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ANNUAL REPORT ON CORPORATE GOVERNANCE, EXECUTIVE COMPENSATION, INTERNAL CONTROL AND RISK MANAGEMENT

EXECUTIVE SUMMARY

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SUMMARY

This report was prepared in accordance with Article L. 621-18-3 of the Monetary and Financial Code, resulting from the Financial Security Act of 1 August 2003, which directs the Autorité des Marchés Financiers (AMF) to draw up an annual report based on the information on corporate governance, executive compensation, internal control and risk management published by companies that have their registered office in France and are listed on a regulated market. This is the fourteenth such report written by the AMF.

To give higher visibility to the most important messages, the AMF decided last year to change the presentation of the report to a more concise format. This same objective was pursued again this year.

The analytical sample in the report continues to consist of 60 companies that have their registered office in France, i.e. the 34 companies in the CAC 40 at 31 December 2016 and the 26 other companies in the SBF 120 with the largest market capitalisations.

■ AFEP-MEDEF code significantly revised in November 2016

The AFEP-MEDEF code underwent further revisions in November 2016 to incorporate certain developments in corporate governance (strengthening of the board's role in strategy, provisions on director independence, reference to the company's corporate social responsibility, inclusion of limited partnerships with share capital, etc.) and in compensation (cap on termination payments, publication of a press release when an executive leaves a company, performance criteria to be met over several consecutive years, etc.), corresponding to certain topics addressed by the recommendations and avenues of discussion put forward by the AMF in its previous annual reports.

■ French and European regulatory framework substantially modified in 2017

The second part of the report discusses the main developments in corporate governance and compensation both in France (Sapin II act provisions on say on pay and anti-corruption, orders on the publication of non-financial information and the simplification of companies' disclosure requirements, reports of the AMF's Retail Investors Consultative Commission and of the High Committee for Corporate Governance, among others) and internationally (Shareholders' Rights Directive II, ESMA report on shareholder identification, planned corporate governance reform in the United Kingdom, in particular).

■ AMF report much the same as the previous year's but in a new format

In the chapters of the report that discuss the findings on corporate governance, compensation, internal control and risk management, the AMF once again adopted a statistical approach combined with an in-depth look at only a few issues considered topical or where it would like to see additional progress.

■ Continuous improvement in companies' compliance with the AFEP-MEDEF corporate governance code

The number of best practices identified this year far exceeds the number of issuers cited for poor implementation of the code.

The AMF observed that, after the 2017 general meetings, the proportion of women on the boards of all the companies in its sample exceeded 40% or these companies were covered by the exemption for boards consisting of no more than eight members. However, the AMF still found a gap between the percentage of women on boards, required by law, and the percentage of women corporate officers (chairman, chief executive officer, deputy chief executive officer).

While the overall proportion of independent directors within boards remains high, the AMF nevertheless observed that a significant proportion of companies in the sample still provide only fragmented information, or publish no information, on the criteria actually used to assess the significance of business relationships. If investors are to be able to properly assess who qualifies as an independent director, companies must present in their annual report, in accordance with the recommendation in the AFEP-MEDEF code, the criteria used by the board of directors or the supervisory board to determine whether the business relationships maintained by directors or members qualified as independent are significant.

In general, the entire sample complied with the recommendations on management of conflicts of interest. The AMF also found that some companies go beyond the recommendations in the code and specify in their documentation that the relevant directors cannot participate in either the voting or the discussions.

All the companies stated that they have conducted an evaluation of the board's operation. Almost all of the companies provided details on the procedure, objectives and topics of the evaluation, the results of the evaluation, and areas where directors would like to see improvements. In contrast, the evaluation of directors' individual contribution to the work of the board remains insufficient. As such, companies could be expected to publish directors' individual attendance rate for the board and the committees on which they sit.

