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French enterprises and corporate governance sanctions: original features and prospects

INTRODUCTION:

1. The genesis of rules of governance:

Recent global and regional crises and their persistent nature have highlighted the limitations of the capitalist system and the risks of lasting turbulence for economies all over the world and within these economies companies who for over two centuries now have formed the foundations on which has been build the greatest development ever seen in the history of the human race.

Awareness of globalization of exchanges and the risks related to it gave rise to a current of thought in favour of adopting new behavioural rules called "good governance"¹ rules, especially from the 70's on and in the aftermath of major financial scandals² (BCCI, Maxwell). The goals of these rules are on the one hand to prevent abuse of the system and on the other to preserve and encourage the extraordinary development potential offered by rationalized exploitation of scientific discoveries by regulating powers, the way information³ is organized and communicated and ensuring the greatest transparency possible⁴.

The financial crisis arising out of the bankruptcy of Lehman Brothers in September 2008 and followed in 2010 by payment difficulties by some European States, the PIGS (Portugal, Ireland, Greece and Spain), increased the urgency of search of solutions.

¹ *Le rapport sur les procédures de contrôle interne: de la loi du 1^{er} août 2003 à la loi du 26 juillet 2005*, Bull. Joly Sociétés, 1 January 2006, n°1 p.135

² *The Corporate Governance Lessons from the Financial Crisis*, Grant Kirkpatrick, OECD, 11 February 2009.

³ *L'information du Conseil d'Administration: gestion et responsabilités*, Bull. Joly Sociétés, 1 February 2006, n°2 p.168.

⁴ *De nouvelles pistes pour la gouvernance ?*: Bull. Joly Sociétés, 1 June 2003, n°6, p. 611.

2. The widespread adoption of rules of governance and the originality of the French position:

Rules of good governance have been widely adopted all over the world through proposals made in particular by the OECD and the World Bank⁵ which are now however mandatory. Nonetheless, they can be used as a guide and reference in drawing up recommendations on a regional and national scale.

On a regional level especially in the European Union, rules of governance have been introduced by adopting regulations and directives⁶; whereas European regulations⁷ set down a uniform rule immediately applicable in all member states without any need to be transcribed into national law, European directives correspond to prescriptions that set general targets for Member states but leave them free to define the legal means by which they will be transposed into national law within the deadlines set.

Thus, each Member state retains a certain decision-making autonomy in numerous areas and in particular when it comes to rules of governance; no less than 18 governance codes were adopted in Europe since 2001 each having its own specific characteristics.

This means that the hold of European law over French law in no way prevents the emergence of specific French governance law. Since good governance was originally designed to be a shield⁸ to protect against the risks of corruption, the original way in which these rules came about, the fact they are relatively recent and the specific nature of their functions all lead us to question the special characteristics of any sanctions associated to them.

From the outset we can consider that since rules of good governance are of an inducement or even educational nature their goal would not be so much to punish as to avert the appearance of infringements for which a system of sanctions already exists elsewhere. However this would be overlooking the fact that the maturity achieved by rules of good governance and the shared belief that they play a leading role in developing and stabilizing a sustainable global, economic,

⁵ Principles of the OECD 2004, governance indicators proposed by the World Bank group: <http://info.worldbank.org>

⁶ The so-called "transparency" directive 2004/109 of 15 December 2004: to ensure a high level of investor protection and efficient markets for securities traded on a regulated market, the said directive reinforces transparency by setting down precise and regular information obligations for securities issuers (e.g.: an annual financial report) (transposed in France by the Act No. 005-842 of 26 July 2005),

Directive 2006/46/EC of 14 June 2006 concerning annual accounts and consolidated accounts of certain forms of companies, banks and other financial establishments, modifying the 4th and 7th accounting directives in terms of corporate governance (transposed in France by the Act of 3 July 2008)

Directive 2006/43/EC of 17 May 2006 on legal controls of annual accounts and consolidated accounts (transposed in France by the order of 8 December 2008)

Directive 2007/36/EC of 11 July 2007 on shareholders of listed companies exercising certain rights (transposed in France by the order of 9 December 2010).

⁷ EC (European Commission) Regulation No. 809/2004 of 29 April 2004.

⁸ On the goals of governance, see the symposium organized by the CREDA on the theme: *Governance in private limited companies. A shield for leaders?; Introduction*, A. Couret: Revue Lamy droit des affaires, August/September 2009, n°41.

financial and legal system, have given rise to a desire to set up an independent model of sanctions compatible with the traditional legal system (I) and an on-going search for greater efficiency (II).

I. An autonomous model of sanctions for rules of good governance:

A close examination of the *Comply or Explain* principle (A) and reputational prejudice (B) enables a certain autonomy of the sanctions model for good governance rules to be characterized.

