-2012) focuses on sustainable competitiveness. In this regard, sound Corporate Governance encourages the long-term positive performance of the company in various markets: resources markets and the markets for goods and services, thus strengthening the sustainable competitiveness of the company. It should also be noted that the "short-termism" followed by institutional investors led to the cracks in the global financial system, which brought about the global financial crisis.

Part two: Corporate governance and competitiveness: about the methodology of research

In alignment with the research objective I tried to find evidence that supports the relation between the corporate governance components and competitiveness. Two groups of countries were examined: on one hand a new EU member country – Bulgaria, and on the other transition economies countries (Western Balkans and few Euroasia countries). The selection of the above countries is determined by my research agenda, on one hand, and my involvement in the various activities in both regions (regular participant in the OECD Round Tables on CG in South Eastern Europe, reviewer of the codes of countries in both regions and contributor to the discussions and seminars with representatives of regulators and stock exchanges from the Euroasia countries). CG is a new phenomenon for the countries under surveys. Ups and downs mark is practice during

the 90's and the first decade of 21st century. It is not only the global financial crisis that impacted the uneven developments. Various economic, political, social and economic factor shaped the current status quo of corporate governance.

In the countries under survey CG was examined as a system with four components: ethical behavior (EB), strength of auditing and reporting standard (SARS)s, efficacy of corporate boards(EfB) and protection of minority shareholders(PMS). *These indicators are part of the pillar N 1(Institutions) from the 12 pillars model for Competitiveness (GCR, WEF 2008/09). They (indicators) correspond to the main principles/components of CG. It goes about the subset "private institutions. In another publication of WEF (2011) "Economic development report" the above indicators and two more "willingness to delegate authority", "professional management" are qualified explicitly as "corporate governance"* . In the course of the construction of the model of corporate governance for the purposes of this research an indicator is excluded: the indicator investor protection. According to the methodology of WEF for countries in the question this component of corporate governance is measured by hard data (the existence or not of the legal norms for the investor protection). The information about this component does not reveal the practice and the results of its implementation. It merits to add a few more comments about the rationale for the selection of the criteria. According the methodology of WEF the four indicators are among the indicators with relationship to the GDP per capita: protection of minority shareholders interests(factor conditions capital market infrastructure); strength of auditing and reporting standards and efficacy of boards (microeconomic competitiveness- context of strategy and rivalry) and ethical behavior of firms (rule of law)(GCR 2008/2009). The message is clear the concept for macroeconomic competitiveness and microeconomic competitiveness, on one hand, and the concept about the contribution of corporate governance: capital market infrastructure and rule of law correspond to the school of thought that investigates the relationship and endogeneity between the CG and economic development

Part three: What are the results from analysis of the data and do they confirm theoretical and methodological views.

3.1. How does corporate governance impact the countries competitiveness in a new EU member country – Bulgaria?

The first test for the theoretical framework was done for a transition economy and for a country that is EU member - Bulgaria. Although the fundamentals of market economy are laid down in the country, a lot of problems still exists - a legacy from the long term transition from planned to market economy. It merits to point out that Bulgarian business, capital market and the regulators

contributed to the establishment of good practice of CG. The problem about the rationale of CG still exists. The question why we need corporate governance determined my academic interest in testing the theory and the concept about the interplay between corporate governance and competitiveness. From a purely scientific point of view is noteworthy to point out that the research rests on the data about the Bulgaria from three sources: Global Competitiveness Report (2008/2009 - 2010/11); Doing Business and World Competiveness Yearbook (IMD). The finding is, however, questioned among public companies. The research has a double purpose: on one hand, to find evidence about role of CG and, on the other, to raise the awareness among the board members about the relation in question and to understand their reaction towards the international statics. The field research aimed to trace out the attitude of the board members towards the international evaluations (annual publications of WEF) about competitiveness. Representatives of 100 listed companies (one and two tier systems) were interviewed. The companies in the sample declared that they implement National Corporate Governance Code. The ownership - dispersed or concentrated, was not under survey.

What are the findings?

According to the Global Competitiveness Report (2010/2011) corporate governance in Bulgarian companies was considered underdeveloped. The efficacy of corporate boards ranking was 111, the ethical behavior of the companies – 100, the strength of the auditing and reporting standards - 91 and the protection of minority shareholders - 124. It is noteworthy to point down that the overall ranking of the country (country competitiveness) was 71. The findings revealed strong deviation between the overall ranking and the corporate governance ranking. Other sources reported different level for some of the CG components for the same year: according to Doing Business (WB) disclosure of Bulgarian companies got the highest scores - 10.

The research revealed different reactions among Bulgarian corporate board members towards international evaluation - efficacy of corporate boards. According to the field research it *was the learning curve that determined the reaction*: the longer serving members accept the negative evaluation.(see table N1)

Table N 1

The attitude of board members towards the negative estimation (accept: yes or no)

Length of member ship/ answer	Yes	No
More than 3 years	0	100
More than 5 years	50	50
More than 7 years	60	40

The analysis of the data revealed another interesting trend: the majority of the independent board members did not accept the evaluation. Contrary to that, the representatives of the shareholders accepted the above evaluation, whereas the representatives of the major shareholders are divided equally concerning the correctness of the evaluation. It would not be fair from a scientific point of view to draw final conclusions, but is clear that the responses of the independent directors do not correspond to a reasonable understanding about their role in the corporate boards.

Case study Bulgaria revealed useful information and determined my scientific interest to look for more evidence about the concept under observation: the role of corporate governance practice (institutions) for level of country competitiveness. The next step of the long study is the research of the importance of the concept for a different group of countries or the tale about corporate governance in Western Balkan countries, on one hand, and corporate governance in 4 Euroasia countries.

3.2. A tale about corporate governance in Western Balkans and Euroasia countries

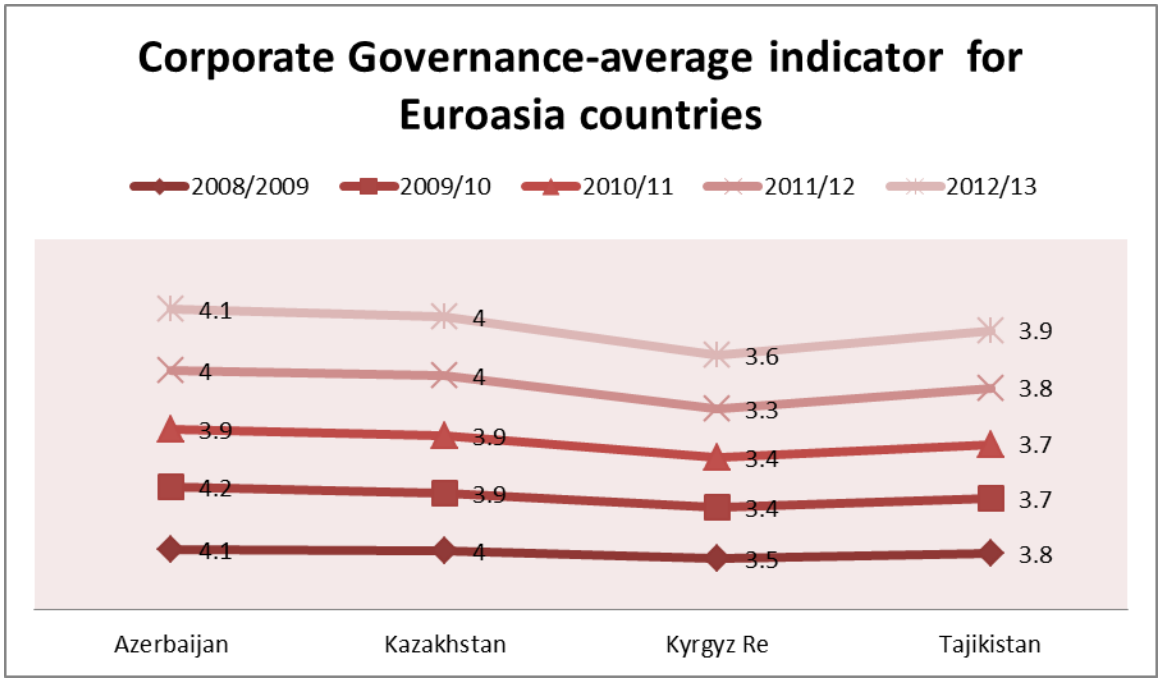
The countries under survey follow the same pattern of socio-economic and political development: transition from planned towards the market economy. It goes about the same policies

for dismantling the institutions of planned economy and building the institutions of market economy. Corporate governance is among the above institutions. The selection of the countries, as above mentioned, is determined by my personal experience and involvement in the process establishing good corporate governance in countries from both groups. Which are the countries and what are the results from the research. On one hand, the information about Albania, Bosna and Herzegovina, FYROM, Montenegro and Serbia was processed, and on the other, information about Azerbaijan, Kazakhstan, Kyrgyz Republic and Tajikistan was examined. The same data sources were: Global Competitiveness Report, Doing Business Report and information from EBRD publication.

The analysis focused on the same indicators: ethical behavior of the firm (EB), strength of auditing and reporting standards (SARS), protection of minority shareholders (PMS) and efficacy of boards (EfB). For every country the average score for corporate governance was calculated (CGav). The research and comparison analysis rest on the comparison of the average scores for corporate governance . The results and main findings of the second study are as following.

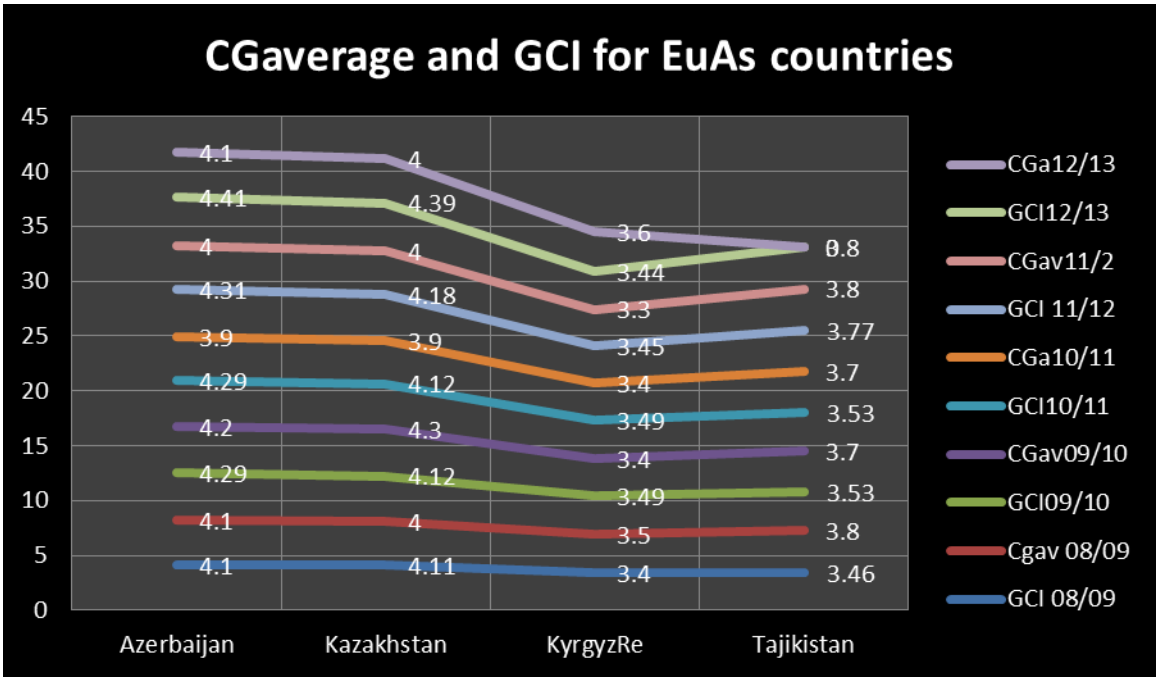
- The level of CG in selected Euroasia countries is comparatively low. The scores are between 3.5 and 4 (chart N1). According to the scale for assessment, the highest is seven. The average value for the first ten countries for the same period for between 5,5 and 6,7 (average score for every indicator - see Chart N3). Among the group of Euroasia countries the results are not homogeneous (Chart N1) The polarization is between Azerbaijan and Kazakhstan, on one hand, and Kyrgyz Republic and Tajikistan, on the other.

Chart N1



- The comparison of the data about average level of CG (GCav) for Euroasia countries with their ranking according Global Competitiveness Index (GCI) do not immediately confirm the theoretical observations about the relationship between the CG and competitiveness (chart N2). It is noteworthy to point out that the developments of two indicators (CGav and GCI) are consistent. The levels of the scores are similar.

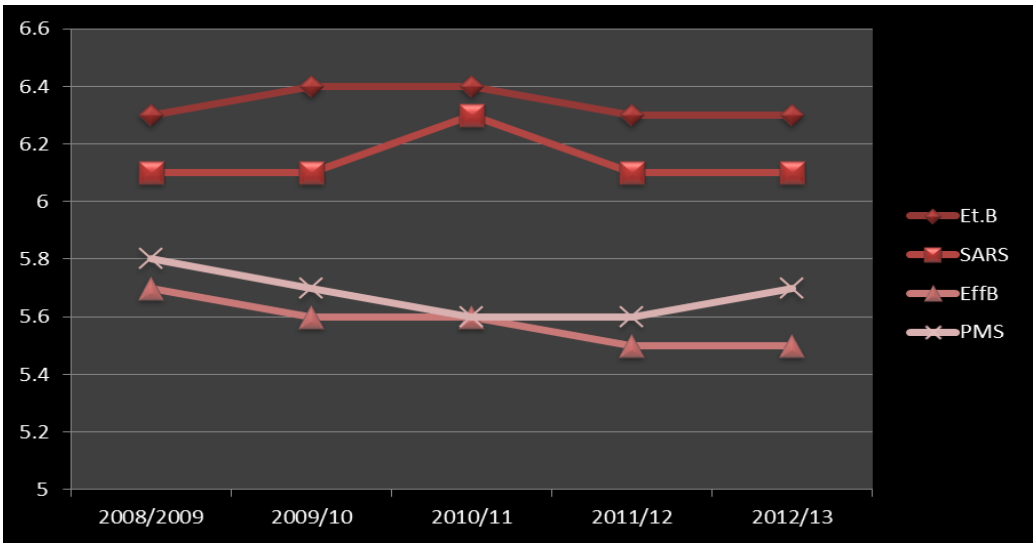
Chart N2



- It was noteworthy to benchmark the trends under observation with the best corporate governance practices. The scores for the various indicators for CG for the champions (developed economies - UK, US, Canada and some emerging market economies are higher - in the range of 5,5 to 6,8 . The average scores or the every indicator rests on the scores for the group of the first ten countries for the respective year (chart N 3)

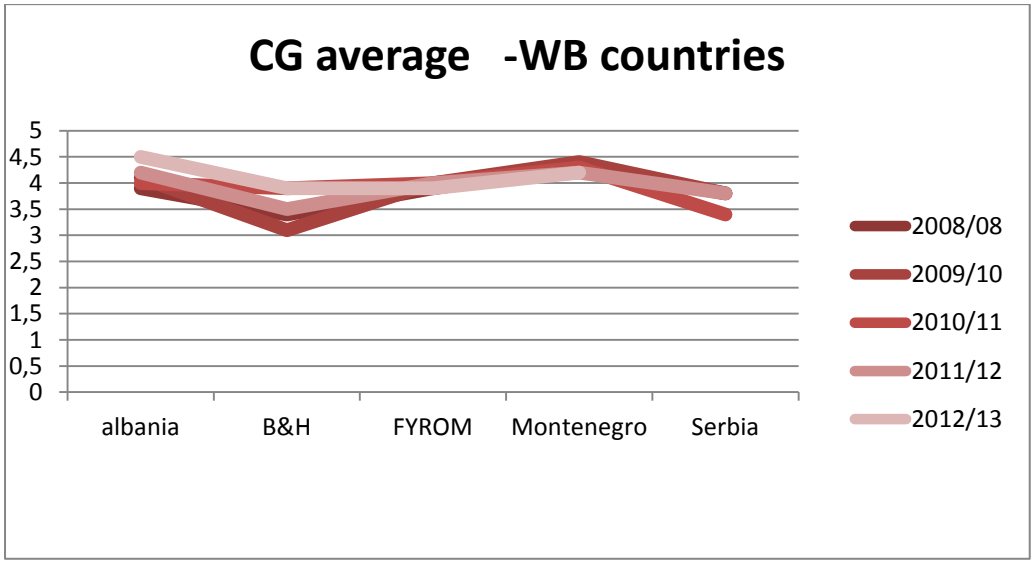
Chart N3

World champions in the area of corporate governance



- The results for CG for the countries in the Western Balkans are consistent with the results for the CG in Euroasia countries: comparatively low average score for corporate governance (chart N4)

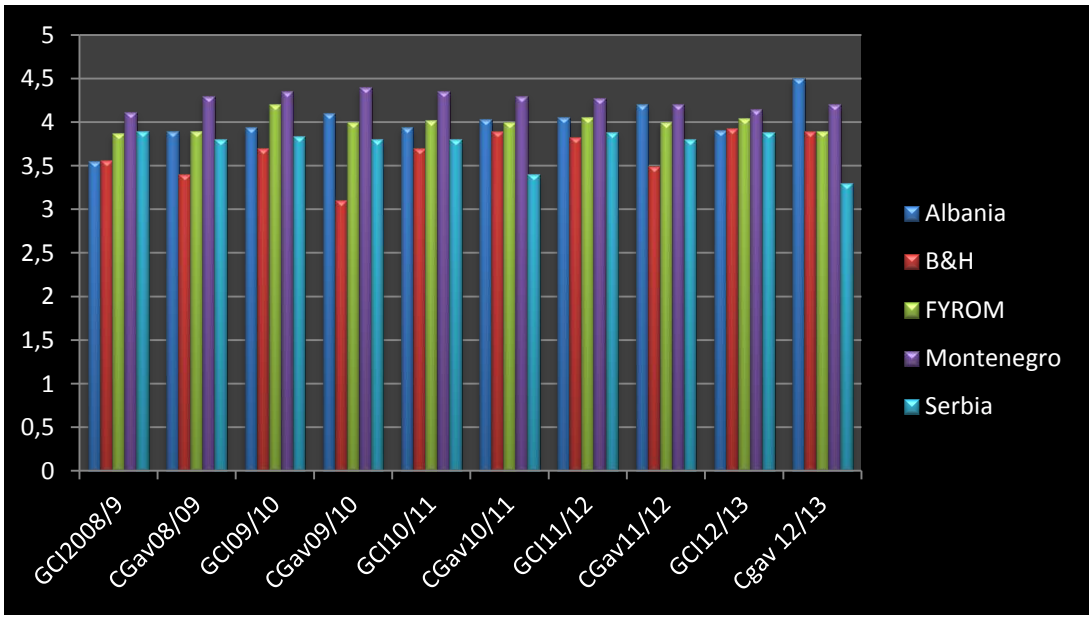
Chart N4



- CG average scores are consistent with the data about Global Competitiveness Index for the same group of countries for the period under survey (chart N5)

Chart N5

CGI and CG average for WB countries



Part three: How do results could be explained: discussions and comments

The comparison of the two indicators revealed a relative level of correspondence: the scores of the CG are closer to the scores for the GCI. The deviations are insignificant. The results correspond to the methodology for the evaluation of competitiveness (GCR 2008/2009) The gaps are better seen on the landscape of the Western Balkans - lower level for the scores of GCI and higher level for CG(Albania) .

3.3. Does CG depends on the transformation of the ownership

The results shed light on the quantitative values of corporate governance and on the development of the corporate governance. The preliminary views about the differences of the two groups of countries need further explanation. At a first place the similarities and differences are examined via the lens of ownership. I tried to found evidence that could explain the endogeneity between the status quo of CG, on one hand and the ownership. In both groups of countries the transition from planned to market economies was aligned with privatization: voucher and strategic. In this regard, another source of information was used - the publications of EBRD. The formal analysis of data on the privatization and the developments of CG (Table N2) reveals controversial trends.

Table N2

Countries	Degree of privatization 1998%	Degree of privatization 2000 %	Degree of privatization 2005%	Degree of privatization 2011%	Governance 1998	Governance 2000	Governance 2005	Governance 2011[2]
Albania	75	75	75	75	2	2	2	2+
B&H	35	35	55	60	2-	2-	2	3-
FYROM	55	55	65	70	2	2+	2+	3-
Montenegro	na	na	55	65	na	na	2+	2+
Serbia	na	na	55	60	na	na	2+	2+

[2] 1= fewer other reforms to promote CG; 2=little action taken to strengthen competition and CG; 3= significant and sustained actions to promote CG effectively; 4=substantial improvement of CG; 4+ =Standards and performance typical for advanced economies, EBRD Transition Reports.

Azerbaijan	45	45	60	75	2	2	2+	2
Kazakhstan	55	60	65	65	2	2	2	2
Kyrgyz Rep	60	60	75	75	2	2	2	2
Tajikistan	30	40	50	55	2-	2-	2-	2

Source: Transition Reports, EBRD

For the group of Western Balkans the trend is comparatively clear: the increasing of the private sector of the ownership leads to positive changes in the level of governance incl. corporate governance. The picture differs for the Euroasia countries: the changes in the ownership structure do not lead to the changes in governance. Although governance encompasses not only corporate governance it is proved for the Western Balkan countries that the privatization process, and more concretely the increase of privatization sector as a part of the countries GDP impacts the quality and the degree of establishment of CG principles. The data do not confirm the same conclusion for the Euroasia countries. A trend which has been revealed and discussed by academia and international institutions (Privatization principles and practice, IFC, W.D.C). A deeper analysis on this relationship could bring to more arguments and more reliable conclusions about the fundamental knowledge about the relationship between ownership and CG (M. Jensen and W. Meckling 1976).

3.2. CG developments and the developments of financial markets

The revealed trends in the development of CG, on one hand, and the controversial trends in the development of the relationship of privatization and CG in both regions directed my interest to look for another evidence that could give more significant explanations about the phenomenon under research. In this regard, the research interest was directed towards the another important factor that impacts the status quo of CG. The data demonstrated low level of the capital markets. It is noteworthy to underline that, although the capital markets in the Euroasia countries remain at a relatively early stage of development, their reform endeavours have been important (OECD Report 2012) One has to mention that the countries under observation are independent since the early nineties and the catch up process is uneven one: in the first decade of their independence the focus was on the macroeconomic issues incl. overcoming hyper-inflation, dismantling some of the structures of planned economy and privatization and on the building new legal framework

(Appendix N1). It was also a period of the establishment of stock exchanges and the adequate legal and regulatory framework. But according to the experts opinion "all capital markets in the region are still at an early stage of development. They differ from each other in terms of market size, market participants and institutional and regulatory frameworks. In some countries there are no organised stock markets"(OECD, 2012). The capital market developed in the vacuum in terms a qualitative stocks and active institutional and individual investors voucher privatization supplied the financial products for the stock exchanges It was during the next decade (the first decade of 21 century) when corporate governance codes were introduced in some of the Euroasia countries (Kazakhstan, Azerbaijan, Tajikistan). International financial institutions supported the process of the reforms in the area of capital markets and CG. Likewise to the top – down direction of the introduction of corporate governance in the Central and East European countries, as well in the Western Balkans, the corporate governance in the Euroasia countries was not a market driven process. It was the State with the support of international institutions that gradually set the basis for the corporate governance. The phenomenon of the top down approach is studied by the economists (Boeva, B., 2001, OECD Round Tables on CG in SEE, Euroasia). It is noteworthy to underline that the top – down approach is among the factors that lead to the gaps between the high quality legislation about the corporate governance components such as: shareholders rights protection and the low level of components such as corporate boards, ethical behaviour of the firms and strengths of the auditing and reporting standards. And I think the observation about the absence of an equity culture (OECD Preliminary Report 2012), on one hand, and the absence of market incentives in the Euroasia countries, on the other, determine the low level of corporate governance or the level of the institutions that shaped the competitiveness at the company and countries level. Ultimately what resulted were markets with low liquidity and little trading volume, and companies with problematic governance structures that had some of the negative characteristics of both concentrated and dispersed ownership.

The other group is the group of Western Balkan countries: Albania, Bosna and Herzegovina, FYROM, Montenegro, Serbia. Looking for more arguments that could shed light on the impact of corporate governance on the competitiveness is important to underline a few trends in their development:

- The countries in the region share common economic developments: all of them without Albania were part of a liberal economic and political socialist system. The phenomenon that impacted the transition to the market economy: institutions, culture and traditional good relations with developed European economies. The countries in the group are on the road to EU accession: some are EU candidates (Macedonia, Montenegro) some are potential EU

candidates (Albania, B&Ha, Serbia). The long-term political and economic goal of the Western Balkan Countries to join EU and the adequate political economy has to be taken into consideration when market and institutional issues are studied. It is important to underline that the period under observation is a period of the gradual process of rebounding of the country economies from the financial crisis.

It merits to explain that different start of the transition of the two group of countries is a factor that impact the corporate governance practice and hence has different impact on the competitiveness of the countries. Different outside economic and political orientation impacts the efficacy of the implementation of corporate governance incl. corporate governance infrastructure: corporate governance codes, institute of directors, scorecards. The Western Balkan countries due to the accession process to EU are more successful in the implementation of the corporate governance Gradually the top down approach of introduction of corporate governance is supported by the market players support of corporate governance (bottom up). On the contrary, the political and economic orientation of the Euroasia countries with the combination the top down approach led to a slower progress of the establishing of good CG practice. The academia researches on the role of the institutions on the development (D. North, 1990) are very helpful for the purposes of the analysis on the revealed trends. One could look for arguments from the social, political and cultural development on the practice of CG.

