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Pierre-Yves GOMEZ

Guidelines
for
reasonable corporate
governance

Report to the board of MiddleNext

MiddleNext

EMLYON business school

I.F.G.E.
Institut Français
de Gouvernement
des Entreprises

Introduction

In October 2008, MiddleNext ordered a report summarising the fundamental principles of corporate governance from an independent expert, Professor Pierre-Yves Gomez.

It seemed important to us to clarify the fundamentals of sustainable governance before MiddleNext defines the code of governance to which Midcaps could refer.

This document presents the report of Professor Pierre-Yves Gomez for the attention of the MiddleNext Board.

We were keen to publish it because it presents the fundamentals of governance on which all companies can base themselves.

Caroline WEBER
General Director

MiddleNext

Professor Pierre-Yves GOMEZ
Director of the Institut Français de
Gouvernement des Entreprises
EM LYON
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Paris, 8 October 2008

Dear Professor Gomez,

MiddleNext is the reference association defending the interests of Midcaps, and provides a forum for exchanges of ideas, giving rise to innovative practice to achieve progress for our companies and their environment.
This role leads us to feel concern today regarding the proliferation of corporate governance standards. We note that over the last decade, we have gone from almost total ignorance of such issues to overproduction of regulations and codes establishing sometimes anarchic requirements and obligations of "good governance". These texts from the legislator and from soft law are resulting in the often cumbersome standardisation of governance practice.

Given recent economic and financial developments, we cannot deny the absolute necessity of updating governance, notably that applicable to listed companies. However, we do have doubts regarding the multiplication of proposals of which the conceptual foundations and practical effectiveness are not always clear. In particular, it seems to us that the specific features of listed midcaps are not always properly taken into account. Codes of conduct seem to be adapting the standards of large, global companies to companies considered as being "smaller", rather than starting out from the nature of listed midcaps and then defining their governance on that basis.

In the light of the above, we do not wish to add one more "code of conduct" that is specific to midcaps to those that already exist. In fact, our aim is to provide some clarity among the many current proposals, in order to distinguish between those based on a genuine economic analysis of companies and those that are the fruit of fashion or of ideology.
We need our entrepreneurs to gain a better understanding of the fundamental issues of governance and the consequences for their organisation, to enable them to sort through the different standards that might be imposed on them.

We would therefore be delighted to be able to count on your renowned expertise in these fields. In particular, your in-depth knowledge of governance theories combined with your direct participation in the changes currently underway in companies, thanks to the work of the social laboratory of the Institut Français de Gouvernement des Entreprises, gives us the hope that you can help us to establish sound foundations for the governance of medium-sized companies.

We would be most grateful if you would accept to produce a report for MiddleNext, not to make new proposals, but to set down the foundations for the governance of listed midcaps. Ideally, this report should be published before December 2008. The terms of its production and the composition of the commission that will validate it can be arranged at your convenience, and we will be delighted to discuss them if you should accept our proposal.

I look forward to hearing from you.

Yours Sincerely.

Caroline Weber
MiddleNext General Director
Co-President of the Smaller Issuers Committee

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Madame Caroline WEBER
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Lyon, 4 November 2008

Dear Madam,

I am greatly honoured by the confidence expressed in me by the MiddleNext board in proposing that I should write this report. As I told you during our meetings, it seems important to me not to move too quickly in proposing a new code to midcaps, on top of the many texts that already exist on "good governance". The work conducted in France on corporate governance tends to suffer from a surfeit of proposals and codes rather than a lack of them.

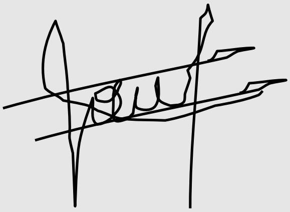
What is lacking in France is the equivalent of what the British have succeeded in achieving through the Combined Code: a text that puts together ideas on corporate governance in a coherent manner to provide a common set of references for all those seeking to make improvements to their practices.

That is what I propose to do in the guidelines I will be submitting to you in May. It will be an opportunity to present the lowest common denominator for all codes of governance by presenting the principles that are the basis of corporate governance.

The MiddleNext association includes medium-sized companies whose capital can in some cases be highly concentrated, and in others widely diluted among the public. Private or family approaches come face-to-face with those of the financial markets. It is therefore an ideal vantage point from which to observe the main issues raised by governance. The general outline I will be presenting provides a framework to be taken into consideration for all kinds of companies. It will then be easy to define governance rules that are compatible with the profile of MiddleNext member companies. That is what we will be doing briefly in the second part of our work, adopting a logical approach that is both pragmatic and consistent.

I look forward to presenting my guidelines to you.

Yours sincerely.



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June 2009

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We are grateful to Corentine Liotard and Fernanda Holterhoff from MiddleNext for their contribution to the editing of this guideline

Preambule

Since the 1990s, there have been a growing number of proposals and rules aiming to improve corporate governance practice. Although they initially concerned listed companies whose capital was diluted among the public, their reach has extended step by step and all companies have now been called upon to practice "good governance".

We have seen an accumulation of codes proposing useful governance reforms: the Vienot I and II reports, then the Bouton report, the codes and guidelines of the AFEP/MEDEF, AMF, AFG, IFA, APIA, IFGE and professional organisations, not forgetting the major steps forward made on the legal front by the Law of 24 July 1966, the Law of 15 May 2001 (Law on New Economic Regulations), etc. This profusion of texts bears testimony to the interest there is in the subject, but it may also have resulted in a certain amount of confusion on the fundamental issues. In particular, the issues specific to each category of company (listed or not, privately- or family-owned or not, etc.) seem so different that it could sometimes be concluded that the preoccupation with governance has mainly focused on listed companies because they are the most concerned by the question – which is quite obviously untrue.
Good governance is just as decisive as good management, and that applies for all companies.

After reviewing the many reference texts, it seemed to us that the business community needs a return to the fundamentals of corporate governance, the "spirit of the laws". This should provide a common language for those concerned by governance, and pinpoint the specific problems it raises for each type of company. On this basis, we will then be able to formulate or reformulate appropriate rules of governance, or to assess those that already exist.

This report presents guidelines for governance that are valid for all types of corporations. They set out the general principles of reasonable governance and serve to pinpoint the governance issues that are specific to the different types of companies. Each representative association or company, if it accepts this framework, will then be able to define the rules that seem best suited to its own governance situation, while remaining consistent with these general principles of reasonable governance.

To compile these guidelines, we have collected information and expert opinions:

– Analysing and synthesising the reference texts issued on governance, to highlight the common ideas to be found in them.

– Observing governance practice in companies of varying sizes and ownership structures, in particular by carrying out in-depth analyses of companies.

– Analysing the many but often-ignored results of research into governance practices that work and those that do not. As for the previous two information sources, we based ourselves on the studies of the French Institute for Corporate Governance (IFGE/EMLYON), a research centre specialised in this field.

– Questioning governance specialists, company managers, corporate officers, consultants and reference institutions to validate the proposals. This work was carried out through bilateral exchanges on the one hand, and through a meeting of a commission of experts representing different sensibilities on governance issues, held in the MiddleNext offices.

The reasonable governance guidelines are made up of three parts:

– In the first part, we present a review of governance issues and highlight the **general principles on which to establish reasonable governance**, whatever the type of company in question (listed or not, diluted shareholding or not, family-owned or entrepreneurial).

– In the second part, we describe the **three fundamental powers of corporate governance** (executive power, supervisory power and sovereign power), clarify their respective responsibilities and the key points to be watched to foster governance practice.

– In the third part, we show that the inter-relation between these three powers defines **five basic governance systems**. For each system, we list the specific issues to be addressed to improve its governance.

> These guidelines ultimately provide a toolbox for users to define rules to resolve the particular governance issues they face in a free and pragmatic way.

Pierre-Yves Gomez
May 2009

Part I: The principles of reasonable governance

Section I - Current principles of "good" corporate governance

Since the 1990s, the rules of corporate governance have been amended in most western countries. This movement has produced a large number of "codes of conduct", mostly written by stakeholders in the business community, and of regulatory texts issued by States or market regulators. Most of these texts consider that the crucial question to be resolved is that of the new responsibility of corporations towards the public investing their savings in them.

