

## **Is the Comply or Explain Principle a Suitable Mechanism for Corporate Governance throughout the EU?: the Dutch Experience**

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### 1. Introduction

The consequences of the financial crisis have led to a renewed attention for corporate governance issues and have increased the discussion regarding what constitutes good corporate governance. It is against this background, in order to restore the public's trust in the Internal Market, that the European Commission launched its Green paper on the EU corporate governance framework in April of last year (hereinafter: the Green paper or the corporate governance Green paper).<sup>2</sup> The purpose of the Green paper is to assess the effectiveness of the existing corporate governance framework within the European Union.<sup>3</sup> The purpose of the Green paper is to foster the debate regarding a diverse range of corporate governance issues. These issues include amongst others: the composition, diversity, functioning and role of the management board, the boards role in relation to risk management, the role of shareholders and the way in which their active participation and interest in sustainable and long term performance of the company can be encouraged and the application of corporate governance codes to small and medium sized enterprises.

Another point for discussion which the Commission addressed in the Green paper which specifically triggered our attention concerns the improvement and enforcement of the application of national corporate governance codes. With regard to this last subject the Commission questions the effective functioning of the comply or explain method within the EU corporate governance framework.

In this paper we will discuss the issues raised by the Commission regarding the functioning and the effectiveness of the comply or explain rule in a Dutch context. We will use the Dutch experiences with the comply or explain rule as a test case to discover its effectiveness in a European continental system characterized by a stakeholder model. The comply or explain rule originates from a shareholder model which was traditionally characterized by dispersed ownership. Our research allows us to draw some conclusions with regard to the functioning of this rule throughout the European Union and the measures that could be taken in order to secure its effective functioning.

In the next paragraph we will first elaborate on the origin of the comply or explain principle after which we will discuss some of the potential drawbacks of the use of this principle as they have been described by the Commission in the Green paper as well as in academic literature. In the remainder of the paper these drawbacks will be tested and compared to the experience with the comply or explain principle within Dutch listed companies. From thereon we will make suggestions with regard to

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<sup>2</sup> The consultation on the Green paper was closed on 22 July 2011. The Green paper can be downloaded from the website [http://ec.europa.eu/internal\\_market/company/modern/corporate-governance-framework\\_en.htm](http://ec.europa.eu/internal_market/company/modern/corporate-governance-framework_en.htm). A summary of the received responses and the feedback statement of the Commission can also be found on this website.

<sup>3</sup> Green paper, p. 2.

enhancing the effectiveness of the comply or explain system by designating the important players who could be assigned a more elaborate role in the enforcement of corporate governance codes. These suggestions can also be used to encourage the effectiveness of the comply or explain rule in other legal systems. Our findings will be summarized in the conclusion.

## 2. Background and origin of the comply or explain principle

The promulgation of corporate governance codes within Europe is a national affair and therefore each Member State has its own code(s) of conduct. Nevertheless, the use of the comply or explain principle throughout the European Union is promoted on a European level by Directive 2006/46/EC. This directive requires listed companies throughout the European territory to incorporate a corporate governance statement in their annual accounts. Companies are free to choose the code to which they subscribe but they have to report on the application of the principles of that code within their company on a comply or explain basis.<sup>4</sup> The principle gives listed companies the possibility to either apply the code's principles and best practice provisions or, in case the application of the principles and best practice provisions is not deemed desirable for that specific company, to deviate from these principles and best practice provisions while giving a well reasoned explanation for such deviation. The corporate governance code is complied with if either the standard rules have been applied or if there is a well founded statement setting out the reasons for deviating from those standard principles.<sup>5</sup>

There are several reasons why the use of (soft law) codes in combination with the comply or explain approach is preferable to rules of corporate governance vested in hard law. One of the advantages of the use of codes is their flexibility. The provisions of corporate governance codes can easily be adapted to new developments without the burden of having to go through a lengthy legislative process.<sup>6</sup> Next to that, the use of codes gives the boards of directors, supervisory board members and shareholders the possibility to adjust their corporate governance to the specific needs of their own enterprise. The use of codes leads to a more flexible approach to corporate governance allowing for tailor made solutions. The comply or explain principle recognizes the necessity to deviate when defining what constitutes good corporate governance. It is a recognition of the impossibility to formulate a 'one size fits all' approach in this respect.<sup>7</sup> The members of the management board, of the supervisory board and the shareholders have to jointly agree on the corporate governance approach most suitable for their company.<sup>8</sup> The shareholders are often designated as the ultimate 'watchdog'

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<sup>4</sup> Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings.

<sup>5</sup> I. MacNeil and X. Li, "Comply or Explain": market discipline and non-compliance with the Combined Code', *Corporate Governance* 2006, volume 14 nr. 5, p. 486.

<sup>6</sup> I. MacNeil and X. Li, "Comply or Explain": market discipline and non-compliance with the Combined Code', *Corporate Governance* 2006, volume 14 nr. 5, p. 493-494.

<sup>7</sup> I. MacNeil and X. Li, "Comply or Explain": market discipline and non-compliance with the Combined Code', *Corporate Governance* 2006, volume 14 nr. 5, p. 487; S. Arcot, V. Bruno, A. Faure-Grimaud, 'Corporate governance in the UK: Is the comply or explain approach working?' *International Review of Law and Economics*, 30 2010, p. 194; L. Enriques, H. Hansmann en R. Kraakman, 'The Basic Governance Structure: The Interests of Shareholders as a Class', in: R. Kraakman c.s., *The Anatomy of Corporate Law*, Oxford University Press 2009, p. 67.

<sup>8</sup> S. Arcot, V. Bruno, A. Faure-Grimaud, 'Corporate governance in the UK: Is the comply or explain approach working?' *International Review of Law and Economics*, 30 2010, p. 194. See also the reaction to the Green paper by C. van der Elst en E.P.M. Vermeulen, 'Corporate Governance 2.0: Assessing the Corporate Governance Green Paper of the European Commission', *ECL* 2011, p. 165-174.

with regard to corporate governance rules and their enforcement.<sup>9</sup> It is in principle up to the shareholders to raise their voice if they do not agree with the corporate governance approach set out by the management board. In the Green paper the Commission asks if there is a need to design specific corporate governance measures adjusted to the size of listed companies. Given the flexibility which the comply or explain principle offers, this question seems to bypass the idea behind the comply or explain principle. After all, the principle in itself already allows for deviations from standard best practice provisions taking into account the specific internal structure, size and needs of a particular company. However, this of course does not exclude the fact that it can be useful to formulate specific standard principles which are more suited for smaller companies. The question is, however, whether this is really necessary. That is also the view held by the majority of the respondents to the Green paper. The respondents refer to the flexibility already offered by the comply or explain approach to support their argument that a separate code for small companies is not necessary. They mention that it is desirable to have the same corporate governance standards for all listed companies and not to have certain companies fall within a subcategory. Furthermore, the difficulty to establish “*meaningful size criteria across the EU*” was mentioned as a potential obstacle.<sup>10</sup>

The comply or explain principle originates from the United Kingdom and was introduced for the first time by the famous Cadbury- report in the 90’s of the previous century.<sup>11</sup> This report can be seen as the predecessor of most contemporary corporate governance codes of the EU Member States. The comply or explain principle fits well within the profile of the UK market at the beginning of the 1990s. At that time the UK market was (and to a large extent still is) characterized by dispersed share ownership, the presence of institutional investors, strong financial markets and an influential financial press.<sup>12</sup> Furthermore, the UK market operates within a common law tradition which was already to a certain extent familiar with self regulation<sup>13</sup> due to the fact that the UK Companies Act did not (and still does not) provide many mandatory rules relating to the division of power between the management board and the general meeting.<sup>14</sup> The abovementioned characteristics have led to a system in which enforcement is mainly delegated to the internal decision makers: the management board and the shareholders meeting.<sup>15</sup> The comply or explain principle fits well within such a system. However, over the years the principle gradually spread across Europe with the adoption of national corporate governance codes based on the UK example. This development took place without taking into account the specific characteristics of the system from which the comply or explain principle originated and without adapting it to the special needs of the legal tradition to which it was transplanted. The question is therefore justified whether the comply or explain principle can

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<sup>9</sup> Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, 4 November 2002, this report can be found on [http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf); Study on ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 183.

<sup>10</sup> Feedback statement. Summary of responses to the Commission Green Paper on the EU corporate governance framework, 15 November 2011, p. 5. (hereinafter also: the feedback statement). The statement can be consulted on [http://ec.europa.eu/internal\\_market/company/docs/modern/20111115-feedback-statement\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/20111115-feedback-statement_en.pdf)

<sup>11</sup> See in this respect the study ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 22; N. Haskovec, ‘Codes of Corporate Governance’, *A Working Paper published by the Millstein Center for Corporate Governance and Performance*, June 2012, p. 7.

