

# APPLICATION OF THE EU-PRINCIPLES IN ROMANIA AND HUNGARY CONCERNING THE BOARDS OF LISTED COMPANIES

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## *Abstract:*

*Corporate governance ensures that boards are able to exercise appropriate scrutiny over management and that shareholders, as owners of the company, are able to hold boards accountable. As such, a high level of corporate governance contributes significantly to investors' confidence and market stability, thus fostering business efficiency. In 2005 the European Commission launched a recommendation on the boards of listed companies and invited Member States to follow the guidelines. In 2008 both Romania and Hungary launched a new Code of Corporate Governance on the basis of the EU recommendations. In my paper I present the EU principles, and by examining the national codes of Romania and Hungary I analyze to which extent and in what issues these two countries have adopted the EU recommendations. I concluded that by the new codes of corporate governance issued in 2008 Romania and Hungary have followed to a large extent the provisions of the EU recommendation.*

*Keywords: corporate governance, European Union, executive and supervisory functions, board, directors, committees*

## **Introduction**

In 2005 the European Commission launched a recommendation on the boards of listed companies and invited Member States to follow the guidelines. In 2008 both Romania and Hungary launched a new Code of Corporate Governance on the basis of the EU recommendations. In my paper I present the EU principles, and by examining the national codes of Romania and Hungary in details I analyze to which extent and in what issues these two countries have adopted the EU recommendations. My hypothesis is that the national codes follow the EU recommendations, but there are certain differences.

## **Background**

Corporate governance ensures that boards are able to exercise appropriate scrutiny over management and that shareholders, as owners of the

company, are able to hold boards accountable. As such, a high level of corporate governance contributes significantly to investors' confidence and market stability, thus fostering business efficiency. (Angyal 2001, Frydman-Rapaczynski 1994)

In 2005 the European Commission launched a recommendation (2005/162/EC) on the role of the supervisory (non-executive) directors of listed companies and on the committees of the (supervisory) board (1 -- see Notes). It seeks to promote standards ensuring that the boards of listed companies offer sufficient guarantees of independence. In doing so, it promotes the convergence of the national corporate governance codes which exist in the Member States, so that investors can benefit from an equivalent level of protection and transparency throughout the Community.

In addition to the global objective of contributing to business efficiency and allowing investors to reap the benefits of the Internal Market, the recommendation was also a response to the corporate fraud scandals of the turn of the century. These scandals demonstrated that the then existing checks and balances were deficient and could not prevent losses of billions of Euros in companies' accounts. The Parmalat case highlighted the inherent danger of concentrating the functions of chief executive and of chairman of the (supervisory) board in the hands of the same person. The Ahold case, on the other hand, demonstrated that a formal separation of executive and supervisory functions by establishing a separate supervisory board may not be sufficient to prevent abuses. Boards are less likely to exercise efficient monitoring if they are staffed with people either with close links to the management or lacking appropriate expertise. Independence is particularly crucial in those areas which involve a potential conflict of interest between managers and shareholders: nomination of the management, manager's pay and audit of the company's performance – itself an indicator of the performance of the manager.

### **EU-principles on the SUPERVISORY bodies of listed companies**

The main principles of the EU are the following (EC 2005).

- **Separation of the role of chief executive director and (supervisory) board chairman**

The separation of past and present chief executive and chairmanship functions is widely considered as a crucial condition for ensuring that management is subject to efficient and independent supervision. It should be avoided that the chief executive immediately becomes the chairman of the (supervisory) board. Furthermore, the Recommendation requires

disclosure of safeguards put in place if a company chooses to combine the roles of chairman and chief executive or to immediately appoint as chairman of the (supervisory) board the former chief executive.

- **Sufficient number of independent non-executive directors on the (supervisory) board**

A sufficient number of independent non-executive or supervisory directors should be elected to the (supervisory) board of companies to ensure that any material conflicts of interest involving directors will be properly dealt with. Independent directors also have a role to play in companies where a controlling shareholder may exert strong control over the management. In such cases, conflicts of interest may arise between the majority and minority shareholders. Independence from the controlling shareholder may be an efficient way of alleviating such conflicts.

- **Creation of board committees for dealing with issues raising conflict of interest**

The creation of nomination committee (NC), remuneration committee (RC) and audit committee (AC) within the (supervisory) boards where these tasks are not the direct responsibility of shareholders is encouraged.