In fact, the capital structure of listed companies has considerably evolved in the last twenty years. The savings now invested in these companies no longer concern just a few hundred well-to-do individuals, but millions of savers, either because they have become "small shareholders" (about 80 million households around the world), or because they entrust their savings to financial intermediaries such as pension or investment funds (about 200 million households around the world). This mass saving phenomenon has fundamentally changed the responsibility of companies towards their shareholders. Companies must demonstrate to the business community and to society more generally, that they can provide an income for a large number of shareholders who are not directly involved in their management and with whom they no longer systematically have an affectio societatis.

In these conditions, it seemed necessary to redefine the rules of "good governance", first for listed companies and then, step by step, for most companies receiving investment from the public via financial intermediaries (private equity, investment funds). This trend has now raised the issue of "good governance" for all companies.

Theoretical foundations of current governance principles

The principles underlying the main codes of "good" governance are very much influenced by the new situation in capitalism we have just reviewed, as well as by the prevailing economic theories. They are based either explicitly or, more usually, implicitly on so-called neo-liberal economic theory and more precisely agency theory, which considers that diluted shareholding is the "normal" structure of corporate capital towards which all companies tend over time. In this theory which dominated from the 1980s through until the 2007 crisis, the power of shareholders is linked to their status as "residual claimants", which is to say that they are the final risk-taker, running the risk notably of not being paid if there are no dividends. The financial market is perceived as being the natural regulator of shareholders' interests and risks.

This theory considers that "conflicts of interest" are inevitable between corporate stakeholders, and in particular between top managers and shareholders. Its central hypothesis is that all the stakeholders in governance have different private interests which they seek to promote in an opportunistic manner. It is therefore necessary to create incentives and controls, in particular to limit misuse of power by top managers contrary to the interests of shareholders.

Influence on the texts defining "good" governance

Whether openly or not, the authors of the texts on good governance have been strongly influenced by this conception of governance. This has resulted in what is referred to as "disciplinary" or "punitive" approach to governance, based on two premises:

(1) **A prejudice of mistrust** towards those who hold power, suspected by definition of seeking to overreach their rights, with governance being the way of regulating this opportunism. It is symptomatic that the texts on governance have often been written in the wake of business scandals (the 1992 Cadbury Report in the wake of the Maxwell bankruptcy, for example, or the 2002 Sarbanes Oxley Act after the Enron bankruptcy); they have overreacted to these crises of confidence in company management, sometimes emotionally and with punitive intentions.

(2) **A definition of governance as a system of incentives/sanctions.** To avoid abuses that are perceived as being inevitable, "good" governance has proposed to bring the interests of the stakeholders into line with those of shareholders via incentive policies (performance-related pay, target-based bonuses, etc.), and by introducing stricter requirements and controls, forcing those in power to "disclose" information they would otherwise have a tendency to hide (transparency, disclosure of regulated information, independence of directors, etc.).

These premises have served to draw up a number of practical, sometimes one-off requirements, which have proved useful in changing practices and mentalities. As a general rule, reforms have sought to restrict the discretionary powers of the manager by increasingly sophisticated and formalised control mechanisms (boards, committees, reports, etc.), and to reduce the autonomy of companies to some extent in favour of the financial markets (large-scale communication of information, management ratios adapted to "shareholder expectations", etc.).

Section II - Current governance principles are unsatisfactory

A simplistic definition of governance

It is often suggested that recent governance reforms have been designed and applied for large listed companies with highly diluted shareholding structures, and according to a very partial, ideological view of economic mechanisms. By considering the specific problems raised by these companies as being universal, it is claimed that pointless and cumbersome systems have been imposed on other companies, too. It is indeed true that certain regulations on the large-scale publication of information or the precise composition of boards of directors, for example, are no longer appropriate when the company is a small or even medium-sized one, or when the top manager holds a very significant share of its capital, even if the firm is partly listed.

If we are to understand this dissatisfaction, it is essential to bear in mind that most of the theoretical literature comparing ownership structure around the world focuses on (at best) the one hundred biggest companies of each country. This neglects the broad diversity of firms and tends to generalized their governance models to all companies. As an example, let us remind the structure of French capitalism.

Of the 2,600,000 French companies, 72% are owned by a single shareholder (either an individual or another company). Only 4% of business corporations have diluted capital, which is to say that the biggest shareholder represents no more than 10% of capital (source: Banque de France, 2000).

Only 800 companies are listed. The average share of their float is about 20%. If we take out the top 100, the next 700 have a capitalisation of less than €1 billion (and that was before the crisis), and together they represent less than 4% of the global capitalisation of the Paris market, and less than 2% of transactions (source: MiddleNext 2008). Most of them are family-run. The world of listed companies is therefore far from being a homogenous one.

4,600 companies form the body of medium-sized companies with between 250 and 5,000 employees. 85% of them are privately owned.

There are 27,600 unlisted small and medium companies with 50 employees or more. They are mainly held by one or several shareholders, but commonly face major governance issues that are the cause of many company failures. These issues are raised in the event of successions or of modifications to their capital, on the one hand, and by the development of private equity and the entry into their capital of financial shareholders, on the other.

Almost 1,200,000 companies have between 0 and 50 employees. They face governance issues at three key stages: 1) on starting up; 2) at the transition stage after 10 years, 3) on the transition between the second and third generations (source: APM/ IFGE study 2008).

Finally, we are seeing a very rapid concentration of all companies, with the formation of micro-groups. The number of these has risen from 600 in 1980 to 5,300 in 1995 and to 32,000 in 2005 (Source: INSEE 2005). This restructuring of capitalism also poses specific governance problems.

The fact that codes of conduct have been perceived as being for large listed companies with diluted capital has therefore had a prejudicial effect, preventing their principles from being applied more generally beyond what may be a decisively important category of company, but remains one that is very limited in quantitative terms.

(1) The suspicion hypothesis has resulted in introducing growing numbers of controls and checks and generates an increasingly costly **and unnecessarily formal** system that is meaningless for most companies.

(2) The crisis that started in 2007 has demonstrated that **the effectiveness of disciplinary control measures** is not proven. The economic theory on which they are based is not as sound as was previously thought, as shown by scientific research over the last decade at least. For example, the efficiency of widely owned companies over companies owned by a dominant shareholder remains debatable. Moreover, there is no statistical relationship between top manager pay and corporate performance, and no proven positive effect of the independence of board members. In contrast, it has been demonstrated that compensation committees have a counterproductive effect on director pay. As well as this, the very principle of the shareholder as "residual claimant" has been demolished by the collective power exercised by markets making it possible to impose dividend levels on companies. Unfortunately, these research results are little known or have simply been ignored.

(3) By focusing on formal aspects that concern a limited number of companies, we neglect **more important questions** that are decisive for the governance and the sustainability of all those companies that do not fall within the scope of this type of "governance".

The situation will therefore remain unsatisfactory as long as corporate governance is based on principles that are both simplistic (because reduced to a single category of company) and outdated (because their theoretical foundations have been undermined by economic realities).

Need for universal principles of corporate governance

These issues do not lead us to the conclusion that questions of "good" governance concern only companies benefiting from investment by households. On the contrary, more than ever before, all companies must meet governance requirements to ensure that it is possible to have **reasonable confidence in their sustainability**. Because the company is open to society, it is natural that the stakeholders should demand such confidence when they are risking their money (shareholders or financial backers), jobs (employees) or economic future (suppliers or clients) on it. As for any organisation, whether the State or an association, a failure of governance can have disastrous effects on the continuation of its activities. This is why "good" governance is indispensable as the foundation of stakeholder confidence. In a period such as the present one when our economic mechanisms are in such disrepute, it is perhaps more necessary than ever to clarify the conditions for "good" governance, to provide some visibility as to the sustainability of companies.

However, these conditions depend very much on the type and complexity of the company. For example, in a listed family company, the company's management by its family owners (on which there are no rules) is much more crucial for its future than the disclosure of highly-detailed financial information to the market (which is now mandatory); for a company headed by a charismatic leader, the terms providing for their succession (to which the rules make no reference) are more decisive for its future than the number and quality of independent directors (a subject of painstaking debate). We must accept this diversity as our starting point, and establish **general principles** that take account of it, rather than adapting a particular theoretical model to all companies.

Section III - New principles for reasonable governance

Definitions

We must begin by clarifying the definitions relating to corporate governance.