<sup>12</sup> Study on ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 178.

<sup>13</sup> Study on ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 178.

<sup>14</sup> I. MacNeil and X. Li, “Comply or Explain”: market discipline and non-compliance with the Combined Code’, *Corporate Governance* 2006, volume 14 nr. 5, p. 486.

<sup>15</sup> Study on ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 178.

effectively function within a system that lacks some or all of the abovementioned characteristic features. Does the monitoring and enforcement of corporate governance by way of the comply or explain rule require adjustment in order to be effective within a system with for example concentrated instead of dispersed ownership? Other differences are amongst others the role of institutional investors within the system and the differences in company models. Contrary to the UK, which uses a so called (enlightened) shareholder model as point of departure, many continental systems in which the comply or explain principle is used are build on a continental stakeholder model.

### 3. The effectiveness and potential drawbacks of the comply or explain rule in theory

The suitability of the comply or explain principle as a basis for corporate governance is not questioned at the European level. The study on monitoring and enforcement practices in corporate governance in the EU Member States, published in 2009, revealed that regulators, investors and companies widely support the use of the comply or explain approach.<sup>16</sup> The flexibility and the tailor made approach to corporate governance, which is enabled by the use of the comply or explain principle, are much appreciated features. However, as mentioned in the introduction to this paper, at the European level questions are raised regarding the effectiveness of this system within the EU corporate governance framework and some drawbacks of this approach have also been identified in academic literature. Some of these drawbacks can be traced back to the fact that the comply or explain approach was transposed from the UK to other legal systems without addressing the characteristics of those systems which might have a negative influence on the effectiveness of the comply or explain approach.<sup>17</sup> In order to give recommendations with regard to measures to be taken in order to increase the effectiveness of the comply or explain principle, we will first describe the potential drawbacks as identified in academic literature. One of the things which have been identified as hampering an effective comply or explain approach is the passive position taken by investors. The comply or explain approach relies largely on enforcement by (often institutional) investors.<sup>18</sup> However, not all markets are characterized by such a large amount of institutional investors as the UK. Moreover, investors often remain passive for several reasons. The passiveness can be caused by the free rider problem which investors face. It can be due to a lack of knowledge and/or expertise or a lack of resources enabling investors to overlook all corporate governance issues related to companies within their portfolios. As mentioned above, the comply or explain approach emerged against the background of a shareholder company law model and is therefore oriented towards creating shareholder value. Some authors argue that one of the drawbacks of this system is that, given the fact that the framework is primarily based on shareholder enforcement, there are not many possibilities to include stakeholder interests.<sup>19</sup>

The absence of meaningful explanations when deviating from the best practices of a corporate governance code is also an issue which is designated in academic literature as hampering the proper

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<sup>16</sup> Study on ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 12.; Green paper, p. 18.

<sup>17</sup> Study on ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 12; Green paper, p. 18.

<sup>18</sup> A. Steeno, ‘Note: Corporate Governance: Economic Analysis of a “Comply or Explain” Approach’, *Stan. J.L. Bus. & Fin.* 2005-2006, p. 400; Study on ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 15; Green paper corporate governance, p. 11 and p. 19.

<sup>19</sup> J. Parkinson en G. Kelly, ‘The Combined Code on Corporate Governance’, *The Political Quarterly* 1999, p. 101-107; S. Arcot, V. Bruno, A. Faure-Grimaud, ‘Corporate governance in the UK: Is the comply or explain approach working?’ *International Review of Law and Economics*, 30 2010, p. 195.

functioning of the comply or explain principle.<sup>20</sup> As was mentioned earlier, the goal of the comply or explain principle is to enable companies to make use of a corporate governance form which is most suitable for their organization and to enable them to use an approach which is tailor made and takes into account the specific needs and characteristics of their company. This means that deviations from standard corporate governance best practices are not problematic as long as they have their merit based on the characteristics of the specific organization and are based on proper explanations. However, these explanations in practice are often vague and the reasons for deviating from best practices are often phrased in general terms not enabling shareholders, as the primary corporate governance enforcers, to engage in a meaningful dialogue with the management board.<sup>21</sup> Part of the problem can be traced back to the abovementioned passive position taken by many shareholders. Some authors suggest that shareholders are only willing to take an active stand regarding the chosen corporate governance policy after periods of dissatisfaction and bad corporate performance.<sup>22</sup> Shareholders often use performance as an indicator of a company's corporate governance quality. This means that companies with low share prices which deviate from corporate governance best practices may be punished by the market for such deviations without investors assessing the merits of such deviations.<sup>23</sup> This can even be the case when deviations are in the interest of the company as a whole. If a company wants to deviate from the corporate governance code it runs the risk that its investors do not agree with that view.<sup>24</sup> Therefore it is said that, instead of steering towards a meaningful dialogue between investors and management board regarding the most suitable corporate governance structure, the codes often enhance compliance. The comply or explain principle therefore runs the risk of in effect leading to a 'one size fits all approach'.<sup>25</sup>

Another aspect which has been identified in academic literature as well as in the corporate governance Green paper as having a negative impact on the effectiveness of the comply or explain approach is the presence of a dominant or controlling shareholder. As stated in the previous paragraph, the comply or explain approach emerged out of a system which is traditionally characterized by dispersed ownership.

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<sup>20</sup> Study on 'Monitoring and Enforcement Practices in Corporate Governance in the Member States', 23 September 2009, p. 178; Green paper, p. 18-20. See also with regard to the situation in the UK I. MacNeil and X. Li, "‘Comply or Explain’: market discipline and non-compliance with the Combined Code", *Corporate Governance* 2006, volume 14 nr. 5, p. 489 and S. Arcot, V. Bruno, A. Faure-Grimaud, 'Corporate governance in the UK: Is the comply or explain approach working?' *International Review of Law and Economics*, 30 2010, p. 193-201. See also in this respect N.K. Cankar, S. Deakin and M. Simonetti, 'The Reflexive Properties of Corporate Governance Codes: The Reception of the ‘Comply-or-explain’ Approach in Slovenia', *Journal of Law and Society* 2010, volume 37, nr. 3, p. 501-525.

<sup>21</sup> I. MacNeil and X. Li, "‘Comply or Explain’: market discipline and non-compliance with the Combined Code", *Corporate Governance* 2006, volume 14 nr. 5, p. 490.

<sup>22</sup> See in this respect amongst others I. MacNeil and X. Li, "‘Comply or Explain’: market discipline and non-compliance with the Combined Code", *Corporate Governance* 2006, volume 14 nr. 5, p. 492; S. Arcot, V. Bruno, A. Faure-Grimaud, 'Corporate governance in the UK: Is the comply or explain approach working?' *International Review of Law and Economics*, 30 2010, p. 199 onwards.

<sup>23</sup> L. Enriques, H. Hansmann en R. Kraakman, 'The Basic Governance Structure: The Interests of Shareholders as a Class', in: R. Kraakman e.a., *The Anatomy of Corporate Law*, Oxford University Press 2009, p. 67 footnote 65 with reference to G. Hertig, 'On-going Board Reforms: One Size Fits All and Regulatory Capture', *Oxford Review of Economic Policy* 2005, p. 273-274.

<sup>24</sup> I. . MacNeil and X. Li, "‘Comply or Explain’: market discipline and non-compliance with the Combined Code", *Corporate Governance* 2006, volume 14 nr. 5, p. 487.

<sup>25</sup> L. Enriques, H. Hansmann en R. Kraakman, 'The Basic Governance Structure: The Interests of Shareholders as a Class', in: R. Kraakman e.a., *The Anatomy of Corporate Law*, Oxford University Press 2009, p. 67 footnote 65 with reference to G. Hertig, 'On-going Board Reforms: One Size Fits All and Regulatory Capture', *Oxford Review of Economic Policy* 2005, p. 273-274. See also in this respect P. Coombes en S. Chui-Yin Wong, 'Why Codes of Governance Work', *The McKinsey Quarterly* 2004, nr. 2, p. 53; N. Haskovec, 'Codes of Corporate Governance', *A Working Paper published by the Millstein Center for Corporate Governance and Performance*, June 2012, p. 11-12, p. 17.

