Manual Corporate Governance

SCGOP

Contents

Foreword

Pension funds strive to protect the benefits of their members as effectively as possible from the consequences of inflation. They therefore invest part of their assets in shares. But the accounting scandals over the past few years have severely damaged investors' confidence in shares. Rebuilding this trust is now a high priority everywhere. Pension funds and other institutional investors are expected to contribute to this rebuilding process.

In the Dutch Corporate Governance Code presented by the Tabaksblat Committee on 9 December 2003, the role of the shareholders is described as follows:
"The general meeting of shareholders should be able to exert such influence on the policy of the executive board and the supervisory board of the company that it plays a fully-fledged role in the system of checks and balances in the company." Giving such influence to the general meeting of shareholders is partly the task of the executive and supervisory directors and partly the task of the legislator. It is then up to the shareholders and particularly the pension funds and the other institutional investors to make the next move. The Code states that the shareholders must participate fully in the decision-making at the general meeting of shareholders. The Code also includes the principle that it is in the interest of the company that as many shareholders as possible should take part in the decision-making at the general meeting of shareholders.

Because some pension funds realised much earlier that an improvement in corporate governance leads to a better risk-reward profile for the respective company, they established the Foundation for Corporate Governance Research for Pension Funds (SCGOP) in March 1998. SCGOP has since then assisted the affiliated pension funds in improving the governance of listed companies. Because SCGOP endorsed the conclusion that a number of sticking points remained in this area at the end of 2002, it willingly assisted with the establishment of the Tabaksblat Committee.

On the assumption that companies and the legislator will implement the tasks assigned to them by the Code in accordance with the intentions of the Tabaksblat Committee, SCGOP will be pleased to support the pension funds and other institutional investors in fulfilling their role as shareholders. To this end it was necessary to update the Corporate Governance Manual published by the Foundation in 2001, bringing it into line with the principles and best practice provisions of the Dutch Corporate Governance Code. I am confident that the new version of the Manual will enable pension funds and other institutional investors to play their part in the much-needed rebuilding of confidence in financial markets and companies.

P.P. de Koning, Chairman.

04

1 The mission of the Foundation for Corporate Governance Research for Pension Funds and the purpose of this manual

Pension funds invest large sums of money on behalf of their members in securities of listed companies. One of the factors determining the value of those investments is the quality of the company's corporate governance. The governance of a company is therefore one of the risk-reward factors which an investor must take into account.

Corporate governance is the term used to describe the practices applied by a company in dealing with the stakeholders directly involved with the company and its business, in particular executive and supervisory directors and providers of capital.

These practices are gradually being laid down in rules for good governance and supervision and rules on the allocation of tasks, responsibilities and powers leading to a balance of influence among those involved with the company and its business. A key principle in this regard is that executive and supervisory directors must account for the performance of their tasks.

The Foundation has the task of enabling affiliated pension funds to monitor and critically assess the governance of the companies in which pension funds invest, and where desirable to help improve it.

The Foundation applies the principle that companies must comply with both the letter and the intent of rules on corporate governance.

The Foundation fulfils its task out of a conviction that a proper system of corporate governance promotes the effective operation of companies and hence contributes to a higher return and/or a lower risk. Against this background, the Foundation's mission is as follows:

The mission of SCGOP is to act on behalf of its members in conducting research into and promoting improvements in the governance of listed companies, particularly in the Netherlands, out of a conviction that in so doing it will improve the risk-reward profile of the companies in question.

In that context, the Foundation promotes and funds research into corporate governance characteristics in relation to financial performance. Such research was begun in 2002 by Prof. G. Mertens (Erasmus University, Rotterdam), together with Messrs D. Dejong (University of Iowa), A. de Jong (Erasmus University) and C. Wasley (University of Rochester). This research will be completed in the course of 2004.

In 1999, Prof. D. Duffhues conducted an initial investigation into the use of option schemes. He completed a follow-up investigation in 2003.

SCGOP also acts as a facilitator and consultation partner. In its role as a facilitator, it provides a platform for discussion on matters relating to corporate governance. The Foundation provides members with regular information which they can use for their own policy development. For example, it provides an alert service, keeping members up to date with the latest developments in Dutch listed companies which may affect the rights of shareholders.

SCGOP is a consultation partner for national and international organisations which are of importance for the development of thinking on corporate governance and for policymakers at national and international level. The Foundation provides these organisations with both solicited and unsolicited advice. It expresses its viewpoint through its chairman and director.

In publishing this manual, SCGOP aims to provide a concise account of what corporate governance means in practice and why the subject is of great importance for pension funds. The Foundation hopes that this manual will help existing and potential members to formulate and implement their corporate governance policy.

2 Corporate governance in practice in the Netherlands

Corporate governance relates to the management and control of companies, to responsibility and participation and to accountability and supervision. Integrity and transparency play a major role.[1]

The principle applied in the Netherlands is that a company is a long-term form of collaboration between the various parties involved. The stakeholders are the groups and individuals who directly or indirectly influence (or are influenced by) the achievement of the aims of the company: employees, shareholders and other providers of capital, suppliers and customers, but also government and civil society. The executive board and supervisory board should take account of the interests of the different stakeholders.[2]

Indirectly, present and future pensioners are increasingly dependent on the value created by listed companies in the long term. These pensioners should therefore be included among the stakeholders who need to have confidence that their interests in the company are being protected.

"Good entrepreneurship, including integrity and transparency of decision-making by the executive board, and proper supervision thereof, including accountability for such supervision, are essential if the stakeholders are to have confidence in the executive board and the supervision. These are the two pillars on which good corporate governance rests." So said the Tabaksblat Committee at the end of 2003.[3]

The origins of the discussion on corporate governance in the Netherlands can be traced back to the discussion which took place in 1986 in response to the report of the Van der Grinten Committee between the Stock Exchange Association (VvdE), which was then responsible for the operation of the stock exchange, and the Association of Securities-Issuing Companies (VEUO), an organisation specially established for the purpose. Initially this discussion only covered the nature and extent of the anti-takeover measures used by listed companies to ward off unwelcome takeover bids.

Ten years later, the two associations reached an agreement providing for a twin-track approach. The legislator would have responsibility for anti-takeover measures in ‘wartime’, and the associations would establish a separate committee to deal with ‘peacetime’ events.

And that is what happened. On 7 November 1997 a bill ‘enabling the Enterprise Chamber to take special measures concerning control of public limited companies’ was laid before the lower house of the Dutch parliament. It has remained there since pending the issuance of a new 13th EU directive, on which an agreement was reached at the end of 2003.

[1] Corporate governance In Nederland, De Veertig Aanbevelingen (1997), p. 9.
[2] De Nederlandse Corporate Governance Code, Beginselen van deugdelijk ondernemingsbestuur en best practice bepalingen (2003), p. 3.
[3] Idem

On 25 June 1997 the Corporate Governance Committee, chaired by Jaap Peters, issued the final version of its report entitled 'Corporate governance in Nederland: de veertig aanbevelingen' (Corporate Governance in the Netherlands: the Forty Recommendations).

The following year companies were required to tell their shareholders how they had complied with these forty recommendations and a year later a monitoring report was published providing a snapshot of compliance. At the end of 2002 the Dutch Corporate Governance Foundation, chaired by Jaap Peters, published a report entitled 'Corporate governance in Nederland 2002: de stand van zaken' (Corporate Governance in the Netherlands 2002: the state of affairs).

