

Corporate Governance Code Monitoring Committee

report on compliance with the
Dutch corporate governance code

December 2005

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Summary

Corporate governance is about how companies are managed and how management is accounted for. Well-managed companies are of crucial importance to the health and competitiveness of the economy. The income and well-being of millions of people and the value of their pensions and investments depend directly on the performance of companies and their governance. In 2003 a committee chaired by Mr Tabaksblat drew up the Dutch corporate governance code (the Code) in order to improve the structure of corporate governance. The effectiveness and success of this Code depend on how it is used in practice.

The Corporate Governance Code Monitoring Committee (the Committee) was established on 6 December 2004. The Committee's terms of reference are to help ensure that the Code is practicable and up to date and to monitor compliance by Dutch listed companies.

Compliance with the Code is mandatory (by law) for listed companies from the 2004 financial year. This means that a listed company should indicate clearly (for the first time) in its 2004 annual report how it deals with the Code. The company may choose in this connection:

- to apply the provisions of the Code directly (i.e. 1:1), or
- explain why and to what extent it does not apply certain provisions of the Code.

The basic approach to the Code is therefore based on the 'apply or explain' principle.

Responsibility for reviewing compliance with the Code rests first and foremost with the shareholders. The management board and supervisory board of a company account to the shareholders for the corporate governance structure that has been adopted. It is up to the Committee to provide general information about how the Code is complied with in practice. The following aspects will therefore be central to this report:

- a) determination of the extent to which the Code is complied by the management board members and supervisory board members of listed companies;
- b) the role of the shareholders;
- c) the Code viewed from an international perspective;
- d) recommendations about elements of the Code requiring clarification.

The Committee has commissioned surveys by various universities in order to obtain information about the above issues.

Compliance with the Code by companies

The rate of compliance with the Code is high, particularly given that the 2004 financial year was the first in which application of the Code was mandatory. On average, companies comply with 88% of the

Code provisions. The direct application of the provisions is slightly lower (81%). The Code has become a real framework for good corporate governance. However, the Committee feels that some smaller companies and 'Dutch' companies having their primary listing on a foreign stock exchange can improve their compliance.

The Code and shareholders (and general meetings)

It is thanks to the Code that corporate governance structure is a regular agenda item at general meetings. A clear point for attention is admission to general meetings. Admission should be simplified. The large-scale use of electronic means of communication is of great importance in this connection. The Committee expresses the hope that the Dutch government will put the subject of remote (cross-border) voting high on the international agenda.

A quarter of the companies in the survey provide no information about anti-takeover measures and also give no explanation for this. This is clearly in breach of the Code. Another point for attention is the application of the Code by trust offices. Here, too, there is clearly room for improvement. The majority of trust offices do not, for example, hold a meeting of holders of depositary receipts for shares. The reports of the trust offices are reasonably complete, but do not always provide clear information about their activities or points of view.

Institutional investors underperform listed companies in terms of application of the Code. For example, the information given by institutional investors about compliance with the Code is not transparent and its user-friendliness is liable to improvement.

International perspective

One of the duties of the Committee is to acquaint itself with international developments and practices in the field of corporate governance. It is important that the Code should be in keeping with these international developments and practices. Account should be taken in this connection of both developments which are rule-based (e.g. the Sarbanes Oxley Act) and developments which are rather principle-based (e.g. the review of the British Combined Code and the Turnbull Guidance on Internal Control, which also comes from the UK).

The Committee notes that the Code is not out of step with international developments.

Practicability of the Code

In general, the Code is highly practicable. However, research by the Committee shows that the Code should be more explicit in two areas. These are the provisions of the Code dealing with:

- remuneration policy; and
- the declaration on risk management and control systems.

For the purpose of the Code's application, the Committee has studied these two issues in more detail and formulated guidance.

Remuneration policy (recommendation)

The rate of compliance with the Code is the lowest in relation to remuneration of management board members (part II.2 of the Code). To promote compliance with the Code the Committee has decided to make recommendations on this subject.

Level of remuneration

The Code provides that the level of remuneration received by management board members from the company should be such that qualified and expert managers can be recruited and retained. The Code does not provide any criterion for reviewing whether the level is reasonable. Nor does the Committee consider that it would be possible to devise such a criterion. A feature of the Dutch situation is the presence of a strong international market not only for executive labour but also for enterprises themselves. The introduction of a national criterion would not be effective in this environment.

Adoption of remuneration policy

The Code focuses on the process for the adoption of the remuneration policy and the structure of the remuneration. Although the rate of compliance in respect of these aspects is high, many companies do not apply the best practice provisions of the Code but explain their deviation from the provisions of the Code. The Committee believes that it would be desirable for the provisions of the Code on this subject to be applied more widely. It therefore makes the following recommendations.

As regards the remuneration process the Committee advocates greater simplicity and uniformity in reporting on actual remuneration. The Committee proposes to consult with companies and other stakeholders on this subject in the next calendar year.

The Committee also believes that the supervisory board should explicitly report on the effectiveness of the company's remuneration policy. In particular, the relationship between remuneration and performance should be made clear not only before but also after the fiscal year concerned. Performance should be interpreted in this connection as the contribution to long-term value creation by the enterprise.

The Committee also considers it important for the remuneration committee of the supervisory board to receive adequate assistance in performing its duties. This will generally mean that the remuneration committee is assisted by a remuneration expert. This expert should perform his duties on the instructions of the remuneration committee. The basic principle should be that any conflicts of interest involving the remuneration expert are to be avoided.

Structure of remuneration

As regards the structure of the remuneration, the first point to be made is that the variable remuneration constitutes a very substantial part of total remuneration. Variable remuneration generally consists of a short-term bonus, mainly for individual performance, and a long-term component which places the emphasis on the performance of the enterprise as a whole.

The remuneration report should provide information about the following three elements in respect of both the short-term and the long-term variable remuneration:

- a) the maximum variable remuneration, for example as a percentage of fixed income;
- b) what part of the variable remuneration is linked to measurable quantitative performance criteria and targets and what part is discretionary determined by the supervisory board;
- c) a description of the measurable quantitative performance criteria insofar as their disclosure would not harm the competitive position of the company.

It is advisable not to depart from the previously established measurable quantitative performance criteria and targets when determining the variable part of the remuneration and to allow for any special circumstances only within the discretionary component of the variable remuneration. The supervisory board should account in retrospect for the policy it has pursued.

As regards long-term incentives the Committee notes that more and more listed companies are switching, in keeping with the Code, to conditional option and share plans. One condition for granting or exercising such rights is the attainment of clearly quantifiable and challenging targets specified beforehand. In the view of the Committee these targets should be directly related to the creation of long-term value for shareholders.

Internal risk management and control systems (recommendation)

Best practice provision II.1.4 concerning risk management and control systems is one of the category of best practice provisions which are frequently not applied or not complied with. The application of provision II.1.4 is generally more complicated than that of many other provisions of the Code. Listed companies and investor organisations have indicated to the Committee that they need more guidance about the declaration of adequacy and effectiveness.

The Committee will make a recommendation in this report about best practice provision II.1.4 (internal risk management and control systems). The Committee considers that best practice provision II.1.4 is fulfilled if:

1. as regards financial reporting risks:
 - it is declared that the risk management and control systems provide reasonable assurance that the financial reporting does not contain any material inaccuracies;

- it is declared that the risk management and control systems have worked properly in the year under review;
- it is declared that there are no indications that the risk management and control systems will not work properly in the current year;
- any material weaknesses which are discovered in the year under review or the current year are specified, together with any changes made or improvements planned.

2. as regards other risks (operational/strategic and legislative/regulatory risks):

- a description of the risk management and control systems is given on the basis of the identified important risks;
- if applicable, important failings which are discovered in the year under review are specified, together with any changes made or improvements planned.

The Committee takes 'reasonable assurance' to mean a degree of certainty that would be satisfactory for a prudent manager in the management of his affairs in the given circumstances.

Future activities

The Committee will continue its work in 2006. In 2005 it has concentrated mainly on making a broad assessment of the situation based on the central theme of compliance with the Code in practice. The monitoring of compliance with the Code and the best practice provisions will be continued in the year ahead. Depending on the degree of application of the Code in practice the Committee will make more far-reaching recommendations next year. The emphasis of the work in 2006 will shift from commissioned research to market consultations. Market consultations will in any event be held in the following areas in 2006:

- compliance with the Code by local companies and 'Dutch' companies having their principal listing abroad;
- remuneration and remuneration policy (information format, valuation, effectiveness and accountability);
- governance of trust offices; and
- general meetings (preparation and effectiveness).

More information about the theme of remuneration and remuneration policy will be gathered in 2006. The aim is to make specific recommendations in 2006 for improving the provision of information about the extent and composition of remuneration. Finally, the Committee will also pay explicit attention in 2006 to the dialogue between companies and their shareholders.

Introduction

Introduction

The Corporate Governance Committee (also known as the 'Tabaksblat Committee') adopted the Dutch Corporate Governance Code (the Code) on 9 December 2003. The Code was drawn up at the request of Euronext Amsterdam, the Netherlands Centre of Executive and Supervisory Directors (NCD), the Foundation for Corporate Governance Research for Pension Funds (SCGOP), the Association of Stockholders (VEB), the Association of Securities-Issuing Companies (VEUO) and the Confederation of Netherlands Industry and Employers (VNO-NCW) at the invitation of the Minister of Finance and the Minister for Economic Affairs. The Code came into force with effect from the financial year starting on 1 January 2004.

The Minister of Finance, acting on behalf of the Minister of Justice and the State Secretary for Economic Affairs, set up the Corporate Governance Code Monitoring Committee (the Committee) on 6 December 2004. The Committee's official terms of reference are to help ensure that the Code is practicable and up to date and to monitor compliance by Dutch listed companies. It has been agreed that the Committee should publish a report annually for this purpose. You have before you the first report, which contains not only findings concerning the use of and compliance with the Code but also a number of in-depth analyses of the uses to which the Code is put.

Two factors are of particular relevance in monitoring compliance with the Code. First, checking compliance is primarily a matter for the shareholders. The first principle in the Code is that the management board and supervisory board are responsible for the corporate governance structure of the company and compliance with this Code. They are accountable for this to the general meeting of shareholders. The second factor of relevance is the nature of the Code. The Code is principle-based. This means that companies have some scope to interpret the provisions in their own way, but it can also lead to major differences in the actual application of the Code, thereby undermining the concept of best practice.

In the case of a principle-based Code it is not possible simply to adopt a box-ticking approach when assessing compliance with various best practice provisions. This is one reason why the Committee has decided not only to have research carried out (frequently including the use of box-ticking) but also to conduct market consultations and hold talks with the various parties involved. This year the market consultations have focused on the subject of risk management and control systems. Next year the Committee will make more frequent use of the market consultation instrument (e.g. in the fields of supervisory board compliance and remuneration policy).

The report you now have before you covers the 2004 financial year, which was the first financial year in which Dutch listed companies were obliged to comply with the Code. The boards reported to the shareholders on the 2004 financial year in 2005. During the general meetings the shareholders were able to express their views on the actual application of the Code and on the interpretation given in

cases where companies departed from the provisions of the Code. The Committee is positive about the position regarding compliance with the Code, particularly in the case of AEX and AMX-listed companies. However, it believes that there is room for improvement of compliance by a number of smaller companies and 'Dutch' companies having their primary listing on a foreign stock exchange.¹

Despite the predominantly positive picture of compliance, there is still scope for improvements in certain respects. These will be dealt with explicitly in this report. Improvements are also possible in the application of provisions of the Code. In its first reporting year the Committee has decided to be cautious about making specific recommendations on the application of the Code. This is, after all, first and foremost a matter for the company itself and for the general meeting of shareholders. In many cases the Committee simply identifies certain practices. This first report of the Committee does not explicitly deal with the quality of the explanation given (where a company does not apply a provision of the Code). The Committee does, however, assume that progress will be made on these issues in the reports of the companies for the 2005 financial year and in their treatment of them. The Committee will return to this in next year's monitoring report.

