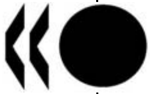

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Corporate Governance and the Financial Crisis

Conclusions and emerging good practices to enhance implementation of the Principles

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In accordance with the decision by the Steering Group at its meeting in November 2009, this document was derestricted by written procedure on 17 February 2010.

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I. EXECUTIVE SUMMARY

1. This report represents the third phase of the OECD Steering Group on Corporate Governance action plan on corporate governance and the financial crisis. It builds on the report *Corporate Governance Lessons from the Financial Crisis*, and its subsequent, preliminary findings that were presented in *Corporate Governance and the Financial Crisis: Key Findings and Main Messages.*

2. The Steering Group's first two reports found that corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights had played an important role in the development of the financial crisis and that such weaknesses extended to companies more generally. Nevertheless, the Group found that the OECD Principles of Corporate Governance provided a good basis to adequately address the key concerns that have been raised and that there was no urgent need for them to be revised. Rather, a more urgent challenge for the Steering Group was to encourage and support the implementation of already agreed international and national standards, including the OECD Principles of Corporate Governance. To this end, the Steering Group decided to issue a set of conclusions and emerging good practices that together seek to assist companies and policy makers to implement more effectively the OECD Principles. They are complementary to the Principles and serve to set them in the current context along the lines of the Commentaries that were introduced by the Steering Group in 2007. In some instances, they develop the implications of individual principles that are important in the current situation and in others develop further the existing annotations in the light of the financial crisis and emerging good practices. As with the OECD Principles, the comments and good practices are generalisations in nature and do not necessarily apply to individual jurisdictions without first considering specific circumstances. They do not necessarily apply to individual companies without first considering, *inter alia*, their size and complexity.

3. In the aftermath of the financial and economic crisis there have been calls for greater use of regulation over what are considered to be self regulating "codes and standards". This is not an appropriate approach in the area of corporate governance that is more complex than, for example, in the case of prudential standards. Nevertheless, there have also been instances of regulatory failure. In line with the Principles, the report therefore calls for jurisdictions to review regularly the capacity of their supervisory, regulatory and enforcement authorities and to promote forward looking capacities. To check if regulation is required, the report reinforces the message of the Principles that the authorities should make full use of both *ex ante* and *ex post* regulatory impact assessment. Where there is resort to a corporate governance code, it is important that a monitoring body be charged with monitoring implementation and to facilitate timely updates.

4. An important public policy issue for some time now has been executive remuneration. The report reinforces the position of the Principles that this is a responsibility of the board. It is important for boards to first set the strategic goals of the company and its associated risk appetite. They are then in a position to establish a compensation structure that meets a small number of performance metrics based on these goals. An explicit governance process needs to be established that will also define the role and duties of compensation consultants who are increasingly important. Good practice is for the process, remuneration structure and performance to be made transparent through some form of remuneration report. There also needs to be a possibility for shareholders to express their views about remuneration policy.

5. An important conclusion is that the board's responsibility for defining strategy and risk appetite needs to be extended to establishing and overseeing enterprise-wide risk management systems. The report notes that in some important cases the risk management system was not compatible with a company's strategy and risk appetite. Along the lines of the Principles which recommend that internal control functions report directly to the audit committee or equivalent, the report argues that it is good practice for the risk management function to be able to report directly to the board. The risk management function needs to also consider any risks arising directly from the compensation and incentive systems in place. It is important that the process of risk management and assessments about its effectiveness be appropriately disclosed, although the report also notes that experience up till now with such disclosures has not been good

6. Numerous criticisms have been levelled against part-time boards and the notions of objectivity and independence in decision making that are a key element of the Principles. To perform better, boards need to be supported in key areas. To this end, it is important for the Chair to play a key role in ensuring that the board tackles the most important issues facing a company. The roles of CEO and Chair are increasingly being separated but where this is not the case, it is appropriate for a company to explain what measures have been taken to avoid conflicts of interest. To promote competent boards, it is good practice for board members to have access to training programs, underpinned by periodic external board evaluations. It is considered important for a board nomination committee or equivalent to specify the skills and experience required by the board and to identify appropriate individuals. As in the Principles, shareholders should also be able to nominate board members and have a significant role in their appointment. Finally, the board structure, composition and working practices need to reflect the complexity of the company and ensure clear lines of responsibility and accountability throughout the organisation.

7. The report also addresses those financial companies that are subject to supervision and where board members are frequently subject to a "fit and proper person test" by a supervisor. It argues that such tests should extend to the technical and professional competence of board members, including general governance and risk management skills. Assessments of independence and objectivity of board members could also extend to considering the length of time members have served under the same CEO.

8. The financial crisis has raised questions about the role of institutional shareholders. The report argues that the Principles need to be seen in a broader context than just those acting in a fiduciary capacity and to cover also institutions acting as owners for ultimate beneficial owners and asset managers. Good practice is for such investors to disclose voting records in order to make transparent how they control conflicts of interest. Good practice is also for them to disclose any codes or principles they follow in exercising ownership rights. It is important for companies to also disclose the voting results of shareholder meetings. Measures to increase incentives to vote shares should be focused and compatible with the Principles with respect to the equitable treatment of shareholders. The authorities need to facilitate cooperation between shareholders regarding voting by clarifying the scope of "acting in concert" rules. Finally, the provision of proxy advisory services needs to take place in a competitive market environment in order to avoid singular approaches to corporate governance and to control conflicts of interest.

II. INTRODUCTION

9. This report represents the third phase of the Steering Group's action plan on corporate governance and the financial crisis. It builds on the Group's fact finding report *Corporate Governance Lessons from the Financial Crisis*, and its subsequent, preliminary findings that were presented in *Corporate Governance and the Financial Crisis: Key Findings and Main Messages.* The Group has already approved a number of points in the *Key Findings* report including some specific to financial companies that were subsequently included in the OECD *Exit Strategy* (Blundell-Wignall *et al*, 2009). They are repeated here for the record.

10. The Steering Group's first two reports found that corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights had played an important role in the development of the financial crisis. Nevertheless, the Group found that the OECD Principles of Corporate Governance provided a good basis to adequately address the key concerns that have been raised and that there was no urgent need for them to be revised. Rather, a more urgent challenge for the Steering Group is to encourage and support the implementation of already agreed international and national standards, including the OECD Principles of Corporate Governance. To this end, the Steering Group decided to issue a set of comments and emerging good practices that could help companies and the authorities to overcome recent weaknesses and support a more effective implementation of the OECD Principles. They are complementary to the Principles, drawing out in some cases the implications of individual principles that are important in practice and in others, further developing the existing annotations in the light of emerging good practices. They are thus intended as a way to keep the Principles current as circumstances evolve and in line with the Commentaries adopted by the Steering Group in 2007.

11. Concise summaries of the analysis are presented in bolded text covering five key areas. This reflects the fact that there is no one solution to address weaknesses in financial and non-financial company's corporate governance practices. Rather, a broad approach to upgrade corporate governance practices in general appears to be warranted. It needs to be noted that like the OECD Principles themselves, the comments and good practices in this report are broad generalisations in nature and do not necessarily apply to individual jurisdictions without first considering specific circumstances. They do not necessarily apply to individual companies without first considering, *inter alia*, their size and complexity.

12. The first section deals with the need to improve the corporate governance framework, including procedures that might support more effective implementation by the national authorities. The following two sections deal with the governance of the remuneration/incentive system, and governance of risk management. The fourth section deals with the need to improve board practices including board composition, independence and competence. The final section focuses on the need to improve the exercise of shareholder rights, especially by institutional investors.

III. ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK

13. The Steering Group's analysis showed a gap between existing standards and actual implementation. The Steering Group therefore concluded that there is an urgent need to encourage and support effective implementation of already agreed standards. One weakness is that standards have been sometimes implemented more in form (i.e. box ticking) than in content, which confirms the need to promote the "outcomes based" approach applied by the OECD Principles. While improved implementation is primarily an issue for companies, their boards and their shareholders, there is also an important role for supervisory, regulatory and enforcement authorities.

14. The crisis has opened the old debate about the costs and benefits of regulation as opposed to market mechanisms. However, there have also been instances of regulatory failure even in the most regulated sectors. In a number of cases, it is now apparent that even amongst what were regarded as properly resourced and empowered regulators, there were important deficiencies, an issue covered by principle I.D: *supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained*. In some cases, the internal processes did not appear to aid decision making and high staff turnover challenged information gathering and analysis. In some instances, the authorities have been also subject to potentially conflicting objectives and interests such as investor protection and maintaining the safety and soundness of institutions. Poor enforcement of existing rules and regulation, together with inadequate supervisory and regulatory powers are also regular themes at the OECD's Regional Corporate Governance Roundtables in Asia (e.g. N.R.Mahood, 2009), Latin America and Southern Africa, and was a key discussion point at the global public consultation organised in March 2009 (DAF/CA/CG/RD(2009)1). Moreover, the crisis has also highlighted the need for the authorities to be forward looking and seek to identify market developments that may challenge the relevance of current corporate governance rule and practices. For effective implementation of Principle I.D it appears that:

It is important for jurisdictions to regularly review whether their supervisory, regulatory and enforcement authorities are sufficiently resourced, independent and empowered to deal with corporate governance weaknesses that have become apparent. This should include an assessment of inter-agency as well as internal communication and decision making systems.