Five years after the publication of the forty recommendations, the state of affairs was found to be unsatisfactory. Companies had tended to anticipate and react to new legislation rather than comply with the forty recommendations of their own accord. Moreover, companies' reactions did not only produce positive changes. A revised code with tight supervision of compliance was considered necessary: "Because five years after the publication of the first corporate governance report in the Netherlands, the conclusion must be drawn that the task of improving corporate governance cannot be left to the corporate sector alone."[4]

In the meantime, the 1997 report had inspired new legislation:[5]

- Article 2: 101/210, paragraph 3 of the Civil Code now states that approval of the annual accounts does not amount to the granting of discharge to an executive or supervisory director.
- The bill on the two-tier board system includes a right for shareholders (or certificateholders) to place items on the agenda. If they represent an interest of 1% or € 50 million, they may place an item on the agenda of the general meeting (provided it is submitted 60 days in advance).
- The same bill gives certificateholders a voting right (in peacetime) and allows shareholders to express their view on major changes in the nature and size of the company.
- Shareholders have also been given more say on the appointment and dismissal of supervisory directors.
- Article 2: 119 of the Civil Code now allows use of the record date system, so shares no longer have to be blocked if shareholders wish to exercise their voting rights.
- With regard to the remuneration of individual executive and supervisory directors, a legal provision has been in force since 1 September 2002 imposing compulsory disclosure.
- Executive and supervisory directors must also submit a return of their shareholdings to the Financial Markets Authority. This information is maintained in a public register.

[4] Corporate governance in Nederland, de Stand van Zaken (2002), p. 42.
[5] In a number of important judgments the Enterprise Chamber of the Amsterdam Court of Appeal referred to ideas which are found in the report of the Peters Committee.

In a report to the European Commission entitled 'A Modern Regulatory Framework for Company Law in Europe', a High Level Group of Company Law Experts has also recommended that each member state should be required to draw up a national corporate governance code. Listed companies would have to comply with this code or disclose any parts of it with which they were not in compliance. "Furthermore, there have recently been scandals, particularly accounting scandals, involving companies in both the United States and Europe. These scandals have, to some extent, undermined confidence in the management and supervision of companies that operate in the financial markets. A sound and transparent system of checks and balances in companies would be an important means of boosting confidence in companies that operate in the capital markets. Following 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), Euronext and the Foundation for Corporate Governance Research for Pension Funds (SCGOP) requested a number of people to sit on a new Corporate Governance Committee, at the invitation of the Minister of Finance."[6]

The Corporate Governance Committee was established on 10 March 2003. Under the chairmanship of Morris Tabaksblat, the committee presented a draft Dutch corporate governance code on 1 July 2003 and a final version on 9 December of the same year.

As the starting point for its work, the Tabaksblat Committee took the forty recommendations of the Peters Committee from 1997. The Tabaksblat Committee's agenda would have to include the following:

- The position of the individual supervisory board member and the functioning of the supervisory board.
- The actual exercise of the rights of shareholders and the functioning of the general meeting of shareholders.
- The functioning of the executive board.
- The relationship with and the role of the auditor in the companies.

The Tabaksblat Committee discharged its duties within the specified period and drew up a code of best practice provisions. To ensure that the code enjoys greater compliance than the Peters Committee's recommendations, the intention is that the legislator will use an order in council to designate the code as a code of conduct, to which companies must refer in their annual report. Companies will also be required to state to what extent they are complying with the provisions of the code.

[6] Terms of reference of the new corporate governance committee, press release by the Ministry of Finance, 10 March 2003.

In order to update the code in the future in line with social developments, the Tabaksblat Committee has recommended that the Ministers of Finance and Economic Affairs set up a panel to rule on any necessary adjustments to the code.

The Committee has also made other recommendations to the legislator concerning legal changes to facilitate a number of best practice provisions.

The above appears to indicate that, after a somewhat faltering start, corporate governance is now set to remain on the agenda.

SCGOP has set itself the objective of helping pension funds to exercise their role as effectively as possible in this regard, both in the Netherlands and abroad.

3 Basic principles of corporate governance

Opinions around the world differ as to what the best form of corporate governance is for a company, although the importance of good corporate governance has been acknowledged universally in the last few years. The reasons why the subject has become the focus of attention nevertheless differ from country to country. In the United States corporate governance came to prominence following the wave of mergers and acquisitions in the 1980s. In the United Kingdom the subject came onto the agenda when the financial markets were shocked by a series of major scandals. In France it was when privatised state companies had to learn how to meet the demands of institutional investors in France and abroad. In the Far East the importance of good corporate governance became clear in 1997 when the Asia crisis showed that rapid growth without proper management gives rise to major risks.

The way in which listed companies are governed varies from country to country. The reason for this diversity lies among other things in differences in history and culture, in national rules and regulations, in the spread of share ownership and the related structure of the national capital markets.

A distinction is made in the literature between the Rhineland and Anglo-Saxon models of corporate governance, according to which the latter focuses solely on the interests of shareholders, while the former takes account of the interests of all stakeholders.

But even within mainland Europe, where the Rhineland system is deemed to operate, there are major differences among the various countries. British and American practices, although referred to collectively as Anglo-Saxon, also differ.

Of more practical use is the distinction between market-oriented systems and control-oriented systems. In the former there is a wide spread of share ownership. In the latter there are large shareholders who can exercise control and thereby discipline the management of companies. In this situation attention is focused primarily on protecting the interests of minority shareholders.

In the Netherlands the important distinction is that between one-tier and two-tier systems. Two-tier means that a separate body (the supervisory board) supervises the management. In a one-tier system there is only one board.

The Netherlands has a two-tier system. With regard to the supervision of a company's management, investors in the Netherlands must therefore place their confidence first and foremost in the supervisory directors. In countries with a one-tier system investors must place their trust in the stock market regulator, although in these countries too independent non-executive directors are playing an increasing role.

All these differences make it difficult to draw up international rules of conduct for good corporate governance. At the beginning of 1999 the Organisation for Economic Co-operation and Development nevertheless made an initial attempt. It published a document entitled 'Principles of Corporate Governance' in order to develop international understanding of the elements of a good corporate governance regime. The OECD guidelines were intended to back up the conditions which the International Monetary Fund (IMF) attached to financial support for certain Asian countries which could not be described as poverty-stricken but did need the support of the international community because of inadequate corporate governance among large companies. The OECD intends to review its principles periodically and adapt them to new developments. A new version is expected in 2004.

On the basis of these OECD guidelines, investors belonging to the International Corporate Governance Network (ICGN) drew up the 'ICGN Statement on Global Corporate Governance Principles (1999)'. This statement was updated in July 2003, and partly on this basis the ICGN 'Statement on Institutional Shareholder Responsibilities' was published in September 2003.[7]

Such general guidelines cannot always address the specific characteristics of the corporate governance system in each country. Such systems are the product of legislation, listing conditions imposed by stock exchanges and case law, but also of particular features of individual companies, such as their articles of association or agreements with or between shareholders. Most countries therefore have their own corporate governance codes. An overview of all these codes can be found on the SCGOP website (www.scgop.nl). The University of Tilburg has carried out a comparative study of all these codes on behalf of SCGOP. This study can also be found on the SCGOP website. Four basic principles of corporate governance can be distilled from this multiplicity of reports:

1. Rights of shareholders

Shareholders must have prompt access to all relevant financial information in order to assess whether the company's policy has met its objective. Important matters must be presented to shareholders for approval. Shareholders must be in a position to cast their vote in a straightforward manner at the general meeting.

