CORPORATE GOVERNANCE COMMITTEE

Letter from the Chairman

Background

1. Corporate governance is a subject that has been much discussed in the Netherlands in the last few years. The debate in the Netherlands was undoubtedly initiated by the Corporate Governance Committee (known as the Peters Committee, after its chairman), which was established in 1996. The report published by the Committee in 1997 – entitled 'Corporate Governance in the Netherlands: the 40 Recommendations' – made an important contribution. In 1998 this report was discussed by virtually all listed companies during their AGMs. In the same year, the legislator used some of the recommendations in the report as a guideline for legislative proposals, and the report was also cited in case law. The recommendations in the report have since become generally-accepted views in the Netherlands. In an evaluation of the corporate governance developments between 1997 and 2002, published on 18 December 2002 ('Corporate Governance in the Netherlands: the present position'), the Dutch Corporate Governance Foundation concluded that progress had been made in the field of corporate governance in the Netherlands in the past five years. However, further progress is desirable. One of the recommendations of the Foundation was therefore to draw up a new code of best practice, as well as a system for monitoring compliance.

2. No clear definition of what corporate governance precisely entails can be found. In its work, the Committee based itself on the description put forward by the Peters Committee: 'Governance is about managing and supervising, about responsibility and control, and about accountability and supervision. Integrity and transparency play a major role in this respect'.

3. In the recent past, various developments have increased the interest shown in good corporate governance both nationally and internationally. First of all, companies are making increasing demands on the international capital market for the financing of acquisitions and other activities. As the shareholders of Dutch listed companies become more and more international, it is necessary for these companies to render account for their policies in accordance with internationally-recognised standards. Second, a spate of insolvencies of large companies and various accounting scandals has prompted the question of whether the system of supervision and accountability of those who determine company policy is properly regulated. Doubt has arisen among capital market participants and the public at large about the probity of management board members, supervisory board members and external auditors. Finally, there is a growing realisation that the corporate governance structure within a company can influence its performance. This means that the investment decisions of institutional investors increasingly reflect the corporate governance structure.

4. In many countries, these developments have led to new corporate governance initiatives, both on the part of the business community and the stock exchange authorities, and on the part of government. For example, proposals have been made in the United Kingdom at the request of the British Minister of Trade and Industry by Derek Higgs (' Review of the role and effectiveness of non-executive directors') and Smith (' Audit Committees - Combined Code Guidance') to supplement the Combined Code of Corporate Governance. The British Minister of Trade and Industry also instituted a consultation process on the remuneration of directors on 3 June 2003 ('Rewards for Failure': Directors' Remuneration - Contracts, Performance and Severance). In France, the existing corporate governance code, as developed by the Viénot Committees I (1995) and II (1997), has been updated by the Bouton Committee. In Germany, 2002 saw the development of the 'Corporate Governance Kodex' and the introduction of legislation to facilitate this code. And in the United States the Sarbanes-Oxley Act came into force on 30 July 2002. This Act is the most substantial item of federal legislation on corporate governance for listed companies in the United States. The SEC, the American stock exchange regulator, is currently engaged in formulating provisions to implement this Act. The New York Stock Exchange and the American screen-based exchange NASDAQ have drawn up their own corporate governance listing rules, which have now been submitted to the SEC for approval.

5. The Organisation for Economic Cooperation and Development (OECD) recently decided to evaluate guidelines for corporate governance drawn up in 1999, and, where necessary, to modernise them. The results of the evaluation are expected in 2004. The European Commission published its communication entitled 'Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward' on 21 May 2003. This contained a proposal for a plan of action to modernise the European company law directives and to develop a number of corporate governance initiatives. The proposal for the plan of action is based on the recommendations of the High Level Group of Company Law Experts published on 4 November 2002. One of these recommendations was that each member state of the European Union should draw up a national corporate governance code with which listed companies should comply, failing which they would have to indicate the reasons for non-compliance with certain parts of the code.

