Using the OECD Principles of Corporate Governance

A BOARDROOM PERSPECTIVE

OECD

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original Member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became Members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971), New Zealand (29th May 1973), Mexico (18th May 1994), the Czech Republic (21st December 1995), Hungary (7th May 1996), Poland (22nd November 1996), Korea (12th December 1996) and Slovak Republic (14th December 2000). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

Foreword

During the last decade, the OECD has taken the lead among international organisations to promote good corporate governance. The OECD Principles of Corporate Governance *has become the global benchmark, accepted in OECD and non-OECD countries alike. These accomplishments are the result of a close partnership with the business community and other stakeholders. Their advice was not only essential to the development of the OECD Principles; they have also put them to active use and supported their implementation around the globe.*

We have therefore called on a group of business leaders to give their perspective on how to apply the OECD Principles -- in the boardroom. Corporate boards will face a diversity of situations and challenges. We wanted to learn about real stories that can provide guidance and advice to those vested with the responsibility of running an efficient board.

The report clearly states the relevance of the fundamental principles laid down by the OECD, and it also highlights some of the key qualities required from individuals. It is unique in the sense that it provides practitioners with concrete examples of how important these qualities can be when applying the OECD Principles. I am sure that this will provide an invaluable source of information and inspiration.

This work would not have been possible without the pro bono *participation of the private sector. In particular I would like to thank Ira Millstein who has been the undisputed driver. Not only has he convened and chaired an outstanding group but, together with Anne Simpson, he personally carried out the interviews on which the report rests with an open mind, often challenging both received wisdoms and his own thinking in the process. I also compliment his fellow members of the business sector advisory group for their critical contributions and for sharing their extensive networks in a generous and inclusive way.*

Finally, I want to thank all those practitioners who have made themselves available for the numerous interviews and discussions on which this report rests. They have all taken time out of busy schedules to candidly share their experiences for the benefit of others.

This is a report of immediate practical use and I strongly recommend it to corporate governance practitioners around the world. Current developments show that the need for flexibility and responsiveness of practitioners can only grow. The OECD's lasting partnership with the private sector will continue to evolve with the aim to promote effective corporate governance.

Angel Gurría
OECD Secretary-General

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Note to Reader

Dear Reader,

This introductory letter is intended to explain the origins of this project and what we hope to achieve through its publication. The work stems from a unique initiative in which business leaders from around the world provided personal insights into what really matters in the boardroom – not in theory, or in principle, but in practice, as distilled from their own experience.

The *OECD Principles of Corporate Governance* ("*OECD Principles*", summarised below) have attracted broad support across major markets worldwide and are regarded by many as embodying the international benchmark for corporate governance. Chapter VI of the *OECD Principles – The Responsibilities of the Board* sets forth a generic framework for best practice in the boardroom.

Chapter VI of the *OECD Principles – The Responsibilities of the Board* is underpinned by the notion that the board directs the affairs of the company. The concept on paper is sound. We wanted to find out what happens in practice, in the imperfect world beyond compliance with guidelines. To that end, we contacted chairpersons, CEOs, directors, general counsels, corporate secretaries and other practitioners from different sectors, regions, corporations and business cultures (including Brazil, Canada, China, France, Germany, Hong Kong, India, the Philippines, Russia, Slovenia, Thailand, the United Kingdom and the United States). The list of contributors is included below. The majority of the interviews were conducted in person and the remainder by teleconference, by Anne Simpson (Executive Director of the International Corporate Governance Network) or me or both of us. Weil, Gotshal & Manges LLP associate, Rebecca Grapsas, acted as scribe and editor of the commentary. Members of the OECD Boardroom Guide Advisory Group also made valuable contributions.

During each interview, we asked contributors to provide their personal reflections upon what Chapter VI of the *OECD Principles – The Responsibilities of the Board* actually requires from a director. We encouraged them to share their thoughts about what they believe are the key challenges faced by directors where the law ends and individual discretion begins, and how they managed the challenges. A number of strong, common themes emerged from the interviews and we found that our own thinking was challenged in various ways.

The first theme that emerged was the importance of judgement. This is the antithesis of – or perhaps the antidote to – "box ticking", or the formulaic compliance with standards which has dogged the corporate governance debate. Regardless of the board's form, structure or process, we came to understand better that for the corporate governance system to work, directors must possess two fundamental qualities – integrity and diplomacy. Integrity, judgement and the conviction to do the right thing are vital, particularly when navigating complex and uncertain territory. As one of the contributors said, "it takes courage." We have yet to see "courage" as one of the essential qualities in a code of conduct – perhaps it should be included, along with a warning that the faint-hearted need not apply.

Diplomacy is also essential – no matter how brilliant and brave a director may be, the director will not be effective if he or she cannot communicate, persuade and bring others along or perhaps, where appropriate, judge the pace of change, and as one put it "know when to stake your reputation on the issue and resign if necessary." Some contributors highlighted the need to plan an active strategy in relation to difficult issues like weak governments, corrupt business environments and controlling shareholders with their own agendas for either family or the state. Determining what a director's scope of action should be, how to garner support from shareholders, where to build alliances in the community and how to rally other directors behind any reform effort – this constitutes the day-to-day work of directors in most markets.

The final theme emphasised that strong board leadership is critical to ensuring that a board can work effectively as a team while drawing on each director's skills and qualities. The board leader may play the role of team coach at times, pushing for improvement and motivating the group. At other times, a more appropriate metaphor may be that of an orchestra conductor, who is responsible for ensuring a harmonious interplay of skills and experience. The board leader is ultimately responsible for evaluating performance, and giving honest and perhaps at times even painful feedback. Directors who have undergone the process of overhauling a failed board know all too well the determination that is required and the difficult decisions that such a situation presents.

Equally important to these overarching themes are the micro-level experiences that were related to us by the contributors, who candidly described methods of managing particular challenges in dealing with the generic *OECD Principles*.

The comments provided by the contributors have been organised as vignettes illustrating complex points, or illuminating areas which have so far been little explored. We grouped the comments that we found helpful, or challenging to received wisdom, around the issues addressed by Chapter VI of the *OECD Principles – The Responsibilities of the Board*. Many of them may be grouped under the themes of judgement, integrity, diplomacy and leadership discussed above.

All experiences were based on actual companies and events. In order, however, to avoid any potentially embarrassing or inappropriate disclosures, the quotations contained in this document are often framed in terms of "advice" to the reader. We emphasise that the "advice" is based on actual experience.

We see this project as the beginning of a process in which the business community is requested to provide insights into what does and what does not work. We hope that this work becomes a source of new thinking and corporate governance advice. If we gather experiences from those who are on the ground and living inside the ideas that others only write about, then corporate governance reform will continue to generate real traction.

We welcome any comments, both from those with experiences to contribute and those who disagree. We look forward to hearing from you.

Ira M. Millstein
Chair, OECD Boardroom Guide Advisory Group

ACKNOWLEDGEMENTS

Sincere thanks to the team at Weil, Gotshal and Manges LLP, for their hard work, expertise and motivation – without them, this project would not have been possible: Ira M. Millstein, for his vision, tenacity and unwavering belief in the project; Holly J. Gregory, who set the project on course from its inception and guided it towards completion; Rebecca C. Grapsas, who participated in each interview, drafted the vignettes and organized the finished product; Lyn F. Fay, who provided editorial input and coordinated with contributors across the globe; and Geraldine Lynch and Diane Connell, for managing everything in between, including document editing, mailings, proofreading and travel arrangements. Last but not least, Mats Isaksson Head of the Corporate Affairs Division at the OECD who had an essential role in shaping and launching this work. He and his team have served as an invaluable link between the Business Sector Advisory Group and the OECD Steering Group on Corporate Governance to which this report was submitted.

Introduction

In October 2004, OECD Member countries invited a Business Sector Group on Boardroom Practices to promote the use of the *OECD Principles* among board members. The initiative reflects the importance that the OECD attaches to the private sector as a leading factor in implementing good corporate governance.

The purpose of the project was not to write a new code or checklist of what the board of directors should do. There are already a multitude of documents that purport to achieve that purpose. Instead, the work started from the premise that the *OECD Principles* already comprise those regulatory provisions and generic principles which underlie good corporate governance. The intention was to illuminate how the aspirations of the *OECD Principles* can be practically achieved in different regulatory, economic and cultural contexts, within which directors face similar challenges – many of which cannot be easily overcome.

The experiences of directors and practitioners in using the *OECD Principles* in a world that is necessarily characterised by incomplete law are of particular importance. How do board members, in performing their everyday functions, fill the gaps that laws, regulations and guidelines cannot, and should not, fill?

It is hoped that the experiences provided in this volume will be useful guidance with respect to how directors can discharge their responsibilities. The experiences provided worked well under different circumstances, during different stages of corporate life and in the context of different regulatory environments. In addition, we believe that the experiences shared in this document can influence boardroom guidelines and best practices that build on the *OECD Principles*; and can influence director conduct and director training curricula, contributing to improvement in board practices across the world.