(1) *Definition of corporate governance* : **Corporate governance is a set of legal, regulatory or practical provisions defining the scope of the power and responsibilities of those responsible for directing the company sustainably. Directing the company means taking and controlling the decisions that have a decisive effect on its soundness and sustainable performance.**

(2) *Definition of the powers that make up governance.* Whatever the company in question, three powers are involved in governance:

a. **Sovereign power** guarantees the continuity of the company, as its highest authority validating the direction of the company and granting legitimacy to those who make the decisions regarding it. In the capitalist system, this power is generally held by the shareholders, but it may be held by other stakeholders, or by partners *(partnership)* or the members of a mutual company. In this report, we will therefore write "shareholders" (in speech marks) to take account of the different possibilities. The important issue is that whoever they might be, the content of their sovereign power, their responsibilities and the practical resources for exercising them must be specified.

b. **Executive power** defines strategies and implements operational decisions to direct the company, within the framework of the powers granted by the previous authority. This power is in the hands of the "top managers".

c. **Supervisory power** ensures that executive power is exercised in compliance with the general interest of the company, its soundness and sustainable performance. This power is exercised by the corporate officers, members of the board of directors or supervisory or other boards, depending on the type of company. As a general rule, to take account of the diversity of company legal statuses, we refer to them in this report as the "directors" (in inverted commas).

The way these three powers (sovereign, executive and supervisory) function together defines the way the company is governed. These powers are not necessarily held by different people, and may even be concentrated in the same hands. The nature of these three powers, which underlies the very notion of corporate governance, should therefore not be confused with the way they are exercised (or not)… The relations between them construct **systems of governance** that are specific to each type of company (listed, family-owned, entrepreneurial, etc.) and which we will describe in the third part of these guidelines. Before that, however, we must define the objective content of each power.

(3) *Definition of the role of governance.* By establishing the fit between the three powers (sovereign, executive and supervisory), a system of governance allows to make and take responsibility for decisions that have lasting consequences for the company. It sets the framework for legitimate decisions and is quite distinct from simple management. <u>Its function consists in establishing a climate of confidence regarding those governing the company.</u> A fair evaluation of governance could therefore consist in asking the following questions: "what reasons are there for having confidence in this company, given the way it is governed?" or "how does the way the company is governed justify confidence in its sustainable performance?"

Three principles for reasonable governance

On the basis of the above definitions, we will talk about **reasonable governance** rather than "good" governance. **By reasonable governance, we mean that it is the spirit of governance that must prevail over the letter, and reason over procedures.** The quality of governance cannot be assessed merely by the strict application of rules, no matter how sophisticated they might be. The multiplication of rules can, on the contrary, diminish the understanding of practical situations and personal liability by hiding behind formalism and quibbling. Reasonable governance supposes that the rules that distribute and control the powers guiding the company over time must be **clear, prudent and effective.**

(1) *Clarification of powers: who is responsible for what?* The role of the players involved in the governance of a company must be carefully set out, so that everyone knows what is expected of them: managing, supervising or legitimising. A large part of the current confusion comes from the fact that the responsibilities of the stakeholders in corporate governance overlap with each other. Clarification is therefore necessary to distinguish between the respective duties and expectations; it avoids encroaching on the roles of others and ultimately blurring responsibilities. **The governance of a company enhances confidence when it testifies to a clear definition of the powers of those governing it.**

(2) *Vigilance to anticipate any failure of governance: can they be foreseen?* Inappropriate use of management and control powers can place the company in peril. Reasonable governance must prevent such malfunctions by avoiding them becoming normal practice. Vigilance does not consist in assuming that the behaviour of those involved in corporate governance is necessarily improper, but in creating the safeguard mechanisms in advance to avoid these malfunctions becoming institutionalised. **Corporate governance enhances confidence when it covers the key points to be watched for each of the powers.**

(3) *Efficiency to enable genuine responsibility.* The governance system must ensure that the three powers (sovereign, executive and supervisory) are exercised effectively. The implementation of rules or procedures must not be a hindrance, but should facilitate the exercise of each power within the limits allotted to it. It is therefore reasonable that a governance system should be composed of a small number of procedures, and that those procedures should be precise, enabling those involved to exercise their responsibility in real terms. **Corporate governance enhances confidence when it ensures that each power is exercised efficiently.**

These three universal principles of reasonable governance are valid for all types of companies, whatever the way power is exercised within them. They will therefore serve as a basis to define reasonable governance guidelines.

In the second part of this report, we will examine the content of the three powers that make up governance: the executive power of the "top managers", the supervisory power of the "directors" and the sovereign power held by the "shareholders". We will define and describe the points to be watched to avoid any excesses.

In the third part of the report, we will describe the five systems of governance that can apply to most companies. For each of them, we will emphasise the particular governance issues that they raise and which need resolving.

Part II: Definition of the three powers that make up governance

In this part, we describe the "powers", which is to say the three main powers that make up corporate governance, regardless of who it is that exercises those powers in practice. Identical people or even one and the same person may hold executive and sovereign powers (when the shareholder is also the top manager). In the next part, we will examine the effective exercise of these functions according to the concentration or separation of the three powers. But in this part, we will begin by specifying what we are talking about when we make the distinction between executive, supervisory and sovereign powers, why it is important that these powers should be exercised, and the points to be watched to prevent any excesses. This will provide us with a general framework in which to analyse specific situations.

Section I - Executive power: the "top managers"

Clarification of this power: the function of the top manager is to take responsibility for strategy

Many current codes of "good" conduct place great emphasis on management control mechanisms (boards, committees, etc.) but much less on the role and responsibility of the manager themselves. Because they guarantee the unity and efficiency of the company and the link between its stakeholders, the top manager does remain the central player in any governance, however.

A lot of confusion has been created, including in the Law, by asserting that all the players in corporate governance should take part, in one way or another, in strategy: board members, and even the shareholders themselves, are sometimes called upon to make decisions on it. **This confusion is unreasonable.** The lack of clarity regarding the stakeholder in charge of strategy blurs actual responsibilities and allows people to attribute the decisions that are made to others, and therefore absolve themselves of responsibility.

It may seem to be something of a commonplace, but it is no doubt necessary to point out that a **strategy can only count if it is applied:** it is according to the available resources and their evolutions that the company can or cannot respond to the demands of the markets and adapt its positioning. Without implementation, there can be no strategy. It is encouraging players not to take responsibility if it is accepted that they can settle for defining the outline of a "strategy" without being involved in its application and in its consequences. However, only the manager and their team can assemble the information about market trends and the company's resources in such a way as to define the optimal strategy and adapt it progressively as it is applied. **This is the *raison d'être* of executive power.**

> **For this reason, reasonable governance guarantees the "top manager" sufficient latitude to define, conduct and take responsibility for company strategy, which is to say all key decisions guiding its activities and structure over the long term.**

By refocusing the role of the top manager on the mission of defining and handling strategy, their particular responsibility in relation to the other figures involved in governance is clarified. This clarification involves a clear separation between management and supervisory powers. However, the key question here is not merely "must the functions of Managing Director and Chairman be separated?" By definition, the management function and the supervisory function are different, as stated by law. The question should therefore be the following: "can these two **different** functions be exercised by the **same** person?" which therefore means concentrating both powers. In the same hands.

For reasons of clarity, it is preferable that these **different** functions should be fulfilled by **different** people, to clearly mark out their specific features. The Managing Director (or executive board) elaborates and handles strategy. The Chairman (or supervisory board) keeps watch to ensure that the activity of the manager is carried out without any excesses likely to bring the sustainable performance of the company into question. While it is important that the manager should be allowed sufficiently wide entrepreneurial latitude to elaborate and conduct strategy, the corollary is that they must not be their own supervisor. The more clearly the missions are defined, the more their separation will be a matter of good sense. Far from weakening the function of the top manager, it actually strengthens it by clearly setting out their specific responsibility upon which other stakeholders must not encroach: this is clearly the aim of the dual form of company (with executive board and supervisory board).