3.3. CG developments and the role of institutions

The institutional scholars (Coase, Hyakek, North) stick to the view that it's the economic, social and political specifics that determine the country specifics of the institutions. Black, B. and others (2011) underline that a central issue in CG research is the extent to which "good"governance practices are universal (one size mostly fits all) or instead depend on country and firm" The results of the study of both group of countries proved that" our "multi-country" results suggest that country characteristics strongly influence both which aspects of governance predict firm market value and at which firms that association is found.(Black, B. and others, 2011) They support a flexible approach to governance, *with ample room for firm choice. Culture in this framework stands for the foundational institutions of society – the system of values and beliefs that underlies more specific formal institutions and informal ones (North, 1990, Williamson, 2000).*

However the culture is not in the focus of my research and more evidence one has to present I support the view not only about the role of the institutions, but the about the role of institutions that bear the mark of the traditions and individuals mind set. And the view (Schwarts, 1999, 2004) that a cultural value dimension framework enabled us to address directly the content of informal

institutions and to identify a particular cultural orientation that exhibits a first-order importance for international investment would not be underestimate when a research target CG in emerging market. In the case of my research, culture about the markets was totally unknown when the dismantling of the institutions of the planned economy started. And that culture incl. egalitarianism that is linked to corporate governance mechanisms(Schwarz, 2004) and supports fairer competition has to be carefully analysed with regard to the CG and competitiveness issues.

5. CONCLUSIONS

The theoretical framework and the preliminary results support the hypotheses of the study that encouraged me to prepare the paper. Which are the positive signals I would like to send to the academia colleagues:

- The problem of the corporate governance from the competitiveness perspective is not among the priorities of the research portfolio of scholars that belong to the research community that work on the corporate governance issues: financial economist, legal academia researchers and macroeconomic.
- The problem of the relation of corporate governance is predominately studies by microeconomists, business and management school of thought. Some publications on the political economy and corporate governance are among the trendsetters of the research agenda: corporate governance and competitiveness: macro and micro.
- It is noteworthy to point out that the problem is of importance for the business practice and the investors in the both regions. Even the last reforms in Kazakhstan (2012) and in the Western Balkans (establishment of Institute of Directors in some countries under survey) revealed the strong presence of the State and international financial institutions. It is the concept about the contribution of the corporate governance to the competitiveness that has *to be promote.*

From my perspective and theoretical understanding and practical experience, the paper is not omitted from some drawbacks:

- The methodology does not support the traditional academic requirement about the endogeneity. In this regard, I could point out that at that stage of the research and the limitation of data supply the task for the endogeneity is not uneasy one.

- The aggregate approach the research on the two groups of study blocks the deeper – micro-level study: interviews with the investors, board members and government officials
- And, finally, my personal involvement in various consultations and workshops in countries from both region may be biased the objectivity of the analysis.

The paper embedded results from a research project and a long term study on the corporate governance and competitiveness and is envisaged the work to continue with concentration on the cases from some of the regions. The qualitative methods and the cross analysis of institutions and culture is envisaged

And, finally, it is important to underline the increasing importance of the problems under survey-corporate governance and national economy competitive and sustainable development. Corporate governance is seen by European Commission as one of the drivers for the country competitiveness: "An effective corporate governance framework is of crucial importance because well run companies are likely to be more competitive and more sustainable in long term." (2012 Action Plan, EC).

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Online

Data bases

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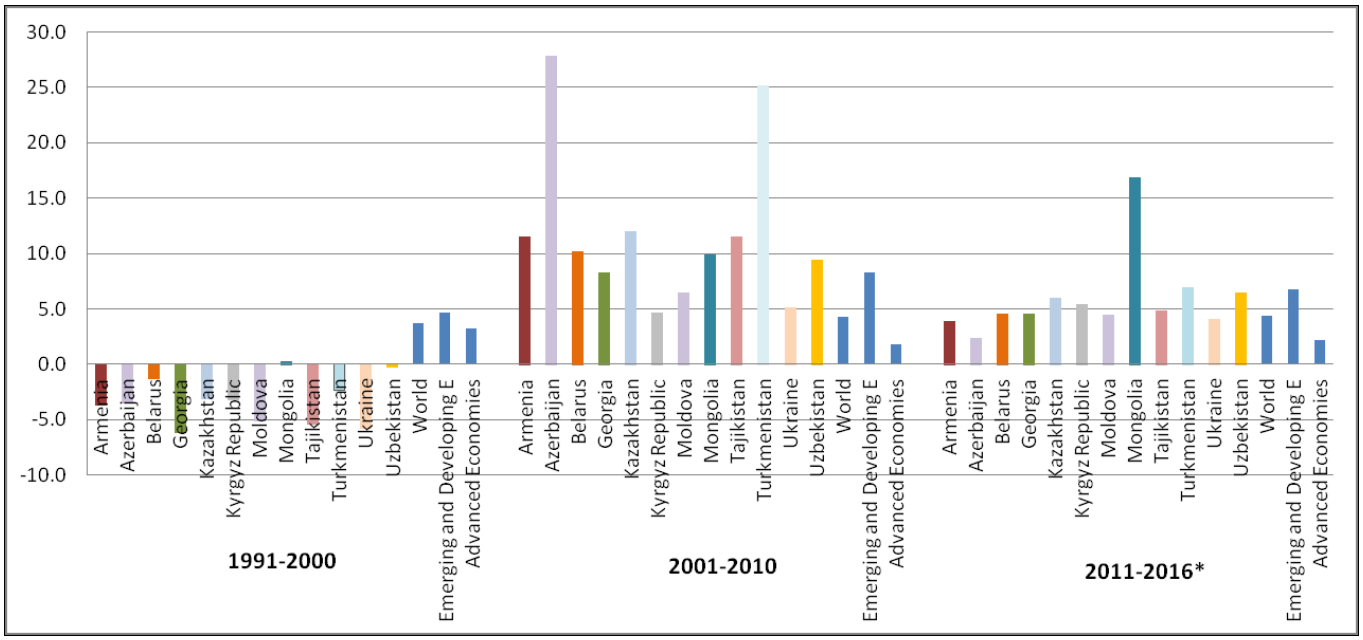
Appendix N 1

GDP development in Euroasia countries



Historical and Projected Average Annual Real GDP Growth Rates (%)

Source: OECD calculations based on data from IMF and EBRD.

**Based on IMF's World Economic Outlook April 2011 estimations.*

OECD Capital Markets in Eurasia:

Two Decades of Reform

Prepublication Final Report

[i] The use of N. Saudi presentation is not accidental. It is known that the Sovereign Wealth Fund of the Sultan of Oman has bought a strategic stake in one of the publicly traded (on Bulgarian Stock Exchange) banks.

Ivana Gažić

ZAGREB STOCK EXCHANGE: ESTABLISHING RULES OF TRANSPARENCY OF CROATIAN COMPANIES IN LIGHT OF SOON ENTRANCE TO EU

Ivana Gažić, President of the Management Board, Zagreb Stock Exchange[1]

Abstract

Harmonization of legislation due to entrance to the EU in area of financial sector was one of the major challenges for Croatian financial industry in the negotiation process for admission to the EU. All of the segments of financial industry were affected, with strong emphasis on different areas of capital market: investor protection, best execution rules, risk management of financial institutions and investment companies etc. Focus of this paper is transparency in relation to obligatory information on issuers whose securities are admitted to trading on a regulated market. Following this request for transparency, internal processes and corporate governance of the companies were improved over time, with different pace and success. Changes in this area are also likely in near future.

INTRODUCTION

What some economies had decades to do, Croatian one had to go through in about 20 years since declaring its independence from Yugoslavia back in 1991. Transition from socialism to free economy was not an easy task and it included, inter alia, establishing of Croatian capital market which was aimed to serve as catalyst of privatisation in the country. With little support from the state, by enthusiasm of group of entrepreneurs, Zagreb Stock Exchange (further: "ZSE") was established right away in 1991 and it started serving as organized market in 1992.

In years to come, capital market developed swiftly, with its peak in prices and volumes happening in 2007. With expected entrance to EU[2] and regulatory changes happening in recent years – companies had to work at very high pace of change in order to achieve levels of transparency and corporate governance required in developed countries of Europe, with strong capital market scene, major players being: Frankfurt, London, Vienna, and recently, Warsaw stock exchanges.

HISTORICAL ASPECTS INFLUENCING PRESENT LEVEL OF TRANSPARENCY IN CROATIAN COMPANIES

Corporate governance and decent transparency were almost not existent back in 1990's. Once Croatian economy has lost ex-Yugoslav market of 22 million inhabitants and was faced with war conditions, companies went through deep restructuring process, with little time left to focus on internal reporting and, consequently, quality reporting to their shareholders. It seemed that State, major owner in large share of companies, had lower reporting requirements than the new investors into the market – coming from Croatia, but especially from abroad.

Companies were also struggling to find the way to finance their operations. Bank loans were scarce while investors, both domestic and international, were rare. Only few examples proved that Croatian companies had business model attractive to international investors – like PLIVA, pharmaceutical company which listed its shares on Zagreb and London Stock Exchange in April 1996. Privatisation of this company was a first example of share activism in Croatia, and it set example for future ones to come. It was also first industrial company from Eastern Europe to have shares listed on London Stock Exchange. At that time organized depository agency did not exist, bringing substantial settlement risk[3] to investors, this however did not stop many international investors to participate in this privatization. It also opened doors not only to international financing in form of club or syndicated loans but also to issuance of other financial market instruments – like bonds, commercial papers. This example set path to other Croatian companies with good and effective business models, on how to finance their growing operations.

One of the first sectors to be almost fully privatized was banking one[4], with major players bought by Italian and Austrian banks at the first stage. Not only individual reporting systems of these entities were improved, but also, companies that were clients to these banks, were required to deliver more information, in shorter period of time, and with more quality – in accordance with international standards. Bank-based economy in which Croatia is living at present (2013) is clear consequence of this early and very extent privatization of banking industry in Croatia. It is important to mention that privatization of banking sector brought many other positive impacts to Croatian financial market: introduction of new financial instruments, trading techniques, placement of domestic securities on international markets, and many other.

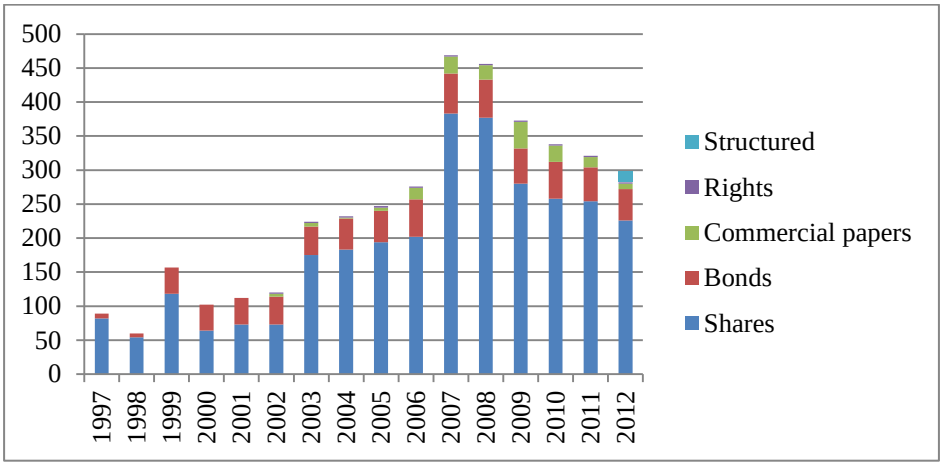
IS GETTING MORE COMPANIES TO STOCK EXCHANGE ENOUGH TO TACKLE ISSUE OF TRANSPARENCY?

A logical and theoretically most expected way to overcome this bank-based system would have been financing company's operations by approaching investors through an organized capital

market. However, voluntarily listing on stock exchange[5] was very rare. Only after adoption of Law on market of securities[6] which came in force on July 25th, 2002 number of listed companies on stock market improved significantly, since all companies which issued shares by public offering or had than 100 shareholders and 30 mil HRK of capital, had to list its shares on stock exchange.

Although initial feelings about this legal action were positive, results of this legal action ZSE feels even today. Many of this companies had no resources to comply with stock exchange regulations, had lagging business models and unfavourable shareholder's structure, which all resulted in non-actively traded stocks with low level of transparency and complying with capital market requirements.

Exhibit 1: Number of listed securities on Zagreb Stock Exchange (1997-2012)



Source: www.zse.hr, Periodical reports on trading on ZSE, end of year data

It is easy to notice from observed period of 17 years that ZSE was struggling for a long time with low number of traded securities prior to 2003. Due to growth of turnover and development of financial industry, together with legal actions done by Regulator, market experienced its peak in term of listed securities in 2007[7]. In this number, shares have always dominated the number, but it is clear that financial needs and experience of companies resulted in number of new instruments, as form of orientation towards market as source of financing for the operations.

As some companies were legally forced to go to the market in 2003, it is logical why in period 2008 – 2012 numbers of listed securities were constantly decreasing. Main reasons for delisting were following:

a. *Voluntarily delisting* – in Croatia, it is possible do delist the share from the regulated market with 75% of votes of the General Assembly for such decision[8]. All shareholders which have voted against such decision of General Assembly have right to fair compensation. Most recent examples of such delisting were: attempt of major

shareholders of Viro Ltd. to leave official market of ZSE in December 2012[9] and delisting of Istraturist Ltd. by major shareholder Zagrebačka banka Ltd. to be finalized on July 1st, 2013[10],

b. *Squeeze out* – this is common way of delisting the companies as well, as for such decision one shareholder has to hold at least 95% of the votes of the General Assembly. Due to concentrated ownership structures of privatized companies, this is the common practice with most prominent examples being:, Pliva Ltd. In 2009, Erste bank Croatia in 2010,

c. *consolidation in various industries* – especially present in tourist sector with examples being Valamar consolidation of their tourist companies and announced voluntary take-over of Maistra in February 2013[11], and lately

d. *Bankruptcy* – in 2012 only, ZSE has delisted nine companies for the reason of bankruptcy[12].

If we combine all this processes together, one can note that number of listed securities is relatively strongly decreasing over past 5 years. In year 2011 twelve companies have left the regulated market, while in 2012 number increased to 20 delisted companies. It is important to mention that decrease in number of issuers does not necessarily mean decrease in attractiveness of the market. On the contrary, issuers that remain listed are the ones who provide required level of information and communication to their investors. All this requires high level of information management, organization of comprehensive Investor Relations Department and alignment of other functions within the company to support listing requirements.

To strengthen this hypothesis from another aspect, it is important to mention that Zagreb Stock Exchange anyhow still has relatively high number of issuers in comparison with turnover and market capitalization of regional stock exchanges (see Exhibit 2), some of them being at much higher level of development than ZSE (Istanbul, Vienna and Frankfurt in particular). This shows that more developed markets are aiming at lower number of issuers with stronger transparency, liquidity and attractiveness.

Exhibit 2: Comparative analysis of regional exchanges, data 2012

	Istanbul	**Bucharest**	**Budapest**	**Vienna**	**Frankfurt**	**Zagreb**
Turnover (€ mil)	654.029,50	1.847,70	8.460,00	18.195,30	1.112.312,70	504,95
Market cap as of 31.12.2012. (€ mil)	240.029,46	12.088,11	15.742,43	80.428,90	1.127.369,78	25.388,79
Number of issuers as of Dec 31, 2012	271	79	52	99	747	184

Source: FEAS – Federation of Euro-Asian Stock Exchanges, official internet pages of federation: www.feas.org

Further on, this conclusion is also supported by the fact that quality of reporting and transparency standards of listed companies in Croatia have been constantly improving over years, not only on like to like basis, but also constantly complying to new, up-to-dated standards. ZSE has imposed number of measures to insure this process over last couple of years.

Important reasons for improved transparency standards can be found in several influences:

a) *Relevant ownership stake by large multinationals* has imposed corporate governance standards to several Croatian companies - examples being Croatian Telecom (ticker: HT-R-A), owned 51% by Deutsche Telekom Germany or Zagrebačka banka (ticker: ZABA-R-A), owned 84,48% by Unicredit Italy [13] and many others,

b) *Constant imposing of new regulatory requirements* (laws and regulations of ZSE),

c) Constant *development of capital market* by introduction of new types of instruments and trading techniques and

d) *Harmonization of local legislation with EU*, which will be the main focus of next paragraph.

There are several facts supporting the hypothesis that company's transparency and corporate governance have been improved in last couple of years:

a) Corporate governance code has been implemented for 5 years now, and number of companies reporting on corporate governance standards to ZSE has become substantial;
b) Companies have participated in number of investor presentations organized by ZSE over the last couple of years;
c) ZSE has started its Academy, with over 2,000 participants taking different forms of education in field of financial markets;
d) ZSE has started postgraduate education for IR professionals, first generation was enrolled in 2012;
e) ZSE, together with HANFA, is organizing in June each year free of charge seminar which is very well visited for all IR professionals working in companies listed on Regulated market, and is discussing with issuers their obligations and answering all of their relevant questions, etc. In 2012 over 100 IR professionals participated in this education,
f) Number of penalties for non-complying with ZSE regulations over the last couple of years has been decreasing in the field in financial reporting;

EU LEGAL APPROACH TO TRANSPARENCY ISSUES AND EXPECTED ACTIONS IN FORTHCOMING PERIOD

With the enactment of the Capital Market Act in 2009, which transposes 15 EU directives on financial services, Croatia has achieved impressive progress in harmonizing its capital market framework with the single EU market[14]. Other achievements include demutualization of the ZSE and granting more regulatory and supervisory power to one competent authority (CFSSA[15]) which should bring more transparency to capital markets and decrease of conflict of interest[16].

Part Three of the Capital Market Act Law deals with issues of public offering and publishing of prescribed information. Both ZSE and Regulator are taking care of fulfilling obligations prescribed in the Law. As existing regulation in this area is applied for 5 years, companies are well informed about their transparency requirements while additions to this regulation are expected to come into force with entrance of Croatia to European Union[17]. Stock exchange considers transparency as one of the main drivers of international investor's interest and has devoted it's time to impose measures in two directions: education and strict following of fulfilment of requirements, followed by punishments, when necessary.

Directive which changes Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market – will be implemented into Capital Market Act on the date of entrance of Croatia to EU. Changes in Capital Market Act are currently being under review of Croatian Parliament.

The Transparency will be covered in particular by Proposal of Directive amending 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 and Commission Directive 2007/14/EC – which is still not in force, but is very important for foreseeing trends which Croatian companies will have to comply in the future, therefor will be discussed in more detail in this paper.

In Explanatory Memorandum of the proposal of Directive, it is said that: "This proposal for an amendment of the Transparency Directive is consistent with the objective of maintaining and, where necessary, enhancing the level of investor protection envisaged in the Directive and ensuring that the information disclosed is sufficient an useful for investment purposes at acceptable costs… The objective of the Transparency Directive is to ensure a high level of investor confidence through equivalent transparency for securities issuers and investors throughout the EU."[18]

Main impacts are expected to be:

1. More flexibility regarding frequency and timing of publication of periodical financial information[19] – in practice this is very important for the companies, as current regime of reporting is hard to maintain, especially for small and medium-sized issuers. This measure will reduce administrative burden for companies as no interim management statements and/or quarterly reports will be required;
2. Simplification of narrative parts of financial reports for small and medium-sized issuers,
3. Elimination of the gaps in requirement for notification concerning major holdings of voting rights,
4. Elimination of divergences in notification requirements for major holdings[20].

Directive will also contain wider range of sanctions and investigation powers to competent authorities. Publication of sanctions is important to improve transparency and to maintain confidence in the financial markets[21]. In addition, the competent authorities in the Member States should have the power to suspend the exercise of voting rights of the issuer who had breached the notification rules on major holdings, as this is the most efficient sanction to prevent a breach of these rules[22].

There are several main changes in concept of information requirements for listed companies:

a. Loosening of requirements in terms of amount of information to be provided – it is now more about the quality, not the quantity of the data;
b. There is less focus on financial fines, and more on public warnings, mostly due to the fact that such warnings have not only impact on the issuer that has omitted to do something (like report on time), but only on other listed companies and general public, about the importance of transparency;
c. Loosening of reporting requirements and decrease of costs connected to it are aimed at encouraging more companies (especially mid-sized) to collect required financing via capital market vehicle, instead of relying on banking sector.

Legislator has touched many very important issues with this proposal of directive and it is author's estimate that such changes will be beneficial not only for the development of capital market in Croatia, but also for attractiveness of the market to investors.

IMPORTANCE OF TRANSPARENCY FOR THE MARKET ATTRACTIVENESS

Although there is no clear functional connection of transparency and market attractiveness, one of the major postulates of financial theory is that information equilibrium is one of the pre-requisites of fully functioning financial market. It is clear that transparency is contributing to attractiveness of securities on the market in many ways, or better to say – without transparency,

market itself would not be able to fulfil its basic role – allocation of capital. There are several aspects of transparency to each listing:

a. Information requirements after listing, consisting of: publishing of financial statements, other material facts, information supervisory board and management board meetings, new partnerships, restructuring processes, acquisition of own shares by related persons[23] etc.
b. Additional information that company voluntarily delivers to its shareholders such as: notifications on new products, changes in legislation relevant for the company, newly appointed members of management team etc. This information can be given in form of announcement on stock exchange or in direct communication of company executives in general public;
c. Structured meetings with company's investors (either shareholders, managers to funds, analysts preparing data for investors, potential investors) – forms being one-on-one meetings, or road-shows and investor conferences;
d. Other ways of communication, which in modern telecommunication era can take many forms out of which author is highlighting most used ones: articles and interviews in media by relevant management team members; LinkedIn, Facebook and other social network profiles; official web site of the company; social responsibility projects; crisis communication etc.

It is very important to mention that communication means under a. and b. are legally prescribed and obligatory, while communication means c. and d. are optional, but highly recommended. Only important remark related to this is that officials of the company have to be very careful not to communicate via optional channels some price sensitive information prior to communication via official channels of ZSE[24]. This is seen as selective approach towards some of the investors, is legally forbidden and is considered to be bad practice.

Companies in Croatia often neglect even mandatory communication while non-mandatory is often not done. This is, however, wrong approach, if one wants to make the company attractive to potential and existing investors. Interest comes first for the country, or economically speaking country's economy, once high level communication about investment opportunities of the country are presented. If investors are interested in economy, they will then look at the market in more details – which sector is attractive and where it has experience or wish to invest[25]. Final selection comes, of course, on company level, where it's crucial that company displays high level of respect towards its shareholders in form of timely and high quality provisioning of information necessary for making informed investment decision.

CONCLUSION

What, how and when is company listed on Regulated market communicating to the public is one of the crucial things when talking about attractiveness of the market to both foreign and domestic investors. Culture of such communication has been neglected in period between 2nd World War and 1990's in Croatia due to the economic system country was operating in. Progress made since then is significant. Quality and number of companies listed on the ZSE are, naturally, influencing this process. Regulator and ZSE have played major role in educating investors, financial industry and issuers about necessary steps to create secure environment for investors and protect investor's rights. Process started in described way is further enhanced by approaching of Croatia to full membership in EU, expected in middle of 2013.

Adoption of Capital Market Act in 2008 was major event impacting all segments of financial markets. This law has adopted EU standards in form of directives into Croatian economy, making reporting requirements for listed companies fully compliant with requested standard of EU markets. Since its inception, financial crisis has brought need for new amendments to this regulation and changes to Capital Markets Act are expected to be in force as of the date of entrance of Croatia to EU. Furthermore, European legislator is working further in adopting new rules, especially in the field of transparency.

We can conclude this article by stressing constant changes in this area, all aimed to provide healthy balance of transparency for investors on one side, and accessibility to capital market for companies on the other. We can expect that this area will remain very active in terms of changes in forthcoming period and all relevant players of financial markets (ZSE, regulator, state officials etc.) have to provide extensive support to listed companies in order to fulfil developed capital market criteria.

References

[1] Author is PhD Candidate in field of Communicology at J.J.Strossmayer University in Osijek, Croatia
[2] At the time this paper was written, entrance was scheduled for July 1, 2013, but not all of the member countries have signed admission agreement.
3 Settlement risk - The risk that one party will fail to deliver the terms of a contract with another party at the time of settlement.

[4] As of December 2012 only two out of 32 banks in Croatia are state owned – Croatian Postal Bank and Croatia Bank, holding insignificant 4,5% of total bank assets in Croatia (source: official pages of Croatian National Bank; www.hnb.hr)
[5] Prior to 2007, there were two capital markets in Croatia, Zagreb and Varaždin Stock Exchange. After their merger in 2007, Croatia remained single capital market – with only Zagreb Stock Exchange remaining.
6 Law on Market Securities, Official Gazzete No. 84/02
[7] Peak in 2007 was caused by already mentioned merger of two regulated markets in Croatia into a single one, but also the fact that Croatian capital market experienced it's all time peak in terms of prices and volumes in 2007, which has triggered nuber of new IPO's of companies such as Croatian Telecom, Magma, Atlantic, Optima etc.
[8] Capital Market Act, Official Gazzete 80/08, Article 332
[9] For details, see http://www.zse.hr/userdocsimages/novosti/5Y5PyLujqLHr7WOkvhdYow==.pdf
[10] For details, see http://www.zse.hr/userdocsimages/novosti/qaGkhq1HVuZkaVLWfvxLKw==.pdf
[11] For details, see http://www.zse.hr/userdocsimages/novosti/IdLjL2ES3j7tIPIMHepg4A==.pdf
[12] Official web pages of ZSE, www.zse.hr
[13] www.skdd.hr, top 10 shareholders data on as of February 5th, 2013.
[14] John Pollner/Tanja Bošković: *Advisory Service on the Implementation of the Markets in Financial Instruments directive (MiFID) in EU Candidate and New Member States, Case study Croatia*, Technical Advisory Report, World bank, April 2011
[15] CFSSA - Croatian Financial Services Supervisory Agency
[16] Ibidem.
[17] At the moment of writing this article expected and most probable date of entrance is July 1, 2013, with Croatia being 28th member state to join
[18] Proposal of Directive amending 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 and Commission Directive 2007/14/EC
[19] Ibidem.
[20] Ibidem.
[21] Ibidem.
[22] Ibidem.
[23] Rules of Zagreb Stock Exchange, Head 5, official internet pages of ZSE: http://www.zse.hr/default.aspx?id=97
[24] For Issuers, official channel of communication is official web page of ZSE (www.zse.hr) which they are accessing via specially developed intranet for issuers and are placing information directly to web
[25] Sector classification of all securities listed on ZSE can be found on: http://www.zse.hr/default.aspx?id=34348. Also, ZSE started to calculate sectoral indexes in February 2013, and they are available on: http://www.zse.hr/default.aspx?id=43538

Joelle Simon*

"THE NEW FRENCH BOARDS?"

