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Guidelines for Reasonable Corporate Governance

Pierre-Yves GOMEZ

First edition - March 2009

New edition, completely revised and updated - May 2015

English translation of the original French language version of the
“Referentiel pour une gouvernance raisonnable des entreprises - Edition 2015”
Translator: Thomas JUDGE

2009 Edition forward

MiddleNext

Professor Pierre-Yves Gomez
Director of the French Institute for Corporate Governance
em**lyon business school**
BP 174
69134 Ecully Cedex

Paris, 8 October 2008

Dear Professor Gomez,

MiddleNext is France's lead association defending the interests of mid-caps. As a forum for exchanging ideas, it contributes to the development of innovative practices leading to advances for our companies and their environment. In this role, we are concerned today by the proliferation of corporate governance standards. Over the last decade, we have gone from virtual ignorance about these issues to an overproduction of regulations and codes. This has resulted in requirements and obligations for "good governance" that are sometimes imposed in a haphazard manner. These texts, originating from both lawmakers and soft law, foster standardisation in governance practices that can at times be burdensome.

Recent economic and financial developments, have confirmed the vital need for updating governance, particularly for listed companies. However, we have doubts about the proliferation of proposals whose conceptual foundations and practical effectiveness are not always clear. In particular, the specific characteristics of listed mid-caps are, in our opinion, not always properly taken into account. Instead of taking the nature of listed mid-caps as the starting point for defining their governance, it appears that standards of codes of conduct developed for large and global companies are also being used for smaller.

In light of the above, it is not our intent to add yet another new code of best practices, specifically designed for mid-caps to the many that already exist. Rather, our aim is to offer a clearer view amidst the many current proposals, by distinguishing between those based on a genuine economic analysis of companies from those that are a product of fashion or ideology. Our entrepreneurs must have a clear understanding of the fundamental issues of governance and the consequences for its organisation. This will allow them to make an appropriate selection from among the different standards they may be required to adopt.

For that reason, we are very pleased to be able to benefit from your renowned expertise in these fields. In particular, given your extensive knowledge of governance theories, combined with your direct participation in promoting current changes within companies, through the work of the social laboratory of the French Corporate Governance Institute (Institut Français de Gouvernement des Entreprises), our hope is that you can assist us in establishing sound foundations for the governance of medium-sized companies.

We would be most grateful if you would accept the task of producing a report for MiddleNext, not with the objective of updating proposals, but rather the very foundations of corporate governance for listed mid-caps. The terms of its production and the make-up of the commission responsible for its validation can be arranged at your convenience, and we will be delighted to discuss them with you should you accept our proposal.

I look forward to hearing from you.

CWeber

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

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Ms. Caroline Weber
General Manager
MiddleNext
Palais de la Bourse,
28 Place de la Bourse
75002 PARIS

Lyon, 4 November 2008

Dear Madam,

I am greatly honoured by the MiddleNext board's expression of confidence in asking me to produce this report. As I indicated during our meetings, I believe it is important not to move too quickly in proposing a new code for mid-caps, on top of the many texts that already exist on "good governance". The work conducted in France on corporate governance tends to suffer more from an excess rather than a lack of proposals and codes.

What is lacking in France, however, is the equivalent of what the British have achieved through the Combined Code: a text assembling ideas on corporate governance in a coherent manner to provide a common set of guidelines for all those seeking improvements in practices.

That is my objective for the guidelines I will submit to you in May. It will provide a baseline for all codes of governance by presenting the principles on which corporate governance is founded.

The MiddleNext association includes medium-sized companies whose capital can in some cases be highly concentrated, and in others, widely diluted among the public. This gives it an ideal vantage point for observing the main issues raised by governance. Indeed, the different rationales driving family-owned companies and financial markets are directly concerned by these issues. For that reason I am very pleased to be offered this opportunity by the MiddleNext board to draft these guidelines. Nevertheless, its purpose is not to serve itself as a code of good conduct for mid-cap companies. Instead, it will propose a framework that is valid for all companies. On that basis, MiddleNext can then define its own rules on its own terms.

I look forward to presenting my guidelines to you,

Yours sincerely,

Pierre-Yves Gomez
Professor of Strategy, em**lyon business school**
Director of the French Institute for Corporate Governance (IFGE)

2014 Edition forward

The preceding version of the "Guidelines for reasonable corporate governance" ended with the following remark: "This first version of the guidelines will provide a starting point for working towards more consistent corporate governance practices in France, and will benefit from feedback and proposals from its users to improve the relevance and efficiency of future versions." Those guidelines provided the foundations for the MiddleNext corporate governance code that represents its direct application. This text has been explored in-depth by hundreds of companies. Others have used it to assess their governance. Academic colleagues have offered comments. After five years of discussions, analysis and feedback from users, the original version of these guidelines now needs to be updated by introducing fine-tuned adjustments and improvements.

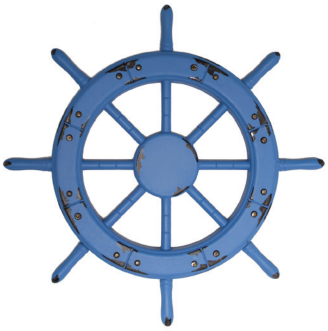
These changes concern neither the spirit, the logic, nor the major principles established by the 2009 edition that we consider as the foundation for reasonable governance. In contrast, definitions for certain concepts have been introduced along with more detailed explanations of the logical construction and reasoning underpinning these guidelines. However, what matters most is that it is used by governance stakeholders, irrespective of the nature or size of their companies, and that it is capable of being adapted to their specific history, circumstances and needs.

In the first part, we in consequence expand upon certain definitions and notions, such as creating confidence, which are critical to understanding the impact of reasonable governance on companies. In the second part, presenting the three powers of corporate governance (sovereign, executive, supervisory), we introduce new developments and analytical tools for better understanding the multiple realities of companies. This is accompanied by new points of vigilance that have been introduced based on feedback from users of the preceding version. Finally, the third part has been enhanced in order to offer a better definition of six corporate governance frameworks (versus five previously), indicating both the benefits and risks associated with each, along with recommendations for limiting these risks.

In the spirit of the previous version, these guidelines constitute a toolbox to assist governance stakeholders (managers, directors, shareholders, analysts, investors, consultants and experts) in producing their own analysis and assessments. This is the very essence of "reasonable governance" whose sole purpose is to promote growth in situational knowledge. That is why we already know that a future version will be further enhanced by contributors who are the users of these guidelines.

Pierre-Yves Gomez
May 2015

Guidelines for Reasonable Corporate Governance



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Preambule

Since the 1990s, there have been a growing number of proposals and rules aimed at improving corporate governance practices. Although initially concerning listed companies whose capital was widely-held among the public, their reach has been gradually extended. Today, all companies are asked to implement "good governance" principles.

In France this has been accompanied by an accumulation of codes proposing useful governance reforms: the Vienot I and II reports, the Bouton report, the codes and guidelines of the AFEP/MEDEF, AMF, AFG, IFA, APIA, IFGE and professional organisations, in addition to major legal advances introduced by the Law of 24 July 1966, the Law of 15 May 2001 (Law on New Economic Regulations Act), the Copé-Zimmerman Act of 27 January 2011 and the Job Security Act of 14 June 2013. At the same time, the European Commission has taken up this issue to achieve convergence in governance approaches in Europe, given the proliferation of codes (nearly 400 throughout the world) and practices.

This profusion of texts bears testimony to the interest in this subject. However, it is also responsible for the proliferation of partial responses to major questions raised by corporate governance. No general doctrine has been developed that is capable of providing guidance applicable to the many specific cases of different companies. And while common principles of corporate governance are necessary, the practical issues companies face may differ significantly, according to their nature (listed or not, privately or family-owned or not, etc.) However, governance reform measures have focused primarily on listed companies and, in particular, very large companies. This bias is a consequence of their greater tendency to go public or raise capital by issuing shares of stock, their considerable economic weight, and also because information about them being easier to find... This distorts reality by giving the impression that the governance of very large listed companies is able to serve as a model which can be applied to all companies. This is the "Gulliver effect" whereby the diversity of companies, particularly small and mid-caps, is eclipsed by the "giants" [1]. This may have led not only to the issuance of inappropriate rules, but also to the dismissal by entrepreneurs of governance issues perceived more as a source of cumbersome standards than an opportunity for progress. This last consequence is particularly prejudicial to the economy as good governance is just as important for the company's sustainability as effective management, and this applies to all companies.

After reviewing the many reference texts and recent developments, we believe that the business community needs an approach that is focused on the **fundamentals** of corporate governance. This should provide a common language for those concerned by governance, and reframe the specific problems it raises for each type of company.

On this basis, we will then be able to formulate or reformulate appropriate rules of governance, and to assess those that already exist.

This report thus presents guidelines for governance intended to apply to all types of companies. On the one hand, they set out the general principles of reasonable governance and, on the other hand, they serve to pinpoint the governance issues specific to different categories of companies. Each representative association or company, if it accepts these principles, will then be able to specify the rules it considers best adapted to its own situation, while remaining consistent with these foundations of reasonable governance.

In drafting these guidelines, we have drawn upon economic data and expert opinions:

→ Producing a synthesis of international reference texts on governance to highlight points in common.

→ Observing governance practice in companies of varying sizes and ownership structures, in particular by conducting in-depth analyses of companies.

→ Analysing the many but often-ignored results of research into governance practices that work and those that do not. For the first two sources of information, we have drawn upon the studies of the French Institute for Corporate Governance (IFGE/em**lyon business school**), a research centre specialised in this field.

→ Questioning governance specialists, company managers, corporate officers, consultants and reference institutions to validate and analyse the proposals. This work was carried out through both bilateral exchanges and the meeting of a commission of experts representing different sensibilities on governance issues. It also drew upon surveys of small-sized companies conducted by the IFGE in collaboration with the APM (Association pour le Progrès des Entreprises) think tank.

→ Taking into account actual governance practices and the opinions of governance code users, and in particular the MiddleNext corporate governance code developed in 2009, from the first version of these guidelines. This code is used today by more than 200 listed companies of all sizes, and a report is produced every year that analyses the profiles of these companies and their uses of its recommendations. [2]

[1] See http://fr.wikipedia.org/wiki/Effet_Gulliver
[2] All document sources cited herein can be freely consulted at www.ifge-online.fr

These reasonable governance guidelines are divided into three parts:

- In the first part, we provide an overview of governance issues and outline the **general principles for reasonable governance**, regardless of the type of company in question (whether listed or non listed, widely-held or held by blockholders, family-owned or entrepreneurial, cooperative or benefit society).

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

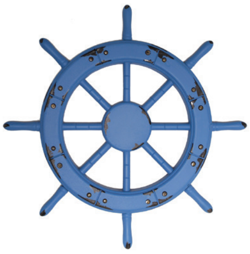
- In the third part, we show how the interaction of these three powers defines **six basic governance systems**. For each system, we list the advantages, risks and specific issues to be addressed to improve its governance.

> **These guidelines propose working principles and a toolbox for users, including lawmakers, to define freely in a pragmatic manner rules for addressing problems relating to specific governance issues.**

Pierre-Yves Gomez
March 2009- Revised in May 2015

PART I

The principles of reasonable governance



Section I: Current principles of "good" corporate governance

Since the 1990s, the rules of corporate governance have been amended in most western countries. This effort led to a proliferation of legal and regulatory texts issued by states or market regulators, as well as more than 400 codes of "good governance", drafted mainly by business community stakeholders. Most of these texts consider that the crucial issue to be resolved is the new responsibility incumbent upon corporations towards the public that is investing their savings in listed companies. Indeed, it is this issue that legitimises intervention by public authorities in the organisation of the governance of economic stakeholders that belong to the realm of private law.

A new responsibility for companies

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It is true that capital structure of listed companies has evolved considerably over the last twenty years. Savings invested in these companies no longer concern just a few hundred high-net-worth individuals, but millions of savers. This reflects both the growth in the number of "retail investors" (about 80 million households around the world), and the number of persons placing their savings with financial intermediaries such as pension or investment funds (about 300 million households worldwide). These developments have altered the fundamental dynamics of how our economies are financed. The inflow of public savings into financial markets raises a question that is both economic and political. How can we ensure confidence in the sustainability of companies on which the assets of a large number of savers depend? This growing influx of savings from retail investors has considerably altered the responsibility of companies towards their shareholders. Companies must now demonstrate to the business community, and to society more generally, that they are able to provide income to a large and disparate group of shareholders who are not directly involved in their management, with whom they no longer systematically share a common interest and purpose (affectio societatis). How this confidence in the sustainability and prosperity of companies is maintained thus becomes a question of major political importance.

At the same time, the role of companies since the 1990s has significantly changed. With the declining economic influence of nation states, globalisation and the development of transnational value chains, the autonomy of companies has increased; but so have their responsibilities towards the society as a whole. It is they who in large part define the strategies for employment, research and innovation. This means that their strategic decisions have long-term consequences for entire regions.

In an effort to curtail this trend, states have rolled out an increasing number of standards and controls, though this solution is far from perfect. Given the role, weight and power of action companies have acquired in society's development, it is only natural that the public calls for a greater clarification of their rules of governance, to ensure that they act as responsible stakeholders within their environment. This demand is reflected, in its own way, by the powerful trend starting in the early 2000s in the area of corporate social responsibility (CSR).

Under those conditions, it seemed necessary to redefine the rules of "good governance", first for listed companies, and then gradually for most companies receiving public capital managed by financial intermediaries (private equity, investment funds), and finally all companies. The result has been a proliferation of codes of "good governance".

The theoretical foundations for current principles of governance

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The principles underlying codes of "good" governance have been in large part influenced by the new configuration of capitalism just outlined, and also prevailing economic theories. These are based explicitly, or more often, implicitly, on so-called neo-liberal economic theory and more specifically, the "agency theory". Developed in the United States in the 1970s, it became the dominant theory in research and training for governance but also the prevailing view of regulators from the 1980s up to the crisis of 2007.

Under this theory, the diluted shareholder base of retail investors represents the "normal" capital structure for companies that will ultimately extends to all companies. Shareholders (and by extension the public) must exercise a key role in ensuring that companies are well managed, reflecting the power associated with their status as "residual claimants", i.e. the risk-takers of last resort. This means that if the company is poorly managed (defined as not generating dividends), they cannot be remunerated. Given the number and fragmented nature of the shareholders, the financial market and stock exchange in this model is viewed as the natural coordinator for balancing their respective interests and risks. The stock price therefore serves as a barometer of the company's good economic health, setting the direction of strategic matters and providing a means for tracking manager performance. This is what is known as corporate financialization.

(3) For a theoretical analysis see Pierre-Yves Gomez, 1995, *Le gouvernement des entreprises : théories économiques et pratiques de gestion*, InterEditions.

Finally, according to this theory, conflicts of interest between company stakeholders are inevitable, in particular between managers and shareholders. The central assumption is that all governance stakeholders are motivated by the different private interests they each seek to maximise in an opportunistic manner, and ultimately against each other; hence the potential for conflicts of interest. This is why incentives and controls need to be created to limit misuse of power by managers against the shareholders' interests. For that reason, the manager must have a personal incentive to generate dividends.