The report is structured as follows. Chapter 1 contains the findings on compliance with the Code and the use of the Code in practice. The surveys carried out on behalf of the Committee by the University of Groningen (compliance with the Code), RSM Erasmus University (activities of shareholders) and the University of Tilburg (international developments),² together with the market consultations held by the Committee, provide the basis for the major part of this chapter. Chapter 2 examines certain aspects in more detail and analyses the background to the operation of certain provisions of the Code in practice. As regards the design of remuneration policy, use is also made of a literature survey carried out by Dr C.M. van Praag at the request of the Committee. Lastly, chapter 3 contains conclusions and recommendations and lists the future activities of the Committee.

Finally, my heartfelt thanks are due to everyone who has provided the Committee with information and cooperated with the surveys carried out on our behalf. Without their efforts it would not have been possible to make a proper assessment of compliance with the Code and of developments in the field of corporate governance.

Professor J.M.G. Frijns,
Chairman of the Monitoring Committee
Corporate Governance Code

¹ It should be noted for the record that the Committee does not report on non-listed companies.

² The survey by the University of Tilburg has not yet been completed. To enable it to prepare the report the Committee was given access to the results obtained by the researchers in certain parts of the survey.

Chapter 1 – Findings

1. Compliance with the corporate governance code by listed companies

1.1 Introduction

This part examines compliance with the code by Dutch listed companies. These companies are obliged in the 2004 financial year to comply with the provisions of the code relating to the management board and supervisory board. Compliance means applying a provision of the code or explaining in the annual report of the company why the provision is not applied³. The code first came into force in the 2004 financial year.

Section 1.2 considers the approach adopted by the Committee in respect of the monitoring of compliance with the code. Section 1.3 gives a general overview of compliance with the code. Section 1.4 deals with non-application of provisions of the code. Section 1.5 examines non-compliance with the provisions of the code. Some provisions of the code that have an above-average chance of not being applied and/or complied with are considered in section 1.6. Section 1.7 studies provisions of the code dealing with the remuneration of management board members. This section (like part 3 of chapter 2) provides information requested by the government about compliance with code rules dealing with the remuneration policy. Finally, section 1.8 lists points for attention.

³ The terms 'apply' and 'comply with' are used in this report in the same sense as in the code. It should be noted that this meaning differs from the sense in which they are used in the explanatory notes on article 3 belonging with the Decree of 23 December 2004 adopting further rules concerning the content of annual reports (Bulletin of Acts and Decrees 2004, no. 747). In the Decree the term 'apply' is understood to mean compliance with a given best practice code or the provision of an explanation in the event of a departure from it. The survey report of the University of Groningen uses the term in the sense of the Decree of 23 December 2004.

1.2 Approach

To obtain objective information about compliance with the code the Committee commissioned a survey by the University of Groningen (RuG)⁴. This survey covers the manner and extent to which 150 listed companies comply with the code. More particularly, it deals with the observance of the best practice provisions by 25 AEX companies, 20 AMX companies, 23 AMS companies⁵, 62 local companies and 15 companies listed abroad but having their registered office in the Netherlands⁶. In addition to the total group of AEX companies, the survey also focuses on a subgroup consisting of the 14 AEX companies with the largest market capitalisation. This subgroup has more impact than the other groups on how the operation of the code in practice is perceived outside the Netherlands. This warrants separate consideration.

In addition to the survey by the University of Groningen, the Committee has also drawn on the findings of the survey of the activities of shareholders in 2005 in the context of general meetings. This survey was carried out on behalf of the Committee by RSM Erasmus University. Finally, the Committee has made grateful use of the findings of various special interest groups and experts as well as published reports on compliance with the code, which have not been commissioned by the Committee.

⁴ The survey by the University of Groningen can be found at the Committee's website (www.commissiecorporategovernance.nl). It should be noted that although the Committee bases its report on the research it has commissioned, it is not responsible for the content of these surveys.

⁵ AEX: Amsterdam Exchanges Index shares
AMX: Amsterdam Mid Cap Index shares
AMS: Amsterdam Small Cap Index shares

⁶ This category is referred to in the remainder of the report as 'foreign companies'.

1.3 General picture

The rate of compliance with the code is high. On average 88% of the code provisions are complied with by the companies. As stated in the introduction, companies are deemed to comply with the code even if they explain why a best practice provision is not applied. The average explanation rate for each code provision is 7%. The average application rate for each code provision is approximately 81%.

The application and compliance percentages are high. Indeed, the figures could even be described as impressive bearing in mind that the 2004 financial year was the first year in which the use of the code was mandatory for listed companies. The code has therefore become a real framework for good corporate governance. The expectation and the ambition of the Committee is that the compliance rate will rise to 100%.

The following sections discuss briefly compliance with and application of the various chapters of the code relating to the management board and/or the supervisory board. Part 2 of this chapter of the Monitoring Report explains how shareholders deal with the code.

(a) Chapter I: compliance with and enforcement of the code

This chapter of the code focuses on the manner of compliance and enforcement. The principle is that the management board and the supervisory board are responsible for the corporate governance structure of the company and compliance with the code. They are accountable for this to the general meeting of shareholders. The chapter also contains two best practice provisions relating to the corporate governance structure and changes to that structure.

The rates of compliance with and application of the best practice provisions of this chapter are high. Only one of all the AEX, AMX and AMS companies failed to comply with the provisions. On average 82% of the local and foreign companies complied with the code provisions.

(b) Chapter II: management board

This chapter is divided into three parts, namely:

- i. role and procedure of the management board;
- ii. amount and composition of the remuneration of the management board members;
- iii. conflicts of interest.

The first part has 7 best practice provisions, the second part 14 and the third part 4. The average compliance rate is the highest (90%) in the case of part (i). The average compliance rate is approximately 70% for part (ii) and 88% for part (iii).

The first part of chapter II contains a best practice provision which is applied by all the companies in the survey. This concerns best practice provision II.1.3 (a) on risk analyses of the operational and financial objectives of the company. Part II.1 of the code also contains three best practice provisions

that will be dealt with in more detail later in this report. These are provisions II.1.1 (maximum term of appointment of management board members), II.1.4 (declaration concerning internal risk management and control systems) and II.1.6 (arrangements for whistleblowers). Compliance with and application of the best practice provisions of chapter II.2 are explicitly discussed in section 1.7.

(c) Chapter III: supervisory board

This chapter has 8 parts, namely:

- III.1, role and procedure;
- III.2, independence;
- III.3, expertise and composition;
- III.4, role of the chairman of the supervisory board and the company secretary;
- III.5, composition and role of three key committees of the supervisory board;
- III.6, conflicts of interest
- III.7, remuneration
- III.8, one-tier management structure.

The rates of compliance in respect of all these parts are high, namely between 80% (III.2) and 94% (III.4). The application rates are on average 6% lower. Only 7 best practice provisions have different application and compliance rates. These are explained in more detail in section 1.6.

(d) Chapter IV: the shareholders and general meeting of shareholders

The great majority of this chapter of the code does not relate to the management board or the supervisory board. As indicated above, part 2 of this chapter explains how shareholders deal with the code in practice. The only part that will be covered here is IV.3, which concerns the provision of information to the general meeting of shareholders. The average rates of compliance and application are high for this part, namely 91% and 88% respectively. These figures are significantly higher in the case of the AEX companies, namely 100% and 99% respectively. The same is true of the AMX and AMS companies, where the averages are approximately 98% and 96% respectively.

(e) Chapter V: Financial reporting

The average compliance and application rates in respect of the provisions of this chapter are in keeping with the overall picture. There is one provision from which companies depart relatively often. This is provision V.3.1 concerning the involvement of the external auditor and the audit committee in drawing up the work schedule of the internal auditor. This aspect will be considered separately in section 1.6.

1.4 Explanation in the event of non-application of best practice provisions

This section deals with the explanation given where best practice provisions are not applied. The researchers used by the Committee found 740 instances (in annual reports or on websites) in which a company had explained why it was not applying a best practice provision. This amounts to almost five explanations per company. In this respect there is scarcely any difference between the average number of explanations in the different categories of companies in the survey (Top 14 AEX, AEX-25, AMX, AMS, foreign and local). It should also be noted that a limited number of best practice provisions (16) account for the majority of the explanations (almost 80%). See the following table (no distinction is made in this table between the 14 largest AEX companies and the AEX companies as a whole).

Best practice provisions most often explained (in absolute numbers)							
Provision	Summary	AEX	AMX	AMS	Local	Foreign	Total
II.1.1	Maximum term of appointment of management board members	14	16	18	48	4	100
II.1.4	Declaration concerning internal risk management and control systems	4	7	6	7	0	24
II.1.6	Arrangements for whistleblowers	2	0	1	12	1	16
II.2.1	Options are granted only conditionally	6	2	4	4	4	20
II.2.2	Granting of unconditional options	3	1	2	5	5	16
II.2.3	Granting of shares to management board members without financial consideration	9	3	2	1	0	15
II.2.6	Regulations concerning ownership of and transactions in securities by management board members	8	7	7	23	4	49
II.2.7	Maximum severance pay	17	16	14	28	6	81
II.2.10	Content of supervisory board's remuneration report	5	7	13	20	5	50
III.2.1	All supervisory board members except one are independent	7	2	6	9	3	27
III.3.4	Maximum number of supervisory board memberships	7	5	2	4	0	18
III.3.5	Maximum of three four-year terms of office	5	3	4	12	3	27
III.4.3	Duties of company secretary	0	2	4	13	1	20
III.7.3	Regulations concerning ownership of and transactions in securities by supervisory board members	9	8	7	21	4	49
IV.3.1	Analysts' webcasting meetings, presentations and press conferences for all shareholders	0	2	5	37	1	45
V.3.1	External auditor and audit committee involved in drawing up the work schedule of the internal auditor	0	2	9	16	2	29
	Total	96	83	104	260	43	586

Analysis shows that the reasons given by the companies can generally be reduced to a limited number of categories. In an average of 25% of the cases the explanation is that the best practice provisions

concerned will be applied in the future in accordance with the code. This percentage is significantly higher in respect of the maximum term of appointment for management board members and the maximum severance pay. Another provision of the code which companies frequently indicate they will apply in the future is II.1.4 concerning the internal risk management and control systems.

Other reasons commonly given are:

- existing legislation in the field of the relevant provision of the code provides scope for alternative application;
- the provision of the code cannot be applied owing to the nature of the company;
- in view of the size of the company application of the provision would entail a disproportionately heavy administrative burden.

Analysis of the application of the code shows that hardly any best practice provisions are applied in full by all listed companies in the survey. Another important finding is that differences exist between the extent to which the different categories of companies apply the best practice provisions. The AEX companies and, to a lesser extent, the AMX and AMS companies compare favourably in this respect. It is also relevant to note that the management structure of the foreign companies in particular is often based on non-Dutch legislation, which can influence the scope of application of the code.

1.5 Non-compliance with code provisions

Code provisions are not always complied with. The average non-compliance rate per code provision is 12%. The following best practice provisions have a higher than average non-compliance rate.

Best practice provisions most often not complied with (in percent)⁷

Provision	Summary	Top 14 AEX	AEX	AMX	AMS	Local + Foreign	Total
II.1.1	Terms of appointment of management board member	7	4	10	4	30	13
II.1.4	Declaration concerning internal risk management and control system	5	7	18	27	33	22
II.2.1	Options are granted only conditionally	0	9	36	37	46	34
II.2.2	Granting of unconditional options	31	30	40	33	40	35
II.2.3	Granting of shares to management board members without financial consideration	0	0	21	0	44	14
II.2.4	Option exercise price	0	9	9	37	22	21
II.2.5	Modification of exercise price and other conditions of options	8	9	9	12	17	15
II.2.6	Regulations concerning ownership of and transactions in securities by management board members	0	4	10	26	43	28
II.2.10	Overview of remuneration policy*	21	17	23	29	48	32
II.2.11	Disclosure of main elements of management board members' contracts	25	46	70	67	86	66
II.2.12	Disclosure of special remuneration of management board member in remuneration report	11	20	11	33	45	32
II.2.14	Disclosure of the value of options granted in annual accounts	0	7	15	39	31	25
III.2.3	Statement in supervisory board report that III.2.1 is complied with	14	12	35	18	57	33
III.3.1	Profile of composition of supervisory board	0	0	0	9	49	22
III.3.6	Retirement schedule for supervisory board members	0	0	0	4	35	14
III.7.3	Regulations concerning ownership of and transactions in securities by supervisory board members	14	12	0	22	39	22
IV.3.1	Analysts' webcasting meetings, presentations and press conferences for all shareholders	0	2	10	15	24	20

*) The overview referred to in II.2.10 contains 24 parts; the figures in the table are average figures for all separate parts.