15. With new regulatory initiatives being announced on a regular basis, it is important to bear in mind the work of the Steering Group and other parts of the OECD (OECD, 2009, OECD, 2005) with respect to regulatory impact assessment (RIA) that is based on principle I.A: *the corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets*. In the rush to new legislation that might be underpinned by the imperative "not to waste a crisis" there might be a tendency to not clearly specify the problem and whether the proposed legislation can address it in a cost effective manner. Where *ex-ante* RIA is not practical, as for example when major regulatory overhauls are being proposed, in accordance with OECD standards there should at least be provision for *ex-post* assessment and monitoring (Kirkpatrick, 2009), a practice that the OECD recommends should in any case be standard practice for new regulation and legislation.

During the process of deciding regulation, the authorities should, where possible, make full use of *ex-ante* regulatory impact assessment and make provisions for *ex post* monitoring and RIA analysis.

16. In most jurisdictions, Corporate Governance Codes are used as a means for seeking to encourage companies to introduce standards and practices of corporate governance that go further than laws and regulations. The danger often pointed out is that implementation might be only formal (i.e. tick the box) and that reliance on market participants for enforcement might be weak in those jurisdictions where active investors do not have a strong presence, interest or incentive, or where corporate control is highly concentrated. As noted below, there are arguments that in key areas such as remuneration and board practices, codes have proved ineffective.

17. In a number of jurisdictions, an oversight/monitoring body has been established to monitor application of the code and to propose revisions and this appears to help underpin the relevance of the codes. However, the general caveat in the annotation of principle I.C is still appropriate: *when regulatory responsibilities or oversight are delegated to non-public bodies, it is desirable to explicitly assess why, and under what circumstances, such delegation is desirable. It is also essential that the governance structure of any such delegated institution be transparent and encompass the public interest.*

In those jurisdictions where voluntary codes and other similar arrangements specify corporate governance outcomes, such as board behaviour and composition, that complement or go beyond laws and other public regulation, it is important that adequate monitoring and compliance mechanisms are provided to ensure their effective implementation and timely update.

IV. GOVERNANCE OF REMUNERATION AND INCENTIVES

18. The ability of the board to effectively oversee executive remuneration appears to be a key challenge in practice and remains one of the central elements of the corporate governance debate in a number of jurisdictions. Implementation of the OECD Principles thus remains a challenge.

19. The *Key Findings* noted that the evidence pointed to remuneration being set by a process where executives held a strong bargaining position. This might include management hiring remuneration consultants and even specifying the basis for comparison (e.g. upper quartile groups so that all would be "above average"). Remuneration arrangements have become very complex for *inter alia*, legal and tax reasons, and thus very difficult and time consuming for board members to understand. As a result, the much discussed and valued nexus of compensation to performance was often not evident, especially *ex post*. Moreover, remuneration arrangements might not take risk into account and in the case especially of financial institutions has sometimes led to risk positions being taken at odds with company strategy and risk appetite. As a result, the Key Findings were critical of board processes and disclosure to market participants (Box 1).

Box 1. Key Findings and Main Messages: Governance of the Remuneration process

- The governance of remuneration/incentive systems has often failed because negotiations and decisions are not carried out at arm's length. Managers and others have had too much influence over the level and conditions for performance based remuneration with boards unable or incapable of exercising objective, independent judgement.

- In many cases it is striking how the link between performance and remuneration is very weak or difficult to establish. The use of company stock price as a single measure for example, does not allow to benchmark firm specific performance against an industry or market average.

- Remuneration schemes are often overly complicated or obscure in ways that camouflage conditions and consequences. They also tend to be asymmetric with limited downside risk thereby encouraging excessive risk taking.

- Transparency needs to be improved beyond disclosure. Corporations should be able to explain the main characteristics of their performance related remuneration programs in concise and non-technical terms. This should include the total cost of the program; performance criteria and; how the remuneration is adjusted for related risks.

- The goal needs to be remuneration/incentive systems that encourage long term performance and this will require instruments to reward executives once the performance has been realised (i.e. ex-post accountability).

- Defining the structure of remuneration/incentive schemes is a key aspect of corporate governance and companies need flexibility to adjust systems to their own circumstances. Such schemes are complex and the use of legal limits such as caps should be limited to specific and temporary circumstances.

- Steps must be taken to ensure that remuneration is established through an explicit governance process where the roles and responsibilities of those involved, including consultants, and risk managers, are clearly defined and separated. It should be considered good practice to give a significant role to non-executive

independent board members in the process.

- In order to increase awareness and attention, it should be considered good practice that remuneration policies are submitted to the annual meeting and as appropriate subject to shareholder approval.

- Financial institutions are advised to follow the Principles for Sound Compensation Practices issued by the Financial Stability Forum (see Annex II) that can be seen as further elaboration of the OECD principles.

Source : OECD Key Findings

4.1 The responsibility of the board in compensation policy

20. The OECD Principles clearly state that responsibility for executive remuneration is with the board and the practical challenge is how to improve their bargaining position vis-à-vis management. However, just stating that remuneration systems should align incentives with the longer term interests of the company may not be enough and additional guidance might be useful.

21. At the time of the last review of the Principles in 2004, board responsibility was strengthened. The Principles clearly make remuneration of the board and executives a key responsibility of the board that is underpinned/enforced through extensive disclosure obligations, supplemented by measures for shareholders to make their views known and by the possibility to vote against the election of board members deemed to be responsible for poor practices. Principle VI.D.4 recommends that the board should fulfil certain key functions including "*aligning key executive and board remuneration with the longer term interests of the company and its shareholders*". The annotations note that "*it is regarded as good practice for boards to develop and disclose a remuneration policy statement covering board members and key executives. Such policy statements specify the relationship between remuneration and performance, and include measurable standards that emphasise the long run interests of the company over short term considerations*". Moreover, the annotations go on to note the importance of board processes: *It is considered good practice in an increasing number of countries that remuneration policy and employment contracts for board members and key executives be handled by a special committee of the board comprising wholly or a majority independent directors. There are also calls for a remuneration committee that excludes executives that serve on each others' remuneration committees, which could lead to conflicts of interests*.

22. Not only do the Principles remain highly relevant, but in light of events it also seems important to draw out the reference to good practice in the annotations (see Key Findings and Main Messages). More recent standards and good practice place greater emphasis on board's specifying the long term interests of the company (i.e. making strategic decisions) and then outlining specific mechanisms to achieve it such as delayed vesting of shares and bonus claw-backs through escrow accounts.

23. The thrust of recent specialised standards (see Key Findings and Main Messages) is that the board should determine a small number of relevant performance metrics based on the strategic goals they have determined. There should be symmetry between the upside and downside performance-based compensation, although in practice there are clear practical limits to this. The plans should be simplified focusing on measurable metrics that drive performance over a long period of time. Pay for performance should only be paid or accrue to an individual if the company exceeds or meets measurable performance targets and not simply due to the passage of time.

24. Experience documented in the Main Findings further indicates that transparency is proving difficult to implement in a number of jurisdictions even though increased information has led to changed

board behaviour. Remuneration reports are often difficult to follow and might not cover all forms of compensation and termination arrangements. Elements such as pension arrangements are also difficult to reduce to one, present value figure. More importantly, both the policy and how it is implemented might not be fully transparent and the performance indicators difficult to assess. Reflecting the finding that sometimes executives /management at lower levels might have a significant impact on a company's risk profile, remuneration disclosure might need to be extended to other corporate officers on a grouped or functional basis. The following observation is suggested:

In their efforts to align remuneration with the longer term interests of the company and its shareholders, it is important for the board to decide and disclose in a remuneration report specific mechanisms that link compensation to the long run interests of the company such as multi-year performance-based vesting conditions, deferred compensation, claw-backs and adjustment for risk. Performance measures should be related to the strategic objectives of the company and the time frame used to measure performance specified.

25. Principle VI.E.1 recognises that board responsibility for executive remuneration has consequences for board structure and processes: "*boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgements to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives and board remuneration".* As is made clear in the annotations, the last two words should in fact read "board and executive remuneration". The annotations recognise the possible need for remuneration committees or equivalent: *the board may also consider establishing specific committees to consider questions where there is a potential conflict of interest*. The principle thus reflects what is regarded as evolving good practice around the world. The Key Findings nevertheless note that in many cases the determination of remuneration is still not an arms-length negotiation.