However, contrary to the UK, most European continental systems are traditionally denoted as systems with concentrated shareholder ownership.<sup>26</sup> In general it is said that concentrated ownership leads to better governance and a stronger monitoring of the management board.<sup>27</sup> However, even though the agency problem between the shareholders and the management may be smaller, the presence of a controlling shareholder leads to a different kind of agency problem.<sup>28</sup> The interests of the controlling shareholder often do not run parallel to those of the minority shareholders. The controlling shareholder may use (or even abuse) his power within the company to serve exclusively his own interest.<sup>29</sup> Moreover, the minority shareholders often lack the ability to use shareholder power in order to influence the corporate governance structure in such a way that their interests are taken into account. According to some studies the presence of controlling shareholders has a negative impact on transparency and leads to hampered explanations with regard to corporate governance deviations.<sup>30</sup> The controlling shareholder is said to act as an insider who has little reason to make private information public.<sup>31</sup> However, academic literature is not unambiguous regarding the influence of a controlling shareholder on corporate governance. Other research shows to the contrary that there is no direct link between the quality of explanations regarding corporate governance deviations and the presence of a dominant shareholder.<sup>32</sup> It can be argued that within a company with a controlling shareholder a different type of corporate governance is needed, a corporate governance approach with more principles aimed at safeguarding minority shareholder interests. The comply or explain approach does allow for such deviations depending on the internal structure and characteristics of a specific company.<sup>33</sup> It is questionable however, whether or not the minority shareholder can dispose of a sufficient amount of power to demand such deviations.

#### 4. An assessment of the functioning of the comply or explain rule in the Netherlands

In this part of our paper we will assess whether or not the abovementioned drawbacks of the comply or explain approach as defined in academic literature influence the effectiveness of the comply or explain

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<sup>26</sup> L. Enriques en P. Volpin, ‘Corporate Governance Reforms in Continental Europe’, *Journal of Economic Perspectives* 2007, volume 21 nr. 7, p. 117. However, it has to be noted that in our opinion there is not a strict division between markets in terms of dispersed and concentrated ownership. Both types of ownership will be present in each market and the type of ownership will differ from company to company. See also E. Moutahaan, ‘Corporate Governance Reform in the US and EU-Time for a Change’, *European Company Law* 2008, p. 124.

<sup>27</sup> A. Steeno, ‘Note: Corporate Governance: Economic Analysis of a “Comply or Explain” Approach’, *Stan. J.L. Bus. & Fin.* 2005-2006, p. 405; L. Enriques en P. Volpin, ‘Corporate Governance Reforms in Continental Europe’, *Journal of Economic Perspectives* 2007, volume 21 nr. 7, p. 122.

<sup>28</sup> L. Enriques en P. Volpin, ‘Corporate Governance Reforms in Continental Europe’, *Journal of Economic Perspectives* 2007, volume 21 nr. 7, p. 117.

<sup>29</sup> A. Steeno, ‘Note: Corporate Governance: Economic Analysis of a “Comply or Explain” Approach’, *Stan. J.L. Bus. & Fin.* 2005-2006, p. 406; L. Enriques en P. Volpin, ‘Corporate Governance Reforms in Continental Europe’, *Journal of Economic Perspectives* 2007, volume 21 nr. 7, p. 122; E. Moutahaan, ‘Corporate Governance Reform in the US and EU-Time for a Change’, *European Company Law* 2008, p. 124. See with regard to the relationship between majority and minority shareholders also Ronald J. Gilson, ‘Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy’, 119 *Harv. L. Rev.* 2006 1641-1679.

<sup>30</sup> S. Arcot, V. Bruno, A. Faure-Grimaud, ‘Corporate governance in the UK: Is the comply or explain approach working?’ *International Review of Law and Economics*, 30 2010, p. 198 with reference to M. Becht, P. Bolton en A. Roell, ‘Corporate Governance and Control’ in: G. Constantinides, M. Harris en R. Stulz (red.), *Handbook of the economics of finance*, London: Elsevier Science.

<sup>31</sup> S. Arcot, V. Bruno, A. Faure-Grimaud, ‘Corporate governance in the UK: Is the comply or explain approach working?’ *International Review of Law and Economics*, 30 2010, p. 198.

<sup>32</sup> Study on ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 14.

<sup>33</sup> See with regard to the protection of minority shareholders in the Belgian corporate governance code A. Steeno, ‘Note: Corporate Governance: Economic Analysis of a “Comply or Explain” Approach’, *Stan. J.L. Bus. & Fin.* 2005-2006, p. 406 ff.

principle in practice in the Netherlands. We have investigated to what extent three of the abovementioned drawbacks surface in Dutch listed companies, in this respect we have looked at: the alleged passive behavior of investors, the explanations given in case of deviations from corporate governance principles and the functioning of the comply or explain rule in companies with controlling shareholders. The research design for each of these topics will be further elaborated on below. The Netherlands has had 8 years of experience with the mandatory application of the corporate governance code for listed companies on a comply or explain basis. Before presenting the results of our research, we will give a brief overview of the corporate governance framework in the Netherlands, the shareholder structure of the Dutch listed companies and the influence of so-called “administratiekantoren” (Trust Offices) on the shareholder structure. All of these issues are of importance when assessing the functioning of the corporate governance code on a comply or explain basis in the Netherlands.

#### 4.1 Dutch corporate governance framework

On 1 August 2012 the Netherlands counted 106 Netherlands-based companies whose shares are listed on the Euronext Amsterdam Stock Exchange. The market capitalization of these listed companies is around € 430 billion which corresponds with approximately 70% of Dutch GDP. The Dutch listed companies have a more international and dispersed ownership structure than most continental European countries. At the end of 2010, an average of 76% of the shares of the Netherlands-based ‘blue chips’, the most traded companies in the leading stock exchange’s index (‘AEX’), were held by foreign investors, about 50% were investors incorporated in the US and UK. Of the largest Dutch listed companies, only 20% have a controlling shareholder (meaning more than 30% of the voting rights; 30% voting rights is the threshold for the mandatory launch of a public bid for all the shares). Most companies have a largest shareholder who owns between 5 and 30% of the voting rights. However, in these figures, so-called Trust Offices (“administratiekantoren”) have not been counted. Taking these Trust Offices into account will make the analysis of the shareholder structure of Dutch listed companies a bit complex as will be discussed below. Before we get into that, we will briefly explain the role of Trust Offices in this context as they are a typically Dutch phenomenon.

*Table 1: shareholder structure of 20 largest Dutch listed companies (figures on 1 August 2012)*

Largest shareholder	Excluding Trust Offices (depositary receipts)	Including Trust Offices (depositary receipts)
More than 30% voting rights	20%	35%
10-30% voting rights	40%	35%
5-10% voting rights	35%	30%
Less than 5% voting rights	5%	0%

*Source: notification register of the Netherlands Authority for the Financial Markets*

Listed companies can choose to issue all or a large proportion of their common shares to a Trust Office which in turn issues certificates of shares (or depositary receipts) to investors. Only the certificates of shares are listed and can be bought by the public. The certificates of shares do not entitle its owner to voting rights. However, they do entail a right to dividend. Voting rights can instead be exercised by the Trust Office. However, since 2004 Trust Offices are legally obliged to grant voting proxies in non hostile takeover situations (in so-called ‘peacetime’) to holders of certificates of shares who so request. The holders of certificates of shares thus authorised can exercise the voting rights at

their discretion. The Trust Office will exercise the voting rights for those holders of certificates who do not request a proxy to vote. With an average turn-out of holders of certificates of shares of around 50-60%, the Trust Office has still a large influence on the voting outcome. In hostile takeover situations Trust Offices have the legal possibility not to grant voting proxies to holders of certificates of shares. However, the Dutch corporate governance code recommends companies not to make the distinction between ‘peacetime’ and ‘wartime’ situations, so that Trust Offices shall, without limitation and in all circumstances, grant proxies to holders of certificates of shares who so request (best practice provision IV.2.8). 3 out of the 20 largest companies have their ordinary shares transferred to a Trust Office. If Trust Offices are included in the figures (as they on average count 40 to 50% of the votes at general meetings of shareholders), the largest Dutch companies have a more concentrated shareholder structure, although still a majority (65%) does not have a controlling shareholder (table 1).

The boards of Dutch listed companies typically have a two-tier structure: a supervisory board and a management board. The role of the supervisory board is to supervise the policies of the management board and the general affairs of the company and its affiliated enterprise, as well as to assist the management board by providing advice. The role of the management board is to manage the company. In discharging their roles, the management board and supervisory board shall be guided by the interests of the company and its affiliated enterprise, taking into account the relevant interests of the company’s stakeholders. The interests of shareholders do therefore not take priority over the interests of other stakeholders: the Netherlands has a stakeholder model. As a consequence, strategy setting and strategy execution are management board responsibilities, under supervision of the supervisory board. The boards are accountable to the shareholders meeting for setting and executing the company’s strategy, but the shareholders do not have formal rights in this field.