⁷ The percentages shown in this table are taken from the survey by the University of Groningen. The non-compliance rates are weighted averages for the parts of the relevant best practice provisions (each of which is dealt with separately). It should be noted that not all best practice provisions are relevant to all companies. The non-compliance figures in the table therefore relate only to the companies from a particular category to which the relevant best practice provision is applicable. For example, best practice provision II.2.3 applies to 44 companies and not to the entire group of 150 companies. 106 companies have a policy of not granting shares to the management board members without financial consideration. 14% of the 44 companies (i.e. 6 companies or 4% of the total number of companies examined in the survey) fail to comply with this provision.

The above percentages show that there is a clear difference in non-compliance between the different categories of company. AEX companies have the lowest non-compliance rate. The combined category of 'foreign and local companies' score the worst in terms of compliance.

A number of additional observations can be made in respect of the above overview:

1. The 'foreign and local companies' category has a high non-compliance rate in respect of best practice provisions III.3.1 and III.3.6. Within this category the 'foreign' companies score worst.
2. Non-compliance with best practice provisions IV.3.1 and IV.3.6 is most common among the AMX, AMS and 'foreign and local companies' categories.
3. The non-compliance rate of the other provisions mentioned in the table is relatively evenly distributed between the different categories of company. The majority of these provisions relate to chapter II.2 concerning the remuneration of management board members. This chapter, like provision II.1.4 referred to in the table (concerning internal risk management and control), will be considered separately later in this chapter.

1.6 Code provisions explained in more detail

This section deals in greater depth with code provisions that are frequently explained or are not complied with relatively often. These categories also include the code provisions from chapter II.2 concerning the remuneration of management board members. Compliance with these provisions is dealt with in section 1.7.

Code provision II.1.1

Best practice provision II.1.1 states that a management board member is appointed for a maximum term of four years. It also provides that a member may be reappointed for a term of not more than four years at a time. 19 companies do not comply with this provision. A further 100 companies explain why they do not apply this best practice provision. Explanations are given mainly by AMX companies (16 of the 20 AMX companies), AMS companies (18 of the 23 AMS companies) and local companies (48 of the 67 local companies). The relatively large number of AEX companies is also noteworthy (14 of the 25).

The most common explanation is that present contracts are being honoured. 72 of the 100 companies indicate in this connection that the code will be applied when new contracts are concluded.

Code provision II.1.6

Best practice provision II.1.6 provides an arrangement for whistleblowers. 16 companies explain why they do not apply this best practice provision: the majority (12) of them are relatively small, local companies. Six of the 16 indicate that the whistleblower arrangement is scheduled for introduction in 2005. Five companies indicate that a whistleblower arrangement is not necessary in view of the open communication within the organisation. Ten of the 150 companies in the survey do not comply with the provision. A further 11 companies do not publish the arrangement on their website.

Code provisions III.2.1 and III.2.3

According to provision III.2.1 supervisory board members should be independent. The provision states that an exception to the requirement of independence may be made for a maximum of one supervisory board member. Provision III.2.3 states that the report of the supervisory board should state that best practice provision III.2.1 has been fulfilled. In addition, it should also be mentioned which supervisory board member, if any, is regarded by the board as not being independent.

Code provision III.2.1 is applied by the great majority of the companies (110 of the 147). A significant number of companies (27 in total, i.e. 18 percent) provide an explanation. These include 7 AEX companies, 6 AMS companies and 9 local companies. Ten companies state in the explanation that they attach importance to the fact that certain groups (in particular the shareholders) are represented on the supervisory board.

Code provisions III.3.1 and III.3.4 to III.3.6

The composition of the supervisory board must be such that it is able to carry out its duties properly. Best practice provisions III.3.1 to III.3.6 concern the profile, composition, introduction, number of supervisory board memberships, term of appointment and number of terms, and retirement schedule.

Best practice provision III.3.1 states that the supervisory board must prepare a profile of its size and composition. The majority of the companies apply this best practice provision. However, a substantial number of the foreign companies (10 of the 15) and local companies (20 of the 64) do not comply with this provision.

Best practice provision III.3.4 states that the number of supervisory boards of Dutch listed companies of which an individual may be a member is limited to five, for which purpose the chairmanship of a supervisory board counts double. Two aspects of compliance with this best practice provision have been verified by the researchers of the University of Groningen: first, whether the provision concerning the number of supervisory board memberships has been fulfilled and, second, whether the company has an overview of the positions held by supervisory board members other than in listed companies. Although the great majority comply with the provision concerning the number of supervisory board memberships, 18 companies do not apply this provision but explain why they do not do so. The most common explanation in this connection (13 companies) is that this is a temporary departure as a consequence of current arrangements. Eleven companies do not comply with the provision.

Best practice provision III.3.5 states that a person may be appointed to the supervisory board for a maximum of three four-year terms. Six foreign and fifteen local listed companies do not apply this provision. An explanation is given in only a few cases (two and five respectively).

Best practice provision III.3.6 concerns of the retirement schedule. The great majority of the companies have such a schedule. Eight foreign and eleven local companies do not comply with this provision.

Code provision III.4.3

Best practice provision III.4.3 concerns the assistance to be provided to the supervisory board by a company secretary. In addition, this best practice provision contains a number of rules concerning the duties of the company secretary. Twenty companies, including 13 local companies and 4 AMS companies, do not apply this provision, but give an explanation. Virtually all of these companies employ a single argument in this connection: the size of the company is not sufficient to warrant the appointment of a separate company secretary. This argument is not in keeping with the explanatory notes to the code. These state, among other things, that the work of the company secretary need not be limited to assisting the supervisory board. The company secretary can be given a broader range of duties.

Code provision III.7.3

This best practice provision concerns the adoption of a set of regulations containing rules governing ownership of and transactions in securities by supervisory board members. 50 companies give an explanation of why they do not apply this provision. Five relatively common arguments are:

1. the introduction of a set of regulations would impose an unduly onerous administrative burden (5 companies);
2. ownership of securities is a private matter for the supervisory board member (12 companies);
3. the existing statutory rules are sufficient (10 companies);
4. the regulations are limited to shares in the company itself and/or shares of associated companies (6 companies);
5. no rules necessary because the enterprise is too small (4 companies – all local).

32 of the 146 companies to which this provision is relevant do not comply with it.

Code provisions IV.3.1 and IV.3.6

Best practice provision IV.3.1 reads as follows: 'Meetings with analysts, presentations to analysts, presentations to investors and institutional investors and press conferences shall be announced in advance on the company's website and by means of press releases. Provision shall be made for all shareholders to follow these meetings and presentations in real time, for example by means of webcasting or telephone lines. After the meetings, the presentations shall be posted on the company's website.' 45 companies explain why this best practice provision is not fully applied. The majority of them are AMS companies (5) and local companies (37). The explanations relate to cost considerations and the size of the company. 20 of the 150 companies in the survey to which this provision is relevant do not comply with it.

Code provision IV.3.6 states that the company shall place and update all information which it is required to publish or deposit pursuant to the provisions of company law and securities law applicable to it, on a separate part of the company's website that is recognisable as such. Twenty companies, most of which are local companies (15), have not arranged their website in the manner recommended by the code. This is not to say, however, that the information cannot be located in all these cases. This provision concerns, above all, the design of the website, which affects the extent to which visitors to the site can find the information.

Code provision V.3.1

This provision states that the external auditor and the audit committee shall be involved in drawing up the work schedule of the internal auditor and that they shall also take cognizance of the findings of the internal auditor. 25 of the 29 companies that do not apply this provision but give a reason are small companies. All these companies in fact employ two arguments. 14 of them simply state that they do not have an internal auditor, and the remaining 15 add that the company is too small to have an internal audit department. 10% of the companies in the survey do not comply with the provision.

1.7 Remuneration of management board members

It has emerged, partly from the research commissioned by the Committee, that the compliance and application rates for the best practice provisions on the remuneration of executive board members (part II.2 of the code) are appreciably lower than those for the other best practice provisions. This section therefore considers compliance with the provisions of this chapter. Chapter 3 of this report deals in greater depth with the remuneration policy and also makes specific recommendations for improvements.

Compliance with the code

The degree of application and compliance in respect of the remuneration of executive board members is as follows.

Best practice provisions with high rates of non-compliance:

- II.2.1 (options are granted only conditionally)
- II.2.2 (granting of unconditional options)
- II.2.4 (exercise price of options)
- II.2.5 (disclosure of changes in exercise price and other conditions during the term of options)
- II.2.6 (regulations concerning ownership of and transactions in securities by management board members);
- II.2.10 (d) (provision of information about periods of notice);
- II.2.10 (j) (disclosure of the non-performance-related granting of securities);
- II.2.10 (l) (provision of information about arrangements for the early retirement of management board members);
- II.2.11 (main elements of the contract of a management board member);
- II.2.12 (disclosure of special remuneration of management board member in remuneration report);
- II.2.14 (disclosure of the value of options granted to management board members in the annual accounts).

Best practice provisions with high rates of non-application:

- II.2.1 (options to acquire shares are a conditional remuneration component);
- II.2.2 (disclosure of performance criteria when granting unconditional options);
- II.2.3 (shares granted without financial consideration);
- II.2.6 (disclosure of securities transactions by management board members);
- II.2.7 (maximum severance pay);
- II.2.10 (b) (explanation of any change in the non-variable remuneration component); and
- II.2.10 (h) (use of external factors as a benchmark when drawing up performance criteria). It should be noted that AEX companies often apply this provision.

In keeping with the code, the companies in the survey often give descriptions of the actual management and remuneration policy. However, the rate of compliance with and application of the code is lower when it comes to providing reasons, making declarations and rendering account for the actual management and remuneration policy.

The survey carried out by the University of Groningen reveals that the larger companies (AEX and AMX) generally have a high level of compliance with the code. It also shows that the application and compliance rates are high in relation to the prohibition on the provision of loans to management board members and supervisory board members (code provisions II.2.8 and III.4.5 respectively). It is also noteworthy that in cases where the provisions on maximum severance pay and on the unconditional granting of options are not applied, one common argument is that existing contracts are being respected and that the code will be complied with when new contracts are concluded. The survey also shows that the reasons given for other departures from the code are often very scanty.

There is a high degree of transparency in respect of compliance with the code and remuneration policy by the AEX, AMX and AMS companies. Although the policy on remuneration is often described in the annual reports in accordance with the code, no quantitative data are given in many cases (code provision II.2.1). Similarly, there is a high degree of transparency with regard to the performance criteria for the variable part of the remuneration, especially in the case of the AEX companies. However, remuneration information is not given in a single overview.

Information about the performance criteria that are applied is given by a majority of the AEX, AMX and AMS companies, whereas there is less transparency in the case of foreign and local companies.

1.8 Points for attention

The rate of compliance with and application of the code is high. The explanation given by larger companies for not applying best practice provisions is often that the departure from the code is temporary. Many smaller companies refer to the size of the enterprise.

No justifiable argument can be conceived for not complying with the code. Even if provisions of the code are not in keeping with, for example, the structure and size of a company, an explanation should always be given.