26. The effectiveness of a remuneration committee will only be as good as the competence and independence of its members and the strength of the board as a whole. Given the increased complexity of remuneration contracts, some have expressed concerns about whether a remuneration committee, many of whom are part-time board members to avoid conflicts of interest, can effectively oversee and control the process. They are effectively forced to use compensation consultants and this would appear to lead to further complexity. At some stage, to restore clarity and ease of comprehension there might be a need for serious simplification of remuneration conditions.[1] Moreover, there is some anecdotal evidence that because of increasing complexity and frustrations in trying to accommodate shareholders with sharply different views, non-executive directors would much prefer other work on the board to that of the remuneration committee. Some have proposed that the chair of the remuneration committee be the subject of a special vote in the event of dissatisfaction but this might make it even more difficult to recruit committee members.

27. An important consequence of the increasing pressures on non-executive board members, and especially independent ones, is that their remuneration could well rise significantly and become controversial. Board evaluation might help to control the potential controversy but equally important will be a process whereby they don't appear to be setting their own remuneration. In some jurisdictions and companies this matter is undertaken by the Chair of the board making it even more important that the Principles recognise this position and the role it should play. Good practice is still evolving in this area.

[1] This is particularly so of retirement arrangements and future perks since the issue arises about their present value, about which there is significant uncertainty with different methods yielding widely different results.

28. Another key issue is that remuneration/incentive schemes lower down the management chain have proven to be important in both financial and non-financial companies. The above issues are reflected in the following observation:

It is important for a company to take steps to ensure that remuneration is established through an explicit governance process where the roles and responsibilities of those involved, including consultants and risk managers, are clearly defined and separated. In a number of jurisdictions, it is considered good practice to give a significant role to non-executive independent board members in the process. Their remuneration should be decided through a transparent and robust process that is disclosed in the remuneration report to shareholders.

29. For financial companies and especially banks, new standards/guidelines are evolving rapidly. They have several factors in common. First, in line with the Principles, compensation structures are a key responsibility of the board: there is an important corporate governance component. Second, remuneration incentives should be compatible with risk policy and systems and the criteria for paying bonuses should be risk adjusted. Third, incentives should be symmetrical. Particularly relevant is the Financial Stability Board's Principles for Sound Compensation Practices (see DAF/CA/CG(2009)1/ANN1) and the Implementation Guidelines that will be part of the Basel Committee's Core Standards. The OECD provided input to the new standard from the viewpoint of corporate governance.

30. One new issue to consider is the use of compensation consultants where new standards emphasise their independence and engagement by the board and not by the management. In some cases such consultants might be employed on other projects by management such as human resource policy, and thus face a conflict of interest, as has been the case with auditors in the past. There are now suggestions in some jurisdictions that they should accept a code of conduct to ensure their ongoing independence and objectivity, which seems reasonable in view of their important role.

Where remuneration consultants are hired to advise on remuneration contracts and conditions, it is good practice for them to be engaged by the board with a key role for independent board members (e.g. the remuneration committee or equivalent) and who are thus independent of management. Their role, including other work for the company, should be disclosed in a remuneration report. Boards need to ensure their continued independence by prohibiting or limiting the contemporaneous provision of other remuneration services and by requiring them to adhere to a code of conduct.

31. In some instances, remuneration systems appear to be strongly influenced by tax provisions, and indeed the tax system affects corporate governance arrangements in many ways, some of which are mentioned below (e.g. capital gains on shareholdings, limits on deductibility of base salaries). A review of how the tax system influences remuneration arrangements, and especially how it might constrain long term incentive systems might be important in some jurisdictions.

In order to avoid unintended consequences, the authorities could find it important to review and understand how the tax system might constrain or influence the development by companies of remuneration systems based on long-term company performance.

4.2 The role of shareholders

32. Principle II.C.3 defines the rights of shareholders to include making their "… *views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval*". The annotations note that "*it is important for shareholders to know the specific link between remuneration and company*

performance when they assess the capability of the board and the qualities they should seek in nominees for the board….Several countries have introduced an advisory vote which conveys the strength and tone of shareholder sentiment to the board without endangering employment contracts". It is probably fair to say that this principle has not been widely implemented.

33. As described in the Main Findings, several jurisdictions have implemented the principle through various forms of "say on pay" voting and while results may have been not as positive as some had hoped such as by stopping the rapid growth in remuneration, neither have they been as negative as some argued in opposition to the plans. In fact, there is evidence reported in the Main Findings that it has helped boards and remuneration committees to "push back" executive demands and has led to a better structure of pay: it is reported that board members do not wish to be in a position where they might lose a vote. On the other hand, the ability of shareholders to formulate a uniform view is also open. Some fear that in view of the complexity of remuneration reports shareholders have come over-rely on proxy advisors for advice on voting or adopt an excessively rigid (box ticking) approach.[2]

34. With experience still evolving and the efficacy of specific measures heavily dependent on the corporate governance system as a whole, including the structure of shareholders (see below), the principle's high level language might still be appropriate. However, with a number of jurisdictions still feeling their way forward to implementation, it might be appropriate for the annotation of principle II.C.3 to be seen in the light of current practices.

In order to increase awareness and attention, it can be considered good practice that remuneration policies and implementation measures are submitted to the annual meeting and that there are procedures that enable shareholders to express their opinions.

[2] One example of "box ticking" is that in the UK many institutional investors insist on the same performance metrics (relative share price performance and inflation adjusted earnings per share) for all companies and view alternative metrics (e.g. return on capital) with a lot of scepticism.

V. IMPROVING THE GOVERNANCE OF RISK MANAGEMENT

35. One of the important lessons of the recent crisis has been the failure of risk management at a number of financial and non-financial companies. All too often, the focus appears to have been on internal controls for the purpose of financial reporting so that risk management became divorced from corporate strategy and its implementation. In a number of cases, the enterprise as a whole was not considered and boards were out of touch with the systems in place (Box 2). However, as is often the case in corporate governance, some companies have performed well thereby establishing what might be considered good practice.

Box 2. Key Findings and Main Messages: Effective Implementation of risk management

- Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management. In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often separated from management and not regarded as an essential part of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company.

- It should be fully understood by regulators and other standard setters that effective risk management is not about eliminating risk taking, which is a fundamental driving force in business and entrepreneurship. The aim is to ensure that risks are understood, managed and, when appropriate, communicated.

- Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually. It should be considered good practice to involve the Board in both establishing and overseeing the risk management structure.

- The Board should also review and provide guidance about the alignment of corporate strategy with risk-appetite and the internal risk management structure.

- To assist the Board in its work, it should also be considered good practice that risk management and control functions be independent of profit centres and the "chief risk officer" or equivalent should report directly to the Board of Directors along the lines already advocated in the OECD Principles for internal control functions reporting to the audit committee or equivalent.

- The process of risk management and the results of risk assessments should be appropriately disclosed. Without revealing any trade secrets, the board should make sure that the firm communicates to the market material risk factors in a transparent and understandable fashion. Disclosure of risk factors should be focused on those identified as more relevant and/or should rank material risk factors in order of importance on the basis of a qualitative selection whose criteria should also be disclosed

- With few exceptions, risk management is typically not covered, or is insufficiently covered, by existing corporate governance standards or codes. Corporate governance standard setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation.

Source : OECD Key Findings

5.1 A need for international standards

36. For a number of principles, the OECD Principles refer to high quality, internationally accepted standards such as accounting and audit standards. With respect to internal controls for financial reporting, widely accepted practices are also in place. However although there are a number of national standards for risk management, a widely accepted and useful international standard is lacking. Thus the report prepared for the OECD concluded that neither COSO nor Turnbull (that maintain a high level of following in the US and the UK) provide effective guidance about how to implement their high level models into the reality of a complicated business, something for which they were not intended. In the view of Anderson (2009), neither provides a helpful approach to the mechanics of creating an effective and lasting risk management and assurance framework over the long term. Missing elements include: risks are frequently not linked to strategy; risk definitions are often poorly expressed and have been reduced to the smallest number of words possible; the need for someone or something to make sure that the whole process takes place is not developed; not all involved stakeholders are considered and; only lip service is paid to important parts of the company's value chain that are outsourced, or where there is a dependence on key suppliers or joint venture partners. The latter point raises the question about whether outside parties manage risk as well as the principal, and in a manner which is compatible with their approach.

5.2 Oversight of risk management is a clear duty of the board

37. At the time of the revision of the Principles in 2004, internal controls were an important current theme but risk management issues were nevertheless emerging and were partially taken into account. Principle VI.D.1 recommends that "*the board should fulfil certain key functions including reviewing and guiding corporate strategy, major plans of action, risk policy…* while VI.D.7 defines a key function to include "*Ensuring the integrity of the corporation's accounting and reporting systems …and that appropriate systems of control are in place, in particular systems of risk management, financial and operational control"*. The annotations to principle VI.D.1 note that risk policy (sometimes termed risk appetite) is closely related to strategy and "*will involve specifying the types and degree of risk that a company is willing to accept in pursuit of its goals. It is thus a crucial guideline for management that must manage risks to meet the company's desired risk profile"*.