- **Strong presence of independent directors in board committees and clear delineation of the role of such bodies**

It is recommended that the nomination committee should be composed of at least a majority of independent non-executive or supervisory directors, and that the remuneration and the audit committees, in turn, should comprise exclusively nonexecutive or supervisory directors, a majority of whom should be independent.

- **Transparency on independent board members**

Disclosure of the competences of individual directors and of adequate information on the board's determination of the directors' independence is recommended.

- **High standards on qualifications and commitment of (supervisory) board members**

In order to boost the efficiency of the (supervisory) board, it is recommended that it be composed of members who, taken together, have the required diversity of knowledge, judgement and experience to properly complete their tasks.

### Application of the EU principles in Romania and Hungary

Member States were invited to take the necessary measures to promote the application of the Commission Recommendation by 30 June 2006 either through legislation or through best practice rules based on the "comply or explain" principle (2 – see Notes). According to this, the Bucharest Stock Exchange launched a "Corporate Governance Code" in 2008, replacing a code adopted in 2001, and so did the Budapest Stock Exchange, replacing the former code of 2004.

### Romania

Companies traded on the Bucharest Stock Exchange (hereinafter: issuers) are invited to adopt the provisions of the Code on a voluntary basis. The Code builds on the "comply or explain" principle saying that if the issuer fails to implement, in whole or in part, one or more recommendations, it shall supply adequate information with regard to the reasons for the omitted or partial application.

The Code is composed of Principles (of good governance), and to certain principles there are Recommendations added to help the implementation of those principles.

The Code states that the issuers are governed by a board of directors (one-tier system) (Principle IV.) But it also says that in the event of adoption of the two-tier system, the Code's references to the Board of Directors and the Board of Managers, or their members, are applied, in principle, to the Supervisory Board and the Directorate, or their members respectively (Principle XIX, Recommendation 41a.)

As far as the EU-principle on the separation of the executive and supervisory functions is concerned, the Code says that it should be a criterion for the non-executive or supervisory director not to be an executive director of the company or of an entity controlled by it, and has not been in such a position for the previous five years (Principle VII-VIII, Recommendation 16/a).

To ensure a sufficient number of independent non-executive directors on the board the Code recommends that the Board of Directors shall evaluate the independence of its non-executive members considering that he

- does not receive, and has not received, significant additional remuneration from the company or of an entity controlled by it, apart from a fee received as a non-executive or supervisory director

- is not and does not represent in any way a strategic shareholder with a 10% or a greater holding

- does not have, and has not had within the last financial year, a significant business relationship with the company or of an entity controlled by it

- is not, and has not been within the last three years, a partner or an employee of the present or former external auditor of the company or of an entity controlled by it

- is not an executive director in another company in which an executive director of the company is a non-executive or supervisory director, and does not have other significant links

with executive directors of the company due to positions held in other companies or bodies

- has not served on the board or supervisory board as a non-executive director for more than three terms;
- is not a close family member – spouse or a relative up to the IV degree -- of an executive director

(Principle VIII, Recommendation 16/b-h).

About the creation of board committees for dealing with issues raising conflict of interest and about the strong presence of independent directors in board committees the Code suggests to the board to evaluate whether to establish a nomination committee made up mainly of independent directors. (Principle X.) It recommends that the board establishes a remuneration committee and an audit committee from among its members. They should be composed exclusively of non-executive directors and they should contain a sufficient number of independent directors. (Principle XI, Recommendation 21-22., Principle XIII, Recommendation 27, 29.)

There is no principle or recommendation to directly ensure the transparency of independent board members, although in Principle I. it says that the issuers will adopt a transparent corporate governance framework which shall be adequately disclosed to the general public.

As far as the high standards on qualifications and commitment of board members is concerned the Code recommends that the directors should update their skills and improve their knowledge of the company's activity, as well as of the corporate governance best practices (Principle VIII, Recommendation 17.) It is also said that the nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular

appointment (Principle X, Recommendation 20.)

## Hungary

The Code makes suggestions relating to recommended, applicable practices, and alignment and compliance with the recommendations are recommended but not mandatory for companies listed on the Budapest Stock Exchange. The Code consists of Recommendations, Suggestions and Explanations. If a company does not apply a Recommendation or applies it in a different manner, an explanation of what the discrepancies are and the reasons for the discrepancies should be provided ("comply or explain" principle). In the case of suggestions, companies shall only indicate whether they apply the given guideline or not; there is no need for a specific explanation.