2. Anti-takeover measures

Anti-takeover measures can be of use in order to guarantee the continuity of the company in particular situations. However, they should not be used to enable the management to disregard the opinion of a majority of shareholders over a long period.

7 Available at www.icgn.org

3. Management structure

In the Dutch system supervisory directors must exercise independent supervision. That means they must not be allied to a specific shareholder, the executive board or other stakeholders. The management structure must also be transparent.

4. Transparency

The company must clearly disclose the policy being pursued, the strategy, the decision-making process within the company and the remuneration of executive and supervisory directors.

In each system, however much it may differ from country to country, satisfactory arrangements must be in place to address these four key issues. It is not a question of which system is best; it is a question of ensuring that the structure complies with the basic principles. It is then up to the investors to ensure that these basic principles are fulfilled. This means that company directors and their supervisors must account adequately for their policy and supervision. The company is accountable in different ways to the various stakeholders in the company. Corporate governance controls in particular the way in which the company accounts to the ultimate providers of risk capital: the shareholders.

4 Corporate governance and performance

Pension funds strive to achieve an optimum investment return within pre-set risk parameters. Every corporate governance policy must meet this primary objective. Since the implementation of a corporate governance policy always entails costs, it must be clear that sufficient compensatory income can be generated.[8]

The view that active use of shareholders rights will deliver higher investment results is nothing new. The ancient Greeks used to say that the eye of the master fattens the horse. Companies that are aware that their activities are being closely monitored by investors will make greater efforts than companies that lack such discipline. The rise of private equity can be seen partly in this light.

But it has taken some time for science to substantiate this proposition on the basis of empirical research. Initially the scientific research was directed mainly towards the relationship between one or more corporate governance characteristics and the trends in the share price, valuation and earnings of the company. In general a positive relationship was found.[9] Far more comprehensive was the study by Gompers, Ishii and Metrick (2001): Corporate Governance and Equity Prices (NBER, 2001), which used 24 different corporate governance criteria for an average of 1,500 companies each year from September 1990 to December 1999. Their conclusion was that the return on investments in American companies with good corporate governance was significantly higher (eight and a half percentage points annually) than the return on investments in American companies with a poor corporate governance score.

Inspired by the study by Gompers, Ishii and Metrick, Rob Bauer and Nadja Günster compared the returns of a portfolio of European companies with good governance characteristics to the returns of portfolios with poor governance characteristics.[10] They too found that the portfolios of companies with a good governance structure performed better than portfolios of companies with a 'poor' structure. The difference recorded in returns in Europe, after correction for sector effects, was approximately three percentage points annually. They concluded that corporate governance pays. This is something the market has been aware of for a long time; well-managed companies are rated significantly more highly by investors.[11]

Apart from returns, pension funds also look at risks. It is not only the case that good corporate governance leads to higher returns; it is also the case that poor corporate governance is a risk factor. Experience over the last few years has shown that insufficient supervision, lack of accountability, opaque structures and managements shielded from the discipline of the market have a negative impact on the risk profile of share investments.

[8] The costs associated with remote voting can be kept within limits, according to calculations made by the SEC in the United States in the context of the obligation placed on investment funds to conduct an active voting policy. A distinction must nevertheless be made between the costs of actual voting and the costs of gathering information to enable 'informed' voting.
[9] A list of the studies conducted in this area can be found on the Foundation's website at: www.scgop.nl.
[10] Goed bestuur loont voor beleggers, ESB 2 May 2003, also available at www.abp.nl
[11] See: "Global Investor Opinion Survey: Key Findings", McKinsey & Company, July 2002: www.mckinsey.com.

Pension funds have traditionally focused on financial and economic factors when investing in shares. Gradually, however, other factors are taking on growing importance in the assessment of risk and return. For example, the liquidity of a share has become an increasingly important selection criterion. Sufficient tradeability gives the investor greater exit potential, i.e. the ability to vote with his feet.

In the same light, the corporate governance structure of a company is increasingly being seen as a risk-reward factor. It indicates the extent to which shareholders can use their voting right to contribute to the checks and balances which are important for good corporate policy. In financial terminology, tradeability offers an 'exit' and corporate governance provides a 'voice'. Both 'exit' and 'voice' are means of limiting risks.

5 Institutional investors and corporate governance

Shareholders play an important role in the field of corporate governance. In 1997 the Peters Committee stated: "It is essential that all the parties involved, i.e. including providers of capital, should make use of their potential to exert influence." The institutionalisation of share ownership means that a growing proportion of shares are held by institutional investors such as investment funds, insurers and pension funds. It has become increasingly clear over the past few years that institutional investors have been assigned a specific responsibility in the improvement of corporate governance. Finance Minister Gerrit Zalm said at the SCGOP symposium on 9 January 2002: "Institutional investors can justly be expected to make effective use of their rights in order to improve corporate governance in the Netherlands." Until recently, institutional investors fulfilled their responsibility mainly by voting with their feet. But already in 1997 the Peters Committee concluded: "Particularly for institutional investors, disposing of an equity interest (voting with one's feet) is not an appropriate means of exerting influence, and nor is it always possible or desirable." The latter is true particularly of institutional investors who track an index and therefore do not wish to dispose of an equity interest. Moreover, the size of the interest which an institutional investor holds may be such that disposal is not possible without considerable price concessions.

Calls for institutional investors to make effective use of their voting rights are growing steadily louder in society. And not only in the Netherlands. In the United Kingdom the Myners Committee recommended in 2001 that the government should compel institutional investors to disclose how they use their voting rights. This approach was adopted in the Corporate Governance Action Plan drawn up by the European Commission in 2003.[12]

For its part, the American Securities and Exchange Commission in 2003 compelled all asset managers registered with it to disclose their voting policy and voting behaviour, in fulfilment of the provisions of the Sarbanes-Oxley Act.

This is all part of the increasing international attention being devoted to the question of how pension funds and other institutional investors use the control rights associated with shares. "Control rights should be seen as an asset, as part of the total value which shares represent. Like the shares themselves, control rights must be managed carefully. (..) In a fiduciary relationship between the institutional investor and his beneficiaries, the institutional investor must be accountable for his 'management' of control rights."[13]

The Dutch Corporate Governance Code presented in December 2003 places a specific responsibility on international investors, including pension funds.

Pension funds are legally obliged to invest their assets soundly in order to meet their payment commitments. They therefore wish to form their own judgment of the company in which they invest and assess the decisions taken by the directors. That does not mean they want to concern

[12] Modernising Company Law and Enhancing Corporate Governance in the European Union – A plan to move forward (21 May 2003).
[13] Stemmen van institutionele beleggers en tegenstrijdig belang. A.F. Verdam, Inaugural address (2003).

themselves with the strategy or day-to-day operation of the company, but they do want to assess whether the company's policy has met its objective and fulfils the financial risk-reward requirements which they set. This requires alertness and responsiveness.[14]

The Dutch Corporate Governance Code also acknowledges that shareholders fulfil an important role in the field of corporate governance. Principle IV.1 of the Code states:

> Good corporate governance requires the fully-fledged participation of shareholders in the decision-making in the general meeting of shareholders. It is in the interest of the company that as many shareholders as possible take part in the decision-making in the general meeting of shareholders. The company shall, in so far as possible, give shareholders the opportunity to vote remotely and to communicate with all other shareholders.
>
> The general meeting of shareholders should be able to exert such influence on the policy of the executive board and the supervisory board of the company that it plays a fully-fledged role in the system of checks and balances in the company. Any decisions of the executive board on a major change in the identity or character of the company or the enterprise shall be subject to the approval of the general meeting of shareholders.