In the name of realism, however, it must be noted that the **formal** separation of functions sometimes gives rise to more red tape than advantages. This reason is often put forward by companies to justify combining the functions in one and the same person. This remains an unsatisfactory solution, however, as regards the spirit of reasonable governance. Therefore, to reduce the cost and complication that this separation can give rise to, particularly in small companies, we can imagine that there could be specific control systems such as, for example, a strategic committee entirely composed of outside figures to which the manager can explain their choices regularly. In this way, each company can find the system that is best suited to its organisation, as long as it complies with this common sense principle: that the power of the top manager is all the more legitimate, and therefore all the greater a source of confidence, when **the control of any misuse this power is placed in hands other than his own.**

Four points to be watched concerning the executive function

(1) *Does the "top manager" have the right skills?* There must be a match between the complexity of the strategy, and the skills required to prepare and apply it. The more complex the environment of the company, the greater the level of skills required to handle that complexity. This is not necessarily linked to the size of the company, because even a small entity can do business in a complex environment. The point to be watched consists in checking to see whether the number of people involved in strategy and the strategic and operational risk management tools are sufficient to cover the different complementary skills. This consists in **assessing the degree of concentration of the skills necessary** for preparing and monitoring strategy. The concentration of these skills among a small number of people (and even more so in the hands of one person) can represent a danger for the sustainability of the company.

(2) *Is the "top manager" isolated?* While the mission of the manager consists in being responsible for strategy, their duty is to report regularly on its implementation and any difficulties encountered. From this point of view, **the solitude of the top manager** represents a non-negligible risk. The point to be watched consists in observing whether the manager has access to sufficient formal and informal forums to allow them to report and discuss their decisions objectively and seriously. The formal forum for this will generally be the board of directors. This concerns small companies as well as large ones, with recent events having shown that solitude can have an effect on top managers, even in large groups. Once again, in the name of realism, there must be a link with the complexity of the company: the more complex it is, the more regular and formal these exchanges must be; they can be less regular if the degree of complexity of the problems to be resolved is small. But at all events, they must exist to ensure that the top manager does not become isolated, which could be dangerous for themselves as well as for the company.

(3) *Can the top manager's compensation seriously influence their decisions?* Much has been written on this polemic issue. Reference is usually made to the level of compensation (deemed to be excessive). However, the question should be seen as being one of the dimensions of governance, and should be approached as follows: is the compensation of the top manager likely to limit their ability to make judgements, and therefore be detrimental to the exercise of their mission? To answer this, attention must be paid to two possible biases.

a. *The level of compensation* must be an incentive for the manager to take on the wide-ranging responsibilities conferred on them. However, it must not be so high that it could make them lose a certain sense of realities, and notably of those experienced by the other persons in the company. There is a psychological phenomenon that is well known among behavioural finance specialists, in which a certain level of financial income causes a disconnection from reality and therefore opens up the possibility of irrational decisions. The fact that excessive pay could generate such excesses has no doubt been underestimated, quite aside from any issues of justice. In the interests of realism, it should be seen whether excessively low or excessively high compensation is not likely **to generate abnormal decisions.** For reasons of caution, it is preferable that **rather than the absolute level of compensation, it should be the change in compensation that is published, at the same time as that of the other stakeholders in the company (employees, shareholders, financiers, State), to ensure there are no excesses.**

b. *Can the type of compensation have an influence on the strategic decisions of top managers?* It has been demonstrated that certain forms of compensation can induce preferences for some strategies rather than others. This is an undesirable effect that should be taken into consideration. A fair compensation system must leave the top manager free to make decisions in the best interests of the company, which is to say in the interest of its soundness and sustainable performance. The compensation systems proposed for top managers must therefore take account of any possible consequences on strategic decisions.

(4) *Are there arrangements for the succession of the "top manager"?* It is important to know what provisions have been made for the succession of the incumbent manager, who can take over from them, in such a way as to **evaluate the risks in the event of a succession crisis.** The codes have not placed much emphasis on this issue, but it is a decisive one for many companies. Given the wide-ranging mission we attribute to top managers, it seems reasonable that the governance system should specify who would replace them in the event of a vacancy. This question is particularly crucial for family companies or for companies headed by a charismatic leader, the future of which can be brought into question in the event of a succession crisis. We therefore recommend that companies should be encouraged to specify who would be responsible for replacing the top manager in the event of a vacancy. This would then allow successions to be prepared for serenely, to ensure that the skills are there to take over, and to avoid the symbolic weight of managing the company resting entirely on the shoulders of a single person.

In brief

The power of the manager must be sufficiently wide-ranging to enable them to exercise full responsibility for strategy. Caution requires, however, that it should be ensured that this responsibility can actually be exercised because the manager possesses the necessary skills or knows how to surround themselves with such skills, because there are forums for discussion and evaluation to avoid the manager becoming isolated, because the manager's compensation does not bias their judgement, and because provisions have been made for their succession.

Some key signs to evaluate this power

- Degree of concentration/dispersion of the powers of the top executive.
- Degree of solitude of the top manager.
- Are there any external people to challenge the top manager?
- Relative increase in compensation compared to company results and compensation of the other stakeholders.
- Is there a potential successor to take over in the event of a top management vacancy?

Section II - Supervisory power: the "directors"

Clarification of this power: it anticipates and prevents any misuse of executive power

Of the three powers that make up corporate governance, the supervisory power is, without a doubt, the one that has given rise to the most discussions and recommendations. Most of the codes take an interest in the roles and responsibilities of the "directors", and to such an extent that it is far from rare for discussions on corporate governance to revolve around the number of directors or their independence. But the interest of giving the "directors" a broader role in supervising the executive does not concern only listed companies:

(1) the fast-growing complexity of the economy has created the need for more precise supervision of the executive function to ensure that it adapts to the economic context.

(2) a more in-depth understanding of company development has highlighted certain stages in that process when particular attention must be paid to changes in the executive function. Notably 1) on the creation of the company; 2) at a first growth plateau after about 10 years; 3) at the time of the succession of the company founder; 4) when the assets pass from one generation to the next, notably to the third generation.

But recent changes in governance have also caused increased expectations of "directors". They have been asked not only to exercise supervisory functions, but also to participate in the executive and, more generally, to take responsibility for most of the risks the company is faced with. From the beginning, the law has itself been quite unclear as to their respective functions, in particular the powers of the Chairman of the board. However, this lack of clarity is detrimental to the responsibility of each stakeholder. It asks of "directors" much more than can be expected of a function that is carried out a few days a year at best. Ultimately, it can result in undermining the credibility of the supervisory function. It is for this reason that we consider it indispensable to refocus the role of the "director" and to distinguish it clearly from that of the executive.

In reasonable governance, the mission of the supervisory power is to check that the conditions are fulfilled for executive power to be exercised without any malfunctions that might bring the future of the company into question.

In other words, while the "top manager" has an obligation to achieve results as far as the strategy they propose is concerned, the "directors" have an obligation to provide the means to ensure that the executive function is fulfilled without any excesses that might be detrimental to the company. Supervision is therefore focused in three directions:

(1) *Check that there are no serious malfunctions in the way executive power is exercised, including in the strategic choices that are likely to bring the long-term performance of the company into question.* The "directors" are

in the front line in the event of a top management vacancy. They ensure that the strategy has been defined and that it is applied without any vacancies of power. It is for this purpose that they have the power to validate budgets, or not, as well as the other major decisions that are explicitly mentioned. The exercise of this right raises genuine difficulties of application because it must be done with all due care to prevent any abuses and avoid interference by the "directors" in this field.

(2) *Contribute to good governance by monitoring the four points to be watched for executive power:* these concern the skills, isolation, compensation and succession of "top managers".

(3) *Make regular reports to the holders of sovereign power – the "shareholders" – on the supervisory duties, and take responsibility for them.* It is the "shareholders" who provide the legitimacy and therefore the real capacity for independence of the "directors".

Therefore, supervisory power must not overlap with executive power, and it is in no way a back-up executive power. Its function is to ensure that the decision-making latitude of the "top managers" is exercised without any excesses that might harm the future of the company.

Five points to watch for supervisory power

(1) *Does supervisory power overlap with executive power?* The company can suffer as much from an absence of supervision as from inappropriate interference in the executive. Although the "dual" form (separation between the supervisory board and executive board) may seem to provide a legal clarification of this separation of responsibilities, the spirit of governance must prevail over the letter in this case too. Each company must choose the form that suits it best in the light of its complexity. However, whatever the choice it makes, **the precise definition of the role of the "top manager" and that of the "director" must be written into the rules it sets out and supplied to the "shareholders", for example at the beginning of the annual governance report.** This definition must take account of two principles:

a. the directors cannot be held responsible either for strategy or operational risks.

b. the directors can be held responsible for the effective supervision of the risks of malfunctions of executive power, and therefore for their diligence in ensuring that the executive power has established the means to control strategic and operational risks.