One of the innovations of the Company Act of Hungary (IV of 2006) is that public limited companies have the opportunity to establish a one-tier board structure, where there is no Supervisory Board operating, and the board called the Board of Directors executes the management and monitoring functions at the same time. Thus, when the Code refers to the "Managing Body" it means the Management Board/Board of Directors, and in those cases where the peculiarities of the law require that a distinction is made between the Management Board and the Board of Directors, one is made. Recommendations and Suggestions relating to the Supervisory Board are only relevant in the case of the dual board structure.

As far as the EU-principle on the separation of the executive and supervisory functions is concerned, the Code says that the definition of the roles and responsibilities of the Managing Body makes clear the division of the tasks between the Managing Body and the management. The overall guidance of the company, as well as ensuring that the strategy approved by the General

Meeting is applied, is the responsibility of the Managing Body, and cannot be delegated to the executive management. (Explanation 2.1.)

In order to separate the responsibilities of the Chairman of the Managing Body from those of the Chief Executive Officer, their responsibilities should be outlined in the basic documents of the company. If the positions of Chairman and CEO are fulfilled by the same person at the company, it is suggested that the company provides information about the means by which it can be ensured that the Managing Body makes an objective assessment of the work of the executive management. It is recommended that the general meeting should not elect a person to the Supervisory Board who has previously (in the three years preceding his nomination for membership in the Supervisory Board) held a function in the Management Board or executive management of the company. (Suggestion 2.5.)

To ensure a sufficient number of independent non-executive directors on the board the Code suggests that the nomination and appointment of the members of the Managing Body and the Supervisory Board should take place in a transparent process, and the presentation include whether the nominees can be viewed by the company as independent. When determining the size and structure of the Managing Body and the Supervisory Board, the right proportion of independent members shall be targeted. The Managing Body consists of executive and non-executive (external) members. The number of non-executive members shall be determined in a way that ensures that their views and decisions may have a considerable effect on the decisions of the Managing Body passed as a board. (Suggestion and Explanation 2.4.)

To ensure the independence of the Management Board, it is recommended that a sufficient number

of independent members be elected, who have no significant relationship with the company, its executive management or key shareholders. The appropriate level of independence of the Managing Body should ensure that the Board performs its duties more effectively in the strategic interests of the company, taking into consideration the interests of all shareholders. When judging a Board member's independence, certain factors should be considered, including the member's employment, his business relationships, family or personal ties, and any other areas that might result in a conflict of interest. (Recommendation and Explanation 2.5.)

About the creation of board committees for dealing with issues raising conflict of interest and about the strong presence of independent directors in board committees the Code says that committees support the company by assisting in certain special corporate governance functions which are especially exposed to the problem of conflict of interest, such as remuneration of executives (Remuneration Committee), executive and director nominations (Nomination Committee), and risk management (Audit Committee). (Explanation 3.1.) Before nominating a new auditor, the Audit Committee should request a written statement from the candidate in which the auditor discloses any connection between himself (or a close relative) and a member of the Managing Body of the company (and the company's subsidiary), or a member of the Supervisory Board or the executive management. (Recommendation 3.2.) It is suggested that the majority of the members of the Nomination Committee are independent. (Suggestion 3.3.) It is suggested that the Remuneration Committee consists exclusively of non-executive members of the Managing Body. (Suggestion 3.4.) The majority of the members of the Remuneration

Committee should be independent. (Recommendation 3.4.)

As far as the transparency of independent board members is concerned the Code recommends that on the company's website, the company should publish its guidelines on the independence of the Managing Body, and the Supervisory Board, and the applied criteria for independence. (Recommendation 2.5.)

To ensure the high standards on qualifications and commitment of board members the Code says that members of the Managing Body and of the Supervisory Board should devote adequate time and effort to the performance of their duties. When accepting further functions or nominations, it is the Board members' duty to decide whether they are able to perform their duties in relation to their current board membership. (Explanation 2.4.)