6. Against the background of the developments described above, the Confederation of Netherlands Industry and Employers (VNO-NCW), the Netherlands Centre of Executive and Supervisory Directors (NCD), the Association of Securities-Issuing Companies (VEUO), the Association of Stockholders (VEB), the Foundation for Corporate Governance Research for Pension Funds (SCGOP), and Euronext Amsterdam took the initiative, at the invitation of the Minister of Finance and the Minister for Economic Affairs, of establishing a new corporate governance committee in December 2002. The function of the committee was to draw up a code of best practice in the field of corporate governance. The new Corporate Governance Committee was established on 10 March 2003 (see annex 3 of the draft code for the composition of the committee).

Procedure of the Committee

7. It was suggested to the Committee in its terms of reference (see annex 2 of the draft code) that it should base itself on the recommendations of the Peters Committee. These recommendations could be updated, clarified, tightened up and possibly supplemented, partly in the light of the present practice and the legislation and regulations already in existence or shortly to be introduced, and partly in the light of international developments. The new code should be principal-based rather than rule-based. It should also be in keeping with international developments. In developing the code, the Committee should take account of the existing statutory framework of Dutch company law, and treat the legislation currently under development as given. This would be subject to the proviso that if the Committee encountered specific problems, for example involving facilitation of parts of the code, it should be free to make recommendations for legislation.

8. In accordance with these terms of reference and the accompanying parameters, a small Committee working group started to analyse a number of topics shortly after the Committee was set up. These topics were: (i) the experience gained of the forty recommendations of the Peters Committee in the period from 1997 to 2002; (ii) the international trends and best practice developments in the field of corporate governance (partly by reference to the international initiatives referred to in sections 4 and 5), and (iii) the relationship between management board, supervisory board, audit committee, the internal auditing process and the position of the external auditor.

9. The analyses formed the starting point for the discussions on the corporate governance code to be drawn up. During its work, the Committee listened carefully to the ongoing public debate on corporate governance and aspects of corporate governance. In accordance with its terms of reference, the Committee focussed on the role and functioning of the various organs of the company: i.e. the general meeting of shareholders, the management board and supervisory board, without detracting from the position of other stakeholders such as employees. Therefore, social and environmental aspects were not considered.

Aim of the Committee

10. The aim of the work of the Committee has been to align the Dutch rules and practices on corporate governance with the best rules and practices in the Western world. It should be emphasised that the Committee has not endeavoured to copy a given model. Indeed, the Committee had no wish to detract from the central tenet of Dutch company law, namely that in carrying out their duties, the management board and supervisory board should (a) be guided not by the interests of a particular group of stakeholders, but by the interests of the company and its business and (b) weigh the relevant interests accordingly.

11. The Committee has endeavoured to strengthen the structure of checks and balances in Dutch listed companies, in particular by clearly defining both the powers and the responsibilities of the different organs of the company and its business, as well as the powers and responsibilities of the external auditor in this respect. This is in order to guarantee the timeliness, completeness and correctness of the external financial reporting. In this way, the work of the Committee can help to restore the confidence of investors in the honesty and integrity of the internal operations of companies.

Content of the code

12. The activities of the Committee have so far resulted in a draft code. The text of the draft code was adopted by the Committee on 27 June 2003. The draft code is divided into: (i) principles (i.e. generally-accepted principles of good corporate governance, which must be complied with by all listed companies) and (ii) more specific 'best practice' provisions (listed companies should indicate in their annual report that they endorse and apply these provisions and, if not, explain why not).

13. The Committee has decided to divide the draft code into five chapters and three annexes: (I) the position and functioning of the management board; (II) the position and functioning of the supervisory board; (III) the functioning of the general meeting of shareholders; (IV) the audit of the financial reporting and the position of the external auditor; and (V) disclosure, compliance and enforcement of the code. Annex 1 contains a summary of recommendations for the legislator and 'accounting standards setters'. Annex 2 contains the Committee's terms of reference and annex 3 its composition.