This document is structured around the text of Chapter VI of the *OECD Principles – The Responsibilities of the Board*. To facilitate the reading of the document, Chapter VI's overarching Principle appears in ***bold italics*** and the sub-principles appear in **bold**. The annotations to the Principle and sub-principles (as published in the *OECD Principles*) appear in plain text and the experiences of the contributors are presented in boxes in *italics*.

In addition to this document, directors of state-owned companies are encouraged to consult the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (2005), as the difficulties inherent in responding to boardroom challenges may be amplified in the state-owned enterprises context.

Composition of the OECD Boardroom Guide Advisory Group

Chair:	**Mr. Ira M. Millstein,** Senior Partner Weil, Gotshal & Manges LLP, USA
Vice Chair:	**Mme Dominique de La Garanderie,** Partner La Garanderie & Associés, France
Vice Chair:	**Mr. Peter Dey,** Chairman Paradigm Capital Inc., Canada
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Chapter 1

Strategic Guidance, Monitoring of Management, and the Board's Accountability

OECD Principle VI: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Annotation to OECD Principle VI:

Board structures and procedures vary both within and among OECD countries. Some countries have two-tier boards that separate the supervisory function and the management function into different bodies. Such systems typically have a "supervisory board" composed of non-executive board members and a "management board" composed entirely of executives. Other countries have "unitary" boards, which bring together executive and non-executive board members. In some countries there is also an additional statutory body for audit purposes. The OECD Principles *are intended to be sufficiently general to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management.*

Choosing between a unitary board and a two-tier board:

"Some countries allow a choice between a unitary board and a two-tier board structure. In making this decision, the board should consider what is best for that particular company. For example, a unitary board may be more suitable if investors of the company understand the unitary board system better. Whichever system is adopted, the board should ensure that it explains the structure to investors so that they can understand and appreciate how the system works and how the board sees its role."

Dr. Roland Koestler

Combining a unitary board with a two-tier board:

"Some companies have major operations in countries requiring a unitary board as well as in countries that mandate a two-tier board – in such cases, it may be possible to structure the company in a way that incorporates features of both systems. For example, a company may have two holding companies (one in each country) and two boards of directors that operate as one and are comprised of people who are directors of both holding companies. The two holding companies may enter into agreements to equalise the rights of shareholders of both companies with respect to dividends, voting and liquidation, and may also guarantee each other's borrowings. In addition, shareholder resolutions passed at one holding company may be made conditional on approval at the other holding company, such as director elections. A separate proxy statement is issued for each annual meeting, while it may be possible to produce a combined annual report, provided both sets of regulators agree that the contents satisfy all applicable regulatory requirements.

Other companies may instead interpose a holding company with one board of directors beneath the two ultimate holding companies, with shareholders owning shares in the holding company."

Alison Dillon

Annotation to OECD Principle VI:

Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. In order for boards to effectively fulfil their responsibilities they must be able to exercise objective and independent judgement. Another important board responsibility is to oversee systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws. In some countries, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable.

Board mandate:

"The board should develop a list of board responsibilities so there is clarity as to what is the responsibility of the board and what is the responsibility of management. Developing such a list is a useful way of ensuring that everyone understands their role and is not stepping on anyone's toes, and that there are no surprises."

Jack Krol

"The board should be responsible for those tasks that are unique to the board. These tasks should be clearly stated as being the responsibility of the board. Such tasks may include selecting and evaluating the CEO, ensuring that the company's strategy is relevant and appropriate, monitoring strategic risk management by the CEO and ensuring that any limitations on delegation to the CEO are in place and functioning. For example, the board may establish an ethics committee to ensure that particular internal controls limiting executive behaviour are effective.

At some companies, the board is required to make operational decisions such as capital expenditures, where the amount involved crosses a certain materiality threshold. At other companies, the board does not get involved in any capital expenditure decisions, no matter how large the amount, unless specifically requested by the CEO – in such cases, the board assumes that management has conducted the financial analysis correctly and board consideration of the issue would add no value. Such boards may instead require decisions with non-financial implications to be brought to its attention, such as issues relating to employment, health and safety, the environment and/or the company's reputation."

Anonymous Contributor

"The board mandate should be clear and in writing. For example, it may stipulate that the board is one group sharing common objectives that reviews how the business is run – but does not run the business itself – by:

- *Agreeing on the strategic framework and keeping it under vigorous review;*
- *Monitoring the implementation of strategy through the operational plans;*
- *Focusing on long-term sustainable value creation;*
- *Safeguarding the longer-term values of the company, which include the brand and corporate reputation;*
- *Overseeing the quality of management and how it is maintained at world class levels;*
- *Maintaining a governance framework that facilitates substance and not merely form; and*

The overriding theme of the board should be profitable growth within an acceptable risk profile."

Niall FitzGerald

"The board's role can be visualised in three dimensions: first, a contributing dimension, where directors bring to bear their expertise and experience to enhance the company's wealth-creating capabilities; second, a counselling dimension, where directors counsel on the approaches the CEO plans to adopt with respect to specific initiatives, so that the wealth-creating processes are smooth and within the company's values; and third, the controlling dimension, where the board exercises its surveillance functions to ensure created wealth passes through to the rightful claimants without undue leakage."

Dr. N. Balasubramanian

Board mandate in controlled companies:

"In a controlled company, the board should discuss the list of board responsibilities with the dominant owner and negotiate with the owner where required to obtain his or her agreement."

Jack Krol

"The board of a family-controlled company that is in transition to becoming a public company should beware the temptation to continue former management habits such as discussing issues at a level that is overly detailed for a company with separate ownership and control. Board involvement with issues that are properly within the province of management results in inefficient board processes and requires devotion of an excessive amount of meeting time. Instead, the board should structure its agenda at the outset to ensure that it focuses on issues such as strategic planning and risk management."

José Monforte

An example of the line between oversight and management – consumer advertising:

"Directors are often fascinated by consumer advertising – it is a subject on which everyone is expert! It would however be fatal to allow directors any say whatsoever in the execution of advertising. That is a management function. There is however a policy aspect to advertising which is a proper matter for the board to discuss and on which to rule, because advertising is part of the public face of a company and has consequences for the way in which the company is perceived by the community. Therefore, the board needs to be aware of the advertising going out in the name of the company and is entitled to take a view as to whether that advertising is in keeping with the standards of the company. Advertising policy is a matter for the board, while advertising execution is the responsibility of management. The line between policy and execution is not always easy to draw in practice but it is the duty of the chair to protect management from board interference in matters delegated to management."

Adrian Cadbury

"Consumer advertising policy can sometimes be the responsibility of the board, because of its potential impact on the reputation of the company. Advertising products overseas may require extra attention, as what is acceptable in one country may be viewed as offensive in another."

Ira M. Millstein

Annotation to OECD Principle VI:

The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context.

Social responsibility:

"Companies should be aware that what seems to be a straightforward approach to a social responsibility issue may have unintended consequences. For example, one company may tackle the issue of child labour by switching from a supplier that uses child labour to a supplier that does not; however, such a switch can leave destitute those children who no longer have work. In contrast, another company may choose to employ children and provide them with regulated wages, schooling and reasonable working hours and conditions."

Adrian Cadbury

"At some companies, social responsibility is integrated into the company's business and is included in management's list of strategic goals. At other companies, social responsibility may roll alongside – but not feed into – the business, and it may be the responsibility of a designated manager. Either way, companies should strive to make social responsibility part of the corporate culture from the very beginning. It is more difficult for companies to create a culture of responsibility down the track."

Alison Dillon

Social responsibility and relations with shareholders:

"Social responsibility issues, in particular, fair competition and the environment, are important to each company's long-range value and should be discussed on a regular basis with shareholders. There should be greater focus on avoiding future problems, and less looking backwards to find problems that occurred in the past. In addition, shareholders should understand that they have a key role to play in supporting social responsibility initiatives, which should in turn positively impact the value of their portfolios in the long-term."

Sir Mark Moody-Stuart

Social responsibility and philanthropy:

"Social responsibility and philanthropy are two different things, although both can result in reputational benefits to a company as well as social benefits to the community. For example, social responsibility encompasses corporate efforts to reduce emissions or energy intake in the operation of the company, while philanthropy relates to humanitarian, educational, scientific or other causes supported by the company."

Laura Cha

"The board should ensure that it consults with shareholders and employees of the company as well as relevant stakeholders with respect to philanthropic initiatives. Corporate philanthropy should, as far as practicable, be somewhat related to the company's present and future business interests. If not, it may be preferable to allow individual shareholders and stakeholders to choose their own beneficiaries according to their personal beliefs and convictions."