A. The *Comply or Explain* principle: a complex sanction:

The *Comply or Explain* principle is a soft law sanction that participates in defining rules of governance (a). The input from French professional associations in defining governance rules (b) and acknowledgement of the principle by the law (c) open the way to the emergence of hard law sanctions (d).

a) The *Comply or Explain* principle is a soft law sanction that participates in defining rules of governance...:

It is the prevention goal that is at the origin of the appearance of the Anglo-Saxon "*Comply or explain*"⁹ principle meaning spontaneously implement good governance rules or explain why you do not.

The *Comply or Explain* principle when applied to governance rules means they constitute a entirely characteristic set since they are indisputably in the general interest, yet not sufficiently so as to be binding; it is a dispositive general interest, a trend that it would be desirable to adopt but which does not have to be applied.

This alternative offered to companies, meaning they are free to not implement good governance provisions is characteristic of the coming of so-called "*soft law*"¹⁰ regulations that from the outset exclude sanctions.

Another characteristic of the *Comply or Explain* principle is that it is likely to bring changes to governance criteria by continually analyzing practices and how they are assessed. We see it clearly in developments in the 2009 and 2010 reports from the AMF (Autorité des Marchés Financiers – the French financial market regulator)¹¹ highlighting a certain number of divergent

⁹ *Rôle, valeur et bon usage des codes de gouvernement d'entreprise*, Bull. Joly Sociétés, 1 April 2009, n°4, p.430; *Les manquements des sociétés cotées à la règle de conformité*, JCP ed. E, n°9-10 of 4 March 2010, p. 24.

¹⁰ Report 2006 from the Council of State, jurisprudence and opinions 2005, Sécurité juridique et complexité du droit: La Documentation Française, p. 222.

¹¹ Report 2009 from the AMF on corporate governance and internal control, 8 December 2009, Report 2010 from the AMF on corporate governance and leaders' compensation, 12 July 2010, www.amffrance.org.

practices by companies, for example when they refuse a dual management structure. The principle takes into consideration practices and company constraints and it is therefore likely to proceed by itself in the adaptation of good governance rules and, as such, it is conceivable that one good practice can be replaced by another on condition it corresponds to a general practice and to the goals of good governance.

This means French companies can hesitate as to the need to effectively implement good governance practices¹² and this all the more since they cover both the reminder and the explanation of pre-existing legal provisions, to which it can consequently appear necessary to comply with, but also more peculiar provisions which sometimes even stray from legal provisions such as the recommendation made in the AFEP-MEDEF Code to directors to hold a significant number of shares (article 17) or the recommendation to link attribution and exercising of free share options to performance conditions (article 20)¹³.

b) The contribution of French professional associations in defining governance rules...:

b.1) An encoding effort that is across-the-board if not concerted:

A consensus formed with the aim of defining the materiality of good governance rules in the form of *best practices* with the coming of reference codes the forerunner of which is the *Cadbury* code (1992)¹⁴; these codes were drawn up in England by an independent authority (*Financial Service Authority FSA* for the *Combined Code*); in France, the act of 3 July 2008 recognized the role of professional organizations in drafting these principles.

Whereas in England, the principles of good governance¹⁵ are the subject of a hierarchized organization, distinguishing *Main Principles*, *Supporting Principles* and *Code Provisions*, with the German code also making a distinction between recommendations and suggestions, the AFEP-MEDEF code, from the French grouping of two associations of French companies and currently the main reference in France since it has been adopted by almost all major listed companies, does not contain any specifics of this type and consequently provides little information on implementation of the *Comply or Explain* principle.

¹² *Quelles préventions ? Quelles couvertures du risk ?* Revue Lamy Droit des affaires, August/September 2009, n°41, p.26.

¹³ Corporate Governance Code of Listed Corporations, December 2008, www.code-afep-medef.com

¹⁴ *Regulation by the market: the case of the Cadbury code and compliance statement*, A. Belcher, Journal of Business Law, 1995, p. 321-342

¹⁵ The combined code on corporate governance, July 2003.

b.2) The peculiarity of the French codification:

French companies however have a peculiar right, that of selecting themselves the governance code they undertake to apply and on which will be based any sanctions incurred by them for failure to comply with its provisions. According to article 26 of the Act of 3 July 2008, *“when a company willingly subjects itself to a corporate governance code drawn up by business representative organizations, the report provided for in this article shall also specify the provisions that have been excluded therefrom and the reasons why they have been so excluded. Also the place where this code can be consulted shall be specified. If a company does not subject itself to such a corporate governance code.*

The report provided for in this article also specifies the special provisions concerning the participation of shareholders in the General Meeting or refers to the provisions of this corporate governance code.”

This is a considerable advantage, a remarkable tool placed at the disposal of French companies that contributes to the autonomy of the sanctions system enabling them to exclude any governance rules they do not wish to apply.

Furthermore, the choice of a sanctions framework can only go to facilitating acceptance of the sanctions by the company concerned and consequently facilitate correct implementation of governance rules in France.