(2) *Are the "directors" carrying out their supervisory duties effectively?* Much has been written on this question: the number and duration of board meetings, regular participation of directors in board meetings, etc. Necessary as these recommendations may be, given the legal vacuum that exists, they have perhaps focused too much attention on the procedures and not enough on the broader meaning of these supervisory duties. Board meetings and the files

and information supplied to directors between meetings are **means and not an end.** In the spirit of reasonable governance, the duty of supervision implies that the "directors" are accountable to the "shareholders" for a genuine evaluation of the executive's ability to lead the company sustainably. **Therefore, the key to expressing the reality of the directors' work is the way they report on this to the "shareholders".** This can be done, for example, in an annual report on their supervisory mission ("report to the shareholders on governance") that must be sufficiently clear and concrete to enable those shareholders to assess their diligence, and must be binding jointly on all the "directors".

a. According to its complexity, each type of company can define, with its "shareholders", the points to be included in such a report, notably the terms of the work (number of board meetings, duration, terms on which the minutes are made available, etc.). Its validation by a general meeting is an essential part of the governance system.

b. For many companies, writing this report can be a way of breaking the solitude of the manager by giving them a fresh insight into their practices. It therefore seems necessary that when the functions of chairman and managing director are fulfilled by the same person, the task of writing the annual report should be delegated to another member of the board.

Whatever the terms that are chosen, the spirit must prevail over the letter of the rules: the supervisory power will be perceived as being unreliable or even inexistent if the "directors" never actually report on their work to the "shareholders".

(3) *Do the directors have the material means to fulfil their mission?* Among other things, these means include organising regular board meetings. But more essentially, they imply two dimensions: first, that the necessary information for preparing board meetings is provided so that the "directors" can inform themselves on the subjects being addressed and forge an opinion, and second, that the board must operate in such a way that it allows respect for, the expression and traceability of any diverging opinions before decisions are made on a collegiate basis. Once again, it is unrealistic to formalise the quantity and nature of the necessary information and the way board meetings should be held. It seems more useful to us to recommend that it should be up to the directors themselves to assess whether the information provided to them seems sufficient to make their judgement, in the same way that statutory accounts auditors do. **It is therefore up to the directors to confirm, for example in the introduction to the "report to the shareholders on governance", that they are in possession of sufficient information to make their judgement on the points to be watched by them (and them alone), and that there are minutes of board meetings as evidence that there has been genuine discussion of the subjects addressed.** The responsibility of the directors, and also that of the executive power, is therefore

engaged if they should consider that they are not free to present their arguments or sufficiently informed to be able to make a judgement.

(4) *Do the "directors" have the right skills?* The panel of "directors" must have sufficient abilities to assess those of the "top manager". A variety of skills within the board is therefore essential, according to the complexity and realities of the company. Director appointments must take account of this, as we will see later.

(5) *Can the work conditions of the "directors" create bias and affect the independence of their judgement?* Judgement depends fundamentally on the material conditions which allow the supervisory function to be fulfilled, or not. Three items must be taken into consideration:

a. *Compensation level*. Excessively low compensation can discourage the involvement of the "director". On the other hand, excessively high compensation can make them highly dependent on the company. Compensation must therefore be defined in such a way that it rewards effective participation in the work of the board, as well as the preparation of this work, according to the files to be addressed. **We recommend that the annual working time expected of the director should be related to the proposed compensation and communicated to the "shareholders" on appointment of the director.**

b. *Term of office*. Too short and it limits the effects of experience. Too long and the director can get used to the function, which may erode the quality of supervision. The term can depend on the nature of the shareholders and the directors representing them. Aside from recommendations on the term, it is necessary to look into **the average "director" turnover** to check that although some directors may remain in office for a long time, due to the fact they hold a stake in the capital, there should still be renewal of the points of view present on the Board.

c. *Dismissal*. While in legal terms the "director" can be dismissed instantaneously by the shareholders, in practice, the top manager can pressure them to resign, in the event of a disagreement, especially if the top executive is also a major shareholder. Diligence in exercising supervisory duty may be weakened by this risk. It would seem reasonable to protect the "director" by demanding of the Board that it should state the reasons for a director's departure to the general meeting of shareholders.

In brief

The supervisory function in corporate governance is not disciplinary, assuming that the "top manager" must be monitored to exercise executive power properly. It contributes to the sustainability of the company at different stages in its history, by anticipating and preventing possible abuses of the executive becoming institutionalised. Except in borderline cases, malfunctions do not concern the content of decisions, but the terms on which executive power is exercised. This definition limits supervisory power and therefore endows it with legitimacy and force.

Some key signs to evaluate this power

- ☛ Repeated conflicts with the executive on the scope of supervisory powers.
- ☛ Material means to do its work: information flows, minutes of meetings available to "directors" for consultation.
- ☛ The holders of supervisory power are not reporting to the "shareholders" on their work.
- ☛ Range and diversity of "directors" skills.
- ☛ "Director" turnover: too high and they cannot be independent in their judgements, too low and there is the risk of arrangements with the executive.

Section III - Sovereign power: the "shareholders"

Clarification of this power: what does sovereign power over a company consist of?

The debate about who should have sovereign power over a company is a recurring theme in the history of capitalism. At present, two options are commonly put forward: the first considers that **ownership of the capital** defines ultimate sovereignty of the company; and the second, founded among other things on the theory of stakeholders, affirms that sovereignty should be broadened to include a **whole set of protagonists who contribute to the company's existence:** staff, clients, public authorities, etc. This approach is based on the fact that in a service economy, financial capital is no longer the main driving force behind value creation. Variants on the number and qualification of these stakeholders are sometimes wide-ranging and define various forms of company (cooperatives, mutual societies, partnerships, etc.).

These questions are complex and do not fall within the scope of this report. To simplify the discussion of these points, we will now call the people who exercise the sovereign function "shareholders", in reference to the commonest form, that of the stock company. This does not presume a single definition of shareholders, which will be left to the discretion of users of these guidelines, who may understand by this term the stakeholder(s) that fit their situation.

Because whatever the legitimate debate, it is indispensable to define who incarnates *responsibility for the continuity of the company*. The proper working of the economy requires that this responsibility is assured, be it by family owners, members of a mutual society or the shareholders of a listed company. Without them, the productive accumulation that is specific to capitalism, and takes time, is not achieved or is done badly. **Continuity assumes the existence of sustainable performance, that is, not only the profit required for business to continue but also profit-making conditions that enable performance over the long term.** A company without a stakeholder who takes responsibility for its sustainability, and therefore takes the long view, has no future. This is why:

Sovereign power over the company consists in embodying the symbolic and practical responsibility for its continuity, and providing the other powers with the means to perform their tasks. The coupling of sovereignty over the company with the duty to commit to its continuity is the basis for corporate governance.

It is likely that the current crisis is a sign of the fact that this elementary principle of capitalistic logic has been forgotten. This is why the key issue in governance is to pinpoint whether those who hold sovereign power actually exercise it with the sustainability of the company in mind, and therefore whether their power is legitimate. But we soon come up against a major difficulty: how can "shareholders" exercise sovereign power in practical terms? Should they be in control, handling strategy directly by sanctioning it? The ambiguity surrounding the reality of the power of "shareholders" largely stems from the difficulty in defining it. It is sometimes implied that the "shareholders" should have extensive knowledge of the company, as if they were themselves the top managers and directors. Given the material impossibility of acquiring this knowledge and the low level of involvement of most "shareholders" in the day-to-day running of companies, it is often concluded that the responsibility of "shareholders" is an illusion. But as we have said, this is prejudicial to the logic of capitalist system itself. This is why we should strictly limit the expression of the sovereignty of shareholders in order to ensure that it can at least be effective:

> **Sovereign power "of shareholders" is exercised in particular by the appointment of those who have supervisory power – the "directors" – and control over their activity.**

As we have seen, the directors take responsibility for monitoring the executive function, and governance is thus cascaded. This minimalist definition of the sovereign function, far from limiting the power of "shareholders", actually gives them a genuine ability to assume responsibility for the sustainability of the company. The aim is therefore to be vigilant that it is genuinely carried out.