Dr. N. Balasubramanian

Operating in developing countries and mature markets:

"Before attempting to do business in a developing country, the company should determine whether it is permitted to do the scope of business it wants to do in that country, as some developing countries impose narrow limits on corporate activity. For example, a company in a developing country may be permitted to build a plant in only one place to ensure job creation in that region or make only one particular product.

If a company is directed by a government body to do something it does not like, it should avoid doing it. For example, if a company is only permitted to build a factory in a region where there is corruption, destruction of property and/or violence against the company's employees, the company should consider whether to cancel its plan to build that factory or build it in another country."

Jack Krol

"A company should not assume that it can afford to relax compliance and monitoring standards when operating in a sophisticated market. A company that focuses heavily on safety and compliance with respect to its operations in developing countries (such as through the use of monitors) should also ensure that it pays attention to its operations in mature markets. For example, a company that does not take seriously safety and financial controls in developed markets, on the assumption that developed markets have adequate regulations, may discover the hard way that the market does not – such a company may find itself facing myriad operational and reputational issues when problems arise such as allegations of bribery or an exploding factory."

Anonymous Contributor

Operating in countries with weak government[1]:

"A company that wishes to operate successfully over the long-term in a country with weak government should ensure that there is a perceived benefit from the presence of the company in that country. The company's operations should benefit the central government (through taxation) and local communities (through employment, training and the supply chain). Facilitating operations from which these benefits flow may be helpful to a government seeking re-election, which may in turn assist companies to win government contracts at the expense of competitors offering corrupt upfront payments to government officials but whose operations may not be as beneficial to the electorate. Companies should understand that operating in a country that is essentially corrupt is not always an unwinnable battle, because not every person in a corrupt country will be corrupt and companies may attract support by refusing to engage in corrupt behaviour.

Companies should also strive to mitigate, eliminate or compensate for any negative impacts that may flow from operations. For example, a company operating in a country where conditions necessitate the presence of armed forces on company premises should take steps to reduce the risk of security abuses by providing training that emphasises human rights and safety.

Companies operating in countries with weak government sometimes face widespread corruption, human rights abuses, security problems and other issues. A practical method of counteracting a specific issue may be to form a coalition with other companies, shareholders, non-governmental organisations and governments – including the government of the host country, where possible – to exchange experiences and develop potential long-term solutions to the issue. Coalitions should start with solutions that are voluntary and work towards gradually building sound legislation that will be effectively implemented and enforced. Governments are usually more likely to view coalition efforts at reform more favourably than those of an individual corporation, which may be viewed as seeking reform to further its own particular interests.

For example, various coalitions around the world have developed voluntary principles relating to corruption, human rights, labour conditions, security and the environment, and encourage disclosure by companies with respect to adherence to the principles (for example, in sustainability reports that are distributed to shareholders). Some coalitions also assess the extent to which companies and/or countries comply with voluntary principles and publish these assessments."

Sir Mark Moody-Stuart

1 The *OECD Risk Awareness Tool for Multi-National Enterprises in Weak Governance Zones* offers guidance to companies operating in countries where public authorities are unable and unwilling to assume their responsibilities.

The "baseline" of compliance:

"Compliance with laws and regulations will not guarantee success, but should be the baseline for companies to adhere to. Some companies think they are being clever by superficially complying with laws and regulations, but this can lead to complications, particularly where things go wrong."

Anonymous Contributor

Political donations:

"Companies may make political donations where appropriate, provided donations are disclosed and/or approved by shareholders as required. For example, a company operating in a fledgling democracy with little resources may wish to support the democratic process by providing political donations to both the government and opposition parties in equal amounts. Political donations should be treated with caution, as they may give rise to expectations that a company will continue to make donations in the future."

Sir Mark Moody-Stuart

Chapter 2

Acting in the Interests of the Company and the Shareholders

OECD Principle VI.A: Directors 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.

Annotation to OECD Principle VI.A:

In some countries, the board is legally required to act in the interest of the company, taking into account the interests of shareholders, employees, and the public good. Acting in the best interest of the company should not permit management to become entrenched.

This principle states the two key elements of the fiduciary duty of board members: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. In some jurisdictions there is a standard of reference which is the behaviour that a reasonably prudent person would exercise in similar circumstances. In nearly all jurisdictions, the duty of care does not extend to errors of business judgement so long as board members are not grossly negligent and a decision is made with due diligence etc. The principle calls for board members to act on a fully informed basis. Good practice takes this to mean that they should be satisfied that key corporate information and compliance systems are fundamentally sound and underpin the key monitoring role of the board advocated by the OECD Principles*. In many jurisdictions this meaning is already considered an element of the duty of care, while in others it is required by securities regulation, accounting standards etc.*

The duty of loyalty is of central importance, since it underpins effective implementation of other principles in this document relating to, for example, the equitable treatment of shareholders, monitoring of related party transactions and the establishment of remuneration policy for key executives and board members. It is also a key principle for board members who are working within the structure of a group of companies: even though a company might be controlled by another enterprise, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group.

The risk of "analysis paralysis":

"Requiring directors to be 'fully-informed' may be misleading, because it is not possible for directors to undertake all of the analysis that may be possible – this may lead to 'analysis paralysis.' It is the role of management to fully analyse information, while the role of the director is to ask questions and seek second and third opinions where required before making a decision. For example, the directors of a company with a chequered history asked so many questions of management on every decision that was brought to the board that the number of agenda items quadrupled and the board became dysfunctional."

Charnchai Charuvastr

Duty of care in the context of the sale of a company:

"If the board has made a judgement that the sale of the company is in the best interests of all of the shareholders, the board should first obtain a view independent of management as to the value of the company and should utilise a sale method or process designed to generate the most value for shareholders. Management's view as to the value of the company will be relevant and management will work closely with outside advisors to execute the sale process."

Peter Dey

The duty of loyalty and competition:

"Directors owe an undivided loyalty to the company that requires that they consider only what is in the best interests of the company in making decisions. Problems related to a director's loyalty usually arise from a director's particular interest in a decision before the board, for example as a party to a particular transaction, as a supplier or customer of the company, or even as a family member of a person having business or employment relationships with the company. These kinds of conflicts can often be addressed through disclosure of the conflict to the rest of the board followed by special care to isolate the

director from the decision-making process and sensitive information related to the matter. It is more difficult to address the fundamental conflicts that arise when a director also serves as an employee, director, consultant or advisor of a competitor. If the competition between the two companies is meaningful (not de minimus), ending the conflict may be necessary. Even aside from antitrust concerns, the director may need to either end the relationship with the competitor or step down from the board since there is no way to 'serve two masters.' Avoidance of these kind of significant and on-going conflicts at the outset is important, and that is why companies often set forth in a code of conduct or board policy the requirement that directors not enter into relationships with competitors of the company."

Holly J. Gregory

OECD Principle VI.B: Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

Annotation to OECD Principle VI.B:

In carrying out its duties, the board should not be viewed, or act, as an assembly of individual representatives for various constituencies. While specific board members may indeed be nominated or elected by certain shareholders (and sometimes contested by others) it is an important feature of the board's work that board members when they assume their responsibilities carry out their duties in an even-handed manner with respect to all shareholders. This principle is particularly important to establish in the presence of controlling shareholders that de facto *may be able to select all board members.*

Director responsibilities in state-owned enterprises:

"All directors have the same responsibilities and are required to act in the best interests of the corporation. The board is not a parliament comprised of directors representing different interests. In a state-owned enterprise, the "best interests of the corporation" should extend to any public interest the state is executing through the state-owned enterprise."

Peter Dey

"The state is different to other types of shareholders because it has an interest other than a return on shares. The state may have policy objectives that it wishes to achieve through the vehicle of a state-owned enterprise, for example, increasing employment or locating businesses in undeveloped regions. State policy objectives should be explicitly acknowledged in the boardroom, along with the obligation of directors to meet those policy objectives before pursuing profits – this is critical particularly where those policy objectives are not consistent with profitability. This is preferable to viewing the board as a political forum of people representing different views, which could result in investors discounting the shares because of a lack of knowledge about the company's real objectives."

Jonathan Koppell

Ownership responsibilities in state-owned enterprises:

"Each state should view its holdings in state-owned enterprises as investments rather than political tools. With ownership comes responsibility, and in many countries, central institutions with the competence to fulfil those responsibilities may need to be established."

Lars Johan Cederlund

Privatisation and the evolution of the board:

"Following privatisation, companies may inherit blocks of shareholders with different backgrounds and interests (such as strategic operators, institutional investors and financial investors). This can lead to boards being populated by members who are driven by their own special interests rather than the best interests of the corporation – this is not a sustainable situation and may drive down the value of the company. Companies seeking to privatise should ensure that robust governance requirements are in place, for example, by including commitments on the part of each party that wishes to buy shares in the privatised company or through listing standards of the relevant exchange."