● The time when boards were men's clubs supportive of the management in place is over.

● Over the last two decades things have dramatically improved concerning boards' efficiency due to the implementation of the AFEP/ MEDEF Code on corporate governance of listed companies.

And now, the boards' composition faces significant changes on two items:

- diversity and especially gender diversity,
- employees' participation

● On both issues, MEDEF and its partner business organisation AFEP, privileged a soft law approach, but the French Parliament and government decided after all to intervene.

I. Board diversity and especially gender diversity first

● **Diversity** that means more directors from abroad, more directors with different backgrounds, more women directors.

→ French listed companies already have one of the highest rates of foreign directors: 23.4 p. cent for CAC 40 index listed companies and 15.2 p. cent for all listed companies.

● **Gender diversity:**

2010: a clear MEDEF's commitment in favour of quotas → the April recommendation: at least 20 p. cent of women within a three years period and at least 40 p. cent of women within a six years period.

* Director for Legal Affairs – French Business Confederation (MEDEF).

Why did we change our mind? "*Quotas, a necessary evil*"

2011: adoption of a law on gender diversity on boards of companies

- scope: all listed companies and some private companies meeting some criteria (new government initiative to lower the threshold)
- calendar: 20 p. cent by 2014, 40 p. cent by 2017
- sanctions: cancellation of any legal appointment; suspension of any payment of fees.

2013: where are we now?

- 25.2 p. cent of women for CAC40 index listed companies (one with already 50 p. cent of women)
- 21.1 p. cent for SBF 120 index listed companies
- not only an increase in numbers but a change of culture

And what are the perspectives after the 2013 general meetings?

By 2017:

- between 800 and 900 positions need to be filled by women
- the current pace should be maintained to reach the goal of 40 p. cent.

● **What about the European proposal for a directive on improving the gender balance among non-executive directors of companies listed on stock exchanges and related measures?**

- MEDEF supportive of the objectives and already compliant within main provisions,
- but critical of some provisions:
    - too intrusive on the internal recruitment process,
    - impracticable for executive directors.

II. Employees on boards of companies:

● **The state of law**: before the reform, already possible and in some cases compulsory to elect or to designate employees on boards of companies:

- **Work council representatives** compulsory above 50 employees, with consultative voice;
- **Employee directors**: an obligation for state-owned companies and denationalized ones, a faculty for others;
- **Employee shareholder directors**: an obligation, if 3 p. cent or more of the capital of the company is held by employee shareholders.

● **Generalization of employees on boards of some companies**:

- A commitment of Mr Hollande as a candidate for the Presidency of the French Republic in 2012,
- A provision of the Growth, Competitiveness and Employment Pact (decision 33), Nov 2012,
- A provision (article 13) of the agreement *"Improving company competitiveness and security of employment"* of 11th January 2013 concluded between trade unions and employer organisations:
    - participation of employees as directors with voting rights in mother companies of groups with 10,000 employees or more worldwide or 5,000 employees or more in France (exclusion of subsidiaries),
    - one employee on boards of directors of 12 directors or less
    - two employees on boards of more than 12 directors
    - elected or designated through proceedings defined by the articles of association
    - employees as directors should have the same rights and duties as other directors
    - representation to be introduced within a period of 26 months as from the passing of the bill that includes this provision

- **The implementation bill** which should be definitive in two weeks.

The government and the Parliament wanted to copy the German codetermination system, but ignored the major difference between a one-tier and a two-tier system.

- Scope of application and number of employee directors: in line with the social agreement + exclusion of mother companies which have less than 50 employees,
- Ways of election or designation: choice between 4 ways:
    - direct election by employees of French companies (candidates proposed by trade unions)
    - designation by the group work council, the central work council or the work council,
    - designation by the most representative trade union,
    - designation by the European work council for one of the two directors, or the council of the European company.

→ We are not fully satisfied with those provisions for the following reasons:

- the lack of the expected flexibility on the ways of election or designation of employees: the trade unions are given too much power through this proposal,
- the refusal to take into consideration the existence of employee shareholder directors when there are some and the international dimension of groups of companies.

Status of employee directors: → They will have a protected status as employees → they will not be directors as other directors as we wanted → more trade union representatives.

That is why the formation of those new directors will be essential, determinant.

Cristoph Van Der Elst

TRANSPARENCY OF DIRECTOR'S ATTRIBUTES

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Abstract

The composition of the board of directors is considered key for the success of the company. The current approach to compose this board is to provide shareholders and investors with individual information of the skills and experience of (candidate) directors. The information is insufficient to qualify whether the candidate will enrich the board. Shareholders and investors are also deprived of information which composition the board considers appropriate to achieve the corporate goals. These problems can be solved with an appropriate disclosure framework. The skills and experience of the current board must be provided as well as the qualities that the new candidates will provide to the board. An example how a disclosure framework for competent boards must look like, is presented. It provides incentives for active ownership. Shareholders can vote for a specific board structure which in their opinion can best achieve the corporate goals.

INTRODUCTION

Since the start of the corporate governance era, the composition of the board of directors is considered as a key feature in the policy debate concerning best practices. Only effective board members can make the company successful. The board is the primary supervisory body for the corporation and the board should make decisions based on what they perceive to be in the best interests of the firm and its constituencies, in particular the shareholders. According to most company legislations the board of directors is entrusted with the management of the company and it is accountable to the company for this management. Companies acts provide in a number of formal board duties but the most important duty, managing the company or ensuring that the company is appropriately managed is not defined in further detail. In non-legal research the advising, networking and signaling roles of the board of directors is stressed (J. Fanto, L. Solan and J. Darley, 2011). The American Bar Association's Committee on Corporate Laws states that the board must review and approve fundamental operating, financial, and other corporate plans and strategies

(Committee on Corporate Laws, 1994). The directors also serve as a sounding board for management (R. Adams and D. Ferreira, 2005).

In light of the critical role played by the board in the governance and organization of companies it can be expected that regulators and corporate governance codes have spent much attention to the appropriate composition of the board. The board must be composed so as to provide in the appropriate skills and experience for managing the company and monitoring the management. Overall it can be expected that the board has general business experience, and specific industry knowledge. Members of the board should have good understanding of business finance and financial reporting and are sufficiently diverse from one another as to provide in the diversity that guarantees better performance. The directors must have the required professional background and the composition of the board must be homogeneous enough so that the different board members can understand the issues to be debated, discussed and decided and heterogeneous enough to match all the different skills and expertise to be successful. The wide variety of industries, lifecycles and activities of companies will result in a wide variety of boards. As a consequence the one-size fits all board is not to be expected. In this article it is questioned how company legislation and corporate governance code provide in the tools for companies to enhance the appropriate board composition. The next sections first study the requirements for and attributes of the board of directors according to the companies acts in Belgium, France, Germany and the UK. Next this paper addresses the corporate governance recommendations to optimize the board structure as well as the best practices to select the appropriate board. The final section analyses the two missing links to develop effective boards and to make board election procedures efficient offering engaged shareholders a say on selection. The analysis focuses on the listed companies in the aforementioned different countries but excludes companies in the financial industry.

1. THE "LEGAL" BOARD

While the company acts of many countries remain vague as to the duties of the board of directors, also the composition of the board to achieve its corporate goals is left to the company's articles of association and the general meeting of shareholders. However, like the fine-tuning of a number of board duties in corporate governance codes and later in the law, corporate governance has also influenced corporate law vis-à-vis the composition of the board of directors. In many countries the board members of listed entities must comply with new (formal) requirements, of which the independence, financial expertise and a number of opposite gender are the most frequently enacted.

The board of directors of a Belgian listed company must be composed of at least three directors. In 1995 the Belgian parliament enacted that the decision of a board of directors of a listed entity that could provide in a direct or indirect financial advantage for a controlling shareholder has to be

approved by a committee of three directors that are independent vis-à-vis the decision or the considered transaction.[1] This requirement was further fine-tuned and in 2002 the legislator defined the criteria to become an independent director.[2] In 2008 Belgian Parliament transposed the European audit committee requirement and provided that at least one independent director must have the necessary expertise in the field of accounting and auditing. The Directive 2006/43/EC[3] allows only non-executive directors as members of the audit committee. Hence, the Belgian law provides that directors that are members of the management committee and managers empowered with the day-to-day management are irrefutably considered executive board members.[4] In 2010 the Belgian legislator made the establishment of a remuneration committee mandatory. More than half of the members of this committee must be independent board members and the committee must have the necessary expertise in the field of remuneration policy.[5] In 2011 the Companies Code was again amended introducing the requirement to compose the board of directors of listed companies for at least 1/3 of members of the opposite gender, but a long transition period until 2018 is provided.[6] The French Commercial Code requires a (supervisory) board of directors of not less than three and not more than 18 members.[7] The Commercial code obliges the articles of association to provide in an age limit for either all (supervisory) board members either a per cent of all members. In case the articles do not provide in an age limit, not more than 1/3 of the board members should exceed the limit of 70 years of age.[8] The chairman of the board must be younger than 65 years of age.[9] He combines this position with the position of CEO unless the board elects another board member as CEO.[10] An individual can only have one position as CEO or member of the management committee in French companies.[11] In 1994 a system was introduced providing employee representatives access to the (supervisory) board of directors. If the employees hold more than 3% of the shares, the general meeting of shareholders elects one or more employee-shareholders as

[1] For a detailed analysis of this provision see E. Wymeersch, *De belangenconflictenregeling in de vennootschappen*, Antwerpen, Maklu, 1996, 209 p.
[2] It was first introduced in article 524 Belgian Companies Code (enacted by Law of 2 August 2002, *Belgian Official Journal* 22 August 2002, p. 36555) and moved later to article 526ter Belgian Companies Code.
[3] Article 41, § 1 Directive 2006/43/EC of 17 May 2006 of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, *OJ* L 157 of 9 June 2006, p. 87.
[4] Article 526bis §3 in fine Belgian Companies Act.
[5] Article 526quater, §2 Belgian Companies Act (introduced by Law of 6 April 2010, *Official Gazette* 23 April 2010).
[6] Law of 28 July 2011, *Belgian Official Gazette* 14 September 2011 p.59600, introducing article 518, §2 Belgian Companies Act.
[7] Article L 225-17 L 225-69 French Commercial Code.
[8] Article L 225–19 and L 225-70 French Commercial Code.
[9] Article L 225-48 French Commercial Code.
[10] Article 225-51-1 French Commercial Code.
[11] Article 225-54-1 and 225-67 French Commercial Code.

board members.[12] Since 2001, the articles of association can also provide in the right for the employees to elect up to five directors but limited to maximum 1/3 of the other directors. In case the employees are provided the right to elect two or more directors, one representative must be elected among the engineers, executives and similar.[13]

Since 2002 an individual is not allowed to combine more than five (supervisory) board memberships in French companies.[14] Membership in a board of a consolidated company is not taken into account for the determination of the number of memberships.

In 2011 France endorsed the requirement of balanced boards and introduced for listed companies and other companies with more than 500 employees and sales or assets of more than 50 million euro[15] the requirement that at least 40% of the (supervisory) board must be board members of the opposite gender from 2017 onwards.[16] In companies with a (supervisory) board of up to 8 members the difference in number between the opposite sex directors must not exceed 2.[17] The management board of French company that opted for a two-tier board must be composed of maximum 7 members not exceeding the limit of 70 years of age.[18]

The German Companies Act is less prescriptive than the French Commercial Code. The management board may comprise one or more members and at least two members in case the capital is more than 3 million euro, unless the articles of association provide otherwise.[19] In companies which have to comply with employees co-determination acts an "employee director" is elected.[20] The Companies Act forbids explicitly any other position in a competing company.[21]

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[12] Article L 225-23 and L 225-71 French Commercial Code. In some cases, the general meeting chooses among the employee-shareholders who are members of the supervisory board of an investment trust which holds shares in the company as (supervisory) board member.

[13] Article L 225-27 French Commercial Code.

[14] Article L 225-21, L 225-77 and 225-94-1 French Commercial Code. Before 2002 the maximum number of board memberships was 8.

[15] These thresholds must be passed three consecutive years.

[16] Law nr. 2011-103 of 27 January 2011 *French Official* Journal n° 23 of 28 January 2011, p. 1680 (Loi n° 2011-103 du 27 janvier 2011 relative à la représentation équilibrée des femmes et des hommes au sein des conseils d'administration et de surveillance et à l'égalité professionnelle).

[17] It limits the composition of small boards as follows:

board	gender 1	gender 2
3	2	1
4	2	2
4	3	1
5	3	2
6	4	2
6	3	3
7	4	3
8	4	4
8	5	3

[18] Article L 225-58 and L 225-60 French Commercial Code.

[19] Section 76 German Companies Act.

[20] Section 33 Employee Codetermination Act; section 13 Mountain Employee Codetermination Act and 13 Supplemental Codetermination Act.

[21] Section 88 German Companies Act.

The supervisory board must be composed of at least three members, all natural persons. The articles of association can provide in a higher number but the number must be divisible by three, unless the co-determination laws provide otherwise. The maximum number of supervisory board members depends on the share capital of the company. Capital up to 1.5 million euros allows for a board of nine members, capital of more than 1.5 million euros up to 10 million euro allows for a board of fifteen members and capital higher than 10 million euros allows boards up to 21 members. Different co-determination requirements further structure the composition of the German supervisory board. Companies with more than 500 employees must organize a supervisory board of which 1/3 of the members are employee representatives. In companies with more than 2000 employees, half of the supervisory board must be representatives of the employees. Depending on the total number of employees, the total size of the supervisory board of the company can be 12, 16 or 20 members.[22] There is a specific interlocking directorship rule. When a member of the management board of a company is member of the supervisory board of another company, a legal representative of the latter is not allowed to become a member of the supervisory board of the first company.[23] Finally, a member of the supervisory board is not allowed to take up more than ten supervisory board memberships, whilst the chairman of the boards counts for a double membership and the first five memberships in the consolidated group are not taken into account.[24]

The UK Companies Act remains silent as to the qualifications of the directors and contains only two requirements for the board of directors. First, the board must be composed of at least two directors and second, the directors must be at least 16 years of age[25]. The FSA Listing Requirements adds an information requirement regarding the director. A Regulatory Information Service must be informed of new director appointments. The information must relate to his position in the company (executive, non-executive or chairman of the board), to the other directorships in quoted companies in the previous five years, to convictions of the director, to receiverships in and liquidations of companies in which he was an executive directors or partner, to public criticisms by statutory or regulatory authorities and to court disqualifications.[26]

Overall all company acts focus more or less on formal requirements for the composition of the board and to a lesser extent for individual board members but deny to a large extent the qualities and expertise of the board members.

[22] For these companies the general rule that the number of supervisory board must be divisible by three is not applicable.
[23] Section 100, (2), 3. German Companies Act.
[24] Section 100, (2) German Companies Act.
[25] Section 154 and 157 Companies Act 2006.
[26] Financial Services Authority , LR 9 Continuing Obligations, 6 Notification, 11 and 13.

2. THE"COMPLIANT" BOARD

Appropriately addressing the board duties incited corporate governance commissions in different countries to develop further guidelines as to the composition of the board of directors. The Cadbury Code phrased it as follows:

Every public company should be headed by an effective board which can both lead and control the business. Within the context of the UK unitary board system, this means a board made up of a combination of executive directors, with their intimate knowledge of the business, and of outside, non-executive directors, who can bring a broader view to the company's activities, under a chairman who accepts the duties and responsibilities which the post entails. […] Given the importance and particular nature of the chairman's role, it should in principle be separate from that of the chief executive. […]Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. We recommend that the calibre and number of non-executive directors on a board should be such that their views will carry significant weight in the board's decisions.[27]

At the European level, the Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board[28] supports a proper balanced board vis-à-vis its qualifications of the members. The appropriateness should be considered in light of the company's structure and activities. Overall the (supervisory) board should meet the diversity requirements 'of knowledge, judgement and experience to complete their tasks properly.'[29] For the European Commission it is of importance that the competences related to the service of candidate directors are disclosed as well as a 'profile of the board's composition'[30].

Along the lines of the Cadbury recommendations many corporate governance codes further developed the best board composition. The commissions developing the corporate governance codes took into consideration the legal requirements to compose the board of directors. Countries within which the company act provides more detailed prescriptions on board composition, like Belgium, seem to be more general in providing composition recommendations in their corporate governance codes than countries with minimal legal provisions, like the UK.

[27] The Committee on the Financial Aspects of Corporate Governance, *Financial Aspects of Corporate Governance*, London, 1992, Principle 4.1, 4.9 and 4.11.
[28] *Pb. L* of 25 February 2005 nr. 52, p. 51.
[29] Recommendation 11.1.
[30] Recommendation 11.4.

The Belgian code supports the aforementioned Cadbury approach. The code requires a board composition that ensures 'that decisions are made in the corporate interest. It should be determined on the basis of the necessary diversity and complementary skills, experience and knowledge'[31]. Also Belgian boards should not be dominated in any manner. 'No one individual should have unfettered powers of decision-making. At least half the board should comprise non-executive directors and at least three of them should be independent'[32].

The French corporate governance code adds that the directors must be honest and competent which includes the understanding of the corporation's operations.[33] The directors must be involved in the strategy development of the company. The composition of the boards depends on the shareholder structure, the size and the business of the company.[34] While the code recognizes the different representatives of both shareholders and employees in the board of directors of large companies, it emphasizes the importance of untied board members, avoiding the board to become a battleground for vested interests, and 'representing all shareholders[35] and act accordingly'.[36] Boards should be balanced with respect to gender and competencies. Apart from the legal requirements regarding board composition, independent directors are the appropriate approach to take into account the different interest of corporate incumbents. Companies with a dispersed ownership structure must be composed of 50 per cent independent directors, companies with a controlling shareholders should strive for a board with at least 1/3 independent members.[37]

The German corporate governance code adds a number of best practices to the list of corporate formalities that are structuring both the management and the supervisory board. The German code recommends a management board composed of several members and the bylaws shall provide the division of powers between the members.[38] The supervisory board must respect diversity, including gender diversity and an age limit in the (s)election procedure of the members of the management board.[39] Diversity recommendations are more specific for supervisory boards. The supervisory board must provide in 'knowledge, ability and expert experience […] to properly complete its tasks'. The supervisory board must assess the required features taking into account the 'international activities of the enterprise, potential conflicts of interest, the number of independent supervisory board members […], an age limit to be specified for the members of the supervisory

[31] Belgian Corporate Governance Commission, *Belgian Code on Corporate Governance*, 2009, Provision 2.1.
[32] Ibid. 2.2.
[33] MEDEF-AFEP, *Code de Gouvernement d'Entreprise des Sociétés cotées*, principle 6.1.
[34] Ibid. principle 1.3.
[35] The Code explicitly refers to the interests of all shareholders and not to the interests of the company.
[36] MEDEF-AFEP, *Code de Gouvernement d'Entreprise des Sociétés cotées*, principle 7.
[37] Ibid, principle 8.2.
[38] Government Commission, *German Corporate Governance Code*, May 2012, Recommendation 4.2.1.
[39] Ibid. Recommendation 5.1.2.

board and diversity'[40]. Management board members of a listed company shall not accept supervisory board memberships in more than three other listed companies (of other groups)[41]. Former management board members must respect a cooling off period of at least two years before standing up for election as a supervisory board member of the company where they were member of the management board.[42] To this end the supervisory board must provide in objectives which must be published in the corporate governance report. Personal and business relationships with the company must be disclosed in the proxy materials.

Since 1992 the UK has fine-tuned the requirements of a balanced board in Cadbury Code's successors. The main code 2012 principle requires a 'balance of skills, experience, independence and knowledge of the company'[43]. The board must be sufficient in size to manage the business and board changes adequately and 'should include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking'[44]. The code prescribes the independent requirements[45] and states that with the exception of the smaller companies for which the minimum number is two, 'at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent'[46]. Directors have a time commitment. An executive director should not take more than one non-executive directorship in a FTSE 100 company and should not accept to become the chairman of the board.[47] The nomination committee of the board is in charge to provide in an appropriately balanced board. According to the UK Corporate governance code it is the nomination committee task to make sure that the aforementioned balance is assessed, to ensure progressive refreshing of the board, to make use of objective criteria taking into account the benefits of diversity. The nomination committee must 'prepare a description of the role and capabilities required for a particular appointment'[48]. The Code

[40] Ibid. Recommendation 5.4.2.
[41] Ibid. Recommendation 5.4.5.
[42] Ibid. Recommendation 5.4.4. If shareholders with more than 25 per cent of the voting rights present a motion to elect a former member of the management board, this recommendation must not be applied.
[43] FRC, *UK Corporate Governance Code*, London, Main principle B 1.
[44] Ibid., Supporting principle B.1.
[45] A board member should comply with the following requirements to be considered independent (Code provision B.1.1): he has not been an employee of the company or group within the last five years; he has not, or has not had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company; he has not received or receives additional remuneration from the company apart from a director's fee, does not participate in the company's share option or a performance-related pay scheme, or is not a member of the company's pension scheme; he has no close family ties with any of the company's advisers, directors or senior employees; he holds no cross-directorships or has no significant links with other directors through involvement in other companies or bodies; he does not represent a significant shareholder; or he has not served on the board for more than nine years from the date of their first election. The board can overrule the list and determine a director that does not comply with one or more requirements to be independent.
[46] Code provision B.1.2.
[47] Code provision B.3.3.
[48] Code provision B.2.2.

Supporting Principle adds that the 'search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender.'

While the different corporate governance codes provide in many recommendations on the composition of the board, they only generally refer to the skills and experiences of directors and leave it at best to the nomination committee how the composition of the board of directors can appropriately support the interests of the company.

3. THE "SELECTED" BOARD

Company acts only provide rules for the election of directors and leave the selection procedure to the company. Generally speaking the general meeting of shareholders elects the (supervisory) board members, the supervisory board elects the management board. The selection process of new board candidates as well as the assessment of the effectiveness of the incumbent board members is left to the discretion of the company. Some corporate governance codes address this issue as it is in many countries recommended that a subcommittee of the board of directors, the nomination committee is established of which the main task is the selection of new candidates for the board. The approach is in line with the European Recommendation which advises the nomination committee to 'evaluate the balance of skills, knowledge and experience on the board, prepare a description of the roles and capabilities required for a particular appointment, and assess the time commitment expected'[49]. The committee must also assess the skills, knowledge and experience of the incumbent directors.

Belgium copied the European Recommendation and complemented the recommendations. While the Belgian corporate governance Code does not explicitly mandate the nomination committee to consider the composition requirements, it can be argued it is its role to take into account provision 4.3. of the code that candidate board members must provide in the needed skills, knowledge and experience in light of the present composition of the board. One of the chairman's tasks is to make sure that the board of directors receives sufficient information of the candidate, including a CV, an assessment of the interview and information on other positions.[50] Indeed, it is the board's duty to provide in a recommendation to the general meeting of shareholders based on the advice of the nomination committee.[51] The French code adds to the European recommendation that the nomination committee must consider a gender balanced composition and must take into account the

[49] Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, *Pb. L* of 25 February 2005 nr. 52, p. 51.
[50] Belgian Corporate Governance Commission, *Belgian Code on Corporate Governance*, 2009, Provision 4.4.
[51] Belgian Corporate Governance Commission, *Belgian Code on Corporate Governance*, 2009, Provision 4.6.

changes in the ownership structure for the nomination of the directors.[52] Both the notice of the general meeting and the annual report should contain a biography of the candidate director sketching his or her CV as well as the number of shares the (candidate) director holds.[53] The German code contains a similar gender requirement for the supervisory board, adds the age limit and an disclosure requirement of the objectives of the composition.[54] The general meeting of shareholders must be informed of the 'personal and business relations of each individual candidate with the enterprise, the executive bodies of the company and with a shareholder holding a material interest in the company'[55]. The UK corporate governance code further develops both the balanced board requirement as well as the disclosure requirement. Before making an appointment for the board of directors the nomination committee should evaluate 'the balance of skills, experience, independence and knowledge on the board and, in the light of this evaluation, prepare a description of the role and capabilities required'[56]. In the section on the work of the nomination committee, the annual report should include 'a description of the board's policy on diversity, including gender, any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives'[57].

4. THE COMPETENT BOARD

While the legislations focus on the formal requirements to become or remain a director, like age in the UK, employee representatives in Germany and France and gender in Belgium and France, the corporate governance codes more emphasize that the individual board members provide the necessary skills and expertise to the board. It resulted every year in more detailed information on the previous positions of the directors on which shareholders can rely for their vote. As an example we refer to mr. Jacques Calvet, a director of the French Foncière Lyonnaise. In 2001 shareholders of Foncière Lyonnaise, a large French real estate investment trust were informed that mr. Jacques Calvet, director of the company, combined his position with the position of chairman of the supervisory board of Bazar de l'Hôtel de Ville, deputy chairman of the supervisory board of Galeries Lafayette, member of the supervisory board of Axa, Cottin Frères and Groupe André, and member of the board of directors of Société Générale and Société Européenne de Participations Industrielles. He was for the first time elected in 1999. In the annual report of 2011 of Foncière Lyonnaise the shareholders were informed that mr. Jacques Calvet reached the age of 80 years, is a French citizen and an independent board member of the company. He started his career as an

[52] MEDEF-AFEP, *Code de Gouvernement d'Entreprise des Sociétés cotées*, 2010, principle 15.2.1.
[53] MEDEF-AFEP, *Code de Gouvernement d'Entreprise des Sociétés cotées*, 2010, principle 12.
[54] Government Commission, *German Corporate Governance Code*, May 2012, Recommendation 5.1.2.
[55] Government Commission, *German Corporate Governance Code*, May 2012, Recommendation 5.4.1.
[56] Ibid., principle B.2.2.
[57] FRC, *UK Corporate Governance Code*, London, Main principle B 1.

auditor at the French Court of Auditors (1957-1959) after which he had different positions as employee at the cabinet of the then Minister Valery Giscard d'Estaing combining that position with the position of deputy director and later head of the department of the Central Administration of the French Ministry of Finance. He got several times promoted at the Ministry of Finance and ended as Director of Finance. In 1974 he moved into business and became deputy director at BNP and later was chairman of the board. He is now an honorary chairman of BNP. He has held several management positions and later board positions at Peugeot. He is still combining his position as independent director of Foncière Lyonnaise with many other directorships like Laser Cofinoga, Laser, Cottin Frères and Le Meilleur Holding, deputy chairman of the supervisory board of Galeries Lafayette, chairman of the supervisory board of Bazar de l'Hôtel de Ville, censor of EPI and Afence and advisory consultant to the French National Bank. Further the annual report provides information of the positions of mr. Calvet over the last five years.

