Revision of the Dutch CORPORATE GOVERNANCE CODE

An Overview of the Most Important Changes

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SUMMARY OF THE CODE’S REVISION

Focusing on the governance of Dutch listed companies, the Corporate Governance Code (the Code) provides guidance for effective relationships between the management board, the supervisory board and the company’s shareholders. Governance is about management and control, about responsibility and influence, and about supervision and accountability. The Code was first adopted in 2003 and was amended in 2008. At the request of the parties supporting the Code, in 2016 the Code has been updated for the second time and brought in line with current practice.¹ This document gives an overview of the most important changes from the 2008 Code.

Long-term value creation and the interests of stakeholders

The most important change is the central role given to long-term value creation. Many of the incidents of misconduct that have occurred over the past years – such as accounting fraud, corruption and cartel activity – can be traced back to a business model that focused too much on achieving short-term gains. The cost was passed on to the future, resulting in business losses, a fall in the value of shares, or, in some cases, bankruptcy and the dismissal of employees. For this reason alone, the consequences of decisions and actions for the company’s long-term value creation, and the impact of these on stakeholders, should be given a prominent role in decision-making processes.

Long-term value creation requires management board members and supervisory board members to act in a sustainable way by making informed choices about the long-term viability of the strategy being pursued. To this end, it is essential that the interests of stakeholders are taken into consideration. Companies are expected to safeguard, and assume responsibility for, the environment within which the enterprise operates and upon which it has an impact. The term ‘value’ does not only refer to profit or benefits that can be directly expressed in monetary terms, but also includes other aspects, such as contributing to improving human rights and reducing the impact on the environment.

Another reason for placing long-term value creation centre stage is the tremendous speed with which new technologies, such as robotisation and digitisation, are being developed and altering revenue models. Being aware of, and anticipating, developments that in some cases will take place outside of the company’s traditional sphere of operation is essential in order to realise ambitions, enable opportunities to be seized and prevent destabilisation.

Focusing on long-term value creation is an ongoing process. In a rapidly changing society, we need to stay aware of the ‘here and now’. Depending on the dynamics of the market within which the enterprise affiliated with the company is operating, it may be necessary to make short-term adjustments to strategy. Discussions about larger trends, and asking disruptive questions, will help keep the company on the right track. In some situations, a company may explicitly decide to focus on the short term, for example in the event of a bankruptcy or takeover. However, for listed companies this is more likely to be the exception than the rule.

In the revised Code, long-term value creation forms the starting point for corporate governance. The Code stipulates that the management board should focus on long-term value creation, and take the stakeholder interests that are relevant in this context into account. The way in which the management board goes about putting this into practice must be explained in the annual management report, and will be supervised by the supervisory board.

¹ The parties that the Code is aimed at are represented by the Association of Stockholders (VEB), Eumedion, Euronext, the Federation of Dutch Trade Unions (FNV), the National Federation of Christian Trade Unions in the Netherlands (CNV), the Association of Securities-Issuing Companies (VEUO) and the Confederation of Netherlands Industry and Employers (VNO-NCW). Together they are referred to as the supportive parties of the Code.
Attention to culture

The achievement of value creation is inextricably bound up with the culture within the company and the enterprise affiliated with it. Management board and supervisory board members are expected to create a culture which promotes desired behaviour and encourages employees to act with integrity. By communicating this culture with its corresponding values, incorporating it into the enterprise and maintaining it, guidance is provided in making everyday decisions and monitoring ethical conduct by people in all tiers of the enterprise. Contact between the top of the company and the employees is essential to get an idea of how the culture is experienced within the organisation.

While the Code addresses culture, it is not prescriptive as to exactly what the culture is or should be. It is up to the management board to develop the culture in a way that is appropriate for the company, and to explain this in the management report. The supervisory board also fulfils a supervisory role where the culture is concerned.

A ‘healthy’ culture can reduce the chance of misconduct and irregularities. It remains important however to be alert to signs of such conduct or irregularities. The topic of reporting suspected misconduct and irregularities is featured more prominently and discussed at greater length in the revised Code. It is important that reports can be filed safely, that the reporting procedure is clear and that reports are adequately followed up.