Up to 2009, whereas various recommendations are presented in particular by the Institut Français des Administrateurs (IFA), the Association Française de la Gestion Financière (AFG), the Association Nationale des Sociétés par Actions (ANSA), in reality French companies opted in mass for the code published by the AFEP-MEDEF. In its December 2009 report, the AMF observed that 81 % of listed companies whose shares are traded on Euronext Paris had spontaneously adhered to the AFEP-MEDEF code which seemed to correspond to the main reference on the Market and meant that in practice French companies did not see the interest in referring to another code.

However, the recommendations in the AFEP-MEDEF code, drawn up for the main French CAC40 companies, may not correspond to smaller companies even if they were listed on the stock exchange.

A study had been carried out for this purpose by the MIDDLENEXT association bringing together small and medium sized French companies (called "VaMPs – Valeurs moyennes et petites – Small and mid caps" this study aimed at sorting governance systems proposed between those requiring a genuine business analysis of companies and *“those that are more a question of fashion or ideology”*¹⁶ while specifying it did not wish to *“add yet another code of good practices specific to medium sized companies to those already existing”*.

However, the conclusions of the study¹⁷ have shown up a framework of so-called "reasonable" governance rules that could be applied to a group of companies, including unlisted companies

¹⁶ Letter from Mrs C. Weber of 8 October 2008 appended to the MIDDLENEXT Corporate Governance Code, www.middlenext.com.

¹⁷ Référentiel pour une gouvernance raisonnable des Entreprises françaises, Mr Pierre-Yves Gomez, June 2009, www.middlenext.com.

and divided between three powers: executive power (leaders), surveillance power (director orientation and control) and sovereign power (shareholders). Furthermore, alongside governance recommendations, this same study defines the need to observe "vigilance points".

The importance of these provisions convinced the MIDDLENEXT association to adopt them in the framework of its own MIDDLENEXT code published in December 2009.

In 2010, this new MIDDLENEXT code was spontaneously adopted by a number of medium and small companies such as shown by the AMF who drew up a specific report on this phenomenon¹⁸.

It must be noted that both AFEP-MEDEF and MIDDLENEXT¹⁹ take part in implementation surveillance for the practices they have recommended.

c) ... and acknowledgement of the principle by the law...:

It remains that the obligation on companies to implement the *Comply or Explain* principle is no longer in doubt and from this point of view, the principle has taken on legislative value since it is specifically mentioned in the Act of 3 July 2008²⁰ that makes compliance with it binding on the Board's report.

Moreover, companies have been progressively subject to a control of compliance with the *Comply or Explain* principle after the fact both by the AMF and by professional bodies themselves.

The creation of the Autorité des Marchés Financiers (AMF) by the Act of 1st August 2003 enshrines the *Comply or Explain* principle with companies now being subjected to implementation controls after the fact, through publication by the Autorité des Marchés Financiers of annual reports on corporate governance and internal controls and in a special manner since 2009, on leader compensation, powers of injunction given for non compliant companies and publications on the AMF's web site²¹.

¹⁸ AMF recommendation No. 2010-15 of 7 December 2010, complementary report from the AMF on corporate governance, leader compensation and internal control – Mid and small caps referring to the MIDDLENEXT Corporate Governance Code of December 2009.

¹⁹ Corporate Governance Code for small and mid caps, December 2009, MIDDLENEXT; Corporate Governance Code for listed companies, revised in April 2010, AFEP-MEDEF.

²⁰ Article 26 of Act No. 2008-649 of 3 July 2008 featuring various provisions to adapt company law to Community law, transposing Directive 2005/56/EC of the European Parliament and Council of 26 October 2005 on cross-border mergers between joint stock companies and Directive 2006/46/EC of the European Parliament and Council of 15 June 2006 amending the 4th and 7th accounting directives.

²¹ www.amf-france.org

d) ... open the way to the emergence of hard law sanctions:

The coming and persistence of the financial crisis have led the AMF to use application and implementation of the *Comply or Explain* principle to associate it to the creation of positive obligations on companies.

Therefore we observe in the reports drawn up by the AMF since 2008 on the Comply or Explain principle a higher level of interventionism aimed at increasing the requirement in France to apply good governance practices.

d.1) In 2009 the AMF attempted to hierarchize practices:

In its 2009 report, the AMF strove to propose a hierarchy of practices by distinguishing four types of practices in particular in relation to justifying the status of independent directors (page 34 of the said report): *best practices, good practices, insufficiently compliant practices and fairly or completely non-compliant practices* and even adds cases it says raise "*serious questions*". As for board missions and activities, the AMF distinguishes "*a good practice and not so good practice*".

Therefore, companies must understand that it is not enough to explain and that even a full explanation may be criticized. If the comply or explain concept is still conceivable for good and best practices, this is not the case for insufficiently compliant practices and fairly or completely non-compliant practices or for cases that raise serious questions for which there is an obligation to improve and hence an obligation to abandon the current practice.

d.2) In 2010, the AMF highlighted the obligation to comply:

d.2.1) A dissociation of the field of application of the Comply or Explain principle:

In 2010, the AMF seems to have toned down its position. Whereas in 2009, the AMF performed its control mission over all listed companies through two reports, one in July 2009 on the compensation of leaders of listed companies and implementation of AFEP/MEDEF recommendations and the other in December 2009 on corporate governance and internal control, in 2010 the AMF modulated its control depending on the size of the companies. It maintained a report on large companies, mainly those in the CAC 40 index and published a new report on small and medium sized companies who adhered to the MIDDLENEXT code.