In addition to the Dutch company law framework, the Dutch corporate governance code came into effect in 2004. The code was the Dutch response to the bankruptcies of a number of large Dutch companies (e.g. KPNQwest), some controversial accounting scandals (e.g. Royal Ahold) and the increase in payment packages of some members of the management board. The objective of the code was to improve the checks and balances within listed companies. The code tried to realise this objective by reinforcing the position of the supervisory board and that of the shareholders’ meeting.

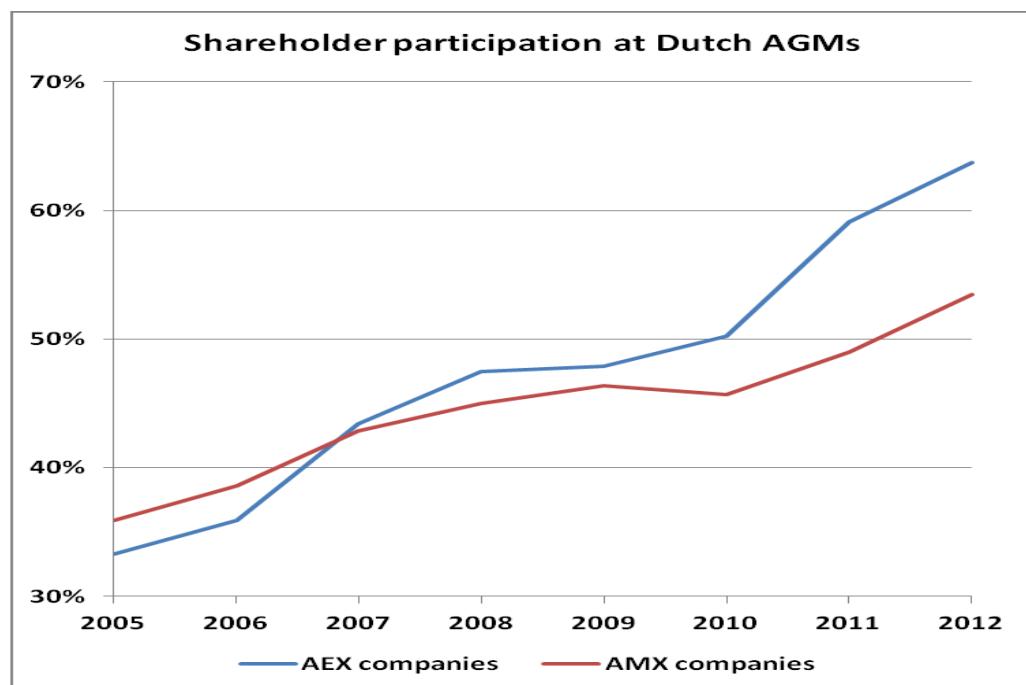
The 'comply or explain' principle has also been embraced in Dutch company law since 2004. Dutch listed companies are required by law to indicate in their annual accounts the extent to which they have observed the principles and best practice provisions of the Dutch corporate governance code. Next to the internal monitoring role given to shareholders and the supervisory board, the enforcement of corporate governance codes is to a certain extent delegated to external monitoring forces such as the external auditor, the Dutch securities supervisor, the Netherlands Authority for Financial Markets (AFM) and the Corporate Governance Code Monitoring Committee. The external auditor has to check whether such a corporate governance statement has been inserted in the annual report and also the AFM supervises compliance with the legal annual report requirements. In addition to these bodies, which ‘only’ check the availability of a ‘corporate governance code compliance statement’, a Corporate Governance Code Monitoring Committee has been set up to monitor compliance with the code. The Monitoring Committee publishes each year a monitoring report, reflecting on the level of compliance by Dutch listed companies in general with the code.

#### 4.2 Shareholder activity

The effectiveness of the comply or explain rule can be deducted from the extent to which shareholders are willing to hold the management board and supervisory board members responsible with regard to the application and possible deviations from corporate governance codes. We have identified three issues from which the ability and willingness of shareholders to actively participate in corporate governance enforcement on a comply or explain basis can be deducted. These three issues are the following: i. the activity of shareholders in terms of voting, raising questions and making comments at general meetings, ii. the willingness of shareholders to place items on the agenda of the general meeting and iii. the willingness of shareholders to start legal proceedings in order to further investigate a company's corporate governance approach. We have looked at the activities of shareholders of Dutch listed companies regarding these three aspects in order to answer the question whether shareholders in practice live up to their role as ultimate corporate 'watchdog'.

It is evident from graph 1 that shareholder engagement with the day-to-day affairs of Dutch listed companies has increased greatly since the Dutch corporate governance code came into being (2004). Growing numbers of shareholders take part in voting on important corporate governance items on the agenda such as the appointment of members of the management board and supervisory board, the discharge of the management and the supervisory board from liability, and amendments to the articles of association.

*Graph 1: average shareholder participation at the annual general meetings of the largest ('AEX') Dutch listed companies and the middle-sized ('AMX') companies*



The Dutch Corporate Governance Code Monitoring Committee had surveys carried out of corporate governance-related shareholder activities at shareholders' meetings over a number of years. Table 2 shows that hundreds of questions were asked every year and comments were made about corporate governance in general and the Dutch corporate governance code in particular. It is interesting to note, however, that the number decreased in 2008. One possible explanation for this may be that five years after the code came into force, most listed companies had ensured that their corporate governance structure was in better shape.

*Table 2: numbers of questions asked and comments made about corporate governance and the Dutch corporate governance code during general meetings at Dutch listed companies<sup>34</sup>*

	2005	2006	2007	2008
Number of questions about corporate governance	-	713	720	522
Number of questions about the Dutch corporate governance Code	400	323	299	177
Comments about corporate governance	-	457	468	367
Total number of questions and comments about corporate governance	-	1170	1188	889

The questions asked and comments made at general meetings about the application of and departures from the Dutch corporate governance code led in a number of cases to the general meeting's rejection of resolutions proposed by the management of the company or to the withdrawal of these proposals. This happened in 2008 for example, to the proposals for changes to the remuneration policies at Philips, VastNed Retail and Corporate Express. The principal objection of shareholders in these enterprises related to the absence of challenging performance criteria in the granting of variable components of remuneration, one of the core principles of the code (principle II.2).<sup>35</sup> In 2011 the general meeting at TNT did not grant discharge from liability to the supervisory board, for reasons including the non-application of best practice provision IV.1.1<sup>36</sup> by TNT Express – the TNT division that was floated on the stock exchange in 2011<sup>37</sup>. In 2010 a proposal from the ING Groep concerning the manner of implementing the revised Dutch corporate governance code was only passed with the 'assistance' of the ING Groep Trust Office. A large majority of the holders of depositary receipts for shares in ING, who themselves took part in the decision-making process on the grounds of a voting proxy from the trust office, voted against the way in which the bank-insurer was intending to implement the code.<sup>38</sup>

Shareholders did not only ask questions about, make comments on and vote on corporate governance proposals prepared by the corporate management, they also took the initiative in placing corporate governance subjects on the agenda in a number of cases. Between 2005 and 2012 shareholders made use of the right to have issues placed on the agenda in a total of forty cases, eighteen of which involved the important corporate governance subjects of the dismissal and appointment of members of the management board and supervisory board.<sup>39</sup> In one case a code provision was explicitly placed on the agenda, viz. the discussion of best practice provision IV.1.1. A shareholder at ASM International asked the management board and supervisory board in 2006 to explain to the general meeting during

<sup>34</sup> Source: the surveys of shareholder activities in 2006, 2007 and 2008 commissioned from Rematch Holding by the Corporate Governance Code Monitoring Committee (can be downloaded at [www.corpgov.nl](http://www.corpgov.nl)).

<sup>35</sup> R. Abma, 'Ontwikkelingen in het aandeelhoudersvergaderingenseizoen 2008', *Tijdschrift voor Ondernemingsbestuur* 2008, no. 5, p.109-117.

<sup>36</sup> Best practice IV.1.1 relates to the procedure for the dismissal and appointment of members of the management board and of the supervisory board.

<sup>37</sup> R. Abma, 'Kroniek van het seizoen van jaarlijkse algemene vergaderingen 2011', *Ondernemingsrecht*, 2011, 74, p. 367-375 (issue 10/11).

<sup>38</sup> R. Abma, 'Kroniek van het seizoen van jaarlijkse algemene vergaderingen 2010', *Ondernemingsrecht*, 2010, 109, p. 526-536 (issue 13).