38. Although the Principles make risk management an oversight duty of the board, the internal management issues highlighted during the financial crisis receive less explicit treatment. Principle VI.D.2 lists a function of the board to be "*monitoring the effectiveness of the company's management practices and making changes as needed*". The annotations are easily overlooked but are highly relevant: *monitoring of governance by the board also includes continuous review of the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organisation*. It is not just accountability but also the process by which information is passed to the top. This more internal management aspect of the Principles might not have received the attention it deserves in Codes and in practice. The annotations to Principle VI.D.7 note that "*ensuring the integrity of the essential reporting and monitoring systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organisation. The board will also need to ensure that there is appropriate oversight by senior management"*. Hence despite what is sometimes said of the Principles, the 2004 revision moved the Principles into the area of assurance, both of internal controls for financial reporting as well as for risk management.

39. What is needed now is to bring together and to reinforce the need for internal controls with the need for assurance to the board about risk management and therefore the implementation of its strategic objectives. This will include as with direct reporting of financial controls, direct reporting about risk positions to the board to avoid the conflicts of interest of line management. This does not mean that line management should be sidelined since they are at an operational level responsible for risk management.

However, what is at stake is independent reporting of their performance to the board, as with financial reporting that is well established in the Principles and in other standards. The following observations are suggested:

It is considered good practice that the Board is responsible for both establishing and overseeing the company's enterprise-wide, risk management system and ensuring that it is compatible with its strategy and risk appetite.

It is considered good practice that risk-management and control functions are independent of profit centres and the "chief risk officer" or equivalent should be able to report directly to the Board along the lines already advocated in the OECD Principles for internal control functions reporting to the audit committee or equivalent.

40. For financial institutions, risk management is of particular importance. Good practice indicates that there should be direct reporting to the board that requires an executive officer who is independent of line businesses and, therefore, to a considerable extent independent of the CEO. Some financial institutions make it a practice for senior executives to serve as the CRO for a period so that the culture of risk management becomes more widespread. This should not violate the principle that the risk function should be independent of line management and be able to take a holistic view about the risk position of a company.

5.3 Improving disclosure about risks and risk management

41. Disclosure of foreseeable risk factors had always been a part of the Principles but the 2004 revision extended responsibility to the board. Principle V.A.6 calls for disclosure of material information on foreseeable risk factors and the annotations go on to note that "*disclosure about the system for monitoring and managing risk is increasingly regarded as good practice*". However, this latter aspect is vague and might even be better related to evolving international or domestic risk management standards similar to the treatment in financial reporting, principle V.B.

42. With respect to Principle V.A.6, research indicates that the readability of risk disclosures is difficult or very difficult and that there is generally no consistent global set of generally accepted risk management principles and guidance available for risk disclosures in the annual report (van Manen, 2009). Reporting tends to be boilerplate in nature. Moreover, previous work by the Steering Group indicated that discussion/disclosure about corporate strategy and business models, closely related to risk management, also tends to be poor even though there appears to be economic returns to improved disclosure (OECD, 2006). Major issues remain in the whole area of corporate reporting such as how to discourage boiler plate reporting without having to establish safe haven rules that might be difficult to do in practice. The Financial Stability Forum (2008) has been concerned about disclosure and encouraged "financial institutions to make robust risk disclosures using the leading disclosure practices … at the time of their upcoming mid-year 2008 reports". Leading disclosure practices were first enunciated by the Senior Supervisors Group in early 2008.

The process of risk management and the overall results of risk assessments should be appropriately disclosed in a transparent and understandable fashion. Disclosure of risk factors should identify those most relevant to the company's strategy.

5.4 Risk management and incentive systems

43. An important feature of the crisis has been the realisation that in a number of companies there appeared to be a disconnect between strategy and risk management on the one hand, and incentives on the other. By incentives is meant not just remuneration but also other aspects such as promotion. The Preamble

to the Principles describes well the needs: *good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.* In a number of cases, strong incentives were not matched by strong risk management and internal controls leading to excessive risk taking compared with the company's stated risk appetite. It is sometimes argued now that the risk management function should have a role in the determination of remuneration arrangements. However, this might confuse the lines of responsibility of the risk management function. As reflected in the Walker Report (Walker, 2009), they will in any case have a role in providing information about risks so that bonuses can be risk corrected.

It is important that the risk management and reporting functions system consider risks that may be related to the company's remuneration and incentive systems.

VI. IMPROVING BOARD PRACTICES

44. The *Key Findings* report set out evidence of poor board performance (relative to the normative outcomes advocated by the Principles) at a number of financial and non-financial companies in different countries (Box 3). Especially important appeared to be dominance of boards by the CEO which appears to have stifled critical enquiry and challenge essential for objective, independent judgement. Boards do change their behaviour and many boards are now in the process of reconstitution, particularly in the financial sector. However these changes are more reactive rather than proactive and more in the way of a cyclical response rather than a profound change in behaviour towards an outcome advocated by the Principles. Despite negative experiences, it needs to be reiterated that there has nevertheless been a great diversity of experience even in the banking sector that supports the identification of good practices.

Box 3. Key Findings and Main Messages: Board practices

- It appears difficult and perhaps impossible to find a "silver bullet" in the form of laws and regulations to improve board performance. This leaves the private sector with an important responsibility to improve board practices through, *inter alia*, implementing voluntary standards.
- The objective should be to facilitate the creation of competent boards that are capable of objective and independent judgement. While there is no inherent conflict between independence and competence, it is important to keep in mind that formal independence should sometimes be a necessary, but never a sufficient, condition for board membership.
- It should be considered good practice that shareholders can nominate board members and have a significant role in their appointment through instruments which take into account the specific features of the ownership structure of a company.
- It should also be considered good practice that the functions of Chief Executive Officer and Chair of the Board of Directors in unitary boards are separated. When a dual board structure exists, the head of the management board should not become chair of the supervisory board upon retirement. In both cases some form of "comply or explain" might be necessary to preserve flexibility for companies in special positions.
- Board member liability and how their duties are specified should remain on the policy agenda since it is not clear that effective arrangements are yet in place.
- It should be considered good practice that boards develop specific policy for the identification of the best skill composition of the board, possibly indicating the professional qualities whose presence may favour an effective board.
- In companies and industries where "fit and proper person tests" are applied by regulators for public policy reasons, so that board membership is not solely a shareholder decision, the criteria could be extended to technical and professional competence of potential members, including general governance and risk management skills.
- The test for those particular companies might also consider the independence and objectivity of boards. To meet concerns about board independence, the test might also consider the time that board members have served under the same CEO or Chair.

Source : OECD Key Findings

45. The Key Findings also discussed deeper concerns that the model of part-time boards relying in good measure on non-executive directors, including those classed as independent, was under severe stress, particularly in large complex companies such as in the financial sector. Questions of independence and competence have again been raised. But it was also pointed out that often the model has not been tried: boards were simply not independent but acquiescent. The key policy issue is how to improve the situation by providing boards with appropriate supporting infrastructure in key area, while also acknowledging that the part-time board will never be all seeing, all powerful in its oversight of management. This section first discusses the role of the chair in supporting effective functioning of the board and then moves to the question of competence and independence. Finally, it discusses an issue that has arisen in the banking sector but that is also relevant for non-financial companies: complexity.

6.1 An important role for the chair of the board

46. The Key Findings (Box 3) note that there is an emerging consensus that the separation of CEO and Chair of the board is a good practice but not one that should be mandated. The Principles already deal with the issue in an annotation to principle VI.E. At the time of the review in 2004 there was no consensus on this issue but the annotation notes that "*in a number of countries with single tier board systems, the objectivity of the board and its independence from management may be strengthened by the separation of the role of the chief executive and chairman, or, if these roles are combined, by designating a lead non-executive director to convene or chair sessions of the outside directors.* S*eparation of the two posts may be regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision making independent of management*". The annotations also cover the case of two tier boards noting that it is not good practice for the CEO to move to the chairs' post of the supervisory board on retirement. Much the same can be said of single tier boards. A new chair that is the retired CEO may still be too close to management and hence may not be sufficiently detached and objective. There may also be confusion as to who is leader of the company.

47. Despite these rather strong annotations, the Principles has nothing more to say about the role of the Chair yet codes around the world normally devote a significant section to this issue and many observers and analysts argue that a good chair can make all the difference. For example, the UK's Combined Code states that: "*the chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda. The Chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The Chairman should ensure effective communications with shareholders. The Chairman should also facilitate the effective contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors*". Moreover, recent discussions in the Netherlands and the UK to improve bank corporate governance have devoted considerable attention to the issue (Walker 2009, Advisory Committee, 2009). The Walker Report in the UK suggests that the chair of a bank should have banking experience and leadership experience in a large complex firm. If there is need for a trade-off, it suggests that preference should be given to leadership experience.