The first observation we can make is that the materiality of the *Comply or Explain* principle now differs in France based on the size of the company. This is a very significant difference when we see that in most States that have adopted governance rules, companies can only refer to one single code regardless of their size or specific features. The French system therefore addresses a

criticism often made of rules of governance and the associated Comply or Explain principle which is that uniform rules of governance would not be suited to smaller companies (VaMPs)²².

Thus, the comparison between the AFEP-MEDEF and MIDDLENEXT codes confirms that small and medium sized companies benefit from a special simplified rules of governance regime (for severance compensation, stock options and free shares, setting up committees, given the size of the company, the code offers greater room for manoeuvre to companies depending on how they operate). Regarding the cumulating of a general management function and a work contract, whereas the AFEP-MEDEF code recommends terminating the existing work contract when a staff member takes up a general management function, the MIDDLENEXT code just recommends that the board of directors take a decision as to whether this work contract should be maintained or not.

It must also be noted that for companies who signed up to the AFEP-MEDEF code, there is the emergence of a new practice directly suggested by the AMF, that of the lead director. In its 2009 report, the AMF had asked companies to indicate the steps taken to prevent any conflicts of interest when changes of governance took place. According to the 2010 report, 15% of companies in the sample spontaneously welcomed this suggestion and appointed a lead director. The AMF noted that the "*lead director is one practical way of preventing potential conflicts of interest; however, this does not mean that boards cannot pursue alternative methods of achieving the same result*"²³.

d.2.2) A more strict application of the Comply or Explain principle:

Secondly, an examination of the AMF's 2010 reports reveals a certain move towards a stricter application of the *Comply or Explain* principle.

d.2.2.1) The report drawn up by the AMF on the AFEP-MEDEF code firstly simplifies the practices distinguished in 2009; from the *best practices, good practices, insufficiently compliant practices and fairly or completely non-compliant practices* and *serious questions* there only now remain practices qualified as best or good.

However, the AMF goes into detail as to the explanations provided by companies to justify their refusal to apply certain rules of governance. On several occasions it criticizes the explanations provided and asks companies to change their practices and sometimes indicates why it considers them unsatisfactory.

Regarding the recommended practice to appoint at least two independent directors to the board, the AMF considers that the existence of two major shareholders or specific legal and regulatory provisions are not satisfactory explanations and fall short of the "comply or explain" principle in that they are neither explained in detail nor adapted to the specific circumstances of the company concerned. The AMF recommends to those few companies that do not yet do so to clearly

²² Référentiel pour une gouvernance raisonnable des Entreprises françaises, Pierre-Yves Gomez; (Doctrine that criticizes the uniform application of governance rules).

²³ AMF 2010 Report of 12 July 2010, p 24.

identify the members of the board qualified as independent by the board, whether these members sit on specialized committees or not²⁴.

As for the recommended practice of limiting the duration of director's mandates, the AMF considers that the existence of an average duration in excess of that recommended by the code is not a satisfactory explanation and falls short of the “comply or explain” principle in that it is neither explained in detail nor adapted to the specific circumstances of the company concerned²⁵.

d.2.2.2) The report drawn up by the AMF on the MIDDLENEXT code noted that some thirty small and medium sized companies adhered to this code whereas they previously had adhered to the AFEP-MEDEF code.

This change of rules of governance frameworks however does not dispense companies from complying with the code they have chosen. The AMF performs stringent controls and stresses that companies will not be able to use their small size as grounds for not adhering to the MIDDLENEXT code since this code is designed specifically for small and medium sized companies.

The AMF does not limit its field of action to compliance with the sole recommendations in the MIDDLENEXT code which it extends to compliance with its points of vigilance. Thus, several companies are reproached for not having carried out their vigilance duty; the AMF recommends that companies state being aware of the content of the points of vigilance and also encourages them to indicate the general opinion of the board about the content of these points of vigilance²⁶.

The comparison between the recommendations made by the AMF to large and small and medium sized companies indicates that the latter are subject to more prominent directives than the former.

This is a sign that implementation of rules of governance corresponds to a certain time and cost constraint that some companies may think twice about before implementing.

The AMF recalls that regardless of their size, listed companies must apply a governance framework. The AMF is particularly vigilant in respect of companies who do not refer to any governance code, stating that *"to comply with the provisions of article L. 227-37 of the Trade Code, a company cannot just state that it does not refer to a corporate governance code or that referring to a code does not seem suitable or wise without explaining in detail the reasons that lead it to draw such a conclusion and without describing the corporate governance rules it has effectively set up"*²⁷, and on page 13 that compliance with a code is recommended since the financial market standards are considered as corresponding to the best practices.