Special attention is paid to compliance with the code provisions relating to supervisory board members and the functioning of the supervisory boards. Supervisory board members are required to set an example. They supervise the enterprise and its management board and are accountable to the shareholders. Sections 1.4 and 1.5 show what code provisions are not applied or not complied with in an above-average number of cases. Five of the 16 best practice provisions for which an explanation of non-application is most often given relate to supervisory board members. The same applies to the provisions that are most often not complied with (4 of the 19). The rate of compliance with two of the provisions even gives cause for concern: these are the provisions relating to the independence of supervisory board members and their ownership of securities.

The following should be said about the application of the one-tier management structure. The code provides as a rule of thumb for companies with a one-tier management structure that the best practice provisions concerning the supervisory board are applicable to the non-executive directors, without prejudice to the management obligations of these non-executive directors. In addition, chapter III.8 formulates a number of provisions that specifically relate to companies having a one-tier management structure. The survey carried out by the University of Groningen shows that the rule of thumb ("for 'supervisory board' read 'non-executive directors'") is hard to apply in relation to some provisions. Obvious examples are the provisions that contain guidelines for the content of the report of the supervisory board (see, for example, provisions III.1.7. and III.1.8 'The report of the supervisory board refers ..'). Reference to the situation in the United Kingdom may be useful here. In the case of the English one-tier boards, the reports of the remuneration committee and the audit committee make up for the absence of a separate report by the non-executive directors.

2. Activities of shareholders

2.1 Introduction

Point 3 of the preamble states that the code is based on the principle that a company is a long-term form of collaboration between the various parties involved. The management board and the supervisory board are required to act in the 'corporate interest'. In this way, they have overall responsibility for weighing the interests of all parties concerned. The confidence of stakeholders that their interests are represented is essential if they are to cooperate within and with the company. Good entrepreneurship, including integrity and transparency of decision-making by the management board, and proper supervision thereof, including accountability for such supervision, are essential if the stakeholders are to have confidence in the management board and the supervision. These are the two pillars on which good corporate governance rests and on which this code is based.

Point 7 of the preamble states that it is up to the shareholders of the company to call the management board and the supervisory board to account in respect of compliance with the code. The content of the chapter of the annual report on the company's corporate governance structure and corporate governance policy and the statement on compliance with the best practice provisions can be raised each year in the general meeting of shareholders at the initiative of the management board or of the shareholders or a group of shareholders.

Shareholders play a role of significance in the system of checks and balances in the company. According to the code, decisions of the management board on a major change in the identity or character of the company or the enterprise should be assessed by the shareholders (principle I of the code). This part of the Monitoring Report explains how shareholders are affected in practice by the code. Section 2.2 describes the survey carried out by RSM Erasmus University on behalf of the Committee. After consideration of the design of the survey, the section examines the findings. Section 2.3 examines the influence of general meetings on companies. Section 2.4 deals with anti-takeover measures and section 2.5 with the role of institutional investors. Finally, section 2.6 lists a number of points for attention.

2.2. Approach

To assess the activities of shareholders in 2005, the Committee commissioned a survey by RSM Erasmus University (EUR)⁸. This survey examined 72 listed companies, 35 trust offices and 20 institutional investors. The analysis examines various aspects such as:

- the influence of general meetings on companies;
- the effect of anti-takeover measures;
- principle IV. 2 of the Code on the issuance of depositary receipts for shares; and
- the role of institutional investors.

⁸ The survey carried out by the EUR can be found on the Committee's website (www.commissiecorporategovernance.nl). It should be noted that the Committee bases its report on the research it has commissioned. However, the Committee is not responsible for the content of these surveys.

2.3 Influence of general meetings on companies

(a) Attendance rates

If shareholders are to exert influence at general meetings, it is essential that they be present or represented. A criterion for this is the attendance rate of those entitled to vote at the general meetings. The average attendance at general meetings of companies is 54.21 %. AEX companies have a lower average attendance rate (44%) than AMX companies (54.21%) and small caps (60.53%). If companies that have issued depositary receipts for shares are disregarded (they have an average attendance rate of 98.4%), the average attendance rates are 32% for AEX companies, 35.5% for AMX companies and 52.4% for small caps.

The average attendance rates in 2005 are at the 2004 level, and approximately four percentage points higher than the average attendance in the period 1998-2003.

(b) Raising corporate governance issues

Many questions are asked during general meetings, for example about corporate governance issues. Subjects such as shareholders' rights and remuneration give rise to many questions. Analysis of the questions shows that corporate governance is an important topic for many shareholders.

(c) Voting behaviour of shareholders

A large proportion of the agenda items at general meetings are voted upon⁹ by the shareholders. One or more votes are cast against resolutions on 43.2% of the agenda items on which shareholders can vote. This percentage is higher in the case of the AEX companies (86.8%). The rates are lower in the case of AMX companies (38.9%) and small caps (15.4%).

In most of the above-mentioned cases the percentage of votes cast against the resolution is under 3% of the total votes cast. However, the percentage of votes against the resolution is higher than 3% in two areas, namely:

- changes affecting shareholders' rights (average percentage of votes cast against the resolution: approximately 13%);
- adoption of the remuneration policy (average percentage of votes cast against the resolution: approximately 7%).

(d) Compliance with provisions on general meetings

Annual reports were examined to ascertain how many companies apply the best practice provisions on general meetings.

- best practice provision IV.3.1 (webcasting) is the provision least applied; the reason given for this, mainly by smaller companies, is that the costs of webcasting are too high and/or webcasting is not considered technically feasible.

⁹ This concerns agenda items put to the vote (other than by acclamation).

- there are 12 companies that partially apply best practice provision IV.1.1 (procedure for appointment and dismissal of management board members and supervisory board members).
- nine companies do not apply provision IV.1.2; the majority of these companies base the voting right in respect of financing preference shares on the face value rather than the fair value of the capital contribution.

The Committee acknowledges the importance of a dialogue between companies and shareholders. Such a dialogue should take place in the context of legislation and regulations that are in force.

(e) Voting on application of the code

There was uncertainty among shareholders and management board members at three general meetings on whether the application of the code and departures from it should be voted upon. It may be noted in this connection that the code does not contain any explicit obligation to vote on these matters. Point 8 of the preamble to the code states that if shareholders disagree with the management board with regard to an important corporate governance issue, they may exercise the rights available to them in the meeting of shareholders not to discharge the management board from liability for its conduct of business and the supervisory board from liability for its supervisory tasks, to alter the policy on remuneration, and to dismiss the supervisory board and/or the management board. Shareholders may also exercise their right to have corporate governance issues placed on the agenda of the meeting of shareholders. In addition, they may take various types of legal action, such as starting an inquiry or annual accounts procedure.

Whether or not a vote is held on the application of the code and departures from it is primarily a matter to be decided by the management board, the supervisory board and the shareholders. It should be noted in this connection that voting on departures from the code can affect the assessment of whether a company acts completely in accordance with the code. Point 7 of the preamble states in this connection:

'... If the general meeting approves the corporate governance structure and authorises the non-application of code provisions, the relevant company is deemed to comply with the code ('explanation constitutes compliance after approval by the general meeting of shareholders').'

The application of the code and departures from the code were voted on in four companies in the past financial year. It follows that these companies acted completely in accordance with the code.

2.4 Anti-takeover measures and issuance of depositary receipts for shares

The survey shows that 25% of the companies do not provide information about anti-takeover measures and give no explanation of this. These companies are acting in breach of best practice provision IV 3.9. Analysis shows that foreign and local companies are strongly represented in this group.

It is also evident that the option to issue (anti-takeover) preference shares is the most common anti-takeover measure. It differs from other measures, such as the issuance of depositary receipts for shares and priority shares, through of its temporary nature. Depositary receipts for shares and priority shares have a permanent character and also affect the extent to which shareholders control the company in the absence of a takeover threat. The code indicates that the company must fully disclose its anti-takeover measures. The information from the companies indicates that many of them consider that only preference shares, priority shares and depositary receipts for shares are anti-takeover measures.

Companies that issue depositary receipts for shares give only a limited explanation of the non-application of the code in their annual reports. The survey conducted by the RSM Erasmus University (EUR) studied 35 trust offices. Documentation was found at 14 of the 35 trust offices showing that a meeting of holders of depositary receipts had been held. Confirmation of compliance with provision IV.2.1 could not be found at the other 21 trust offices.

The survey carried out for the Committee shows that one company considered that the code was not applicable to depositary receipts already listed prior to the effective date of the code. Some companies also considered that the code was not applicable to preference shares without official listing. These interpretations of the code are incorrect. As these are exceptions rather than the rule, the Committee will simply note this point for the time being.

The reports of the trust offices are reasonably complete, but tend to be in keeping with the letter of the code and do not always provide clear information about the activities of the trust office and the positions taken by it. One other point to note is that many trust offices issue voting proxies to depositary receipt holders (who ask for them) or accept binding voting instructions from them. Finally, the analysis of depositary receipts for shares reveals that some companies do not subscribe to the principle that the issuance of depositary receipts is not used as an anti-takeover measure. Reference is normally made in this connection to Dutch law¹⁰.

The issuance of depositary receipts for shares will be dealt with in greater detail in chapter 2.

¹⁰ Article 2:118a Dutch Civil Code.

2.5 Role of institutional investors

The role of institutional investors in their capacity as shareholders in Dutch listed companies has received considerable attention in the debate on corporate governance. It should be noted that the shareholdings of Dutch institutional investors in Dutch companies (particularly Dutch large caps) are relatively small. Foreign investors in particular have greatly expanded their interests in Dutch blue chip companies in recent years. The role of institutional investors is therefore examined against this background.

The responsibility of institutional investors is recorded in the code (principle IV.4). 60% of institutional investors provide information about voting policy and therefore apply best practice provision IV.4.1. 30% apply best practice provision IV.4.2 (implementation of policy on the exercise of voting rights). 55% of the 20 institutional investors included in the survey apply best practice provision IV.4.3 (quarterly publication on the website of how they have voted in practice).

The EUR survey shows that the information provided by institutional investors on compliance with the code is usually not transparent. The user friendliness is far from optimal. This picture is confirmed by representatives of institutional investors. They indicate that institutional investors need time to become accustomed to the code rules applicable to them. Website information about voting behaviour and quarterly reports on this sometimes lag behind. The representatives of institutional investors have indicated that they consider it to be one of their duties to pay suitable attention in the future to the reporting on corporate governance policy.

Almost all institutional investors that provide information about the principles of general voting policy refer to their own corporate governance code. The basic principles cited are (long-term) value creation, risk mitigation and enhancement of return. The codes are all based (in part) on the Dutch corporate governance code. A small number of the institutional investors in the survey indicate that they exercise the voting right only in certain circumstances (depending on the size of their shareholding, level of participating interest, loaned shares). A few other companies indicate that they do not exercise their voting rights if this entails high costs. Finally, some institutional investors in the survey state that possible conflicts of interest can be a reason for not voting.

2.6. Points for attention

The code is one reason why the subject of corporate governance structure is often discussed at general meetings. Many questions are asked about corporate governance.

2005 was not a year of high attendance rates at general meetings. The point that clearly requires attention in connection with the attendance figures is admission to general meetings. This should be simplified. The large-scale use of electronic means of communication is an important instrument. It is now technically possible to attend and take part in general meetings virtually. The Bill to amend Book 2 of the Civil Code in order to promote the use of electronic means of communication in voting within legal entities will provide the required future legal framework. A point for attention in this connection, having regard in part to the interest of foreign investors in Dutch companies, is the legal status of and conditions for remote cross-border voting. The Committee expresses the hope that the Dutch government will put the subject of remote (cross-border) voting high on the international agenda. Naturally, the ultimate responsibility for using electronic means of communication rests with the listed companies themselves.

A quarter of the companies in the survey provide no information about anti-takeover measures, and also give no explanation for this. Such a procedure is clearly in breach of the code and the companies in question are being given notice to observe code provision IV.3.9. This provision refers to a survey of all existing or potential anti-takeover measures.

The timely availability of the agenda of the general meeting and associated documentation is another point for attention.