Five points to watch for the sovereign function

(1) *Are the "shareholders" informed of the foreseeable risks that might threaten the sustainability of the company?* Any "shareholder" must be able to withdraw from the company if they think it necessary. To do so, they must be informed of the situation fairly. **The point to be watched is therefore to assess whether the shareholder has clear information about the major foreseeable risks that may threaten lasting profit.** These risks are of two types:

a. The foreseeable risks relating to strategic choices, particularly those that may call into question the sustainability of performance. This is what the information should emphasise, so that these risks may be assessed in full knowledge of what is at stake and may enable them to decide whether to remain in the company, or otherwise.

b. The risks relating to malfunctions in the governance system. The key responsibility of "shareholders" is to ensure that the sustainability of the company is in no way lessened by a lack of governance supervision. They should therefore be informed of the way the company is responding to the five points to watch as regards the "directors". This is the essential purpose of the **governance report** which we defined in Section II.

All in all, rather than information claiming to be exhaustive and which ultimately obscures or dilutes the reality of their responsibility, reasonable governance should prefer **information that is targeted** to the "shareholders" on the major strategic risks and on the work of those who exercise the supervisory powers.

(2) *Do the "shareholders" really choose the "directors"?* The appointment – and control – of the corporate officers fully epitomises sovereign power. But the "shareholders" must be given credible choices, since a vote without choice is only a simulacrum of a vote. For this reason, the appointment of each "director" must be the subject of a specific resolution.
In addition, each resolution must provide the shareholders with sufficient information about the experience and skills of the possible "director" to enable them to make a fully informed decision on the appointment.

(3) *Do the "shareholders" take part in votes?* The main element in sovereign power is voting in general assemblies. These votes are both actual and symbolic. They should therefore be organised in such a way that no doubt can be cast over their legitimacy. Greater attention should be paid to **the concrete practice of voting,** which is one of the weakest points in current governance. Five possible areas are to be explored:

a. The real power of an annual general assembly of "shareholders" can only be exercised realistically if the number of "shareholders" is limited. This sort of assembly becomes inoperable when sovereign power is exercised by thousands of "shareholders" and makes discussion and actual participation in the votes physically impossible. There is no point in pretending otherwise. A great deal of imagination will be necessary in the future to come up with **shareholder representation bodies which take account of their mass** and allow true, knowledgeable voting with peace of mind. This task will be inevitable for listed companies with highly-diluted capital, if their governance is to become reasonable once again.

b. For the shareholders' vote to be legitimate, the summons to this vote and the information about its purpose must be sent sufficiently in advance and with perfect clarity as to what is at stake.

   Rather than the quantity, the emphasis should be on the quality and relevance of the information that is provided.

c. The possibility of taking part in the vote in the two decisions described above (standpoint on future major risks, and choice of "directors") is the epitome of the symbolic and material power of the "shareholders". This is why **the existence of non-voting shares or of "shareholders" who do not use their voting rights is an aberration**. It institutionalises the removal of responsibility from the shareholders or makes them nothing more than capital investors without sovereign power, as in limited equity partnerships. In this case, it is preferable to call these types of players investors, providers of capital without any say, and to exclude them from governance in order to distinguish them from the true "shareholders" exercising their sovereign responsibilities fully.

For the same reason, **the existence of shares with additional voting rights is not devoid of interest** if it encourages the long-term commitment of the "shareholders". It is difficult to ask shareholders to be guarantors of the continuity of the company without giving more influence to those who accept to take a personal risk in this continuity. **Nonetheless, the existence of additional voting rights can also give rise to abuse,** allowing someone with few shares to have control over a company. This is why the debate remains open, although it concerns only a few hundred companies: to decide, it will be reasonable to explain clearly, in the adaptations of these guidelines by the companies in question, the benefits the companies expect of such systems and the ways in which they can increase confidence in their governance.

d. The act of voting is the concrete expression of the shareholder's sovereign function. It does not seem absurd to establish a variable link between the remuneration of shareholders and participation in the vote, as has been done for directors (compensation linked to their actual participation on the Board)…

e. The control of the "shareholders" over the "directors" is a decisive element in governance. Therefore, a proxy cannot be used by any other protagonist in corporate government (executive or supervisory) without the whole logic of the edifice being threatened. This is why it is not right for "shareholders" to be able to give a proxy to a "director" or, even worse, to the chairman of the board, and this practice must be limited to exceptional cases in terms of capital structure.

(4) *Is there the risk of depriving minority shareholders of their rights?* Decisions in assemblies are taken by majority vote, and minority shareholders may systematically be the victims of choices in which they have no influence. While it is true that minority shareholders cannot hope to influence decisions when they only have a very small part of the capital, if their claims are excessive when set against the derisory financial risk they are taking, or when their involvement in the sustainability of the company is arguable. But irrespective of the companies under consideration, discrimination of certain shareholders constitutes a prejudice, be it through one-sided information transfers, regulated conventions, excessive remuneration for managers who hold the majority of the capital, etc. In most Western countries, there are rules to protect minority shareholders. From our angle, this protection is essentially achieved if the shareholders really exercise control over the supervisory function, within the limits that we have outlined. This assumes 1) choices, in particular in the appointment of corporate officers, thereby avoiding

the "referendum effect"; 2) publicly announced clear information that engages the responsibility of the "directors", giving a list of practices that would lead to depriving shareholders of their rights: absence of control over executive excesses, existence of regulated conventions, etc. The definition of these practices must be written into the governance report and will be at the heart of the adaptation of these guidelines to the situations of companies. The responsibility of the directors should be engaged in the event of failure to provide information about these practices, and the ensuing sanctions should be defined. The principle of reasonable conduct, limited to certain possible abuses but precise as regards failure to comply, seems sufficient to ensure protection of minority shareholders.

(5) *Is the development of share ownership properly managed?* Bearing in mind the importance of sovereign power in the balance of corporate governance, reasonable governance must include management of share ownership over the long term. In particular, it must anticipate two classic phenomena: the division of shareholders into rival factions, and the loss of *affectio societatis* because of the growing size of the body of shareholders. Both have devastating effects on the company and are among the commonest causes of failures, notably among private or family-owned companies. The vigilance points mentioned earlier must contribute to maintaining **the sovereignty / quest for sustainability link** throughout the life of the company. Forward-looking procedures for the management of share ownership could be envisaged, in order to ensure long-term balanced government via:

a. Training the shareholders in how to exercise their responsibility, over and above the mere convocation to assemblies.

b. Anticipation of the natural changes to share ownership or the future needs in this respect as and when the company develops.

c. Preparation of mechanisms to safeguard and buy back shares in the event of disagreement between shareholders likely to damage the running of the company, well in advance of any crises.

In brief

The sovereign power of "shareholders", irrespective of the way they are defined, is one of the cornerstones of good corporate governance, and probably the most fragile today. It consists in symbolically being accountable for the existence of sustainable performance, in concrete terms. Vigilance involves ensuring that this power is not unduly extended or, conversely, misused because there is no real commitment by the shareholders. We therefore recommend clear, targeted information about the key strategic risks, a choice between candidates for the position of corporate officers; encouragement of actual voting when shareholders are consulted, and forward-looking management of share ownership. These issues concern all types of companies at various moments in their history. The contemporary crisis has shown us that corporate governance must re-integrate the question of share ownership in order to lay the foundations for reasonable, confidence-generating governance.

Some key signs to evaluate this power

- ☛ Quantity and quality of information given to shareholders tailored to the decisions they have to make.
- ☛ A degree of genuine choice in the appointment of managing agents.
- ☛ Voting percentage in assemblies.
- ☛ Rate of resolution approval and "referendum effect".
- ☛ Rate of distribution between voting rights and share of capital.
- ☛ Number of resolutions adopted originating from minority shareholders.
- ☛ Intensive training of shareholders.

Synthesis: definition of the three powers

EXECUTIVE POWER

Defines, manages and is accountable for corporate strategy, i.e. all the decisions that orient its activities and structure, decisively and long-term.

Four points to watch
(1) *Does the "top manager" have the right skills?*
(2) *Is the "top manager" isolated?*
(3) *Can the "top manager's" compensation blas their judgement?*
(4) *Are there arrangements for the succession of the "top manager"?*

SUPERVISORY POWER

Cheeks that the conditions are fulfilled for executive power to be exercised without any malfunctions likely to call the sustainability of the company into question.