José Monforte

"In some countries, privatisation of state-owned enterprises resulted in widely dispersed ownership structures, as shares in many companies were parcelled out to citizens and/or employees. Over time, ownership became more consolidated as people sold their shares to entrepreneurs and investment funds. These shareholders began demanding representation on boards that were traditionally populated by friends of the CEO. Some CEOs resisted these efforts initially, preferring instead to rely on the support of employees (who were considered to be natural allies of the CEO). This changed over time however, when CEOs realised the importance of investor support."

Leonardo Peklar

Chapter 3

Ethical Standards and the Interests of Stakeholders

OECD Principle VI.C: The board should apply high ethical standards. It should take into account the interests of stakeholders.

Annotation to OECD Principle VI.C:

The board has a key role in setting the ethical tone of a company, not only by its own actions, but also in appointing and overseeing key executives and consequently the management in general. High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only in day-to-day operations but also with respect to longer term commitments. To make the objectives of the board clear and operational, many companies have found it useful to develop company codes of conduct based on, inter alia, professional standards and sometimes broader codes of behaviour. The latter might include a voluntary commitment by the company (including its subsidiaries) to comply with the OECD Guidelines for Multinational Enterprises which reflect all four principles contained in the ILO Declaration on Fundamental Labour Rights.

"Tone at the top":

"Establishing a common operating philosophy of ethics and values in business, across cultures, geographies, and the business value-chain is one of the toughest challenges for the board and top management. The board should begin by adopting a set of values to guide the functioning of the corporation, and articulating them throughout all levels of the organisation, for example, through company-wide speeches by the CEO and/or directors, and company training programmes. The message should be communicated strongly that decisions should be made in accordance with the value framework and that breaches will be penalised appropriately. Recruitment processes should focus on ensuring that employees embody the values of the company."

Dr. N. Balasubramanian

"'Tone at the top' is like a tuning fork – values vibrate from top to bottom and from bottom to top within an organization. As part of its responsibility for the 'tone at the top,' the board should ask, 'What is the organization's pure note and when are people within the organization in tune?' The board should query where momentum is generated with respect to 'tone at the top,' who determines the values of the company, how those value systems are presented and received, and whether they form part of the company's policy governing its business dealings."

Dominique de La Garanderie

Annotation to OECD Principle VI.C:

Company-wide codes serve as a standard for conduct by both the board and key executives, setting the framework for the exercise of judgement in dealing with varying and often conflicting constituencies. At a minimum, the ethical code should set clear limits on the pursuit of private interests, including dealings in the shares of the company. An overall framework for ethical conduct goes beyond compliance with the law, which should always be a fundamental requirement.

Codes of conduct and ethics in international companies:

"International companies, particularly those operating in developing countries, should ensure that they have a code of ethics that is strictly enforced throughout all areas of the company. For example, if a company discovers that management of a subsidiary is engaged in unethical conduct (such as attempting to influence customers by providing extravagant gifts or paying salaries to people with relatives working at customers to influence business), the company should take immediate action and fire people where required."

Jack Krol

Board communication with employees:

"Site visits by the board and direct communication between directors and employees can be an effective way of driving a message home across an organisation and ensuring that everyone is 'singing from the same hymn book.' For example, directors may wish to speak to employees about 'tone at the top' and issues the board is focused on as an oversight group, while emphasising that the CEO is in charge as the manager of the company. Directors should ensure that they communicate confidence in the management team and avoid discussing management issues with employees to minimise the risk of mixed messages."

Jack Krol

Chapter 4

Corporate Strategy, Risk Policy and Performance Objectives

OECD Principle VI.D.1: Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

Strategic oversight:

"Strategy should be regarded as a fundamental board issue. The whole board should be involved in strategic development – the executive directors should have in-depth knowledge about the company's competitive position, while non-executive directors provide an outside perspective.

For example, an outside director once asked what would be the advantages and disadvantages of concentrating company resources on confectionery and drinks, and selling the company's food business. To answer the question, management was required to determine what resources would be released by the sale of the food business and what options the company had available to it to utilise those resources. No decision was reached at the initial board meeting held to discuss the issue, but a decision was made thereafter to sell the food business and concentrate on the company's international brands. This was not an easy decision – particularly as the food business included Cadbury cocoa, one of the company's original products – however, as Sir John Harvey-Jones has said, the strategic move was required so as to 'create tomorrow's company out of today's.'"

Adrian Cadbury

"Boards should be involved in strategic development and risk oversight. However, in some developing countries, the board's role in practice has been minimal and reactive – instead, majority shareholders may consult with executives to set the strategic direction of the company and manage risk.

Boards may become more active in strategic development, risk oversight and setting the 'tone at the top' through use of the 'balanced scorecard' approach. The balanced scorecard is a technical approach that utilises the expertise of board members by connecting the broad vision and strategic direction of the company to its operational targets and outcomes.

Board involvement in strategy is useful in helping management bring the strategy down to the operating level. The board should discuss with management the types of reports management will submit to the board, and become involved in operating plans and targets – such involvement enhances oversight by enabling the board to determine whether management is effectively executing the strategy."

Jesus Estanislao

"The board may listen to presentations by outside advisors such as market researchers and consulting firms who can provide forecasts, analyses of trends, market forces and strengths, weaknesses, opportunities and threats facing the company, and alternative strategic options. These presentations may be preceded or followed by management presentations. The board can then debate strategic scenarios amongst themselves and with management, and select a strategy. The board may request management to provide it with a risk profile relating to the selected strategy and will consider how to mitigate and manage key risks."

Charnchai Charuvastr

"The role of the board is to approve overarching strategies at the company and to provide support to management in the execution of those strategies. Independent directors in particular can provide a perspective to the discussion based on their experience, technical expertise and wisdom that make a great contribution in the area of strategy.

Effective strategic oversight requires directors to be informed and engaged. Directors are required to know the basics of the company's business and must pay attention in the boardroom. Directors should invest time to understand the industry in which the company operates, how the company makes money, and should read information relating to competitors as well as industry reports prepared by analysts.

Management is responsible for initial strategic development and should present their primary and alternative strategies to the board along with their background material, competitive analysis, rationale and reasoning. This material should be sent to the board in advance to allow directors time to digest and analyse it before meeting with management. The board should thoroughly test management on its assumptions and the details of the strategy by asking many questions and should send management back to the drawing board on issues if required. For example, at some strategy reviews, 70 percent of meeting time can be spent on questions, with management presentations occupying the remainder of the time.

Strategy should be viewed as a living, breathing process and not as something the board focuses on once a year. An effective board should look at the strategic context for the board's discussions and decisions as the year progresses, regularly test assumptions underlying the strategy and monitor continuously to ensure that the company is achieving what the board thought it would be achieving. The board has the right to challenge management if progress is not proceeding as planned. If the CEO misses plan after plan but maintains to the board that he or she can turn it around, the board should ask how the CEO will make it happen, agree on a timeframe for evaluation, and how the turnaround will be funded within the strategy."

Michele Hooper

Operational performance issues in the two-tier board system:

"Operational performance issues should be discussed at the supervisory board level – not just at the management board level. Awareness of such issues is key to the board's role with respect to strategic oversight."

Red Wilson

Strategic planning and alternative options:

"The board should ask what alternative options were considered by management, but which were not presented to the board. An analogous example may be drawn from the advertising industry, where many ideas are explored internally, but few are presented."

Dr. Hans-Dietrich Winkhaus

Board decision-making and the merger process:

"The merger process may be initiated by the company or it may be initiated by a third party in either a friendly or unfriendly manner. Companies initiating the process will often publish a release stating that the company is exploring strategic alternatives, which may lead to a transaction. A third party initiative will require the board to assess the value of the initiative compared to the value implied by the company's long-term strategy. If the board rejects the initiative, it may need to engage in tactics designed to rebuff the bid. In the short term, this may involve relying on a shareholder rights plan (a 'poison pill') but ultimately it will require the support of the company's shareholders. In the merger context, it is of even greater importance than usual that the company know who its shareholders are and what their value expectations are. If the company does agree to a merger, management will receive financial advice from an advisor who will normally have an incentive to complete the merger. In these circumstances, the board may consider engaging its own advisor, who should be compensated regardless of whether the transaction is completed."

Peter Dey

Impact of short-term pressures on long-term strategy:

"Tension exists between balancing the market's short-term expectations and the long-term objectives of corporate strategy. The board should recognise that even though corporate strategy should be long-term, it has to 'pay the piper' and deliver bottom-line results and growth in the short-term. Short-term pressure can undermine the speed at which a company executes its long-term plan. For example, a board may decide that it needs to restructure a business to reduce costs over the long-term. The board may feel that the restructuring should happen as quickly as possible, but may ultimately decide to string out the restructuring over a longer period so as to reduce the impact on short-term financial results."

Jack Krol

"The board should counsel against any short-term strategic moves that may militate against the company's long-term objectives. Boards should avoid providing estimations with respect to future performance ('guidance'), as such estimations can motivate decisions to be made with a short-term focus; instead, boards should leave it to investors to ascertain for themselves what the future holds for their investments. Some companies attempt to manage any gap in expectations between short-term performance and long-term objectives through analyst briefings and media interviews."