<sup>39</sup> R. Abma, 'Kroniek van het seizoen van jaarlijkse algemene vergaderingen 2010', *Ondernemingsrecht*, 2010, 109, p. 526-536 (issue 13), with additional information from R. Abma, 'Kroniek van het seizoen van jaarlijkse algemene vergaderingen 2011', *Ondernemingsrecht*, 2011, 74, p. 367-375 (issue 10/11).

discussion of that agenda item why it was not being proposed to bring the articles of association of the company into line with best practice provision IV.1.1. of the Dutch corporate governance code.<sup>40</sup>

A last indicator of shareholder interest in corporate governance subjects is the surfacing of issues regarding the corporate governance structure and the provisions in the Dutch corporate governance code in legal proceedings. Shareholders may take various types of legal action, such as starting an inquiry procedure before the Enterprise Chamber of the Amsterdam Court of Appeal, the court in the Netherlands which specialises in settling disputes between shareholders and the management board of the company. Various stakeholders (e.g. trade unions and shareholders representing at least 10% of the issued share capital or with a par value of € 225,000<sup>41</sup>) may request the Enterprise Chamber an inquiry if there are sound reasons to doubt the policies of the company and/or the conduct of its business. In assessing whether the board's behavior has amounted to 'mismanagement', the Enterprise Chamber also takes into account the extent to which the code principles and best practice provisions are followed. The following lawsuits brought by shareholders are examples of proceedings in which provisions of the code played a role: Versatel<sup>42</sup> (issues including the provisions relating to conflicts of interest), ABN Amro<sup>43</sup> (issues including the provisions relating to the division of powers between the management board and the general meeting, and concerning severance pay) and ASM International<sup>44</sup> (issues including the provisions relating to the procedure for the appointment and dismissal of members of the management board and members of the supervisory board, and concerning the role of the supervisory board).

It may be concluded from the indicators considered above that shareholders in Dutch listed companies believe that corporate governance is an important subject. They asked numerous questions and made numerous comments on and during discussion of this subject at general meetings of shareholders, which sometimes resulted in the rejection of resolutions proposed by the management board and the supervisory board. Shareholders themselves also used their right to put an item on the agenda of general meetings in order to address corporate governance issues. They started legal proceedings in a number of cases, in order to obtain a court ruling in disputes relating to issues including the corporate governance structure of the enterprise in question, and/or the failure to apply provisions in the code. It would appear, therefore, that shareholders have taken good heed of the Dutch Corporate Governance Committee's call in 2003 to exercise the rights available to them (in the general meeting of shareholders and otherwise), including legal action, in the event of deadlock on important corporate governance issues.<sup>45</sup>

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<sup>40</sup> See explanatory notes to agenda item 20 for the general meeting of ASM International on 18 May 2006 ([www.asm.com](http://www.asm.com)).

<sup>41</sup> On 12 June 2012 the Dutch Senate passed a Bill that amends the corporate inquiry procedure. The Bill will a.o. change the access to the inquiry procedure by shareholders of large companies (issued share capital of more than € 22.5 million). At these companies the requesting shareholder needs to hold 1 percent of the issued share capital or a € 20 million interest (market value) in the company. The Bill will enter into force on 1 January 2013.

<sup>42</sup> Supreme Court of the Netherlands [hereafter HR] 14 September 2007, *Jurisprudentie Onderneming & Recht* [hereafter JOR] 2007, 238, legal ground 3.2 and legal ground 4.4.3.

<sup>43</sup> HR 13 July 2007, JOR 2007, 178, legal ground 4.4, and Amsterdam District Court, 29 December 2008, JOR 2009, 26, legal grounds 1.7, 1.8, 1.21 and 29.

<sup>44</sup> HR 9 July 2010, JOR 2010, 228, legal grounds 3.1, 3.4.8, 4.4.2 and 4.5.1 and Enterprise Division of the Amsterdam Court of Appeal [hereafter OK] 14 April 2011, JOR 2011, 179, legal grounds 3.14 and 3.17.

<sup>45</sup> See also Organisation for Economic Co-operation and Development, "Peer review 4: Board Nomination and Election", June 2012, p. 71. (DAF/CA/CG(2012)1/FINAL).

#### 4.3 Soundness of reasons given for instances of non-application of the corporate governance code's best practice provisions

Another critical factor in the effectiveness of the comply or explain rule is the provision by listed companies of serious reasons for non-application of provisions of the code. It is stated in the preamble to the Dutch corporate governance that non-application is not objectionable in itself, but these instances of non-application should be based on “*specific circumstances of the company and its shareholders*” as described in the same paragraph. Non-application must, therefore, have specific and not generic grounds.

In order to express an opinion on the situation in the Netherlands, we have scrutinized the reasons provided for the non-application of a number of best practice provisions, specifically those which are often not applied,<sup>46</sup> i.e.: best practice provisions II.1.1 (maximum period for which members of the management board are appointed)<sup>47</sup>, II.2.8 (maximum severance pay for members of the management board), III.3.5 (maximum period of appointment for members of the supervisory board) and IV.1.1 (requirements for the general meeting to be able to cancel a binding nomination for appointment and/or to dismiss members of the management board and members of the supervisory board). We have made an inventory of the non-compliance and the explanations given for non compliance with the above-mentioned best practice provisions in the financial year 2010 by the hundred largest Dutch listed companies.

*Table 2: nature of the explanations provided by companies that did not apply certain best practice provisions (total number of companies studied: 100)*

	II.1.1	II.2.8	III.3.5	IV.1.1
Generic explanation	13	17	9	9
Maintenance of flexibility	3	7	5	
Specific explanation		2	2	1
No explanation			3	18

*Note: we define “generic explanation” as explanation based on arguments that the Dutch Corporate Governance Committee had already taken into account when drafting the final version of the code, as apparent from the ‘Account of the Committee’s work’ (appendix to the 2003 Dutch corporate governance code) This type of explanation therefore does not specifically focus on the company’s situation.*

*Under “maintenance of flexibility” we classify explanations such as: the relevant provision of the code is applied “in principle” or “in essence”, but the company still wishes to retain the freedom to be able not to apply the provision in specific circumstances.*

*Under “specific explanation” we range explanations that focus on the specific circumstances of the company.*

*The classification “no explanation” means that we have found no explanation for an instance of non-application in the corporate governance paragraph or statement.*

<sup>46</sup> Corporate Governance Code Monitoring Committee, ‘Second report on compliance with the Dutch Corporate Governance Code’, December 2010, table 1, p. 18-19.

<sup>47</sup> We have not classified ‘Existing cases’ ( i.e. terms of office of members of the management board who were already members before the Dutch corporate governance code came into operation in 2004) as non-application, as these cases are sanctioned by the code.

Table 2 shows that only a limited number of companies relate the reasons for deviating from the best practices to the specific situation of the company in question. In the majority of cases in which the code has not been applied either a generic explanation is all that is provided or no explanation whatsoever is given. The latter choice occurs relatively often in the case of non-application of best practice provision IV.1.1, which means that companies are acting in violation of the law.<sup>48</sup>

Our finding on this component is that in the great majority of cases of non-application, the reasons have been formulated in general terms, a disclaimer has been incorporated, or no reasons whatsoever have been provided. This finding confirms the critical comments on the comply or explain rule expressed in the literature, which were discussed in paragraph 3. The lack of explanation does not contribute to the confidence of society, shareholders and other stakeholders in the effectiveness of the comply or explain rule.<sup>49</sup>

#### *4.4 The effectiveness of the comply or explain principle in case of controlling ownership*

We stated in paragraph 3 that the comply or explain rule may prove ineffective within companies characterized by one or more controlling shareholders. In order to investigate this, we examined the reasons provided for non-application of certain specific best practice provisions. These best practice provisions concern: the required level of independence of the supervisory board (best practice provision III.2.1), the period for which members of the supervisory board may be appointed (maximum of 12 years; best practice provision III.3.5) and the functioning of the Trust Office in case depositary receipts have been issued and listed (best practice provisions under section IV.2). These are precisely the provisions for which we would expect to find relatively frequent non-application when controlling shareholders do not take the provisions of the code seriously. We can well imagine that controlling shareholders would want seats on the supervisory board and would consequently be less inclined to comply with the maximum term of office imposed by the code. In addition, we can imagine that the major shareholder in companies that have issued depositary receipts, i.e. the trust office, may find it difficult to relinquish its “power” voluntarily. Let us first look at the composition of the Dutch market in terms of concentrated ownership. In this context, we define a controlling shareholder as a shareholder that holds an interest that is greater than 30%, because the legislature assumes that a party that has reached a percentage on this scale has a controlling interest in a company and has an obligation to make a public offer for all the shares.<sup>50</sup>

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<sup>48</sup> We arrive at 28 instances of non-application of best practice provision IV.1.1, while the Dutch Monitoring Committee arrives at a total of 16 in its monitoring report of December 2010 (for the financial year 2009). This leads us to suspect that the Dutch Monitoring Committee relies only on the corporate governance report provided by the company and that no check is made of whether this report is consistent with other public sources of information, such as articles of association and press releases.