Companies are therefore clearly invited to adhere to a governance code rather than define their own rules, which gives rise to the problem of interpreting the legal rule, thus positively confirming that a company can apply a special system of governance.

²⁴ AMF 2010 Report of 12 July 2010, p.37.

²⁵ AMF 2010 Report of 12 July 2010, p 35.

²⁶ AMF 2010 complementary report of 7 December 2010, p. 6.

²⁷ AMF 2010 complementary report of 7 December 2010, p.15.

Therefore this change to the Comply or Explain principle must be highlighted. Originally a soft law rule, it seems to be gradually taking the form of a more restrictive standard aimed at subjecting all listed companies to uniform financial market standards defined by professional codes.

In any case, it is necessary to stress the importance of companies clearly explaining the reasons why they do not comply with rules of good governance and to justify these reasons in relation to the founding principles of governance that are the balance and control of powers, transparency, and they must indicate in what way would adopting a given provision be inappropriate to the company corporate interest.

B. The reputational prejudice:

The reputational prejudice is a sanction the scope of which is continually expanding (a) and that has specific characteristics (b).

a) The on-going expansion of the scope of reputational prejudice:

Exchange globalization and the spread and immediacy of communication modes have exposed companies to a new sanction called "reputational".

The coming about of this sanction is linked to the multiplication of information sources enabling companies' failings to be highlighted.

The scope of reputational prejudice is considerable since it concerns the individual leaders whose failings can be criticized but also the companies themselves for which these leaders work and beyond this, groups of companies or professions concerned by such shortcomings. The current across-the-board condemnation of bankers and traders said to be responsible for the financial crisis is from this point of view particularly edifying²⁸.

Reputational prejudice is seen most often, as regards company leaders, in an obligation to put an early end to their functions, whether through resignation or dismissal. And given the publicity surrounding this prejudice, the damage is further compounded by the attack on the honour and reputation of the person in question and consequently serious risks arise as to the possibility of this person pursuing his/her career. The company itself suffers from the sanction to the extent that its image can be severely damaged.

With the coming of the financial crisis in September 2008, reputational prejudice has taken on a new dimension and now affects an entire profession on a global scale.

The scope of reputational prejudice is such that it gave rise to a massive normative reaction aimed at setting frameworks for the trader and banker professions and the financial sector as a

²⁸ *It is estimated that the tax on bonuses will effect 2,000 to 3,000 bankers in France*, Les Echos, 14 December 2009, p.27;

The 2009 bonuses of 20,000 City bankers will be taxed 50%, Les Echos, 10 December 2009, p.7;

London: the tax on bonuses could yield several billion euros, Les Echos, 7 January 2010, p.26.

whole. The risk of such a reaction is it may give rise to hastily-taken decisions without consultation and constitute distorted treatment. In France, rules on the payment of bonuses to traders were until recently set down in professional standards but they have just been the subject to a decree dated 13 December 2010²⁹ by which payment of 40% of the bonus (60% for the highest bonuses) must be deferred over a period of at least three years and 50% of the bonus must be paid in the form of shares or equivalent instruments. Yet this is not currently the case in many other European countries or even in other regions of the world and risks encouraging companies to relocate their trading operations to countries with more favourable legislation.

b) The characteristics of reputational prejudice:

The characteristics of reputational prejudice are:

- the legal uncertainty linked to the diversity of potential sanctions: that, following a serious breach of a rule of good governance, a leader has to resign or be dismissed may seem acceptable and predictable. Beyond this however the questioning of the company or sector concerned remains an event that is not easy to predict and can furthermore constitute an excessive sanction with no possibility of any efficient control being exercised.
- it is an exception to the principle of no double sentences³⁰; the application of reputational prejudice does not prevent the person concerned from suffering traditional sanctions i.e. legal proceedings.

c) Interactions between reputational prejudice and *Comply or Explain* principle:

The shift in the *Comply or Explain* principle towards an effective sanction of companies' behaviour seems correlated with the development of reputational prejudice. It is sufficient to read the 2010 AMF report on the AFEP-MEDEF code to see that whether rules of governance and the *Comply or Explain* principle are complied with or not is published by the company and therefore communicated to markets.

Thus, the reputational prejudice linked to the publicity surrounding failure to comply with a rule of governance further obliges companies to comply with these rules. This begs several reservations and questions; that of the legitimacy of the obligation to the extent that the rule of governance comes from professional circles, even if it is confirmed by the AMF; that of a possible recourse against the obligation which seems quite theoretical and illusory given the

²⁹ Decree of 13 December 2010 amending several regulatory provisions on control over compensation for staff exercising activities likely to have an impact on the risk profile of credit institutions and investment companies as well as various provisions of a prudential nature; Press Release from the Minister Mrs Christine Lagarde on 19 December 2010.