Another point for attention is the application of the code by trust offices. There is clearly room for improvement in this field. Most trust offices do not hold a meeting of holders of depositary receipts for shares. Not all trust offices have amended the definition of their object in the articles of association from 'the company and the enterprise connected with it' to 'representing the interests of depositary receipt holders'. The reports of the trust offices are reasonably complete, but do not always provide clear information about their activities or the positions they adopt.

Finally, some observations should be made about institutional investors. The survey shows that institutional investors comply with the code to a reasonable extent. However, the information provided by institutional investors on compliance with the code is not transparent and its user-friendliness is far from optimal. The Committee therefore calls on the institutional investors to provide information about compliance by reference to a standard format. Such a format could be developed in consultation between the institutional investors.

3. International developments

The Committee has examined whether there have been noteworthy international developments in the area of corporate governance since January 2004.

European Commission

In recent years the Company Law Action Plan (the Action Plan) of the European Commission has set the agenda in the corporate governance field. The Action Plan has two underlying principles: to enhance transparency and to empower shareholders. In the past two years almost all the short-term priorities specified in the Action Plan have been implemented. In 2005, for example, the Company Law Directive on Statutory Audit was adopted. This directive requires companies to set up an audit committee.

As the medium-term and long-term priorities of the Action Plan are the next step, the European Commission wishes to take the opportunity once again to consult with stakeholders about the plan. Consultation rounds will be held in order to ascertain whether the original medium-term and long-term priorities still meet market requirements. According to the European Commission the basic principles of the Action Plan referred to above (i.e. transparency and shareholder empowerment) will not be subject to reconsideration. Mr McCreevy, the European Commissioner for Internal Market and Services, has stated that the consultations will start within a few weeks.

In addition to revising the Action Plan, the European Commission intends to introduce in the short-term a draft directive to harmonise the voting rights of shareholders in the EU (the Shareholder Rights Directive). In the course of drafting this directive the European Commission has already held two rounds of public consultations. The subjects covered by the directive include:

- harmonisation of the registration date (to ensure fairness in relation to attendance at general meetings); and
- cross-border voting.

The European Commission will hold a number of public consultations on corporate governance in 2006. One of these concerns hedge funds and another the 'one share, one vote' principle.

In 2006 the European Corporate Governance Forum¹¹ established by the European Commission in 2004 will consider, among other things, the 'in control' statement and the 'comply or explain' principle.

¹¹ European Commissioner Bolkestein announced the establishment of the European Corporate Governance Forum on 18 October 2004. The functions of the forum are:

- to advise the European Commission on corporate governance;
- to enhance convergence of national corporate governance codes of EU Member States.

The Takeover Directive

2006 will be the year in which the EU Member States are required to implement the Takeover Directive. Among the matters dealt with in the directive are:

- the protection of minority shareholders;
- mandatory transparency concerning the use of anti-takeover measures; and
- the use of anti-takeover measures.

As regards the use of anti-takeover measures the directive leaves open a number of options from which the Member States can choose. The precise manner in which the Member States will implement the directive is not yet known. Only one Member State (Denmark) has already implemented it. The Dutch government has indicated that it will present a bill to parliament in December 2005.

United Kingdom

In the United Kingdom the Turnbull Guidance on Internal Control has been revised. This revised Guidance has been taken into account by the Committee in assessing the application of best practice provision II.1.4. In addition, the Financial Reporting Council is expected to publish a review of the 2003 Combined Code at the end of 2005. This review will be taken into account in the next Monitoring Report.

Germany

A law regulating the transparency of executive pay will come into force in Germany in 2006. Companies will then be obliged by law to publish the amount and structure of the remuneration of individual directors (*Vorstandsvergütungs-offenlegungsgesetz*).

Other developments

On the basis of its research the Committee has concluded that no significant changes have occurred in respect of company law, codes and listing rules either in the EU or in the USA since January 2004.

4. Internal risk management and control systems

4.1 Introduction

It was indicated in part 1 of this chapter (compliance with the code) that best practice provision II.1.4, concerning risk management and control systems, is one of the best practice provisions which are frequently not applied or not complied with. The application of provision II.1.4 is generally more complicated than that of many other provisions of the code. This warrants extra attention and is why the best practice provision concerned will be dealt with not only in this chapter but also in chapter 2 (assessment and analysis) and chapter 3 (conclusions).

The key question here is what experience has been gained of best practice provision II.1.4 concerning the risk management and control systems and whether it would be desirable in the light of this experience to clarify or to have this provision amended at some point.

The management board is responsible for the adequate functioning of risk management and control systems. This responsibility is defined in best practice provisions II.1.3 and II.1.4.

II.1.3 The company shall have an internal risk management and control system that is suitable for the company. It shall, in any event, employ as instruments of the internal risk management and control system:

- (a) risk analyses of the operational and financial objectives of the company;*
- (b) a code of conduct which should, in any event, be published on the company's website;*
- (c) guides for the layout of the financial reports and the procedures to be followed in drawing up the reports; and*
- (d) a system of monitoring and reporting.*

II.1.4 The management board shall declare in the annual report that the internal risk management and control systems are adequate and effective and shall provide clear substantiation of this. In the annual report, the management board shall report on the operation of the internal risk management and control system during the year under review. In doing so, it shall describe any significant changes that have been made and any major improvements that are planned, and shall confirm that they have been discussed with the audit committee and the supervisory board.

The notes to the code also contain the following section:

'It would be logical for the management board to indicate in the declaration on the internal risk management and control systems what framework or system of standards (for example the COSO framework for internal control) it has used in evaluating the internal risk management and control system.'

In answering the key issue the Committee has also examined whether best practice provision II.1.4 actually does result in better risk management and better financial reporting. It has also studied how the obligations resulting from the Code compare with the obligations resulting from major foreign legislation such as section 404 of the Sarbanes-Oxley Act (SOX) in the USA and the Revised Turnbull Guidance on Internal Control (Turnbull) in the UK. The Committee has also formed an opinion on the liability risks for management board members and supervisory board members as a result of the issuance of the declaration referred to in II.1.4.

Section 4.2 explains how the Committee set to work. Section 4.3 presents the main findings and section 4.4 concludes with a number of points for attention.

The subject of internal risk management and control systems will also be dealt with explicitly in this report in chapters 2 and 3.

4.2 Approach

First of all, the Committee carried out a literature study of internal risk management and control systems. This included consideration of existing systems such as the recommendations of the 'Committee of Sponsoring Organizations of the Treadway Commission' (COSO), SOX and Turnbull.

In addition, the Committee drew on the findings of various studies carried out on its behalf. These were the aforementioned surveys conducted by the University of Groningen, the RSM Erasmus University and the University of Tilburg.

Roundtable meetings were also held with management board members of Dutch listed companies, with Dutch investor organisations and with Dutch audit firms.

4.3 Main findings

The studies carried out on behalf of the Committee into the annual reports (University of Groningen) and the activities of shareholders (RSM Erasmus University) reveal the following picture of how best practice provision II.1.4 is applied in practice.

Around one third of the companies concerned had not included an explicit declaration by the management board in the annual report that the system was adequate and effective. A minority of them implement the Code in this respect by explaining why this best practice provision is not observed. In almost all cases the explanation is that the company is taking the necessary steps and expects to be able to report on this in 2006 (on the 2005 financial year). However, two thirds of the companies in the survey did issue a declaration, albeit hedged by many provisos.

Around a quarter of the companies give no explanation and do not apply the provision. Half of them are local companies. However, approximately a quarter of the AMX and AMS companies also fail to apply this provision. In the case of foreign companies the figure actually exceeds 40 percent. Approximately two thirds of the companies in the survey fulfil the obligation that an explicit report of the operation of the system should be contained in the annual report. Such a report can be found in the annual reports of almost all AEX, AMX and (to a lesser extent) AMS companies. However, reports are quite often missing in the case of foreign and local companies. It is also clear from the survey findings that a relatively large proportion of companies fail to report what improvements to the risk management and control system have been made or planned.

The surveys also show that few questions concerning II.1.4 are raised at general meetings.

Not a single listed company has issued an unqualified declaration of adequacy and effectiveness. In the *meeting with members of management boards* it transpired that the precise wording of the declaration had been a subject of lengthy discussion both within the management organs of the listed companies and with their auditors and legal advisers. An unqualified declaration of adequacy and effectiveness which creates the impression that nothing can go wrong and that no risks and shortcomings can occur in practice is considered impossible. After all, in practice something is always bound to go wrong and shortcomings will occur; this is part and parcel of doing business. Residual risks can never be excluded. Creating the impression that this would be possible would mislead the investors. In addition, the listed companies are concerned about the risk of being held liable. This is an important consideration, especially in the case of international investors. The listed companies were found in practice to have implemented the declaration required by II.1.4 by listing the risks and describing the risk management and control systems in their annual reports. In the meeting with the members of management boards, they indicated the need for more guidance in the application of II.1.4 as regards the content of the declaration.

The scope of the declaration corresponds with the wide survey of risks prescribed by II.1.4. The meeting of the Committee with members of the management boards shows that although they have questions about the content of the declaration they regard best practice provision II.1.4, including its broad scope, as useful. This has apparently prompted the management boards to make extra and even more detailed checks of risk management and control systems as an extension of their normal practice, which involved checks carried out partly owing to the risk of personal liability. In fact, the provision creates greater awareness and accelerates current practice, thereby helping to ensure that risks are identified and controlled and internal processes tightened up. This is generally viewed as a healthy development. The declaration concerning the internal risk management and control systems has not given rise to any problems in general meetings. Few questions are asked about this, as is also evident from the survey of general meetings.

The meeting of the Committee with investor organisations shows that they too consider II.1.4 to be an important provision. These organisations found that the annual reports for 2004 contained much information about the risk exposures of the companies concerned. This is a major step forward. The wide scope of the risks on which the companies must report is considered very useful. It was thought that if the risks were limited to financial reporting risks (as in SOX), this would be an impoverishment because it is precisely these other risks that are often a major determinant of a company's soundness. In order to form a good picture of the risk profile and the value of the business, investors need a clear explanation by the management board of the material risks and the risk management and control systems. In the opinion of the investor organisations, it is therefore a major deficiency that the information provided is not specific enough to enable them to put effective questions about the declaration to the management board and the external auditor in the general meetings. The answers which they now receive are described as fairly non-informative. The fact that not a single listed company has simply declared that the risk management and control systems are 'adequate' and 'effective' is also seen as a deficiency. In order to make improvements, they consider it necessary for guidance to be given about the meaning of the terms 'adequate' and 'effective' in the provision. In their view, management boards have a point when they say that they do not really know what the declaration means. As regards the financial reporting risks, the company must be stated to be 'in control'. The situation is different in respect of operational, regulatory and strategic risks. The information must be designed to provide a description of the risk and control systems, and should indicate what the strengths and weaknesses of the system are and what steps or improvements underlie the declaration of the management board. Sometimes it is possible to quantify risks and indicate margins. Some risks can be influenced and others not. Some risks can be more easily quantified (e.g. the exchange rate risk - what margins are set in advance) than others (e.g. the competition risk). The management board must itself set standards for the company concerned and describe them explicitly; they may differ from company to company. This could enhance the informative value of the 'in control' declaration and enable more specific questions about the declaration of adequacy and effectiveness to be put in the general meetings. In addition, it should be

noted that the information about II.1.4 is often scattered throughout the annual report. A fixed place for this information in the annual report would enhance transparency and is therefore desirable.

Opinion on the role of the external auditor is unanimous. Expansion of his present role is not considered desirable. Nor is it considered desirable for the auditor to report on the management board's declaration of adequacy and effectiveness.

The findings of the meeting of the Committee with the *auditors* are broadly in line with those of the meetings held by the Committee with management board members and investor organisations. The auditors indicate that in their view observance of the provision is fairly poor. In addition, the wordings used in the explanatory notes differ widely. However, auditors' clients (i.e. Dutch listed companies) regard internal control as an important area of consideration, and take a positive view of the wide scope of the provision. Users (shareholders) are also thought by the auditors to appreciate the wide scope of the provision.