The influence of this theory on texts defining "good" governance

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Whether acknowledged or not, those drafting the codes and laws have been strongly influenced by this conflictual conception of human and social relations and, in consequence, its applicability to governance. This is the origin of what is referred to as "disciplinary", or "punitive", approach which is based on two premises:

(1) **A bias of mistrust** towards those holding power, who are suspected by definition of seeking to overstep their rights. Governance must accordingly be capable of limiting their opportunism. It is no coincidence that regulations on governance are often drafted in the wake of business scandals (the 1992 Cadbury Report in the wake of the Maxwell bankruptcy, for example, or the 2002 Sarbanes Oxley Act after the Enron bankruptcy). As overreactions to crises of confidence in company management, they are sometimes driven by emotion and a will to exact punishment.

(2) **Governance defined as an organised system of transparency.** To avoid abuses considered to be inevitable, "good" governance proposes the alignment of stakeholders' interests with those of shareholders through incentive mechanisms (performance-related pay, target-based bonuses, etc.). At the same time, it has introduced stricter requirements and controls, forcing those in power to disclose information they would otherwise be inclined to conceal (increasing the number of disclosures of regulated information). Mistrust and suspicion are consequently considered to be held in check by an ever-increasing degree of transparency.

These premises provided the justification for a number of practical, sometimes one-off requirements that have contributed to changing practices and mind-sets, often overly-compartmentalised and characterised by a culture of secrecy. As a general rule, reforms have sought to restrict the manager's discretionary powers through increasingly sophisticated and formalised control mechanisms (boards, committees, reports, etc.).

This requirement for transparency has resulted in relative loss of autonomy by companies, in favour of the financial markets (the publication of information on a massive scale, management ratios adapted to shareholder expectations, etc.). Such changes were no doubt necessary to address public demand for greater confidence in companies. However, as we will now demonstrate, they have shown their limits.

[4] See Gérard Charreaux and Philippe Desbrières, "Gouvernance des entreprises: valeur partenariale contre-valeur actionnariale, Finance Contrôle Stratégie, June,1 (2), 1998, pp. 57-88.

Section II: The shortcomings of current governance principes

A simplistic definition of governance

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It is often suggested that recent governance reforms have been designed and applied for large listed companies with highly diluted shareholding structures, and according to a very partial, ideological (neo-liberal) view of economic mechanisms. Yet adopting the assumption that the specific problems raised by these companies are universal has resulted in imposition of cumbersome and ineffective systems on other companies as well.

It is indeed true that certain regulations, such as imposing requirements to disclose information on a massive scale or the precise composition of boards of directors, are ill-adapted for smaller companies, or where the manager holds a very significant percentage of its capital, even if the firm is partially listed. However, the disciplinary approach to governance raises serious questions for both companies and regulators, as well as for large companies.

Problems for companies:

(1) First, disclosing strategic information to the market poses a problem regarding the company's economic security. The controls exercised by external parties (analysts, markets) impose obligations on companies to disclose information that may be considered crucial, even to its own competitors. As a result, even though being listed provides genuine benefits in terms of financing, it is becoming more and more **counter-productive in strategic terms**. Certain companies go as far as to voluntarily delist or go private for this reason. [5]

(2) On the other hand, claiming that conflicts of interest between the different stakeholders of the company are "normal" (which may be referred to as the "the presumption of mistrust") produces distortions in the behaviour of governance stakeholders. While it is indeed desirable to protect minority shareholders from actions by those (majority shareholders or managers) in a position to take advantage of their power for personal benefit, to consider this behaviour as "normal" establishes it as normative, as has been largely demonstrated by research on management practices. [6]
In other terms, the presumption of mistrust pushes stakeholders to turn this presumption into reality: some will demand more incentives to work for the general interest, others ever more information to control the company, or personal compensation to act as good managers. In the end, this leads to **an escalation in opportunistic behaviour**.

(3) Finally, the disciplinary approach to governance cannot be considered to be applicable to all companies in the same manner. To understand, it is important to consider the structure of a country such as France that is in line with the average for developed countries.

- Of the 2,900,000 French companies, 75% are owned by a single shareholder (either an individual or another company). This shareholder is both the owner and the manager. The notion of conflicts of interest thus has no meaning.
- Only 4% of stock companies have diluted capital, defined as when the largest shareholder represents no more than 10% of capital (source: IFGE, 2009).
- Out of the total 800 listed companies, the average float as a percentage of total shares outstanding is approximately 20%. If we take out the top 100, the next 700 have a market capitalisation of less than €1 billion and represent less than 4% of the aggregate capitalisation of the Paris market, and less than 2% of trading volume. A large majority are family-owned. The universe of listed companies is therefore far from homogeneous.
- There are 4,800 companies classified as medium-sized in France (entreprises de taille intermédiaire, or ETI) with between 250 and 5,000 employees. 85% of them are family-owned with one controlling shareholder (often a long-term family shareholder).
- There are 270,600 unlisted small and medium companies with between 10 and 50 employees. Mainly held by one or a few shareholders, they nevertheless face major governance issues that are common causes of company failures. Such issues arise at the time of management successions or modifications in their capital, and also when financial investors acquire a stake in their capital.
- Almost 1,200,000 companies have between 0 and 50 employees. Companies face governance issues at three key phases in their life-cycle: 1) the start-up phase; 2) the transition phase after 10 years; 3) the transition between second and third generation shareholders (source: APM/IFGE study, 2007).
- Finally, we are seeing a trend of very rapid concentration among all companies, with a wave of takeover bids and

[5] Voir le Preuves à l'Appui *Pourquoi sort-on de la bourse ? Cahier n°2, 2012*, disponible sur le site http://www.ifge-online.org/wp-content/uploads/2013/11/preuvesalappuin2.pdf

[6] Voir par exemple, Sumantra Ghoshal Bad Management Theories Are Destroying Good Management Practices, *Academy of Management Learning*, Vol. 4 (1), 2005, pp. 75-91.

the formation of micro-groups. The number of groups of companies rose from 600 in 1980 to 5,300 in 1995, and to 32,000 in 2005 (Source: Insee). This restructuring of the capitalist landscape also raises new governance challenges.

Imposing codes of conduct based on the logic of large listed companies, or their general application, inspired by cases of companies with diluted capital (cases that are no doubt important but limited in number), has accordingly had a prejudicial effect on the many forms and practices of governance that also exist.

Problems for regulators:

In terms of regulation, the prevailing theory of governance based on mistrust produces dysfunctions, including those of an economic nature:

(1) The presumption of mistrust results in the proliferation of controls and verifications to ensure transparency. It is responsible for an increasingly costly disciplinary system and **a futile focus on formalism** that for most companies is without purpose.

(2) The crisis that began in 2008 demonstrated that **the effectiveness of disciplinary control measures** has yet to be proven. This is because the economic theory they are based on is not as sound as previously thought, as shown by scientific research over the last decade. For example, there is no statistical relationship between manager pay and corporate performance, and no proven positive effect of the independence of board members. On the contrary, it has been demonstrated that the effect of compensation committees on growth in director pay is counter-productive. In addition, the very principle of the shareholder as residual claimant has been undermined by the collective power of markets that are capable of imposing high dividend levels on companies. This goes against (and even reverses) the principle of residual claimant, i.e. determined at year end and accordingly a "risk" for the shareholder.

(3) By focusing on formal control measures designed to prevent excesses for a limited number of companies, we neglect **more important questions** that define governance, and therefore how to create confidence for all companies, including those not falling within the framework of this type of governance. These questions deal with subjects like succession planning, managing the family shareholder base, the manager's isolation, etc.

The current situation is therefore unsatisfactory to the degree that corporate governance is based on overly simplistic principles that are reduced to a single company profile; and it is out-dated because its theoretical foundations no longer reflect economic realities.

The need for universal principles of corporate governance
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These criticisms do not mean that "good" governance concerns only companies issuing shares destined in particular for retail investors. On the contrary, more than ever before, every company must meet governance requirements that provide the basis for having **reasonable confidence in their sustainability**. Because the company is open to society, this demand for confidence is only natural from stakeholders risking their capital (shareholders or financial backers), their jobs (employees), or their economic future (suppliers or clients). The more companies occupy a key role in society's regulation and development, **the more their governance must inspire confidence**. Entrepreneurs cannot demand greater freedom of action without accepting the economic as well as the social and environmental responsibilities that come with this freedom.

As with all organisations, whether the state or an association, a failure of governance can have disastrous effects on its sustainability, and on the social or natural environment. This applies to any company, regardless of its size, complexity or capital structure. That is why quality governance **is the key to laying the foundations for stakeholder confidence**. Consequently, in a period such as the present, when our economic mechanisms have lost credibility, clarifying the conditions for governance is more necessary than ever to ensure a clearer outlook of the sustainability of companies.

However, these conditions depend to a great extent on the type and complexity of the company. For example, in a listed family company, harmonious relations among family owners (not subject to regulations) is much more crucial for its future than the disclosure of highly detailed financial information (which is now mandatory). For a company headed by a charismatic leader, the succession plan (to which the law makes no reference) is more decisive for its future than the number of independent directors (a subject of painstaking debate). And yet, is it enough to simply note the multitude of configurations? To the contrary, we must establish the underlying logic for the governance of all companies.

> **This diversity opens the way to a definition of the general principles of governance that provides a coherent framework that can be used to evaluate each case. This is the objective of these guidelines.**

Section III: The principles for reasonable corporate governance

Enterprise

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The purpose of these guidelines is to establish **the general principles of corporate governance**. For that reason, I propose that we briefly consider the notion of enterprise. As defined by French Decree no. 2008-1354 of 18 December 2008, the enterprise is "*the smallest combination of legal units that is an organisational unit producing goods or services, which benefits from a certain autonomy in decision-making, especially for the allocation of its current resources*".

Even if it fails to mention that production is destined for sale (distinguishing it, for example, from an administrative undertaking), this detailed definition has the merits of establishing **the role of autonomous decision-making regarding the use of resources** as the basis of the meaning of enterprise. The enterprise is on that basis fundamentally an economic organisation possessing its own resources to achieve its project.

To exist over time, the enterprise defines an economic and social **project** that provides sufficient benefits to address a market and attract stakeholders. To offer an illustration, if one compares the enterprise to a boat, the project is the boat's underlying purpose: recreational boating or commercial shipping, a transatlantic vessel or coastal navigation, transportation or fishing, etc. Every entrepreneur must ask the question: What is my company's purpose, and for whom is it destined?

As an autonomous entity, the enterprise must also generate a **profit** to remain autonomous. This is necessary to pursue its activities and allow the enterprise to project itself into the future and reproduce resources within a competitive universe. In other words, the boat must not go down with the first storm.

→ *The Project (from the Latin pro-jecto, to leap forward, create a future) defines the objectives, the underlying purpose, the economic and/or social benefits. The enterprise by nature supports a useful project, as the origin of the word project suggests : "A plan that one executes". Without this plan, this project, a company becomes merely a bureaucracy.*
Profit ensures it the material conditions for reproducing capital, its autonomy and, on that basis, the project continuation over the long-term.

Project and profit are connected. However, adjusting the project to the profit or, conversely, adjusting profit to the project is not an insignificant detail. Defining the level of profit required to pursue a project is not the same thing as defining the type of project to achieve a certain level of profit. However, this adjustment depends on those who set the strategy. **This is why the interaction between the project and profit is the fundamental and often implicit priority of corporate governance systems**.

The foundations of corporate governance

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Key definitions relating to corporate governance.

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

→ *To govern comes from the Latin gubernaculum, which means the "helm". Confidence is established (or not) by clearly defining who exercises the power, according to what procedures, subject to what limits and what controls. Knowing how the "helm is held" makes it possible to define and predict the decisive strategic decisions that determine the enterprise's future, by carrying out the project and generating the necessary profit.*

(2) The different powers of corporate governance. Regardless of the company in question, three powers are involved in governance: sovereign power, executive power and supervisory power.

a. **Sovereign power** guarantees the continuity of the company, by confirming, as the highest authority, the company's direction, and by giving legitimacy to its decision-makers.

→ *In all enterprises (as in all human communities), one person is at the origin of the powers of all the others. By way of illustration, it is the ship owner's role to define the type of vessel, and ultimately its hull and keel. That does not mean that this person exercises all the powers, but rather that his/her power cannot be called into question without calling into question the very nature of the enterprise. This is the meaning given to "sovereign" power, or a power of "highest authority".*

In the capitalist system, this power is generally held by the shareholders. It may, however, be held by other stakeholders, by partners of a partnership, member-policyholders of a mutual company or members of a cooperative society. In these guidelines our goal is to establish general principles of corporate governance regardless of the nature of the enterprise. This is why we employ "shareholders" in quotes as a generic term to be used broadly: the term can thus be applied to members of a mutual company or a cooperative enterprise held by employees (société cooperative et participative, or SCOP). In any case, the important issue will be to specify the content of the sovereign power they hold, their responsibilities and the practical resources for exercising this power.

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

→ *This is the power of the captain of the vessel whose hand guides the helm. He sets the vessel's course and keeps it on course over the long-term.*

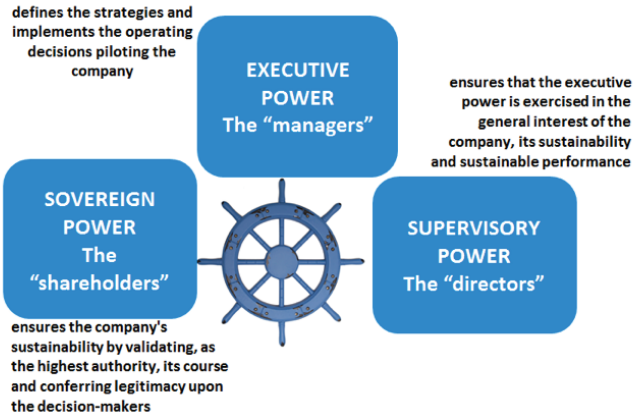
Here again, we use the generic term to encompass the management team, regardless of the status of its members.

c. **Supervisory power** guarantees that executive power is exercised in accordance with the company's general interest, sustainability and sustainable performance.

→ *In this case, "supervisory" is understood to mean "watching over". For reasons of consistency, the supervisory power watches over the executive power to ensure it does not go off course in relation to the expectations of the sovereign power. If the objective of the sovereign power is to ensure the company's sustainability, it follows that the supervisory power watches over the company's general interest, sustainability and sustainable performance. Continuing with this same image, this is the role of the navigator who holds the vessel's compass, and calculates its course.*

This power is exercised by the corporate officers, members of the board of directors, supervisory board or other boards, depending on the type of company. Used as a generic term to cover the many different legal forms of companies, they are referred to in these guidelines as "directors" in quotes.

The way these three powers (sovereign, executive and supervisory) interact defines how the company is governed.


defines the strategies and implements the operating decisions piloting the company
EXECUTIVE POWER The "managers"
ensures that the executive power is exercised in the general interest of the company, its sustainability and sustainable performance
SOVEREIGN POWER The "shareholders"
SUPERVISORY POWER The "directors"
ensures the company's sustainability by validating, as the highest authority, its course and conferring legitimacy upon the decision-makers

Of course, these three powers may be held by the same person or by different persons. Nevertheless, **the nature** of these three powers, which apply to all companies and underpin the very notion of corporate governance, must not be confused with **how they are actually exercised (or not)**. We will return to this fundamental issue further on as it provides a way to move from general and universal principles to their concrete application within companies.