<sup>49</sup> The quality of the explanations of non-application by Dutch companies actually compares favourably with those provided by many companies registered in other EU member states (Study of ‘Monitoring and Enforcement Practices in Corporate Governance in the Member States’, 23 September 2009, p. 14, which can be consulted at [http://ec.europa.eu/internal\\_market/company/ecforum/studies\\_en.htm](http://ec.europa.eu/internal_market/company/ecforum/studies_en.htm)).

<sup>50</sup> Section 5:70 in conjunction with section 1:1 of the Netherlands Financial Supervision Act (Wft). Parties which had a pre-existent controlling interest at the time when this statutory obligation entered into force are exempted from the obligation to make a public offer, as are parties that hold a controlling interest at the moment the shares of the company in question are introduced on a stock exchange ('IPO'). The control threshold stipulated by the legislator does not alter the fact that shareholders with an interest of less than 30% already have actual control over companies with widely dispersed share ownership and limited shareholder participation in the decision-making at shareholders' meetings.

Twenty-six of the one hundred companies surveyed have one or more controlling shareholders, not including trust offices. Fifteen companies have placed (a quantity of) their ordinary shares with a trust office and have only listed the depositary receipts on a stock exchange.

The findings for best practice provisions III.2.1 and III.3.5 are presented in table 3.

*Table 3: number of instances of non-application of best practice provisions III.2.1 and III.3.5 by the 26 companies with one or more controlling shareholders*

	III.2.1	III.3.5
Non-applications	4 (= 15%)	6 (23%)

In the case of the four companies that do not apply best practice provision III.2.1 and that have one or more shareholders with a controlling interest, non-application is also connected with the fact that one or more members of the supervisory board are associated with the controlling shareholder in question. The reasons given for non-application refer to the stipulated rights of the controlling shareholder, or the company's belief that knowledge and experience are more important than independence. A total of ten of the whole population of companies surveyed do not apply best practice provision III.2.1. Of the six companies reporting non-application of best practice provision III.3.5 that are characterized by one or more controlling shareholders, there is one company where the non-application is connected with the fact that the supervisory director who is associated with the major shareholder has held this position for longer than 12 years. As is shown in table 2, a total of nineteen out of the one hundred companies surveyed report non-application of best practice provision III.3.5.

Four (27%) of the 15 companies that have issued depositary receipts for (a quantity of) their ordinary shares report non-application of the provision that the Trust Office will issue proxies to the holders of depositary receipts under all circumstances. In the reasons provided for this non-application, two companies refer to existing legislation and the other two refer to the necessity of protecting the company on account of its size or of safeguarding the confidential nature of the information from customers. These are not company-specific reasons. The other eleven companies have ended the protective nature of the issue of depositary receipts in the last few years.

It may be concluded from these findings that a number of companies with controlling shareholders do indeed fail to apply important provisions intended to protect minority shareholders against the 'power' of the controlling shareholder. It should be noted in this context, however, that this refers to a minority of the companies monitored and that the number of instances of non-application of these provisions is no greater (is actually smaller in fact) than it is within companies that lack a controlling shareholder. In addition, a large majority of the companies which had issued depositary receipts has decided either voluntarily or under pressure from the Dutch corporate governance code to abolish the protective nature of issuing depositary receipts and have themselves curtailed the power of the controlling shareholder by doing so. We therefore see no need to introduce additional rights or best practice provisions aimed at protecting minority shareholders against the controlling shareholder. This opinion is shared by the majority of the respondents to the European Commission's corporate governance green paper.<sup>51</sup>

## 5. Towards a more effective comply or explain principle

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<sup>51</sup> Feedback statement, p. 16.

The analysis in paragraph 4 shows that the shareholders in Dutch listed companies consider corporate governance and compliance with the Dutch corporate governance code to be important subjects. This can be partly contributed to the pressure that has been exerted in the past and that still rests on the shoulders of institutional investors stimulating them to take an active stance with regard to corporate governance issues.<sup>52</sup> Another factor which may have contributed to this shareholder activity may be the easy access to court proceedings and rulings related to the internal governance of companies in the Netherlands. The Enterprise Chamber does take corporate governance practices and principles into account when deciding a deadlock situation between various stakeholders within the company.<sup>53</sup> Despite the active position taken by shareholders, they at the same time are apparently not able to: i) force companies to provide sound reasons for significant instances of non-application of code provisions; and ii) to call companies to account for failing to report an instance of non-application when this non-application has become evident from other sources of information. There is no (statistical) difference in this respect between companies controlled by one or a small number of shareholders and companies with widely dispersed share ownership. We conclude that the absence of reports on non-application and the inadequate solidity of the substantiation for non-application are, therefore, the most important obstacles to the effectiveness of the comply or explain rule in the Netherlands. In this paragraph we will examine whether there are possible ways of eliminating these obstacles. We will successively consider the role of the external auditor, the role of the public supervisor, the strengthening of the role of the shareholder and the extension of the task of the Dutch Corporate Governance Code Monitoring Committee.

### *5.1 Extending the task of the external auditor*

Section 2:393 paragraph 3 of the Dutch Civil Code[DCC] requires the external auditor to examine whether the annual report has been prepared in accordance with the statutory requirements and is consistent with the annual accounts. Section 3c of the Decree establishing further regulations for the contents of the annual report<sup>54</sup> specifies the review of the corporate governance statement by the external auditor. The external auditor must verify whether a listed company has included the following information in its annual report:

- a) a statement on compliance with the principles and best practice provisions of the Dutch corporate governance code addressed to the management board or the supervisory board;
- b) reasons for (intended) non-application of principles and best practice provisions contained in the Dutch corporate governance code.

The Netherlands Institute of Registered Accountants, the Royal NIVRA, clarified in a practical guide<sup>55</sup> that when (some of) the information referred to above is absent, this must be reflected in the auditor's report. The Royal NIVRA distinguishes the following situations in this respect:

- i) there are shortcomings in the annual report, e.g. not all of the code provisions have been applied and the reasons for this have not been included in the annual report;

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<sup>52</sup> The Dutch corporate governance code also contains provisions concerning the responsibilities of institutional investors (principle IV.4). They are required to publish their policy on the exercise of voting rights on shares they hold in listed companies on an annual basis, report on how they have implemented that policy and report on how they have voted. See also Organisation for Economic Co-Operation and Development, "Peer review 4: Board Nomination and Election", June 2012, p. 70. (DAF/CA/CG(2012)1/FINAL).

<sup>53</sup> See also Organisation for Economic Co-Operation and Development, "Peer review 4: Board Nomination and Election", June 2012, p. 71. (DAF/CA/CG(2012)1/FINAL).

<sup>54</sup> Decree of 23 December 2004 establishing further regulations for the content of annual reports (*Stb.* 747). Most recently amended by Decree of 10 December 2009 (*Stb.* 545).

<sup>55</sup> Practical guide 1109, 'De verantwoordelijkheid van de accountant bij de toetsing van in het jaarverslag opgenomen corporate governance-informatie', Royal NIVRA, 11 March 2010.

- ii) the account given of the application of the provisions contains a material misstatement of facts;
- iii) the account given in the annual report with reference to the information on the application of the code provisions contains material inconsistencies with the annual accounts.

The chairman of the Dutch Corporate Governance Code Monitoring Committee writes in the 2010 Monitoring Report that: “*The Monitoring Committee is aware that the auditor’s role in monitoring compliance with the Code by listed companies is unclear. Nonetheless, the Committee calls upon auditors to hold the management board of the company to account if the Code is not complied with (i.e. if it is not applied and no explanation is given).*”<sup>56</sup> The lack of clarity identified by the chairman of the Monitoring Committee may relate to the question of how far the auditor should go in carrying out a review, and specifically when answering the question of whether there is a “material misstatement of facts” if the company does not report non-application of best practice provision IV.1.1 for example (see paragraph 4.2), while the articles of association do not reflect this application. In other words, the question is: should the external auditor not only check whether the annual report contains a corporate governance statement, but also whether the content of this statement is consistent with other sources of information? In our opinion, this should be the case in the example quoted since the omission of this non-application may mislead investors. The presence or dismantling of anti-takeover schemes – increased thresholds for the right of the shareholders’ meeting to dismiss members of the management and supervisory board can be placed in this category – have indeed proven to influence share prices in the past. Correct information on this subject is of material importance for investors. We therefore argue in favour of the external auditor also examining the corporate governance statement for consistency with other public or non-public sources of information known to the external auditor during its regular audit of the annual accounts. An examination of this nature should always take place when information on the (non-)application of the relevant code provision may influence an investor when making an investment decision. In our opinion, a check of this kind follows from the instructions to the external auditor to verify whether the information in the corporate governance statement provided by the company contains a material misstatement of facts.