In the view of the auditors there is a clear need for guidance about this provision. In addition, they emphasise that there is no clear framework of standards for application of this best practice provision. The Committee will return to this point in chapters 2 and 3.

4.4 Points for attention

As a result of its research the Committee considers that the following points require attention.

Listed companies and investor organisations expect II.1.4 to have a positive effect on the quality of risk management and reporting. It is too early to assess whether this best practice provision will actually bring about better risk control and better reporting. The first indications are positive, but further improvements can and must be made in due course. The broad scope of the provision – i.e. not only financial reporting risks but also operational/strategic and regulatory risks – is positively assessed by listed companies and investor organisations.

Listed companies and investor organisations need more guidance about the declaration of adequacy and effectiveness.

The Committee also wondered what liability risks are run by management board members and supervisory board members in respect of the declaration that must be issued in keeping with best practice provision II.1.4. By law, misleading information in the annual report can result in personal liability of the management board members and supervisory board members. The court has a degree of discretion in determining whether information is misleading. The Corporate Governance Code (Code Tabaksblat) introduces a standard for this in best practice provision II.1.4. Owing to the liability and litigation risks (high costs and harm to reputation) listed companies are very hesitant in applying II.1.4. The question is what is actually promised by this provision (to the investors).

The liability risks would increase strongly if the terms ‘adequate’ and ‘effective’ were to be interpreted as an absolute obligation. Such an interpretation is not, however, a necessary consequence of II.1.4. The same provision requires the management board to indicate what significant changes have been made and major improvements planned. This suggests that the standard is relative rather than absolute. This approach is in keeping with normal international standards. In the light of internationally accepted best practices and prevailing opinions on the practical implementation of the ‘in control’ statement, differentiation by risk type would be desirable in the management board declaration under II.1.4.

Chapter 2 – Assessment and analysis

1. Issuance of depositary receipts for shares

This part deals with compliance with the code in relation to the issuance of depositary receipts for shares. Section 1.1 briefly considers the system by which depositary receipts are issued. Section 1.2 examines the relevant provisions of the code. The last section focuses on the role and functioning of trust offices.

1.1 Issuance of depositary receipts for shares and anti-takeover measures

The issuance of depositary receipts for shares is a system in which the beneficial ownership of and legal title to shares are separated. Under this system the shares of the company are transferred to a foundation known as a trust office. In exchange for the shares the trust office supplies depositary receipts for shares to the company. The depositary receipts can then be issued by the company on the stock exchange by means of a securities issue. As a result of this structure, the voting rights attached to the shares are exercisable by the trust office and not by the holder of the depositary receipts. The net asset value represented by the shares is reflected in the depositary receipts. As a result, the depositary receipts have the same value as the shares. The trust office pays any dividends in full to the holders of the depositary receipts.

The rules applicable to statutory two-tier companies were modified in October 2004. As a result of this modification, changes have been made to the way in which voting rights are exercised by trust offices. In normal circumstances¹² the holders of depositary receipts can now request the trust office to issue them with a voting proxy. The trust office is obliged by law to issue such a proxy. However, no such statutory duty exists in the case of a takeover. The government has indicated that the question of whether there should also be a duty to provide a proxy to holders of depositary receipts in takeover situations will be included in the bill which it will shortly be presenting to implement the Takeover Directive. This Directive must be implemented by the EU Member States by May 2006 at the latest.

¹² Article 2:118a Civil Code provides that a depositary receipt holder may be authorised to exercise the voting right (attached to the shares). The person entitled to vote (i.e. the trust office) may limit the scope of the proxy in a number of situations, namely:

- i. a takeover situation;
- ii. a situation in which the holders of depositary receipts control over 25% of the issued capital;
- iii. a situation of essential importance.

1.2 How the code affects the issuance of depositary receipts

As mentioned previously, point 3 of the preamble to the code mentions two basic elements of good corporate governance, namely:

- i. good entrepreneurship, including integrity and transparency of decision-making by the management board, and
- ii. proper supervision thereof, including accountability for such supervision.

These basic elements contribute to the internal functioning of the checks and balances of a company. In the field of accountability and supervision there is a prominent role for the shareholders and the general meeting. Some companies have to deal not only with shareholders but also with holders of depositary receipts for shares.

It was stated in the previous section that the system for the issuance of depositary receipts for shares can influence voting ratios and hence the supervision and accountability mechanism. To ensure that supervision functions properly within a company the code takes account of the issuance of depositary receipts for shares. The principle relating to chapter IV.2 states as follows in relation to the issuance of depositary receipts for shares:

'Depositary receipts for shares are a means of preventing a (chance) minority of shareholders from controlling the decision-making process as a result of absenteeism at a general meeting of shareholders. Depositary receipts for shares shall not be used as an anti-takeover measure. The management of the trust office shall issue proxies in all circumstances and without limitation to the holders of depositary receipts who so request. The holders of depositary receipts thus authorised can exercise the voting right at their discretion. The management of the trust office shall have the confidence of the holders of depositary receipts. Depositary receipt holders shall have the possibility of recommending candidates for the management of the trust office. The company shall not disclose to the trust office information which has not been made public.'

Under the code the holders of depositary receipts for shares are therefore entitled to be issued, on request, with an unrestricted proxy in all circumstances. The application of this principle (which is defined in more detail in code provision IV.2.8) means that a depositary receipt holder can exercise the voting right in all situations. This goes further than the statutory duty to provide proxies as described in section 1.2. In both situations the trust office exercises the voting right attached to shares in respect of which no voting proxies have been issued.

It is important in the context of a properly functioning set of checks and balances that the executive (i.e. the management board) should be scrutinised by the supervisory board and the shareholders. Where depositary receipts have been issued, supervision of the management board is in principle a

matter for the trust office. In order to perform this role the trust office must have a properly functioning system of internal governance. The code includes a number of best practice provisions concerning the trust office governance.

1.3 Trust offices

Trust offices play an important role in the corporate governance of companies that issue depositary receipts for shares. Eight provisions of the code relate to the functioning of trust offices. The survey conducted by RSM Erasmus University shows that three of these code provisions are frequently not applied. These are:

- IV.2.1 concerning the confidence of the depositary receipt holders in the management of the trust office and the independence of the office in relation to the company;
- IV.2.2 concerning the appointment of managers of the trust office;
- IV.2.8 concerning the issuance of proxies to depositary receipt holders.

It was stated in section 2.6 of chapter 1 that the functioning of trust offices is clearly a matter for attention. The non-application of provisions of the code relating to trust offices detracts from the effectiveness of the internal checks and balances of a company. The Committee therefore calls on trust offices to apply the provisions of the code relating to them. Next year the Committee will return to the subject of application of the code by trust offices. In addition, market consultations on the application of the code by trust offices will be held in the coming year.

The final point to be made in this section concerns the argument advanced in a few cases that code provisions on the issuance of depositary receipts for shares cannot be applied because they conflict with the General Rules (previously known as the Listing and Issuing Rules) of Euronext. This concerns, for example, code provision IV.2.5 which states that in exercising its voting rights, the trust office shall be guided primarily by the interests of the depositary receipt holders. Article 6 of Appendix X, chapter B of the General Rules of Euronext provides that the standard terms and conditions of the trust office should contain a criterion governing the voting behaviour of the trust office. This criterion should relate to the representation of the interests of the issuing company, its affiliated enterprise and all stakeholders.

With a view to the conflict mentioned above between the provisions of the code and the General Rules of Euronext, Euronext has sought to clarify its practice by issuing communication 2005-043 (of 24 June 2005). This states that: *'... in the enforcement of the General Rules the provisions and future provisions of the code and those of legislation and future legislation prevail over any provisions of the General Rules that conflict with them, which in any event means article 6 of chapter B, Appendix X of the General Rules'*.¹³

¹³ The Dutch text of the Euronext communication can be found on the Committee's website (www.commissiecorporategovernance.nl).

2. Internal risk management and control systems

The application of best practice provision II.1.4 in 2005 gave rise to questions concerning the content of the declaration. There is uncertainty about the scope and substantiation of the declaration on internal control required by the code. There is also the question of whether it is possible to declare that the risk management and control systems are adequate and effective. Does not such a declaration give the impression that no risks and shortcomings can occur in the future? What standards are applied in order to determine whether there is adequacy and effectiveness? In practice there is found to be a need for more guidance on the application of this provision.

To assess these questions, it is important to examine the composition of the COSO framework, to which reference is made in the explanatory notes to the code as an example of a framework or system of standards. The COSO model is also applied by the Sarbanes-Oxley Act (SOX) and Turnbull as a framework. This is partly why the COSO model has become the accepted standard for internal control.

The 1992 COSO report developed a framework for the establishment of a system of internal control and a framework for the establishment of a system of reporting on internal control. Internal control is defined in the COSO report as: 'A process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial reporting;
- compliance with laws and regulations.'

There are considerable differences between SOX and Turnbull in terms of their ultimate application in practice. SOX goes further than Turnbull in terms of its in-depth treatment of the subject matter and Turnbull goes further than SOX in the breadth of its subject matter:

- *in-depth treatment of subject matter*: SOX requires a very specific and detailed record of all internal controls, whereas Turnbull requires a high-level approach and does not demand detailed documents;
- *breadth of subject matter*: SOX goes no further in section 404 than the internal controls relating to the financial information, whereas Turnbull deals with all internal controls that exist.

It follows that there are considerable differences between the management declarations required by SOX and Turnbull:

- SOX requires, in brief, a declaration of the management that the internal control of financial reporting is adequate and effective and that the management is responsible for this and a declaration that the external auditor has reported on the effectiveness of the management's internal control of financial reporting. The standard applied in this connection is 'reasonable assurance'.

- *Turnbull* requires, in brief, a description of the main features of the internal control system concerning financial reporting, operational and compliance risks and a statement by the management that it is responsible for this. Although this also covers adequacy and effectiveness, a declaration of the management on this subject is not required. Nor is an assessment report of the external auditor required.

The declaration required by the Dutch corporate governance code combines the wide scope of the risks (as in *Turnbull*) with the requirement that the risk management and control systems in respect of these risks are adequate and effective (as required in SOX with respect to financial reporting risks). In addition to internal controls in respect of financial data, information on the other objectives of COSO is important for investors (this is also apparent from the *Turnbull Review*). In order to link up as far as possible with internationally accepted best practices and prevailing views on their practical implementation, it would, in the opinion of the Committee, be logical for the declaration of the management board under II.1.4 to differentiate by risk type. This would mean that in respect of the financial reporting risks the management board declares 'with reasonable assurance' that the management systems are adequate and effective, whereas in respect of operational and compliance risks it broadly describes the management systems.

Recommendations on the internal risk management and control systems are made in chapter 3.

3. Remuneration policy

3.1 Introduction

In recent years there has been more and more debate in the Netherlands on the remuneration of management board members of large companies, and the subject has been very much in the public eye. The debate in society about the manner in which remuneration is determined, the relationship between performance and remuneration and, above all, the level of remuneration tends to flare up year after year. Similarly, the subject has also attracted political attention. However, the political debate extends beyond the subject of compliance with the relevant provisions of the code (see chapter 1, section 1.7). This also concerns the adequacy and effectiveness of the code.

For the record, it should be pointed out that the Committee, in keeping with the scope of the code, reports only on listed companies. It does not therefore make pronouncements about non-listed companies or about the public or semi-public sector. According to the Committee, a distinction should be made between the remuneration of executives in the market sector and in the public and semi-public sector. The salary of members of management boards of listed companies is established in a free market context. As there are also non-financial income components (intrinsic motivation, risks, status and power), it is not possible to make a good comparison between the remuneration of executives of listed companies and managers in the public and semi-public sector.

The analysis below is partly based on the survey carried out by the University of Groningen for the Committee. The design of this survey has already been explained in chapter 1, section 1.2. Section 3.2 examines factors that play a role in determining the remuneration of management board members and the level of remuneration. Section 3.3 contains a number of findings concerning remuneration policy.