Dr. N. Balasubramanian

Annotation to OECD Principle VI.D.1:

An area of increasing importance for boards and which is closely related to corporate strategy is risk policy. Such policy 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.

Risk management:

"Risk management is the next key board responsibility, after CEO selection and strategy. The board needs to truly understand where the company's risks lie in all areas, which may include financial risk, enterprise risk, investor risk and reputation risk. Many boards do a good job defining and monitoring risk, and determining whether to include specific risks as a board agenda item. However, risks don't always happen in isolation – the board should try to prepare for a number of risks materialising at the same time and should be on the lookout for issues that have a trickle-down effect.

For example, a board may not be prepared for a company facing issues relating to product failures and options backdating at one time (a 'perfect storm'). A similar situation could arise at any company. It is difficult for boards to anticipate every issue – 'you don't know what you don't know.' The most a board can do is pay attention to alternative risk scenarios, discuss them in depth in the boardroom, and ask questions of management."

Michele Hooper

"Boards can effectively identify and assess a company's key risks by visiting the major units of the company and discussing elements of risk with management. It is possible that some managers may not have a good idea about what risks may affect the business when the board begins the process, but the board should push to develop this understanding."

Jack Krol

"'Risk management' may include operational risk, market risk, currency risk, rising commodity prices, reputational risk and industrial health and safety risk. For example, directors wishing to analyse the industrial health and safety risk of a company may wish to visit operation sites and request reports on the company's safety records, industrial accidents as well as safety training of staff. The board acts as an extra pair of eyes for management and board requests for reports would help focus management attention."

Laura Cha

The risk of success:

"One of the greatest risks a company can face is its own success – when a company is successful and the CEO is successful, the board and management often have stars in their eyes and tend to look the other way. No one wants to be the pessimist, but the board should ensure that it is not blindsided by success, by instilling a culture of asking questions and of allowing discussion around the table."

Ira M. Millstein

"The existence of a long-term auditing relationship may also take the edge off oversight with respect to financial issues."

Anonymous Contributor

Chapter 5

Monitoring Governance Practices

OECD Principle VI.D.2: Monitoring the effectiveness of the company's governance practices and making changes as needed.

Annotation to OECD Principle VI.D.2:

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. In addition to requiring the monitoring and disclosure of corporate governance practices on a regular basis, a number of countries have moved to recommend or indeed mandate self-assessment by boards of their performance as well as performance reviews of individual board members and the CEO/Chairman.

Delegation of executive authority:

"The board should determine which powers to delegate to management and which powers to reserve to the board (in addition to any powers required to be reserved to the board by statute). For example, a board may delegate all executive power to the CEO, who will in turn have the ability to sub-delegate. At other companies, the board may delegate certain enumerated powers to the CEO and reserve the remainder for the board. In all cases, the CEO will need to ensure that any actions taken are within his or her delegation of authority."

Alison Dillon

Development and implementation of corporate governance policies:

"Each board should develop its own corporate governance policy, which should clarify the responsibilities of the board and the role of the independent director."

Charnchai Charuvastr

Shareholder intervention in governance matters:

"Shareholders should have the ability to intervene with respect to any major governance issue (such as compensation and board nominations), provided a reasonably high barrier is established with respect to such intervention. For example, the board may wish to allow shareholders access to the company's proxy where a supermajority of shareholders has voted in favour of such access. In contrast, a lower threshold, such as requiring the support of ten percent of shareholders, may result in intervention by shareholders who do not have the interests of other shareholders in mind."

Anonymous Contributor

Board guidelines and efficient board meetings:

"The chair should ensure that board meetings are run efficiently and should consider developing board guidelines with respect to meeting procedures, agenda-setting and expectations. For example, board guidelines could require that new agenda items suggested during a board meeting may only be discussed by the board if a certain number of directors support the agenda item. Such a policy may be a useful way of minimizing discussion of issues raised by directors who consistently wish to debate issues that are of interest to them but not to the rest of the board."

Leonardo Peklar

Chapter 6

Selecting Key Executives and Overseeing Succession Planning

OECD Principle VI.D.3: Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

Annotation to OECD Principle VI.D.3:

In two tier board systems the supervisory board is also responsible for appointing the management board which will normally comprise most of the key executives.

Selecting and replacing management:

"CEO selection is the board's most important role. Before selecting a CEO, the board should agree on the company's strategic direction and needs for the future, as the CEO's job is to be successful at pursuing the company's strategy.

A CEO is bound to fail if there is a mismatch between the skills, abilities and style of the CEO and where the company needs to go. Although the board may choose to overlook the CEO's pursuit of a different strategy when the company is successful, this cannot be ignored when the CEO is not successful.

For example, if a board is concerned about the company's lacklustre performance over a long period of time, the non-executive directors should discuss in 'executive session' (i.e. without senior management present) whether the incumbent CEO understands the board's concerns and is moving to address them. The board should also consider whether the company is pursuing the most effective strategy. If the CEO is pursuing a strategy that is different to the one the board wants, and is not achieving the agreed-upon results, that CEO is the wrong person for the environment the company is in and the board should move to replace him or her.

Some companies may require a CEO who steps down to also retire from the board because of power and control issues – in particular, former CEOs are often perceived to be unable to *truly step aside, to relinquish to their successors their former responsibilities and relationships with management. This can undermine the new CEO as he or she seeks to establish their position in the company. It can also foster problems with board dynamics if the former CEO tries to control the agenda rather than letting their successor do their job. Former CEOs can often make difficult directors where their former companies are concerned.*

Retirement can take place either immediately or after a short transition time. It is best if a succession plan is implemented that allows a successor candidate to join the board 6 months to 12 months prior to the retirement of the CEO. This allows the successor candidate and the board to have increased exposure to each other and the issues of the board to facilitate a smooth transition."

Michele Hooper

"When interviewing potential CEOs, the board should ask the CEO how he or she expects to work with the board. Many boards also present potential CEOs with a list of board responsibilities and see how they react."

Jack Krol

"Where two companies merge and the CEOs of the merging companies assume positions in the merged entity, it is important that those executives share a strategic vision for the merged entity. If not, the board should remove one of the executives as soon as possible."

Anonymous Contributor

"An effective working relationship between the board and the CEO is one of the keys to board effectiveness – this is often a question of chemistry and succession planning. The CEO and the board should understand each other's roles and responsibilities, and the CEO should be forthcoming with information. Maintaining a good relationship can be challenging, as the board must still be able to fire the CEO when required."

Red Wilson

Selecting and replacing management in developing countries:

"The power of the board to select and replace senior management is still conceptual and theoretical in some developing countries. In these countries, this power in fact resides with controlling shareholders, who select senior management based on professional competence and personal loyalty to the major shareholders; these choices are then 'rubber-stamped' by boards. The gap between theory and practice must be narrowed, but it will take time."

Jesus Estanislao

"Replacing the CEO is one of the board's most difficult tasks. For example, a board attempting to replace an imperial-type CEO may be rebuffed by the CEO and told that the board does not have the power to fire him or her."

Ira M. Millstein

Succession planning in family-controlled companies:

"Succession planning in companies that are controlled by families can be complicated by the fact that members of the family may have different ideas about suitable successors. The board of a family-controlled company can help streamline the process by adopting a succession planning policy that requires family members and incumbent senior executives to consider succession planning as an ongoing priority issue. The board should also adopt broader policies addressing human resources and employment of family members."

Jesus Estanislao

"At family-controlled companies, the independent directors should work with the family to develop a succession plan. This may be a gradual process. If a dominant family member is not willing to talk about succession, the independent directors should gently press the issue to develop a mechanism over time, like 'water dripping on a rock.'"

Jack Krol

"Succession planning in many family-controlled companies is primarily an issue to be resolved by the family, with minimal involvement by independent directors. In addition, in some developing countries, CEOs are often considered dispensable (this applies even to favourite sons and daughters) and succession planning is not a high priority for the board. However, succession may be accorded a higher priority at some family-controlled companies. For example, the first generation owner of a company workshopped succession ideas at a director education course he attended – he knew that other family members were not interested in running the company and wanted to consider other options well in advance of his retirement."

Charnchai Charuvastr

Selecting and replacing management in state-owned enterprises:

"The CEO of a state-owned enterprise is generally selected by the government, which may also assume responsibility for firing the CEO. It is often unclear what the role of the board is – if any – with respect to management selection and removal at a state-owned enterprise."

Claude Lamoureux

"Succession planning should occur through development of a modern enterprise system based on teamwork, rather than grooming an individual successor. This is particularly important in state-owned companies, which may experience abrupt changes to the top one or two executives in the company – depth in the management team should reduce the impact of such changes. However, developing a modern enterprise system in some developing economies can be challenging where there is a dearth of professional managers."