14. In the chapter covering the position and functioning of the management board, the Committee has focused in the first place on clarifying the responsibility of the management board to control the risks connected with the objects of the company and the strategy for achieving these objects. The internal risk management and control system is an important link in the corporate governance structure between the management policy and objects of the company on one hand, and the actual deeds of the company on the other. In the opinion of the Committee, a good corporate governance structure can only be made operational if there is an effective internal risk management and control system. The Committee has proposed that the operation of the internal risk management and control system should be reported on annually. It has also paid considerable attention to measures designed to remove doubts about the integrity of management board members. The Committee has drawn up standards relating to, among other things, the structure of the remuneration package of management board members, and the procedure to be followed when granting the different remuneration components. The Committee has also considered the question of whether it is still socially desirable to base the severance compensation for management board members on the so-called 'sub-district court formula'. The length of service is an important factor in determining the amount of compensation under this formula, which is frequently applied by sub-district courts when dealing with cases of termination

of employment. The Committee considers that a management board member has a special relationship with the company, for which he also often receives a special level of remuneration. The Committee therefore believes that, whereas the sub-district court formula may be applied to other staff, it should not be the basis for determining the amount of compensation to be received by management board members. The Committee also makes numerous recommendations for increasing the transparency of the remuneration policy pursued and yet to be pursued by the supervisory board. To promote integrity in business life, the Committee also proposes some rules to regulate conflict-of-interest situations.

15. In chapter 2 the Committee has included provisions on the supervisory board. These provisions are designed to strengthen and clarify the role of supervisory board members in exercising supervision. The function of supervisory board members is to ensure that management board members perform their duties properly. The Committee proposes ways of improving the quality and expertise of the supervisory board members. These proposals include a tighter definition of the independence of supervisory board members, limits on the number of non-executive directorships that can be held by a supervisory board member, obligations to follow induction and training programmes and arrangements for preparatory work to be carried out by committees established from members of the supervisory board. As in the case of management board members, the Committee makes proposals for regulating conflict-of-interest situations involving supervisory board members.

16. Chapter III deals with the position and powers of the general meeting of shareholders as an organ of the company. The basic premise is that the general meeting must be able to function as a correction mechanism where management and supervision fail. For this purpose, it is necessary to strengthen the position of the general meeting of shareholders. If the general meeting is to fulfil its role as a correction mechanism, it is essential that the shareholders make greater use of their rights. A substantial increase in the participation of shareholders in decision-making at general meetings is necessary. The Committee therefore makes various proposals to utilise current technological developments in order to increase the participation of shareholders and promote remote voting by shareholders. The Committee expresses the hope that the measures will produce the same effect in the Netherlands as they have in the United Kingdom, where the number of votes cast during the general meeting of shareholders rose from 35% to 55% between 1994 and 2002[1]. If the participation of shareholders in the decision-making at general meetings of Dutch listed companies increases substantially, the reason for issuing depositary receipts for shares (namely to ensure that decision-making in the general meeting of shareholders is not dependent on the chance presence of shareholders) will decline. The Committee makes a number of proposals for regulating the issue of depositary receipts for shares. In order to strike a new balance in the decision-making at the general meeting of shareholders of companies that have issued depositary receipts for shares, and against the background of the modern principles

[1] The Economist, *Shareholder activism; Herding fat cats*, 3 May 2003, pp. 34-35.

of good corporate governance, the Committee proposes that the power of the management of the trust office be limited, that the management of the trust office be made independent of the company and that the interests of the depositary receipt holders be given priority in the exercise of the voting rights. The Committee recommends that depositary receipts should not be employed as an anti-takeover measure.