³⁰ The principle of necessity and proportionality of the sentence is posed by article 8 of the Declaration of Human Rights in 1789 setting down that "*The Law must prescribe only the punishments that are strictly and evidently necessary*"; see in particular: *Droit pénal général*, F. Desportes and F. Le Guehec, Economica 13th ed., p. 235.

trouble the company would suffer if it decided to not comply with the AMF's recommendation. Of course companies have a theoretical right to choose a given system of governance, in line with the article L. 225-37 of the Trade Code, but this recourse is ill-fitted to the position adopted by the AMF which positively recommends adopting a code it feels corresponds to the best practices for the market³¹. There are also the predictable complexities and difficulties that would most certainly arise when these particular rules are controlled by the AMF. In this sense, the AMF refuses that small listed companies use their size as an argument for not adhering to the MIDDLENEXT Code.

II. The search for more efficient sanctions:

The efficiency of rules of good governance bring up numerous questions especially since the financial turmoil of September 2008 and the European public debt financing crisis; the criticism of rules of good governance does not so much seem to target the rules themselves as the way they are implemented (A) and militate in favour of proposals aimed at improving the efficiency of sanctions (B).

A. The criticism of rules of good governance does not so much seem to target the rules themselves as the way they are implemented:

The application of good governance rules has given rise to certain reservations:

- signs of lack of tolerance are observed constantly: for listed companies, the AMF (like the AFEP-MEDEF) highlights in its reports an on-going improvement to practices but a persistence of non-compliant behaviour; it proposes improvements to be made both by companies and professional bodies in the form of subjects for reflection. For unlisted companies, information obligations incumbent on them may seem too taxing. Therefore the Breton act of 26 July 2005 went back on the obligation they had to draw up an annual report on internal controls.

On another level, the large volume of formalities required, their cost and the time spent complying with good governance rules gave rise to some reservations; isn't the company thus distracted from its essential tasks and in particular that of drawing up its strategy?

- the absence of uniform regulations which hinder acceptance of the sanction and make it possible to get round certain rules of governance by being subject to a given legal system.

- finally, were the bankruptcy of the financial system and the financial defaulting by States a sign that the principles of good governance were inappropriate or a failing in their implementation?

³¹ AMF 2010 Report of 12 July 2010, p.17.

Reflections on the adaptations to be made have been led in particular by the OECD which made this the theme of a report published in June 2009 entitled "*Corporate governance and the financial crisis: Key Findings and Main Messages*"³². The OECD stressed that its principles remain entirely relevant and that the failings of public leaders and companies are due to faulty implementation of the principles. On 24 February 2010, the OECD published a new report confirming its previous findings and stating that in its view the weaknesses observed in implementing rules of governance in particular as regards compensation, the practices of the board of directors and shareholders rights had played a major role in the development of the financial crisis and companies' vulnerability³³.

So it would seem necessary to move towards more efficient sanctions.

B. Proposals for greater efficiency of sanctions:

a) A greater effort of harmonization:

In its above-mentioned reports from June 2009 and February 2010, the OECD stresses the importance for a State that its public leaders be aware of and analyze the experience of other countries and calls for a process of mutual examination and dialogue.

In this sense, a work group, put together by the World Bank, compared the global governance satisfaction indices in a study updated in 2009. This comparison identifies the geographic zones in which it would be desirable to make improvements to enable better implementation of the rules of governance³⁴.

Such an approach assumes that the intervention of the legislator favours better implementation of governance principles. The OECD, in the above-mentioned June 2009 report, acknowledges such a move and does not criticize it but does question the efficiency of this strategy. Again, in its February 2010 report, the OECD warns against excessive legislative intervention given the spontaneous development of codes and standards: "*In the aftermath of the financial and economic crisis there have been calls for greater use of regulation over what are considered to be self regulating "codes and standards". This is not an appropriate approach in the area of corporate governance that is more complex than, for example, in the case of prudential standards*"³⁵; the OECD insists on the fact that the two procedures by which the rules of governance are implemented must be fully applied.

Indeed, the implementation difficulties encountered at present by the willingness to tax trader bonuses without any consultation in the U.K. and France must be highlighted. This leads to a risk

³² *Corporate governance and the financial crisis: Key findings and main messages, June 2009, www.oecd.org*

³³ *Corporate governance and the financial crisis: conclusions and emerging good practices to enhance implementation of the Principles, 24 February 2010, p.3, www.oecd.org.*

³⁴ <http://info.worldbank.org/governance/wgi/index.asp>

³⁵ *Corporate governance and the financial crisis: conclusions and emerging good practices to enhance implementation of the Principles, 24 February 2010, p. 3 no. 3, www.oecd.org*

of seeing the professionals concerned relocate their trading operations to countries with more favourable legislation.

This being said, awareness of the systemic risk that may be caused by the financial crisis has led to financial regulation by States and the international community. Whereas the G20, presided by France, is examining new global regulation procedures, the European Union has already taken numerous steps that go well beyond the transposition required and in progress of the four main directives on governance rules.

After the creation in 2010 of a Systemic Risk Board, the European Union has just given birth to three new authorities, two with sector competence, the European Banking Authority and the European Insurance and Occupational Pensions Authority and a third with multi-sector competence, the European Securities and Markets Authority (ESMA)³⁶.