(3) What is the purpose of governance? Through the interaction of these three powers (sovereign, executive and supervisory), governance provides the mechanism for legitimising, making and assuming decisions, particularly those of a strategic nature with enduring consequences for the company. In this way, corporate governance is distinguished from simple management. **It establishes stakeholder confidence in those who govern the company (literally, and those who define its course and have their hand on the helm)**. A fair evaluation of governance would therefore involve asking the following questions: "What reasons are there for having confidence in this company, given the way it is governed?" or "How does the manner in which such a company is governed justify confidence in its sustainable performance?" These legitimate questions raised by internal (employees) and external (public authorities, shareholders) stakeholders provide a basis for defining "good" corporate governance: **a system of governance which instils confidence in the future because the company is "in good hands**". In an open, informed and agile society, offering a clear answer to this question is a political, social and economic necessity.

Three principles for reasonable governance: clarity, effectiveness, vigilance

On the basis of the above definitions, we will speak about **reasonable governance** rather than "good" governance. **By reasonable governance we mean governance that both gives clear reasons to define its form and establishes the reasonable basis for a common-sense approach**. This means that the spirit of governance must prevail over the letter, and reason over procedures. The quality of governance cannot be assessed merely by the strict application of rules, no matter how sophisticated they might be. The proliferation of rules can, on the contrary, reduce situational intelligence and personal accountability by offering a way to hide behind formalism and manoeuvring. Reasonable governance assumes that the rules that define and frame the powers guiding the company over the long-term are **clear, effective and vigilant**.

(1) Clarity regarding the exercise of powers: who is responsible for what? The role of the different parties involved in the governance of a company must be carefully defined. That way, everyone knows what is expected of them: managing, supervising or legitimising. Much of the confusion stems from the fact that the responsibilities of parties participating in corporate governance overlap. Clarification is therefore necessary to distinguish between the duties and expectations of each. This ensures that there are no infringements of their respective powers, and ultimately no dilution in their responsibilities.

A company's governance creates confidence when the powers and responsibilities of those governing it are clearly defined.

(2) Effectiveness to enable genuine responsibility: are rules of governance useful? The governance system must ensure that the three powers (sovereign, executive and supervisory) are exercised effectively. The objective is to make strategic decisions that ensure the company's development and sustainability. Implementing rules and procedures must not impose constraints, but rather facilitate the exercise of each power with its prescribed limits. For that reason, a governance system is considered reasonable if composed of only a small, though precisely defined, number of procedures so that those involved in governance concretely exercise their responsibilities.
Corporate governance creates confidence when each of the powers is efficiently exercised in the interest of the company.

(3) Vigilance to anticipate failures in governance: can they be foreseen? There is no point to dream of a perfect or ideal system of governance. One the other hand, an inappropriate exercise of executive power and its oversight can put the company at risk. Vigilance is the ability to anticipate the adverse consequences of inadequate governance. Reasonable governance must be vigilant with respect to anticipating misuse and failures of the different powers. Vigilance does not entail suspecting all behaviour of those involved in corporate governance as implicitly improper (as does the agency theory based on mistrust). Instead, it seeks to create safeguard mechanisms in advance to prevent abuses from becoming institutionalised and inappropriate behaviour from becoming normal.
Corporate governance creates confidence when it takes into account the points of vigilance designed to prevent the failures by each of the three powers.

The purpose of applying these three universal rules of reasonable governance (clarity, vigilance, effectiveness) is to increase confidence in the governance and, by extension, the company itself. **This means abandoning the logic of mistrust in favour of an approach based on confidence.**

These three principles will accordingly provide a framework for defining our guidelines for reasonable governance.

→ In the second part of this report, we will examine **the concrete content of the three powers that make up governance**: the sovereign power held by the "shareholders, the executive power held by the "managers and the supervisory power held by the "directors.

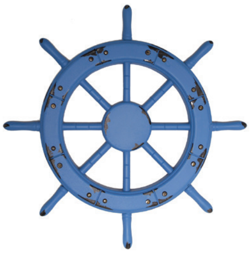
*Note: In contrast to the first version of these guidelines, the three powers are presented in logical sequence: first, **sovereign power**, which establishes the legitimacy of the other two, then **executive power**, and finally, **supervisory power**, which establishes the link between the first two.*

We will define in succession each power according to the principle of **clarity** and **effectiveness**, and then determine the points of vigilance to prevent possible abuses according to the principle of **vigilance**.

→ Finally in the third part of the report, we will describe the six systems (or frameworks) of governance that may be applied to most companies according to the manner in which these powers are exercised. For each of them, we will present the advantages and particular issues of governance that they must address.

Part II

The three constituent powers of governance



In this part, we describe the three main powers constituting the balance of power defining corporate governance, without prejudging at this stage the definition at this stage of who actually exercises these powers in practice.

For each of these powers, we must specify:

(1) **What we are talking about** when distinguishing between an executive power, a supervisory power and a sovereign power (principle of clarity).

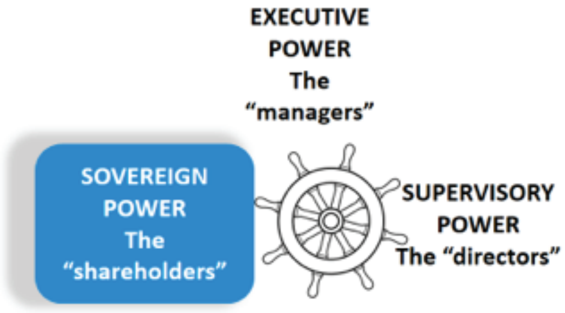
(1) Why it is important that these powers **should be exercised** (principle of effectiveness).

(1) The **points of vigilance** to prevent their misuse (principle of vigilance).

> **This will provide us with a general framework to then analyse the specific situations of each company.**

Section I:
Sovereign power: the "shareholders"

Clarification of this power: what is sovereign power over a company?



Sovereign power over the company assumes a legitimate basis that is conventionally accepted by all for the exercise of this power. The debate about who should be vested with sovereign power is a recurring theme in the history of capitalism.

At present, two options are commonly invoked: in the first, reflecting the prevailing tradition of Western capitalism for the last three centuries, ultimate sovereignty over the company is defined as **capital ownership**; in the second, based in particular on stakeholder theory, the definition of sovereignty is broadened to encompass **all stakeholders who contribute to the company's existence**: employees, customers, public authorities, etc.

This approach is based in part on the fact that in a service economy, as the human factor, expertise and capabilities, connections and networks acquire more importance, financial capital is no longer the main driving force behind value creation. Limiting the definition of sovereignty solely to the possession of capital is for that reason out-dated. Variants on the number and qualification of these stakeholders are sometimes wide-ranging and define various forms of companies (cooperatives, mutual societies, partnerships, etc.). Other options are sometimes proposed where the ultimate sovereignty is held by the state (public enterprises) or communities (enterprises as public goods).

These issues are very important and will no doubt nourish debate within the companies of tomorrow. Nevertheless, they will not be included within the scope of these guidelines. The discussion that follows on the **content** of sovereign power does not seek to take sides, much less put an end to discussions as to **who should exercise this power**.

It is thus only for the purpose of simplification that "**shareholders**" **hereafter shall refer to all those exercising the sovereign function over the company**, in reference to the form that most typifies the capitalist system, namely, stock companies. This means that the term "shareholders" as used here does not refer to a single definition. This will instead be left to the discretion of users of these guidelines, who may include within this term the stakeholder(s) that fit their situation. "Shareholders" may accordingly refer to customer-policyholder (for a mutual company), members of a cooperative enterprise held by employees (société cooperative et participative or scop), the state (for a public company) or others.

Hence whatever legitimate debate there might be**, a sovereign power **necessarily** exists (or once again, as we have already emphasised, a power of last resort) that must be carefully defined since it personifies the responsibility with respect to the company's sustainability. For the economy to function correctly, this responsibility must be exercised, whether by family owners, members of a mutual society, the state, a community or the shareholders of a listed company with a diluted ownership structure.

How should this sovereignty be defined? As noted in the first part of these guidelines, **sustainability assumes the existence of sustainable performance. This in turn requires the existence of an economic and social project, as well as profit to maintain this performance over time**. Adjusting the project to the profit, or vice versa, defines the company's trajectory, and as such falls under the scope of strategy. This adjustment depends both on expectations and the balance of powers between the different stakeholders in governance and, in particular, between the shareholders themselves. Their role is in consequence much more critical than that of a mere capital investor. Sovereign power is the cornerstone of the legitimacy of corporate governance stakeholders. Without this power, the renewal and accumulation of productive resources, which require time, are not achieved, or done so poorly. Without this power, the corporate project lacks an enduring foundation.

A company in which no stakeholder assures the sustainability and its continuing operations over time –regardless of the time frame–, in other words, a convincing **project** and sufficient **profit**, quite literally has no future. Even more so, giving priority to the project over profit, or vice versa, ultimately depends on the sovereign power of the "shareholders" and, in consequence, their responsibility. That is why:

> **For governance to be reasonable, sovereign power embodies the symbolic and practical responsibility for the company's sustainability by giving legitimacy to the other powers to perform their own missions. Linking sovereign power over the company with the duty to contribute to its sustainability is the foundation of governance and the very notion of an enterprise.**

Effectiveness: from principle to practice or the concrete exercise of the “shareholders” power

Two characteristics of “shareholders” provide a way of measuring the scope of their sovereign power within the company:

- The loyalty of “shareholders”. The “shareholders” are supposed to retain their shares over a long period. It is this long-term relationship that legitimises their sovereignty over the company. However, their power is relatively weak when they have no alternative other than exiting the company in the event of a disagreement. By increasing the liquidity of the shares, the development of financial markets has called into question the once-obvious link between the company’s sustainability and stable share ownership. At the same time, it has increased the relative power of “shareholders” capable of exercising even greater pressure, to the extent that they are able to sell their shares.

- The division of “shareholders”. Each “shareholder” can possess an individual power that is more or less significant. This power is strong when the shareholder holds a sizeable number of shares, but weak when it is divided among multiple “shareholders”.

By combining these two dimensions, one can define the different forms of “share ownership”:

			DIVISION OF STAKEHOLDERS	
			WEAK	STRONG
FIDELITY OF STAKEHOLDERS	WEAK	Stable “Shareholders	Few “shareholders but loyal SOLID SHARE OWNERSHIP STRUCTURE	Many loyal “shareholders ERODED SHARE OWNERSHIP STRUCTURE
	STRONG	Unstable “shareholders	Few “shareholders but disloyal VISCOUS SHARE OWNERSHIP STRUCTURE	Many disloyal “shareholders FLUID SHARE OWNERSHIP STRUCTURE

Regardless of the form of “share ownership”, the role of the “shareholder” is essential in ensuring confidence in the company: the current crisis provides an indication that this fundamental principle of economics has been forgotten (and in particular for the capitalist economy). When the “shareholder” (or its equivalent) agrees to **hold on** to their shares even though **they are not sure** to receive remuneration (for example, if no dividends are paid out at year-end), this sends a strong signal to the other stakeholders of their genuine confidence in the company. Conversely, a wish to **exit** the company can be interpreted as a lack of confidence in its future.

→ *This logic can be considerably tested if the existence of highly liquid markets facilitates investment inflows and outflows (or in the case of mutual companies, for example) that lo no longer have any ties to the enterprise’s specific logic, but rather are the consequence of speculative expectations of stakeholders. For this reason, it is important to distinguish between the logic of a financial “investor” and that of a “shareholder”. Only the latter is defined by us as vested with sovereign power over the company. In reasonable governance, the “investor” is a mere provider of funds, in the same way as, for example, a banker.* [7]

The major challenge for contemporary governance is therefore to determine, in practice, whether sovereign power is effectively exercised, with a genuine interest in the company’s sustainability by those who hold it. Only on this condition is their power legitimate.

This problem, however, gives rise to a major difficulty: how can the sovereign power of shareholders be exercised in practice? Should they exercise direct control over strategy by taking actions against it? The ambiguity surrounding the material reality of the power of “shareholders” largely stems from a difficulty in defining the actual scope of sovereign power. It is sometimes suggested that “shareholders” should possess extensive knowledge of the company, as if they were themselves the “managers” and “directors”. However, as it is clearly impossible to acquire such knowledge, and given the limited involvement of most “shareholders” in the day-to-day operations of companies, it may be concluded that the responsibility of “shareholders” is an illusion. But, as we have indicated, this undermines the very logic of the economic system itself, and particularly, the capitalist model. This is why **the content of the sovereignty of** “**shareholders**” **should be concretely defined** to ensure that it can be truly exercised.

Boundaries: In practical terms, the sovereign power of “shareholders” is exercised, on the one hand, by appointing and renewing the terms of the officers in charge of the executive power (the “managers”) and the supervisory power (the “directors”) and, on the other hand, by regularly expressing a vote of confidence in the strategy implemented by the company.

As we have seen, “directors” themselves exercise vigilance over the executive function. In this way, governance is organised in successive layers: the “shareholders monitor the quality of the “managers and “directors they appoint, while the latter exercise oversight over the “managers to ensure they comply with their missions. The “shareholders legitimise the strategy on a regular basis by voting in favour (or against) its continuation.

This limited though realistic definition of the function of sovereignty, far from reducing the power of the “shareholders, enables them to concretely ensure the company’s sustainability, which is their primary mission. The actual exercise of sovereign power thus implies the existence of points of vigilance.

(7) The distinction between “investor and “shareholder and its consequences has been discussed at length my work with H. Korine, Entrepreneurs and Democracy: A political Theory of Corporate Governance, Cambridge University Press, 2008.

Five points of vigilance concerning sovereign power

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- ***Point of vigilance No. 1: Are "shareholders" informed of the foreseeable risks that may threaten the sustainability of the company?***

Any "shareholder must be able to exit the company if he/she deems necessary. This is because only if shareholders' continuing presence is based on **a full knowledge of the facts** can they exercise a role in establishing confidence. For this, they must be provided with information in good faith about the company's situation. **The point of vigilance is therefore assessing whether the "shareholder has obtained clear information about major foreseeable risks that might adversely affect the sustainability of the company's project or profit.** These risks are of two types:

a. *Foreseeable risks relating to strategic choices*, particularly those that may call into question the sustainability of performance. Information must focus on these risks in such a way as to allow "shareholders to assess them with a full knowledge of the issues and decide whether or not to remain shareholders of the company.

b. *Risks relating to failures in the governance system*. The key responsibility of "shareholders" is to confirm that the company's sustainability is in no way impaired by failings in governance due to inadequate oversight. This means that they must be kept informed about the work of the "directors. This is the essential purpose of the **governance report** which we will define in Section III.

All in all, rather than putting the emphasis on providing "shareholders with exhaustive information which ultimately obscures or dilutes the reality of their responsibility, reasonable governance should give preference to targeted information about the major strategic risks and the concrete actions taken by those exercising supervisory power on their behalf.