The Managing Body and the Supervisory Board should evaluate the performance of the Board(s) annually. This should involve an assessment of the competence of each member (and of the Board committees), and an assessment of how well the Managing Body, and Supervisory Board have fulfilled their tasks. (Recommendation, Explanation 2.7.) It is suggested that committees consist of members who hold the capabilities, professional skills and experience required to perform their duties. (Suggestion 3.1.)

Some issues concerning the boards of companies are regulated in the Hungarian business associations' act. The relevant parts of Act IV of 2006 are the following.

- An executive officer and his close relatives or domestic partner may not be elected as a member of the supervisory board at the same business association. (III/2/24/4)

- The majority of the board of directors shall be made up of independent persons, unless the articles of association prescribe a higher

percentage. A board member shall be considered independent if holding an office only on the board of directors of the public limited company. A board member shall not be considered independent, in particular, if:

- a) an employee of the public limited company, or if a former employee for five years following the termination of such employment;

- b) providing services to the public limited company or its executive officers for consideration as an expert or other similar services;

- c) a shareholder of the public limited company controlling at least thirty per cent of the votes, whether directly or indirectly, or is a close relative [Civil Code, Paragraph b) of Section 685] or a domestic spouse of such person;

- d) a close relative of any - non-independent - executive officer or executive employee of the public limited company;

- e) entitled to receive financial benefits based on his board membership if the public limited company operates profitably, or receives any other form of remuneration from the company apart from the salary for his board membership, or from a company that is affiliated to the public limited company;

- f) engaged in a partnership with a non-independent member of the public limited company in another business association on the strength of which the non-independent members attains control;

- g) an independent auditor of the public limited company, or an employee or partner of such auditor, for three years following the termination of such relationship;

- h) an executive officer or executive employee of a business association, whose independent board member also holds an executive office in the public limited company. (X/2/309/2-3)

- Public limited companies shall set up an audit board consisting of three

members elected by the general meeting from the board of directors, or from the independent members of the supervisory board, where applicable. (X/2/311/1)

- If the shares of a public limited company are admitted for trading on the Budapest Stock Exchange, the Management Board shall present to the annual general meeting the corporate governance and management report. The report shall contain the Management Board's conclusions on the company's policy adopted with a view to sound governance and management in the previous financial year, and shall demonstrate any

derogation from the Recommendations of the Budapest Stock Exchange for Sound Corporate Governance. The report shall be posted on the official website of the public limited company. (X/2/312/1-2)

### Conclusions

The evaluation of to what extent Romania and Hungary has implemented in their Codes of Corporate Governance the requirements of the EU recommendations can be seen in Table 1.

**Table 1**

**Implementation of EU recommendations concerning the boards of listed companies**

CRITERIUM	ROMANIA	HUNGARY
code with regard to EU recommendations	yes	yes
"comply or explain"	yes -- obligatory	partly – to explain is obligatory only for recommendations, not for suggestions
separation of chief executive and board chairman functions	yes (5 years between the functions)	yes (3 years between the functions)
sufficient number of independent board members	yes, independence criteria defined in Code	yes, criteria outlined in Code, defined in Act
creation of N, R, A committees	partly -- RC and AC creation recommended, NC only to be considered	yes, all the three
clear definition of committee roles		yes, for all the three
majority of independent directors in committees	partly -- yes in NC (if created), only "sufficient number" in RC and AC	yes in all three
transparency on independent board members	partly -- not well defined, only as a general principle	yes
qualifications and commitment of board members	yes -- high standards required	yes -- high standards required

*Source: own compilation.*

As it is shown, by the new codes of corporate governance issued in 2008 Romania and Hungary have followed to

a large extent the provisions of the EU recommendation.

## NOTES

(1) The Anglo-Saxon governance system is one-tier for there is no supervisory board operating, and the board (often called board of directors) -- including executive and non-executive (supervisory) directors -- executes the management and the monitoring functions at the same time (unitary board structure). The German or continental European governance system is two-tier, there is a management board loaded with the executive directors, and there is a separate supervisory board with the non-executive directors (dual board structure). The EU recommended that listed companies in the EU should have

the option between a one-tier board structure and a two-tier board structure, thus several traditionally two-tier countries has recently included this option in their company law.

(2) "Comply or explain" gives flexibility to companies. Some companies may find that a certain recommendation is ill suited to their specific characteristics and/or compliance with this standard would be excessively burdensome or difficult. These companies are not required to comply with this specific principle as long as they disclose these deviations and provide an explanation to the market.

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