The ESMA will have the task of overseeing the various national market authorities, in France the AMF, and ensuring uniform application of European legislation.

In France, a new Prudential Control Authority (Autorité de Contrôle Prudentiel) has been set up for the banking and insurance sectors as well as a Financial Regulation and Systemic Risk Board (Conseil de Régulation Financière and du Risque Systémique)³⁷.

All these new bodies and authorities should enable market risks to be detected more efficiently and ensure better handling of the difficulties encountered. This will require efficient collaboration between European and national authorities especially when it comes to defining rules of governance.

In France, it will be interesting to examine the basis on which the AMF performs its legal control of governance rule compliance. In 2009, the AMF referred specifically in its reports to the conclusions of the OECD, with which it however sometimes disagreed³⁸. In 2010, the AMF abandoned all references to the OECD, while tightening its control and warning powers over companies by strengthening application of the Comply or Explain principle in line with an increase in its powers provided by the Act of 22 October 2010 called the "Banking and financial regulation" act. Will the reaffirmation of the prerogatives of the AMF be hindered by the coming of the ESMA? As things stand, the financial means available to the ESMA are considerably less than those of the AMF and this fact, also true in the case of other national market authorities, would tend to confirm that the distinctive French governance rules are here to stay.

³⁶ *The European Securities and Markets Authority must impose itself in the different jurisdictions*, Les Echos, 3 Jan. 2011, p. 27; *The new European insurance supervisory authority on the tracks*, Les Echos, 11 Jan. 2011, p. 29.

³⁷ Act No. 2010-1249 of 22 October 2010 on banking and financial regulation.

³⁸ AMF 2009 Report on corporate governance and internal controls of 8 December 2009, p. 2 and 19.

b) Facilitate a better adaptation and more spontaneous evolution to governance rules:

Greater efficiency in sanctions for non-compliance with rules of good governance implies an in-depth understanding of their goals i.e. prevent deviant behaviour and organize an efficient economic system; sanctions will only be truly efficient if they are accepted³⁹ by companies.

It is in this sense that recourse to the law must be put into perspective, as the OECD very clearly states in the above-mentioned reports, adopting binding directives is only one of a number of solutions; voluntary standards and initiatives by companies have a role to play that is certainly no less important and may be implemented through application of the *Comply or Explain* principle and the increasing importance of the role of professional associations, independent administrative authorities and the courts.

Credit must however be given to French lawmakers who, far from ignoring this state of affairs, seem to encourage it by refraining from making excessively precise legislation and letting independent administrative authorities such as the AMF and professional bodies specify how appropriate it is to have recourse to rules of governance.

b.1) The use of the comply or explain principle:

We indicated above the remarkable potential for use of the *Comply or Explain* rule which, while acknowledging the behaviour of companies and their explanations, is likely to reform or upgrade rules of governance.

In this sense, in its December 2009 report, the AMF highlighted the failure by some companies to implement the dual separation of management functions (page 19), but without drawing any conclusions or proposing a hierarchy between practices, only stressing the need to explain. In its February 2010 report, the AMF acknowledged that many companies came back to a monistic structure on the grounds that it enabled more efficient decisions adapted to a crisis situation. The AMF seems therefore to join the OECD which in its above-mentioned June 2009 (page 10) and February 2010 reports, also tackles this question considering that the approach that applies the same schema to all situations is difficult to implement in this area such that we must view this approach as a good practice but not as the required practice and that the company must explain in case it changes governance.

We still observe that the different qualifications of governance practices applied by the AMF and the OECD in 2009 seem to fade away in 2010 since the AMF has abandoned some rather unclear categories such as fairly or completely non-compliant practices or insufficiently compliant practices.

It might be worthwhile questioning the wisdom of retaining a practice hierarchy beyond best or non-compliant practices and, if so, calling for a concerted harmonization approach, now

³⁹ On the characteristics of the punishment: *Pénologie*, B. Bouloc, Dalloz 3rd ed., p. 5; *Criminologie*, R. Gassin, Dalloz 4th ed., p. 520.

including the ESMA, between the different practices distinguished by the AMF and the OECD and more generally, by international bodies such as the UN, World Bank, etc.

A uniform hierarchized framework, suggested by an OECD report dated 1st December 2006 on the methodology of assessing implementation of the principles of the OECD on corporate governance, would constitute a guarantee of legal security for companies.

b.2) The proposed reflection to be initiated on the scope and role of the Autorité des Marchés Financiers and the courts in interpreting rules of governance:

b.2.1) The law sets down general principles ...

It could still be considered developing the intervention powers of the AMF and the courts in the framework of implementing governance principles.

For several years now French lawmakers have striven to bolster the existence of rules of governance both by transposing European directives and by a multitude of recently adopted legislative provisions⁴⁰ (separation of management functions, report on governance or the degree of 8 December 2008 obliging listed companies to set up an audit committee (art 823-19 of the Trade Code)).