- ***Point of vigilance No. 2: Do the "shareholders" really choose the "directors"?***

The exercise of sovereign power is manifested by the appointment and oversight of corporate officers since it is the latter who exercise supervision in practice and on which they are required to report. However, "shareholders" must be given credible choices, since a vote without choice is a vote without meaning. Up-and-down votes to simply approve or reject shareholder resolutions for appointing "directors do not provide a genuine opportunity for exercising judgement and are more referendums than votes. Such votes present "shareholders with a fait accompli where decisions have already been made (by the other powers). This means they do not genuinely exercise what constitutes the very essence of their responsibility. **That is why it is useful to offer choices**, according to the expertise and professional background of candidates for the position of director. In this manner, the "shareholders can exercise their preference for a given profile, expertise, or experience over another. Without this ability to choose their representatives on the Board by a binding act of responsibility, the general meeting of the shareholders is nothing but a simple formality for rubber-stamping decisions. This in turn may undermine confidence in the quality of the corporate governance.

- ***Point of vigilance No. 3: Do the "shareholders" take part in the votes?***

Voting in general meetings is the material manifestation of sovereign power. These votes are both practical and symbolic in nature. For that reason, they must be organised in a manner that leaves no doubt as to their legitimacy. Considerable attention should accordingly be paid to the **concrete conditions of the voting process**, which is one of the weakest points in current governance. Five areas in particular may be considered:

a. The real power of an annual general meeting of "shareholders" can be realistically exercised only if there is a limited number of "shareholders". Such meetings become ineffective when sovereign power is exercised by thousands of "shareholders, making discussion and genuine participation in the voting process physically impossible. There is no point in pretending otherwise, particularly in stock companies or mutual companies. A great deal of imagination will be necessary in the future to come up with bodies that represent "shareholders and take account of their number, and in which voting is possible on an informed and dispassionate basis. This task will be inevitable for listed companies with highly-diluted capital, if their governance is to become reasonable once again. This representation may be achieved through a "board of shareholders acting as an intermediary between the board of directors and the shareholders as a whole. Indeed, this model already exists in reality in certain family-owned companies, mutual companies and even innovative stock companies that regularly organise meetings with a panel of "shareholders.

b. For the "shareholders' vote to be legitimate, the meeting notice and the information defining its purpose must be sent sufficiently in advance and clearly explain the stakes of the issues involved. This implies, in particular, that clear alternatives are presented that allows for the possibility of choice. The increasing complexity of capital structures, with holding companies exercising control over successive layers of companies, calls for particular attention regarding comprehensive information that "shareholders require to ensure that decisions made at each level are pertinent. By dividing up a given item of information into different parts, it is easy to formally respect the rules of law, while in practice undermining the reality of the decision-making process.
Procedures must exist for invalidating the vote, if a sufficient number of shareholders considers that the proposed resolutions prevent them from exercising their sovereign function, for two reasons: 1) the level of information provided insufficient, either because it is incomplete or too exhaustive and, as such, prevents the "shareholders from understanding the stakes of the issues on which they were asked to vote and, 2) because, in the absence of an alternative, they do not have a real choice.
Rather than encouraging class-action procedures to seek an award for damages *after a dysfunction*, we would encourage instead shareholder participation to prevent such dysfunctions.

c. The ability to participate in votes in the two areas described above (expressing an opinion on future material risks, and the choice of “directors”) is the quintessential expression of both the symbolic and material power of the “shareholders. For that very reason **non-voting shares or “shareholders” who do not exercise their voting rights are an aberration**. This situation institutionalises “shareholder disempowerment by reducing “shareholders to capital investors who refuse to fully exercise their sovereign power. As mere providers of capital, it makes more sense to refer to them as “investors, and exclude them from governance in order to distinguish them from genuine “shareholders, who are fully exercising their sovereign duties. This is the case for example with partnerships limited by shares (société en commandite par actions).

For the same reason, **shares with additional voting rights may be useful** if they encourage the long-term commitment of “shareholders. It is difficult to ask shareholders to be guarantors of the company’s sustainability without giving more influence to those agreeing to incur personal risk in that sustainability.

Nonetheless, additional voting rights can also give rise to abuse by allowing someone with a limited number of shares to exercise control over a company. This is why the debate is still open. To settle this question, companies should be asked to explain the benefits obtained from providing multiple voting rights and how this contributes to increasing confidence in their governance.

d. Voting is the concrete expression of the “shareholder’s sovereign function. Establishing a performance-based link between “shareholder remuneration and voting participation, as has been done for directors (attendance fees based on Board participation) does not seem absurd.

e. The oversight of “directors by “shareholders” is the very foundation of governance. For that reason, a proxy vote cannot be exercised by another corporate governance stakeholder (executive or supervisory) without undermining the logic behind this governance. This is why it is not right that “shareholders” are able to give a proxy to a “director, much less to the board of directors’ chair. Indeed, this practice should be limited to exceptional cases in terms of capital structure.

- ***Point of vigilance No. 4: Is there a risk of depriving minority shareholders of their rights?***

Because decisions in shareholders’ meetings are taken by majority vote, minority shareholders may systematically find themselves the victims of choices over which they have no influence. At the same time, minority shareholders cannot expect to influence decisions when they have an extremely small share of the capital. In this same way, their claims might be considered excessive in relation to their very limited financial risk or occasional contributions to the company’s sustainability. However, irrespective of the company in question, discrimination against certain shareholders constitutes unfair treatment. This is the case whether regarding the transmission of information, regulated agreements or excessive remuneration for “managers who hold the majority of the capital, etc. In most Western countries, rules exist to protect minority shareholders.

From our perspective, genuine protection exists when “shareholders choose the “directors and truly evaluate their performance, and in particular the quality of their work. This implies the existence of: 1) a choice, in particular, when appointing corporate officers, which eliminates the “referendum effect referred to above and, 2) clear and public information for which the “directors are held accountable regarding practices that could deprive “shareholders of their rights. For example, conflicts of interest, regulated agreements, procedures for public tender offers, etc. The “report to the shareholders on corporate governance mentioned in the preceding section must highlight the responsibility of directors where a failure to provide information on practices could result in a loss of rights, and specify the resulting punitive measures to be applied. The principle of loyal and reasonable conduct, limited to certain possible abuses but precise in the event of breaches of conduct, may be sufficient to ensure protection of minority shareholders.

- ***Point of vigilance No. 5: Is the development of “share ownership” properly managed?***

Bearing in mind the importance of sovereign power as the foundation of corporate governance, reasonable governance must be concerned by how share ownership evolves over time. In particular, it must anticipate two classic phenomena: 1) the division of “shareholders into rival factions, and 2) the loss of a common interest and purpose (affectio societatis) as the size of the shareholder base increases.

Both have devastating effects on the company and are among most frequent causes of failures in governance, notably among family-owned companies. The points of vigilance mentioned above must contribute to maintaining a strong link **between sovereignty and the focus on sustainability** throughout the company’s life. Forward-looking share ownership management could provide a mechanism for anticipating failures in sovereign power and the loss of identification with the company by:

a. *Training shareholders in how to exercise their responsibility*, over and above regular attendance at meetings. The “shareholders, in particular family-owners, have a right to receive training so they can acquire an understanding on the company, its priorities, its changing environment and social context, independently of the strategic plans presented to them. Numerous experiences show that the more training “shareholders receive, excluding matters requiring urgent decisions, the better equipped they are to exercise their responsibilities with confidence, particularly in the event of a crisis.

b. *Anticipating natural changes to share ownership* or future needs in this respect, as and when the company develops. Share ownership evolves with the company but also according to its own demographic, cultural and historical characteristics: founders pass the rein to their successors, families break up, investors change their projects, etc. The alignment of the company’s trajectory with that of the “shareholders represents a dimension of governance that must be taken into consideration to avoid crises in governance.

c. *The “shareholders must always have the option of exiting.* The shareholders create confidence in the company through their continued presence. If they do not have the choice to do otherwise, then this approach no longer has any meaning. Even worse, it creates tension between shareholders with the potential for creating a lasting burden on the company’s operations. This is why mechanisms for share buybacks must always be planned to maintain, to the extent possible, fluidity in purchases and sales of shares by shareholders.

In brief

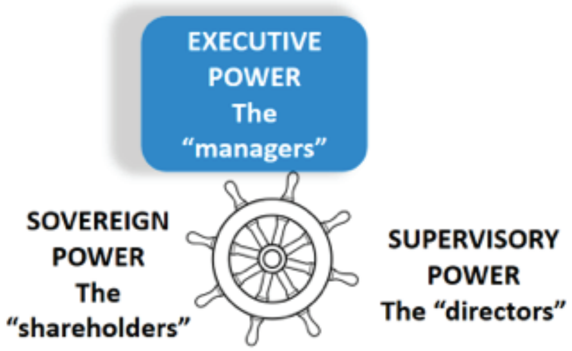
The sovereign power of “shareholders symbolically implies the possibility of lasting and concrete performance. Vigilance is thus required to ensure that this power does not unduly infringe upon the other powers, or to the contrary, that it is not inoperative due to a lack of genuine engagement by “shareholders. We also note the existence of targeted but clear information on major strategic risks: a choice between candidates for the positions of corporate officers; important votes at shareholders meetings; and forward-looking management of share ownership. These issues concern all types of companies at various moments in their development. The contemporary crisis has shown us that corporate governance must reappropriate the issue of “share ownership to lay the foundations for reasonable governance able to generate confidence. To a certain extent, the exemplary nature demanded of the other powers of governance must be equally exemplified by the exemplary manner in which the “shareholders exercise their function. The solidity of the sovereign power and the relevance of the way it is exercised are the cornerstone of the corporate governance system.

Selected criteria for evaluating the exercise of this power

- The quantity and quality of information provided to shareholders to support their decision-making process.
- The degree of genuine choice in appointing corporate officers.
- Voting percentage in shareholder meetings.
- Resolution approval rate and the “referendum effect”.
- The breakdown between voting rights and the percentage of capital ownership.
- Number of resolutions adopted originating from minority shareholder proposals.
- Existence and depth of “shareholder training.
- Latent or direct conflicts between “shareholders.
- Possibilities for “shareholders” to exit.

Section II: Executive power: the "managers"

Clarification of this power: Is the concentration of executive and supervisory powers advisable ?



Many current codes of "good" conduct place great emphasis on management control mechanisms (boards, committees, etc.) but much less on the role and responsibility of the "managers themselves. By guaranteeing the unity and efficiency of the company, and the link between its stakeholders, the manager remains the central player in any governance system. Managers "hold the helm of the company. Their missions include developing and executing the strategy that sets the company's course over a long term. This means that they exercise a major responsibility of governance.

The first question is whether it is absolutely necessary to separate the functions of chief executive officer and chair of the board of directors to effectively clarify their respective roles. This is a recurrent subject of debate. British and German models have imposed a strict separation, whereas in the US and France, this remains a matter of choice.

The issue is not to provide an unequivocal response but rather to return to a logic of reasonable governance. By definition, the content of executive power and supervisory power **differ**. The question to be asked is accordingly: can these two **different** powers be exercised by the **same** person, which entails a **concentration** in the exercise **of two distinct powers**?

For reasons of clarity, it is obvious that these **different** powers must be exercised by **different** persons, to clearly distinguish their specific roles and respective limits. The chief executive officer (or executive board chair) is tasked with developing and executing the strategy. The chair of the board of directors (or the supervisory board) ensures the compatibility of the strategy with the company's general interest, its project, its sustainable performance, and that the manager exercises his/her duties without any excesses with potential for undermining the objectives that have been set. While it is important that managers should be allowed sufficiently wide entrepreneurial latitude to develop and execute the strategy, the corollary is that they must not be their own supervisor. The better their missions are understood, the more their separation will be accepted as a matter of common sense. Far from weakening the manager's function, it is actually strengthened by this separation by clearly defining his/her specific responsibility that must not be infringed upon by the stakeholders: the two-tier system (with a supervisory board and an executive board, or the separation between the chair and chief executive officer) offers a clear illustration.

At the same time, actual practice has shown that, at times, the **formal** separation of functions sometimes results in more inefficiencies than genuine benefits. This is particularly the case when the company is small, family-owned or the context calls for an ability to make rapid strategic decisions. These reasons are often invoked to justify combining these two functions in one and the same person (Chair-CEO). While understandable in certain circumstances, this solution remains unsatisfactory from the perspective of reasonable governance, particularly for companies of a certain size.

To offset the cost and complexity that can result from the separation of these functions, it is possible to imagine different mechanisms of control; for example, a strategic committee composed entirely of outside persons to which managers can regularly explain their choices and, above all, in the case of family-owned companies, which offers them the benefits of a mirror effect. One solution would be to appoint a presiding "director, **along the lines of the lead director now proposed by US and English codes**, to ensure the smooth functioning of governance. This provides a mechanism of control for the concentration of powers with the manager, to prevent potential abuses.

In this way, each company can find the solution best suited to its organisation, as long as it respects this principle of common sense: the manager's power is all the more legitimate when **the control of any misuse of this power is placed in hands other than his or her own**.

Effectiveness: the function of the manager taking responsibility for strategy.

Understanding who controls the strategy is a source of controversy among the different authorities, extending well beyond the corporate governance stakeholders. A lot of confusion has been created, including in law, by asserting that all the corporate governance stakeholders have a decision-making role, in one way or another, in strategy. This being said, the actual responsibilities of each are diluted when each stakeholder can attribute decisions on strategy to the others, and in this way absolve themselves of responsibility.

There is no doubt that all the stakeholders in corporate governance contribute in some way to strategy. How could it be otherwise when strategy constitutes the quintessential decision of governance, the decision setting the company's course, thereby ensuring its sustainability? In contrast, these different powers do not intervene **either to the same extent or at the same time**.

To prevent unnecessary tension, we need to take another look at the content of the strategic approach in order to define the specific role of each.

Four stages are traditionally defined in describing a strategic planning process:

- Stage 1: **Formulation**: establishing the different scenarios and the decisions to be taken, based on the company's project and the information at its disposal.
- Stage 2: **Choice**: selecting as strategy the best scenario developed in the initial stage, based on the project defined and the opportunities for profit.
- Stage 3: **Implementation**: making concrete decisions that are adapted to achieve the objectives defined by the chosen strategy.
- Stage 4: **Evaluation**: assessing its performance in relation to these objectives.

It is self-evident that **the formulation of a strategy (stage 1) is dependent on its implementation (stage 3)**. Responding to market demands and adapting its position is dependent on available resources and related trends. In consequence, strategy cannot exist in isolation from its implementation.

Allowing stakeholders to settle for defining the general outline of a strategy - its formulation without being involved in its execution and consequences - discourages them from taking responsibility. However, only the “manager and his/her team can obtain all the information about market trends and the company's resources and their relations to define the different strategic options and adapt the selected strategy as it is gradually applied. **Taking concrete actions in this manner is the raison d'être of executive power**. From this point of view, the “manager will by nature always profit from information asymmetry in his/her favour on strategic matters by managing first-hand data and implementing strategic decisions as part of the day-to-day operations.

In contrast, **the choice of a strategy** among the different possible and debatable options implies not only that the quality of the scenarios and information has been taken into account, but also that this strategy is compatible with the company's **sustainability**. This means that it is neither too cautious nor too risky. This is why **the final strategic choice** cannot fall to the executive power, but instead must revert to the supervisory power held by the “directors. In the same way, **the review process** that assesses performance in relation to strategic objectives cannot be given to the executive power tasked with its implementation, which would create a dangerous situation of self-review.

Finally, it is the responsibility of the “shareholders to renew their support for the chosen strategy by voting on a regular basis in favour (or against) its continuation, as we have seen in section I.