Anonymous Contributor

CEO selection and removal in the two-tier board system:

"In a two-tier board system, the supervisory board can make decisions with respect to CEO selection and removal, without requiring participation by the management board. Supervisory boards should have the ability to make management dismissal decisions quickly.

Conflicts can arise between employee directors and shareholder-elected directors in situations where shareholder-elected directors propose people to executive positions who are not personally known to the employee directors, for example, people recruited from outside the company. Employee directors often want to become familiar with potential managers before approving appointments – indeed, some employee directors will not make a personnel decision based purely on a curriculum vitae."

Dr. Roland Koestler

"It may be difficult for a supervisory board to remove a CEO who has the support of the employee directors on the board, even if the CEO does not have the support of the remainder of the board and the shareholders of the company. Boards that cannot replace management when required and deal effectively with unions run the risk of falling behind with respect to global competitiveness."

Red Wilson

Board familiarity with the management team:

"Senior officers should be invited to board and committee meetings where appropriate to make presentations and respond to director questions. However, the practice may be discouraged by CEOs who fear erosion of their perceived status and authority within the organisation."

Dr. N. Balasubramanian

"The board should encourage interaction with management teams outside of formal settings to increase management visibility to the board. Good relationships between boards and management are important, particularly as the board should be familiar with the management team and be comfortable with the talent coming through the organisation for succession planning purposes.

For example, a board may wish to hold a board dinner the night before each board meeting, at which one or two members of senior management give short presentations followed by informal discussions between management and the board (including questions and answers). This will permit board members to get to know high potential and senior executives through less formal discussions than can be had in the boardroom."

Michele Hooper

Evaluating the CEO:

"The board should be responsible for evaluating the CEO and should work with the CEO to develop an evaluation process. The independent board chair or lead director should drive the process. For example, the board leader could develop an evaluation form by asking each director for ideas on what a 'model CEO' should look like. The board leader may then ask each board member to list the main strengths of the company's CEO and the major areas that the CEO can improve on for his or her development. The board leader should synthesise the information gathered and use it in evaluation discussions with the CEO. The board should avoid using outside consultants to evaluate the CEO."

Jack Krol

Chapter 7

Executive and Board Remuneration

OECD Principle VI.D.4: Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

Annotation to OECD Principle VI.D.4:

In an increasing number of countries 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 longer run interests of the company over short term considerations. Policy statements generally tend to set conditions for payments to board members for extra-board activities, such as consulting. They also often specify terms to be observed by board members and key executives about holding and trading the stock of the company, and the procedures to be followed in granting and re-pricing of options. In some countries, policy also covers the payments to be made when terminating the contract of an executive.

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 either wholly or a majority of 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 interest.

Managing excessive CEO compensation:

"It is the responsibility of the board to ensure that executive compensation is reasonable and aligned with shareholder interests (for example, through the use of stock grants tied to achievement of sustainable results). Disclosure of executive compensation should be encouraged as shareholders and the media can pressure companies into reining in compensation that is viewed as excessive. However, compensation disclosure can have the unintended consequence of increasing compensation levels – no CEO wants to be at the median or in the lower quartile and a company may be required to meet those compensation demands if it wants to attract the best talent."

Niall FitzGerald

Addressing the inherent conflict in board remuneration:

"Although the board is conflicted in setting its own compensation, there is no one else who is positioned to determine board pay. Certainly management cannot decide what to pay the very board that sets its own pay and provides it with oversight. Given the inherent conflict in setting one's own pay it is important that director compensation be as transparent as possible and as simple and straightforward as possible. It is helpful to canvas what peer companies pay to ensure that compensation is not out of line and many boards turn to consultants for this information. At the same time, however, the board should avoid just going along with the crowd. The board needs to develop its own pay philosophy, and director compensation should have some relationship to the effort and attention required."

Holly J. Gregory

Compensation of the CEO/controlling shareholder:

"If the controlling shareholder of a company is also the CEO, the work of the remuneration committee may be more complicated. The CEO may decline significant compensation where he or she is satisfied with the performance of his or her shareholding. The remuneration committee should nevertheless establish a compensation system for the CEO with conventional CEO compensation objectives. The remuneration committee should understand the incentives that are driving management behaviour. CEO compensation should be determined with respect to achievement of proper incentives and should not be solely driven by the short-term market. It is important to establish the compensation of the CEO, even if the CEO is a major shareholder, because the CEO's compensation will normally establish a benchmark for compensation of other senior officers."

Peter Dey

> *"Controlling shareholders may be tempted to over-compensate executives who are members of the controlling shareholders, instead of paying dividends which would include minority shareholders. It is up to the board – and the independent directors, in particular – to ensure that executive compensation is reasonable."*
>
> Laura Cha

Chapter 8

Board Nomination and Election

OECD Principle VI.D.5:Ensuring a formal and transparent board nomination and election process.

Annotation to OECD Principle VI.D.5:

> *These* OECD Principles *promote an active role for shareholders in the nomination and election of board members. The board has an essential role to play in ensuring that this and other aspects of the nominations and election process are respected. First, while actual procedures for nomination may differ among countries, the board or a nomination committee has a special responsibility to make sure that established procedures are transparent and respected. Second, 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 improve its value-adding potential for the company. In several countries there are calls for an open search process extending to a broad range of people.*

Building a board:

"Directing an enterprise through a board is a more difficult form of governance than is commonly supposed. It is a fundamental error to regard committees of any kind as natural forms of governance or to believe that if you sit competent people of goodwill around a boardroom table, they will function as an effective board. Building an effective board takes time and patience on the part of board members, but especially on the part of their chairs. It is the chair's task to weld a group of capable individuals into an effective board team."

Adrian Cadbury

Director selection:

"The nominations process could require nominees to prepare a statement explaining why they will add value to the board."

Adrian Cadbury

"The most important prerequisites to being a good director are interpersonal skills, the ability to communicate and high personal and moral ethical standards – these skills cannot be learned. Other skills, such as technical knowledge, are also important and can be developed."

Leonardo Peklar

"Building a good board should be the work of the board, not the CEO. However, at many companies, the independent nominating committee treats the CEO as a partner in the director selection process, by involving the CEO in interviews and asking for his or her opinion about the suitability of potential directors."

Jack Krol

"Supervisory board directors are selected by the workforce or nominated for election by the shareholder-elected directors on the supervisory board. If the shareholder-elected and/or employee directors on a supervisory board feel that a board nominee may be the wrong fit for the company or is conflicted, they should question the decision to nominate that person."

Dr. Roland Koestler

"Board audit committee members must be motivated. Personally, I participate in audit committee work because I want to be connected with excellent, top-performing companies and I want to help increase investor confidence in the company and in the capital markets. As a chemist, I also enjoy scrutinizing detailed work."

Dr. Reatha Clark King

Director selection in developing countries:

"Companies in developing countries should observe best practices if they want to be competitive internationally. To that end, they should seek directors who are committed to improving the system and who can push for the changes that may be required to enhance the company's competitiveness in international markets – they should be people of integrity who are willing to make a difference. Companies can determine whether a person may be suitable by looking at his or her track record and reputation in the business community."

Jesus Estanislao

Chair and director selection at state-owned enterprises:

"At many state-owned enterprises, the government selects the chair, while internal directors are approved by the government body that supervises state-owned assets. Independent directors are selected by an independent nominating committee and approved by the full board."

Zhang Chunjiang

Employee directors and workplace relations:

"Employee directors enable the supervisory board to discuss the future of the company with the workforce directly and have the ability to bring board decisions down to the workplace quickly and smoothly. In contrast, a lack of employee involvement in board decisions can result in tension when decisions are brought to the workplace."

Dr. Roland Koestler

Deciding whether to join a board:

"Before joining a board, directors should ask two questions: first, why they are being asked to join that particular board and second, whether the board opportunity is real or just 'window-dressing.' Potential directors should ascertain whether they are being asked to join the board for diversity reasons, to satisfy regulatory requirements or because of their skills, experience and judgement. In addition, directors should satisfy themselves about the role of the board and whether its input is valued at the company, especially at controlled or family companies.

Directors should know their own skills and abilities and be comfortable that their skills are in line with what the company needs and will be valued – if a potential director feels that these factors are not aligned, he or she should decline joining the particular board as he or she will be unlikely to make a real contribution.

Boards often resemble families with each person appearing to have a particular role. Some boards also have director 'cliques.' Upon joining a board, directors should think about their role on the board and where they fit. New directors should work to establish themselves by leading with their unique skills. For example, a director with a strategic background could ask questions about how well the company analyses what its competitors are doing and how its operating structure compares to theirs. It can be difficult for new directors – particularly those in the minority – to find their voice on a board. New directors should strive to bring a different perspective to build credibility and avoid 'add-on' comments. Directors may need to work extra hard to make their mark and avoid exclusion from debates on issues that do not directly relate to their minority status.