We are not in favour of the work of the external auditor being extended to also include the verification and assessment of the explanations for non-application of the code provisions. In the first place, a review of this kind would require the external auditor to express an opinion on the quality of the reasons provided, while the preparation of an opinion of this kind would require a separate assessment framework, which is not (yet) available at present. An opinion on compliance with this assessment framework would also be subjective to a great extent, which is not in line with the current role of the external auditor. Furthermore, the external auditor would have to express an opinion on the question of whether, in view of the situation of the company: i) the non-application is justified; and ii) to the extent that there is no non-application, whether the application of the best practice provision does justice to the specific circumstances of the company in question. The comply or explain rule is, after all, intended to facilitate non-application if non-application would lead to better corporate governance under certain circumstances (see paragraph 3 in this context). We do not believe that it is in line with the terms of reference of the external auditor to give an opinion on the organization of the corporate governance structure at the company in question. The external auditor would, in that case, be expressing an opinion on the policy of the management board. We believe that this right must remain

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<sup>56</sup> Corporate Governance Code Monitoring Committee, ‘Second report on compliance with the Dutch Corporate Governance Code’, December 2010, p. 7.

reserved to the supervisory board which, together with the management board, renders account to the shareholders' meeting in this respect.<sup>57</sup>

## 5.2 Extending the task of the public supervisory authorities

As previously mentioned, the AFM verifies whether annual reports of listed companies contain a statement on compliance with the Dutch corporate governance code, as required by section 2a of the Decree establishing further regulations for the contents of the annual report, in conjunction with section 2:391 paragraph 5 DCC. In the Explanatory Memorandum to the Bill introducing public supervision of financial reporting, the legislator comments that the AFM does not verify the contents of the corporate governance statement.<sup>58</sup> The AFM must, however, verify "*whether the contents of this statement are consistent with the contents of the rest of the annual report and with other public information (consistency assessment). The AFM assesses, therefore, whether the content of the statement is consistent, but not whether the content of the corporate governance statement is substantively correct, or whether it demonstrates good corporate governance in the view of the AFM. That is the responsibility of the AGM,*" according to the legislator.<sup>59</sup>

It may be concluded from various AFM Activity Reports on the supervision of financial reporting and also from the jurisprudence, that in every year since the AFM started supervising financial reporting, it has notified a number of companies in writing that there are shortcomings in the corporate governance statement and/or has recommended that the report on compliance with the Dutch corporate governance code should be improved.<sup>60</sup> In view of the passage quoted above from the explanatory memorandum to the bill introducing supervision of financial reporting, we assume that these notifications and recommendations did not refer to the soundness of the reasons for non-application. It is not clear from the activity reports whether the notifications and recommendations referred (in part) to the lack of consistency between the content of the corporate governance statement and other public information, such as the articles of association.

The European Commission has suggested in its Green Paper that it would like to extend the role of public supervisory authorities to include an assessment of the soundness of the explanations (see paragraph 1). It is not clear how the European Commission envisages doing this. In line with our comments in paragraph 5.1, a framework for the assessment of the soundness of explanations will be necessary. Furthermore, the supervisory authority will have to become acquainted with the specific circumstances of the company, if it is to arrive at a substantive opinion on how apposite the non-application is. It is dubious whether a role of this kind is appropriate for a supervisory authority. Here too, the initial question that has to be asked is whether it is advisable for a supervisory authority to be given a substantive role in shaping or assessing the chosen corporate governance structure of listed

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<sup>57</sup> This does not alter the fact that the external auditor may have his own professional views on the quality and effectiveness of the corporate governance structure of the company in question. The consequence of these views could be taken into account in the auditor's opinion and when considering whether an emphasis of matter or other matters paragraph should be included.

<sup>58</sup> *Kamerstukken II* 2005/06, 30 336, no. 3, p. 14 [Kamerstukken: Parliamentary Papers].

<sup>59</sup> On this subject also see J. Dinant, 'Comply or explain; Publiekrechtelijk toezicht op de naleving van de Code Tabaksblat', *Tijdschrift voor Jaarrekeningrecht*, 2007, no. 4, p. 66-71.

<sup>60</sup> See the AFM Activity Reports on Financial Reporting for 2007, 2008, 2009 and 2010, which can be consulted at [www.afm.nl](http://www.afm.nl), and OK 28 December 2007 (Spyker/AFM), *JOR* 2008, 38, legal grounds 3.58. The AFM has sent a total of 22 notifications to listed companies, in which it is stated that there are reasons to doubt the correct application of the reporting standards for the code (ranging from 9 in 2007 to 3 in 2010); also see *Kamerstukken II* 2010/11, 22 112, no. 1220, p. 8.

companies.<sup>61</sup> The European Commission has reached the conclusion in the interim that a role of this kind is desirable in the case of financial institutions.<sup>62</sup> We are extremely dubious about whether this supervision should be extended to non-financial institutions. The structure and implementation of corporate governance at listed companies, including decisions not to apply the best practice provisions of the code, should primarily be and remain a matter for the management board, the supervisory board and the shareholders<sup>63</sup> possibly augmented by a corporate governance code Monitoring Committee established on a self-regulatory basis, which provides recommendations and interpretations (see paragraph 5.4). If defects in corporate governance are discovered, such as the inadequacy of explanations for the non-application of code provisions, we believe that it is preferable for these defects to be repaired by amendments to the internal division of powers within a company - including the options for shareholders to participate in decision-making on the structure and implementation of the governance - than to expect a supervisory authority to be the source of "salvation".<sup>64</sup>

We do believe, however, that the public supervisory authorities could monitor more closely the consistency between the contents of corporate governance statements and other public sources of information.<sup>65</sup> Our findings on the application of best practice provisions III.3.5 and IV.1.1 (see table 2) show that the enforcement of this point by the Dutch public supervisor has not yet produced adequate results. In addition, it is recommended that the public supervisor explicitly discloses to the outside world in its annual activity reports whether the notifications and recommendations sent regarding compliance with the corporate governance code referred to: i) provision of inadequate information in the annual report with regard to the application of the code provisions; ii) inconsistency between the content of the corporate governance statement and other public sources; or iii) inconsistency between the content of the corporate governance statement and the annual accounts.

### 5.3 *Enhancing the role of shareholders*

Shareholders of Dutch listed companies have a number of options at their disposal to call the management board and the supervisory board of a listed company to account for the content of the corporate governance statement. In the first place, they may ask questions to the management and the supervisory board about the application of the code. As remarked in the preamble to the Dutch corporate governance code, shareholders who do not agree with the extent of the company's compliance with the code, or who believe that the reasons given for non-applications are inadequate, may, for example, decide in the general meeting not to discharge the management board and the supervisory board from liability. They may furthermore decide not to adopt the annual accounts, to amend or reject the remuneration policy of the management board, or to dismiss (members of) the

<sup>61</sup> In this context also see P. Davies et al., 'Response to the European Commission's Green Paper "The EU Corporate Governance Framework"' European Company Law Experts, which can be consulted at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1912548](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1912548).

<sup>62</sup> See the European Commission's proposal for a directive published on 20 July 2011 for enhanced capital requirements and better corporate governance for banks and investment firms ('CRD IV'), specifically the proposed articles 86 to 91 inclusive (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0453:FIN:EN:PDF>).

<sup>63</sup> An opinion shared by the Netherlands Minister of Finance in *Kamerstukken II* 2008/09, 31 083, no. 32, p. 25.

<sup>64</sup> J.B.S. Hijink points out for example, that the Spanish supervisory authority has a major role in the monitoring of compliance with the Spanish corporate governance code, while the quality of the explanations given by Spanish companies is much lower than that of Dutch companies. See J.B.S. Hijink, *Publicatieverplichtingen voor beursvennootschappen* (dissertation), Kluwer, 2010, p. 468.