Realising opportunities through conscious risk-taking

Entrepreneurship is realising opportunities by consciously taking risks. Having an adequate risk control system in place is indispensable for this. The Code sets out what is expected of companies in the field of risk management, and how they are to render account of this. It is important for companies to provide insight into the quality of its risk management and control systems. What is new compared to the 2008 Code is that, when reporting on the risk management measures in place, the management board must also look ahead by indicating which material risks may impact upon the continuity of the company. Another new element is that the statement of the management board is not limited to financial reporting risks, but pertains to material risks in general.

Another innovation in the Code is the stronger positioning of the internal audit function, which among other things reviews the design and operation of the risk management system. The supervisory board is involved more closely in the appointment, evaluation and possible dismissal of the lead internal auditor. The basic principle in the Code is that companies should appoint an internal auditor and establish an internal audit department. If a company does not comply with this principle, the supervisory board is expected to assess whether adequate alternative measures have been put in place, and explain why these measures are sufficient.

The role of the external auditor is discussed in the Code from the perspective of management board and supervisory board members. This covers both the procedures for the appointment and evaluation of the external auditor, and the performance by the external auditor of his duties and the nature of the management board’s and the supervisory board’s involvement in this process. The Code does not assign the external auditor an explicit role in complying with the Code. The management board and supervisory board should be able to trust that the external auditor will report his findings as part of his role as the company’s accountant.

Checks and balances

The makeup of the management board and the supervisory board was already set out in great detail in the 2008 Code. New emphases have been introduced in this part of the Code which contribute to the checks and balances, effective corporate governance and independent supervision. A diverse composition of the supervisory board and the management board, both in terms of the male-to-female ratio and in terms of expertise, background and competencies, is a prerequisite for effective management and supervision and, by extension, for long-term value creation. The current state of affairs with regard to the diversity targets should
be described in the corporate governance statement. If the targets have not been achieved, the report should explain which measures will be taken to achieve the targets, and within what time period.

Appointment and succession also impact on the quality of management and supervision. It is essential to develop a sound plan for the succession of management board and supervisory board members which maintains or brings a good balance in terms of expertise, experience and diversity.

The management board members are responsible for implementing the standards stipulated in the Code in practice. Supervisory board members play a crucial role by providing independent and expert supervision. They must be capable of keeping the management board on their toes. The Code has been made slightly more lenient compared with the 2008 Code in terms of the number of non-independent supervisory board members that are permitted to have or represent a shareholding of more than 10%. Share ownership on this scale tends to be a sign of long-term involvement and parallel interests. The independence of the supervision continues to be safeguarded, as the Code still stipulates an independent majority.

Close supervision is also promoted by the supervisory board having an appropriate composition. Instead of appointment of supervisory board members for three four years periods, the basic principle in the Code has been changed into appointment for two four years periods. Reappointment after this is possible for a maximum of a further two two-year periods, and must be justified in the report of the supervisory board. The requirement to provide a justification for reappointments promotes a greater focus on the composition of the supervisory board when a supervisory board member is reappointed after an eight-year period. Given the speed at which society is changing and new developments in technology and the corresponding business models are taking place, more frequent changes in the supervisory board can be expected.

Companies increasingly work with an executive committee, which tends to be made up of members of senior management and members of the management board of the company. The number of directors has often been reduced to two: the CEO and the CFO. The executive committee fulfils an important role in the management board’s decision-making, while the members of senior management fall outside the scope of direct supervision by the supervisory board. The design of an executive committee is often dependent on the specific characteristics of the company. To guarantee an appropriate system of checks and balances, the Code has been amended to stipulate that the competence of the management board and their provision of information to the supervisory board must be safeguarded. Supervisory board members are expected to pay specific attention to the dynamic and the relationship between the management board and the executive committee.

**Responsible remuneration**

Even more than previously, the Code is predicated on personal responsibility on the part of management board and supervisory board members. Setting out requirements in too much detail may detract from and discourage self-reflection as to the design and operation of governance. The principles and best practice provisions have been formulated in a principle-based way as much as possible, so that management board and supervisory board members are encouraged to find an appropriate way to fulfil their responsibilities. This approach is reflected in the section of the Code that deals with remuneration. The number of provisions on this topic has been reduced compared with the 2008 Code, and is less detail-oriented. The Code has returned to the core principle – that the company’s remuneration policy must be clear and understandable. A transparent account must be rendered of the remuneration that is ultimately awarded.