17. After extensive consultations, the Committee has decided not to formulate best practice provisions on the admissibility of anti-takeover measures in the event of (hostile) takeover bids. Since the future of the company is at stake in such no-holds-barred situations, the Committee considers that they should be regulated by law. Self-regulation by means of a corporate governance code is too weak for this purpose, and therefore unsuitable. Moreover, there is no best practice governing anti-takeover measures in the Western world: almost every country has its own forms of legal and economic anti-takeover measures for listed companies. In short, there is no level playing field for international takeovers. From this point of view too, a national code is not suitable for resolving this issue. The issue should be dealt with internationally. Within this context, the Committee does not wish to anticipate the results of the negotiations in the European Council of Ministers and the European Parliament regarding the proposal for a takeover bids directive. However, the Committee has included a provision requiring disclosure of existing and potential anti-takeover measures and the conditions on which they may be used.

18. Chapter IV deals with the external financial reporting. The Committee expects the proposed obligation for listed companies to report on the basis of the International Financial Reporting Standards of the International Accounting Standards Board will promote the national and international comparability of financial reporting. The financial report forms the basis on which the management board and the supervisory board render account of the policy they have pursued. In addition, the reports provide support for decisions, since they are an important instrument for those deciding whether to enter into, continue, alter or end legal relations with the company. In view of these functions, it is of great importance for the stakeholders that financial reporting should be reliable. For this purpose it is necessary to have good internal procedures in the company. These procedures ensure that all important financial information is known to the management board, so as to guarantee the timeliness, completeness and correctness of the external financial reports. The management board ensures that the financial information from corporate divisions and subsidiaries is reported directly to it and that the integrity of the information is not compromised. The supervisory board should check this. The Committee also proposes that the external auditor should be involved in the adoption of all external financial reports, although this should not compromise his independence.

19. Finally, proposals are made in chapter V to limit the freedom to decide whether or not to comply with the corporate governance code. The Committee proposes that listed companies should explicitly describe the outline of their corporate governance structure in a separate chapter of their

annual report, partly on the basis of the principles listed in the code. Companies should also expressly indicate the extent to which they comply with the corporate governance code and, where applicable, why and to what extent they do not comply. This means that the chapter on corporate governance (a) should be audited by the external auditor in the same way as the rest of the annual report and (b) will fall under the system of supervision of financial reporting by the Authority Financial Markets (AFM), which is shortly to be introduced. Within this context, the Committee is of the opinion that that the said supervision should be limited to checking (a) that the annual report includes both a chapter describing the broad outline of the company's corporate governance policy and a declaration on compliance with the corporate governance code and (b) that the description and the declaration are mutually consistent. It follows that there should be no substantive check by the Authority Financial Markets. It is ultimately up to the shareholders, if they so wish, to call the management board and supervisory board to account regarding the content of the chapter on corporate governance and the declaration on the corporate governance code. The content of the chapter on corporate governance and the declaration on compliance with the corporate governance code can be raised each year in the general meeting of shareholders, for example during the discussion about the annual report. If it so wishes, the general meeting of shareholders may take the conclusions of the corporate governance chapter into account in the agenda item on the discharge of the management board from liability for its conduct of the company's affairs and on the discharge of the supervisory board from liability for its supervision.

20. Under its terms of reference, the Committee may make recommendations about the existing statutory framework or current draft legislation if it encounters specific problems, for example regarding facilitation of parts of the code, which can only be resolved by means of legislation. The Committee has discovered several such problems. These problems relate, among other things, to the legal status of management board members upon dismissal under Dutch employment law, the position of the general meeting of shareholders in relation to important management decisions, the regulation of the issue of depositary receipts, compliance with the code and the possibilities for shareholders to vote electronically and to communicate with the company and other shareholders. The Committee makes recommendations for the legislator in annex 1 of the draft code.