Their concrete engagement, in this way legitimises the strategic choices and **their consequences for the company's project**.

This clarification thus implies a clear separation of the roles of management and supervisory powers summarised below in the following table:

	Role in the strategic approach reverting to the “manager”	Role in the strategic approach reverting to the “directors”	Role in the strategic approach reverting to the “shareholders”
DEVELOPMENT	**YES**	no	Regularly and explicitly adopting a position on the strategy selected and implemented
DECIDING THE STRATEGY	no	**YES**	
EXECUTION	**YES**	no	
MONITORING RESULTS	no	**YES**	

By refocusing the role of the manager on **defining** and **implementing strategy**, their particular responsibility in relation to the other stakeholders involved in governance, and particularly the directors, is clarified.

Scope: For this reason, reasonable governance must guarantee the “manager” sufficient latitude in charting and implementing the company's strategy. This accordingly covers all key decisions setting a long-term course for its activities and structure.

Of course in practice, these different dimensions may overlap. This is why it is even more important to clearly define the responsibilities of each power. In particular, the primary mission of the “manager is to personify, and therefore assume, the strategy he/she develops and implements, and on which they report, to consolidate the **confidence** of stakeholders **in the company**.

In this breakdown of roles, the following key questions remain: Is the strategy chosen capable of strengthening the stakeholders' confidence in the company? Are potential abuses in its implementation uncontrollable? This gives rise to the following points of vigilance.

Five points of vigilance concerning the executive function

- ***Point of vigilance No. 1: Does the "manager" have the right skills?***

There exists a strong correlation between the complexity of the strategy, and the skills required for its development and implementation. The more complex the company's environment, the greater the manager's need to possess the skills to address this complexity. This is not necessarily linked to the size of the company, because even a very small entity can operate in a complex environment.

The point of vigilance therefore consists in determining whether the number of people involved in developing strategy and using the strategic and operational risk management tools are sufficient to cover different complementary skills. This consists, in addition, **of assessing the degree of concentration of the skills** necessary for developing and monitoring strategy. The concentration of these skills among a small number of people (and even more so in the hands of one person) can represent both a strength, in terms of "strategic agility, and a risk in the event of strategic error.

Finally, this point of vigilance makes it possible to determine if the "manager is the right person for the strategy selected by the company: even if successful in the past, and, frequently, precisely because of this success, a "manager may be less suited for dealing with the necessary strategic changes, due to changing conditions in the company's environment.

This point of vigilance is particularly important as the manager's skills and experience are less important than their **relevance** to the context in which the company operates at the time the strategy is defined. It is this therefore this relevance that must be assessed.

- ***Point of vigilance No. 2: Is the manager isolated?***

The manager is responsible for strategy and has a duty to regularly report on its implementation and any difficulties encountered. From this point of view, **the isolation of the manager** constitutes a very common risk. This may be due to the fact that the manager is alone at the helm or surrounded by persons that are too dependent to challenge his or her opinion. This concerns small companies to the same extent as large companies.

The point of vigilance consists in determining if there exist adequate formal venues (generally board of directors or executive committee meetings) or informal venues for managers **to present and discuss their decisions in an objective and serious manner**. Here as well, in the name of realism, there must be a connection with the company's complexity. The greater the complexity, the more frequent and formal such meetings should be. Conversely, if the degree of complexity of the issues to be resolved is small, they may be less frequent. However in all cases, venues for exchange must exist to ensure that the "manager does not become too isolated, which is equally dangerous for the "manager and the company.

- ***Point of vigilance No. 3: Could the personal interests of the "manager" adversely affect his or her decisions?***

Much has been written on this controversial topic. There are two dimensions to this question: conflicts of interest (as the manager may give preference to strategies or decisions that serve his/her private interests) and the level of compensation (because if considered excessive, it is a form of misappropriation of corporate resources permitted by the power of the "manager).

With regards to conflicts of interest, the question is more complicated than it seems because many situations might appear to involve conflicting interests. This is why it is necessary to refer to an objective principle: how may a potential conflict alter the decisions of the "manager? However, it is not so much the potential conflict of interest itself that calls for vigilance, but rather its potential **consequences**.

Concerning compensation, this issue must be considered in the same way: could a manager's compensation **skew his/her judgement** and as a result interfere in the performance of his/her mission to such an extent as to undermine the confidence that might be placed in him/her? To answer this question, attention must be paid two potential biases.

a. *The level of compensation* must incentivise the manager to assume broad responsibilities conferred upon him/her. At the same time, it must not be so high as to contribute to losing touch with reality, in particular, **reality as experienced by other stakeholders of the company** (employees and customers alike) There is a psychological phenomenon well known among behavioural finance specialists, where a certain income level causes a disconnection from reality, and on that basis the potential for irrational decisions. Beyond the issues of social justice, the incidence of extreme behaviour resulting from excessive compensation has no doubt been underestimated. In the interests of realism, it should accordingly be determined if excessively low or high compensation might **not contribute to abnormal decisions**. As a measure of prudence, rather than disclosing the absolute amount, **it is preferable to disclose the change in compensation in relation to the change in compensation of other stakeholders in the company (employees, shareholders, suppliers, state) to ensure that there are no excesses and appropriation of resources for their benefit**.

b. Can the type of compensation have an influence on managers' strategic decisions? It has been demonstrated that certain forms of compensation (stock options, variable compensation or poorly-defined bonuses) may induce preferences for certain strategies over others, including those detrimental to the company's long-term interest. It is necessary to anticipate this undesirable effect. A fair compensation system must leave **the manager free to make decisions in the company's best interests**, defined as in the interests of its sustainability and sustainable performance. Compensation systems proposed for managers must therefore anticipate potential biases in their decision-making when developing or implementing the strategy.

- ***Point of vigilance No. 4: Are there arrangements for the manager's succession***

Ensuring the company's sustainability requires knowing what arrangements have been made for the incumbent manager's succession and who might be the successor. In this way, it is possible to assess **the potential risks in the event of a succession crisis**. The codes have not placed much emphasis on this issue despite its critical importance for many companies. Given the wide-ranging mission assigned to the "manager, it seems reasonable that the governance system should specify his/her successor in the event of a vacancy.

This question is particularly crucial for family companies or companies headed by a charismatic leader, since the future of such companies can be jeopardised in the event of a succession crisis. We therefore recommend that companies should be encouraged to specify **who would be responsible for replacing the manager in the event of a vacancy**. This would make it possible to ensure that successions could be planned in advance to allow for a smooth transition, that requisite skills exists for that purpose, and that the full symbolic weight of managing the company does not rest entirely on the shoulders of a single person. Options for addressing this concern include the existence of a credible number two, potential successors, and even a succession consultant tasked with training the future manager over a certain period, particularly in the case of an heir.

- ***Point of vigilance No. 5: Does the manager's exemplary conduct contribute to strengthening confidence?***

The manager incarnates the company. His/her mission goes beyond expertise alone for the purpose of approving technical or economic decisions. The "manager is on the front line in the stakeholders' perception of the company and, by extension, their trust. For that reason, **the "manager's exemplary conduct constitutes an objective component of reasonable governance**. Exemplary conduct means the alignment of the message conveyed to, or required by, stakeholders with the requirements self-imposed by the "manager, as exemplified in the exercise of his or her functions. Maintaining "managers who are not exemplary in power is a signal of a major dysfunction in governance.

In brief

In accordance with the principle of clarity, the managers' power must enable them to develop and implement strategy. In accordance with the principle of effectiveness, this power must be sufficiently broad to enable them to fully exercise their part of responsibility for the strategy. In accordance with the principle of vigilance, however, it should be ensured that this responsibility can actually be exercised because: 1) the managers possess the necessary skills or know how to surround themselves with such skills; 2) there are venues for discussion and evaluation to prevent the manager from becoming isolated; 3) the managers' compensation or conflicts of interest do not create biases in their judgement; 4) succession plans have been prepared; and, 5) the managers are not in contradiction, through their personal behaviour, with the expectations they incarnate for other stakeholders of the company.

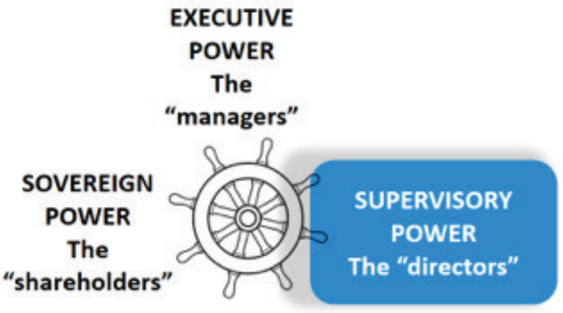
Under these conditions, the "manager contributes to strengthening confidence in the company and, in this way, fully exercises his/her role in reasonable governance.

Selected criteria for evaluating the exercise of this power

- What is the degree of concentration/dispersion of the powers of the top executive?
- What is the degree of isolation of the "manager?
- Are there any external people to challenge the "manager?
- What potential conflicts of interest might impact strategic decisions?
- Is the increase in compensation incoherent in relation to growth in company results and the compensation of other stakeholders?
- Is there a potential successor to take over should the position of the "manager become vacant?
- Is the manager's personal behaviour, public pronouncements or manner of acting in contradiction with the expectations of the stakeholders with respect to the company?

Section III: Supervisory power: the “directors”

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



Of the three powers making up corporate governance, supervisory power has without a doubt been the focus of the most discussion and recommendations. Most codes devote considerable attention to the roles and responsibilities of the “directors to such an extent that discussions of corporate governance are often limited to the number of directors or their independence.

Two types of “directors exercise supervisory power: **internal directors** that exercise an activity within the company (“managers or employee directors, for example) and **external directors** that do not exercise any activity in the company. The first contribute their knowledge about the history, resources and ongoing operations of the company; the second have a more detached perspective and experience in other areas, sectors or companies that could prove useful in opening up new opportunities for the company.

This distinction between internal and external is often confused with the distinction between **independent and non-independent** introduced by governance codes in the 1990s. The independence of a “director implies that his/her personal ties with the company are sufficiently limited so as not to create a bias in their point of view on questions to be discussed. Ideally, independence may be determined by the fact that the “director is able to resign from the board without incurring any financial, contractual or reputational harm. Often determined by the absence of a direct contractual relationship with the company for a period considered sufficient, the meaning of independence consequently goes much farther, as it characterises a subjective situation of the “director: a capacity to analyse situations in a neutral manner.

In contrast, “external or “internal defines an **objective position** of the director, in particular according to his/her situation within or outside the company. Independence, or its absence, instead conveys a frame of mind, a capacity for judgement more or less free of interests. This distinction makes it possible to better describe the dynamics within boards, and the conditions for exercising effective supervision.

		OBJECTIVE EVALUATION: Does the “director” exercise an activity within the company?	
		YES: he or she is internal	**NO: he or she is external**
SUBJECTIVE EVALUATION: Could the judgement of the “director be biased by his/her personal situation?	**YES: he or she is not independent**	*Number of directors in this situation*	*Number of directors in this situation*
	NO: he or she is independent	*Number of directors in this situation*	*Number of directors in this situation*

External directors may have limited independence in reality if, for example, their revenue depends significantly on attendance fees, or if their private ties with the “manager could affect the objectivity of their judgement. Conversely, an internal “director – for example an employee – may be independent in terms of judgement because he/she draws upon representations that are different from those of the “manager”.

For reasonable governance, it must be determined whether the “directors are able to exercise their supervisory role. Thus, the board composition needs to be properly evaluated in a realistic manner and on a case-by-case basis. The more a “director is external and independent, the greater the likelihood that he/she is able to judge the actions of the executive power without being influenced by routines or the biases of the company. However, he or she will inevitably be less informed about the internal reality of the company, its resources and specific capabilities which can only be well known by the “internal directors. In other words, what is gained by a detached perspective is lost with respect to knowledge of the specific characteristics of the company. This is why an effective supervisory power requires a balance involving a sufficient number of external and internal “directors. This offers a mix of opinions that combines knowledge of the inner workings of the company with more detached assessments and a contribution of knowledge from different perspectives capable of challenging excessively routine representations.

After outlining these points, it should be noted that the growth in supervisory power in all companies is the result of a deeper logic which goes far beyond the problems of governance, strictly speaking.

- The fast-growing complexity of the economy has created the need for more vigilant supervision of the executive function to ensure that it adapts to the economic context. Companies exercise major roles, not only in the economic life, but also in the social, and sometimes political, life of our societies. Their management has an impact on the social fabric that goes far beyond their direct stakeholders. For public opinion as for markets, strategic choices can no longer be accepted without an assurance that these choices have been thoroughly considered and verified. **In an open and fluid society, confidence calls for such an approach**.

- A better understanding of company development has highlighted certain stages in the development of the executive function. The expectations, skills and way that responsibilities are assumed are not the same, particularly: 1) at the time the company is created; 2) on reaching a first growth plateau after approximately 10 years; 3) at the time of the company founder's succession; and 4) when the assets are transferred from one generation to the next, particularly to the third-generation.
  In addition to these historic phases are economic transformations. The company has a history which alters the exercise of executive power. To maintain confidence, the supervisory power must be sufficiently established to assist the company through these stages of transformation and provide a confirmation that the company is subject to ongoing supervision.

However, recent changes in governance have also resulted in increased expectations vis-à-vis "directors. They have been asked not only to exercise supervisory functions, but also to get more involved in strategy and, more generally, to take responsibility for most of the risks the company encounters. From the beginning, French law has itself been rather unclear as to their respective functions, in particular the powers of the chair of the board of directors, with a very broad definition that is ultimately unrealistic.

This lack of clarity is detrimental to the responsibility of each stakeholder. It asks much more of directors than can be expected for a function that is performed a few days a year at best. Finally, asking too much from "directors undermines the credibility of their supervisory function and dilutes their real responsibilities.

For this reason we consider it indispensable to refocus the role of the "director" and to clearly distinguish it from the executive power. We started to do this in the preceding section by specifying their precise role with respect to strategy: 1) to select from the possible scenarios the best option for the company's project, its sustainability and its sustainable performance; 2) to verify that the execution of the strategy is consistent with the objectives that have been defined.

The directors are responsible for identifying what contributes to promoting the company's project and what generates its profit. They are the guardians, in the final analysis of the strategy, of the balance between the project and the profit which, as we have seen in the first part of the guidelines, is at the heart of the company's dynamics. The supervisory power must not infringe upon executive power as it does not represent a backup or a parallel executive power. Its function is to ensure that the decision-making latitude of the "managers" is exercised without any excesses that might jeopardise the company's sustainability. This constitutes the power of vigilance and guarantees stakeholders that the company is managed in the interest of its sustainability and sustainable performance. As such, it constitutes a factor of confidence. Conversely, without adequate supervisory power, the company incurs the risk of excessive concentration of decision-making exclusively among the holders of the executive power, for better or for worse.

This enables us to define how exercising this supervisory power can contribute to making this governance reasonable:

> **The function of supervisory power is to verify that the conditions are fulfilled for executive power to be exercised without any failures that are capable of calling the company's sustainability into question.**

In other words, while the "manager" has an absolute obligation (obligation de résultat) with regards to the results of the strategy he/she proposes, the "directors" **have a best efforts obligation** (obligation de moyens) to ensure that the executive function is fulfilled without any excesses that might be detrimental to the company. Some of the possible excesses are economic in nature while others are linked to the very functioning of governance itself. This is why supervision that is clearly and correctly exercised may be a source of confidence for the company's stakeholders.