While this information provides evidence that the board member is exceptionally experienced, it only allows to appreciate the qualities of the board member, but not the qualities in relationship to the actual board of directors and neither the qualities that the company - as it stands today - requires. Shareholders, investors and other stakeholders miss pertinent information. First, the knowledge and experience of this member of the board is presented isolated from the overall board's competences. Second, as boards must uniquely fit with the company's size, industry, lifecycle, and other company characteristics, the director's attributes must fit in the mix of skills and experience the board should provide to the company. Achieving these two additional corporate governance features, the board of directors or its subcommittee, the nomination committee will have to prioritize those skilled and experienced directors for the future board which are lacking or underrepresented at the current board. This prioritization exercise can only take place after the skills and experience which the company needs at board level are identified. Optimization of the board structure will need a strategic plan which must be presented to and voted at the general meeting of shareholders. A procedure that integrates these feature in the (s)election of board candidates has many advantages.

First it emphasizes the board's duty to and interest in the identification of the most appropriate board skills and expertise. When the company's strategy and business has been determined, it follows from the strategy which board fits best in monitoring the company's choices. The selection procedure will have to focus on these experiences, expertise and skills which are lacking or are underrepresented in the board. This method will be in conformity with the demand of (institutional) shareholders. In a recent report of the Association of British Insurers it is recommended that companies 'seek to provide more forward-looking and candid disclosures on the steps they are

taking to ensure they have the right balance of skills and experience in their boardrooms' (Association of British Insurers, 2012).

Second and in combination with the appropriate involvement of the shareholders, it reduces the pressure on the short termism of boards. In some countries directors must stand up for reelection each year. While it is many times a mere formality, board members experience the current pressure for more short term behavior when they retrieve their names in the company proxy materials each year. Aligning board composition with the corporate strategy alleviates this pressure as the alignment of the board's composition with the corporate goals reduces the need for affirmative votes for the individual director but increases the need for affirmative votes for best board composition.

Third a strategic composition board plan will foster companies and consultants to go beyond the mere static fact finding on boards of directors. Up till now most corporate governance studies and board composition studies do not go beyond "formalities" like size, number of independent directors, non-executive directors, woman directorships and foreign directors, age of directors, tenure and number of meetings. In the most recent board index report of Spencer Stuart a comparison is provided on the main features of the board in a number of European countries and the US.[58] The results of the comparison, in the order of the report can be found in table 1. It is striking that none of the criteria provide insights in skill or expertise of board members. It is informative but improvements are certainly possible.

Table 1. Board composition in six countries

	France	Germany	Italy	Spain	UK	US
board size	14	14,8	12,8	11,6	10,4	10,7
foreign directors	27%	22,8%	6,5%	11,4%	34%	9%
at least one woman	95%	92%	53%	71%	84%	91%
woman	22%	17%	5,7%	10%	15%	17%
avg. age of NED	59,7	61	61	59	59	62,6
meetings	8,95	6,3	10,2	10,3	8	8,3

Source: Spencer Stuart, UK Board Index Report 2012, December 2012, 44 p.

There are examples of a method that is useful to identify and (s)elect competent boards. The Canadian financial services group Manulife Financial provides in its Proxy Circular good insight of the skills and expertise of the candidate board members and the directors that were elected over the

[58] It should be noted that the Spencer Stuart reports are very informative as they also contain the individual results of the companies in the study which allows for more detailed assessments than many other corporate governance reports.

last years as well as of the experiences of the individual board members. Table 2 summarizes the information disclosure of the recently elected board members of the Manulife Corporation. This information is provided next to the individualized information for each director allowing the shareholders to assess the conformity of the CV with the board's assessment of the experience.

Table 2: Expertise of recently elected board members of Manulife Financial

experience	director 1	director 2	director 3	director 4	director 5	director 6	director 7
senior executive	x	x	x	x	x	x	x
human resources		x	x	x	x	x	x
financial	x	x	x	x	x	x	x
global financial, investments	x				x		x
risk management	x		x		x	x	x
Asia		x		x	x	x	
public sector		x	x			x	

Source: Manulife Corporation, Proxy circular Annual Meeting 3 may 2012, p. 8

Following the information on the experience of the directors which were elected over the most recent years, the company discloses the full scale of director's expertise and skills in an elaborated matrix which is provided in table 3. Next to the general professional skills and experience as senior manager and understanding of finance, risk and remuneration, the company's board focuses on the experience of the American and Asian market and global financial services in light of the corporate goals and industry in which the company operates.

Table 3: Skills and expertise of board members of Manulife Corporation

experience	director 1	director 2	director 3	director 4	director 5	director 6	director 7	director 8	director 9	director 10	director 11	director 12	director 13	director 14	director 15	director 16	director 17
Senior executive (all)																	
Broad business experience as a senior officer or chair of the board of a major organization (public, private, non-profit)	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
Other directorships (Majority)																	
Director of a major organization		x	x	x	x	x	x		x	x	x	x	x	x	x	x	x
Public sector (minimum 2)																	
Including a Crown Corporation, educational	x		x	x	x			x						x	x		x

institution, or any other non-commercial organization																	
Financial experience (majority)																	
Based on the definitions of financial literacy or expert for members of the audit committee under securities laws	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
Risk management experience (minimum 4)																	
Experience in identifying principal risks of an organization and the oversight or management of risk management system - may have been gained as a CEO, risk management executive or member of a board risk committee of a public company		x	x	x		x		x	x	x	x		x	x	x	x	
Global financial services executive, knowledge of investment management (minimum 4)																	
Experience in the financial services industry or experience overseeing complex financial transactions and investment management			x	x						x	x		x			x	
Asia operations/governance (minimum 3)																	
Experience gained through direct involvement with business or regulatory operations in Asia	x			x	x		x		x		x	x	x		x		
U.S. operations/Governance (minimum 4)																	
Experience gained through direct involvement with business or regulatory operations in the United States		x		x		x	x		x	x	x		x				x
Human resources management & executive compensation (minimum 3)																	
Experience in overseeing compensation design either as a CEO, CFO, senior human resources executive or consultant, or member of a board compensation committee of a public company	x	x	x	x	x			x	x			x	x	x	x	x	x

Source: Manulife Corporation, Proxy circular Annual Meeting 3 may 2012, p. 9

The Proxy Circular further elaborates on the development of the skills of the director with an overview of the training sessions board members attended. In order to reduce the possible deficiencies of members of the board of directors, the board received training sessions through the year on global restructuring of financial services, derivatives, China-Canada relations, China economics, branding, etc.[59] It is a good example of embedded corporate governance practices. Many (formal) features that are less relevant according to abundant academic research are no longer prominently present.

[59] Manulife Corporation, Proxy circular Annual Meeting 3 may 2012, p. 62.

Fourth, the procedure requires shareholders to consider and assess the best board proposals and it invites them to monitor and evaluate the board structure in relationship to the company strategy. It is our believe that this information would not only encourage shareholders to vote but more importantly to vote diligently upon the information provided. Information from the voting poll shows that the shareholders individually assess the qualities of the directors as the opposition – votes withheld- against the director starts at less than 1% for 5 directors and soars to more than 12% for three other directors.

Table 4 Voting results of the election of the 17 board members in Manulife in 2012

director	votes withheld	director	votes withheld	director	votes withheld	director	votes withheld
1	5,02%	6	8,60%	11	8,35%	16	0,85%
2	13,39%	7	0,64%	12	5,35%	17	12,98%
3	8,83%	8	7,90%	13	0,83%		
4	12,99%	9	12,98%	14	12,88%		
5	8,39%	10	0,94%	15	0,75%		

Source: Manulife Corporation, minutes of the meeting 2012.

5. CONCLUSION

The composition of the board is pivotal for the success of the company. The (s)election procedure for new members of the board must emphasize that the candidates will enhance (the probability of) this success. However, the current approach in many countries and companies is to provide shareholders and investors with individual information of the skills and experience of (candidate) directors. The information is insufficient to qualify whether the candidate has the experience and skills that will enrich the board. Shareholders and investors are also deprived of information of the experience and skills that the board of directors must present to achieve the corporate goals. These problems can be solved with an appropriate disclosure framework. The skills and experience of the current board must be provided as well as the qualities that the new candidates will provide to the board. Examples how a disclosure framework for competent boards must look like, can easily be found. It provides incentives for active ownership. Shareholders can vote for a specific board structure which in their opinion can best achieve the corporate goals.

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UNBLOCKING WOMENS´S PATHS TO THE BOARDROOM
A CRITICAL NOTE ON THE EC´S PLANS TO REGULATE BOARD DIVERSITY ONE-DIMENSIONALLY

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The recent financial crisis has led to a loss of trust in the quality of corporate governance worldwide. The European Commission (EC) currently intends to regulate board diversity (at first gender diversity) by quota, as companies have not voluntarily met the EC's expectations on this issue. Considering the political debate, it often becomes obvious that the debate on board diversity is primarily discussed from a moral perspective and on the basis of standard economic arguments or stereotypes, ignoring the majority of empirical findings in this field. Focusing on this gap, we identify very mixed results on the links between different attributes for board diversity and economic outcomes. Furthermore, these empirical findings mainly do not consider important aspects of work psychology and organizational behavior in the black box/closed circle of corporate boardrooms and often only focus on single attributes for board diversity and their direct impact on economic outcomes. Thus, without having a deeper understanding of the processes and dynamics within corporate boardrooms, we do not think this is the right time to regulate board diversity. Additionally, we think such a measure disproportionately intervenes in companies' authority to staff their boards and neglects companies' specific (economic) situations.

Keywords: Board Diversity, Economic Perspective, Moral Perspective, Regulation

INTRODUCTION

The current financial crisis is challenging a host of our traditional conceptions and theories and has revealed severe shortcomings in corporate governance arrangements. As Alan Greenspan, former Chairman of the Federal Reserve of the United States, stated: "I made the mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best

capable of protecting their own shareholders and the equity of the firm."[1] Thus, in the aftermath of the global financial crisis, a loss of trust has put pressure not only on companies but also on policy makers, regulators and researchers to improve corporate the quality of governance.[2] The topic of increasing diversity of corporate boards has been heavily discussed since then. Board diversity has been at the forefront of social debates, as it is recognized that there are systemic barriers preventing equal opportunity and a belief that diverse boards may produce more effective decision-making and mitigate groupthink within boardrooms. Whereas a focus was often put on gender diversity, now there are further group-based dimensions, especially nationality, culture, ethnicity, age and educational background/experience. The European Commission (EC) discusses these dimensions in its recent Green Paper on a new corporate governance framework.[3] Nevertheless, in the political and social debate, it often becomes obvious that the issue of board diversity is discussed more from a moral perspective than from an economic perspective. Economic studies on the relationship between board diversity and firm performance are poorly reflected and often such studies only find a positive relationship.[4] Thus, we highlight the current situation from an economic perspective, researching the state-of-the-art link between board diversity and economic outcomes. We additionally address some aspects which seem to be important for future board diversity performance research.

The strong desire for executive experience—and in particular, CEO and C-suite operating experience—as part of a board makeup, and often reflected by "old boys" networks, could have the undesired effect of systemically discriminating against women, cultures, nationalities or minorities. Therefore, some boards have chosen to accord primacy to diversity considerations explicitly, in the form of designated groupings for individuals (for example, women, nationalities, cultures, racial minorities, and persons with disabilities) within a competency matrix. In addition, some boards have exercised care in defining competencies (such as different forms of leadership, market knowledge, board experience and functional capabilities) with a view to being inclusive and not unintentionally disadvantaging prospective directors, but still draw on the best-qualified directors to lead the company. Individual types of board diversity—e.g., professional or gender diversity—may

[1] Alan Greenspan, *Hearing by the Congressional Committee for Oversight and Government Reform on the Role of Federal Regulators in the Financial Crisis*, Preliminary hearing transcript (Washington, 23 October, 2008).
[2] Hussein Tarraf, "The Role of Corporate Governance in the Events Leading Up to the Global financial Crisis: Analysis of Aggressive Risk-taking," *Global Journal of Business Research* 5, no. 4 (2011): 93–105.
[3] European Commission, *Green Paper: The EU Corporate Governance Framework* (Brussels: European Commission, 2011).
[4] European Commission, *Progress in Gender Equality Leads to Economic Growth* (Brussels: European Commission, 2012).

transcend nation–state boundaries (e.g. financial acumen and women).[5] There are, however, nuances—such as industries that have been, and still are, male-dominant whereas other industries have made somewhat greater progress towards achieving (but are certainly far from reaching) desired gender parity (e.g. financial services or consumer products industries) at board and senior management levels.[6] Companies may operate in certain languages, milieus and jurisdictions. This generates a tremendous demand for international and cultural diversity. Therefore the talent pools (or the supply of directors) and the needs (or the demand for directors) may not be equal across industries and jurisdictions; diversity considerations should address this reality.[7]

2. BOARD DIVERSITY AND ARGUMENTS FOR BOARD DIVERSITY

As for diversity in general, also for the special field of board diversity: "there is no agreed *definition* of what [attributes or dimensions] board diversity covers."[8] One can distinguish between board diversity on observable or readily detectable attributes and less visible or underlying attributes.[9] Gender, ethnic, nationality and age board diversity can be derived from these observable or readily detectable attributes. Other attributes of board diversity, like education and functional background, can be derived from less visible or underlying attributes. Board diversity research focuses exclusively on the "narrow category-based" and the "broad category-based" definition of diversity and not on "definitions based on a conceptual rule." There are two basic arguments for board diversity.

First, board diversity is assumed to increase companies' economic benefits. This paper deals with this argument. Research conducted to empirically explain the economic benefit of board diversity in its various forms is based on different, concurrent, or complementary theories taken as a basis for board diversity research. *Agency Theory,* among others,[10] claims that board independence is crucial for boards to act in line with stakeholders' interests and to be successful. As board diversity is suggested to increase board independence, diverse boards are assumed to better monitor top managers' actions and thus contribute to the overall success of the firm, e.g. by higher attendance,

[5] Richard Leblanc and others, "General Commentary on European Union Corporate Governance Proposals," *International Journal of Disclosure and Governance* 9, no. 1 (2012): 1–35.
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[9] Frances J. Milliken and Luis L. Martins, "Searching for Common Threats: Understanding the Multiple Effects of Diversity in Organizational Groups," *Academy of Management Review* 21, no. 2 (1996): 402–33.
[10] Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (1976): 306–60.

enhanced monitoring roles, or a greater propensity to replace poorly performing CEOs.[11] *Resource Dependence Theory*[12] claims that diverse types of board members provide different valuable resources such as talent and expertise that may increase firm performance. Similar insights with a special focus on education can be derived from *Human Capital Theory*,[13] which argues that diverse educational background, including expertise and experiences is beneficial for companies. *Social Psychological Theory*[14] argues that different characteristics of board members reduce their social cohesion and thus decrease the probability that the minority's opinion will influence decision-making by the rest of the board. There are advantages and disadvantages which arise from these effects, like creativity and innovation on the one hand, and conflict and complexity on the other hand. Another well-known theory in the field of board diversity research is *Critical Mass Theory*, which indicates that a certain number of persons are required to exert influence on social action.[15] In the context of board diversity, this theory is mainly used to describe the number of women needed to make a significant influence on the decision-making process and to evoke fundamental changes in the boardroom. Finally, *Social Cognition Theory*[16] demonstrates that individuals tend to categorize others, e.g. female directors, into certain groups (groupthink). Individuals then treat members of a certain group with respect to previous experience, knowledge, and biases.[17]

Second, board diversity is discussed from a moral perspective. This argument mainly excludes economic aspects, arguing on the basis of the discrimination-and-fairness paradigm and considering board diversity policy as an instrument to achieve equal opportunity and fair treatment in accordance with legal prescriptions (especially anti-discrimination law). Supporters of this perspective argue that individual differences between persons are neglected or ignored and, as a consequence, (assumed) economic opportunities were passed.[18] This moral perspective has gained much attention in the political and social debate and is seen as sufficient to drive change.[19] Apart

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[11] Richard Leblanc, *A Fact-based Approach to Boardroom Diversity* (Toronto: Institute of Corporate Directors, 2011), 6–8.
[12] Jeffrey Pfeffer and Gerald R. Salancik, *The External Control of Organizations: A Resource Dependence Perspective* (New York: Harper and Row, 1978).
[13] Theodore W. Schultz, *Investment in Human Capital* (New York: Free Press, 1971).
[14] Bibb Latane and Sharon Wolf, "The Social Impact of Majorities and Minorities," *Psychological Review* 88, no. 5 (1981): 438–53.
[15] Pamela Oliver, Gerald Marwell and Ruy Teixeira, "A Theory of the Critical Mass," *American Journal of Sociology* 91, no. 3 (1985): 522–56.
[16] Neal E. Miller and John Dollard, *Social Learning and Imitation* (New Haven: Yale University Press, 1941).
[17] Ernst & Young, *Groundbreakers: Using the Strength of Women to Rebuild the World Economy* (New Jersey: Ernst & Young, 2009).
[18] David A. Thomas and Robin J. Ely, "Making Differences Matter: A New Paradigm for Managing Diversity," *Harvard Business Review* 5, no. 9 (1996): 79–90; Peyvand Sepehri and Dieter Wagner, "Managing Diversity," *Personal* 52, No. 7 (2000): 456–61.
[19] Leblanc et al., "General Commentary on European Union Corporate Governance Proposals," 9.

from this moral perspective, we try to highlight this gap in political and social debate by focusing on the link between the most commonly used attributes of board diversity and economic outcomes.

3. APART FROM THE MORAL PERSPECTIVE: BOARD DIVERSITY AND ECONOMIC OUTCOMES

Analyzing empirical studies considering the attributes of nationality and ethnicity for board diversity and their impact on organizational outcomes, we provide insights into the possible but also limited connection between both topics. *Gender* is certainly the most discussed attribute of board diversity and is the subject of regulation by quota in single countries (e.g., Norway, Belgium). As much as gender diversity is discussed, as mixed are the empirical results connecting gender diversity in boards and economic outcomes. Single empirical studies predict that a higher proportion of women in corporate boards raises creativity and innovation,[20] leads to a better understanding of stakeholder expectations[21] and expectations of female customers,[22] and generally increases the firm value[23] or firm performance.[24] Female directors have a significant impact on board inputs and firm outcomes. They have better attendance records than male directors and male directors have fewer attendance problems the more gender-diverse the board is, and women are more likely to join monitoring committees. These results suggest that gender-diverse boards allocate more effort to monitoring. However, the average effect of gender diversity on firm performance is negative. This negative effect is driven by companies with fewer takeover defenses. Thus, mandating gender quotas for directors can reduce firm value for well-governed firms.[25] Single studies also show negative effects of gender diversity in corporate boards on firm performance, as women were found to be much too risk-averse.[26] There are additional empirical studies, predicting no impact of gender diversity in corporate boards on firm performance

[20] Nina Smith, Valdemar Smith and Mette Verner, "Do Women in Top Management Affect Firm Performance? A Panel Study of 2,500 Danish Firms," *International Journal of Productivity and Performance Management* 55, no. 7 (2006): 569–93.

[21] Stephen Brammer, Andrew Millington and Stephen Pavelin, "Corporate Reputation and Women on the board," *British Journal of Management* 20, no. 1 (2009): 17–29.

[22] Val Singh and Susan Vinnicombe, "Why So Few Women Directors in Top UK Boardrooms? Evidence and Theoretical Explanations," *Corporate Governance: An International Review* 12, no. 4 (2004): 479–88.

[23] David A. Carter, Betty J. Simkins and W. Gary Simpson, "Corporate Governance, Board Diversity, and Firm Value," *The Financial Review* 38, no. 1 (2003): 33–53; Kathleen A. Farrell and Philip L. Hersch, *Additions to Corporate Boards: Does Gender Matter?* (Working Paper University of Nebraska, 2001).

[24] Kevin Campbell and Antonio Minguez-Vera, "Gender Diversity in the Boardroom and Firm Financial Performance," *Journal of Business Ethics* 83, no. 3 (2008): 435–51; David A. Carter et al., "The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance," *Corporate Governance: An International Review*, 18, no. 5 (2010): 396–414.

[25] Renee B. Adams and Daniel Ferreira, "Women in the Boardroom and their Impact on Governance and Performance," *Journal of Financial Economics* 94, no. 2 (2009): 291–309.

[26] Frank Dobbin and Jiwook Jung, "Corporate Board Gender Diversity and Stock Performance: The Competence Gap or Institutional Investor Bias?" *North Carolina Law Review* 89, no. 3 (2011): 809–38.

(assuming that less homogeneous groups do communicate and cooperate less and do have to solve more emotional conflicts.[27]

Bantel and Jackson find *educational and functional diversity* of the top management team (TMT) are positively related to innovation performance.[28] Simons, Pelled and Smith demonstrate that educational diversity has a positive but not significant effect on both changes in profitability and sales growth, whereas functional background diversity has a negative and significant impact.[29] Additionally, they find that open discussion among TMT members acts as a moderator between diversity and performance. A culture of open discussion in combination with educational as well as functional background heterogeneity has a positive impact on firm performance. Cannella, Park, and Lee distinguish between intrapersonal (within-member breadth of functional experience) and dominant (heterogeneity in the functional areas in which each TMT member has served the longest) functional diversity. This study finds that intrapersonal functional diversity has a positive impact on firm performance. Environmental uncertainty and top management team co-location are tested to have a strong and positive moderating effect on intrapersonal diversity and its impact on firm performance. The authors also find a positive and significant effect of team member co-location on dominant functional diversity and its effect on firm performance.[30] Camelo, Fernandez-Alles, and Hernandez find a positive direct relationship between educational diversity in TMT and innovation performance. Contrarily, they find a negative direct effect of functional diversity on innovation performance. However, considering the context effects, testing for strategic consensus among TMT in a context with high strategic consensus, functional diversity shows a positive impact on innovation performance. However, in situations with low strategic consensus, functional diversity has a negative effect on innovation performance.[31]

[27] Charles B. Shrader, Virginia B. Blackburn, and Paul Iles, "Women in Management and Firm Financial Value: An Exploratory Study," *Journal of Managerial Issues* 9, no. 3 (1997): 355–72; P. Christopher Earley and Elaine Mosakowski, "Creating Hybrid Team Cultures: An Empirical Test of Transnational Team Functioning," *Academy of Management Journal* 43, no. 1 (2000): 26–49; Rose, "Does Female Board Representation Influence Firm Performance? The Danish Evidence" 404–13.

[28] Karen A. Bantel and Susan E. Jackson, "Top Management and Innovations in Banking: Does the Composition of the Top Team Make a Difference?," *Strategic Management Journal* 10, no. 1 (1989): 107–24.

[29] Tony Simons, Lisa Hope Pelled, and Ken A. Smith, "Making Use of Difference: Diversity, Debate, and Decision Comprehensiveness in Top Management Teams," *Academy of Management Journal* 42, no. 6 (1999): 662–73.

[30] Albert A. Cannella, Jong-Hun Park, and Ho-Uk Lee, "Top Management Team Functional Background Diversity and Firm Performance: Examining the Roles of Team Member Co-location and Environmental Uncertainty," *Academy of Management Journal* 51, no. 4 (2008): 768–84.

[31] Carmen Camelo, Mariluz Fernandez-Alles, and Ana B. Hernandez, "Strategic Consensus, Top Management Teams, and Innovation Performance," *International Journal of Manpower* 31, no. 6 (2010): 678–95.