48. An issue of potentially wider importance has also been raised by the UK's Walker Report: the time commitment of board chairmen is likely to be substantial and this could involve unclear demarcation with the CEO. To address this problem, some best practice guidelines recommend that the chair should not be a full-time employee of the company and that boards should develop terms of reference for key positions, including the chair and CEO roles. The more general issue is dealt with by principle VI.E.3: "*board members should be able to commit themselves effectively to their responsibilities*".

49. The Principles tackle some of the above issues without mentioning the role of a board chair. In particular, principle VI.F recommends that "*in order to fulfil their responsibilities, board members should have access to accurate relevant and timely information"* and the last line of the annotations states that "*in*

order to fulfil their responsibilities, board members should ensure that they obtain accurate, relevant and timely information". In the light of recent experience, it should be noted that in a number of jurisdictions it is regarded as good practice for the chair to take responsibility for board members having access to relevant information and to allow time for appropriate discussions. The following observations are suggested:

It is important for the Chair of the board to play a key role in ensuring an effective board by setting the agenda and ensuring that the board tackles the most important issues, whether it is on strategy, risk, management succession, ethics or relations with shareholders. When the roles of CEO and the Chair are not separated, it is important in larger, complex companies to explain the measures that have been taken to avoid conflicts of interest and to ensure the integrity of the chairman function.

6.2 Promoting competent boards

50. The Key Findings (Box 3) refer to competence of the board, including skills, and placed the debate in terms of board composition as a whole. The Principles do deal with the issue but in scattered places and often only in annotations and not in a principle. Principle V.A.4 recommends that disclosure should include information about the qualifications of board members but it is not in a whole board context. Chapter VI covering the responsibilities of the board includes principle VI.D.5 stating that "*the board should fulfil certain key functions including …ensuring a formal and transparent board nomination and election process*". The annotations state that in this context "*… the board has a key role in identifying potential members for the board with the appropriate knowledge, competencies and expertise to complement the existing skills of the board and thereby its value adding potential for the company*". This is almost a principle in itself that is often overlooked in practice in favour of an excessive focus on board independence. What is meant here is a balanced board with some non-executive board members bringing key capacities to the board with independent non-executive board members bringing other capacities essential for some duties. The view of the board as comprising only two classes of members is not a correct interpretation of the Principles.

51. The annotation of principle VI.E covering independence also touches on competence noting that "*…while establishing necessary conditions, such "negative" criteria defining when an individual is not regarded as independent can usefully be complemented by "positive" examples of qualities that will increase the probability of effective independence"*. Finally, principle VI.E.3 deals with an important contemporary issue: "*Board members should be able to commit themselves effectively to their responsibilities*" and the annotations recommend the publication of attendance records to facilitate legitimacy, especially seeing that those with intensive commitments such as being on the audit or risk committees might require significant compensation. Tucked away at the bottom of the annotation is another key contemporary issue: "*in order to improve board practices and the performance of its members, an increasing number of jurisdictions are now encouraging companies to engage in board training and voluntary self-evaluation that meets the needs of the individual company. This might include that board members acquire appropriate skills upon appointment, and thereafter remain abreast of relevant new laws, regulations and changing commercial risks through in-house training and external courses*". A number of companies go beyond this compliance oriented annotation to include training seminars and courses covering the evolution of the competitive landscape, industry trends and visits to various company facilities. Visits and discussions might also be organised with customers, suppliers, analysts etc.

52. Board evaluation is also evolving and becoming good practice although there are also cases of flattering evaluations (Heidrik & Struggles, 2009). Anecdotal evidence (e.g. interviews with chairmen) indicates that when conducted in a robust professional manner, board evaluation can be an effective tool to improve board performance. It provides an opportunity for board members to set collective and individual

goals and subsequently measure their performance against them in a constructive and reflective manner. In addition, the use of an external facilitator can improve board evaluation by bringing an objective perspective and sharing best practices from other organisations. An experienced facilitator can also help identify important "people and behavioural issues that would otherwise remain hidden and unaddressed" (Wong, 2009a).

53. If the Principles were to be reviewed, the OECD Steering Group might wish to make these issues more explicit but in the meantime a re-statement should suffice to draw attention to how the issue is treated:

To promote competent boards, it is good practice especially in larger enterprises for board members to have access to training programmes, complemented by periodic, externally facilitated board evaluations. The process and general results of evaluations should be disclosed to shareholders.

54. The question of board member competence in financial enterprises that are subject to supervision by the authorities due to their public policy importance has been identified in the Key Findings as an important issue. The regulatory authorities already usually review proposed membership through the "fit and proper" person test but normally focus on probity issues. In a number of jurisdictions, the test also extends to key officers of the company such as the chief risk officer or equivalent. It has often been argued that judgement about competence is a question for shareholders and that the authorities should not second guess boards. However, the crisis and evidence of over friendly boards and ineffective shareholders raises doubts about the general validity of this argument. Regulators would, however, have to put in place appropriate procedures to give their vetting process credibility.

In companies and industries where "fit and proper person tests" are applied by regulators for public policy reasons so that board membership is not solely a shareholder decision, the criteria for the test should be extended from probity requirements to technical and professional competence of potential members, including general governance and risk management skills. The supervisory authorities should disclose their procedures and criteria, and where candidates are rejected, provide written explanations to the board of the proposing company.

6.3 Improving board independence and objectivity

55. Perhaps the most important policy issue concerns the normative proposal that boards be capable of objective, independent judgement, principle VI.E: *The board should be able to exercise objective independent judgement on corporate affairs*. Principle VI.E.1 goes on to recommend that: *boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives and board remuneration.* As noted above, executive remuneration should be added to the principle and also risk management, a crucial assurance role of the board. Once it is noted that the Principles also advocate competent board members (see above) and a balance of skills for the whole board, it is hard to take issue with the principle *per se*. Implementation is another issue. Statements that the model has failed are often beside the point. In a number of cases boards were not capable of independent, objective judgement as the list of friendly/captured boards at many banks attests.[3] Moreover, broad executive experience of some independents did not always translate into

[3] Some were investment banks such as Lehman Brothers, Merrill Lynch and Bear Stearns, which were not subject to the same level of prudential regulation as commercial banks. Others such as RBS and HBOS in the UK, and at Landesbanken in Germany were conventional banks and therefore highly regulated.

competence and an ability to identify problems ahead of time. However, it is not self-evident that there is necessarily a trade-off between competence and independence, especially when it is accepted that board members do not need to be other CEOs but can and should be drawn from a wider pool of skills and experiences.

56. Implementation issues depend in part on the nature of ownership and control and the nomination process. In those jurisdictions with controlling shareholders, the annotations note that *independence from controlling shareholders or another controlling body will need to be emphasised, in particular if the ex ante rights of minority shareholders are weak and opportunities to obtain redress are limited.* Good practice is starting to evolve in this area with some countries moving either to nomination and voting by non-controlling shareholders of independent board members, or other methods such as cumulative voting. In companies with diffused ownership, the power of the existing board to nominate itself might be the obstacle so that good practice appears to be for a "nominations committee" comprising board members independent of management who can consider the balance of skills that the board requires. However, exceptions need to be made to take account of board failure. Principle II.C.3 defines a shareholder right as *effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members should be facilitated.* This might need to be supplemented.

It is good practice for a board nomination committee to specify the skills and experience a board requires and to identify appropriate individuals. It is also important that shareholders be able to nominate board members and to have a significant role in their appointment through instruments which take into account the specific features of the ownership structure of a company.

57. Ensuring appropriate board composition and independent objective behaviour is particularly important in banking. The fit and proper powers could also be extended to a controversial area: term limit on board membership. Age *per se* is not the issue here but rather length of time on the board, especially under the same CEO or chair that can lead to lack of independence. In the UK, the code sets a limit of 9 years if the director is to be considered independent while in Netherlands and France it is 12 years.

58. Small jurisdictions and especially ones protected by language "barriers" often have the problem of very close relationships within the director community and this might require policy initiatives. For example, as a result of a scandal in the banking sector, Ireland is to ban cross directorships and chief executives becoming chairmen. This goes beyond the Principles which only call for disclosure of cross directorships in Principle V.A.4. The annotations note that: …*the information should include membership of other boards and whether they are considered by the board to be an independent member. It is important to disclose membership of other boards not only because it is an indication of experience and possible time pressures facing a member of the board, but also because it may reveal potential conflicts of interest and makes transparent the degree to which there are inter-locking boards*.