In its response to the Code, SCGOP welcomed the fact that it strengthened the position of the shareholder. SCGOP believes it is right that the Code should include a provision whereby the general meeting of shareholders must play a fully-fledged role in the system of checks and balances of listed companies. Institutional investors, including pension funds, have their own role to play. The Dutch Corporate Governance Code states as principle IV.4:

> Institutional investors shall act primarily in the interests of the ultimate beneficiaries or investors and have a responsibility to the ultimate beneficiaries or investors and the companies in which they invest, to decide, in a careful and transparent way, whether they wish to exercise their rights as shareholders of listed companies.

In addition to the call for them to use their voting and other rights, institutional investors have been assigned another specific task in the context of compliance with the Dutch Corporate Governance Code. The second part of principle IV.4 of the Code states:

> Institutional investors shall be prepared to enter into a dialogue with the company if they do not accept the company's explanation of non-application of a best practice provision of this code. The guiding principle in this connection is the recognition that corporate governance requires a tailor-made approach and that it is perfectly possible for a company to justify instances of non-application of individual provisions.

[14] SCGOP policy plan 2003.

SCGOP believes that a dialogue can be very effective if consequences can be linked to its results: in many cases that currently means just 'voting with one's feet'. But that is not in the interests of the shareholders themselves, of the companies or of corporate governance in general. SCGOP therefore also seeks to emphasise that it is a shared responsibility of entrepreneurs, the legislator and shareholders to make a success of the Code and improve the governance of Dutch listed companies.

SCGOP has played its part in this dialogue over the past few years by alerting affiliated pension funds to important developments in corporate governance arising on the agendas of general meetings and by co-ordinating members' attendance at these meetings. After all, the Foundation believes that the general meeting is the appropriate platform on which to conduct this dialogue on the corporate governance of a company.

The Foundation's practice in previous years has always been to formulate specific subjects ('spearheads') which affiliated pension funds could use in their dialogue with the company management at the general meeting. The boards of the large Amsterdam-based listed companies have always been given advance notice of these 'spearheads'.

As well as conducting a dialogue on corporate governance, pension funds are expected to account for the way in which they use their voting rights.

The Dutch Corporate Governance Code contains three best practice provisions relating to the use of voting rights by institutional investors. Pension funds can therefore be required to account for their compliance with these provisions, which are as follows:

IV.4.1 Institutional investors shall publish annually, in any event on their website, their policy on the exercise of the voting rights for shares they hold in listed companies.

IV.4.2 Institutional investors shall report annually, on their website and/or in their annual report, on how they have implemented their policy on the exercise of the voting rights in the year under review.

IV.4.3 Institutional investors shall report at least once a quarter, on their website, on whether and, if so, how they have voted as shareholders in the general meetings of shareholders.

No sanctions are imposed in the event of non-compliance with these provisions. The Tabaksblat Committee has, however, recommended that the legislator lay down these best practice provisions in law.[15] Each of the best practice provisions will now be considered in detail in the sections that follow.

[15] Code p. 64, point 12.

6 Formulation of a voting policy

Each pension fund must take its own policy decision as to whether or not to use the voting rights attaching to shares. Such a decision must take account of the fiduciary responsibility. A precondition will be minimising costs and the time commitment.

If a pension fund is considering exercising its voting rights, it must first answer the following policy questions:

What shares will I vote on?

A pension fund may decide to vote on all the shares in its portfolio, or may apply restrictions for practical reasons. These restrictions may be of a geographic nature. For example, a pension fund may decide (initially) to vote only on shares in Dutch companies, or in European companies.

Another restrictive criterion may be the size of the shareholding. A pension fund may decide (initially) to vote only on those shares which make up a specific part of its invested capital or only on holdings which represent a certain market value. A pension fund may make its decision on whether to vote dependent on the nature of the agenda items to be considered and decide whether to vote at all general meetings or only at those where major decisions have to be taken.

What will I do in the case of externally managed portfolios?

Most pension funds outsource the management of part of their assets to third parties. With regard to the self-managed part of the assets, the pension fund itself will have the task of implementing the voting policy. In the case of assets managed by third parties, implementation can be assigned to the external asset manager, with the pension fund itself naturally remaining responsible for the voting policy, since implementation can be delegated but responsibility cannot.

The Foundation can advise affiliated pension funds on this question. For example on the role of the custodian bank, which must enable the pension fund to vote, if necessary remotely, on the shares which it holds. To this end, the Foundation will if required provide a standard clause which can be included in the custody agreement. In cases where asset management activities are outsourced, the Foundation will also advise pension funds on the contractual underpinning of the external asset manager's obligation to vote on behalf of the pension fund. Here too, the Foundation will if required provide a standard clause for the asset management agreement.

How will I deal with legal restrictions?

Cross-border voting in particular will give rise to many legal complications. A pension fund will also want to ensure that use of the voting right does not place unacceptable restrictions on the liquidity of the investments. In each company in which voting takes place it will be necessary to see whether there is a blocking period, and if so whether the blocking of the shares should weigh more heavily than the fiduciary duty to exercise the voting right. A separate issue arises with regard to stock lending. In each company it will be necessary to assess whether the benefits associated with the lending of shares compensate for the loss of the voting right if the respective shares are lent at the mandatory time of deposit.

Will I attend the meeting myself or vote remotely (by proxy)?

A pension fund will have to decide whether to attend the meeting itself in all or some cases in order to exercise its voting right. It will have to consider factors such as whether it is desirable to conduct a dialogue with the company management at the particular shareholders' meeting, as urged in the Dutch Corporate Governance Code. But the time commitment and the location of the general meeting will also play a role. When physical attendance at the general meeting is not considered necessary, a pension fund has at least three alternatives:

- Voting through another pension fund (by proxy). For a number of years it has been standard practice in SCGOP for affiliated pension funds to grant each other proxies to vote on behalf of each other at meetings in the Netherlands. Such arrangements can also be made internationally.
- Voting through the Shareholders' Communication Channel Foundation or Algemeen Nederlands Trustkantoor. This is an efficient voting method, but it can only be used in those (Dutch) companies which permit it.
- Voting remotely through an international voting service. This is a relatively new development. For 2004 the Foundation has entered into an arrangement whereby affiliated pension funds can use this service at a discount.

How will I deal with publicity concerning my voting behaviour?

Media interest can be aroused when a pension fund uses its voting right. Pension funds must decide in advance whether to deal with such publicity reactively or proactively.

Once the management has answered the above questions, has decided that it is beneficial to vote and has decided where voting will take place, guidelines must be drawn up on the basis of which (in most cases) a decision can be taken in advance on how to vote in individual cases.

As a guide, shareholders can refer to the national and international corporate governance codes (OECD, ICGN, the Dutch Corporate Governance Code).