The Code does not stipulate any explicit requirements with regard to the amount of remuneration. It does, however, address aspects that play a role in establishing and awarding remuneration and rendering account of this. When determining the amount and structure of remuneration, supervisory board members are expected to outline the extent to which the remuneration is in keeping with the envisaged long-term value
creation of the company and the social context within which the enterprise operates. A new requirement is that the supervisory board must also take into consideration the management board member’s own views in determining the amount and structure of their remuneration. Each management board member is expected to critically reflect on their own remuneration from a broad perspective, by considering factors such as the performance of the company, the pay ratios within the company and the appropriate ratio between the fixed and variable remuneration components.

Another change compared to the 2008 Code is transparency about the ratios between the remuneration of management board members and employees. The monitoring report on compliance with the Code in the 2011 financial year reveals that 67% of companies have already anticipated this by including a statement in their management report confirming that they have taken internal pay ratios into consideration, even though the 2008 Code does not specifically prescribe this. Transparency about internal pay ratios is already common practice in the UK and the US. The EU is expected to adopt regulations on this topic in the near future.

The role of the shareholder
The part of the Code that deals with the relationship with shareholders has been carried over from the 2008 Code virtually unchanged. Although some principles and best practice provisions would benefit from freshening up, the Committee currently prefers not to implement any substantive changes. This is for the reason that a lot of developments are currently under way at the European and national levels with regard to the position and rights of shareholders, the outcome of which remains unclear. It makes more sense to hold off on any changes until this wider context has fully taken shape – especially in order to prevent a seemingly simple change in the text from inadvertently having far-reaching consequences, legal or otherwise.

The achievement of long-term value creation requires patient capital. Shareholders have a personal responsibility in this. How shareholders can be encouraged to move in that direction is a question that merits closer reflection – for example about what it takes to get shareholders to be more patient when quarterly figures are disappointing, and what links in the chain play a role in this. Clarity about how value is being created and about the company’s objectives may give shareholders the necessary confidence and promote patience. An ongoing and constructive dialogue between the company and its shareholders is indispensable in this context.

One-tier boards
The Code is aimed at companies with a two-tier board. Chapter 5 deals with the applicability of the Code to companies with a one-tier board, where there is one management board comprised of both executive and non-executive directors. Compared with the 2008 Code, the relevant principle and best practice provisions for one-tier boards have been formulated more clearly in a number of areas. Although currently only 10% of companies have a one-tier board structure, their number may increase in the future. As a general rule, the provisions in the Code that pertain to supervisory board members apply to non-executive directors, without prejudice to the other responsibilities these non-executive directors may have.

Scope of and compliance with the Code
The Code applies to listed companies, which vary in terms of their size and the markets they serve. Unlike legislation, the Code explicitly gives companies the scope to depart from the principles and best practice provisions stipulated, as it operates according to the ‘comply or explain’ principle. This means that listed companies should apply the principles and best practice provisions, or provide reasons as to why they are opting not to do so in specific cases. A sound explanation is therefore essential for the Code to be effective. For this reason, the quality requirements for this explanation have been set out more clearly in the Code.

Change in the structure: from functional to thematic
The new structure of the Code is the final important change which needs to be explained in greater detail. Since the introduction of the Code in 2003, its chapters have been divided according to function. The various
Responsibilities were discussed in the principles and best practice provisions for each body of the company. With this revision, the structure has shifted from functional to thematic: the focus is on the topics to be addressed, with the Code explaining who fulfils which role within these areas. The thematic structure provides greater insight into the interaction and relationship between the management board and the supervisory board, and encourages an integrated approach to the topics. In addition, the Code must be viewed in the context of the relevant legislation and case law on corporate governance. The key principle in this revision was to avoid overlap with the relevant legislation as much as possible, and be in line with international practice.

In closing
Since 2003, the Code has played an important part in the corporate governance of Dutch listed companies, gaining a firm footing in corporate governance regulation. The Code provides guidance regarding the division of responsibilities within a company. In doing so, it facilitates cooperation between the various parties involved. However, this is only possible if there is broad-based support for the principles and best practice provisions set out in the Code. Only then will those involved be willing to put the Code into practice, and can mutual trust be strengthened.