59. The system based on part-time board members is under pressure from the burden of work especially with respect to audit, risk and remuneration committees at major financial and non-financial companies. This has led to proposals for full time, independent directors. This does not appear to be plausible, not the least objection being the contradiction between full time employment dependent on the company and independence. The question of availability might be more related to the number of directorships. Principle VI.E.3 states that "*board members should be able to commit themselves effectively to their responsibilities*" and the annotations go on to state that "*service on too many boards can interfere with the performance of board members. Companies may wish to consider whether multiple board memberships by the same person are compatible with effective board performance and disclose the information to shareholders*". Other memberships should be disclosed to shareholders.

6.4 Dealing with complexity

60. An issue that has come to the fore during the financial crisis concerns company complexity that has strained the efficient discharge by the board of its duties and has also challenged senior management in some significant instances. The problem is not unique to global banks, encompassing many different activities. A number of non-financial firms can be characterised as complex especially now that the boundaries of the firm have become diffuse through technology sharing and out-sourcing (Gilson, 2008). Some companies have set the standard by, for example, having board meetings at different subsidiaries and locations. Some NEDs including independent ones might even sit on the boards of key subsidiaries and joint companies. Complexity has particular implications for non-executive board members and their oversight of executives, senior management and assurance duties (e.g. risk management and internal audit). It will also need to be reflected in the structure and operation of the board and its resources. It is important that the board responds in an appropriate manner in terms of specifying controls and assurance functions rather than interfering in day to day management of the company and its subsidiaries.

61. The annotations deal with many of the issues arising from complexity. For example principle VI.D.2 defines a duty of the board: *monitoring of governance by the board also includes continuous review of the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organisation*. The annotations to Principle VI.D.7 note that "*ensuring the integrity of the essential reporting and monitoring systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organisation. The board will also need to ensure that there is appropriate oversight by senior management"*. The implications for risk management are dealt with above and the annotations could be given the status of a principle at some point in the future:

The board should ensure that there are clear lines of responsibility and accountability throughout the organisation, including subsidiaries, key partnerships and other contractual relations. The structure, composition and working procedures of the board need to take into account and accommodate the complexity of the company.

6.5 Duties of the board and its members

62. One way in principle to improve board performance is to clearly define their duties and then to allow/encourage enforcement by shareholders and/or regulators. Board responsibility is covered by principle VI.A (*Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders*), principle VI.B (*Where board decisions may affect different shareholders groups differently, the board should treat all shareholders fairly*) and Principle VI.C (…*The board … should take into account the interests of stakeholders*). Taken together they set strict normative standards for boards and reflect the legal position in a number of jurisdictions. They also indicate that the Principles advocate long run wealth maximisation and not simply "shareholder value".

63. However, it is also clear from the above principles that the duties of the board are quite complex and more in the way of arbitrating between constituencies. Shareholders have widely diverging views and the notion of acting in the best interest of the company is also not clear cut. In such situations, a simple approach to define duties and then enforce them might not be appropriate to improve board performance. The duty of care does, however, offer a way forward by making the board liable for not having assurance systems in place such as risk management and internal financial controls. Indeed, this is the case in the jurisprudence in some jurisdictions. Generally speaking though, enforcement possibilities are weak in many jurisdictions due in part to poor powers of discovery and high costs.

64. Financial liability for board members both collectively and individually remains an area of controversy. If too strong, it might discourage board members or merely be offset by insurance. However, even nominal liability might at least "encourage the others". The following more general statement of duty is therefore suggested as appropriate in the light of recent experience and practices:

Boards should ensure that appropriate assurance mechanisms such as risk management and internal financial controls are in place and functioning in accordance with design.

65. The Key Findings concluded that in sum, it appears to be difficult to find a single measure in the form of laws and regulations to improve board behaviour and performance. It is simply not possible to regulate for board competence and objectivity. Improved enforcement of fiduciary duties and other forms of legal liability might help although it is a blunt instrument. Some other options might be available in banking but these do assume that the authorities possess significant information and an ability to act. At the end of the day, it is hard to escape the conclusion that the appointment and recall of board members might sometimes be seriously flawed raising questions about shareholder behaviour.

VII. THE EXERCISE OF SHAREHOLDER RIGHTS

66. With substantial strengthening of shareholder rights in the OECD area and other markets in recent decades, coupled with increasing institutionalization of share ownership, attention has begun to turn to the effectiveness of shareholders in demanding accountability from the boards of investee companies, including in the run up to the current financial crisis. Although institutional investors and others have become considerably more vocal recently and have registered unprecedented levels of dissent and input on executive compensation, director re-election and other matters at shareholder meetings in 2009, their monitoring of boards has generally proved deficient relative to what is required: the Key Findings, summarised in Box 4, found that shareholders have been largely passive and reactionary in exercising their rights, in many cases voting in a mechanical manner relying on proxy voting advisers and generally failing to challenge boards in sufficient number to make a difference.

67. At the same time, there are continuing impediments in some markets for shareholders to exercise their rights, from share blocking and other administrative requirements to the lack of clear guidance on the permitted boundaries of shareholder collaboration. Taxation arrangements might also adversely affect the calculus about whether to invest in monitoring and voting or whether to remain passive.

Box 4. Key Findings and Main Messages: The Exercise of Shareholder rights

- Shareholder interests and those of management have been "aligned" in the past period of a bull market but this was not sustainable and was associated with a great deal of short term behaviour.

- Shareholders have tended to be reactive rather than proactive and seldom challenge boards in sufficient number to make a difference. Ineffective monitoring by shareholders has been experienced both in widely held companies and firms with more concentrated ownership. In some instances shareholders have been equally concerned with short termism as have managers and traders, neglecting the effect of excessive risk taking policies.

- The equity share of institutional investors continues to increase but their voting behaviour suggests that they can have important conflicts of interest. Many institutional investors are still not playing an active informed role and when compelled to vote the reaction often appears to be mechanical.

- As the importance of institutional shareholders increases, greater attention needs to be given to proxy advisors and to the potential for conflicts of interest. It is also claimed that there is a danger of "one size fits all" voting advice.

- Institutional investors (and others) should not be discouraged from acting together in individual shareholders meeting, both through consultation before the meeting and the presentation of common proposal, provided that they do not intend to obtain the control of the company.

- Even though barriers to voting (e.g., share blocking) do not fully explain low voting participation, they are still significant namely with regards to cross-borders voting. Measures should be taken, both by regulators and by all the institutions involved in the voting chain (issuers, custodians, etc) to remove remaining obstacles and to encourage the use of flexible voting mechanisms such as electronic voting.

- Institutional shareholders acting in a fiduciary capacity should be required to publish their voting records so

as to provide more information to their beneficiaries.

- The role of alternative investors (private equity finds and activist hedge fund), which have been active investors in recent years, should not be hampered as a side-effect of regulatory reforms which might be developed to address the specific issues that have created problems.
- Effective enforcement of shareholders' rights is still an open issue both in systems with strong private litigation traditions and in systems more based on public enforcement mechanisms. Stronger complementarity between private and public enforcement instruments could contribute to create a more favourable framework for active informed shareholders.

Source : Key Findings

68. On the other hand, both in the run up to the crisis and in its aftermath there have been moves to roll back shareholder rights in some countries such as the Netherlands and Germany and strong resistance to further rights in the US. For example, it is proposed that the corporate governance code in the Netherlands curtail the ability to place items on the agenda where they concern strategy and proposes to link the right to the length of shareholding period. The conflicting tendencies – "say on pay" on the one hand (see above) and restrictions on the other-- can perhaps be resolved by recognising the various types of shareholders more clearly and not treating them for the purpose of policy analysis as one amorphous group.

7.1 Institutional investors: transparency of voting actions

69. The Principles are very extensive about the rights of shareholders in chapters II and III, including facilitating the use of voting rights, and discuss at a high level how shareholders should seek to hold boards accountable. When the Principles were reviewed in 2004, attention was given to the fact that institutional shareholders – pension funds, insurance companies, mutual funds, hedge funds, and other collective investment schemes – were often the dominant investors in many OECD markets. Reflecting the fact that they might have many motives for their investment decisions, the Principles focused only on those acting in a fiduciary capacity. Principle II.F states that: *The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated. 1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights; 2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.* The annotations for Principle II.F.1 notes that "*in several countries institutional investors are either required to disclose their actual voting records or it is regarded as good practice and implemented on a comply or explain basis*". The Steering Group did consider calling for disclosure of actual voting records but it was considered premature until more information was gathered from those jurisdictions that had gone further. Amidst important empirical findings during the past few years indicating that reality did not match institutional rhetoric, summarised in *Key Findings and Main Messages*, and indications of continued institutional shareholder passivity, there have been renewed calls in different markets for the disclosure of voting records by institutional investors.

The disclosure of voting records by institutional investors acting in a fiduciary capacity to their clients should be regarded as good practice, as it makes transparent how they exercise their ownership rights and control conflicts of interest.

