SWEDISH
CORPORATE
GOVERNANCE BOARD

COULD EXPANDED REGULATION OF CORPORATE GOVERNANCE PREVENT NEW CRISES?

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Summary

Within the EU, there is an on-going discussion about corporate governance of stock exchange listed companies, with some far-reaching consideration of broader and tighter regulation. The issues involved include the role of the board of directors and the auditor, companies' risk management procedures and the exercise of shareholder power, but there is also a more fundamental discussion concerning self-regulation and the system of corporate governance codes based on the principle of comply or explain.

The Swedish Corporate Governance Board is concerned by this development, not only with regard to the maintenance of a strong, dynamic cadre of Swedish listed companies based on private ownership in a market economy, but also the defence of the role of self-regulation in the securities market. In the opinion of the Board, any regulatory system which is too far-reaching and insufficiently adapted to Swedish conditions risks damaging the dynamism and competitiveness of listed companies to the detriment of growth and the creation of new jobs in the Swedish economy.

However, these discussions are still at an early stage, and there is probably still room for member states and individual organisations at national level to influence the direction of any new regulation. The aim of this paper is to focus the attention of the Swedish government and other key stakeholders on the ongoing process and to urge consideration of a concerted Swedish response to counter any form of regulation that is not in the interest of the Swedish business community and society as a whole. The potential for a common Nordic approach to the subject might also be considered.

The Board is happy to participate in any continued discussion of these issues.

The ongoing discussion within the European Union

In the wake of the economic crisis, the EU Commission's DG Internal Market and Services has worked extensively to expand the regulation of corporate governance within the Union. This has resulted in recommendations on remuneration within the financial sector and of directors of listed companies; changes to a number of EU Directives to further regulate remuneration in the financial sector; a green paper on corporate governance within the financial sector; and a green paper on company audits. Another green paper on corporate governance of stock exchange listed companies is currently being prepared and is expected to be published in April 2011.

The material that has been made available so far and the discussions that have taken place at hearings and seminars on the subject of the upcoming green paper indicate that the Commission is considering a substantially expanded, and to a larger extent mandatory, regulation than previously. The issues under discussion can be divided into four main themes.

The exercise of shareholder power and the interplay between the board and the shareholders' meeting

The engagement of institutional owners in companies and the way they discharge their shareholder role is currently the subject of lively debate in the EU. A whole host of ideas and suggestions for increasing shareholder influence and facilitating the exercise of their ownership role in an active, informed manner have been presented. Many of these would hardly present any problems for Sweden, as shareholders in Swedish listed companies already have extensive rights and engage relatively actively in their ownership role. The type of regulation being discussed would to a great extent, however, be perceived from the Swedish perspective as unwarranted and unnecessarily prescriptive

The role of the board, its composition etc.
As well as issues concerning the tasks and responsibilities of the board, the Commission is considering limiting the size of boards and the number of directorships board members may have; requiring a certain degree of diversity and competence in the composition of the board, including greater gender balance; the use of external expertise to assess the work of boards; and the evaluation of chief executive officers. In addition, further regulation of the remuneration of board members is being considered, though much of this has already been implemented in Sweden, either through legislation or the Swedish Corporate Governance Code. There is also the question of whether a particular code of conduct for board members is required to assist them in the discharge of their responsibilities.

Risk management and the role of the auditor
In this context, measures to improve companies' procedures concerning risk management are also being discussed, e.g. the mandatory creation of a risk committee within the board and a requirement for companies to have a chief risk officer at executive level, possibly reporting directly to the board. Furthermore, there is discussion of the role of the auditor in the management of the company's risks, including the consideration of a requirement on the auditors to report to supervisory authorities in certain situations.

The role of self-regulation
Since the new Commission began its work at the start of 2010, the system of codes based on the principle of comply or explain, which to a great extent has provided the foundation for the development of corporate governance within the EU in recent decades, has been called into question. Instead, proposals involving more mandatory regulation with stricter supervision and tougher sanctions have been presented.

The Board is concerned about this development, particularly as the EU's regulation in this area is largely based on the Anglo-Saxon model of corporate governance, which differs in important ways from the Swedish/Nordic model. This means that the new rules are often poorly suited to Swedish circumstances. They also risk limiting the scope for the type of self-regulation within corporate governance that has so far been applied with considerable success in Sweden and other Nordic countries.

Against this background, the Board believes it is vital that Sweden considers the following issues in the continuing discussion of expanded EU regulation of corporate governance.

Expanded regulation is no guarantee against future crises

Corporate governance is basically about creating systems and procedures to ensure that companies are run in the interests of their owners, that the systems are well structured and that the governance is as transparent to the market and society as is feasible. The primary aims are to provide better opportunities for shareholders to exercise influence and to ensure that good governance contributes to the successful running of the company.

Poor corporate governance in the financial sector is frequently said to have played a significant role in the causes and development of the financial crisis, though this has not so far been substantiated empirically to any great extent.[1] What we see now, not least in the ongoing debate within the EU, is that this notion is being applied without much opposition to listed companies in general, and there is even less evidence to support this. There is certainly no shortage of individual cases in which poor corporate governance can be identified as one of the causes of the problems, but in the majority of cases, the difficulties encountered by companies had other causes: the withdrawal of credit, the collapse of markets and a global recession – often in combination with a lack of business acumen and bad management. But there is little systematic evidence that it was companies with poor corporate governance – or companies acting under weak corporate governance regimes – that were hit hardest by the crisis, which should be the point of departure if it is the regulatory framework that is to be changed.