Effectiveness: the actual responsibilities of "directors"

While recent trends in boards have considerably expanded expectations for "directors, it is still necessary to ensure that they are capable of assuming the responsibilities expected from them. It therefore seems reasonable that the exercise of their supervisory power be limited to three levels of actual responsibilities.

(1) *Check that there are no serious malfunctions in the way executive power is exercised, including when strategic choices are likely to call into question the company's sustainable performance*. The "directors" are on the front line should the manager's position become vacant. They do not develop strategy and are not responsible for its implementation. Rather, they ensure that the strategy has been rigorously defined and then applied without any failures on the part of the executive power. This logic provides the basis for the power they possess to validate or invalidate the strategy and associated investments (as well as other major decisions provided for in the company's articles of association). It is also on this basis that "directors must ensure that there are no conflicts of interest when decisions are made, or biases resulting from the system of compensation system for "managers (see the preceding section).
Exercising supervision poses real material challenges. It must be carried out wisely to prevent excesses, while avoiding interference by "directors in the area of executive management, and systematic suspicion that undermines the climate of confidence which is an objective of reasonable governance. "Directors effectively exercise their role when priority is given

to anticipating excesses. “Directors are useful and contribute effectively to reasonable governance when their supervisory role is exercised as far upstream as possible of potential excesses.

(2) *Contribute to good governance by focusing on the five points of vigilance defined for executive power and described in the previous section*: 1) sufficient capacities to manage, 2) isolation, 3) occurrences of conflicts of interest, 4) succession planning and 5) the exemplary conduct of “managers. The “directors are the first to exercise vigilance and their involvement produces or fails to produce the confidence of other stakeholders without the same proximity to the “manager.

(3) *Regularly provide a synthesis report on their supervisory duties* to the holders of sovereign power – the “shareholders. It is the “shareholders” who guarantee the legitimacy and therefore the real capacity for independence of the “directors”. For that reason, the “directors must report to them on the exercise of the supervisory power conferred upon them. The clarity and relevance of this communication with the “shareholders are the signs of genuine independence of the supervisory power in relation to the executive power.

It is from the expectations about these three actual responsibilities that evaluating the directors has meaning, and vigilance over their work can truly be exercised.

Seven points of vigilance concerning supervisory power

- ***Point of vigilance No. 1: Do the “directors” have the right skills?***

This is a common assumption though it warrants an objective evaluation as reality demonstrates that the facts are far from obvious. To establish confidence, the board of “directors” must have sufficient abilities to assess those of the “manager”. A variety of skills within the board is therefore essential, depending on the complexity and realities of the company, but so is range of temperaments and experiences. **Directors representing the stakeholders, with different expectations with respect to the company, like employees or customers, may prove very useful and effective if the expectations regarding them are well-defined**. When the board is truly considered as the venue for watching over the company, it must include members capable of taking an interest in its sustainability and sustainable prosperity, and who know how to assume the resulting responsibilities. In this sense, the “independence of directors is not a sufficient quality, even if it is understood in terms of an independent mind-set. An interest in the future of the company is also necessary. Procedures for appointing directors must take into account this expectation, as we will see further on.

- ***Point of vigilance No. 2: Do the directors fulfil their mission within the strategic process?***

We have seen that in sharing tasks, two strategic dimensions fall on the “directors: 1) **choosing from the strategic options** (presented by executive management) the strategy ultimately adopted by the company; and 2) monitoring the **implementation** of this strategy and results.

To fulfil their mission, the directors must have the technical expertise to understand the data about the problems presented to them, and sufficient knowledge about the company and its environment to ensure that the proposed strategic options are achievable and efficient. “Directors too detached from the company tend to encourage strategies based on knowledge derived from other situations that are often adopted in a mimetic fashion. They will also give preference to evaluations based on financial data that does not require in-depth knowledge of the company. This behaviour encourages the financialization of strategic choices that are not sufficiently rooted in the history of and knowledge about, the company, ultimately contributing to a loss of competitive advantage. This is often due to a misunderstanding of the notion of “independent director. Independence defines the capacity to intervene without the director’s judgement being impaired by private interests. It does not evoke either detachment or negligence with respect to the company’s specific characteristics.

For “directors to fulfil their mission, they must take the necessary time to meet with employees, customers and other stakeholders, even when they are persons external to the company. A sufficient number of internal “directors in relation to external “directors also guarantees a productive dialogue about the company’s resources and capacities in discussions about strategy.

- ***Point of vigilance No. 3: Are the “directors” performing their supervisory duties effectively with regards to the executive power?***

It is their responsibility, first and foremost, to monitor the five points of vigilance relating to the executive power defined in the previous section. Much has been written on this issue: the number and duration of board meetings, regular meeting attendance by directors, etc. Necessary as these recommendations may be, given the legal vacuum that exists, they have perhaps focused too much attention on the procedures and not enough on the broader meaning of these supervisory duties.

Board meetings and the files and information supplied to directors between meetings are a means and not an end. The supervisory duties can also be accomplished outside these board meetings through formal or informal meetings.

In the spirit of reasonable governance, the duty of supervision implies that the “directors” are accountable to the “shareholders” to provide a genuine evaluation of executive management’s ability to lead the company in a sustainable manner. **This is why the most significant way to demonstrate the relevance of the directors’ work is how they report to the** “**shareholders on this subject. This can be done, for example, in an annual report on their supervisory mission (“report to the shareholders on governance”)** for which they are jointly and severally liable, and that must be sufficiently clear and concrete so that the “shareholders are able to assess their activity.

a. According to its complexity, each type of company can define, with its “shareholders”, the items to be covered by this report, and notably the board practices (number of board meetings, duration, the manner in which the minutes are made available, etc.). Its approval by the general meeting represents an essential component of the governance system.

b. For many companies, producing this report provides a way to counter the manager's isolation through the mirror effect by providing fresh insight on his/her practices. That is why when the functions of chair and chief executive officer are fulfilled by the same person, **the task of writing the annual report should be assigned to a member of the board of directors tasked with monitoring compliance with governance practices**.

Whatever the procedures adopted for drafting this report, the spirit must prevail over the letter: the supervisory power will be perceived as being unreliable or even non-existent if the "directors" never report on their work of "watching over in a concrete and informative manner.

- ***Point of vigilance No. 4: Do the "directors" have the material means to fulfil their mission?***

These means naturally entail the organisation of regular board meetings. But more importantly, they imply two dimensions: first, that **the information necessary** for preparing board meetings is provided so the "directors" can inform themselves on the subjects being addressed and forge an opinion; and second, that the board must operate in a manner that allows for **the expression and traceability of differing opinions** before decisions are made on a collegial basis.

Providing information, in particular on situations that might result in conflicts of interest and accordingly create biases in the decisions of "managers, is critical. This is especially the case for companies controlled by "parent holding companies with a tiered organisation that tends to create opacity as to the real interests of the different governance protagonists.

Here as well, as a general rule it is unrealistic to apply a formal definition regarding the quantity and nature of the necessary information and how board meetings should be held. In our opinion, recommending the following two principles is more practical:

a. The principle of appropriate information. Information provided must enable "directors **to understand the stakes of the decision** they are asked to make. A massive amount of exhaustive information may be just as difficult to exploit as information that is too vague. Appropriate information presents what is essential, namely, the alternatives requiring a decision and the information provided for that purpose. It is then the responsibility of the "directors to request additional information they consider useful. The ability to provide appropriate information is a sign of the intelligence of the "manager with regards to the role of "directors. It is on that basis a sign of reasonable governance.

b. The principle of self-assessment. The "directors themselves assess whether the information provided to them is sufficient to make their judgement, in the same way as statutory auditors. The directors incur liability if they are not free to present their arguments, or if they are not sufficiently informed to make a judgement. That is why it is their responsibility to clearly indicate if they have received sufficient information and given a sufficient amount of time, outside the board meeting, and if their supervisory work has been realistic. This in turn may be a source of confidence. **It is therefore up to the directors to confirm, for example in the introduction to the "report to the shareholders on governance", that they possessed sufficient information to formulate their judgement on the points of vigilance by them (and them alone), or that board meeting minutes exist that provide evidence of genuine discussion on the subjects addressed**.

- ***Point of vigilance No. 5: Does the supervisory power infringe upon the executive power?***

The company can suffer as much from an absence of supervision as from **inappropriate interference by** "**directors** in executive management. The two-tier system (separation of the supervisory board and the executive board, or the functions of chair and the chief executive officer) admittedly appears to offer a legal clarification for this separation of responsibilities. However, here as well, the spirit of governance must prevail over the letter.

The definition of the roles of the "manager" and "director" must be written into the rules they establish, and which are communicated to the "shareholders", for example at the beginning of the annual report on governance. This definition must take account of two principles:

a. The directors cannot incur liability either for developing the strategy or for the actual operating risks.

b. In contrast, their responsibility may be incurred with respect to the choice of a strategy and monitoring its implementation, as well as the actual supervision of risks involving a misuse of the executive power. In practical terms, the "directors are responsible for ensuring that the strategy was developed with impartiality and rigour, and that they were presented different scenarios allowing them to approve the project that best served the interests of the company's project and sustainable performance. Similarly, the "directors confirm that the executive power has implemented sufficient risk management measures for controlling strategic and operational risks.

Vigilance will be exercised to ensure that "directors have properly understood their **fiduciary** role, a creator of confidence, by **providing assurance to stakeholders that the risks assumed by the company are known and accepted on a reasonable basis**.

- ***Point of vigilance No. 6: Can the conditions for the work of the "directors" create biases affecting their independence of judgement?***

Judgement is fundamentally dependent on the material conditions which allow the supervisory function to be fulfilled, or not. Three items must be taken into consideration:

a. *Compensation level*. If compensation is too low, it may discourage the participation of the "director, and if too high, render the "director too dependent on the company. Compensation must therefore be defined to reward actual participation in the board's work, and in its preparation according to the subjects to be addressed. **The total annual amount of time expected for the director's work must be explicitly related to the proposed compensation, and communicated to the "shareholders when the "director is appointed, as a way to reinforce the director's engagement**.

b. *Terms of office*. If too short, it can restrict the beneficial effects of experience, and if too long, it promotes routinization that can reduce the quality of surveillance, and in particular the ability to anticipate failures. The term can also depend on the nature of the shareholders and the "directors representing them. This means that it is not so much the term which needs to be considered, but rather **the average turnover of** "**directors**. Even if certain directors, due to their stake in the capital or their specific expertise, remain in office for a long period, the points of view represented on the board need to be renewed. Here as well, the spirit of governance must prevail over formalism after considering what is expected from a "director. An effective board regularly introduces new blood. Furthermore, there must be a sufficient number of these new members so that vigilance is not weakened by routinization that inevitably results from long terms of office.

c. *Dismissals*. While in legal terms the "director" can be dismissed instantaneously by the "shareholders, in practice, the chair can pressure them to resign, in the event of a disagreement, especially if the chair is also a major shareholder. This issue is crucial when the functions of chief executive officer and chair are combined, since in this case the executive function can eliminate its own supervisors. Diligence in exercising the supervisory duty may be jeopardised by the risk of removal. To avoid abuse, it seems reasonable to protect the "director by providing for **a term of office that cannot be revoked without a cumbersome procedure, even if only symbolic**, before a general meeting of the "shareholders. Another option is assigning a special role in the event of dismissal to the director responsible for ensuring compliance with governance procedures (who is not the chair).

Such concrete mechanisms provide a much more effective way for ensuring the real **independence** of the "director than reference to hypothetical and abstract formal definitions.

- ***Point of vigilance No. 7: Does the exemplary conduct of the "director" contribute to reinforcing confidence?***

In the same way as the "manager, "the directors must be **exemplary to generate confidence** in the company. The manner that they exercise their mission sends a powerful signal about the quality of the governance. The law provides for a collegial decision-making process. This approach must be used to the extent that the board's functioning permits **a fair exchange of opinions** and decision-making, after considering all points of view. Compensation in the form of attendance fees must reflect genuine participation in the work of "directors. Conflicts of interest that could induce a "director to skew his/her evaluation of decisions must be identified. It is the role of the chair or director responsible for compliance with governance procedures to assure the stakeholders that such conflicts of interest do not exist or, if they do, that they have not had an impact on the collegial decision making process.

In brief

The supervisory function is not disciplinary in nature. It is not based on the premise that the “manager must be supervised to properly exercise executive power. Supervisory power contributes to the company’s sustainability through a mirror effect, offering insight to executive management and a venue for exchange about decisions. The “directors are tasked with anticipating and preventing the institutionalisation of possible misuses of executive power. In the most common cases, dysfunctions do not concern strategic decisions, but rather the exercise of executive power: conflicts of interest, excessive isolation, or absence of a succession plan. The legitimacy and strength of the supervisory power is based on its ability to increase the stakeholders’ confidence in the company.

Selected criteria for evaluating the exercise of this power:

- Have recent events demonstrated the usefulness and efficacy of the board?
- The composition and diversity of the “directors skills. The number of external in relation to internal directors, and independent in relation to non-independent directors. The overall balance of board membership.
- The level of knowledge of the “directors about the company.
- Material means for carrying out their work: information flows, meeting minutes available to “directors for consultation.
- Do the “directors report to the “shareholders” on their supervisory work (and not only on the company’s results)?
- The manner in which possible conflicts of interest in the company are addressed.
- Is there a “director responsible for ensuring compliance with governance procedures?
- Are there recurrent conflicts with the executive on the scope of supervisory powers?
- What is the turnover for “directors: (if too high they cannot exercise independent judgement, if too low there is a risk of making compromises with executive power)?
- Are there repeated cases of “directors being removed or resigning?

Summary:
The three constituent powers of Corporate Governance

> **We have now a toolbox for defining the content, scope, role and potential abuses of each power.**

It is has been made clear that by definition these guidelines are not designed to be applied to the letter. Instead, they offer a coherent framework for asking the right questions and finding the keys for answers adapted to the company's situation.

These guidelines also depend on how the powers are distributed and held. This is what we will examine in part three.

EXECUTIVE POWER

The “managers”

Develops, manages and is accountable for corporate strategy, i.e. all key decisions setting a long-term course for the company’s activities and structure.

6 points of vigilance

1. **Does the “manager” have the right skills?**
2. Is the “manager” isolated?
3. **Can the “manager’s” compensation create a bias in judgement?**
4. Is there a succession plan for the “manager”?
5. **Could the personal interests of the “manager” have a serious adverse impact on his or her decisions?**
6. Is the manager exemplary?

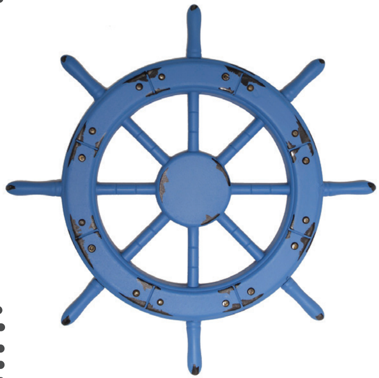
SUPERVISORY POWER

The “directors”

Verifies that the conditions are fulfilled for executive power to be exercised without any dysfunctions likely to call into question the company’s sustainability.