70. In terms of actual voting, companies also bear an important responsibility: principle III.A.5 recommends "*processes and procedures for general shareholder meetings should allow for equitable*

treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes". The Methodology for this principle mentions a number of practices that have been observed: *in some countries and jurisdictions, it is the practice at general shareholders meetings to obtain the voting intentions of the largest shareholders first, and as soon as there is a clear majority the remainder are disregarded and not counted. For the principle to be judged as implemented, it is important that the corporate governance framework ensures that all votes cast are counted equally and that the result of all votes cast in whatever form are registered. Many investors would like to see results communicated to shareholders and this is standard practice in some jurisdictions and companies.* Voting transparency is a good check and balance for both companies and investors.

To ensure equitable treatment of all shareholders, it is important that aggregate voting results from a meeting of shareholders be disclosed by the company to the market in a timely manner.

7.2 Deepening contacts between shareholders and companies

71. Acknowledging the importance of active shareholder involvement, the annotation for Principle II.F notes that "*in considering the costs and benefits of exercising their ownership rights, many investors are likely to conclude that positive financial returns and growth can be obtained by undertaking a reasonable amount of analysis and by using their rights*." The annotations for Principle II.F.1 observe that "*a complementary approach to participation in shareholders' meetings is to establish a continuing dialogue with portfolio companies. Such a dialogue between institutional investors and companies should be encouraged, especially by lifting unnecessary regulatory barriers, although it is incumbent on the company to treat all investors equally and not to divulge information to the institutional investors which is not at the same time made available to the market*." In a growing number of OECD markets, ongoing dialogue between companies and investors is viewed as highly beneficial. In Japan, the Financial System Council recently issued a report recommending that "shareholders and investors should not confine themselves to monitoring management just through the trading of shares and the exercising of voting rights... it is important that they also routinely enrich constructive discussion on management amid their dialogue with managers" (Financial System Council, 2009). Similarly, the Australian Council of Superannuation Investors observed:

"Australian super funds are 'permanent shareholders' in the Australian stock market. Therefore, the long-term performance and behaviours of the companies that super funds invest in will impact on the retirement income of their members and as owners they need to monitor and mitigate risks associated with those investments and one of the most efficient and effective ways of doing that is through engagement with companies on a collective basis." (McKay, 2007).

72. In some markets, such as the Netherlands and the UK, detailed best practice guidance has been developed on the behaviour expected of institutional investors, addressing such topics as how institutional shareholders are to discharge their responsibilities, monitor investee company performance, engage investee companies, resolve conflicts of interest, and evaluate and report their activities. In the Netherlands, institutional investors are required under the law to disclose on a "comply or explain" basis whether they have complied with provisions in the corporate governance code that are applicable to them. In the UK, the Institutional Shareholders Committee has proposed to convert its Statement of Principle on the Responsibilities of Institutional Shareholders and Agents (which is incorporated into the Combined Code by reference) into a stand-alone code which investors can sign up to and report compliance against it on "comply or explain" basis (Institutional Shareholders Committee, 2009). Globally, the ICGN Statement of Principles on Institutional Shareholder Responsibilities provides useful guidance on internal governance, management of conflicts of interest, engagement with companies, and voting.

73. With the emphasis in recent decades on strengthening shareholder rights in order to permit a meaningful participatory role for shareholders, however, the corporate governance codes in most markets focus principally on the responsibilities of companies while giving much less attention to the duties of shareholders. In light of widespread findings of deficient monitoring of boards by institutional investors, greater emphasis on shareholder responsibilities in codes and principles appears warranted. As discussed below, this should also refer to foreign shares.

In disclosing their corporate governance and voting policies, including with respect to foreign shares, institutional investors should make reference to any codes or principles that recommend how they should discharge their ownership responsibilities and how they have implemented such advice.

7.3 Implications of different types of shareholders

74. In important respects, the debate about the role of shareholders in ensuring accountability needs to recognise different types of shareholders. For instance, at Fortis Bank in Belgium the persistent low shareholder turnout for crucial decisions[4] was in part due to a very large individual shareholder base (including some with bearer shares), and the same can be said for some other banks. Individual shareholders often lack the incentives to remain informed and to participate, relying on others, especially large institutional shareholders to take the lead. The latter are, however, quite heterogeneous, in terms of investment approach (active vs. passive, quantitative vs. fundamental, long only vs. long-short, etc.), strategy (growth, value, event-driven, etc.), time horizon, degree of portfolio concentration, size, investor base, and so forth. In a number of countries the institutionalisation of shareholdings continues and the form in which this has occurred (mutual funds and other collective investment vehicles) means that there is a significant difference between asset ownership and asset management.[5] This phenomenon, termed "separation of ownership from ownership," raises a number of governance issues that the Principles and policy makers need to address, including the quality of monitoring of asset managers by asset owners, management of conflicts of interest, and incentive structure to ensure alignment between the two parties. For instance, the use of relative performance metrics and short-term performance measurement cycles may lead asset managers to pay less attention to longer-term value creation. Similarly, the sharing of securities lending revenues between asset managers and their clients may contribute to the reluctance of some fund managers to recall shares for voting purposes, particularly if lending income contributes substantially to an asset manager's bottom line (Wong, 2009 (2)).

75. Given the growing complexity of the capital market and proliferation of investor types and investing strategies pursued, the reference in the Principles to "institutional investors acting in a fiduciary capacity" may no longer be useful in practice. For the purpose of improving analysis as well as allocating shareholder responsibilities correctly, it may be helpful for the Principles to distinguish the different categories of institutional shareholders.

76. While there are numerous ways to segment institutional investors, a key distinction is between asset owners – such as pension funds, insurance companies, endowments, and wealth funds – and their asset managers. Pension funds and insurance companies, for instance, are concerned with meeting

[4] It should be recalled that although 95 per cent approved the fateful purchase of ABM-AMRO, only 35 per cent of the votes were present.

[5] The Main Findings discussed the increasing institutionalization of share ownership in many developed markets. In the US, for instance, institutional investors accounted for 60 per cent of equity ownership in 2006, with mutual funds experiencing the greatest growth. Furthermore, the top 5 mutual fund families managed about 37 per cent of all assets, and the top 25 held 70 per cent (J. Taub, 2007). Similarly, institutional investment is highly concentrated in the UK, the Netherlands, France and other markets. In Italy, Germany and Portugal, institutional investors are effectively a small number of banks that run mutual funds.

obligations over an extended time period (typically spanning decades) while their asset managers – due to how their performance is measured and incentive structures – are usually much more focused on the short-term. Corporate governance, which seeks to contribute to value creation over the long-term, should therefore be of greater inherent interest to asset owners than asset managers. Furthermore, as asset managers are retained by asset owners, efforts at strengthening shareholder involvement should also focus on the obligations of the latter investors, in particular ensuring that they incentivize their asset managers appropriately and monitor their agents' investment and corporate governance activities.

77. In terms of investment styles, it is important to note that active monitoring is especially critical for "passive" investors that invest principally or exclusively according to a pre-set portfolio benchmarks, thereby limiting their ability to exit underperforming investments. For these investors, the adage that "if you can't sell, you must care" is highly relevant. As the same time, the breadth of their portfolio (sometimes, in excess of one thousand stocks) makes it relatively costly for them to intervene at individual companies. Some passive investors, therefore, actively monitor only their largest holdings while others rely on collective shareholder efforts.

78. In such a complex institutional landscape, it is important to broaden the scope of the Principles.

Reference by the Principles to institutional shareholders acting in a fiduciary capacity needs to be extended to a wider class of institutions acting as owners for ultimate beneficial owners, and to asset managers.

79. In some jurisdictions and circles there is a call to reward a type of investor termed long-term (see *Key Findings and Main Messages*) with for example double voting rights. More recently some have proposed tax credits on dividends to encourage long term holding or at least increase the cost of churning.[6] Whatever the scheme, the justification is usually similar: increase long term holding of shares that would result in more monitoring. However, it does not necessarily follow that a long term holder is also an investor that will incur costs to monitor a board or have that capacity. *Key Findings and Main Conclusions* noted cases such as cross holdings by companies that might be for defensive reasons and achieve the opposite effect in terms of monitoring. By contrast, an event trader might not wish to hold shares long term but can certainly contribute to strong monitoring and analysis.

80. When agreeing the Methodology, the Steering Group considered whether additional voting schemes were compatible with the Principles. They decided that they would not be in breach of the equitable treatment of all shareholders and that all shareholders of the same series or class should be treated equally, only if the scheme would be transparent and based on objective, verifiable criteria. That still does not guarantee that the scheme would achieve its objective. A general conclusion is therefore proposed.

National measures to increase the benefits of informed voting might be considered, but any measures need to be focused and compatible with the principle of the equitable treatment of shareholders.