Simons, Pelled, and Smith demonstrate a negative relationship between *age diversity* and change in profitability.[32] Bantel and Jackson find that age diversity is not correlated with innovation performance.[33] Moreover, Richard and Shelor find that TMT age diversity has a negative impact on firm performance (measured by ROA). However, TMT age diversity shows a curvilinear impact on sales growth. For low and medium levels of age diversity, the relationship between age diversity and sales growth is positive. For high levels of age diversity, there's a negative impact on sales growth. Furthermore, the authors conclude that context plays an important moderating role with the impact of age diversity on firm performance. Innovation and environmental complexity both have a positive moderating effect for the relationship between age diversity and firm performance.[34]

Rose indicates that the proportion of foreigners (*nationality*) on the supervisory board has no influence on Danish firms' performance.[35] Oxelheim and Randøy find that including board members from a different (here the Anglo-American) corporate governance system has a positive impact on the value of Norwegian and Swedish firms.[36] Santen and Donker show a positive relationship between the presence of foreign non-executive directors and financial distress. They suggest that this is caused by negative communication and misunderstandings.[37] Nielsen, researching Swiss companies, finds that TMT internationalization leads to subsequent foreign market entries, which in turn are positively related to firm performance.[38]

Ethnicity as an attribute of board diversity covers race, culture, and ideology.[39] During the past two decades, only a few authors have examined the ethnic diversity of corporate boards and its effects on firm performance. Carter et al. examine the relationship between the ethnic diversity of directors and firm performance and indicate no significant impact.[40] Van der Walt et al. find only limited support for the assumption that ethnic diversity among boards, strategic context and corporate

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[32] Simons, Pelled, and Smith, "Making Use of Difference: Diversity, Debate, and Decision Comprehensiveness in Top Management Teams," 662–73.
[33] Bantel and Jackson, "Top Management and Innovations in Banking: Does the Composition of the Top Team Make a Difference?" 107–24.
[34] Orlando C. Richard and Roger M. Shelor, "Linking Top Management Team Age Heterogeneity to Firm Performance: Juxtaposing Two Mid-range Theories," *International Journal of Human Resource Management* 13, no. 6 (2002): 958–74.
[35] Rose, "Does Female Board Representation Influence Firm Performance? The Danish Evidence" 404–13.
[36] Lars Oxelheim and Trond Randøy, "The Impact of Foreign Board Membership on Firm Value," *Journal of Banking & Finance* 27, no. 12 (2003): 2369–92.
[37] Bernard Santen and Han Donker, "Board Diversity in the Perspective of Financial Distress: Empirical Evidence from the Netherlands," *Corporate Board: Role, Duties and Composition* 5, no. 2 (2009): 23–35.
[38] Sabina Nielsen, "Top Management Team Internationalization and Firm Performance," *Management International Review* 50, no. 2 (2010): 185–206.
[39] Among others, Carter, Simkins, and Simpson, "Corporate Governance, Board Diversity, and Firm Value," 33–53.
[40] Carter et al., "The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance," 396–414.

decision quality may be linked.[41] In opposition, Carter, Simkins, and Simpson state that the increase of minority directors on the board increases firm value.[42] Van der Zahn demonstrates a positive effect of ethnic composition of South African boards of directors on intellectual capital performance.[43] Elron examines the performance of multinational corporations' international subsidiaries and the subsidiaries' respective TMT composition. The author indicates a positive relationship between cultural diversity of TMTs and TMT performance.[44] Roberson and Park report that firm performance declines with increases in the representation of racial minorities on the TMT up to a point, beyond which further increases in diversity are associated with increases in performance.[45]

4. BOARD DIVERSITY AND ECONOMIC OUTCOMES: IMPORTANT ASPECTS FOR FUTURE RESEARCH

Our analysis shows critical aspects for future research on the link between board diversity and firm performance:

First, most studies simply concentrate on one single attribute of board diversity. Obviously, there are likely to be connections between single attributes and impacts on organizational outcomes where different dimensions are combined. Present approaches prevent a deeper understanding of the complex interaction between single attributes and their impacts. This makes it difficult to compare the existing (mixed) empirical findings and to give recommendations as to which board composition fits best.

Second, this is also important considering the different, concurrent theories of board diversity. Researching different strengths of influence from single attributes of board diversity could make it easier for researchers, and also for companies, to decide which attributes or which combinations fit best, considering the companies' current situations and future challenges.

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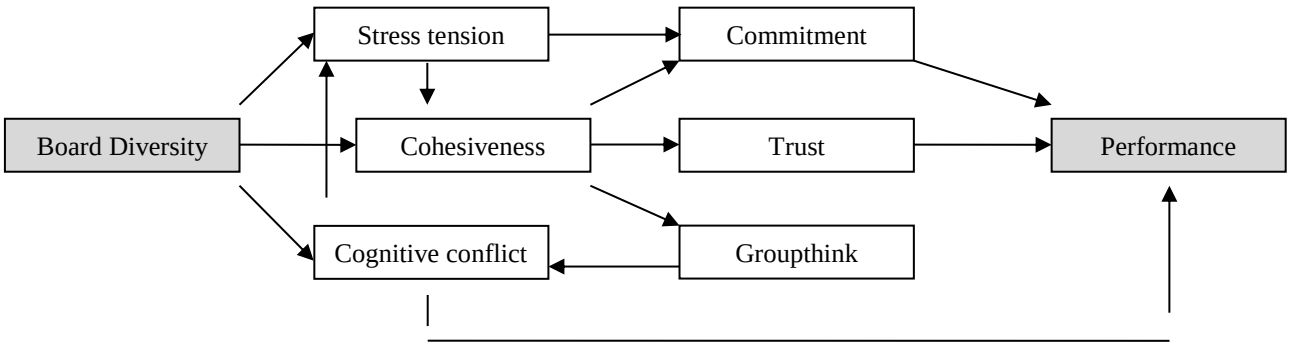
[41] N. T. Van der Walt et al., "Board Configuration: Are Diverse Boards Better Boards?" *Corporate Governance: The International Journal of Effective Board Performance* 6, no. 2 (2006): 129–47.
[42] Carter, Simkins, and Simpson, "Corporate Governance, Board Diversity, and Firm Value," 33–53.
[43] Jean-Luc Wolfgang Mitchell Van der Zahn, "Impact of Gender and Ethnic Composition of South African Boards of Directors on Intellectual Capital Performance," *Corporate Board: Role, Duties and Composition* 2, no. 1 (2006): 7–22.
[44] Efrat Elron, "Top Management Teams within Multinational Corporations: Effects of Cultural Heterogeneity," *Leadership Quarterly* 8, no. 4 (1997): 393–412.
[45] Quinetta M. Roberson and Hyeon Jeong Park, "Examining the Link between Diversity and Firm Performance: The Effects of Diversity Reputation and Leader Racial Diversity," *Group Organization Management* 32, no. 5 (2007): 548–68.

Third, board diversity research generally doesn't consider the complex constructs of work psychology (see Figure 1). Mixed results also occur as a consequence of indirect impacts of board diversity on organizational outcomes (performance) that most studies suggest with their models. Studying and integrating universals and differences in psychological constructs and organizational behaviour could be beneficial for board diversity research and help to predict organizational outcomes. Nevertheless, corporate boards' work often is qualified as a black box or a closed circle. The black box phenomenon of boards makes it difficult to study psychological constructs and organizational behaviour. Thus, most empirical studies only identify single attributes for board diversity that predict or moderate organizational outcomes and only marginally consider more complex processes or constructs. This leads to a disappointing situation where the behavioral aspects of the theories of board diversity aren't really tested. Authors simply choose a theory which fit the data best, excluding the possibility that different theories might count in a single model/situation.

Figure 1. Processes influencing the link between board diversity and performance[46]



Fourth, some attributes of board diversity are less reflected empirically than others, e.g. there are only few studies on cultural board diversity, and their effects are limited to industrial countries. The integration of cross-cultural work psychology helps researchers compare companies within different cultural clusters or settings with respect to a globalized economy.

5. CONCLUSION

In the case of board diversity, we do not find evidence that researchers or practitioners have the goal of eliminating diversity or proving that, in principle, it is problematic. Nevertheless, researchers try to give (and companies expect) answers as to which processes actually occur with diversity in

[46] Based on Christoph Maier, *Leading Diversity: A Conceptual Framework* (Bamberg: Difo-Druck, 2002), 99.

boards (gender, nationality, ethnicity, etc.) and whether it is economically beneficial to have diverse boards. So far, there aren't definite empirical results to answer these questions. Studies exist which report a very limited connection between board configuration, strategic context, and corporate decision quality.[47] Taking a further look at Germany, the authors find that co-determination (employee representatives and investor representatives in the supervisory board) is internationally considered crucial for firm performance and is criticized much. Not surprisingly, companies frown upon plans to regulate board diversity by quota, missing definite empirical (economic) proof. Nevertheless, we must recognize the moral and philanthropic aspects of board diversity, which are associated with the idea of corporate social responsibility, or for democratic reasons—being seen not to discriminate, to comply with diversity norms, and to gain a sense of legitimacy, credibility and integrity. Nonetheless, the corporate board is the main element of the corporate governance system. Thus, we consider the regulation of board diversity by quota as a hard measure, which disproportionately intervenes in companies' authority to staff their boards and neglects companies' specific situations. Companies themselves do certainly staff their TMTs to the realities of their particular organization and situation, e.g. they push internationality when they try to enter new markets and their boards stay international after that process.[48] The industry of a company seems to play a key role in whether a board is ethnically diverse, which is reported to be a consequence when there is a close proximity to consumers.[49] Without more accurate information on the situation, board diversity is not recommended as a plan of regulation (as by the EC) and is not considered a suitable measure (and aimless activism) to build up new trust after the financial crisis. Nevertheless, the integration of both issues (board diversity and work psychology) might help to shed light on this complex construct.

[47] Van der Walt et al., "Board Configuration: Are Diverse Boards Better Boards?" 129–47.
[48] Nielsen, "Top Management Team Internationalization and Firm Performance," 185–206.
[49] Stephen Brammer, Andrew Millington, and Stephen Pavelin, "Gender and Ethnic Diversity among UK Corporate Boards," *Corporate Governance: An International Review* 15, no. 2 (2007): 393–403.

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IMPLEMENTATION OF THE CAPITAL REQUIREMENTS DIRECTIVE III RULES ON REMUNERATION POLICIES IN FINANCIAL INSTITUTIONS

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European Commission adopted Recommendation on remuneration policies in the financial services sector in 2009 as response to financial crisis in period since 2008 to 2009. The Recommendation was applicable to all financial institutions. Listed financial institutions were also subject of previous Recommendations on remuneration policy of listed companies adopted in 2004, 2005 and 2009. Different practices of the EU Member States in implementation of non-binding recommendations in national legislations have resulted in differences in application and endangered achievement of goals of the European Commission. To eliminate such situation European Parliament and European Council enacted Capital Requirements Directive (CRD III) in 2010 which regulates remuneration policy in credit institutions and investment firms. Committee of European Banking Supervisors adopted Guidelines on Remuneration Policies and Practices in 2010 to facilitate implementation of CRD III. CRD III harmonizes national legislations of the EU Member States on design, implementation and oversight of the remuneration policy in credit institutions and investment firms. Croatian Parliament amended provisions of the Credit Institutions Act in April 2013, with aim to harmonize its provisions with CRD III provisions on the remuneration policy in credit institutions. Croatian National Bank adopted the Decision on employees' remuneration in December 2012, which regulates remuneration policy in credit institutions in detail.

Key words: *remuneration policy, credit institutions, investment firms, Capital Requirements Directive III, European Union, Republic of Croatia*

1. INTRODUCTION

European Commission deals with remuneration policies in public companies for a decade. Financial scandals in listed companies which emerged at the end of the 20th and beginning of 21st century in the USA and Europe demanded improvement of corporate governance in listed companies. In the USA such improvements were better auditing of annual financial accounts and transparency of remuneration policies in listed companies. In Europe emphasis were on strengthening the role of independent members of supervisory bodies in listed companies regarding design of remuneration policies and regulation of remuneration structure for members of management bodies in listed companies.[1]

Financial crisis in financial institutions since 2007 to 2009 directed attention on performance of credit institutions and connection between hazardous business and inadequate remuneration policies in credit institutions. Numerous American and European credit institutions received state aid in this period with imposing of restrictions on remuneration policies in these institutions.[2] Similar restrictions were soon introduced in some non-ailing credit institutions. As response to financial crisis the European Commission adopted few recommendations on remuneration policies in listed companies.[3] Most Member States of the EU adopted these recommendations in their national corporate governance codes which are applied on listed companies. Non-binding nature of corporate governance codes produced different practice in application of European recommendations in different Member States of the EU.[4] As regards financial institutions, the Commission adopted the Recommendation on remuneration policies in the financial services sector in 2009,[5] taking into account peculiarities of corporate governance in financial institutions. Identical problem of different application of recommendation emerged in the Member States. Consequently the European

[1] Jurić, Dionis, Primanja za rad i objavljivanje podataka o primanjima za rad članova uprave i nadzornog odbora dioničkih društava, in Čulinović Herc, Edita, Jurić, Dionis, Žunić Kovačević, Nataša (editors), Financiranje, upravljanje i restrukturiranje trgovačkih društava u doba recesije, Pravni fakultet Sveučilišta u Rijeci, Rijeka, 2011, pp. 118.–119.

[2] In the UK such state aid was given to Lloyds Bank and Royal Bank of Scotland, in Germany to Commerzbank, in France to BNP Paribas, Société Générale, Crédit Agricole, Caise d`Epargne, in the Netherlands to Fortis and ING, in Switzerland to UBS. See in u Ferrarini, Guido, Ungureanu, Maria Cristina, Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks, Vanderbilt Law Review, Vol. 64., No. 2/2011., pp. 457.-463.

[3] Commission Recommendation on fostering an appropriate regime for the remuneration of directors of listed companies, 2004/913/EC, Commission Recommendation on the role of non-executive or supervisory directors and on the committees of the (supervisory) board, 2005/162/EC, Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, 2009/385/EC. See in detail in Jurić, D., op. cit., pp. 120.-131.

[4] Some Member States decided to implement these recommendations in national laws which are binding for all companies (Germany, Slovenia). See in Jurić, D., op. cit., pp. 132.-143.

[5] Commission Recommendation on remuneration policies in the financial services sector, 2009/384/EC.

Parliament and the Council enacted the Capital Requirements Directive III (CRD III)[6] in 2010. CRD III is binding for the Member States which must harmonize their national provisions on remuneration policies in credit institutions and investment firms.

2. PECULIARITIES OF CORPORATE GOVERNANCE IN CREDIT INSTITUTIONS

Corporate governance in credit institutions is different with regard to corporate governance in other public companies. These differences stem from special features of business activities of credit institutions.[7] Shareholders and members of management bodies of credit institutions have incentives to take more risks. This is combined with lack of proper regulation and supervision of their activities.[8] Role of the credit institutions as main creditors in national economies encourages higher risk levels in business activities with threat of emerging of higher losses in long term. They are main source of liquidity in national economies. Credit institutions secure maintenance of deposits with state deposit insurance and coordinate national payment systems. Performance of credit institutions has major impact on national economy.[9]

Credit institutions have higher debt-to-equity ratio than other public companies which results in more acute conflict of interest between shareholders and fixed claimants.[10] Asset

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[6] Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.

[7] Ferrarini, Guido, Ungureanu, Maria Cristina, Unique Features in the Governance of Bankers´Compensation, http://www.clfge.org/files/gf_unique_features_in_the_governance_of_bankers_c.pdf, 23 January 2013, p. 2.

[8] Ferrarini, G., Ungureanu, M.C., Economics, Politics, and the International Principles for Sound Compensation Practices…, p. 439.

[9] Ferrarini, Guido, Ungureanu, Maria Cristina, Unique Features in the Governance of Bankers´Compensation, p. 2. Special feature of credit institutions is duty of members of management bodies to take into account interests of different stakeholders: shareholders, depositors, creditors and others. Business activities of credit institutions are under external influences which emerge from disclosure of information on financial market, control by the auditors and activities of rating agencies. Finally, business activities of credit institutions are regulated by special and detailed provisions and supervised by national supervisory authorities. See in Hopt, Klaus J., Corporate Governance of Banks after the Financial Crisis, in Wymeersch Eddy, Hopt, Klaus J., Ferrarini, Guido (editors), Financial Regulation and Supervision – A Post-Crisis Analysis, Oxford University Press, 2012., pp. 341.-343.

[10] Investment decisions which increase risk will transfer wealth from the fixed claimants to the residual claimants (shareholders). This problem is aggravated in credit institutions because of the high debt-to-equity ratio and the existence of deposit insurance. In other public companies the problem of excessive risk-taking is mitigated by various protective devices for fixed claimants (creditors). The deposit insurance encourages excessive risk-taking of managers and shareholders in credit institutions. This reduces the control of excessive risk-taking by depositors. See in Macey, Jonathan R., O'Hara, Maureen, The Corporate Governance of Banks, Economic Policy Review, Vol. 9, No. 1, April 2003., available on SSRN: http://ssrn.com/abstract=795548, 23 January 2013, p. 98., Avgouleas, Emilios, Cullen, James, Market Discipline and Corporate Governance in the EU Banking Sector: Intellectual Fallacies, Cognitive Boundaries and Groupthink, University of Edinburgh, School

structure of the credit institutions is different from other public companies. They tend to have very little equity relative to other public companies and primarily finance themselves from debt.[11] Credit institutions' liabilities are largely in the form of deposits which are payable on demand to depositors and creditors, while their assets are mostly in the form of loans that have longer maturities. This disparity between liquid liabilities and illiquid assets is very problematic in a crisis situation when depositors tend to withdraw their deposits in credit institutions. Credit institutions usually keep only a fraction of deposits on reserve. Remedy for such situation is deposit insurance.[12] Negative effect of the deposit insurance is incentivizing of managers and shareholders on excessive risk-taking in credit institutions. Excessive risk-taking is especially negative when credit institution approaches insolvency, because it still attracts new funding. On the other hand, shareholders do not bear the risk of investment losses and even may enjoy certain benefits from such situation.[13] Asset substitution is relatively easier in credit institutions than in non-financial companies. This allows more flexible and faster risk shifting, which increases agency costs between shareholders and fixed claimants and increases risk-taking of managers. Finally, there are difficulties in assessment of risk profile and stability of credit institutions because of complexity of their activities and information asymmetries.[14]

3. INFLUENCE OF CORPORATE GOVERNANCE IN CREDIT INSTITUTIONS ON EMERGING OF THE FINANCIAL CRISIS

Empirical research of activities of credit institutions between 2007 and 2008 indicated that deficiencies in the corporate governance did not significantly contributed in emergence of the financial crisis. On the contrary, credit institutions with management bodies which had more pro-shareholders orientation performed worse.[15] Main cause of the financial crisis was

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of Law, Research Paper Series No 2012/24, available on SSRN: http://ssrn.com/abstract=2163118, 23 January 2013, pp. 3.-4.

[11] Credit institutions typically receive 90 percent or more of their funding from debt. See in Macey, J.R., O'Hara, M., op. cit., p. 97., Ferrarini, G., Ungureanu, M.C., Economics, Politics, and the International Principles for Sound Compensation Practices…, pp. 439.-440.

[12] O'Hara, M., op. cit., p. 97., Ferrarini, G., Ungureanu, M.C., op. cit., p. 440., Hopt, K.J., op. cit., p. 351.

[13] Risk-taking in other public companies close to insolvency is constrained by market forces and contractual instruments. See in Macey, J.R., O'Hara, M., op. cit., p. 98., Ferrarini, G., Ungureanu, M.C., op. cit., p. 440.

[14] Ferrarini, G., Ungureanu, M.C., op. cit., pp. 440.-441., Avgouleas, E., Cullen, J., op cit., pp. 4.-5.

[15] Beltratti, Andrea, Stulz, Rene M., Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation (July 13, 2009). Fisher College of Business Working Paper No. 2009-03-012., available on SSRN: http://ssrn.com/abstract=1433502, Adams, Renee B., Governance and the Financial Crisis (May 4, 2009). ECGI - Finance Working Paper No. 248/2009., available on SSRN: http://ssrn.com/abstract=1398583, according to Ferrarini, G., Ungureanu, M.C., op. cit., pp. 441.-443.

bad investment decisions and collapse of the mortgage market in the USA, which spread worldwide in other credit institutions.[16]

Despite this fact, initiatives for a reform of the corporate governance in credit institutions and improvement of practice are ongoing. The European Union institutions legislation deals with the design of the remuneration policies in financial institutions, as well as setting new capital requirements for credit institutions in order to ensure these institutions from future shocks in the financial market. When it comes to the remuneration policies, emphasis is given to the remuneration structure, alignment of the remuneration with risk-taking, improvement of the adoption process of the remuneration policies and disclosure of the remuneration policy and practice in financial institutions.[17]

4. INTERNATIONAL STANDARDS ON THE REMUNERATION POLICIES IN CREDIT INSTITUTIONS

As a consequence of the financial crisis and pointing by politicians and the media that the main cause of the crisis were short-term incentives to credit institutions managers, Financial Stability Forum (now Financial Stability Board)[18] adopted in 2009 two international documents: the Principles for Sound Compensation Practices[19] and the Principles for Sound Compensation Principles: Implementation Standards.[20] The FSB Principles and Standards deal with governance, remuneration structure, supervision and disclosure of the remuneration policies and practices.[21]

The Principles accept some common corporate governance standards, such as strategic and monitoring role of the supervisory bodies in the process of setting and implementing of the remuneration policies. Additionally, the Principles deal with risk management and oversight

[16] Reinhart, Carmen M., Rogoff, Kenneth S., Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison, NBER Working Paper No. 13761, January 2008, available on NBER: http://www.nber.org/papers/w13761, 31 January 2013, pp. 11.-12., Štefulić, Petra, Radman Peša, Anita, Kompenzacije menadžera kao jedan od uzroka suvremene financijske krize, Oeconomica Jadertina, No. 2/2012., pp. 47.-52.

[17] Ferrarini, G., Ungureanu, M.C., op. cit., pp. 444.-451., Hopt, K.J., op. cit., pp. 363.-364., Winter, Jaap, The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve It?, in Wymeersch, E., Hopt, K.J., Ferrarini, G. (editors), Financial Regulation and Supervision – A Post-Crisis Analysis, Oxford University Press, 2012., pp. 374.-375.

[18] Available on FSB: https://www.financialstabilityboard.org/about/history.htm, 26 January 2013.

[19] Financial Stability Forum Principles for Sound Compensation Practices, 2009, available on FSB: https://www.financialstabilityboard.org/publications/r_0904b.pdf, 26 January 2013.

[20] Financial Stability Board Principles for Sound Compensation Practices: Implementation Standards, 2009, available on FSB: https://www.financialstabilityboard.org/publications/r_090925c.pdf, 26 January 2013.

[21] Ferrarini, G., Ungureanu, M.C., op. cit., pp. 464.-469.

by the supervisory bodies of credit institutions. The Standards emphasize the role of remuneration committee in setting and supervision of the remuneration policy and practice.[22] The FSB Principles and Standards had significant influence on the content of the Recommendation on remuneration policies in the financial services sector adopted by the European Commission.

5. THE RECOMMENDATION ON REMUNERATION POLICIES IN THE FINANCIAL SERVICES SECTOR

The European Commission adopted the Recommendation on remuneration policies in the financial services sector in April 2009. The Recommendation establishes general principles on the remuneration policies in financial institutions. These principles should apply in parallel to any rule or regulation governing a specific financial sector, whether they are of national origin or resulting from legislative activities of the EU institutions. This Recommendation applies together with the Recommendation on the remuneration of directors of listed companies 2004, the Recommendation on the role of non-executive or supervisory directors and on the committees of the (supervisory) board 2005 and the Recommendation on the regime for the remuneration of directors of listed companies 2009 on listed financial institutions.[23] The Recommendation deals with design of the remuneration policies (remuneration structure, performance measurement criteria, process of design and implementation of the remuneration policies), disclosure of remuneration policies and role of supervisory authorities in the review of remuneration policies in financial institutions.

The Recommendation provides that the Member States should ensure that the principles contained in the Recommendation apply to all financial institutions having their registered office or their head office in their territory (point 1.1).[24] Financial institution means any institution, irrespective of its legal status, whether regulated or not, which performs any of the following activities on a professional basis : a) it accepts deposits and other repayable funds; b) it provides investment services and/or performs investment activities within the

[22] Ibid., pp. 469.-473.

[23] The Recommendations in 2004 and 2005 were aimed at improving the corporate governance and disclosure of remuneration policies. Under the Financial Services Action Plan were enacted directives which deal with remuneration transparency and insider-dealing issues (the Transparency Directive 2004/109/EC, the Market Abuse Directive 2003/51/EC, The Prospectus Directive 2003/71/EC). Ibid., pp. 474.-476.

[24] The Member States should ensure that branches of financial institutions having their registered office or their head office in a third country and which operate in the territory of a Member State should be subject to similar principles on remuneration policy which apply to financial undertakings having their registered office or their head office in the territory of a Member State.

meaning of Directive 2004/39/EC; c) it is involved in insurance or reinsurance business; d) it performs business activities similar to those set out in points (a), (b) or (c). A financial institution includes, but is not limited to credit institutions, investment firms, insurance and reinsurance undertakings, pension funds and collective investment schemes (point 2.1). The aim of the European Commission was to establish identical regime for all financial institutions. This ensures the same standard of conduct in all financial institutions and prevents distortion of competition between different types of financial institutions, which compete to attract similar profile officers in the same labour market.[25]

With regard to the remuneration structure, remuneration policies for risk-taking staff should be consistent with and promote sound and effective risk management. Financial institutions should strike an appropriate balance between the level of fixed and variable component of remuneration. The payment of major part of variable component of the remuneration should be deferred in order to take into account risks linked to the underlying performance through the business cycle. Performance measurement criteria should give advantage to long-term performance of financial institutions and adjust the underlying performance for risk, cost of capital and liquidity. When data has been proven to be manifestly misstated, financial institutions should be able to claim back already paid variable remuneration (clawbacks). With regard to the governance, remuneration policy should be transparent internally, should be clear and properly documented and contain measures to avoid conflicts of interest. The supervisory board/non-executive directors should be responsible for oversight of implementation of the remuneration policy for the financial institution as a whole with an adequate participation of internal control functions and human resources departments or experts. Members of the supervisory board and other staff engaged in design and implementation of remuneration policies should be independent.

Interested stakeholders should be adequately informed on the remuneration policy. The disclosure should be made in clear and easily understandable way and contain main elements of the remuneration policy, its design and implementation.

National supervisory authorities should ensure, using the supervisory tools at their disposal, that financial institutions apply the principles on sound remuneration policies to the larges possible extent and have remuneration policies consistent with effective risk management. With regard to the proportionality principle, national supervisors should take account of the

[25] European Commission, Report on the application by Member States of the EU of the Commission 2009/384/EC Recommendation on remuneration policies in the financial services sector, Bruxelles, 2010, p. 3.

nature and scale of a financial institution and complexity of its activities in order to assess its compliance with the principles on sound remuneration policies.[26]

The Recommendation envisaged that the Member States should take necessary measures to promote application of the principles on remuneration policies by 31 December 2009 and inform the European Commission on taken measures. In June 2010 the European Commission published its report on application of the Recommendation in the Member States.[27]

The Report demonstrated major differences between the Member States in application of the Recommendation as regards the number of the Member States which adopted principles of the Remuneration, time, scope and extent of the application and the method of implementation in national legislation (non-binding or binding legal acts).[28] Such situation required further legislative action of the EU institutions, especially as regards credit institutions and investment firms which were most exposed to the financial crisis. The European Parliament and the Council enacted the Capital Requirements Directive III in 2010 with goal to harmonize national legislations of the Member States on the remuneration policies in credit institutions and investment firms.[29]

6. THE CAPITAL REQUIREMENTS DIRECTIVE

The European Parliament and the Council, on a proposal of the European Commission, enacted the Directive 2010/76/EU amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies (CRD III) in November 2010. The Annex I of CRD III provides the amendment of the Annex V of the Directive 2006/48/EC by introducing a new Section 11 entitled the Remuneration Policies. CRD III is applied only on credit institutions and investment firms with duty of the Member States to harmonize their national legislations until 1 January 2011.