3.2 What factors determine the remuneration (and level of remuneration) of management board members?

In the principle relating to chapter II.2 (remuneration), the code states as follows regarding the level and composition of remuneration:

“The amount and structure of the remuneration which the management board members receive from the company for their work shall be such that qualified and expert managers can be recruited and retained. If the remuneration consists of a fixed and a variable part, the variable part shall be linked to previously-determined, measurable and influenceable targets, which must be achieved partly in the short term and partly in the long term. The variable part of the remuneration is designed to strengthen the board members' commitment to the company and its objectives.

The remuneration structure, including severance pay, is such that it promotes the interests of the company in the medium and long term, does not encourage management board members to act in their own interests and neglect the interests of the company and does not 'reward' failing board members upon termination of their employment. The level and structure of remuneration shall be determined in the light of, among other things, the results, the share price performance and other developments relevant to the company ...”

It can be inferred from the above that the code makes a distinction in relation to executive pay between the level of the remuneration on the one hand and the relationship between remuneration and performance on the other. As required by code provision II.2.10 (on remuneration policy), the level of remuneration should be in keeping with market rates. According to the code, the relationship between remuneration and performance should be clearly present.

Factors that play a role in remuneration but are completely or largely beyond the control or influence of the Committee are the importance of the external labour market for executives, internationalisation, and the risks of failure (or increasing risks of failure) for management board members. These factors relate mainly (but not exclusively) to the level of remuneration.

Importance of the external labour market

The labour market for executives of listed companies is undergoing far-reaching changes on both the demand and supply side. A noteworthy development on the supply side is the increasing internationalisation of the labour market. As a result, it can be attractive for Dutch executives (or potential executives) to choose a career abroad. The increasing frequency with which companies are engaged in restructuring operations is creating extra demand for experienced executives. As the pace of change in the business sector increases and companies are increasingly obliged to take on new executives quickly, proven expertise plays a major role. However, executives with a proven track record are in short supply. To meet the specific wishes of a company, it is therefore often necessary to

search for successful executives in other companies within the same industry, either in the Netherlands or abroad.

This brings us to the question of how the labour market functions. It is by no means a perfect market characterised by full competition. As we have already seen, supervisory board members tend to opt for the proven qualities of executives with other companies. There are also indications that the transparency required by legislation or codes in respect of the level and structure of executive pay affects executives' remuneration¹⁴. As a result of the ever greater transparency of executive pay, it is becoming easier to make comparisons. Owing to the increasing role played by these comparisons and also to the involvement of remuneration experts, a system of self-reference is developing and there is an absence of an external anchor. This can lead to spiralling remuneration as below-average pay is raised, thereby causing a constant rise in the average itself. Insofar as there is an external anchor, this will be for Dutch executives above all the level of remuneration of executives abroad. As this level is still much higher than in the Netherlands, it cannot be expected to have a moderating effect.

Internationalisation

The executive labour market differs from country to country. As a result of ongoing international integration, the setting in which the remuneration of executives of listed companies is determined has greatly changed in recent years. This internationalisation is reflected in the composition of the management board¹⁵. Often companies recruit foreign executives whose level of remuneration is likely to be higher than that of their Dutch counterparts. This applies in particular to executives from the United States and (to a lesser extent) the United Kingdom. As a result, the average remuneration of management boards in the Netherlands is rising, since there are still major differences in levels of executive pay between the Netherlands on the one hand and the United States and some other European countries on the other. Second, large Dutch listed companies have an increasing number of foreign shareholders. A recent survey conducted by the *Financieel Dagblad*, the Dutch financial daily, shows, for example, that on average 80% of the shareholders of AEX-listed companies are foreigners. American shareholders in particular are keen on ensuring that the variable part of executive pay is the greatest. Their reasoning is that if an executive performs well, he or she merits a high salary. The 'pay for performance' adage plays an important role here.

The risks (or increasing risks) of failure for executives

There is an ever greater chance that executives whose performance proves disappointing will be held to account for bad management. In view of the increasing transparency and accountability, executives and in particular CEOs and CFOs are exposed to an ever great risk. As against this, they receive a higher risk premium (remuneration). The ever faster pace of change in business, which is reflected in mergers, takeovers and restructuring operations, can play a role in this connection. As a result, the

¹⁴ See, for example, Cools, *Corporate governance aan de macht* (2005) and the advisory report of the Council of State on the bill concerning publication of top incomes (Parliamentary Papers II, 2004/2005, 30 189 no. 5)

¹⁵ Since 1999 the number of foreigners on the boards of Dutch listed companies has increased from a third to a half. Source: Towers Perrin.

term of office of management board members has become shorter, which is reflected in their higher remuneration. In addition, the imposition of a maximum on severance pay can increase the downward risk.

These factors are a partial explanation of the excessive increases in executive pay. Nonetheless, the question arises of whether this has not been due in part to deficiencies of corporate governance. In the late 1990s it became clear that there were problems with the structure of the pay package of executives of listed companies and that the checks and balances relating to the determination of remuneration were inadequate. For example, no performance criteria were applied when granting options and modifications to the exercise price of options were sometimes made after the options had been granted. The classic corporate governance problem relating to executive pay is the possibility of self-enrichment by management board members. Essentially, this is the problem that the income of the top executives of listed companies is not the result of keen bargaining by independent supervisory board members in recruiting top talent, but is instead determined to a greater or lesser extent by the executives themselves. An effective corporate governance system can prevent this problem.

An effective corporate governance system takes account of the remuneration process and the structure of the remuneration package. Shareholders have an interest in participating in the decisions made on the components and level of the remuneration. Effective participation is possible only if shareholders have sufficient information about the remuneration package of executives. The code lays down explicit provisions governing remuneration policy and the responsibilities of the general meeting and the supervisory board in this connection. The supervisory board is often the organ of the company that is competent under the articles of association to determine the remuneration of an individual management board member on the recommendation of the remuneration committee. In addition, the law lays down far-reaching rules governing the level and structure of executive pay. The powers of the general meeting too are laid down by law. The general meeting should determine the remuneration policy for management board members and approve share and option schemes (including the number of options and the criteria for granting them). The internal checks and balances are therefore regulated by law and in the code. There is an ever greater role in this connection for the supervisory board (and its remuneration committee) and the shareholders.

It is the structure of the remuneration that is of particular importance to shareholders. This is also apparent from research abroad¹⁶. The remuneration of management board members is often divided into different components and consists of the fixed remuneration, a variable cash bonus, variable long-term instruments such as shares and options, and the other components such as pension and payment in the event of a change of control. Shareholders have an interest in ensuring that the executive remuneration package is challenging and is designed to achieve the company's long-term strategic objectives. There should be a connection in this respect between the variable remuneration

¹⁶ Jensen en Murphy, *Remuneration: Where we've been, how we got to her, what are the problems, and how to fix them* (2004).

of the management board members and the company's performance (i.e. long-term value creation, to be measured as a mix of short and long-term objectives). To assess the executive remuneration determined by the supervisory board, the shareholders need to have information about the remuneration package of the management board members. In addition, the supervisory board should make clear, when paying variable remuneration, that there is a link with long-term value creation.

3.3 Findings about remuneration policy

Transparency and accountability

There is a high level of transparency among the AEX, AMX and AMS companies in respect of compliance with the code and in respect of the remuneration policy. The remuneration policy is generally described in the annual reports as required by the code, but the explanation required by the code is often not given¹⁷. There is also a high level of transparency in relation to the performance criteria for the variable part of the remuneration, particularly in the case of AEX companies. An explanation of the performance criteria applied is provided by a majority of the AEX, AMX and AMS companies, but there is less transparency in the case of foreign and local companies.

Changes in total remuneration and the separate components

The total remuneration of management board members differs according to the category of listed company. The tables below¹⁸ show that there are noteworthy differences between the remuneration of the top executives of AEX companies and AMX companies. Firstly, the remuneration paid by the AEX companies is higher than that paid the AMX companies. Moreover, the granting of options and shares tends to take place mainly in the AEX companies, where the cash bonus is also higher. The average fixed remuneration of the CEOs of AEX companies is also higher than that of their counterparts in AMX companies.

There are also differences in the total remuneration within management boards. This is true above all of AEX companies. The CEOs of AEX companies receive remuneration which is on average much higher (twice as high) as that of the other board members (€ 4.07 million compared with € 2.04 million). The main differences in both absolute and relative terms occur in the value of the options and shares (approximately € 1.75 million compared with approximately € 0.9 million for options and € 0.9 million compared with € 0.4 million for shares). On average, 21% of the remuneration of the CEOs consists of fixed remuneration. The other components account for the following percentages: cash bonus 14%, options 43% and shares 22%¹⁹. The fixed remuneration of the other board members accounts on average 26% of the total remuneration. These percentages show that the different components have a comparable share in the total remuneration of both groups of board members.

¹⁷ Although the code is observed in a number of respects, it is unclear whether this information also sheds light on the relationship between the variable pay and the corporate results.

¹⁸ The statistics used for these tables come from the Hay Group and can be consulted at www.haygroup.nl. The data concern the figures for the remuneration of the top executives of all AEX and AMX companies in 2003 and 2004.

¹⁹ Pension and other perks are not shown.

**Remuneration of CEOs (CEO) and other management board members (BM)
of the AEX companies, 2004**

	n	Median	Standard deviation	Variation
Fixed remun. (CEO)	24	761,000	329,303	0.691
Fixed remun. (BM)	23	507,333	171,936	0.698
Cash bonus (CEO)	24	445,911	559,142	0.964
Cash bonus (BM)	23	202,319	182,736	0.660
Value options (CEO)	24	726,532	2,931,262	2.656
Value options (BM)	23	379,700	1,350,120	2.808
Value shares (CEO)	24	241,618	1,410,451	1.910
Value shares (BM)	23	138,993	584,764	2.070

Note: all the figures in the tables are expressed in euros, with the exception of the figures for the variation.

**Remuneration of CEOs (CEO) and other management board members (BM)
of the AMX companies, 2004**

	n	Median	Standard deviation	Variation
Fixed remun. (CEO)	21	431,100	148,617	2,311
Fixed remun. (BM)	20	333,500	84,835	0,137
Cash bonus (CEO)	21	147,333	154,773	1,013
Cash bonus (BM)	20	99,500	89,209	0,840
Value options (CEO)	21	0	471,619	3,186
Value options (BM)	20	0	352,167	2,940
Value shares (CEO)	21	0	168,629	4,130
Value shares (BM)	20	0	113,727	4,212

Note: all the figures in the tables are expressed in euros, with the exception of the figures for the variation. It is striking that the median of the value of the options and shares for CEOs and other board members is nil. This means that over half of the companies do not grant options and shares to their management board members. By way of illustration, the average values of the options and shares that are granted is € 191,642 for value options (CEO); € 162,078 for value options (BM); € 49,362 for value shares (CEO); and € 32,395 for value shares (BM).

Determining the value of the total remuneration package is very complex, but it is necessary in order to obtain information about the total remuneration of management board members. The value is determined at the time when the remuneration is granted, but the final results can differ sharply from this. This is particularly true of options. As more and more conditions have been imposed on the granting of remuneration as time has passed, it is no easy matter to compare overall remuneration. The Committee has insufficient information at present about the value attributed to shares and to other remuneration components. For a good comparison over time, however, comparison of the value of the total remuneration is necessary.

Relationship between variable remuneration and corporate results

The code shows that there must be a clear relationship between the performance of the company and the variable remuneration of management board members. Two instruments are available within the framework of the code for achieving this relationship: the *process* by which the variable remuneration is established and the *structure* of the remuneration contract.

The most important features of the *process* by which variable remuneration is established are:

- a) information about the structure (transparency of the structure) of the remuneration contract, as reflected above all in best practice provision II.2.10;
- b) complete independence of both the remuneration committee and any remuneration expert consulted by the committee; and
- c) shareholders have a say on the explanation in the remuneration report of the supervisory board members concerning the manner in which remuneration policy is implemented in practice.