With regard to the Netherlands, SCGOP recommends that the following positions be adopted in respect of the most frequently occurring agenda items. It is assumed that the items on the agenda have been proposed by the executive board with the approval of the supervisory board.[16]

Agenda item		
Approval of annual accounts	For	Unless the company fails to comply with (international) accounting standards, changes the accounting principles without sufficient explanation or the external auditor qualifies or declines to approve the accounts.
Profit appropriation	For	Unless it deviates from the existing dividend policy without sufficient explanation.
Discharge	For	Unless there are compelling reasons why discharge should not be granted.
Delegation of authority to issue ordinary shares	For	Unless the requested period is longer than 18 months, or the number of shares for which delegation is requested without pre-emptive rights exceeds 10 per cent of the number outstanding at that time.
Delegation of authority to issue preference shares	For	Unless the management fails to account satisfactorily for the associated financing advantages or if there is an unbalanced relationship between the capital contribution and control.
	Against	If options are to be granted on ordinary or protection preference shares which have a longer term than the delegation of the authority to issue such shares.
Repurchase of own shares	For	Unless the motion fails to make clear for what purposes the authority will be used, the shares will not be repurchased through the market or the maximum repurchase price differs too greatly from the market price.
Appointment of executive directors	For	Unless the criteria for the remuneration policy differ fundamentally from the recommendations on executive remuneration of SCGOP (appendix, p. 33).
	Against	If the motion deviates from the Code's provisions on the appointment of executive directors without sufficient justification.

[16] In cases where items have been placed on the agenda by shareholders, no "in principle" decision will be taken to vote in favour, but a judgment will be formed on a case-by-case basis.

Appointment of supervisory directors	For	Unless the motion deviates from the Code's provisions on the appointment of supervisory directors without sufficient justification.
Remuneration	For	Unless the motion deviates from the Code's provisions or from SCGOP's recommendations on executive remuneration (appendix, p. 33) without sufficient justification.
Amendment of articles of association	For	Unless this impairs the existing rights of ordinary shareholders.
Appointment of auditor	For	Unless the proposed auditor fails to give adequate answers to questions raised at the general meeting.
Major transactions	-	Voting policy will have to be decided on a case-by-case basis. In any event, the shareholder should not vote for the motion if it fails to show clearly how the interests of the shareholders have been considered in relation to other interests, including in relation to the interests of any large shareholders.
Any other business	-	No voting takes place on this agenda item, but it can be used as part of the recommended dialogue between the shareholders and the management.

The above policy principles must of course never result in the blind issuance of voting instructions. The pension fund must always form a judgement on its voting behaviour – if necessary on the basis of expert external advice for each company and for each agenda item. A 'box-ticking' approach is completely unacceptable.

The Foundation does its utmost to provide affiliated pension funds with advice at reduced rates via the internet to assist with voting at general meetings of companies listed in the Netherlands. [17]

[17] For details of the available services, see www.scgop.nl.

7 The exercise of voting rights

The exercise of voting rights is considered both nationally and internationally to be an essential component of the system of checks and balances in a company. An important part of the terms of reference of the committee which drew up the Dutch Corporate Governance Code was therefore the actual exercise of shareholders' rights. The ICGN's Statement on Institutional Shareholder Responsibilities also places great emphasis on the importance of exercising voting rights.

In view of the international spread of pension funds' investment portfolios, in most cases it is impractical to attend all meetings of shareholders. In order to vote, pension funds will therefore usually grant a proxy to a third party. The third party can be anyone. In practice it is usually an asset manager, a custodian, a specialist organisation (such as the Shareholders' Communication Channel or a trust office) or the management of the company.

The proxy can be 'unlimited', which means that the proxyholder can decide how to vote, or 'limited', in which case the proxyholder is instructed beforehand how to vote. Proxy voting is a form of 'remote voting'. Other forms are postal voting or voting via the internet, which is known as e-voting. In practice, the latter is not usually possible for formal reasons. The Tabaksblat Committee therefore recommends that the Securities Giro Transfer Act and Book 2 of the Civil Code be amended in order to facilitate remote voting and proxy solicitation. The Foundation has been calling for the introduction of a practical system of remote voting for a number of years.

In his Action Plan on Company Law and Corporate Governance, EU Commissioner Frits Bolkestein has given priority to enabling remote voting. But until such time as European legislation has been amended, shareholders who do not attend the general meeting themselves will have to vote by proxy.

Shareholders' Communication Channel

A new facility was introduced in the Netherlands for the 2000 meeting season whereby shareholders could vote by proxy through the Shareholders' Communication Channel. This communication channel offers shareholders a simple and efficient way of casting their vote. In formal terms they give a proxy to a central proxyholder who votes on their behalf at the meeting. The central proxyholder has no will of his own; he merely receives proxies and votes blindly in accordance with the instructions he has been given. This is therefore essentially a form of 'remote' voting (without a physical presence at the shareholders' meeting).[18]

[18] M.P. van de Hoek, Resultaten Communicatiekanaal 2000 en 2001, Ondernemingsrecht 2002-1 p. 25-31.

The communication channel nevertheless has its limitations. One of these is that only a small number of companies are taking part. The second is that in practice it only extends to holders of Dutch securities. It therefore covers private individuals who hold a securities account with a participating Dutch bank, but institutional investors with an account at a non-Dutch custodian bank cannot vote through the communication channel in practice, or can only do so with difficulty. The reason for this is the largely uncharted territory of securities ownership rights in international chains of intermediaries.[19]

However, the Foundation does believe that for pension funds too the communication channel can be a suitable means of casting votes in respect of Dutch companies, particularly if more companies join.

International practice

A pension fund's share portfolio will consist for the most part of shares issued by non-Dutch companies. Its custodian bank(s) will generally have a relationship with an international voting service. Pension funds that wish to exercise the voting rights attaching to these non-Dutch shares can do so by using the internet facilities provided by such international voting services. It is then up to the custodian as a proxyholder to ensure that the vote actually reaches the company.

A recent development is that the internet facility not only allows votes to be cast, but also enables voting advice to be obtained for each agenda item from the consultancy firm with which the pension fund has a relationship.

In this way a pension fund can outsource a large part of the voting process and make its vote count in a rational and efficient manner. SCGOP provides affiliated pension funds with access to such a system at discounted rates.

The pension fund will nevertheless have to specify who within its own organisation is responsible for implementing the voting policy. It must be borne in mind that in many cases decisions will have to be taken at short notice, as the time between the publication of the agenda and the recording of the vote is limited. It must also be borne in mind that since the date of the general meeting is linked to the closing date of the financial year, it is often a seasonal activity, with the peak occurring between March and July.

[19] On this subject see J.W. Winter, Grensoverschrijdend Stemmen. Lecture, Rotterdam (2000).

Pension funds can enter into agreements with their external asset managers whereby the latter will vote in a standard way in respect of the shares in the portfolio, in accordance with the voting policy laid down by the pension fund. This must be specified in the management agreement. However, it will still be necessary for the pension fund to ensure that the policy is actually implemented.

Proxy solicitation

An active pension fund will not only wish to vote itself, but if necessary will also wish to contact other shareholders in order to achieve greater voting power by means of proxy solicitation. Such a recommendation was made by the Peters Committee in its 1997 report (page 26): "The aim must be to achieve an efficient proxy solicitation system to be used by companies and (groups of) shareholders and certificateholders, on payment of reasonable costs." The Shareholders' Communication Channel has not yet been able to produce such a system of proxy solicitation. The Tabaksblat Committee also stated in its 2003 report (page 63) that shareholders must have the possibility of communicating with each other prior to the general meeting: "The Committee therefore supports the proposal of the Ministers of Finance and Justice to make provision by law for proxy voting and proxy solicitation in the near future." In anticipation of such provision, SCGOP is already co-ordinating members' efforts in this direction, with one of the members seeking proxies from other pension funds in each case.