Issuers still have room to improve on the most recent topics, such as the targets for board member diversity, the practice of holding meetings not attended by corporate executive officers ("executive sessions") and executive succession planning. The AMF also once again assessed the 12-year criterion and business relationships involving the independence of directors, as well as the tasks of the chairman of the board. This last topic gave rise to a new avenue of discussion calling on companies to provide ex post information on the tasks assigned to the chairman.

Lastly, the AMF presented a more detailed than usual analysis of the topics of lead director and non-voting members. While not conclusive, this analysis should give companies a better idea of where their practices stand relative to the sample. As such, the AMF found that the lead director has become a "key person" on certain boards and that his tasks and the overview of his activities are being described in greater detail. The analysis nevertheless shows that one-third of companies that have decided not to separate the duties of chairman of the board and chief executive officer have not appointed a lead director and that, when there is a lead director, he is independent only in less than one-fifth of cases.

■ Overall improvement in the presentation of compensation

With respect to compensation, the AMF found that there was an overall improvement in 2017 in the presentation of executive compensation in the disclosure documents made available to the public. This section, presented in graphical format, was underpinned by an analysis of the relationship between the different components of compensation paid to executives and the procedures for determining these components.

Companies properly justified the circumstances that led them to increase their executives' fixed compensation.

Transparency on determining annual variable compensation was on the whole satisfactory. With very few exceptions, companies specified the ceiling on annual variable compensation, the criteria used to determine this compensation, and the overall extent to which these criteria have been met. The AMF nevertheless observed, on this last point, that additional clarifications could be made, in particular by detailing, at least for each quantifiable target, the extent to which it has been achieved. Similarly, when the share of annual variable compensation awarded on the basis of the observed achievement of qualitative targets deviates significantly from the ratio initially set and starts to outweigh the component based on the achievement of quantifiable targets, the board should have to justify the reason of such decision.

As the AFEP-MEDEF code was published at the end of 2016, issuers did not all have the time to factor in the new nomenclature used which now differentiates quantifiable criteria from qualitative criteria and annual variable compensation from long-term compensation.

Regarding long-term compensation, the AMF focused on the criteria used to determine this component and on how demanding these criteria were. The AMF notes that several companies have implemented mechanisms that could lead to a reduction in the amount of variable compensation, and potentially long-term compensation, when negative factors emerge after one of these components of compensation has been determined (malus and clawback mechanisms).

Companies complied with the AFEP-MEDEF code's recommendations for executive departures, and the ceiling of two years of compensation (fixed + annual variable) was applied.

With respect to pension plans, new plans have been implemented to replace the defined-benefit and defined-contribution plans usually granted to executives. To the extent that these new plans are not explicitly governed by the recommendations in the AFEP-MEDEF code, the AMF calls on the professional associations to address the possibility of extending the scope of their recommendations.

Lastly, ex ante voting was implemented in 2017. The AMF, based on its findings after reviewing the resolutions submitted to general meetings, had a number of comments. Both the way in which the items put to a shareholder vote were presented and the degree of detail in their descriptions were dissimilar. One recommendation was made to improve the transparency of the information presented at general meetings and shareholder voting. Unlike the previous year, all the resolutions presented within the sample for ex post and ex ante votes were approved.

- **Inclusion of a section on internal control and risk management**

Each year, the AMF prepares a study on chairman's reports on internal control and risk management procedures. This year the study was included in this report, after being published for several years on an ad hoc basis. It examines the recent legislative amendments made in July 2017 as well as statistics for the information disclosed in the chairman's reports on internal control and risk management procedures for 2016.

- **The main changes to be factored in for financial years beginning in 2017**

Order no. 2017-1162 of 12 July 2017 introduced several measures to simplify and clarify companies' disclosure requirements, including some related to information on internal control and risk management procedures which had previously been included in a dedicated chairman's report. These new provisions will apply to reports for financial years beginning on or after 1 January 2017, i.e. reports that will be published in 2018.