The research commissioned by the Committee shows that in many cases information about the structure of the remuneration contract is still insufficient and incomplete. However, the AEX companies are taking the lead in ensuring that the (variable) remuneration is transparent. The main reasons why information about the structure of the remuneration contract is insufficient and incomplete are the frequent absence of complete and clear information about the main components of the valuation of the remuneration, such as conditional options and shares and also an adequate valuation of the pension entitlement. The second element of the process by which variable remuneration is determined, namely approval of the remuneration policy by the shareholders, has been regulated by law since October 2004. There is now a requirement in the case of both statutory two-tier companies and other companies that shareholders adopt the remuneration policy. In a substantial number of cases²⁰ shareholders have actually asked questions about the remuneration policy. The extent to which shareholders exercise their right to ask critical questions and to give or withhold approval is a matter for the shareholders themselves.

The *structure* of the remuneration policy has three elements (which are adequately elaborated in best practice provision II.2.10):

- a) what percentage the maximum and/or average variable remuneration is of the fixed salary;
- b) what part of the variable remuneration is dependent on measurable and predetermined performance criteria, which of these criteria are disclosed publicly and what part of the variable remuneration is determined on the basis of subjective criteria and/or on a discretionary basis; and
- c) what part of the variable remuneration is dependent on this year's performance, what part is dependent on the long-term performance, and to what extent the variable remuneration is granted conditionally.

²⁰ The survey by RSM Erasmus University shows that over 150 questions concerning executive remuneration were asked during the general meetings started buying it. The category of remuneration is thus the aspect of corporate governance about which the most questions are asked.

Clear information about the remuneration structure is an important prerequisite for establishing a direct link between the performance and the (variable) remuneration of management board members (see the principle in chapter II.2. of the Code concerning the level and composition of the remuneration). To what extent the remuneration structure also results in an actual link between remuneration and performance can only be determined by gathering empirical data over a number of years. No such empirical survey of Dutch listed companies has ever been carried out²¹. The Committee is considering commissioning such a survey in 2006. In this case, the actual relationship between performance and remuneration in Dutch listed companies will be reported in the Committee's 2006 report.

²¹ This research has been carried out in the US. A good example is the study of Hall and Liebman (1998).

Chapter 3 – Conclusions

Conclusions

Corporate governance is a subject that generates considerable public interest. Shareholders are taking an increasingly proactive stance, the issue of top remuneration is receiving much media coverage, and codes of conduct for corporate governance are mushrooming.

What can we conclude after one year of the Tabaksblad code? Although the code is still in its infancy, it is clear that almost everyone is doing everything possible to make a success of corporate governance. The rate of compliance with and application of the code is high. Good corporate governance boosts confidence in business world and the economy, and creates favourable conditions for business development. Ultimately, everyone reaps the benefits of this.

Although the picture is predominantly positive, there are nonetheless a number of points about compliance which require attention. The complete list of points for attention can be found in chapter 1 of this report. Below are some of the most noteworthy points.

- Small and foreign companies are lagging behind somewhat in relative terms in compliance with the code.
- Code provisions are not complied with by companies from all categories. The Committee sees no justification for non-compliance with provisions of the code. If a code provision is not applied, the reason should be explained. Provisions of the code that are frequently not complied with will receive extra attention in next year's monitoring report, as will provisions that are frequently not applied for reasons that are explained.
- The compliance and application rates are lower in respect of the chapter on the remuneration of management board members (part II.2 of the Code) than in respect of the other chapters of the code. There is still too little information about the relationship between variable remuneration and corporate performance. This requires a better understanding of the structure of the remuneration contract.
- Admission to general meetings should be improved. It is therefore necessary that the Dutch government should try to place remote (cross-border) voting high on the international agenda. Another point for consideration is that documents required for general meetings should be made available to shareholders in good time. The Committee also emphasises the importance of a good dialogue between management board members and shareholders.
- Compliance of Institutional investors with the Code is lower than public companies. The Committee therefore urges them to use clear and preferably standard formats when publishing information about compliance.

Recommendation on internal risk management and control systems (good practice)

The Committee considers it desirable to make recommendations concerning the application of best practice provision II.1.4. In this case the Committee talks of *good practice*.

The Committee considers that it is desirable to indicate that best practice provision II.1.4 is fulfilled if:

1. as regards financial reporting risks:

- it is declared that the risk management and control systems provide reasonable assurance that the financial reporting does not contain any material inaccuracies;
- it is declared that the risk management and control systems have worked properly in the year under review;
- it is declared that there are no indications that the risk management and control systems will not work properly in the current year;
- any material weaknesses which are discovered in the year under review or the current year are specified, together with any changes made or improvements planned.

2. as regards other risks (operational/strategic and legislative/regulatory risks):

- a description of the risk management and control systems is given on the basis of the identified important risks;
- if applicable, important failings which are discovered in the year under review are specified, together with any changes made or improvements planned.

The Committee takes 'reasonable assurance' to mean a degree of certainty that would be satisfactory for a prudent manager in the management of his affairs in the given circumstances.

The Committee takes 'reasonable assurance' to mean a degree of certainty that would be satisfactory for a prudent manager in the management of his affairs in the given circumstances.

The Committee notes in this connection that only one year's experience has been gained of best practice provision II.1.4. Needs and experiences evolve over time, just as what is regarded as good practice in this field. Monitoring by the Committee in the next few years may reveal a need for further clarification and/or modification of II.1.4. The Committee will therefore continue to take soundings in the period ahead.

Recommendation on remuneration policy (good practice)

Level of remuneration

The Code provides that the level of remuneration received by management board members from the company should be such that qualified and expert managers can be recruited and retained. The Code does not provide any criterion for reviewing whether the level is reasonable. Nor does the Committee consider that it would be possible to devise such a criterion. A feature of the Dutch situation is the presence of a strong international market not only for executive labour but also for enterprises themselves. The introduction of a national criterion would not be effective in this environment.

Adoption of remuneration policy

The Code focuses on the process for the adoption of the remuneration policy and the structure of the remuneration. Although the rate of compliance in respect of these aspects is high, many companies do not apply the best practice provisions of the Code but explain their deviation from the provisions of the Code. The Committee believes that it would be desirable for the provisions of the Code on this subject to be applied more widely. It therefore makes the following recommendations.

As regards the remuneration process the Committee advocates greater simplicity and uniformity in reporting on actual remuneration. The Committee proposes to consult with companies and other stakeholders on this subject in the next calendar year.

The Committee also believes that the supervisory board should explicitly report on the effectiveness of the company's remuneration policy. In particular, the relationship between remuneration and performance should be made clear not only before but also after the fiscal year concerned. Performance should be interpreted in this connection as the contribution to long-term value creation by the enterprise.

The Committee also considers it important for the remuneration committee of the supervisory board to receive adequate assistance in performing its duties. This will generally mean that the remuneration committee is assisted by a remuneration expert. This expert should perform his duties on the instructions of the remuneration committee. The basic principle should be that any conflicts of interest involving the remuneration expert are to be avoided.

Structure of remuneration

As regards the structure of the remuneration, the first point to be made is that the variable remuneration constitutes a very substantial part of total remuneration. Variable remuneration generally consists of a short-term bonus, mainly for individual performance, and a long-term component which places the emphasis on the performance of the enterprise as a whole.

The remuneration report should provide information about the following three elements in respect of both the short-term and the long-term variable remuneration:

- d) the maximum variable remuneration, for example as a percentage of fixed income;
- e) what part of the variable remuneration is linked to measurable quantitative performance criteria and targets and what part is discretionary determined by the supervisory board;
- f) a description of the measurable quantitative performance criteria insofar as their disclosure would not harm the competitive position of the company.

It is advisable not to depart from the previously established measurable quantitative performance criteria and targets when determining the variable part of the remuneration and to allow for any special circumstances only within the discretionary component of the variable remuneration. The supervisory board should account in retrospect for the policy it has pursued.

As regards long-term incentives the Committee notes that more and more listed companies are switching, in keeping with the Code, to conditional option and share plans. One condition for granting or exercising such rights is the attainment of clearly quantifiable and challenging targets specified beforehand. In the view of the Committee these targets should be directly related to the creation of long-term value for shareholders.

Future activities

The Committee will continue its work in 2006. In 2005 it has concentrated mainly on making a broad assessment of the situation based on the central theme of compliance with the code in practice.

The monitoring of compliance with the code and the best practice provisions will be continued in the year ahead. Special attention will in any event be paid to:

- compliance with the code by local companies and 'Dutch' companies having their primary listing abroad;
- code provisions relating to supervisory board members and the functioning of the supervisory board;
- remuneration policy;
- anti-takeover measures and the governance of trust offices;
- general meetings (preparation and effectiveness)
- internal risk management and control systems.

The emphasis of the work in 2006 will shift from commissioned research to market consultations. This shift of emphasis is partly prompted by the positive experience that has been gained with market consultations in the field of risk management and control systems. Market consultations will in any event be held in the following areas in 2006:

- compliance with the code by local companies and companies listed abroad;
- remuneration and remuneration policy (information format, valuation, effectiveness and accountability);
- governance of trust offices; and
- general meetings (preparation and effectiveness).

It follows from the above that more information about the theme of remuneration and remuneration policy will be gathered in 2006. The aim is to make specific recommendations in 2006 for improving the provision of information about the level and composition of remuneration. In addition, the Committee is considering whether to commission research into the actual relationship between performance and pay in Dutch listed companies.

Finally, it should be noted that in addition to the above the Committee will also pay explicit attention in 2006 to the dialogue between companies and their shareholders.

Composition of the Corporate Governance Code Monitoring Committee

Chairman

Professor Jean Frijs

Professor of Investments at the Vrije University of Amsterdam

Former asset management director and member of the board of the ABP Pension Fund

Members

Professor Kees Cools RA

Professor of corporate financing and strategy at the University of Groningen

Partner in The Boston Consulting Group

Gert-Jan Kramer

President of Fugro NV

Chairman of the supervisory board of Royal BAM Groep NV

Professor Jaap van Manen RA

Professor of Auditing at the University of Groningen

Partner in PricewaterhouseCoopers Accountants NV

Professor Henri Ophof

Emeritus Professor of civil and commercial law at the Erasmus University

Rotterdam

Chairman of the Association of Stockholders

Ms Kitty Roozmond

Director of the Association of Provincial Authorities

Former vice-chair of the Federation of Netherlands Trade Unions (FNV)

Jos Streppel

Chairman of the Shareholders Communication Channel Foundation

Chief Financial Officer Aegon NV

Member of the supervisory board of KPN NV

Professor Albert Verdam

Professor of company law at the Vrije University of Amsterdam

Legal adviser to Royal Philips Electronics NV

Secretary

Wicief Poesiat

Financial Markets Directorate, Ministry of Finance

Marco Knubben (assistant secretary)

Entrepreneurship Directorate, Ministry of Economic Affairs

Wim Helmink (assistant secretary)

Entrepreneurship Directorate, Ministry of Economic Affairs

Annex

Surveys (commissioned by the Committee)

- University of Groningen, *Corporate governance in Netherlands, a survey of the position in the 2004 financial year and the reasons for the differences between listed companies*. Completed: November 2005.
- RSM Erasmus University, *Activities of shareholders 2005*. Completed: 21 October 2005.
- Dr C.M. van Praag, *Relationship between remuneration of top managers and corporate performance*. Completed: November 2005.
- University of Tilburg, *International developments and customs in connection corporate governance in 2004/2005*. Survey still under way.

Market consultations on internal risk management and control systems

- Meeting with members of management boards
- Meeting with representatives of investor organisations
- Meeting with accountants

Written reactions received

- Corporate Governance Research for Pension Funds Foundation (SCGOP), once in September 2005 and once in November 2005
- Association of Stockholders (VEB), December 2005.

Other reactions received from institutions

Various reactions have been received from institutions, including the SCGOP, the VEB, the Dutch Centre of Management Board Members and Supervisory Board Members, the Association of Securities-Issuing Companies, the VNO-NCW Association, Towers Perrin, Hay and Hewitt.