8 Reporting on the implementation of the voting policy and voting behaviour

Implementation of the voting policy

On the basis of best practice provision IV.4.2 of the Code, institutional investors are expected to report at least annually, on their website and/or in their annual report, on how they have implemented their policy on the exercise of the voting rights in the year under review.

In fulfilling this responsibility, it is conceivable that a pension fund (or other institutional investor) will choose not to apply the voting policy to all share investments, or to implement the voting policy on a phased basis, for example on the basis of regions, sectors or universes in which the share investments are grouped. Such an approach does of course mean that the reporting on the implementation of the voting policy will be subject to the same limitations or phasing.

Furthermore, pension funds (and other institutional investors) are of course quite at liberty to report more than once a year on the implementation of the voting policy. Other possible aspects which could be included in the reports are:

- the number of shareholders' meetings at which the pension fund has voted in the year under review in total, per region, per sector or per universe (remotely or directly);
- the number of shareholders' meetings which the pension fund has physically attended and the content of any dialogue which the pension fund has entered into with the company management;
- individual cases of non-compliance with the voting policy, for example in the event of (potential) conflicts of interest.[20]

Reporting on voting behaviour

Transparency is a core concept in corporate governance. Pension funds and other institutional investors that use their voting rights are expected to disclose their voting behaviour. This is stated explicitly in best practice provision IV.4.3 of the Dutch Corporate Governance Code: "Institutional investors shall report at least once a quarter, on their website, on whether and, if so, how they have voted as shareholders in the general meeting of shareholders." Such reporting may detail the voting behaviour for each agenda item at a shareholders' meeting at which the pension fund has voted physically or remotely (e.g. by proxy or through an international voting service). If external asset managers are used, agreement must be reached with them on how they will report on the voting behaviour.

[20] See: ICGN Statement on Institutional Shareholder Responsibilities, section III, sub h and i, at www.icgn.org, and Stemmen van institutionele beleggers en tegenstrijdig belang, A.F. Verdam, inaugural address (2003).

9 Pension fund governance

The amount of attention companies are devoting to corporate governance reflects the increasing importance to society of good management and accountability. But it is not only companies that have to answer questions on management, transparency and accountability; pension funds too have to concern themselves with these issues. This is referred to as pension fund governance. Pension funds which have drawn up a corporate governance policy will have already prepared for this, mindful that they must "do as they would be done by". Just as pension funds call for transparent corporate governance structures and accountability in companies in which they invest, they in turn can be questioned on their own corporate governance arrangements.

But it is not only pension funds active in the field of corporate governance that will face questions on pension fund governance. Attention is increasingly being focused on the way in which the board and management of pension funds report to members on their stewardship of the pension fund.

Corporate governance and pension fund governance coincide when pension funds account for their investment policy. Pension fund boards are increasingly drawing up codes of conduct as a basis for their reporting on their investment policy. In accordance with the Dutch Corporate Governance Code, such reporting covers the policy on corporate governance.

The formulation and implementation of a governance policy can be seen as part of the way in which a pension fund is managed. Corporate governance and pension fund governance are therefore closely related.

10 Socially responsible investing

Corporate governance and socially responsible investing are only related indirectly. But as the two concepts are often confused, it is useful to have a clear understanding of the differences. Pension funds' corporate governance policy is aimed at improving the risk-reward ratio of share investments. Investment can be said to be socially responsible if an investment portfolio is composed not merely on the basis of financial return, but if other factors also play a role.

The trade union movement in particular has focused attention on socially responsible investing. As a follow-up to its 1996 memorandum entitled 'Van Pensioen Verzekerd' (Assured of a Pension), which advocated a socially responsible investment policy, the Dutch Trade Union Federation (FNV) published a further memorandum in 2002 entitled 'Goed belegd' (Well invested). This sets out a strategy for socially responsible investing of pension assets based on a three-track approach:

1. The minimum approach. The FNV believes that the investment policy must fulfil minimum social and environmental conditions. For example, it does not want assets to be invested in countries that violate human and/or trade union rights. The FNV wants such conditions to be laid down in investment codes to be developed by company pension funds in 2004.
2. The positive approach. Investing in companies that score well in terms of social and environmental policy. The FNV believes that a good social and environmental policy leads to a good return and wants to see half of pension assets invested partly on the basis of this positive approach by around 2008.
3. The dialogue approach. An active dialogue must be conducted with companies in order to critically assess their policy and adjust it where necessary. The FNV believes that in the long term the dialogue will help deliver better results than a policy consisting only of buying and selling shares and bonds of companies which score well or badly in the area of sustainability.

The National Federation of Christian Trade Unions in the Netherlands (CNV) also advocates a just and sustainable investment policy. For the CNV the achievement of an optimum return is central, but that return must not be achieved at the expense of everything else. The CNV drew up an investment code in 1999 and issued a revised version in 2003 entitled 'Principes in praktijk' (Principles in practice). The CNV believes that the other stakeholders to be addressed in the pension fund's policy in accordance with article 5, paragraph 4 of the Pension and Savings Funds Act should be deemed to include future generations and it therefore applies the definition used by the World Commission on Environment and Development (the Brundtland Commission): "Development that meets the needs of the present without compromising the ability of future generations to meet their own needs". The CNV lists various strategies from which pension funds can choose in order to achieve a sustainable investment policy. These are:

- Excluding companies which do not meet the specified sustainability requirements.
- Excluding worst-in-class companies in the field of sustainability.
- Selecting best-in-class companies in the field of sustainability.
- Selecting companies with the best financial and sustainability ratios.
- Active engagement as a shareholder.

At the beginning of 2001 the Social and Economic Council (SER) published an advisory report entitled 'De winst van waarden' (The profit of values). The central themes of this report are social enterprise and corporate social responsibility. In the appendix to the report, however, the SER also devotes a passage to the investment policy of pension funds. The SER believes that the actuarial and business memorandum, in which a pension fund sets out various matters including its investment policy, could also include its vision of socially responsible investing.
The SER does not link socially responsible investing to corporate governance, but takes the view that "the social partners, given their direct or indirect involvement in the policy of the pension funds, have ample opportunity to encourage pension funds to pursue a socially responsible investment policy – naturally within the framework of the Pension and Saving Funds Act."
The social partners intend to discuss this matter within the Labour Foundation (StvA).

Corporate governance and socially responsible investing are therefore different matters. The terms of reference of the Tabaksblat Committee stated: "The purpose of this code is to provide a guide for listed companies in improving their governance. Compliance is intended to boost confidence in the good and responsible management of companies. The perspective of the capital markets is therefore central; in other words, the relationship between listed companies and providers of capital, without detracting from the position of other stakeholders such as employees.
This perspective also means that the subject of socially responsible entrepreneurship does not form part of the renewed code. After all, this subject is not tied to a national corporate structure and extends way beyond the development of a new code for the functioning of Dutch companies in the capital markets."[21]

SCGOP therefore does not consider socially responsible investing to be within its purview, although one of the aims of corporate governance policy is of course that companies should devote more attention to the wishes of their shareholders.

If the majority of those shareholders are in favour of socially responsible entrepreneurship, a company with a good corporate governance structure will be more receptive to it than a company with a less sound corporate governance structure.

[21] Terms of reference of the new corporate governance committee, Ministry of Finance, 10 March 2003.

11 About SCGOP

The Foundation for Corporate Governance Research for Pension Funds was established in 1998 by eight pension funds in order to assist pension funds in devising and implementing their corporate governance policy. The Foundation includes founders, members and observers. The board of the Foundation consists of representatives of the founders and one representative from the circle of members.