CRD III provides general rules on remuneration policies in credit institutions and investment firms which must be in line with their long-term interest and must promote sound and

[26] European Commission, Financial services sector pay: Commission sets out principles on remuneration of risk-taking staff in financial institutions, Press Release, IP/09/674, Bruxelles, 29 April 2009, available on: http://europa.eu/, 15th July 2010, pp. 1.-2., Ferrarini, G., Ungureanu, M.C., op. cit., pp. 476.-478.

[27] European Commission, Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Report on the application by Member States of the EU of the Commission 2009/384/EC Recommendation on remuneration policies in the financial services sector, Bruxelles, 2010.

[28] Ibid., pp. 3.-9.

[29] Ferrarini, G., Ungureanu, M.C., op. cit., pp. 476.-477.

effective risk management. It also provides specific rules on the remuneration structure. Credit institutions and investment firms shall disclose at least annual detailed information on the remuneration policy and practice for categories of staff whose professional activities have a material impact on their risk profile. Pursuant to the provisions of CRD III, the Committee of European Banking Supervisors (CEBS) issued the Guidelines on Remuneration Policies and Practices[30] in order to facilitate application of the provisions of CRD III on remuneration policies.[31]

6.1. SCOPE OF APPLICATION OF CRD III

Remuneration consists of all forms of payments or benefits made directly by, or indirectly, but on behalf of credit institutions and investment firms in exchange for professional services rendered by staff. The remuneration has fixed component (payments or benefits regardless of any performance criteria) and variable component (additional payments or benefits depending of the performance criteria or other contractual criteria). Both components of the remuneration may include monetary payments or benefits[32] or non-monetary benefits.[33] Ancillary payments and benefits that are part of a general, non-discretionary policy of the institution and do not have incentive effect in terms of risk assumption can be excluded from the definition of the remuneration in applying of CRD III.[34]

Provisions of CRD III apply to all credit institutions as defined under Article 4(1) of Directive 2006/48/EC and investment firms as defined under Directive 2006/49/EC, which in turn refers to Article 4(1)(1) of Directive 2004/39/EC (MiFID).[35]

These institutions have responsibility to determine the members of staff whose professional activities have a material impact on institution's risk profile and to whom the specific requirements of CRD III will apply. Following categories of staff must be included as the Identified Staff: a) executive members of the credit institution or investment firms'

[30] CEBS Guidelines on Remuneration Policies and Practices (2010), available on EBA: http://www.eba.europa.eu/Publications/Guidelines.aspx, 28 January 2013. European Banking Authority (EBA) is successor to the CEBS.

[31] Ibid., p. 477., Okoń, Szymon, New Approach to Remuneration Policy for Investment Firms: a Polish Capital Market Perspective, Contemporary Economics, Vol. 6., No. 1/2012., pp. 72.-73., Avgouleas, E., Cullen, J., op. cit., pp. 13.-14.

[32] Such as cash, shares, options, cancellation of loans to staff members at dismissal, pension contributions, remuneration by third parties.

[33] Such as health insurance, discounts, fringe benefits or special allowances for car, mobile phone, etc.

[34] Annex V Section 11 point 23 Directive 2006/48/EC, CEBS, Guidelines on Remuneration Policies and Practices (2010), pp. 13.-14.

[35] Ibid., pp. 14.-15.

corporate bodies;[36] b) senior management responsible for day-to-day management;[37] c) staff responsible for independent control functions;[38] d) other risk takers.[39] Additionally, if they have a material impact on the institution's risk profile, other employees/persons, whose total remuneration takes them into the same remuneration bracket as senior managers and risk takers must be included as the Identified Staff.[40]

The provisions of CRD III shall be applied by credit institutions at group, a parent company and subsidiaries established within the European Economic Area (EEA), as well as subsidiaries established outside the European Economic Area (offshore subsidiaries).[41]

6.2. THE PROPORTIONALITY PRINCIPLE IN APPLICATION OF CRD III

Purpose of the proportionality principle is to match the remuneration policies and practice with the individual risk profile and strategy of each credit institution or investment firm.[42] This ensures effective achievement of the objectives of CRD III. The proportionality principle applies to the general as well as to specific requirements on the remuneration policies. The effect of the proportionality principle is that some institutions have to implement more sophisticated remuneration policies and practices to meet requirements of CRD III and some institutions will meet these requirements in a simpler and easier way. It is primary the task of institutions to assess their nature and possible application of the proportionality principle in design and implementation of the remuneration policies. National supervisors have duty to apply this principle in oversight of the remuneration policies.[43]

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[36] Such as: the members of the management and its president; the chief executive director and other executive directors; the members of the board of directors if they are also executive directors.

[37] Such as: the members of the management committee not included in the category above; all the individuals who directly report to an institution's corporate bodies; all the individuals responsible for heading significant business lines (including those responsible for heading regional areas).

[38] Such as: senior staff responsible for heading the compliance, risk management, human resources, internal audit and similar functions.

[39] Such as: staff members, whose professional activities, either individually or collectively, can exert influence on the institution's risk profile, including persons capable of entering into contracts/positions and taking decisions that affect the risk positions of the institution (individual traders, specific trading desks, credit officers.

[40] Annex V Section 11 point 23 Directive 2006/48/EC, ibid., pp. 15.-17.

[41] If a subsidiary is established within the EEA and a parent company is established outside the EEA, provisions of CRD III shall apply only to the subsidiary. The provisions of CRD III shall apply to branches of credit institutions established in third countries and which operate in the EEA. See in Annex V Section 11 point 23 (t) Directive 2006/48/EC, ibid., pp. 22.-23.

[42] Annex V Section 11 point 23 Directive 2006/48/EC.

[43] The proportionality principle may exclude application of some requirements of CRD III in the pay-out process of variable remuneration (variable remuneration in instruments, retention, deferral, ex post incorporation of risk for variable remuneration). Neutralization of these requirements can be achieved by application of the proportionality principle among institutions or by applying the principle between different categories of staff

The proportionality principle is applied on division of credit institutions and investment firms on large (significant) and small institutions. The criteria addressing the application of the proportionality principle among institutions are the size, internal organization and the nature, scope and complexity of their activities.[44] All mentioned criteria should be combined and, if it is necessary, other criteria which are not listed in CRD III in assessing what is proportionate. This principle is also used in determining the categories of staff whose professional activities have a material impact on institution's risk profile to which the specific requirements of CRD III are applied.[45]

6.3. GOVERNANCE OF REMUNERATION

The supervisory board or board of directors of credit institution is responsible for adoption, implementation and oversight of the remuneration policies for the management or executive directors.[46] The supervisory bodies should include in their work non-executive members with sufficient knowledge on the remuneration policies and structures.[47] In monitoring of the implementation of the remuneration policies supervisory bodies should decide on possible subsequent changes of the remuneration policy and consider their effect. Procedure to determine remuneration should be clear, well-documented and internally transparent. In the design and oversight of the remuneration policies supervisory bodies should include all elements which affect the level and structure of the remuneration.[48] The supervisory bodies should ensure that an institution's remuneration policy is consistent with and promotes sound

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whose professional activities have a material impact on institution's risk profile. The proportionality principle also excludes requirement to establish the remuneration committee in small credit institutions. Ibid., pp. 17.-20.

[44] The size criterion can relate to the value of assets; liabilities or risk exposure; level of capital; the number of staff or branches of an institution. The internal organization can relate to the legal structure; the listing on regulated markets; the authorization to use internal/advanced methods for measurement of capital requirements (e.g. IRB, AMA methods); the corporate goals (e.g. non-profit oriented co-operatives vs. profit oriented institutions). In considering the nature, scope and complexity of the business activities relevant elements can be: the type of authorized activity (saving banks, investment banking); the type of clients (retail, corporate, small businesses); the portion of the riskier activities or clients on the total of activities or clients; the national or international nature of the business activities; the nature, stability, measurability and predictability of the risks of the business activities; the frequency, time horizon and significance of the risks; the complexity of the products or contracts. Ibid., pp. 20.-21.

[45] With criteria of the size, internal organization and the nature, scope and complexity of institution's activities, into account are taken the degree of seniority, the size of the obligations into which a risk taker may enter on behalf of the institution, the size of the group of persons, who have only collectively a material impact on the risk profile of the institution, the business model of the line of business of the staff members, the ratio variable/fixed payment and/or in combination with the total amount of remuneration. Ibid., p. 21.

[46] If some members of the board of directors are simultaneously appointed as executive directors, they cannot participate in decision-making on the adoption and implementation of the remuneration policies.

[47] Annex V Section 11 point 23 (b), (c) i (d) Directive 2006/48/EC.

[48] Such as: powers, tasks, expertise and responsibilities of members of the management or executive directors; the risk management, compliance, human resources, strategic planning, etc.

and effective risk management. Members of the management and executive directors should not determine their own remuneration. The supervisory bodies should also approve and control the remuneration of senior executives and staff members who receive the highest amounts of total remuneration within the institution. In order to properly address conflicts of interest, it is recommended to compensate the members of the supervisory bodies only with fixed remuneration.[49]

The approval of the institution's remuneration policy and decisions relating to the remuneration of members of the management body may be assigned to the shareholders' meeting, depending on the national rules of Member States. Decision of the shareholders' meeting may be either consultative or binding and shareholders should be provided with adequate information in order to make informed decisions. The supervisory bodies remain responsible for the proposals submitted to the shareholders' meeting, as well as for implementation and oversight of the remuneration policies and practices.

The supervisory bodies should ensure that the institution's remuneration policy will be reviewed on an annual basis at a minimum. The reviews should assess whether the overall remuneration system operates as intended and is it compliant with national and international regulations, principles and standards. The relevant internal control functions and supervisory function committees should be closely involved in reviewing the remuneration system of the institution. Small and less complex institutions may decide to outsource the review process according to the proportionality principle. The results of reviews of the remuneration policies should be made available to the competent bodies, committees and functions.[50]

The significant institutions should establish a remuneration committee. The remuneration committee should be constituted in such a way as to enable it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity. The members of the remuneration committee should be members of the institution's supervisory body who do not perform executive functions and at least the majority of whom qualify as independent. The Chair of the remuneration committee should be an independent, non-executive member of the supervisory body. At least one member of the committee should have sufficient expertise and professional experience concerning risk management and control activities, namely with regard to the mechanism for aligning the remuneration structure to risk and capital profiles of

[49] The variable remuneration should generally be excluded. If variable remuneration occurs, it must be strictly connected with monitoring and control tasks, reflecting individual's capabilities and achieved results. If financial instruments are granted, it is necessary to adopt retention periods until the end of the mandate.

[50] Ibid., pp. 28.-31.

the institution. In its activities the committee seeks expert advice internally and externally. The members of the management or executive directors should not participate in the meetings of the committee which discuss and decide on their remuneration. The remuneration committee should be responsible for the preparation of decisions regarding the remuneration, including those which have implications for the risk and risk management of the credit institution concerned and which are to be taken by the supervisory body.[51] In the preparation of these decisions, the committee should take into account the long-term interests of shareholders, investors and other stakeholders in the credit institution.[52]

Staff engaged in control functions should be independent from the business units they oversee and have appropriate authority. They should be remunerated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.[53] The remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee or, if such a committee has not been established, by the supervisory body of the institution.[54] This ensures the independence of the staff engaged in control functions such as risk management, compliance, internal audit, human resources and similar functions.

6.4. GENERAL REQUIREMENTS ON THE REMUNERATION POLICIES

6.4.1. THE BASIC PRINCIPLE OF RISK ALIGNMENT

General requirements on the remuneration policies are binding for all institutions and all categories of staff. The application of these requirements ensures the alignment of remuneration with prudent risk taking. The remuneration policy must be consistent with and promote sound and effective risk management. It should not encourage risk-taking that

[51] The remuneration committee should be responsible for: a) the preparation of recommendations to the supervisory body, regarding the remuneration of the members of the management body as well as of the highest paid staff members in the institution; b) providing support and advice to the supervisory body on the design of the institution's overall remuneration policy; c) seeking advice of internal and external independent experts; d) the review of the appointment of external remuneration consultants that the supervisory body engages for advice or support; e) supporting of the supervisory body in oversight of the remuneration system's design and operation; f) the assessment of the mechanisms adopted to ensure that the remuneration system properly takes into account all types of risks, liquidity and capital levels as well as ensuring that the overall remuneration policy is consistent with the long-term sound and prudent management of the institution; g) the review of a number of possible scenarios to test how the remuneration system will react to future external and internal events, and back test it as well. The remuneration committee may be in charge of the oversight of the central and independent review of the remuneration policies and practices.

[52] Annex V Section 11 point 24 Directive 2006/48/EC. Ibid., pp. 31.-33.

[53] Annex V Section 11 point 23(e) Directive 2006/48/EC.

[54] Annex V Section 11 point 23(f) Directive 2006/48/EC.

exceeds the level of tolerated risk of the credit institution.[55] The remuneration policy must be in line with the business strategy, objective, values and long-term interests of the credit institution.[56] Taking into account these requirements credit institutions must design and implement such remuneration policy, in particular, to determine a proper balance of variable to fixed remuneration, the measurement of performance, the remuneration structure as well as the risk-adjustment of variable remuneration.

The credit institution should give due consideration to the contribution of the remuneration in preventing excessive risk-taking and the consistency of the remuneration policy with effective risk management in design of its remuneration policy.[57] The second aspect which the credit institution must take into account is the inclusion of the remuneration in capital and liquidity planning and the contribution of the remuneration to safeguarding a sound capital base of the credit institution.[58]

The pension policy should be in line with the business strategy, objectives, values and long-term interests of the credit institutions. If the employee leaves the credit institution before retirement, discretionary pension benefits should be held by the credit institution for a period of five years in the form of shares or equivalent ownership interests, share-linked instruments or equivalent non-cash instruments and other instruments that adequately reflect the credit quality of the credit institution. In case of an employee reaching retirement, discretionary pension benefits should be paid to the employee in the form of previously mentioned financial instruments subject to a five-year retention period.[59]

6.4.2. GENERAL PROHIBITIONS IN THE REMUNERATION POLICIES

CRD III envisages general prohibitions on design and implementation of the remuneration policies. These prohibitions relate to the application of guaranteed variable remuneration, the payment of severance, and the application of personal hedging.

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[55] Annex V Section 11 point 23(a) Directive 2006/48/EC.
[56] Annex V Section 11 point 23(b) Directive 2006/48/EC.
[57] The variable remuneration may encourage staff to take undesirable and irresponsible risks in hope of generating more turnovers or making more profit and thus increasing their variable remuneration. The staff may manipulate information with a view to making their measured performance look better. Ibid., pp. 38.-39.
[58] Annex V Section 11 point 23(i) Directive 2006/48/EC. Credit institutions should include the impact of remuneration pay out levels in their capital planning and in their overall capital assessment process, taking into account their current capital position. The total variable remuneration awarded by an institution shall not limit the ability of the institution to maintain or restore adequate capital base in the long term and has proper regard to the interests of depositors, investors and other stakeholders. Remuneration represents an important cost factor for financial institutions as remuneration payments influence the institution's capital base. Ibid., pp. 39.-40.
[59] Annex V Section 11 point 23(r) Directive 2006/48/EC.

The guaranteed variable remuneration is exceptional and occurs only when hiring new staff and is limited to the first year of employment.[60]

Payments related to the early termination of a contract (severance pay) should reflect performance achieved over time and should be designed in a way that does not reward failure.[61] This prevents payment of the severance in situation of non-satisfactory performance of an employee. The severance payment without any performance criteria and risk adjustments creates incentives for employees to take excessive risks, with guarantee of benefits in any situation.

In certain situations it is possible to reduce the amount of variable remuneration awarded to staff.[62] Efficiency of the alignment of the remuneration with risks will be significantly weakened if employees are able to transfer the downside risks to another party through hedging or certain types of insurance. Therefore, the employees should not enter into such insurance contracts, which are applied to deferred and retained variable remuneration.[63]

6.5. SPECIFIC REQUIREMENTS ON THE REMUNERATION POLICIES

6.5.1. RATIO BETWEEN FIXED AND VARIABLE REMUNERATION

Fixed and variable components of total remuneration should be properly balanced and portion of the fixed remuneration component should represent a sufficiently high portion of the total remuneration. This allows the operation of a fully flexible policy, on variable remuneration, including the possibility to pay no variable remuneration component.[64] This enables not only the reduction of variable remuneration in situation of failing to meet performance criteria, but also non-payment of complete variable remuneration. On the other hand, the fixed remuneration should be high enough to compensate employees' work regarding their level of education, the degree of seniority, the level of required expertise and

[60] Annex V Section 11 point 23(j) Directive 2006/48/EC. The guaranteed variable remuneration can take different forms (e.g. guaranteed bonus, welcome bonus, minimum bonus, etc.) and can be granted either in cash or in financial instruments. This prohibition prevents credit institutions to guarantee multi-year variable remuneration over, for example, two or three year. Ibid., p. 41.

[61] Annex V Section 11 point 23(m) Directive 2006/48/EC. This prohibition does not exclude payment of the severance in situations such as early termination of the contract due to changes in the strategy of the institution, or in merger and takeover situations. The severance pay may include payments related to the duration of a notice period, redundancy remuneration for loss of office, and may also include a non-competition clause in the contract. Ibid, pp. 41.-42.

[62] For example if performance adjustment measures such as malus are implemented, or implicitly, if the value of deferred financial instruments is reduced.

[63] Annex V Section 11 point 23(s) Directive 2006/48/EC. This would not prohibit insurance designed to cover personal payments such as health care and mortgage instalments. Ibid., pp. 42.-44.

[64] Annex V Section 11 point 23(l) Directive 2006/48/EC.

skills, the job experience and the relevant business sector and region. This requirement does not prescribe the amount of fixed remuneration, recognising that it results from negotiations between individual employee and the institution. However, individual amount of the fixed remuneration is indirectly impacted by the basic principle of risk alignment and by the requirement that remuneration should be included in the capital and liquidity planning of the institution and should contribute to safeguarding a sound capital base.[65]

Each credit institution should set the appropriate ratio between fixed and variable component of the total remuneration. Variable remuneration provides an incentive for employees to pursue the goals and interests of the institution and enables them to share in its success. It also promotes interests of shareholders and other stakeholders. The variable remuneration aligned to performance can have a positive effect on risk-sharing and promotes safe and sound performance, under the condition of appropriate portion of variable component of the total remuneration. The higher portion of the variable remuneration compared to the fixed remuneration promotes stronger incentive to employees to deliver the needed performance, but with possibility of appearance of bigger associated risks. If the portion of fixed remuneration is set too low, this may create difficulties for credit institution in the reduction or elimination of variable remuneration in a poor financial year. Therefore, it is necessary to set appropriate ratio between fixed and variable component of the total remuneration.[66]

The credit institution should explicitly set in its remuneration policy the maximum portion of variable remuneration in relation to the portion of fixed remuneration. The institution should determine this maximum portion of variable remuneration for different categories of employees whose professional activities have a material impact on institution's risk profile. Specific ratio between fixed and variable remuneration will depend on: a) the quality of performance measurement and associated risk adjustments; b) the length of the deferral and retention periods; c) the legal structure of the institution, kinds and scope of the activities; d) business types and which risks are involved; e) category of staff;[67] and f) level of the staff member in the organization and responsibilities attached to the job position.[68]

[65] Ibid., pp. 44.-45.
[66] Ibid., p. 45.
[67] Employees with control functions should have a lower ratio of variable to fixed remuneration.
[68] Ibid., pp. 46.-47.

6.5.2. RISK ALIGNMENT OF THE VARIABLE REMUNERATION

In order to limit excessive risk-taking, the variable remuneration should be related to performance and subject to adjustments due to modification of risks. Risk alignment of variable remuneration is realized in the performance and risk measurement process, the award process and the payout process.

Where remuneration is performance related, the total amount of remuneration should be based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution. Institutions should use financial and non-financial criteria for assessing individual performance.[69]

The assessment of the performance should be set in a multi-year framework in order to ensure that the assessment process is based on longer-term performance. The payout process of the variable remuneration should be spread over a period which takes account of the underlying business cycle of the credit institution and its business risks.[70]

The measurement of performance used to calculate variable remuneration or pools of variable remuneration should include an adjustment for all types of current and future risks and should take into account the cost of the capital and the liquidity required. The allocation of the variable remuneration within the credit institution should also take into account all types of current and future risks.[71] This enables the adjustment of the remuneration policy during the performance measurement process and the award process of variable remuneration as regards to modified risks. The variable remuneration should be paid or vested only if it is sustainable according to the financial situation of the credit institution as a whole, and justified according to the performance of the credit institution, the business unit and the individual concerned.[72]

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[69] Annex V Section 11 point 23(g) Directive 2006/48/EC. Financial (quantitative) criteria relate to capital needed to generate revenues. Non-financial (qualitative) criteria relate to the achievement of strategic targets, customer satisfaction, adherence to risk management policy, compliance with internal and external rules, creativity, team work, motivation and cooperation with other business unites, etc. Ibid., pp. 52.-53.

[70] Annex V Section 11 point 23(h) Directive 2006/48/EC. The variable remuneration is partly paid upfront (short-term variable remuneration), directly after the award and rewards employees for performance delivered in the accrual period. Another part of the variable remuneration is deferred (long-term variable remuneration). Long-term variable remuneration is awarded to employees during and after the deferral period. It rewards employees for the sustainability of the performance in the long term, which is the result of decisions taken in the past. Ibid., p. 49.

[71] Annex V Section 11 point 23(n) Directive 2006/48/EC.

[72] Annex V Section 11 point 23(q) Directive 2006/48/EC. Ibid., pp. 56.-59.

6.5.3. THE PAYOUT PROCESS OF THE VARIABLE REMUNERATION

It has already been pointed out that the payment of variable remuneration should be carried out in instalments over a specific period. There is distinction between short-term and long-term variable remuneration. Long-term variable remuneration is characterized by existence of the deferral period for its payment, which enables ex-post risk adjustment. This further ensures the risk alignment of the variable remuneration. To this end, CRD III prescribes the minimum portion of deferred variable remuneration and the deferral period. A substantial portion, and in any event at least 40 %, of the variable remuneration should be deferred over a period which is not less than three to five years and is correctly aligned with the nature of the business, its risks and the activities of the employee in question.[73] Remuneration payable under deferral arrangements shall vest no faster than on a pro rata basis.[74] In the case of a variable remuneration of a particularly high amount, at least 60 % of the amount should be deferred. The length of the deferral period should be established in accordance with the business cycle, the nature of the business, its risks and the activities of the employee in question.[75]

CRD III sets forms of payment of the variable remuneration. The variable remuneration can be paid in cash or in shares and other financial instruments. By assigning of shares and other financial instruments to employees, their interests are aligned with interests of shareholders. This stimulates better work of employees and increases the institution's value and value of the financial instruments. It is necessary to combine variable remuneration in cash and financial instruments. To this end, CRD III determines that a substantial portion, and in any event at least 50 %, of any variable remuneration should consist of an appropriate balance of: a) shares or equivalent ownership interests,[76] subject to the legal structure of the credit institution concerned or share-linked instruments or equivalent non-cash instruments, in

[73] The deferral period always starts at the moment of payment of the short-term variable remuneration and ends when the last variable remuneration has vested. The length of the deferral period depends on the potential impact of an employee on the risk profile of the institution, his responsibilities and tasks and expected fluctuations in the economic activity of the institution. At least for members of the management and executive directors, the institution should consider longer deferral periods.

[74] Pro rata vesting (or payment) means for e.g. a deferral period of three years that at the end of years n+1, n+2 and n+3, 1/3 of the deferred remuneration vests, if the end of n is the moment at which the performance is measured to determine the variable remuneration. In any case, vesting should not take place more frequently than on annual basis, which ensures proper assessment of risks and thus, an ex-post adjustment of remuneration.

[75] Annex V Section 11 point 23(p) Directive 2006/48/EC. Ibid., pp. 59.-61.

[76] For credit institutions in the legal form of a stock corporation these instruments are common shares and share-linked instruments whose value is based on a market appreciation of the stock and that have the share price as a reference point (e.g. stock appreciation rights (SAR), types of synthetic shares (options)). Ibid., p. 63.

case of a non-listed credit institution,[77] and b) where appropriate, other instruments that adequately reflect the credit quality of the credit institution.[78] These financial instruments should be subject to an appropriate retention policy[79] designed to align incentives with the longer-term interests of the credit institution.[80]

The variable remuneration should not be paid through vehicles or methods that facilitate the avoidance of the requirements of CRD III.[81]

Once an initial variable remuneration has been awarded to employees and short-term variable remuneration has already been paid, the institution still will be able to adjust the variable remuneration as time goes by. This ex-post risk adjustment of the variable remuneration is accomplished by means of malus arrangement of clawback clauses.[82] These methods should be arranged in contracts with employees and they are applied in the case of poor or negative financial results of the institution on deferred variable remuneration as well as on already paid variable remuneration.[83]

[77] For credit institutions which are not established in the legal form of a stock corporation and for non-listed credit institutions share-linked instruments are not suitable, either because of their legal form, either because of difficulties in determining the share price of non-listed shares. Therefore, they use equivalent non-cash instruments, whose value is determined by a third party, not by a stock market. In such cases, it is particularly important to determine the correct value of the credit institution, which must be determined directly on the moment of awarding, before the vesting and before the retention period ends respectively. Loc. cit.

[78] Hybrid financial instruments are, for example, convertible bonds and preference shares. Ibid., pp. 63.-64.