If a new director feels uncomfortable about the culture of the board (for example, if there is a mismatch of culture between the director and the board), it may interfere with his or her effectiveness. Unfortunately, if they cannot adapt to the style or find support to change the culture, they should leave the board.

When deciding whether to join a board, directors should try to ascertain whether the director's own values align with those of the management team, the board and the company.

For example, a prospective director may value a down-to-earth lifestyle and culture, which may also indicate genuineness and integrity. Such a director may seek to gauge the values of management, the board and the company by asking the following questions:

- *Is the CEO humble? Does the CEO keep his or her role in perspective? Does the CEO view the company as his or her own ('my company'), or do they view themselves as there to be of service to the company for as long as required?*
- *Has the CEO come up through the ranks of the company? Does the CEO know what it means to work?*
- *Are executives selfless? Do they ask the board to make decisions that are in a 'grey area' and that could cause the company harm? Do executives bring their attorneys to compensation committee meetings and say they will leave the company if they don't get what they ask for?*
- *Are the executive pay scales reasonable? Do they indicate an ultimate respect for what it takes to earn a dollar?*
- *Are the perquisites and benefits at the company reasonable? Do executives use the corporate fleet appropriately?*
- *Do executives and the board appear to utilise accounting techniques that may be legal but not appropriate? Do you trust the leaders will make the right decisions?*
- *How do people talk about the company and their role (what their team does, what the company does, what the board contributes)? Is there a focus on 'I' or 'us'? What does the social atmosphere and culture of the company indicate about employee attitudes?*

Centred and selfless executives may be more likely to understand board decisions by the board to not do things a certain way, and less likely to resign."

Michele Hooper

"Some people are so flattered when asked to join a board that they accept before conducting any analysis about the board and the company – rather, the answer should be 'maybe' instead of 'yes.' Before accepting a board position, a potential director should ascertain the level of board support and commitment to governance at the company and whether there is a fit between the director and the company such that the director can make a contribution to the board. An independent director who is asked to join the board of a controlled company should also consider meeting with the chair to determine whether there are processes in place that enable the director to register a dissent in the minutes of meeting with respect to any decision he or she strongly disagrees with – if not, the director should refuse to join the board."

José Monforte

"It is sometimes suggested that directors should 'interview the company' before joining the board, but interviewing the CEO and the board can be difficult and considered impolite in some cultures."

Laura Cha

"Some directors meet with the other independent directors on the board to discuss their experiences and comfort level in how they have been able to discharge their responsibilities, as well as the outgoing director (if any) to determine whether there are any reasons for that director's departure (other than the ostensible personal reasons that are often disclosed as the reason). In addition, before joining a board, directors should ensure that they understand the ownership and control structure of the company and seek information where the ultimate ownership is unclear. If the company is not forthcoming with this information, the director should refuse to join the board."

Dr. N. Balasubramanian

"Controlled companies often wish to recruit independent directors – sometimes known as 'trophy' directors – to improve the reputation of the company. However, in controlled companies, boards are often dominated – not by an 'imperial CEO,' but rather by the 'Emperor' (the controlling shareholder).

Upon joining the board, if the director discovers that he or she cannot make a difference in reality, the director should resign from the board."

Jesus Estanislao

"A director should communicate his or her terms of reference and 'non-negotiables' – those issues of principle that may be worth resigning over – to the controlling shareholder or government upfront. Resignation is the independent director's key lever but the threat of it should be used sparingly as a director can only resign once."

Anonymous Contributor

Chapter 9

Conflicts of Interest and Related Party Transactions

OECD Principle VI.D.6: Monitoring and managing potential conflicts of interest of management, directors and shareholders, including misuse of corporate assets and abuse in related party transactions.

Annotation to OECD Principle VI.D.6:

It is an important function of the board to oversee the internal control systems covering financial reporting and the use of corporate assets and to guard against abusive related party transactions. These functions are sometimes assigned to the internal auditor which should maintain direct access to the board. Where other corporate officers are responsible such as the general counsel, it is important that they maintain similar reporting responsibilities as the internal auditor.

In fulfilling its control oversight responsibilities it is important for the board to encourage the reporting of unethical/unlawful behaviour without fear of retribution. The existence of a company code of ethics should aid this process which should be underpinned by legal protection for the individuals concerned. In a number of companies either the audit committee or an ethics committee is specified as the contact point for employees who wish to report concerns about unethical or illegal behaviour that might also compromise the integrity of financial statements.

Board approval of related party transactions:

"The board should develop a policy requiring different levels of approval of related party transactions depending on the amount involved. However, the board should not micro-manage. Related party transactions that come before the board for approval have generally already been negotiated and it may be difficult for the board to scrutinise the transaction and seek modifications."

Laura Cha

"Too many directors, when faced with a related party transaction, skip the basic question, 'Is the transaction in the best interests of the company?' Too many directors instead go immediately to the standard governance mechanisms (i.e., independent committee receiving independent advice and so on), so that the analysis simply becomes one of value rather than the best interests of the company."

Peter Dey

Related party transactions at family companies:

"Companies should ensure that clear lines are drawn with respect to the use of company assets and related party transactions. Independent directors of family companies should consider resigning where such transactions are entered into with family members that may be detrimental to the company.

For example, an independent director of a family company resigned after the board approved a long-term lease for a new luxury office building that had been built by a family member. The lease was on competitive terms and had been approved by the board and the shareholders as a related party transaction; however, the lease required a large upfront cash payment that the director felt the company could not afford to pay, given its cash position at the time, the cash-flow needs of the company and the fact that having a new office building was low on the company's list of priorities. The director resigned because he was of the view that the transaction would not be in the best interests of the company and its non-family shareholder. He was not dissuaded by the fact that no other directors resigned even though some of them expressed agreement with him in principle."

Charnchai Charuvastr

Crisis management and regaining credibility and growth in the wake of wrongdoing:

"The board should have a crisis management plan in place to ensure that the board knows who is going to do what in the event of a catastrophe at the company. As part of this plan, the board should identify who will be the company spokesman, who will deal with the financial community and who could take over the duties of the CEO if required. The board should think separately about the kinds of crises the company could encounter, for example, the death of the CEO, a factory explosion or a railcar going off the tracks.

Rebuilding a company after corporate scandal requires the board to focus first on regaining credibility in the eyes of employees, shareholders, regulators and the community – the 'save' phase. This requires the board and the CEO to agree on what needs to be done by whom and at what speed. The board is often allocated responsibility for governance processes, while the CEO is responsible for operations.

The board should begin by setting the right 'tone at the top,' by stating what the tone is and what the expectations of the board and management are. The board should work with management to develop or revise a code of ethical conduct and require every director and employee to read it and acknowledge that they are not aware of any ethical issues. The CEO and the board should publicise the code of conduct throughout the company to emphasise its importance.

For example, in the wake of wrongdoing at an international company, the board and its CEO worked to change the ethical culture at the company by encouraging a new 'tone at the top' and developing a comprehensive code of ethical conduct which set forth rules of conduct relating to harassment, conflicts of interest and fraud. The code of ethical conduct was translated into a number of languages and rolled out to thousands of company employees worldwide. The roll-out was structured to achieve maximum impact. As part of the roll-out, the CEO spoke to all employees either live or via video. The guide itself was designed to be attractive and readable, utilizing examples, cartoons and colour. The company also hired a senior executive in charge of corporate governance to show that it was serious about improving its governance and credibility, and was willing to invest real resources in it.

The CEO should also spend time with the company's major shareholders discussing issues the company faces to ensure that they are comfortable with the steps that are being taken. Major board and management changes may be required to regain credibility. For example, one company replaced its board and 97 percent of its top management as part of its renewal process.

The next phase of corporate recovery requires the board and management to focus on strategy and operations – the 'fix' phase. For example, this may require a shift away from growth through acquisitions towards growth through operations.

Once the credibility and operational issues are under control, the board should focus on growing shareholder value – the 'growth' phase.

For example, at one troubled company, the board analysed the company's structure with the help of management consultants and bankers, and decided to spin-off non-core segments of the business. The board worked through the processes necessary to split the business units apart, by ensuring that resources were available and selecting the right senior executives and new board members to populate the spun-off businesses. The board established a special committee to recruit directors to the boards of the spun-off businesses. The committee worked with a director search firm for more than six months to build the new boards, by defining the businesses, determining what skills would be required on each board and interviewing and selecting potential directors."

Jack Krol

Lessons from the Asian financial crisis of 1997:

"Before the Asian financial crisis in 1997, stock markets were booming and many companies sought public listing without appreciating the implications and responsibilities that accompany public ownership. Cash was available at low interest rates and many companies over-borrowed without justification or a strategic plan, often investing in diversified, non-core businesses. Board meetings during that period were often viewed as a nuisance or, at best, an opportunity for social gatherings between directors. Agenda items were focused on management presentations of backward-looking financial information, with few questions asked (if any). Important corporate decisions were first approved by an executive committee that was often dominated by management and controlling shareholders, and decisions were 'rubber-stamped' by the board at the end of the meeting. Independent directors were generally reluctant to raise difficult issues. For example, a director who was concerned about the level of a company's borrowings in light of signs of a weakening currency added the issue of hedging to the agenda for board consideration. The director's concern was given short shrift because it was contrary to government advice at the time and seemed too far-fetched. Two months later, the government changed and the currency and stock market crashed."