This order is the culmination of the discussions begun several years ago by the AMF, which in March 2015 had created a working group "*on the chairman's report on internal control and risk management procedures*". In the report this group published in February 2016, Mr Jean-Claude Hanus, a member of the AMF Board and chairman of the working group, stressed the need to modernise these reports and noted that *"they seem, on reading [them], like an increasingly formal exercise that has lost sight of the objective of providing information that is useful because it is relevant".*

The order thus replaces the old chairman's report with a report on corporate governance, falling within the jurisdiction of the board of directors (or of the supervisory board for a company with a two-tier board system), which can take the form of a separate report appended to the management report or a specific section[1] in that report. The chairman's report as it currently exists will therefore be eliminated.

Information on the internal control and risk management procedures is incorporated directly into the management report, which, as of the next financial year, will have to include information on "*the main characteristics of the internal control and risk management procedures implemented by the company and relating to the preparation and processing of the accounting and financial information*". It should be noted that lawmakers confined the scope of the information requested to merely the preparation and processing of the accounting and financial information, thus aligning with Article 20 of amended "accounting" directive 2013/34/EU of 26 June 2013. In the future, the management report will therefore include all the information that had previously been found in the chairman's report on internal control and risk management procedures. The future management report will have to contain, in addition to the already required "*description of the main risks and uncertainties the company is facing*", information on "*the main characteristics of the internal control and risk management procedures implemented* […]" and "*information on the financial risks related to the effects of climate change and the measures adopted by the company to reduce them, by implementing a low-carbon strategy in every component of its activities*".

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[1] Only in the case of a "one-tier" structure with a board of directors.

All of the provisions of the amended AFEP-MEDEF code, for which application was deferred in certain cases, will also apply to the drafting of future reports.

- **The AMF's new recommendations and avenues of discussion**

The AMF put forward a total of four new recommendations and four new avenues of discussion. They supplement the recommendations and avenues of discussion already set out in recommendation 2012-02[2].

- *New recommendations for issuers:*
  - the tasks carried out by the chairman of the board of directors or of the supervisory board and an overview of his activity should be presented precisely and in detail;
  - when calculating annual variable compensation:
    - companies should specify clearly, at least for each quantifiable target, the extent to which it has been achieved; and
    - the board of directors or supervisory board should clearly justify its decision when the ratio between the qualitative component and the quantifiable component deviates significantly from the ratio initially set; this situation should remain exceptional;
  - separate resolutions should be drafted when they cover different categories of executives and/or when the scope of the vote by shareholders is different.

- *The new avenues of discussion for the AFEP and the MEDEF concern:*
  - a more standardised presentation of the membership of the board and the committees, similar to what is already proposed in their code for the compensation of corporate executive officers;
  - the discussion that should be had about the level of detail and relevance of the information to be provided about business relationships, in particular regarding the claim of confidentiality to avoid disclosing materiality thresholds;
  - a revision to the wording of the code with respect to conflicts of interest to reference abstention from both voting and discussions;
  - a broadening of the code to rules governing the new pension plans established for the corporate executive officer(s).

- **Update of the AMF's consolidated recommendation on corporate governance and executive compensation**

The AMF is updating this document, in conjunction with the publication of this report, by incorporating the recommendations and avenues of discussion put forward in the 2016 and 2017 reports on corporate governance and executive compensation, taking into account the November 2016 update of the AFEP-MEDEF code and the adoption of the "Sapin II" act[3] and its implementing decree[4].

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[2] AMF Recommendation 2012-02 - Corporate governance and executive compensation in companies referring to the AFEP-MEDEF code – Consolidated presentation of the recommendations contained in the AMF annual reports.

[3] Act 2016-1691 of 9 December 2016 on transparency, anti-corruption and economic modernisation.

[4] Decree 2017-340 of 16 March 2017 on the compensation of executives and members of supervisory boards of listed public limited companies (*sociétés anonymes*).