(1) *Check that there are no serious malfunctions in the way exective power is exercised, including in the strategic choices that are likely to bring the long-term performance of the company into question.*

(2) *Monitor the four points to be watched for excutive power.*

(3) *Make regular reports to the holders of sovereign power - the "shareholders" - on the supervisory duties, and take responsibility for them.*

Five points to watch
(1) *Does supervisory power overlap with executive power?*
(2) *Are the "directors" carrying out their supervisory duties effectively?*
(3) *Do the "directors" have the material means to fulfil their mission?*
(4) *Do the "directors" have the right skills?*
(5) *Can the work conditions of the "directors" create bias and affect the indemendence of their judgement?*

SOVEREIGN POWER

Embodies the symbolic and practical responsibility for the continuity of the company. This continuity assumes profit-making conditions allowing long-term performance.

Five points to watch
(1) *Are the "shareholders" informed of the foreseeable risks that may threaten the sustainability of the company?*
(2) *Do the "shareholders" really choose the directors?*
(3) *Do the "shareholders" take part in the votes?*
(4) *Is there the risk of depriving minority "shareholders" of their rights?*
(5) *Is "share ownership" managed properly?*

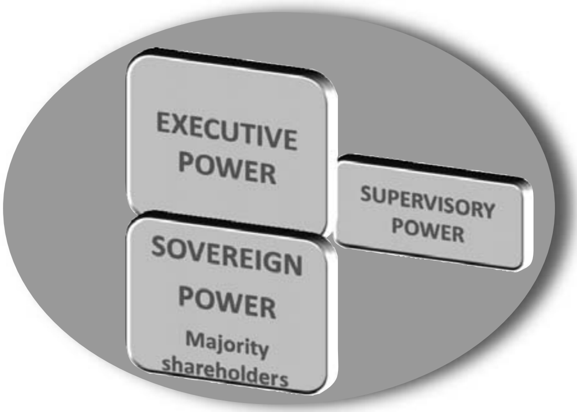
We have a first toolbox enabling us to pinpoint the extent and possible excesses of each type of power. We can see that by definition, the purpose of these guidelines is not to be applied extensively. They offer a framework for asking the right questions and finding the keys to their answers. Naturally, these also depend on the way the powers are distributed and held. This is what we are going to examine in Part Three.

Part III: The five systems of governance

The way the three powers we have described are organised defines a **system of governance**. In this part, we describe **five standard systems of governance** which represent the majority of cases seen in companies. For each system, we emphasise the particular risks run when governance is not adapted, and give special recommendations for improving governance. It is to deal with these risks that representative associations of the companies themselves can put forward reasonable, practical systems.

System n° 1: Closed entrepreneurial autocracy

The executive power and the sovereign power are held by the same person. Shareholding is concentrated. Supervisory power is very weak or nonexistent.



CHARACTERISTICS: The executive, i.e. the "top managers", control 100% of capital and the supervisory authority.

TYPE: Companies run by an entrepreneur, privately- or family-owned companies with concentrated, closed shareholding.

RISKS LINKED TO GOVERNANCE:

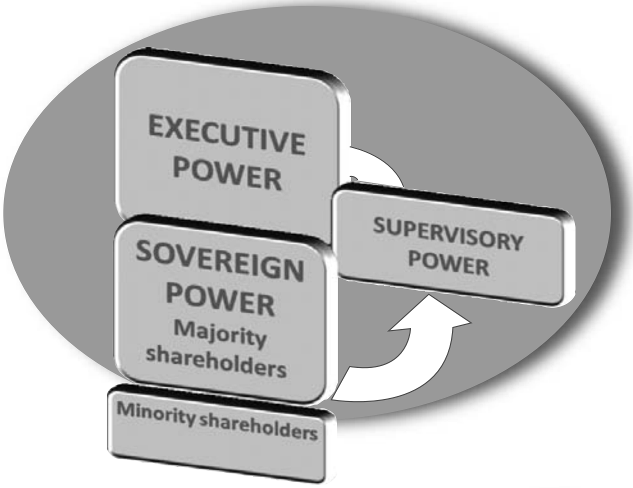
1) Absence of supervision, notably in regard to the way the manager's powers evolve, their isolation and succession.
2) Break in cohesion in the event of opening up the capital or demographic growth in the number of shareholders caused by expansion of the company.

SPECIAL RECOMMENDATIONS:

1) Minimise the formal obligations of governance.
2) Encourage flexible structures allowing supervisory power to be increased, notably in the three key periods: creation, 10 years of existence, transmission.
3) Anticipate the fragmentation of share ownership and the appearance of minority shareholders, even if they are part of the family.

System n° 2: Disclosed entrepreneurial autocracy

Majority shareholders control the executive power but there are minority shareholders. Supervisory power and executive power are in the hands of majority shareholders.



SITUATION: the executive controls the majority of capital except for a minority shareholding. Supervisory power is under the control of the executive.

TYPE:

– Unlisted privately- or family-owned companies with fragmented shareholding (e.g. family branches in disagreement), or including external capital investors.
– Listed privately- or family-owned companies with a small float.

RISKS:

1) Lack of supervision identical to previous case. +
2) Depriving minority shareholders of their rights because they have no means to supervise.
3) Unstable governance due to the strategies of minority shareholders.

SPECIAL RECOMMENDATIONS:

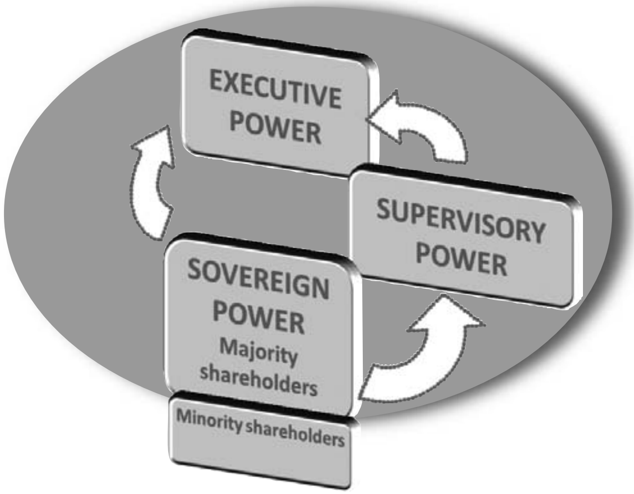
Identical to previous case

+ Develop governance of shareholders and corresponding points to watch, in particular:

1) Systems allowing minority shareholders to have their say and to withdraw from the capital.
2) In companies for which the withdrawal of minority shareholders (non-listed family firms, for example) is difficult or impossible, training of minority shareholders to ensure their commitment to company dynamics and their loyalty.

System n° 3: Shareholder domination

The shareholders are powerful because they are concentrated, but do not directly exercise executive power.



SITUATION: Dominant shareholders control the capital and the supervisory power. The executive power is entrusted to managers. There may be minority shareholders.

TYPE:

– Privately-owned companies in which the founding families no longer run the company.
– Entrepreneurial companies dominated by private equity or private equity funds.
– Listed companies with concentrated capital.
– Certain subsidiaries of groups.
– Micro-groups: set of medium-sized or small companies owned by a holding company or group head.

RISKS:

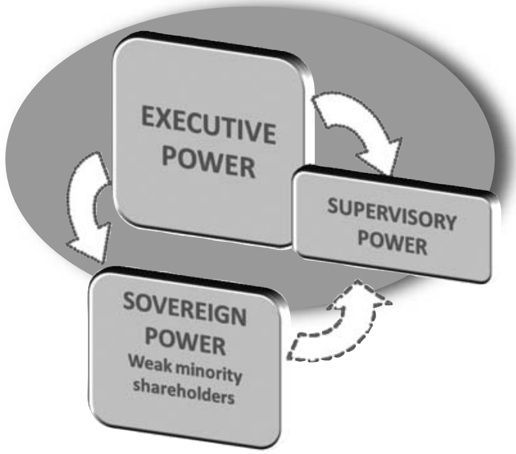
1) Superimposition of the executive and supervisory roles. Direct interference from shareholders challenging the authority of the executive.
2) If there are minority shareholders, same risks of being deprived of their rights as in previous case.