[79] A retention period is determined by the credit institution taking into account: a) the length of period for the assessment of the performance, b) the length of the deferral period, c) the impact of employees on the institution's risk profile, d) the accuracy of the risk adjustment in the performance measurement process and in the award process, e) the time required for realization of certain relevant risks and f) other significant elements. During the retention period, the employee agrees not to sell financial instruments that were awarded to him as the variable remuneration.

[80] The Member States or their competent authorities may place restrictions on the types and designs of financial instruments or prohibit certain instruments as appropriate. The requirement on the portion and types of financial instruments should be applied to both the portion of the deferred variable remuneration and the portion of the variable remuneration which is not deferred. See in Annex V Section 11 point 23(o) Directive 2006/48/EC, ibid., pp. 64.-66.

[81] Annex V Section 11 point 23(t) Directive 2006/48/EC.

[82] This results in lowering cash remuneration or awarding a lower number of financial instruments. Malus is a method for the implementation of risk adjustment and reducing the value of a part of the deferred remuneration. Maluses operate by affecting the vesting process and cannot operate after the end of the deferral period. Clawback is a method for achieving an ex-post risk adjustment of the variable remuneration by returning of already paid amount of remuneration or by returning of awarded financial instruments. It typically operates in the case of subsequently established fraud or misleading information by employees. Clawbacks can be arranged for deferred variable remuneration or variable remuneration which is not deferred.

[83] Annex V Section 11 point 23(q) Directive 2006/48/EC. Ibid., pp. 66.-69.

6.5.4. SPECIFIC REQUIREMENTS FOR THE VARIABLE REMUNERATION OF CREDIT INSTITUTIONS WHICH RECEIVED GOVERNMENT FINANCIAL SUPPORT

CRD III sets special rules on the remuneration policy of the credit institution which received government financial support to ensure financial stability in the event of extraordinary circumstances on the financial market. These rules should prevent influence of the variable remuneration on orderly and adequate payback of the government support. In such credit institution variable remuneration is strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support. The relevant competent authorities can require credit institutions to restructure remuneration in a manner aligned with sound risk management and long-term growth.[84] They can, where appropriate, require establishing limits to the remuneration of the persons who effectively direct the business of the credit institution (members of the management and executive directors). Variable remuneration is not paid to the persons who effectively direct the business of the credit institution, unless its payment is justified.[85]

6.6. DISCLOSURE OF THE REMUNERATION POLICIES OF CREDIT INSTITUTIONS

CRD III also amends the Annex XII Part 2 of the Directive 2006/48/EC entitled the Technical Criteria on Transparency and Disclosure. In the Annex XII Part 2 of the Directive 2006/48/EC a new point 15 is introduced about information on the remuneration policies and practices of credit institutions that should be disclosed to the public.

Institutions should disclose detailed information regarding their remuneration policies and practices for members of staff whose professional activities have a material impact on the institution's risk profile. They should also provide general information about the basic characteristics of their institution-wide remuneration policies and practices.

Remuneration disclosures may be made in accordance with the proportionality principle. The type and amount of disclosed information depends on the size, internal

[84] Measures for restructuring remuneration may be: a) setting limits for remuneration of members of the management and executive directors; b) prohibition of payment of variable remuneration for the year in which government support was asked for; c) reduction of variable remuneration which is deferred and not yet vested; d) prohibition of awarding any variable remuneration as long as the government support is not yet paid back, or until a recovery plan for the institution is implemented/accomplished; e) other similar measures.

[85] Annex V Section 11 point 23(k) Directive 2006/48/EC. Ibid, pp. 27.-28.

organization and the nature, scope and complexity of institution's activities. Small or non-complex institutions will only disclose some qualitative information and very basic quantitative information.[86] Institutions should disclose how they have applied the proportionality principle, including possible neutralizations of some provisions.

Disclosure of the remuneration policy should be made on, at least, an annual basis and as soon as possible.

Qualitative information is related to the design and implementation of the remuneration policy.[87] They are: a) information concerning the decision-making process used for determining the remuneration policy, including if applicable, information about the composition and the mandate of a remuneration committee, the external consultant whose services have been used for the determination of the remuneration policy and the role of the relevant stakeholders; b) information on link between pay and performance; c) the most important design characteristics of the remuneration system, including information on the criteria used for performance measurement and risk adjustment, deferral policy and vesting criteria; d) information on the performance criteria on which the entitlement to shares, options or variable components of remuneration is based; e) the main parameters and rationale for any variable component scheme and any other non-cash benefits.[88]

Quantitative information is related to the total amount of remuneration in the credit institution. Institutions should provide aggregate quantitative information on remuneration, broken down by business area.[89] In addition, institutions should disclose more detailed quantitative information for senior managers and other members of staff whose actions have a material impact on the risk profile of institutions including aggregate information on amounts of remuneration, amounts and forms of variable remuneration and amounts of outstanding deferred remuneration.[90] Significant credit institutions should also disclose more detailed aggregate quantitative information for persons who effectively direct the business of credit

[86] For example small credit institutions do not have to disclose all information under point 15(g) of Annex XII.
[87] Annex XII Part 2 point 15(a)-(e) Directive 2006/48/EC.
[88] Ibid., pp. 71.-73.
[89] Annex XII Part 2 point 15(f) Directive 2006/48/EC. The information for each of the major business areas at an institution, i.e. investment banking business area, retail banking business area, etc. should include: number of staff, total remuneration and total variable remuneration.
[90] These information are: a) the amounts of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries; b) the amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types; c) the amounts of outstanding deferred remuneration, split into vested and unvested portions; d) the amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments; e) new sign-on and severance payments made during the financial year, and the number of beneficiaries of such payments; and f) the amounts of severance payments awarded during the financial year, number of beneficiaries and highest such award to a single person. See in Annex XII Part 2 point 15(g) Directive 2006/48/EC.

institutions (members of the management/executive directors). This will be a separate category of disclosure information to the categories of senior management and other staff members who have a material impact on the risk profile of the institution.[91]

Information on the remuneration policy of a credit institution or investment firm should be accessible to all staff members of that institution. In internal disclosure institutions apply the proportionality principle. Therefore, the information provided to staff members might contain some of the elements listed in Annex XII Part 2 point 15. The staff members should know in advance the criteria that will be used to determine their remuneration. The performance measurement process should be properly documented and should be transparent to the member of staff concerned.

7. IMPLEMENTATION OF CRD III IN NATIONAL LEGISLATIONS OF THE EU MEMBER STATES

The EU Member States harmonized their national provisions[92] on the remuneration policies in credit institutions and investment firms with the provisions of CRD III.[93] Member States implemented the provisions of CRD III as a combination of legislative acts, regulation, circulars and explanatory memoranda. These national provisions were adopted by national parliaments, national governments or national supervisory authorities.[94] The general feature of

[91] Ibid., pp. 70.-74.

[92] In most Member States of the EU national provisions were harmonized with provisions of CRD III and came into force on 1 January 2011. They also started with application of the CEBS Guidelines on Remuneration Policies and Practices in financial sector. Some Member States suffered from delays in the legislative process. See in EBA, Survey on the implementation of the CEBS Guidelines, available on EBA: http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Implementation-survey-on-CEBS--Guidelines-on-Remuneration--final-.pdf, 31 January 2013, p. 3., Linklaters, Overview of Remuneration regulation for financial institutions in selected jurisdictions, available on Linklaters: http://www.linklaters.com/pdfs/mkt/london/4531_Generic_Remuneration_Guide_FINAL.pdf, 31 January 2013.

[93] The European Commission proposed revision of the Capital Requirements Directives through a Directive and a Regulation (CRD IV) on 20 July 2011. The goal of proposed new Directive and Regulation is implementation of the Basel III rules on the capital requirements, the liquidity regime and the absorption of losses in credit institutions. The CRD IV contains rules on the new capital conservation and counter-cyclical buffers in credit institutions and investment firms. The Regulation contains rules on the quality and quantity of capital, counterparty risk rules and liquidity and leverage management. Article 74 of CRD IV regulates the oversight of remuneration policies of credit institutions by national supervisors and their co-operation with EBA. Articles 88 to 91 of CRD IV contain provisions on the remuneration policies in credit institutions and investment firms which follow rules of CRD III. EBA shall develop draft regulatory technical standards with respect to the criteria to determine the appropriate ratios between fixed and variable component of the total remuneration and to specifying the classes of hybrid financial instruments. The Commission shall adopt these regulatory technical standards. See in Winter, J., op. cit., pp. 382.-383.

[94] Harmonization of national rules was implemented by: a) regulation adopted by national supervisory authority or central bank (FR, DE, IT, NL, SE); b) regulation or decision adopted by national government (BE, FI, PT); c) circulars adopted by national supervisory authority (LU); d) code adopted by national supervisory authority (UK). See in Linklaters, Overview of Remuneration regulation…, pp. 1.-16.

implementation is existence of differences between Member States in application of the provisions of CRD III, depending on the importance of the financial sector in national economies. This created differences between credit institutions from different Member States and the differences between European credit institutions and credit institutions from third countries.[95]

Regarding the scope of institutions, there are no differences between Member States in application of CRD III. Some Member States extended application of the CRD III requirements on remuneration policies to the financial sector as a whole.[96]

Application of the proportionality principle may neutralize some requirements on the remuneration policies in credit institutions. Credit institution itself assesses its nature and risk profile taking into account its size, internal organization and the nature, scope and complexity of its activities. Member States set fixed criteria[97] or apply an open case-by-case approach for the assessment of institution's risk profile and for division of credit institutions on significant and small institutions. Such different application of the proportionality principle can lead to significant variation in the net degree by which institutions are subject to the CRD III requirements.[98]

Regarding the categories of staff whose professional activities have a material impact on institution's risk profile to which the specific requirements of CRD III are applied, credit institutions alone determine these employees. They use various criteria, which are often not sufficient for the assessment of employees' impact on risk profile of institutions. The numbers of Identified Staff differ considerably between Member States, but there is a clear tendency of institutions to select very low numbers. This affects the efficiency of the CRD III

[95] Application of CRD III has increased the portion of fixed component in total remuneration in the period since 2007 to 2012 and reduced flexibility in design of the remuneration policies. Levels of remuneration were in decline in institutional bank segment, grew in private bank segment and reduced slightly in risk/control segment. Such remuneration policies resulted in decrease of the number of employees in the financial sector and the reduction of levels of remuneration in comparison to other sectors of the economy. See in Shelton, Mark, Perspectives – The impact of European regulation on pay in financial services, available on: http://www.towerswatson.com/assets/pdf/7157/TW-EU-2012-25851-Perspectives-on-CRDIII.pdf, 31 January 2013, pp. 2.-6.

[96] For example in BE, IT, DE, LU, NL, PT, SE, UK. See in Linklaters, Overview of Remuneration regulation…, pp. 1.-16., Jain, Madhu, Insurance Update, September 2011, available on Linklaters: http://www.linklaters.com/pdfs/mkt/london/FINAL_InsuranceUpdate_September2011_PDF.pdf, 16 January 2012, pp. 15.-18.

[97] In Germany the Institutions' Remuneration Regulation 2010 sets criteria for significant institutions which must carry out a risk analysis (an average balance sheet total of no less than €10 billion at the end of each of the past three financial years). See in Kurz, Antje - Irina, Steck, Andreas, Tepass, Michael, Q&A Institutions´ Remuneration Regulation, December 2010, available on Linklaters: http://www.linklaters.com/pdfs/mkt/london/A13022231_101222_QA%20Institutions%20Remuneration%20Regulation.pdf, 16 January 2012, pp. 4.-5.

[98] EBA, Survey on the implementation of the CEBS Guidelines…, p. 3.

requirements and the achievement of goals of CRD III.[99] Therefore, national supervisory authorities express the need for clear criteria and a process to identify risk takers in a single institution and within groups. They require additional guidance on the application of the proportionality principle and the neutralization of requirements.[100]

The governance of remuneration in credit institutions is a part of the CRD III requirements which is widely accepted by Member States. Requirements of CRD III and the CEBS Guidelines on the general principles on corporate governance, the role of the supervisory and management bodies and the establishment of a remuneration committee are applied in all Member States. Certain differences arise in the implementation of requirements in groups of institutions, when the parent company and subsidiaries are established in different Member States.[101]

Shortcomings in the implementation of CRD III arise in risk alignment of remuneration policies and their risk adjustment process. Principles of risk alignment during performance measurement process and the parameters used ex ante for setting variable remuneration are accepted in practice. Deficiency is manifested in the fact that ex ante risk adjustment is still restricted too much to the highest levels of employees in the credit institution. Regarding ex post risk alignment, improvements are needed in establishing more sensitive malus arrangements and in the performance measurement process. Underdevelopment of risk adjustment techniques is reflected in the ratios of variable to fixed remuneration that institutions have set in their remuneration policies, where portion of variable remuneration is still high. The criteria by which institutions decide on ratios in practice are not always clear. Progress has been achieved in setting up multi-year framework for the performance measurement process and in wide acceptance of deferral periods for payment of variable remuneration.[102]

CRD III requires that at least 50 % of the variable remuneration should be paid in financial instruments. This enables more flexibility to credit institutions in tailoring this requirement to their own needs and possibilities. In some Member States, there is delay in complying with this CRD III requirement because credit institutions have difficulties in finding suitable financial instruments.[103]

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[99] This problem especially arises in a group of institutions, where the Identified Staff can be determined differently between parent institution and subsidiaries.
[100] Loc. cit.
[101] Ibid., pp. 3.-4.
[102] Ibid., p. 4.
[103] In some Member States listed credit institutions do not use common shares due to practical problems. Equivalent non-cash instruments are more frequently used by both listed and non-listed institutions. The main

Disclosure of remuneration policies and practices is different in Member States because of applying the proportionality principle and by the fact that disclosure requirements relate to those categories of employees selected as Identified Staff. Number of Identified Staff can differ considerably between Member States, as already mentioned. This prevents the achievement of an equal level of application of the disclosure requirements, which is a prerequisite for effective supervision of the financial market and national supervisory authorities on relation between remuneration, risk-taking and performance of employees. Disclosure requirements encourage better enforcement of remuneration policies and promote the financial stability and the institutions' need for competitive remuneration policies.[104]

8. REGULATION OF THE REMUNERATION POLICIES IN CREDIT INSTITUTIONS IN THE CROATIAN LAW

In Croatian law recommendations of the European Commission on remuneration policies were partially implemented in the Corporate Governance Code which was adopted in 2010.[105] The rules of the European Commission's Recommendations from 2004 and 2005 were partially adopted in the Code.[106] Contrary to this, the rules of the European Commission's Recommendations from 2009 have not been adopted in the Code. Only listed credit institutions have applied the rules of Corporate Governance Code.[107] In practice, listed

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open issue concerns the valuation of these instruments. Hybrid financial instruments are so far in practice not used. Ibid., pp. 4.-5.

[104] Ibid., p. 5.

[105] First Corporate Governance Code was adopted in 2007 (Official Gazette no. 46/2007). In December 2010 the Croatian Financial Services Supervisory Agency (CFSSA) and the Zagreb Stock Exchange (ZSE) adopted new Corporate Governance Code, which applies to listed companies since 1 January 2011. The rules of the Code are in line with new provisions of the Capital Market Act, the Companies Act and the Rules of ZSE, which have been amended since 2007 to 2010.

[106] CFSSA and ZSE have not accepted the participation of shareholders in design of remuneration policies in listed companies. Rule 4.2. of the Recommendation 2004 envisages that the remuneration statement should be submitted to the annual general meeting of shareholders for a vote. The vote may be either mandatory or advisory. Member States may, however, provide that such a vote will be held only if shareholders representing at least 25 % of the total number of votes held by shareholders present or represented at the annual general meeting request it.

[107] Rule no. 150 of the Rules of ZSE determines that the Code of corporate governance is applied to any Issuer of the shares listed on the regulated market, with the exception of closed-end funds. The requirement to fill out the questionnaire, which is a constituent part of the Code of corporate governance, applies to any Issuer whose shares are listed on the regulated market and who are required to submit it to the Exchange no later than the time of the annual report delivery (Rule no. 151). The Issuers which are bound by the Code of corporate governance shall comply with this requirement by having the completely filled-out annual questionnaire which is a constituent part of the Code: 1. disclosed on their Internet sites, 2. submitted to the Exchange for disclosure on the Exchange website (Rule no. 152). Available on ZSE: http://zse.hr/default.aspx?id=144, 31 January 2013. Listed credit institutions are: Banco Popolare Croatia d.d. Zagreb, Banka Splitsko-Dalmatinska d.d. Split, Centar banka d.d. Zagreb, Erste&Steiermärkische banka d.d. Rijeka, Hrvatska poštanska banka. d.d. Zagreb, Istarska kreditna banka Umag d.d., Jadranska banka d.d. Šibenik, Karlovačka banka d.d. Karlovac, Kreditna banka

companies do not apply all recommendations of the Code because of its non-binding character.[108]

Corporate Governance Code in point 6.3 sets recommendations on design and implementation of remuneration policy for members of the management of listed company (publication of the statement on the remuneration policy for the management and supervisory board, structure of remuneration, methods of determining remuneration, disclosure of remuneration).[109] Points 4.12 and 4.12.2 of the Code regulates the role of remuneration committee. The content and disclosure of the statement on remuneration policy is regulated by point 6.3 of the Code. Disclosure of information on remuneration for members of management and supervisory bodies in the annual report of the company is regulated by point 6.3.3 of the Code (the statement on remuneration). The Code regulates determination and disclosure of remuneration to members of the supervisory board in point 4.7.[110]

Croatian Parliament amended provisions of the Credit Institutions Act in April 2013. Purpose of these amendments is harmonization of the Credit Institutions Act with the Capital Requirements Directive III (Directive 2010/76/EU), the Directive on the powers of EBA (Directive 2010/78/EU) and the Directive on supervision of financial conglomerates (Directive 2011/89/EU).[111] Amendments of the Credit Institutions Act introduce duty of credit institutions to design remuneration policy in accordance with sound and effective risk management.[112] The Croatian National Bank (CNB) adopted Decision on employees'

Zagreb d.d., Nava banka d.d. Zagreb, Podravska banka d.d. Koprivnica, Privredna banka Zagreb d.d., Slatinska banka d.d. Slatina, VABA d.d. Varaždin, Zagrebačka banka d.d. Zagreb. Available on ZSE: http://zse.hr/default.aspx?id=36769, 4 February 2013.

[108] Listed company should explain reasons for non-compliance of the recommendation in the annual questionnaire. The Companies Act in Article 272.p envisages that the management/executive directors of listed company should give a statement in the annual report of the company on the application of Corporate Governance Code.

[109] These recommendations shall also apply in determining remuneration for executive directors. Point 6.3 shall be applied appropriately on remuneration for members of the board of directors (point 5.8. of the Code). This recommendation should be interpreted that it applies only to the executive directors. On remuneration for non-executive directors should be applied point 4.7 on remuneration for members of the supervisory board.

[110] Recommendations of the Code on the remuneration policy are not different from recommendations of the Code from 2007. See in detail in Jurić, D., op. cit., pp. 143.-154.

[111] Act on amendments of the Credit Institutions Act, Official Gazette no. 54/2013 (NN 54/13), available on NN: http://narodne-novine.nn.hr/default.aspx, 8 May 2013.

[112] Act on amendments of the Credit Institutions Act envisages: a) duty of the supervisory board to establish remuneration committee and to identify holders of key functions in credit institution (Article 22), b) duty of credit institution to establish and implement efficient and reliable remuneration policy, according to the type, scope and complexity of its activities (Article 28), c) prohibition of payment of variable remuneration which is not in line with the Credit Institutions Act, bylaws and institution's remuneration policies and procedures (Article 29), d) the powers of the Croatian National Bank (CNB) to adopt bylaws which set rules, procedures and criteria regarding remuneration policy and way and deadlines for reporting CNB on remuneration of institution's employees (Article 36), as well as to establish benchmark trends and practices of credit institutions regarding remuneration of employees (Article 38), e) duty of credit institution to disclose general information on remuneration policy and practice (Article 41). CNB may require credit institution to limit variable remuneration

remuneration in December 2012, which has adopted provisions of CRD III on remuneration policies in credit institutions.[113] Provisions of the Decision will be applied on remuneration policy of credit institutions in 2013.[114] These legislative activities of the Croatian Parliament and CNB, as a national supervisory authority, will enable harmonization of national provisions with the provisions of CRD III on remuneration policies and practices in credit institutions. This would eliminate current practice of voluntary application of recommendations on remuneration policy in listed credit institutions.

9. CONCLUSIONS

The European Commission adopted four Recommendations on corporate governance in listed companies and financial institutions. Special attention was given on remuneration policies. Recommendations from 2004 and 2005 set rules on design and implementation of remuneration policy and disclosure of remuneration in listed companies. Recommendations from 2009 have addressed attention to the structure of remuneration in listed companies and financial institutions. Member States of the EU implemented these recommendations in their national legislations in different ways. Most of Member States adopted non-binding national corporate governance codes and some of them enacted binding provisions. Such different practices of the Member States in implementation of Recommendations have resulted in different application of requirements and endangered achievement of goals of the European Commission.

Remuneration policies and practices of financial institutions were originally regulated by the Recommendation on remuneration policies in the financial services sector from 2009. The Recommendation should be applied to all financial institutions. Implementation of the

as a percentage of total net profit, if it finds irregularities (Article 61). In the case of a special administration of the credit institution, all management contracts cease and payment of severance and variable remuneration is forbidden (Article 72). The Act envisages misdemeanour responsibility of credit institution which fails to comply with the provisions of the Credit Institutions Act on remuneration policy (Article 127). The Act on amendments of the Credit Institutions Act shall enter into force eight days following its publication in the national Official Gazette.

[113] Nacrt Odluke o primicima radnika, available on CNB: http://www.hnb.hr/propisi/odluke-nadzor-kontrola/nacrti_odluka_srpanj_2011/h-nacrt-odluka-o-primicima-radnika-v6.pdf, 5 January 2013.

[114] Significant credit institutions are those institutions whose average balance sheet exceeds 7 billion HRK (around €1 billion) at the end of each of the past three financial years, regardless of the assessment of their risk profile. Significant credit institutions must apply all provisions of the Decision on their remuneration policy (Article 4(5) of the Decision). They should establish a remuneration committee, with exemption for significant credit institutions which are subsidiaries of domestic or foreign parent credit institutions which established a remuneration committee on a group level and if the remuneration policy of subsidiary is in accordance with the remuneration policy of parent institution (Article 4(6) and 12 of the Decision). The approval of the institution's remuneration policy and decisions relating to the remuneration of members of the management may be assigned to the shareholders' meeting by statute of the credit institution (Article 5(6) of the Decision).

Recommendation in national legislations of the Member States revealed same problems. European institutions decided to enact a directive which has binding nature. The European Parliament and the Council, on a proposal of the European Commission, enacted the Capital Requirements Directive III in 2010, which contains provision on remuneration policies in credit institutions and investment firms. The Committee of European Banking Supervisors (CEBS) issued the Guidelines on Remuneration Policies and Practices in order to facilitate the application of the provisions of CRD III on the remuneration policies. Regarding remuneration policies in other financial institutions, it is expected that relevant directives will be amended. Some authors complain on harmonization of remuneration policies in credit institutions and investment firms, because this reduces the flexibility in design of remuneration policy, the number of employees and the level of remuneration in comparison to other sectors of the economy.

Recommendations of the European Commission from 2004 and 2005 were implemented in the Corporate Governance Code which was adopted in 2010. Lack of the Code is its non-binding nature, the application only to listed companies and the fact that it did not comply with Recommendations from 2009. Therefore, the Croatian Parliament amended provisions of the Credit Institutions Act in April 2013 according to provisions of CRD III. That expands application of CRD III on all credit institutions. The Croatian National Bank adopted the Decision on employees' remuneration in December 2012, a by-law which regulates remuneration policies in credit institutions in detail.

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EXTERNAL AUDITOR'S NORMATIVE CHARACTERISTICS SET OUT IN THE DIRECTIVE 2006/43/EC AS AN ELEMENT ENSURING CORRECTNESS OF BUSINESS ENTITIES´ DISCLOSURE

Statutory auditor's normative characteristics set out in the Directive 2006/43/EC as an element ensuring correctness of business entities' disclosure

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Abstract

The purpose of an article is the analysis of selected issues of European Union accounting law, understood as a set of EU regulations about accounting and statutory audit. Accounting law seems to be underrated by judicial doctrine, although it plays an important role in the functioning of enterprise (especially companies), capital market or finally the tax system. Therefore, the analysis of reasons, for which EU puts an effort on harmonisation process, and sometimes also the unification of accounting law seems to be interesting. The integration of an accounting law on the European level should be evaluated in the context of potential influence on the EU internal market. The purpose of the study is an attempt to formulate the assessment if some important institutions of EU accounting law meet the requirements of internal market. Currently, the most significant function in this matter regulates the directive adopted in 2006[1]. The directive regards to statutory audit of annual

[1] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L 157, 9 June 2006, p.87-107.

financial statements and consolidated financial statements. It is worth adding, that it is the newest normative act concerning accounting law - important because it deals with the challenges faced by regulators of an economic activity.

The considerations in this essay are based on the assumption that, from the perspective of proper functioning of the internal market, comparability of financial statements of business entities from different EU Member States and comparability of the statutory audit, both are necessity. One of the elements constituting optimal state of affairs is a high degree of harmonization of legal regulations on accountancy in a strict sense, but also the high degree of harmonization of legal regulations on external audit (financial revision). Concern for the high professional degree of the external audit process requires establishing of legal rules for defining external auditors' normative characteristics. This issue will have an important influence on the quality of information presented and disclosed in financial statements. It is one of the arguments for maintaining the comparability of financial statements of business entities from different EU Member States. It also plays an essential role in the internal market functioning.

The three essential issues in the paper are pointed out. First of all, this study does not concern all the issues in the field of the external audit regulated by the Directive 2006/43/EC, but only the issue of the independence and objectivity of external auditors. The authors recognized that those are the essential elements from the point of view of the normative characteristics of such entities. Secondly, the European Union's accounting law, in the regulatory sense, shares the imperfections of the European Union's law, as it lacks comprehensiveness and instruments of integration, appropriate from the internal market's perspective. And thirdly, it may be astonishing that compared with the proper diagnosis of essential problems, the proposed substantial solutions appear to be inadequate (the example of rotation or the principles of independence and objectivity).