Many people also have exaggerated expectations of what can be done to prevent the failure of individual companies and avert economic crises through greater regulation of corporate governance. It is unrealistic to believe that good corporate governance can act as a guarantee against commercial failure. Key success factors for good business such as business acumen, sound judgement, strong leadership and personal integrity cannot be brought about by regulation. Instead, unnecessarily detailed attempts to prevent such problems through binding regulation run the risk of creating an illusion of strong action and may even counteract its aims by resulting in unclear responsibilities or overly complex decision making processes.

There is also good reason to draw attention to the danger that further comprehensive additions to EU conform regulation of members states' differing corporate governance legislation will lead to an impenetrable flora of mutually incompatible laws and rules to be applied in different jurisdictions by people who often have limited business experience and no personal responsibility for the financial consequences.

Shareholders' rights and responsibilities must not be eroded

The market economy system is founded on free enterprise, where individual entrepreneurs are given the opportunity to set up and run companies in order to achieve their aims in the manner they consider the most appropriate within the framework provided by society. The rights of the owners and their associated responsibilities play a key role in this system. If company owners' rights to

[1] For an example, see Mülbert. P.O.: *Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms*, ECGI Law Working Paper No. 130/2009, April 2010.

control their property are limited too greatly, there is a danger that the creativity, initiative and ambition that are the foundations of the market economy's unique capacity to create wealth will be inhibited. In the longer term, such a development might also reduce the incentive for private owners to work proactively and take responsibility for their companies and thus force society to assume this responsibility.

The latest crisis has certainly shone the spotlight on the problem of "too big to fail" more brightly than ever before, particularly with regard to banks and other financial institutions, but in some case other types of company as well. This in turn has been seen as a reason to question whether the owners of such companies always have the will and the ability to assume their full proprietary responsibility in accordance with the rules of the market economy and if that might in some cases justify the state stepping in to assume some of this responsibility. This is a problem that concerns very few companies however, primarily within the financial sector, and a general set of regulations to rectify the problems of a small group of companies risks causing great damage to the vast majority of stock exchange listed companies.

In this perspective, there is good reason to pay close attention to certain aspects of the regulations now being discussed within the EU. These include rules for the composition of boards, their size and how their work is organised, as well as how various functions within companies are organised and run and how the role of shareholders is to be discharged. In the green paper on auditing mentioned above, there is also a proposal to transfer the responsibility for appointing auditors of listed companies from the shareholders to an external party, e.g. a supervisory authority.

The Board believes that many of these proposals, and especially if all are taken together, may lead to an erosion of proprietary rights and thus by extension an erosion of the owners' responsibility for listed companies, with potentially damaging consequences for the workings of the market economy.

In defence of Swedish self-regulation

In some EU circles, there is a belief that self-regulation is too toothless an instrument for the effective regulation of corporate governance. In particular, the system of codes based on the principle of comply or explain has recently been called into question, with increasing calls for more mandatory regulation and tougher sanctions.

Legislation and other binding regulation, however, can only define minimum levels for what is acceptable corporate governance, a threshold that all companies must clear at all times. Codes based on comply or explain, on the other hand, can set the bar higher and define not only what is acceptable, but also what is good – and even very good – corporate governance. Hence they can impose a level that not all companies will be able to attain at all times, or even have reason to attain, but one which provides a goal at which to aim.

It is therefore the opinion of the Board that a combination of legislation and self-regulation, in the form of a code based on the principles of comply or explain, is the most effective system for regulating corporate governance. Laws and other mandatory regulations set minimum requirements, while the code provides motivation for companies to develop and improve their corporate governance beyond these levels. In this respect, the development within Swedish corporate governance in recent years provides a case in point.

Against this background, it is vital that Swedish self-regulation within the field of corporate governance can be retained and developed further. Every attempt to turn back the clock should be strongly resisted.

Maintaining the competitiveness of listed companies

Swedish and European companies are competing in increasingly global markets, not least with companies from the emerging economies of the “new world”. This competition is growing ever tougher, and there are signs that Europe is beginning to fall behind. At the same time, companies from these new markets are often considerably less encumbered by different kinds of regulation than their western competitors.

Listed companies also find themselves in competition for key resources such as capital, technology and management competence with other models of company ownership, not least private equity companies. Such companies normally face less burdensome regulatory requirements in areas such as accounting, financial reporting and corporate governance than listed companies. There is a danger that this will reduce the competitiveness of listed companies when trying to attract the strategic resources necessary for their operations, which might in turn reduce the incentives for growth companies to list their shares on the stock exchange.

In the long run, such a development threatens access to strong and dynamic listed companies for risk capital in search of investment opportunities. This may in turn inhibit economic growth and hold back the creation of new jobs. Recent studies[2] suggest that the relatively weak market for IPOs on the American stock market in the last decade may have resulted in over 20 million fewer new jobs being created in the American economy.

Against this background, it appears counterproductive from a societal point of view to place regulatory burdens on Swedish and European listed companies without thorough justification, as these may lead to reduced competitiveness, both in global product markets and in relation to companies whose ownership form makes them unavailable for investment from the broader public. The opinion of the Board, therefore, is that the benefit to society of each new regulation must be carefully weighed against the costs that may be incurred as a result of reduced competitiveness for listed companies. The benefit-to-cost ratio requirement of any proposed new regulation should be set at a high level, with the burden of proof lying with those who advocate the regulation.

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[2] See Weild, D. and Kim, E., Grant Thornton LLP: *A wake-up call for America,* November 2009, and *Market structure is causing the IPO crisis – and more*, June 2010 respectively.