7 points of vigilance

1. Do the “directors” have the right skills?
2. Do they effectively fulfil their mission within the strategic process?
3. Do they fulfil their supervisory duties effectively?
4. Do they have the material means to fulfil their mission?
5. Does the supervisory power infringe upon the executive power?
6. Can the work conditions of the “directors” create bias in their judgement?
7. Are the “directors” exemplary?



SOVEREIGN POWER

The “shareholders”

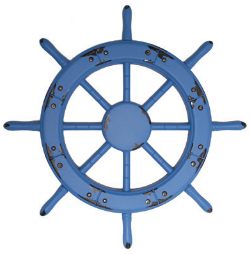
Embodies the symbolic and practical responsibility for the company’s sustainability. This sustainability is based on the existence of a project and profit-making conditions to perpetuate this performance over time.

5 points of vigilance

1. Are the “shareholders” informed of the foreseeable risks that might jeopardise the sustainability of the company?
2. Do they really choose the “directors”?
3. Do they participate in the voting?
4 Is there a risk of depriving minority “shareholders” of their rights?
5. Is “share ownership” managed properly?

Part III

The exercise of power: the six systems of governance



In the beginning of these guidelines, we demonstrated that governance is **the result of the interaction** of three powers (sovereign, executive, supervisory) that provide a mechanism for making decisions with enduring consequences for the company.

In the maritime image provided for illustration, the sovereign power defines the type of vessel (hull and keel), the executive power pilots the vessel, and the supervisory power keeps it on course.

In a boat, these functions can be carried out by the same person or by different persons. It is the same thing for a company. It is, for example, obvious that in a small-sized company the same person may hold the sovereign power (the main shareholder), the executive power and the supervisory power in the same way the owner of a recreational boat fulfils the three functions.

It is thus one thing to define the content of the three powers that are invariably the constituent parts of corporate governance. It is another thing, however, to determine who exercises these powers in practice. Are they combined, or separated among different parties?

Systems of governance are then defined in the same way as we speak of political systems. The company may indeed be managed by a sole shareholder or, in contrast, by a manager who is independent from the main shareholder. The supervisory power may be more or less under the control of the "managers or the "shareholders, or, alternatively, have a large degree of independence.

The systems of governance depend on how each power is exercised, for example employing a heavy-handed approach or, in contrast, considerable restraint. Based on these configurations, **six systems of governance** can be defined:

1. **Closed entrepreneurial autocracy**: the three powers are exercised by the same parties.

2. **Open entrepreneurial autocracy**: the sovereign power is partially held by the minority "shareholders that do not exercise the other powers.

3. **Shareholder domination**: the "shareholders are powerful and influential but do not directly exercise executive power.

4. **Managerial domination**: the "shareholders have limited power and influence, and the executive power has considerable genuine autonomy and practice.

5. **Board domination**: the "shareholders have limited power and influence, and the executive power has little genuine autonomy because the board has appropriated the actual power.

6. **Entrepreneurial democracy**: the three powers are completely separate and exercised in reality by a different protagonist.

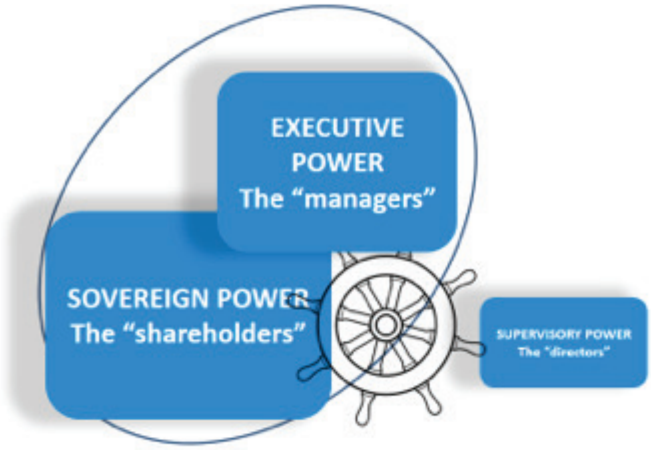
It should be emphasised that the terms *autocracy*, *domination* and *democracy* **do not carry any negative or positive connotations in these guidelines**. They refer in a completely neutral manner to political systems: autocracy means, in the literal sense, that the power (cratos in Greek) is exercised by oneself (auto), since the "manager is also the "shareholder. Shareholder or managerial domination expresses the idea that one of the powers may be more influential than the others and thus sets the direction for all of governance. Finally, entrepreneurial democracy conveys the idea of a formal and genuine separation of powers without prejudging its effectiveness.

In this part, we describe **the six basic systems of governance** representing the majority of cases seen in companies. These systems are presented schematically in the form of short descriptive summaries. For each system, we outline its **benefits**, the particular **risks** incurred by the company and **recommendations for reasonable governance**. These six basic systems do not cover all the actual categories that can be found. Rather, they provide benchmarks for a more precise evaluation on a case-by-case basis. They also highlight the risks that are associated with the manner in which the company is governed.

To address these risks, the company may find in these guidelines a framework for developing responses and reasonable suggestions that may be implemented according to their specific situations.

System n°1:
Closed entrepreneurial autocracy

When the company is piloted by the managing shareholder



The executive power and the sovereign power are held by the same person (or the same group of persons). The share ownership is concentrated and strong, i.e. it genuinely exercises its influence. The executive power, i.e. the "managers", controls the capital and supervisory authority. This latter authority is in consequence weak or non-existent, and the "directors are limited to a role of representation.

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

BENEFITS

1) Flexibility, highly adaptable to circumstances and the environment.
2) Benefits associated with strong entrepreneurial leadership: consistency, collective engagement, vision.
3) Independence, capacity for independent action.
4) Streamlined governance structures.

RISKS

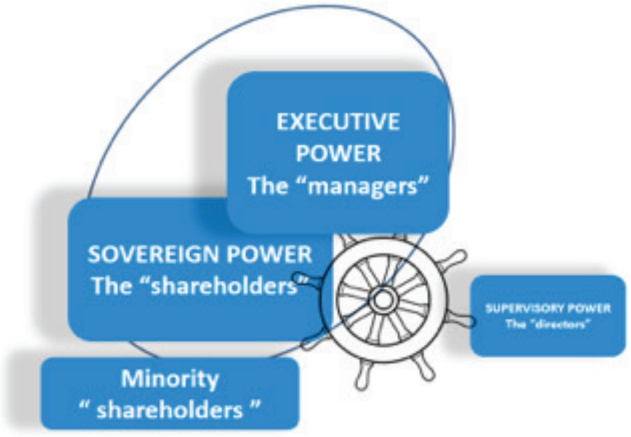
1) Absence of supervision, notably in regard to the way the manager's skills evolve.
2) **Isolation of the manager, particularly in the case of success encouraging the tendency to repeat "strategic recipes responsible for his or her success but which may become ineffective when the environment changes.**
3) Difficult succession, including at the human level, if the manager controls the company's drivers and networks.
4) Breakdown in cohesion if outside investors acquire a stake in the capital or if the number of "shareholders is increased to meet the company's financing needs.
5) Conversely, a refusal to grow to avoid outside parties from acquiring a stake and sharing power. The "glass ceiling effect.

RECOMMENDATIONS FOR REASONABLE GOVERNANCE

1) Minimise the formal obligations of governance.
2) Encourage the presence of outside directors to bolster the supervisory power, particularly during the three key periods: creation, the 10 years milestone, transmission.
3) Anticipate the fragmentation of share ownership and the introduction of minority shareholders, even if they are part of the family.

System n°2: Open entrepreneurial autocracy

When the company is steered by the managing shareholder but the capital is opened up



The executive power and the sovereign power are held by the same person (or the same group of persons) as with the previous system. However, if a majority of shareholders continues to control the executive power, minority shareholders exist. This difference considerably modifies the system of governance. The supervisory power becomes a potential venue for dialogue - or conflict. Thus minority shareholders may be weak (and in consequence, marginally active), or strong with a commitment to genuinely participate in the corporate governance. Managing the minority shareholders is thus an issue of governance.

Type of company: Companies run by an entrepreneur, with either minority family shareholders (a branch of the family excluded from operational management) or financial minority shareholders (investment funds). Listed family-owned companies with a small float.

BENEFITS

1) Strong management power assured by a solid majority. Coherence between the economic project and profit.
2) Expanded financing capacity not limited to the capacities of the entrepreneur.
3) Possibility for discussions, access to different perspectives from those of the entrepreneur.

RISKS

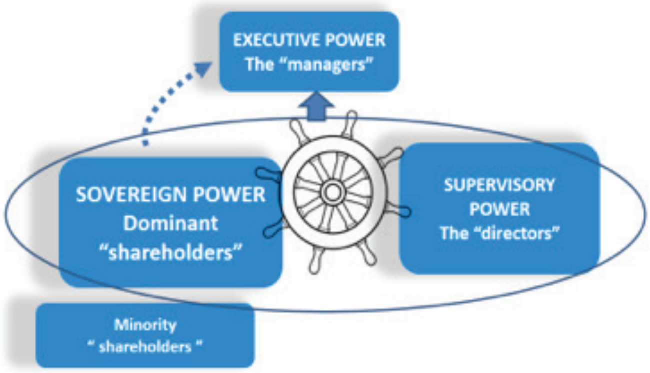
1) The same risks linked to the manager as those indicated for the previous system: evolving skills, solitude, and succession. These risks may be expected if the minority shareholders exercise a role of control or may be aggravated if the majority locks up its power by seeking to use it against them.
2) Possibility of depriving minority interests of their rights if they are weak or inactive. The strategies of the majority shareholder-manager may be detrimental to them, without the opportunity for them to intervene in the absence of a majority.
3) Significant disagreements about the project / profit logic between majority and minority shareholders leading to blockages or severe tension. Breakdown in the company's cohesion.
4) Impossibility for minority shareholders to "exit, market liquidity problems or procedures provided for that purpose.

RECOMMENDATIONS FOR REASONABLE GOVERNANCE

1) Put into place mechanisms for minority shareholders to express their opinions.
2) Provide training to shareholders (majority and minority shareholders) to encourage their engagement in the life of the company, and their loyalty.
3) Appoint independent directors to exercise the role of referee, if required.
4) Provide for mechanisms to allow minority shareholders to exit the capital.

System n°3: Shareholder domination

When the company is driven by the shareholders



The executive power and the sovereign power are henceforth separate. Dominant "shareholders control the capital and the supervisory power. The executive power is entrusted to managers. There may be minority shareholders.

The supervisory power takes on more importance: board meetings represent venues for the dominant "shareholders to exercise control over the "managers. The minority shareholders are more or less active, which may create conflicts between them and the dominant shareholders. The dominant shareholders may also intervene directly in the management (dotted line arrow) by circumventing the board.

Type of company: Family-held companies in which the founding families no longer run the company. Companies dominated by private equity, or private equity firms or funds. Listed companies with concentrated capital. Subsidiaries of groups. Cooperatives subject to strong influence by their employee-members.

BENEFITS

1) Stable governance if the dominant "shareholder exercises its power by pursuing a consistent approach regarding the economic project/profit over the long term.

2) Broader managerial skills with "managers recruited for their capacities.

RECOMMENDATIONS FOR REASONABLE GOVERNANCE

1) Develop governance of the supervisory power, specifying roles and responsibilities. A formal two-tier structure becomes preferable.

2) Provide training to shareholders (majority and minority shareholders) to encourage their engagement in the life of the company and their loyalty. Provide for mechanisms to allow minority shareholders to exit the capital.

3) Appoint external and independent directors able to exercise the role of referee, if required.

RISKS

1) Certain risks described for the preceding systems: A barrier for growth if the dominant shareholders do not wish to lose their dominant position. Possible tensions between majority and minority shareholders, in particular at the time of successions.

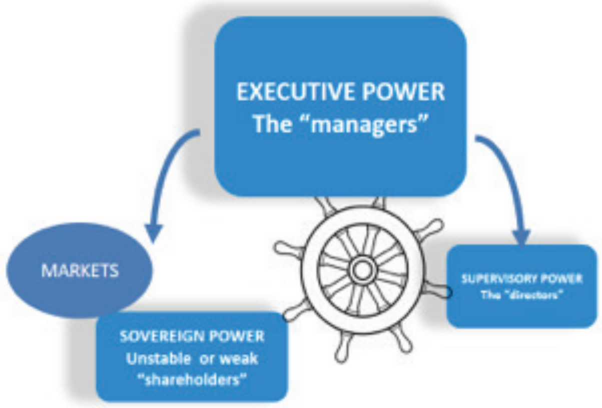
2) Depriving minority interests of their rights if they are weak or inactive. The strategies promoted by the dominant "shareholders may be detrimental to the minority interests.

3 Significant disagreements about the project/profit logic between majority and minority shareholders or majority shareholders and "managers. Risk of unstable governance.

4) Potential overlap in powers when the majority "shareholders circumvent the legitimate governance bodies to impose their views on the "managers. "Phantom governance. The "managers are under pressure or their entrepreneurial freedom of action is unclear.

System n°4: Managerial domination

When the company is controlled by the manager



The sovereign power is weak because the “shareholders are too numerous, divided or unable to express themselves, or form cohesive constituencies in general meetings. The “managers in this case dominate the governance: in board meetings they approve those strategies that appear to be the best, in their opinion, and appoint the “directors based on their own priorities. This system of governance is nevertheless very different from the entrepreneurial autocracy because the “managers do not have the sovereign power and do not incur the risk of failure. The supervisory power alone can limit the all-powerful managerial authority.

Type of company : Family-owned companies with dormant shareholders. Public companies in which the state does not exercise its role as shareholder. Listed companies whose capital is highly diluted among the public shareholder base (float exceeding one-third of the share capital). Mutual companies characterised by limited participation of member-policyholders.

BENEFITS

1) Increased entrepreneurial capacities for “managers in relation to the previous system.
2) No interference from the private interests of shareholders.
3) It is easy to finance the company by increasing the number of shareholders.

RECOMMENDATIONS FOR REASONABLE GOVERNANCE

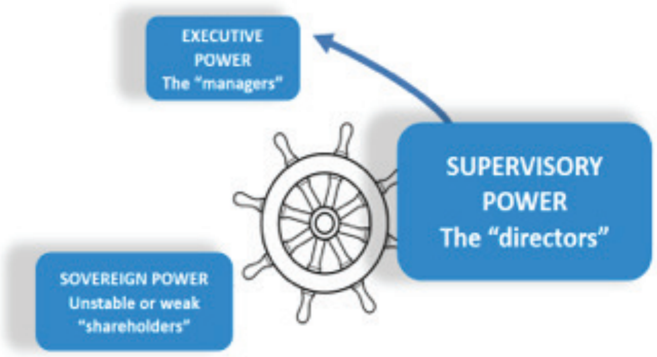
1) A two-tier structure becomes indispensable to separate the functions of management and supervision.
2) Appoint external (independent) and internal (employees) directors capable of exercising a role as a countervailing power or neutral observers.
3) Stabilise the share ownership, encourage the presence and training of long-term “shareholders, including by giving them multiple voting rights.