Despite the fact that the European legislator attempts to take basically right legislative action, the details of these regulations leave much to be desired. In terms of efficient functioning of the internal market, EU accounting law requires more unification and determination, so that it can effectively conduce the freedoms of internal market.

INTRODUCTION

The purpose of this article is the analysis of selected issues of European Union accounting law, understood as a set of EU regulations about accounting and statutory audit. Accounting law seems to be underrated by judicial doctrine, although it plays an important role in the functioning of enterprise (especially companies), capital market or finally the tax system. Therefore, the analysis of reasons, for which EU puts an effort on harmonisation process, and sometimes also the unification of accounting law seems to be interesting. The integration of an accounting law on the European level should be evaluated in the context of potential influence on the EU internal market. The purpose of the study is an attempt to formulate the assessment if some important institutions of EU accounting law meet the requirements of internal market. Currently, the most significant function in this matter regulates the directive adopted in 2006[2]. The directive regards to statutory audit of annual financial statements and consolidated financial statements. It is worth adding, that it is the newest normative act concerning accounting law - important because it deals with the challenges faced by regulators of an economic activity.

The considerations in this essay are based on the assumption that, from the perspective of proper functioning of the internal market, comparability of financial statements of business entities from different EU Member States and comparability of the external audit, both are necessity. One of the elements constituting optimal state of affairs is a high degree of harmonization of legal regulations on accountancy in a strict sense, but also the high degree of harmonization of legal regulations on external audit (financial revision). Concern for the high professional degree of the external audit process requires establishing of legal rules for defining external auditors' normative characteristics. This issue will have an important influence on the quality of information presented and disclosed in financial statements. It is one of the arguments for maintaining the comparability of financial statements of business entities from different EU Member States. It also plays an essential role in the internal market functioning.

[2] Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L 157, 9 June 2006, p.87-107.

EU ACCOUNTING LAW – SYSTEMIC APPROACH

When taking up the issues of EU accounting regulations, one should primarily refer to the matter of reasons that made the EU legislator decide to standardise this field of economic life. Undoubtedly, the main objective of European Union's functioning is the proper operation of the internal market. This market operates thank to the free movement of goods and workers, freedom of establishment, free movement of services and capital. The implementation of those freedoms, from the point of view of the entities engaged in an economic activity, requires adequate information, constituting the basic criterion for making of business decisions. As far as the information on the entities engaged in an economic activity is concerned, the reference to accounting as a system providing such information seems obvious[3]. Thus, the fact of taking up the legal issues of the accounting at community level by the EU legislator should be connected directly with the proper operation of the internal market.

However, if the standardisation of the issues in the accounting field is to produce the anticipated, integrating results, the observance of several fundamental requirements in the field of quality standardisation appears to be necessary. There is no doubt, that a good legal regulation should be characterized by a comprehensive presentation of a particular sphere of socio-economic life, internal cohesion, high degree of quality and, what is specific for the European Union law, a proper instrument for integration of law[4]. The doctrine emphasizes that the stronger the instrument for integration of law is, the better its results achieved from the internal market operation's point of view will be (if the adequate quality of the suggested solutions is assumed). Therefore, a total harmonization directive should be promoted over a minimum harmonization directive, and the regulations over the directives[5]. It is obvious that some spheres of the socio-economic life need standardisation (unification), not just the resemblance (harmonisation), even though the latter is undoubtedly a lot easier politically to achieve.

Currently, the EU accounting law can be systematized into three groups. The first group includes regulations which urge unification by the application of IAS in the preparation

[3]Accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information! [as cited in:] American Accounting Association.

[4] Unfortunately, the European Union performs improper (in technical sense) regulatory policy, characterized by sketchiness, lack of internal cohesion and low degree of competence quality, cf.: F. Grzegorczyk, The Consequences of Imperfect Legislative Policy using the Example of Selected Directives, in: Argumenta Oeconomica Cracoviensia, No 7, 2011, pp. 57-68.

[5] F. Grzegorczyk, Single European market as a factor determining development of consumer law in the European Union, Kwartalnik Prawa Prywatnego (Quarterly of Private Law), volume 4, 2010, pp. 905-946.

of consolidated financial statements by the publicly listed companies and also which accept the possibility of application of IAS in the preparation of annual financial statements by the publicly listed and other companies.[6] This group includes also directives which urge the assimilation of recognition, valuating, presentation and information disclosure principles, enabling the preparation of annual financial statements of all the other entities.[7] The second group of issues concerns the financial auditing and is regulated by the Directive 2006/43/EC. It is generally a minimum harmonization directive. The third group of the rules consists of sectoral regulations determining the accounting law for the chosen categories of entities (especially credit institutions and insurance undertakings).[8]

The outlined view of the EU accounting law may raise certain doubts from the point of view of comprehensiveness. For instance, limiting the obligation of applying unified rules, resulting from the IAS, solely to the preparation of consolidated statements by the publicly listed companies does not seem fully justified. However, the idea to standardize the law in this field should be approved. One of the doubts concerning the comprehensiveness of the accounting law is the possibility of extension by the particular member states the application of IAS during the preparation of financial statements of the companies other than listed companies. Several fundamental questions arise immediately in this context. Does such kind of approach influence the comparability of the information presented and disclosed in the financial statements of the private companies? Is the EU legislator not interested in creating solutions which would increase the comparability of the financial statements of the mentioned entities? Do such entities have, by definition, smaller influence on threatening the safety of

[6] "The Regulation has as its objective the adoption and use of international accounting standards in a Community with a view of harmonising the financial information presented by the publicly traded companies in order to ensure a high degree of transparency and comparability of financial statements and hence an efficient functioning of the Community capital market and of the internal market" art.1 of the Regulation EC no 1606/ 2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards OJ L 243, 11 September 2002 and OJ l 216 , 21 August 2007.

[7] For example: Fourth Council Directive of 25 July 1978 on the annual accounts of certain types of companies (78/660EEC); OJ L 222, 14 August 1978; Seventh Council Directive of 13 June 1983 on consolidated accounts (83/349/EEC), OJ L 193, 18 July 1983) (the mentioned directives have been updated many times, currently the works on the development of a new directive on accounting are in progress – the draft of the new directive is available on the website http://ec.europa.eu/internal_market/accounting/index_en.htm, constituting the fundamental acts of law regulating the principles of preparation, presentation and disclosure of financial statements by the companies; Directive 2012/6/EU of the European Parliament and of the Council of 14 March 2012 on the annual accounts of certain types of companies as regards of micro-entities (OJ L 81, 21 March 2012).

[8] Council Directive of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions (86/635/EEC); OJ L 372, 31.12.1986; Council Directive of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings (91/674/EEC); OJ L 374, 31.12.1991.

business transactions? Globalization of financial markets demands reflecting upon this issue, however the problem goes far beyond the scope of this study.

When concentrating only on the statutory audit, from the perspective of the internal market, the question of the imperfection of the accepted instrument for integration of law should be raised. A directive, and particularly a minimum harmonization directive, can only result in slight resemblance of the matters regulated in legislation of the EU Member States. It is not enough, if the requirements of the internal market are to be treated seriously, since the fundamental issue is the comparability of information on the financial situation of entities operating in different Member States. Such comparability is possible thank to standardized principles of preparation, presentation and disclosure of information in financial statements.

This is the first, however, not the last condition for achieving comparability. The second condition is the functioning of standardized, that is identical (not only similar), standards regulating the audit of financial statements. Such approach assumes using the regulation as an instrument for integration of law and it was not achieved by the EU legislator. As a consequence, we were given a directive (that is, binding tips), which will not change the existing situation of national diversification such important issues as the professional qualifications of external auditors, the rules determining their independence and objectivity or the procedures of conducting the statutory audit. In turn, such state of affairs cannot meet the requirements of the efficiently operating internal market, which was the objective of the adopted rules in the first place.

The question arises, whether it would not be advised to speed up the work over implementation of International Standards on Auditing and International Standard on Quality Control into the EU legislation? Especially, if the Directive 2006/43/EC stipulates, that during the statutory audit of annual and consolidated financial statements the Member States will require the application of the same audit standards from the auditors. It should mean the Standards drawn up by the International Auditing and Assurance Standards Board (IAASB), being an independent body of the International Federation of Accountants (IFAC).)[9] Moreover, in the preamble of the mentioned directive the EU legislator points out the possibility of adopting, under the conditions set forth in the European Union, the international standards of auditing, as stated in the directive.[10] It seems important to establish above

[9] Article 26, para.1 of the 2006/43/EC Directive.

[10] „For the Commission to adopt an international auditing standard for application in the Community, it must be generally accepted internationally and have been developed with full participation of all interested parties following an open and transparent procedure, add to the credibility and quality of annual accounts and consolidated accounts and be conductive to the European public good. The need for the adoption of an

mentioned rules by way of EU regulations, in order to strengthen the unification of these set of rules.

INDEPENDENCE AND OBJECTIVITY OF THE AUDITOR – THE NOTION

The Directive 2006/43/EC is an extensive normative act regulating the issues significant from the point of view of statutory audit of annual and consolidated financial statements. One of the aspects regulated by this Directive are the professional standards for auditors, including the professional ethic, independence, objectivity, confidentiality and professional secrecy. Thus, the EU legislator emphasized the significance of the professional standards for auditors and their effect on the quality of information presented and disclosed in the financial statements. It stresses the role of the auditor as a significant link in the process of ensuring safety of the business transactions.

In this context is appears that the article 22 of the Directive 2006/43/EC, concerning the issue of independence and objectivity of auditors and auditing firms[11], is crucial from the point of view of business transactions safety.[12]

The Directive 2006/43/EC does not regulate the notions of objectivity and independence. However, it should be undoubtedly stated that, when preparing the Directive, the EU legislator utilized the ethical rules established in the professional community of accountants and auditors, included in the Code of Ethics for professional accountants published by IFAC.[13] For that matter, the Code of Ethics should be referred to for the purpose of clarification of the notions in question. In the Code of Ethics the notion of objectivity constitutes one of the five basic principles of the auditor's conduct, next to the honesty, professional qualifications and due diligence, information confidentiality and professional conduct. Independence, on the other hand, is defined in the context of threats that may infringe the compliance with the fundamental principles, which is required from the auditor.

International Auditing Practice Statement as part of a standard should be assessed in accordance with Decision 1999/468/EC on a case-by-case basis. The Commission should ensure that before the start of the adoption process a review is conducted in order to verify whether those requirements have been met and report to member of the Committee set up under this Directive on the outcome of the review." – Directive 2006/43/EC preamble. Cf.: article 26, para.2 of Directive 2006/43/EC.

[11] Substantial solutions presented in the directive, due to the size of the text, will be limited to the issues of independence and objectivity of the external auditor.

[12] Proposal of the Commission, grounds for chapter 5 - Proposal for a Directive of the European Parliament and of the Council on Statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC (COM/2004/0177 final – COD 2004/0065), alike the Opinion of the European Economic and Social Committee (EESC), section 4.3

[13] Handbook of Code of Ethics for Professional Accountants, IESBA, 2012 Edition. Hereinafter referred to as the Code of Ethics.

The objectivity is expressed throughout the actions aimed at making a judgement of professional or economic nature, which is not burdened by the bias, conflict of interests, undue influence of others to override professional or business judgements. [14] The auditor's independence should be perceived as:

- the independence of mind – the auditor has to be free from various kinds of influence distorting his professional judgement, which may affect his honest action, objectivity and maintaining professional scepticism;
- the independence of appearance – the auditor has to avoid the facts and circumstances which would allow the third parties, demonstrating rational thinking, well-informed and possessing the knowledge about all the appropriate information, to come to a justified conclusion, that the honesty, objectivity and professional scepticism were not maintained.[15]

The independence and objectivity are measured by means of the criterion of lack of connections between auditors and the entities undergoing the statutory audit. It is essential for the auditor not to engage in the management decisions if the examined entity or any other activity for the behalf of such entity, which could threaten the auditor's objectivity and independence. In practice, the expert auditor may find himself in unique, difficult to define situations which may affect his objectivity. When performing professional services, the auditor is obliged to, first of all, determine the threats that may affect the maintenance of objectivity, and secondly, to ensure such maintenance. The objectivity maintenance is possible only if the independence is obtained and maintained at the same time.

RECOGNITION OF THREATS FOR THE INDEPENDENCE AND OBJECTIVITY OF THE AUDITOR

The factors threatening the independence and objectivity of an auditor and auditing firms pointed out by the EU legislator include auditing of auditor's own business activity, self-interest, acting in someone else's interest, intimacy, trust, intimidation.[16] The Directive 2006/43/EC allows the occurrence of the abovementioned factors, however it stipulates, that the prohibition to perform the audit will be only then revised, if the intensification of those factors is so strong, that it results in the infringement of the auditor's independence. The obligation to give up the audit constitutes the most radical sanction.

[14]Ibidem, sec.100.5.
[15] Ibidem, sec.290.6.
[16] Cf. art. 22 para. 2 subparagraph 1 of Directive 2006/43/EC. Cf. Handbook of Code of Ethics for Professional Accountants, IESBA, 2012 Edition, Sec.100.12. The factors presented in the Directive coincide with the threats listed by the Code of Ethics (self-interest, self-review, advocacy, familiarity, intimidation).

At this point it should be pointed out, that the Directive 2006/34/EC differentiates the procedures connected with the independence maintenance depending on the type of the entity subject to the statutory audit. In case of entities of public interest the auditors and auditing firms are obliged to inform the Audit Committee about the circumstances and events which may threat their independence.[17] If the entities not being the public interest entities are the ordering party, the auditors and auditing firms will make the decision concerning the maintenance of independence by themselves.

The independence of an auditor conducting a statutory audit of a financial statement of a public interest entity is regulated a little better. Article 22 para. 2 subparagraph 2 of the 2006/43/EC Directive clearly defines that the audit cannot be conducted due to the occurrence of risk of auditing one's own business or the occurrence of self-interest. The EU legislator assumed *ex definitione* that in such cases the auditor's independence and objectivity are threatened. However, why is such a connection obvious only in relation to the public interest entities? Why the same connection is not notices by the EU legislator in case of entities not being the public interest entities? The situation of public interest entities is clearer also due to the fact that the monitoring of auditor's and/or auditing firm's independence is one of the mandatory principles of the Audit Committee (obligatory in such entities).[18]

The basic doubt arises in situations of occurrence of risk factor, which the auditor deems unthreatening to his independence and objectivity. Leaving such a decision to the auditor himself seems to be an improper solution, as it assumes an appropriate ethical conduct of the auditor at all times.[19] Such situation suggests a minimal requirement of informing the public oversight authority about the occurrence of doubts.

The EU legislator adopted such solution because of the existence of specific procedures established in the professional community.[20] It may appear that the procedures established and accepted by the professional community should serve their purpose, however the experience shows that they require a legislative reinforcement.[21]

Taking the above into consideration it should be pointed out that the obligations concerning the independence maintenance by the auditors result from the Code of Ethics, as well as the International Standards on Quality Control and International Standards on

[17] Cf. art. 42 of Directive 2006/43/EC.
[18] Cf. art. 41 para. 2 section d of Directive 2006/43/EC.
[19] It should be remembered that the crises on the financial markets resulted precisely from, among others, the wrong conduct of the auditors.
[20] Directive 2006/43/EC preamble – „Statutory auditors should adhere to the highest ethical standards. (…) The Commission may adopt implementing measures on professional ethics as minimum standards. When doing so, it might consider the principles contained in the International Federation of Accountants (IFAC) Code of Ethics".
[21] In USA – Sarbanes-Oxley Act of 2002, Public Law 107-204, 116 Stat.745-810 (SOX).

Auditing. It is also worth emphasizing that the listed standards refer to the ethical requirements, and the Code of Ethics – to the cited standards.

The Code of Ethics obliges the auditor and auditing firms to separately recognize the threats to independence and objectivity, evaluate them and take definite actions aiming at their elimination or at least restriction to an acceptable level. Moreover, the Code describes the particular circumstances and connections which pose or may pose a threat for independence in case of orders of the audit and review assurance engagements of the financial statements, as well as in case of other assurance engagements.[22] The Code of Ethics does not refer to the independence of persons employed by the auditor, pointing out that the independence of such persons may depend upon the size, structure and organization of the auditor. The auditor, following the principles of the professional ethics, is obliged to determine the rules and procedures allowing to state the independence maintenance by the company, its employees and other persons subject to such requirement (other companies operating in the network and their employees).

The International Standard on Quality Control imposes on the auditor several obligations connected with the maintenance of independence and its constant monitoring.

First of all, the auditor has to establish rules and procedures designed in such a way that he would gain enough confidence that he, his staff and employees of other companies in the network meet the requirement of independence.

Secondly, the auditor is obliged to develop and implement the rules and procedures allowing him to acquire information about the cases of infringement of the independence requirement. The effectiveness of such procedures is determined by the information flow between the auditor, partners responsible for the execution of the order and the hired employees, as well as by the proper manner of gathering of information.

Thirdly, the auditor is obliged to establish the rules and procedures determining the criteria whose fulfilment would require a specific reaction connected with the implementation of protection serving the purpose of reducing to the acceptable level the threat of excessive intimacy in relation to senior executives employed for a long time for the execution of the assurance engagement. The International Standard on Quality Control pays special attention to the audit order for the financial statements of the listed companies. In this scope the auditor is obliged by the Standard to implement the requirement of rotation of a partner responsible for the order, as well as the persons conducting the quality control of the performed order

[22] Handbook of Code of Ethics for Professional Accountants, IESBA, 2012 Edition, sec. 290 and 291.

after a definite period of time. It is worth noting, that the ISQC refers also the entities in the public sector, other than the listed entities. In case of other entities in the public sector, especially those, which because of their size, complexity or the aspects of public interests, have numerous stakeholders, the auditor has to establish the rules and procedures allowing him to acquire information necessary for taking proper actions concerning the quality control procedures with regard to independence. The ISQC recommends the auditors to establish rules and procedures promoting the principle of the rotation of a partner responsible for the order. [23]

Fourthly, the auditor has to, at least once a year, obtain from all of the employees required to maintain independence a written confirmation concerning observance of the independence rules and procedures.

The International Standards on Auditing oblige the partner responsible for the audit to formulate the proposal concerning the observance of independence requirements applicable for a particular order. For this purpose, the partner responsible for the audit has to obtain from the auditor the information which will enable the recognition and measurement of circumstances and connections which may influence the maintenance of independence. Should the infringement of auditor's rules and procedures on independence be recognized, the partner should establish whether they pose a threat for the independence in relation to the order performed. He is also obliged to take appropriate actions eliminating or reducing the threats to independence, or to withdraw from the performance of the order, informing the auditor about this fact. [24]

PROVISION OF SERVICES OTHER THAN AUDIT, REVIEW AND ASSURANCE ENGAGEMENT BY THE AUDITOR VERSUS INDEPENDENCE AND OBJECTIVITY[25]

A threat to auditor's independence can also be posed by the pressure from the owners, partners and management staff of the auditing company on the auditor conducting a statutory audit on their behalf. Article 24 of the Directive 2006/43/EC prohibits putting pressures of any kind on the auditor, and the entities connected with the auditing firms are also subject to this regulation. It seems that the EU legislator accurately noticed the analysed risk factor,

[23] ISQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements, para.21-25.
[24] ISA 220 Quality Control for an Audit of Financial Statements, para.11
[25] By services other than audit, review and assurance engagement we understand e.g. taxation consulting, management consulting, financial management services, book keeping.

however it also has to be mentioned here that the biggest auditing companies are related by capital with the entities providing consulting services (e.g. in the field of accounting or tax law). It can be also concluded from the Directive 2006/43/EC that the basic threat to the auditor's independence is posed by the provision of additional services - that is the services going beyond the auditing activities.[26] The European Commission, aware of the threats created by the provision of additional services by the auditors, announced the conduction of analyses referring to the potential taking of legal measures, aiming at the implementation of a ban on offering any additional services.[27]

However, the European Parliament has not shared the above restrictive position. The Committee on the Internal Market and Consumer Protection emphasized, that the strict delimitation of the auditing and other services than audit, review and assurance engagement should apply only to the entities of public interest, because if referred to other entities results only in the increase of their operating costs.[28] An even more far-reaching approach was formulated by the EP Committee for Economic and Monetary Affairs, in whose opinion the services offered by the auditors should not be restricted only to the auditing services.[29]

It appears that the regulations provided for by the directive constitute a certain compromise between the "liberal" Parliament and "restrictive" Commission, whereby the Commission's approach is the one which should rather be acceded to. Since, if it is deemed accurate that the provision of other services than audit, review and assurance engagement poses a threat to the independence and objectivity of the auditor, the adoption of adequate measures preventing such phenomenon seems to be justified[30].

Maybe the only appropriate solution would be the implementation of the principle of separation of activities (so called ownership unbundling), postulated and already partially accomplished in case of separation of the regulated activities in the power sector. However exotic it may seem to refer the issues of auditing to the regulation of the power sector, yet the identity of the problem prompts such reference. The power sector was thinking about such a

[26] Directive 2006/43/EC preamble, section 11.
[27] Proposal of the Commission, grounds for chapter 5.
[28] Cf. Opinion of the Committee of the Internal Market and Consumer Protection, amendment 1.
[29] Cf. Opinion of the Commission for Economic and Monetary Affairs, short justification, critical analysis.
[30] In Polish law the independence of auditors is guarded by art.56 para. 3 of the act of 7 May 2009 on auditors and their self-government, entities entitled to audit financial statements and public supervision (Dz.U. 2009, no. 77, item 649), it is worth adding, that section 4 of the cited regulation clearly indicates that objectivity and independence are not maintained, if even in one year within the last 5 years, the expert auditor drew at least 40% of the annual income due to the provision of services for the benefit of the entity, for whom he conducted the auditing activities. The regulation in question shows that the state legislator is trying to handle the problem of provision of additional services in the context of independence and objectivity of the auditors, however those solutions are far from perfection.

legal solution, which would be able to ensure independence[31] of the transmission system operator and distribution system operator. In the conclusion the EU legislator stated that the independence of such operator is infringed if he acts within a vertically integrated enterprise (production of energy, and particularly energy trading). After the fiasco of other solutions, the ownership unbundling was finally adopted, resulting in a normative prohibition of conducting by the operators any activity other than the operating activity. Such measures were taken in order to guarantee the independence of the operators[32].

Thus, if the provision of the other services than audit, review and assurance engagement is one of the most significant threats to the independence and objectivity of the auditors, then it might be worth to consider the application of ownership unbundling rules, similar to the ones in the power sector, in reference to the services other than audit, review and assurance engagement of the auditors and auditing companies.

Another element influencing the external auditor's independence and objectivity is a sufficiently frequent rotation (article 42 para. 2 and 3 of the Directive 2006/43/EC referring exclusively to the entities of public interest)[33].

[31] Emphasis added by the authors.

[32] For the issue of unbundling, cf. comprehensive monograph by F. Grzegorczyk, The Electricity Transmission System Operator. Understanding EU Energy Policy, Warsaw 2012.

[33] As envisaged by SOX, the EU legislator ordered the member states to implement a regulation requiring the rotation of so called key audit partner, responsible for the conduction of the statutory audit. The rotation obligation is revised once in 7 years, whereas the possibility of another audit occurs after 2-years' break. The issue of the rotation of expert auditor is controversial. One has to agree with the view of the European Parliament's Commission for Economic and Monetary Affairs, stating that frequent rotation has a positive influence on the auditor's independence. The change of auditor prevents from formation of unfavourable, from the perspective of objectivity, relations between the auditor and the audited entity. However, on the other hand, the members of EU legislation process have pointed out the inconveniences connected with the frequent rotation. The cited argument was the necessity of additional costs borne by the audited entities and the risk of increase in the number of auditor's errors, resulting from the new auditor's unfamiliarity with the audited entity. Moreover, they stated that small enterprises audited by the small auditing companies do not have the financial capacity to change the auditor; they also proposed that the rotation did not concern small and medium enterprises. The Committee on Industry, Research and Energy suggested exceeding the rotation from 5 to 7 years. The Economic and Social Committee went even further in their objection against rotation, expressing the view, that the change of auditor will not contribute to the improvement of audit's quality, but it will result in the loss of experience by the auditors, deterioration of the market situation of small auditing companies and monopolization of the auditing services market by the largest entities. The above views, negative towards the rotation may sound a bit astonishing in the context of almost common agreement on the necessity of rotation. The present regulation is a compromise, however the reasonability of the compromise is to be questioned. On the one hand, the principle of auditors' rotation was implemented, on the other hand – a narrow scope of entities that it encompasses and the period of rotation are the causes of the principle's illusoriness. It is worth emphasizing that 7-years of co-operation between the auditing company and the audited entity is a period long enough to consider as almost natural the formation of bondas infringing the independence and objectivity of the auditor. It appears that such rare rotation is not capable of meet the ratio legis of the regulation, thus the Polish legislator adopted the 5-years' period of rotation, which can be deemed as a small step made in the right direction (art. 89 of the act of auditors).

CONCLUSION

Three essential issues should be pointed out in the conclusion. First of all, this study does not concern all the issues in the field of the external audit regulated by the Directive 2006/43/EC, but only the issue of the independence and objectivity of external auditors. The authors recognized that those are the essential elements from the point of view of the normative characteristics of such entities. Secondly, the European Union's accounting law, in the regulatory sense, shares the imperfections of the European Union's law, as it lacks comprehensiveness and instruments of integration, appropriate from the internal market's perspective. And thirdly, it may be astonishing that compared with the proper diagnosis of essential problems, the proposed substantial solutions appear to be inadequate (the example of rotation or the principles of independence and objectivity).

Despite the fact that the European legislator attempts to take basically right legislative action, the details of these regulations leave much to be desired. In terms of efficient functioning of the internal market, EU accounting law requires more unification and determination, so that it can effectively conduce the freedoms of internal market.

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