More generally, however, the law does not intend to control rules of governance in an excessively precise manner leaving this up to professional bodies (Act of 3 July 2008) and also to the AMF.

A movement in this direction very clearly came about during 2010 such as described above and which remains to be confirmed in the future. The French governance model has truly original advantages as to the freedom granted companies to choose their code or governance framework. This seems coherent with the nature of rules of governance that must continue to favour spontaneous acceptance of their application by companies themselves.

b.2.2)...the interpretation of the binding force of which may be performed by the AMF and the courts:

It could be considered endowing binding force to some of the principles of good governance and consequently to the recommendations proposed by the AMF⁴¹ and this both through specific powers of sanctions acknowledged for this authority and through possibly submitting cases to the courts.

⁴⁰ NRE Act of 15 May 2001, Financial Security Act of 1st August 2003, Act No. 2005-842 of 26 July 2005, Act No. 2006-1770 of 30 December 2006, TEPA Act 21 August 2007, DDAC Act of 3 July 2008, LME Act of 4 August 2008, Act No. 2010-1249 of 22 October 2010 on banking and financial regulation.

⁴¹ In the state of positive law, the AMF in the framework of its missions cannot exercise an opportunity control: *CA Paris, 19. Oct. 1999, aff. Primagaz.*

Several obstacles have been raised as to the intervention of the courts concerning the difficulty of condemning failure to comply with a rule of governance on a civil or penal level. However it would be appropriate to see whether certain legal areas of competence might be possible or even desirable. In French law, article 632-1 of the general regulations of the AMF may enable a company to be taken to court on the grounds of misrepresentation resulting from a false statement concerning compliance with a code of governance⁴². Furthermore, since the Comply or Explain principle has been adopted by the Act of 3 July 2008, failure to comply with it seems naturally to permit that the case be submitted to the civil courts to the extent that the plaintiff is in a position to show proof of a legitimate grievance. Yet, there is no doubt that failure to comply with a rule of governance for example the lack of independent directors on the board or the existence of a hidden conflict of interest is likely to characterize an infringement against the entity's corporate interest and consequently a prejudice caused to this entity and its shareholders. On a penal level, since the purpose of rules of governance is to prevent fraudulent behaviour it is just as likely that a breach of a rule of governance may reveal a penal offence and justify legal proceedings.

This move would have the following advantages:

- Firstly, since the legislative method adopted consists in delegating to the AMF⁴³ and professional bodies responsibility for drawing up rules of good governance, it is necessary for companies to avail of clear interpretation rules. It is not normal that companies have no clear recourse against the decisions of the AMF obliging them to comply with governance recommendations.

The French law specifies very clearly that a company is entitled to not apply a provision of a code on condition it explains why. In case of disagreement between the company and the AMF as to the explanation provided, it should be possible for the company to have a recourse enabling the litigation to be settled.

- Secondly, companies can legitimately question the risks they are incurring in not implementing a practice recommended by the AMF even though they gave the grounds for deciding not to adopt this practice. It has been indicated above that as things stand, a company criticized by the AMF will tend to comply due to the negative publicity and the prejudice the company may suffer. Providing a right to recourse would correspond to a legal and democratic security.

- Thirdly, exercising the courts' interpretation function could be extended to take in all rules of governance, barring none, to favour a more global vision of the usefulness of these rules of governance and be free of any considerations concerning specific circumstances.

⁴² Article 632-1 of the General Regulation of the AMF: *"All persons must refrain from disclosing or knowingly disseminating information, regardless of the medium used, that gives or may give false, imprecise or misleading signals as to financial instruments. This includes the spreading of rumours or false or misleading information, where the person making the dissemination knew or ought to have known that the information was false or misleading (...)"*.

⁴³ *Le pouvoir de sanction de l'AMF, un élément central de la crédibilité de la Place et de ses acteurs*, Editorial du Bull. Joly Bourse n°5, Sept.-Oct. 2009.

To conclude, the rules of governance confirm all their relevance in moving in the direction of greater market and corporate regulation. The French governance system, when viewed through its sanctions, shows an undeniable originality due to the freedom offered French companies to determine themselves the code of governance they must apply. This freedom, facilitating acceptance of the rule, has given rise to two reference codes, one for large corporations, the second for small and medium sized companies.

In this way, France has managed to overcome obstacles encountered by other countries. However it must pursue its work in implementing the rules of governance. Fully active on the world stage and a member of the European Union, France has the ambition of presenting rules of governance adapted to the challenges companies must take up.

Taking the specific nature of sanctions associated to rules of good governance into account, in the sense of a spontaneous and harmonized evolution and a regulation accepted and sanctioned by the AMF and the courts, would help speed up a profound change in corporate behaviour and obtain more spontaneous and widespread compliance with rules of governance and thus greater efficiency of their sanctions. It is also possible that such a change may enable the unpredictable consequences of reputational prejudice to be better grasped.

Greater efficiency of sanctions associated to rules of good governance will enable these rules to achieve their prime goal which is to combat corruption and improve the overall efficiency and morality of economic relations.