The Foundation was not established in order to develop corporate governance independently of its members. The members themselves specify how they wish to achieve this. The Foundation provides infrastructure and support. The Foundation therefore conducts research, issues information to the members and facilitates exchanges of views among pension funds and between pension funds and company boards on their management, supervision and accountability.
The individual member's freedom of choice and own responsibility is emphasised and respected at all stages.

The following are eligible to be members:
- Company pension funds
- Industry pension funds
- Occupational pension funds
- Management organisations associated with pension funds.

Board members

PGGM
Stichting Pensioenfonds ABP
Stichting Unilever Pensioenfonds "Progress"
Blue Sky Group
Philips Pensioenfonds
SPF Beheer
Shell Pensioenfonds Beheer

Members

Stichting Pensioenfonds Openbaar Vervoer
Stichting Lucent Technologies Pensioenfonds
Bedrijfstakpensioenfonds voor de Metalektro (PME)
Pensioenfonds Metaal en Techniek
Stichting Bedrijfspensioenfonds Zorgverzekeraars
Pensioenfonds Horeca & Catering
Stichting Grafische Bedrijfsfondsen
Amonis

Stichting Pensioenfonds voor Fysiotherapeuten
Stichting Pensioenfonds voor de Media PNO
Stichting Pensioenfonds voor de Woningcorporaties
Stichting Pensioenfonds Solvay Pharmaceuticals
Stichting Pensioenfonds Kon. Volker Wessels Stevin
Stichting Predikantenpensioenen in de Ned. Herv. Kerk
Stichting Bedrijfspensioenfonds voor de Bouwnijverheid
TPG KPN Pensioen
Stichting Pensioenfonds HBG
Stichting Bedrijfspensioenfonds voor het Schilders- Afwerkings- en Glaszetbedrijf
Stichting Pensioenfonds Casinospelen
SBA Artsenpensioenfondsen
Stichting Pensioenfonds AKZO Nobel
Beon Pensioen- en Vermogensbeheer
Stichting Pensioenfonds van de ABN AMRO Bank NV
Relan Pensioen
Kunst en Cultuur Pensioen- en Levensverzekering Mij NV

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Appendix:
Recommendations on Executive Remuneration

Responsibilities and powers

1 Responsibility for the remuneration of the Executive Board lies with the Supervisory Board. The Supervisory Board sets up a remuneration committee consisting of independent members. The committee draws up a remuneration policy which complies with the recommendations stated below.

2 The Supervisory Board is responsible, and approachable through the General Meeting of Shareholders, for all aspects of executive remuneration. The Supervisory Board accounts for its activity in this area in the annual report.

3 The approval of the General Meeting of Shareholders is necessary for share and option schemes in themselves, but not for their specific implementation on an individual level. The latter remains a task for the remuneration committee.

Reasonableness and effectiveness

4 The overall remuneration package must be tested for reasonableness and effectiveness. With regard to the level of remuneration, the Supervisory Board must form an independent judgment and not only assess it on the basis of market comparisons or historical precedents.

5 The link between the remuneration policy and the company's long-term strategic objectives must be explicitly defined and must be testable.

A substantial part of the overall remuneration package must be linked directly to predetermined performance objectives; the executive remuneration must also be largely of a long-term nature.

6 The remuneration system must take account of the prevailing social standards and values. This will prevent outcomes which could be seen as excessive. A good remuneration system provides the right incentives but does not unintentionally encourage behaviour which conflicts with the interests of the company or leads to the reporting rules or other legal provisions being applied in a way which runs counter to their material purpose.

7 The remuneration committee must periodically ascertain whether the chosen instruments have actually contributed to the achievement of the strategic objectives.

Use of remuneration instruments

8 The use of remuneration instruments is a function of the chosen mix of fixed and variable and short- and long-term remuneration instruments.

9 The choice of specific instruments must be made on the basis of effectiveness; reporting practice or fiscal possibilities are secondary factors.

10 Option and/or share schemes can be part of the long-term, variable part of the overall remuneration package.
These schemes must meet a number of requirements:
- long-term nature
- realisation or sale spread over time; preferably at predetermined times over a period of many years
- linkage to the company's strategic objectives can be achieved by:
  - making the number of options or shares to be issued dependent on the achievement of preset targets, or
  - issuing 'customised' options or shares whereby only the relative performance of the share compared to a previously agreed benchmark is remunerated.
- repricing of options is not acceptable.

11 The combination of high variable remuneration and favourable exit schemes is not acceptable; a favourable exit scheme detracts from the incentive which should result from a variable remuneration structure.

12 The company should as a rule not grant loans to executives.

Reporting

13 All aspects of executive remuneration, including the policy, objectives and results, must be reported on transparently, fully and consistently in the annual report.

In the case of options or shares, details must be given on holding periods and sale times.

Directors must report the realisation of options and the sale of shares at the time of realisation or sale.

14 The economic value of options at the time they are granted must be stated as an expense in the company's profit-and-loss account.

Notes to the Recommendations

1 Carrot or stick?

The current structure of public companies is characterised by a separation between the company management and the shareholders. It is managers' capitalism and not owners' capitalism. In this model, the emphasis is on the company management: it is they who determine and implement the strategy. The Supervisory Board only has a supervisory role and the shareholder can at best consent to it.

In order to ensure that the interests of shareholders and executives nevertheless run in parallel in this model, the remuneration instrument has been selected. The remuneration package has built-in incentives which are intended to make managers' capitalism more shareholder-friendly. In other words, the carrot[22] has been chosen. The question is then whether the chosen system also works well in practice. This depends on its design and actual implementation, for which clear and measurable objectives must first be specified.

2 Clarity of objective

In a system based on maximising shareholder value, the objective appears to be clear: to maximise the market value of the company. But in practice it is not that simple. Maximising the market value turns out to be a largely unsustainable process, particularly when it is driven by easily manipulated figures such as pro forma earnings per share.

The great emphasis on short-term market value makes the company prey to the volatility of the stock market. This is illustrated by the following quotation from The Economist of 16 November 2002.

Drugs in the boardroom
Mr. Jensen[23] now thinks that the way in which executive pay was typically tied to share performance through options meant that, in the bubble, the carrots became what he calls 'managerial heroin', encouraging a focus on short-term highs with destructive long-term consequences. Once a firm's shares became overvalued, it was in managers' interests to keep them that way, or to encourage even more overvaluation, in the hope of cashing out before the bubble burst. Doing this not only meant being less than honest with shareholders, or being creatively optimistic with corporate accounts. It also encouraged behaviour that actually reduced the value of some firms to their shareholders-such as making an acquisition or spending a fortune on an Internet venture simply to satisfy the whims of an irrational market.

[22] It is also possible to opt for the stick by combining high basic pay with a simple dismissal mechanism. Shareholders will not readily do this unless the continuity of the company is guaranteed. Gilt-edged exit schemes are nevertheless completely out of the question. Dismissal must be a disincentive.
[23] Michael Jensen was a senior lecturer at Harvard Business School, and in the 1970s was the great advocate of option-based remuneration for executives as a solution to the principal-agency conflict in the modern company

But what are the alternatives.
We can identify three:

- Long-term profit growth;
- Long-term profit growth translated into an operational performance contract;
- Long-term price growth against a previously defined benchmark.