<sup>65</sup> Herein lies the difference with the task of the external auditor (see paragraph 5.1): when assessing consistency, the auditor is also allowed to use non-public sources of information with which he is nevertheless familiar.

management board and the supervisory board. They also have the option of placing the extent of compliance with the Code on the agenda as a point for discussion or as a voting item. They may furthermore request the management and supervisory board to increase the level of compliance by amending contracts of employment for example, and/or by preparing an amendment to the articles of association. Shareholders may also take various kinds of legal action, such as starting an inquiry or annual account procedure.<sup>66</sup> We commented in paragraph 4.1 that shareholders have actually made use of these rights in the last few years. It is dubious, however, whether shareholders' rights should be extended (further) in order to deal with the two defects identified in the effectiveness of the code instrument. With reference to the first defect, i.e. the failure to report instances of non-application that do actually exist, it is our opinion that there are important roles to be played here by the external auditor and the public supervisor (see paragraphs 5.1 and 5.2). We also believe that shareholders have a responsibility of their own to study the available documents thoroughly and to bring inconsistencies to the attention of the management board, the supervisory board and the external auditor, at the general meeting and otherwise, and to ask for clarification. The existing rights of shareholders to address the general meeting of shareholders and to request information suffice. Where the second defect is concerned, i.e. the lack of sound reasons for instances of non-application, we think that putting the corporate governance statement to a vote at the general meeting would give the management board and the supervisory board an incentive to provide better reasons.<sup>67</sup> This applies all the more now that the representation of shareholders at the general meeting has increased greatly in recent years (figure 1). The incentive is greatest when each non-application and reason is put to a separate vote, so that the explicit opinion of the general meeting is asked for every instance of non-application. When the general meeting is not convinced by the reasoning, we believe that the consequence of the failure to obtain approval must be that the management board and supervisory board take measures to end the non-application of the code. It is pointed out in the literature that members of a management board are afraid to deviate from the best practice provisions of corporate governance codes out of fear for being called to account by the shareholders, since it is not clear whether the shareholders will take the same view of instances of non-application (see paragraph 3). We assume that this anxiety on the part of members of management boards will be limited, in the case of Dutch listed companies in any event. Considering the significant shareholder engagement in the Netherlands with the subject of corporate governance (see paragraph 4), it would seem logical to expect that shareholders will approve non-application when the company's management provides cogent company-specific arguments for this and that approval is in the company's interest. Submitting non-applications for a vote to the shareholders' meeting enables a management board to test its decision in advance, so that it does not have to await the market's reaction to the non-application, which may turn out to be negative. The shareholders are requested to form a substantive opinion on the question of whether full application of the code really is appropriate for the company in question, and on the quality of the explanation of the non-applications with the best practice provisions. Their opinion is something from which the quality of corporate governance may benefit, if the shareholders also carry out this task conscientiously. To the extent that a shareholder believes that it is in the interest of the company not to apply one or more best practice provisions, notwithstanding the views of the management board, this shareholder is free to place this matter on the agenda for a shareholders' meeting. If this shareholder succeeds in winning

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<sup>66</sup> Each shareholder of a Dutch listed company has the possibility to request the Enterprise Chamber of the Amsterdam Court of Appeal to order that company to further explain its application of the statutory accounting requirements (section 2:447 DCC).

<sup>67</sup> A number of companies, such as Ballast Nedam, Beter Bed Holding, Fugro, Heineken, ING Groep, Sligro Food Group and Wereld have actually done this in 2005, 2006 and 2010. The corporate governance statements of these companies were approved by the shareholders' meetings, although it should be noted in this context that five of the said companies have a controlling shareholder (either a Trust Office or otherwise).

the support of a majority of the votes casted at the meeting, it is nevertheless dubious whether the management board will follow a recommendation to this effect from the shareholders. The management board has no obligation to do so, in our opinion, since the general meeting has no authority to issue instructions. This is, however, a means by which shareholders can initiate a substantive internal dialogue on corporate governance policy.

#### *5.4 Naming and shaming by the Corporate Governance Code Monitoring Committee*

When the Dutch corporate governance code came into force, the Dutch government appointed a committee, known as the Dutch Corporate Governance Code Monitoring Committee, whose task it is to ensure that the code is up-to-date and practicable.<sup>68</sup> This committee, which is rooted in self-regulation, reports annually on the application of the provisions of the code by listed companies and institutional investors and is intended to identify gaps and ambiguities in the code and to express its opinion in this respect, by formulating interpretations, guidelines or recommendations for example. We believe that the formation of a committee of this kind has contributed to the permanent interest that there has been in the subject of corporate governance in recent years. It has contributed to the ability to provide relatively fast interpretations for ambiguities and consequently, to the development of the code as a ‘living’ document. The formation of the Monitoring Committee has, however, been unable to prevent the defects identified in paragraph 4. The Monitoring Committee itself has acknowledged this and has announced, for example, that it is going to hold companies individually accountable for non-compliance (the absence of an explanation for an instance of non-application) and intends to improve the quality of the explanations for the non-application of code provisions.<sup>69</sup> It is not clear how it wishes to achieve this second objective.

We would like to recommend the Monitoring Committee to disclose the names of the companies that, in the view of the Monitoring Committee, have not provided an explanation for non-application of the code provisions or when the quality of the explanation is not satisfactory (‘naming and shaming’). The potential loss of reputation with investors and customers that may ensue might induce companies to comply with the code or to improve the soundness of the reasons given for non-application. It is important in this context, however, for the Monitoring Committee to develop an assessment framework for monitoring the quality of explanations and also to make this assessment framework public.<sup>70</sup> It should be noted that the Committee would only have to assess the explanations given for non-application and not the soundness of the non-application itself. After all, providing an answer to the question of whether non-application is preferable to compliance with the code is reserved to the management board, the supervisory board and the shareholders. Before the Committee discloses the name of a non-compliant company it will have to become acquainted with the specific characteristics, structure and circumstances of the company in question. It is also important to point out that the Monitoring Committee will have to apply the principle of hearing both sides and will have to give the company the possibility to defend itself before taking it to the ‘Court of Public Opinion’.

### 6. Conclusion

In the Green Paper, the European Commission raises a number of questions concerning the functioning of the comply or explain rule. This prompted us to carry out a further study of the

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<sup>68</sup> Stcrt. 14 December 2004, no. 241, p. 11.

<sup>69</sup> Corporate Governance Code Monitoring Committee, ‘Second Report on Compliance with the Dutch Corporate Governance Code’, December 2010, p. 15.

<sup>70</sup> The Monitoring Committee could, for example, build on the experiment in the 2007 monitoring report to assess the quality of the explanations provided (see Corporate Governance Code Monitoring Committee, ‘Third Report on compliance with the Dutch corporate governance code’, December 2007, p. 33-35).

functioning of the comply or explain principle in the Netherlands. Significant factors influencing the effectiveness of the comply or explain rule referred to in the literature are passivity and lack of interest on the part of the shareholders, the lack of sound reasons for any non-applications of the code and the dispersal of share ownership, in addition to the presence of controlling shareholders. Our study of the effectiveness of the comply or explain rule in the Netherlands has shown, however, that the criticism on the effectiveness of this approach as uttered in academic literature and by the Commission is only true in part for Dutch listed companies. The shareholders in Dutch listed companies have demonstrated, by asking questions and making critical comments, that they believe corporate governance and the Dutch corporate governance code to be important subjects. In addition, companies with one or more controlling shareholders do not score significantly worse for compliance with those best practice provisions also intended to protect minority shareholders against controlling shareholders. What our study does show, however - and this result is in line with the criticism in the scientific literature - is that in a large majority of the cases in which a code provision has not been applied, the reasons have been formulated in general terms, a disclaimer has been incorporated, or no reasons whatsoever have been provided. These defects can be eliminated, in our opinion, when:

- i) external auditors and the public supervisory authorities perform their tasks more stringently and shareholders pay closer attention to the consistency between the content of the corporate governance statement included by the company and other public sources of information, such as articles of association, press releases and explanatory notes to agenda proposals;
- ii) companies put each instance of non-application (and the reasons for this) to a vote at the shareholders' meeting;
- iii) the Corporate Governance Code Monitoring Committee discloses the names of those companies that provide no explanation for the non-application of code provisions or that provide an explanation of unsatisfactory quality. The Monitoring Committee must, however, draft and publish an assessment framework for this purpose.

All of this can be established within the boundaries of the existing legal infrastructure in the Netherlands. Therefore, we come to the conclusion that in the case of the Netherlands there is no need for more regulations or a greater role for the public supervisor, as suggested in the Green Paper.

Our analysis furthermore shows that the comply or explain method can be an effective corporate governance tool also in other jurisdictions which do not all have the same characteristics as the UK system, from which the principle originates. We have seen however that, in order to be effective, some additional preconditions will have to be fulfilled and additional enforcement measures might have to be taken. One of those preconditions is shareholder activity. Efforts undertaken in the Netherlands in order stimulate institutional investors to take an active stance with regard to corporate governance issues seem to have paid off and have resulted in a high level of shareholder activity. Another important factor in this respect is in our opinion access to the court. The possibility for shareholders to start an enquiry procedure at the Enterprise Chamber of the Amsterdam Court of Appeal has enhanced corporate governance developments and has contributed to changing the behaviour of board members, shareholders and external auditors. As we have indicated, the Enterprise Chamber has given rulings on corporate governance issues. In terms of additional enforcement measures, the role of the Monitoring Committee has to be emphasized. The reports of the Committee have contributed to the permanent interest for corporate governance issues in the market. These prerequisites can be supplemented by the abovementioned three additional measures in order to further enhance the effectiveness of the comply or explain rule.