RISKS

1) The risks associated with type 1) and type 2) autocracy systems of governance: isolation, skills, and succession. The team of “managers forms a type of oligarchy subject to potential influence peddling.
2) Abuses of authority of the executive power, resulting in particular in excessive increases in compensation.
3) Control of the supervisory power by the “managers who have independent directors appointed that are incapable of exercising a genuine countervailing power.
4) Strategic instability: risk of sudden change in demands from the “dormant shareholders, or a permanent risk of takeover bids when the company is listed.
5) If the market allows the “shareholders to easily exit the capital, the ties between the “shareholders and the company can weaken. The market share price becomes the indicator of the “managers’” supervision. This encourages decisions on their part designed to maximise the share price. Profit takes precedence over the project: the definition of the financialization of the company.

System n°5: Board domination

When the directors take over the helm



Influential "directors may come to exercise power, for instance, by taking over a part of the executive power. All important decisions, going far beyond those concerning the supervisory duty, are made in board meetings. The managers are subject to, and adapt their decisions to, the expectations of powerful "directors. The "shareholders allow them to do as they wish. This system differs from system 3 ("shareholder domination) to the extent that the directors exercising the supervision are not in this case dominant shareholders. They may even consist of external directors, taking advantage of weak executive power.

Type of company : An ambitious minority shareholder acquires control by getting appointed to the board. Uncertain succession for the manager. Association managed by its board of directors, leaving little leeway to the chief executive officer.

BENEFITS

1) Renewal of the strategic outlook.
2) Possibility to ultimately re-establish the shareholders' influence that was previously usurped by the "managers.
3) An interim system when shareholder participation is limited.

RISKS

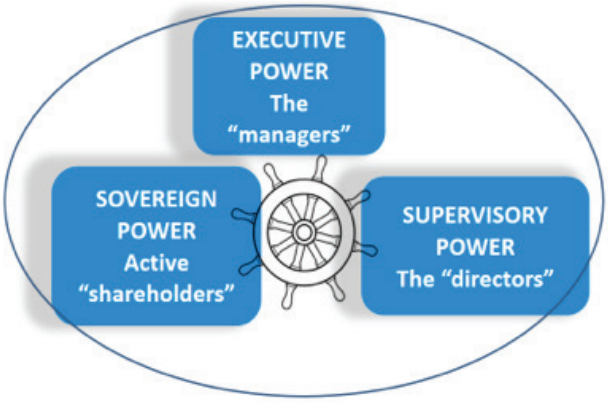
1) The dominant directors do not have the legitimacy to influence the executive power.
2) A situation of confusion within the company: one does not know who manages.
3) An interim system encouraging political calculations to determine who will prevail among the "directors", and between the "directors" and the "managers".

RECOMMENDATIONS FOR REASONABLE GOVERNANCE

1) Determine whether influential directors obtain private advantages from their position.
2) Appoint external directors to balance the powers.
3) Promote "shareholder" engagement.
4) Restore the power of the manager and reformulate the boundaries of the three powers.

System n°6: Entrepreneurial democracy

When the company is steered by the three powers, though separated



This represents an ideal scenario providing the model for contemporary governance, in particular since the increase in the number of “shareholders tends to weaken sovereign power, and leads companies to shift to the No. 4 governance system of managerial domination.

In this case, the three powers are perfectly separated and exercised by each protagonist. The sovereign power is exercised by many “shareholders, though sufficiently active supervision is assured in an independent manner by the “directors, and the executive power has considerable freedom of action to fulfil its mission.

Type of company: Family-owned companies, mutual companies, cooperatives or companies with diluted capital characterised by a strong culture of governance, and having in particular anticipated problems relating to changes in sovereign power resulting from the growth in the capital, the number of policyholder-members, cooperative employee-members, etc., by putting resources in place so this power can be properly exercised.

BENEFITS

1) The strength of balanced governance, with each party ensuring its responsibilities.
2) Stakeholder engagement and cohesion.
3) Considerable resilience and a capacity to anticipate dysfunctions or the effects of changes in the environment, by effectively leveraging the participation of stakeholders.

RISKS

1) High supervisory costs to operate the system, with the risk of increased formalism and power plays that are detrimental to effective decision-making.
2) Reduced responsiveness in the case of a sudden or profound change in the economic environment.
3) An unstable system capable of shifting to the manager or shareholder domination system of governance, if there is a change in the balance of power, or the governance protagonists no longer exercise their role, etc.

RECOMMENDATIONS FOR REASONABLE GOVERNANCE

1) To avoid excessive costs, determine whether the complexity of the company requires such a complex system of governance.
2) Avoid formal complexity, maintain vigilance about the effectiveness of decision-making.
3) Appoint external directors to serve as watchdogs in the event of changes in the environment, or as referee between powers.
4) Provide continuous training about the corporate governance culture.

Summary:
The diversity of governance systems

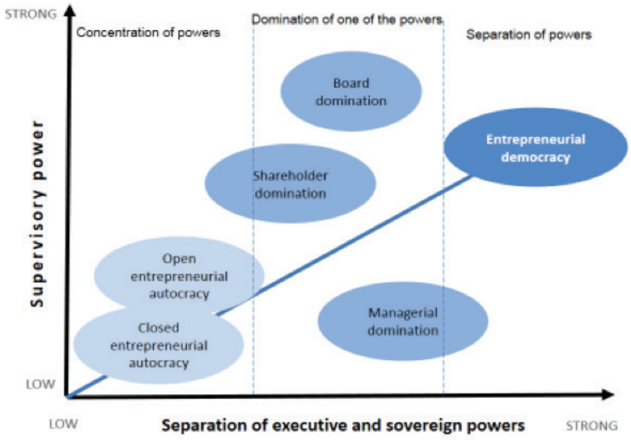
The six systems of governance presented above do not pretend to cover all cases. Rather they provide a typology making it possible to analyse real systems of governance used by companies. In reality, their governance **tends to represent a combination of these different type**s.

Each system of governance is more or less adapted to the company's environment and changes in its strategy. It provides direction for the company based on either its project or its profit, according to the balance existing between the three powers. It is essential to determine which system of governance is in place and if it is truly appropriate, to analyse not only the quality of governance, but also the company's development and, in particular, the strategic leeway provided (or not) by the system of governance.

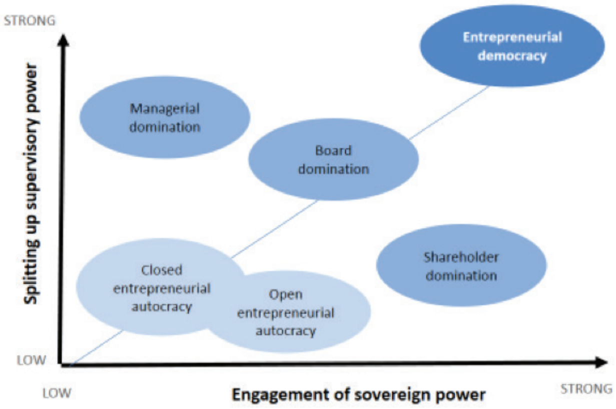
→ *For example, a company wishing to maintain a shareholder domination system of governance because the majority shareholder does not wish to give up its influence, must define a strategy that is not overly capital-intensive. Defending the system of governance (and on that basis the power of majority shareholders) may create a barrier impeding the company's growth. As another example, a company operating under the entrepreneurial democracy governance model may encounter difficulties if the environment changes quickly and calls for management decisions that are slowed down by the formal separation of powers.*

How these governance systems operate can be analysed along two main levels:

(1) **The degree of concentration of the powers** (separation or not between the executive and sovereign power) and the role of referee, more or less important, given to the supervisor power.


STRONG
Concentration of powers
Domination of one of the powers
Separation of powers
Board domination
Entrepreneurial democracy
Shareholder domination
Open entrepreneurial autocracy
Closed entrepreneurial autocracy
Managerial domination
Supervisory power
LOW
LOW
Separation of executive and sovereign powers
STRONG

(2) **The real influence of the shareholders**, which depends also on the degree of fragmentation and the shareholders' desire to genuinely participate in governance.


STRONG
Entrepreneurial democracy
Managerial domination
Board domination
Splitting up supervisory power
Shareholder domination
Closed entrepreneurial autocracy
Open entrepreneurial autocracy
LOW
LOW
Engagement of sovereign power
STRONG

No one system can be considered better than another, and each must be analysed as it is, and adapted to the company's economic situation to address it needs, history and complexity. **This is why the recommendations for ensuring reasonable governance always relate to the situation of each company**.

This is particularly crucial for the four key phases in the company's life-cycle:

1) creation;

2) after 10 years of activity, when structural barriers to further growth can emerge;

3) the first transfer between generations;

4) when the historic owners are replaced by managers and new shareholders.

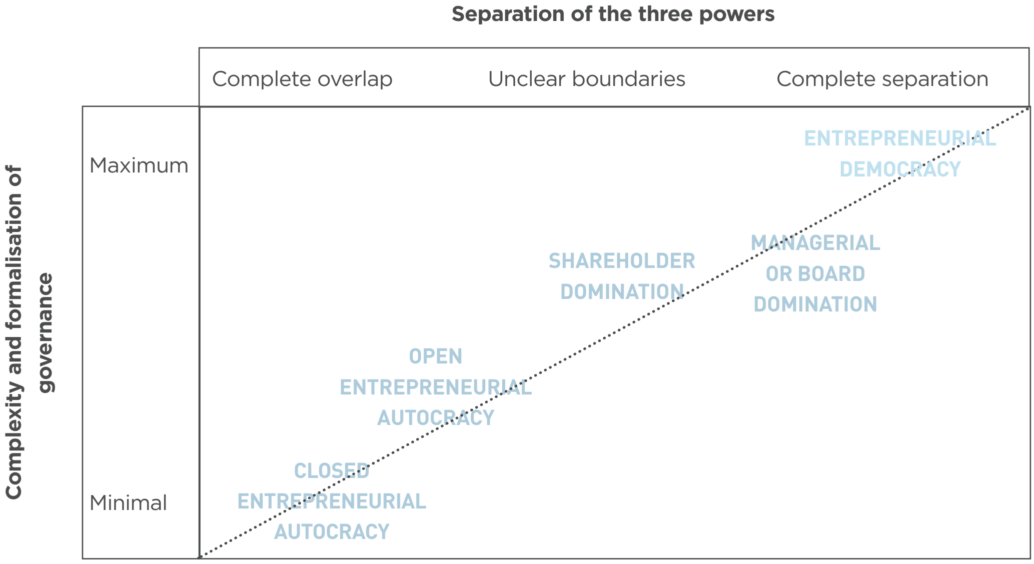
At each of these stages, the configuration of governance can be decisive. Through anticipation, the governance system can be adapted to the circumstances by introducing changes.

By analysing the system of governance, it can be updated and the problems specific to each governance system can be addressed. This also makes it possible to anticipate, if necessary, issues that might arise from a change in governance system.

Finally, the direct costs of operating each system of governance depend on the sophistication of the procedures and, in particular, the degree of separation of the three powers. The more the powers are held by the same persons, the lower the corporate governance operating costs related to coordinating and transferring information.

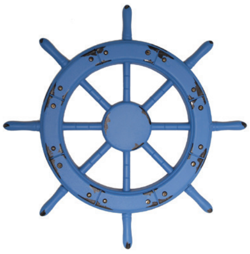
Between these two extremes (entrepreneurial autocracy and entrepreneurial democracy) the standards and formalisation of procedures of governance tend to increase as the boundaries between the three powers are defined. **The complexity of the governance system and its operating cost are therefore linked**.

The greater the degree of formalisation, the greater the complexity and, therefore, the operating costs. On the other hand, they make it possible to combine more financial and human resources, and consequently better respond to the complexity of the company. As a result, every company is faced with a trade-off between the cost and effectiveness of governance. This means that one must not choose the most (or least) sophisticated system of governance, but rather the most effective, i.e., the system best adapted to the company's environment and able to guarantee the stakeholders' confidence in those tasked with exercising governance over the company.


Separation of the three powers
Complete overlap
Unclear boundaries
Complete separation
Complexity and formalisation of governance
Maximum
Minimal
ENTREPRENEURIAL DEMOCRACY
MANAGERIAL OR BOARD DOMINATION
SHAREHOLDER DOMINATION
OPEN ENTREPRENEURIAL AUTOCRACY
CLOSED ENTREPRENEURIAL AUTOCRACY

Conclusion:

How to use these guidelines



The objective of these guidelines is to provide **a simple and unified framework for defining governance issues concerning all companies, but capable of being adapted to the specific situations of each**.

To construct this framework we defined:

(1) **The three powers**: **sovereign**, **executive** and **supervisory**, and the **three principles** underpinning the definition of reasonable governance: **clarification** of powers; **effectiveness**, to enable each power to exercise its responsibilities; and **vigilance** in monitoring potential misuses of each power. Part I.

(2) **The content of the three powers**, their definition and the points of vigilance to prevent their misuse. Part II.

(3) **The six basic systems of governance** and their specific characteristics in terms of governance. Part III.

We also emphasised from the start the critical role of reasonable governance in establishing a **climate of confidence**, not only with regards to those who govern the company, but also the entire company itself. The business world must have confidence for the stakeholders in the economy to project themselves into the future. Whether employees, suppliers, customers or public authorities, they all need **to believe that the company with whom they work will continue in the future not only to exist, but also to achieve a reasonable performance capable of ensuring their own remuneration**. It is in this sense that confidence is indispensable, particularly in a market economy.

Each company must create a climate of confidence that is necessary to attract and retain resources. **This confidence contributes to the creation of economic value**. As we have seen, corporate governance is a powerful contributor to the establishment of this climate, and, to the contrary, its destruction.

> **Reasonable governance creates confidence because the stakeholders consider the definition and the exercise of the powers in the company to be clear and effective.**

Our guidelines offer two toolboxes for analysing, evaluating and, if necessary, adjusting corporate governance: the first makes it possible **to define the major issues raised by the exercise of the three constituent powers of governance**. This does not entail applying all the points of vigilance listed in the guidelines, but rather to understand their spirit and the need to revisit them when necessary.

The second toolbox enables the user to situate its company within a given corporate governance system and the specific issues raised by that system, including its strengths and specific risks. To address the governance issues raised, users of these guidelines may refer to the description of the three powers and the points of vigilance to establish rules of conduct that they consider necessary to consolidate, develop or redefine each of the powers.

An assessment of the governance can be carried out in the following manner:

Stage 1: Identify the corporate governance system within which the company is situated.

Stage 2: Analyse how the three powers are actually exercised in practice: who does what, in a formal or informal manner? Who are the key persons, what are the normal practices?

Stage 3: Identify the points of vigilance, power by power: How to ensure confidence? How to improve sensitive issues?

Stage 4: Anticipate changes in the governance system resulting from the company's development: What would happen if the capital were opened up, in the event of the manager's succession?

Stage 5: Analyse changes in the exercise of powers: How will the concrete exercise of powers evolve? Who will be the new key persons?

Stage 6: Conclude by considering the quality of present and future governance.

These two tools therefore offer a complementary and coherent, and hopefully, useful method.

> **These guidelines can be used to analyse all types of companies (stock companies, mutual companies and others) and to identify the necessary changes linked to their specific history, size, or growth, without imposing general standards. It is then up to each association representing different categories of companies (listed or otherwise, medium-sized, family-owned or run by a founder-entrepreneur, etc.), and of course to each company that adopts these principles, to use them to develop specific rules of application adapted to its reality, according to the three key criteria of clarity, effectiveness and vigilance.**

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