Long-term profit growth looks like an attractive alternative at first sight, but the drawback is that the notion of profit can be manipulated and is therefore, in an amplified form, the derivative of profit: profit growth. Moreover, the notion of profit used in accounting makes no allowance for other factors that determine the value of the company, such as changes to the risk profile, the levelling off of forecast profit growth and, last but not least, the quality and reputation of the company. That makes achieved long-term profit growth unsuitable for use as the sole objective variable.

The second alternative is based on long-term profit growth as a primary objective of the company, but translates this primary objective into measurable instrumental objectives. Executive remuneration is linked to performance measured against these instrumental objectives. This model, in which the remuneration is linked to an explicit performance contract which in turn is derived from the strategic corporate objective, is very appealing. However, it requires the Supervisory Board to become involved in the operational activities of the company in a way which is often unworkable in practice.

The third alternative accepts the information asymmetry between the management and the supervisory directors as a fact. By linking remuneration to the long-term trend in the share price, set against an appropriate benchmark, alignment of interests can easily be achieved between the agent (= company management) and the principal (= shareholder). This model too has problems of measurability. In particular, the choice of benchmark is susceptible to manipulation. M. Jensen recommends opting for a cost-of-capital benchmark; others prefer a peer-group index.
The advantage of a peer-group approach is that it affords protection against the high absolute volatility of the stock market and focuses more on the specific factors which determine the value of the company. It is left to the market to discount all the factors that are of relevance for the value of the company. In this regard it can therefore be described as an objective system.

The conclusion is perhaps that an explicit performance contract with measurable instrumental targets derived from the company's strategic objective is preferable, but in many cases is aiming too high. That applies in particular in situations in which the Supervisory Board operates at a relatively large distance. In such situations, a direct link to the share price is a good second choice, provided its long-term nature is guaranteed and the price trend is set against a relevant benchmark.

3. The design of the remuneration policy

The remuneration policy must be assessed from two perspectives:

- Is it sufficiently attractive to high-calibre executives and of a reasonable level having regard to the delivered performance?
- Does the policy produce the right incentives to achieve the company's strategic objective?

In other words, is it reasonable having regard to the specific labour-market situation and fair having regard to the social standards, and finally is it effective?

The question concerning reasonableness and fairness relates chiefly to the level of the remuneration, in relation to the delivered performance and the specific market environment in which the company operates. The Supervisory Board must form an independent judgment on these aspects and cannot simply hide behind benchmarking studies by external consultants. Furthermore, the company must expressly state with which reference group it is comparing itself when setting the level of executive remuneration.

The question of effectiveness relates chiefly to the design of the remuneration package. The relevant factors are the mix of fixed and variable and short- and long-term remuneration components. In market-oriented companies, in which the Executive Board has primarily to demonstrate entrepreneurship, a suitable remuneration mix is one which puts the emphasis on variable and long-term remuneration components. In companies focusing on operational efficiency, capital efficiency and managed growth, the emphasis can be on fixed remuneration elements. In the Netherlands, the balance between fixed and variable has traditionally been in favour of fixed; greater emphasis on variable and long-term elements would benefit the effectiveness of the remuneration policy.

Variable remuneration instruments are cash bonuses, options and shares. The cash bonus is mainly a short-term instrument; options and shares are suitable instruments for the variable, long-term component. Options have recently acquired a bad name. This has more to do with defective design (short-term, hidden costs, link to absolute share performance, etc.) than with the benefits of the instrument itself. Options should be used as a long-term instrument, preferably in the form of overlapping schemes with fixed exercise times spread over many years. The repricing of previous option packages is out of the question. The incentive character of options would be negated if repricing were to become standard practice. The granting of shares must also be of a long-term nature, with pre-defined minimum holding periods. In all cases, the costs of these schemes must be carried in the profit-and-loss account.

Long-term remuneration can also be of a fixed nature, for example through pension schemes and other fringe benefits. Because of their long-term nature, they are loyalty-enhancing and should be explicitly included in the assessment of the overall level of the remuneration package. Their costs must be clearly visible. As a rule, long-term loyalty instruments such as the granting of loans should not be used.

Exit schemes and change-of-control provisions should be assessed primarily from the perspective of effectiveness. Covering the risk of non-performance appears to provide a good stimulus to achieve a maximum result. As a general rule, effectiveness should prevail over cost-efficiency when setting executive remuneration.

4. Should share and option schemes be approved by the General Meeting of Shareholders?

Until a few years ago, executive remuneration was not a major subject of discussion. In the United States, options were seen as an important instrument for creating alignment of interests between the management and the shareholders. In Europe, the attitude was generally somewhat more reserved, but here too this view gradually gained ground. Objections were raised – chiefly in Europe – when the bull market of the last few years caused remuneration to rise exponentially. In particular, the scandals at Enron and elsewhere have convinced many people that an efficient remuneration system must be accompanied by effective safeguards. The list below shows that whereas up to 2000 remuneration policy was seen as a responsibility of the non-executives and supervisory directors, since then the general trend has been towards promoting approval by the General Meeting of Shareholders to provide an additional safeguard.

1	Peters (1997)	Remuneration a task for Supervisory Board (recommendation 15 et al.)
2	OECD Principles of CG (1999)	Remuneration a task for non-executives (point V.D.2)
3	ICGN Statement on Global CG Principles (1999)	ICGN appears to concur (Statement 5 and amplification of OECD point V.E.1)
4	SCGOP manual (2001)	Option schemes to be approved by shareholders' meeting (Benchmark 14)
5	Final Winter Report (2002)	Executive option schemes to be approved by shareholders' meeting (p. 66)
6	Hoogervorst, Fortis Lecture (2002)	Bill in preparation: approval by shareholders' meeting of executive remuneration in shares and options (p. 8)
7	ICGN Report on Executive Remuneration (2002)	Remuneration a task for Remuneration Committee (point 9), but approval by shareholders' meeting is desirable and necessary (point 55)

In the Netherlands, companies such as Unilever, ReedElsevier and Philips now present their option and share schemes for approval by the General Meeting of Shareholders.

It is fair to say that seeking approval of the General Meeting of Shareholders for instruments of flexible remuneration is increasingly seen as best practice. The question is why. In this connection it is important to consider the arguments for and against such a requirement. The main arguments are as follows.

Arguments in favour of the requirement of shareholder approval:
- Quite often costs are involved which could have a substantial impact on shareholder value.
- The requirement helps to reduce agency effects, by forcing executives to focus their incentive structure more on the interests of shareholders.
- In many cases the transparency of remuneration is still very poor. The requirement of shareholder approval can serve as an additional means of improving transparency. After all, shareholders can withhold their approval if they are not satisfied.
- The disciplinary effect of the approval requirement can further help to prevent abuse and excesses.

Arguments against:
- Shareholders can become inclined to concern themselves with (individual) remuneration at a detailed level.
- Detracts from the company's flexibility and competitive strength in the "market" for captains of industry.
- Shareholders could abuse the right in order to achieve other aims, even though – were that to happen – the problems would probably then be far greater.

Shareholder approval can take many forms. In general, shareholders' involvement in (individual) remuneration at the detailed level is undesirable. They must limit themselves to setting the framework and monitoring the main points. In this connection, the recommendation of the Winter Committee is constructive: approval by the General Meeting of Shareholders is necessary for share and option schemes in themselves, but not for their specific implementation on an individual level. The latter remains a task for the remuneration committee.

The Winter Committee's recommendation creates a bridge between the responsibility of the company and the interests of shareholders in a way which accords with general best practice standards. It would seem sensible to seek to apply these findings also in the Netherlands.