7.4 Encouraging investor co-operation

81. The Principles recognise the severe problems arising from "free riding" which lead to collective action problems. Thus Principle II.G reads: *shareholders, including institutional shareholders, should be*

[6] One has even proposed that voting rights could be separated from the economic interest in a share and sold (Lord Myners, 2009). It should be noted that share-lending amounts to some separation of voting rights since dividends still accrue to the lender and the voting rights can be used by the borrower.

allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse". The annotations elaborated that institutional investors *"should be allowed, even encouraged, to co-operate and co-ordinate their actions in nominating and electing board members, placing proposals on the agenda and holding discussions directly with a company in order to improve its corporate governance."* At the same time, the annotations admonished that *"co-operation among investors could also be used to manipulate markets and to obtain control of a company without being subject to any takeover regulations"* and that, *"for this reason, in some countries, the ability of institutional investors to co-operate on their voting strategy is either limited or prohibited."* The Steering Group reconsidered the issue at its meeting in November 2008 and agreed to launch a public consultation (DAF/CA/CG(2008)3/REV1) at an appropriate moment.

82. In many OECD markets, however, the boundaries of permissible collaboration among investors are not clearly defined, resulting in the reluctance of institutional investors to consult each other on corporate governance matters at investee companies lest they fall afoul of beneficial ownership disclosure, market abuse, and takeover regulations. In the US, for instance, some large institutional investors do not, as a rule, collaborate with other investors on company-specific matters out of fear that they will be required to make a Schedule 13D filing with the US SEC. In Australia, institutional investors are concerned that collaborative activities on corporate governance matters outside of shareholder meetings will contravene the Corporations Act (McKay, 2007).

83. Responding to pleas by institutional investors for clearer guidance on collective shareholder engagement, the UK FSA recently confirmed that existing market abuse, changes in control and disclosure of substantial shareholdings regulations do not "prevent collective engagement by institutional shareholders designed to raise legitimate concerns on particular corporate issues, events or matters of governance with the management of investee companies" (Dewar, 2009). To remain compliant with current regulations, the FSA emphasized that collaboration by investors must be on an *ad hoc* basis and not result in an "agreement between two or more persons which obliges them to adopt a lasting common policy towards the management of the issuer through the exercise of their voting rights".

84. In Germany, the Risk Limitation Act of 2008 reaffirmed that "singular arrangements" among investors – such as with respect to several agenda items at one shareholder meeting or the same matter at different companies – fall outside of the scope of "concert party" (Shearman & Sterling, 2009). At the same time, the Act has expanded the term to include actions among shareholders outside of shareholder meetings, in particular the pursuit of a common strategy to "substantially" or "permanently" alter the strategic direction of an investee company.

It is important for the authorities to clarify the scope of "concert party" rules (e.g., takeover rules, beneficial ownership filing requirements, market abuse restrictions) in order to facilitate investor cooperation on corporate governance matters at investee companies.

7.5 Establishing an effective framework for proxy advice

85. To assist shareholders to exercise their voting rights, Principle V.F states that "*the corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice*. Rating agencies clearly have failed in providing reliable and conflict free ratings on financial products and this issue is now being dealt with (*Corporate Governance Lessons from the Financial Crisis*). At a more profound level there are questions more generally about whether the "issuer pays" model is viable.

86. More recently questions have started to be raised about the influence of proxy advisors with many companies fearing "tick the box" advice with investors avoiding their "responsibilities". In Australia, North America and Western Europe, large institutional investors (which tend to have large portfolios but limited resources devoted to proxy voting) are highly reliant on proxy advisors. While some institutional investors employ proxy voting research to identify contentious issues efficiently, others adhere strictly to the recommendations of proxy advisers, particularly for companies in which they have smaller stakes and foreign holdings. Proxy advisers also derive their considerable influence from their role in developing and implementing voting guidelines for institutional investors. A recently published American Bar Association report noted that "with some exceptions, mutual funds tend not to invest significant monies in their analysis of corporate governance issues... the result is that some mutual funds defer to proxy advisors to determine how to vote their shares and focus their resources on determining when to buy, hold and exit" (American Bar Association, 2009). Given the influence of proxy advisers, attention therefore turns to the quality of their voting recommendations, which – discussions with institutional investors reveal – can vary significantly by company and by market. Concerns have also surfaced that the market for global proxy voting advisory services in North America and Western Europe has become highly concentrated, with the growing dominance of one firm through acquisitions and organic growth. Moreover, there is the issue of conflicts of interest arising from proxy advisors that serve both corporate and institutional investor clients.

The authorities should ensure a competitive market for proxy advisory services and monitor the management of conflicts of interest by advisors, notably the contemporaneous provision of services to investors and companies.

7.6 Improving the contribution of foreign investors

87. Principle III.A.4 stresses that "impediments to cross border voting should be eliminated" while Principle III.A.5 notes that "processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes". Effective implementation, however, leaves a great deal to be desired. Moreover, increased international diversification appears to have reduced the level of commitment by institutional investors in a given jurisdiction.

88. Due to continued portfolio diversification overseas, equity holdings by foreign investors have risen dramatically in recent years. In Germany, the holdings of foreigners have jumped from 20% in 2005 to 52.6% in 2007 in DAX 30 companies (DW Online, 2007). In the UK, foreigners owned 16% of the stock market in 1994; in 2006, this figure rose to 41% (Office of National Statistics, 2007). In the Netherlands, non-Dutch investors own 85% of the shares in the AEX 25 index (Manifest, 2007).

89. Yet, empirical findings show that in many markets foreign shareholders vote a smaller portion of their holdings than domestic investors. In Finland, for example, only 18.5% of the shares owned by foreign investors participated in shareholder meetings, compared to 54% for domestic shareholders (European Commission, 2006). While the failure of foreign investors to exercise their voting rights is partly attributed to shareholder passivity, voting obstacles such as share blocking and cumbersome powers of attorney requirements also play a part. For example, one London-based institutional investor spent nearly one year to put in place voting arrangements for its holdings in a Nordic country. In some cases, elimination of voting obstacles in the law has not cascaded down the voting chain. In the Netherlands, legislators had eliminated share blocking as a legal requirement but some custodians continued to demand the deposit of shares prior to voting.

90. At the same time, there are continuing problems with respect to the quality and timeliness of information disclosure by issuers (which is especially disruptive when translation is required) and short

custodian deadlines for voting. In Japan, the concentration of shareholder meetings in late June means that domestic and foreign investors alike are denied an opportunity to meaningfully exercise their votes. One Tokyo-based institutional investor, for instance, is able to actively evaluate only 30% of the shareholder meetings occurring that month. The annotations for Principle III.A.5, which urge *"companies to remove artificial barriers to participation in general meetings,"* should be expanded to include intermediaries such as custodians.

91. In terms of on-going dialogue (engagement) with companies, the lack of familiarity with local practices appears to have hampered foreign investor participation. For instance, although Americans are significant portfolio investors in the UK, many US institutional investors – due in part to differences in regulatory frameworks and commercial practices – are reluctant to follow the active engagement approach that their British counterparts employ with investee companies. Similarly, foreign investors are less likely to sit on the nomination committees of Swedish companies, even where they are among the largest shareholders. Given their substantial and growing holdings, encouraging foreign shareholders to engage in on-going dialogue with investee companies is essential, especially in markets that rely on shareholders to monitor issuers' compliance with a "comply or explain" code.[7] Private sector solutions offer a way forward. For example, in the Netherlands, the institutional shareholder association Eumedion has opened its membership to non-Dutch institutional investors. The code of corporate governance also aims to reduce share blocking by considering the use of a record date as good practice but some custodians continue to demand the deposit of share prior to voting. On the basis of an EU directive share blocking is to be prohibited for listed companies. In the UK, the Walker Report (2009) urges the Financial Reporting Council and major UK institutional investors to "invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds," to participate more actively in engagement activities. This raises the potential importance of the observation above calling for regulatory clarification of shareholders cooperating with each other in corporate governance and voting matters.

7.7 Enforcing shareholders rights

92. The above has focussed on shareholders themselves and the exercise of their rights. In deep capital markets where institutional shareholders are important this emphasis is appropriate. However, there are also many companies and jurisdictions where the question is more about shareholder rights and the ability to enforce them, in many cases against controlling shareholders. The issue of enforcement and redress is dealt with by the above conclusions and is dealt with at length in the Methodology. While it remains a serious issue for many jurisdictions further more detailed recommendations are not warranted for the purpose of this Report.

[7] The corollary of increased foreign portfolio investment is that domestic institutions in many OECD countries account for a decreasing portion of equity ownership. In the UK, the percentage of shares held by UK pension funds and insurance companies declined from 52% in 1990 to 27% in 2006 (Walker, 2009). In the Netherlands, Dutch investors own only 15% of the shares in the AEX 25 index. UK institutional investors worry that, with decreasing aggregate holdings in UK equities, their influence over UK companies – including with respect to adherence with the Combined Code – has waned.

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