21. In annex 1 of the draft code, the Committee proposes that the courts should have the power to dismiss management board members and supervisory board members who publish misleading financial information, and to bar them from holding such office for a given period of time. This idea anticipates the proposal of the European Commission to include such a provision in a European directive in the medium term. This provision could already be included in the bill being prepared in the Netherlands for the supervision of external financial reporting of institutions that issue securities. The Committee would like to see a debate on this proposal, and therefore welcomes reactions.

22. In summary, the draft code may be regarded as a further elaboration of - and addition to - various recommendations of the Peters Committee, partly in the light of the recent events that have discredited management board and supervisory board members. For example, unlike the general recommendations of the Peters Committee, the code defines the independence of supervisory directors, describes the role and function of committees of the supervisory board, defines more closely the required expertise and composition of the supervisory board and lists conflict-of-interest situations. In the light of the recent public debate on 'fat cat pay (rewards for failure)', the code includes a large number of provisions on the structure of the remuneration package of management board members, which go further than the recommendations of the Peters Committee. As a result of the recent accounting scandals, the Committee has devoted considerable attention to the relationship between the management board, the supervisory board, the internal auditing process and the position of the external auditor. This has resulted in a number of concrete provisions in these fields. In order to strike a new balance between the management board, the supervisory board and the general meeting of shareholders, the Committee also intends to strengthen the position of the general meeting in a number of respects, thereby ensuring that it can fulfil its role if management and supervision fail. Finally, the Committee goes further than the Peters Committee by choosing a form of institutionalised supervision of compliance by listed companies. Unlike the Peters Committee, the Committee also makes a number of recommendations for amendment of the statutory rules, including statutory implementation of the 'comply or explain' rule.

Variety of companies

23. Good corporate governance cannot be achieved by a single model that fits everyone. Different approaches are needed for companies of different size, in different stages of development and having a different degree of internationalisation, different shareholder structures and a different history. It follows that departures from individual best practice provisions by a company may very well be justified. The company should, however, provide reasons for the non-compliance in its annual report. For example, some of the best practice provisions of the code would be difficult to implement for the small caps (the companies listed on the local market of Euronext Amsterdam) owing to their size and available capacity. However, this does not mean that these companies should not comply with the principles of good corporate governance, as formulated.

24. Corporate governance must therefore be made to measure. A surfeit of new legislation could have a paralysing effect and even be counter-productive. Good corporate governance is primarily the responsibility of the organs of the company. Within this context, the Committee has formulated general principles and criteria for proper corporate governance standards. In doing so, it has remained as far as possible within the statutory framework and within the ambit of the corporate governance bills currently under consideration by Parliament. The corporate governance code should be regarded as an addition and supplement to the existing statutory framework. The advantage of a code is that it is more flexible than legislation, especially at a time when major

changes are taking place inside and outside companies. There is also a growing need in the capital market for rapidly-adjustable standards for management board members, supervisory board members and shareholders. The Committee calls on the legislator to facilitate the use of the code, and to adjust the code fairly regularly to take account of new developments. The responsible Ministers should, in the opinion of the Committee, establish a small panel to examine, on an ongoing basis, whether certain best practice provisions should be modified or extended. Where necessary, this panel could also ask one or more experts to prepare changes to parts of the code.

Consultation

25. The Committee would like to receive reactions to the content of the draft code before adopting the final version of the code. These reactions should be received by the secretary of the Corporate Governance Committee before 5 September 2003 at P.O. Box 20201, 2500 EE The Hague or by e-mail at R.Abma@minfin.nl. Unless expressly prohibited, the comments received by e-mail will be published on the website of the Corporate Governance Committee at www.commissiecorporategovernance.nl. The Committee awaits reactions with interest.

26. The Committee is of the opinion that this code represents a significant leap forwards for the Netherlands in the field of corporate governance. It would once again point out that the pace of developments – both inside and outside companies and in the capital markets - is such that regular amendment of the code is desirable and necessary.

Yours sincerely,

Morris Tabaksblat
Chairman Corporate Governance Committee