SPECIAL RECOMMENDATIONS:

1) Develop governance of the supervisory power, specifying roles and responsibilities. A clear dual structure becomes preferable.
2) If there are minority shareholders, develop shareholder governance and corresponding points to watch (see system n°2).

System n° 4: Managerial domination

The shareholders have little power because they are dispersed or inactive and delegate the executive power to salaried top managers.



SITUATION: The shareholders do not exercise their sovereign responsibility because they are indifferent to the company:

- Either because they are uninterested in the realities of the business (e.g. dormant family shareholding).
- Or because they are speculative and have no particular affectio societatis (e.g. large volatile float of listed companies).

The executive is composed of managers who have no capital but have de facto control over the supervisory functions and define management of shareholders.

TYPE:

– Privately or family-owned companies with dormant shareholders.

– Public companies in which the State does not play its role as shareholder.

– Listed companies whose capital is totally diluted in the public.

RISKS:

1) As the responsibility for the continuity of the company is not assumed by the shareholders, there is strategic instability: permanent risk of takeover bids when the company is listed, risk of sudden unexpected changes to the demands of dormant shareholders.
2) Abuses of executive power, excessive increases in pay, absence of supervision (see case n°1).
3) Shareholders deprived of some of their rights (see previous cases).

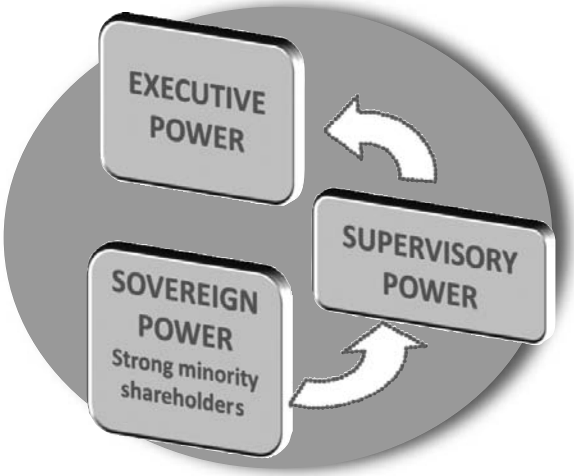
SPECIAL RECOMMENDATIONS:

See cases n°1 and 2 +

Develop sovereign power and the related points to watch to increase the stability of shareholders: training, involvement, alternative votes etc.

System n° 5: Entrepreneurial democracy

This is the ideal system of the textbooks symmetrical to system n°1.



SITUATION: The three powers are perfectly separated and exercised by each protagonist. The capital belongs to active shareholders, supervision is conducted independently and the executive power has freedom to fulfil its mission.

TYPE:

– Companies with a strong culture of governance.

RISKS:

1) Unstable system which may switch to the manager leadership system or shareholder leadership system if there is a change in the balance of power.
2) High control costs to ensure the system works.

SPECIAL RECOMMENDATIONS:

Examine whether the complexity of the company requires such a complex system of governance in order to avoid excessive costs.

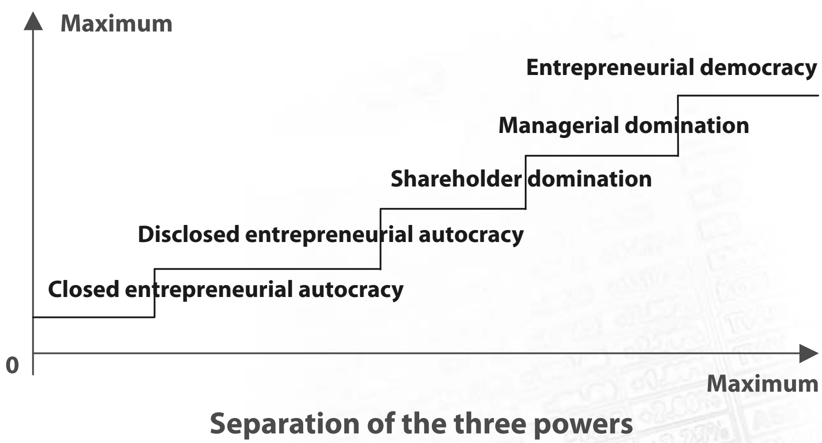
As the above descriptions show, there is no such thing as a single system of governance, and even less so, just one "good governance". Each system depends on:

(1) the degree of concentration of the powers depending on the confusion between management and ownership of the company.

(2) the real power of influence of the shareholders, notably because of varying degrees of fragmentation.

No one system is better than another, but each must be adapted to the economic situation of the company and meet its needs and complexity. As a result, the recommendations to ensure reasonable governance relate to the situation in which each company finds itself. This second toolbox can be used to detect the problems specific to each system of governance and to anticipate, where necessary, those that will arise when there is a change of system..

Complexity and formalisation of governance



It is clear that between the two extremes (entrepreneurial autocracy and entrepreneurial democracy), the norms and the formalisation of governance procedure increase with the separation of the three powers and make governance increasingly complex, and therefore costly. In the other direction, they enable an association of more financial and human resources and therefore a better response to the company's complexity. This is the trade-off faced by all companies.

Conclusion

How to use these guidelines

The objective of this report was to put forward a **simple, unified guidelines to define the general problems of governance that occur in all companies.**

To build these guidelines, we have described:

(1) The general principles that must be behind the definition of governance codes: clarification of powers, vigilance about excesses in the exercise of each power, efficiency in order to enable each power to exercise its responsibilities. Part I.

(2) The three powers, their definition and the points to watch regarding their excesses. Part II.

(3) The five systems of governance and their specific features in terms of governance. Part III.

These guidelines propose two "toolboxes": the first is used to define the key issues raised by the exercise of the three powers composing governance. This is not a question of applying all the points to watch mentioned here, but to understand their spirit and the need to come back to them when necessary. The second "toolbox" helps the user of these guidelines situate their governance and the particular questions it raises. To respond to the governance problems raised, users can refer to the description of the three powers and the points to watch in order to set the necessary rules of behaviour that seem necessary to them to consolidate, develop or redefine each of the powers.

> These global guidelines can enable dialogue about governance of all types of company, and pinpoint the changes they need according to their history, their size, their growth, etc., without imposing any general norms. It is then up to each association representing the categories of company (listed or otherwise, medium-sized, family owned or run by a founder-entrepreneur, etc.), if it adopts these principles, to transform them into **special application rules adapted to the reality of the company.**

This first version of the guidelines will provide a starting point for working towards more consistent corporate governance practice in France, and will benefit from the remarks and proposals of its users to improve the relevance and efficiency of future versions, especially in international contexts.

Experts consulted

The Commission set up under the aegis of MiddleNext and chaired by Pr. Pierre-Yves Gomez was composed of a panel of personalities representing most of the stakeholders in corporate governance. In accordance with the work protocol that was adopted, these experts expressed their sometimes diverging opinions freely, and for this reason the conclusions of these guidelines engage the sole responsibility of their author.

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About the IFGE

Based on the work underway at EM LYON Business School since 1996, the purpose of the French Institute for Corporate Governance (Institut Français du Gouvernement des Entreprises - I.F.G.E) is to conduct research into corporate governance within the European framework, and to place the results at the service of society. Currently headed by Pierre-Yves Gomez, the Institute promotes a form of corporate governance based on a sense of individual responsibilities and seeking the common good.

The IFGE:

- Conducts organised fundamental research in a Centre with 21 international researchers. It uses databases tracing the evolution of governance in France since the 1990s.
- Participates in public debate by inviting corporate governance stakeholders to discuss their practices to encourage sharing of their experience. The IFGE regularly speaks out on governance issues in the media and in debate forums.
- Passes on knowledge through top-level training courses, and notably its "director certificate".

The IFGE is a founder member of the European Corporate Governance Group.

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About MiddleNext

MiddleNext is the French independent professional association representing Midcaps.

It was founded in 1987 and represents only companies listed on NYSE Euronext's Euronext and Alternext, whatever their sector of activity.

The action of MiddleNext is threefold:

- representing and defending the interests of its members in relations with the market and public authorities;
- promoting the listed companies in the association and raising their profile among stakeholders in the financial community, investors and the media;
- helping company directors to master the stock market techniques that are essential to optimise their market listing.

MiddleNext co-chairs the Smaller Issuers Committee of EuropeanIssuers, the leading European association promoting the interests of listed companies. It covers 15 countries and represents almost 9,200 companies with total market capitalization of around €8,500 billion.

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