Charnchai Charuvastr

Chapter 10

The Integrity of Accounting and Financial Reporting

OECD Principle VI.D.7: Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

Annotation to OECD Principle VI.D.7:

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. One way of doing this is through an internal audit system directly reporting to the board. In some jurisdictions it is considered good practice for the internal auditors to report to an independent audit committee of the board or an equivalent body which is also responsible for managing the relationship with the external auditor, thereby allowing a coordinated response by the board. It should also be regarded as good practice for this committee, or equivalent body, to review and report to the board the most critical accounting policies which are the basis for financial reports. However, the board should retain final responsibility for ensuring the integrity of the reporting systems. Some countries have provided for the chair of the board to report on the internal control process.

Ensuring appropriate application of accounting principles:

"The board, through the audit committee, should ensure that accounting principles that are followed in preparing the company's financial statements are not just acceptable – they should also be appropriate. The audit committee should discuss with the independent and internal auditors whether any accounting decisions that have been made may warrant a more appropriate treatment and whether there have been any disagreements between the auditors and management."

Dr. N. Balasubramanian

Risk assessment systems:

"To be prudent, directors can no longer rely entirely on management to determine what issues the board considers and what information is presented for board attention. Directors should assure that systems are in place for flagging relevant and material issues. This key capability should be integrated into a company's risk assessment and internal control systems."

Ira M. Millstein

Compatibility of control systems:

"The board of any company which is an amalgam of one or more corporations should, at the outset, understand the compatibility of the control systems of the corporations that merged and should require management to convert the systems to one system on an urgent basis. The conversion process may expose differences in accounting practices which may form the basis of a financial restatement."

Peter Dey

Annotation to OECD Principle VI.D.7:

Companies are also well advised to set up internal programmes and procedures to promote compliance with applicable laws, regulations and standards, including statutes to criminalise bribery of foreign officials that are required to be enacted by the OECD Anti-bribery Convention *and measures designed to control other forms of bribery and corruption.*

Moreover, compliance must also relate to other laws and regulations such as those covering securities, competition and work and safety conditions. Such compliance programmes will also *underpin the company's ethical code. To be effective, the incentive structure of the business needs to be aligned with its ethical and professional standards so that adherence to these values is rewarded and breaches of law are met with dissuasive consequences or penalties. Compliance programmes should also extend where possible to subsidiaries.*

Oversight of state-owned enterprises in transition:

"In some developing countries, discipline committees may be utilised to oversee the transition of state-owned enterprises to public corporations to ensure that bribery does not take place. Effective oversight may also be achieved through a combination of internal control and outside audit."

Anonymous Contributor

Transparency and disclosure at state-owned enterprises:

"Transparency and disclosure are the responsibility of the board at many state-owned enterprises. The board must ensure that information is disclosed accurately and in a timely manner, in compliance with relevant law. At some state-owned enterprises, disclosure of inaccurate information is not treated as a simple mistake or error, but is treated as a violation of the business ethics of the enterprise and penalised."

Zhang Chunjiang

Chapter 11

Disclosure and Communications

OECD Principle VI.D.8: Overseeing the process of disclosure and communications.

Annotation to OECD Principle VI.D.8:

The functions and responsibilities of the board and management with respect to disclosure and communication need to be clearly established by the board. In some companies there is now an investment relations officer who reports directly to the board.

Shareholder communications:

"The board should facilitate shareholder communications with the board by providing a contact person with whom shareholders may discuss any issues. During times of change, it may be useful for the board to communicate regularly with shareholders to explain what is happening at the company. For example, shareholders of a company contemplating a merger or major joint venture may wish to meet with the board and the potential acquirer or joint venture partner to discuss the proposed strategy for the company should the merger or joint venture be approved – such discussions should help shareholders decide whether to hold or sell their shares."

Leonardo Peklar

"The board should ensure that it is informed about management communications with shareholders – it should know which shareholders management is talking to and what they are talking about. Board monitoring of shareholder communications is particularly important in countries that require disclosure of all communications with shareholders. For example, directors may wish to accompany management on company roadshows to ascertain what information is communicated to whom."

Dr. Roland Koestler

"Many boards find it beneficial to discuss issues to be voted on at an upcoming meeting with shareholders in advance of the meeting. However, identifying a company's shareholders is not always straightforward, in particular, who holds bearer shares. In addition, in situations where few shares appear to be voted on an important resolution, it may be worth following up with shareholders to find out why. Shareholders may think they have voted but a glitch may have caused their vote to be lost, while some shareholders may have lost track of their ownership completely."

Alison Dillon

Chapter 12

Independent and Objective Judgement

OECD Principle VI.E: The board should be able to exercise objective independent judgement on corporate affairs.

Annotation to OECD Principle VI.E:

In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the corporation, it is essential that the board is able to exercise objective judgement. In the first instance this will mean independence and objectivity with respect to management with important implications for the composition and structure of the board. Board independence in these circumstances usually requires that a sufficient number of board members will need to be independent of management.

Maintaining board balance – the mix between executive and independent directors:

"The standard in some jurisdictions that a board comprise a majority of independent directors has been carried by most boards to the extreme such that the board includes only one director who is a member of management – usually the CEO. This approach to creating an independent board potentially deprives the corporation of a useful perspective. In addition, including some non-independent directors can help ensure that management is always candid in its dealings with the board.

Boards considering adding members of management to the board should remember that executives are available to the board at all times and can be asked to sit in on and fully participate in discussions with respect to areas in which they have expertise (for example, strategic, operational, financial or environmental). An officer does not have to be a director to have his or her views expressed to the board."

Peter Dey

"Each board should have a comfortable majority of independent directors and a reasonable number of executive directors – a 2:1 ratio may be sufficient. The board should include a sufficient number of independent directors to populate committees effectively and avoid excessive overlap of committee assignments."

Niall FitzGerald

"Director independence requirements in some countries may have resulted from an overreaction with respect to managerially dominated boards of the past. A board that does not include a sufficient number of executive directors may not be able to effectively engage in the strategic planning process because of a lack of transparency between management and the board – especially at companies where the board generally deals only with the CEO, who is also the chairman of the board AND the only management director."

Ira M. Millstein

"There should be a compelling reason for any member of management other than the CEO to be on the board. The notion that the presence of managers will increase transparency is not sufficient – there should be something unique about that particular executive. For example, a company with international operations may include a regional manager on the board for the purpose of increasing confidence in the company throughout that particular region."

Anonymous Contributor

"The balance of power and influence on the board should be taken into account when selecting new directors. If one or two directors are too influential, other directors may feel impeded in expressing their opinions. Balancing power on the board is like balancing different ingredients when preparing a dish – if just salt or spice is added, the dish will not taste good. A good dish requires a balance of flavours."

Haiying Zhao

Annotation to OECD Principle VI.E:

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 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. Separation 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.

Choosing whether to separate the roles of CEO and chair:

"A board that is considering whether to separate the roles of CEO and chair should carefully weigh the advantages and disadvantages of each model. For example, separating the roles may lead to concerns about a lack of decisiveness, split accountability at the top and the pace at which the company can move with vigour and robustness given the CEO/chair will no longer be the single responsibility point. There may also be concerns in some countries that a company might have difficulty hiring a CEO if that person is not also offered the position of chair.

On the other hand, separating the roles of CEO and chair can bring a number of advantages that may outweigh the disadvantages. First, separating the roles overcomes the difficulty of finding any one person with the skills required to manage the board and the business of a complex company, and who can sustain performing such a role. Second, a company that separates the roles and finds suitable people for each role should be equipped with a complementarity of skills that can be extremely valuable. Third, it can be beneficial for the CEO to have someone else that they can test their ideas with who is not a competitor or threat, and who wants to see the CEO succeed – the job of the CEO is often lonely. Finally, separating the roles of the CEO and chair may minimise the risk of egregious abuses that are more likely to happen when power is concentrated in one person. For example, a separate chair may be more likely to rein in excessive compensation and closely scrutinise a proposed private equity transaction such as a management buy-out."

Niall FitzGerald

Selecting a separate chair:

"The board should exercise great care in selecting the chair – board dysfunction can result when an inappropriate chair is selected. The chair should have the right character and values, be truly independent and have what it takes to run the board of a complex company. At the end of the chair's term, the board should assess his or her performance rather than automatically renew the appointment."

Niall FitzGerald

The role of the separate chair:

"The separate chair and the board should reach agreement early on the board's role and how it should go about fulfilling its responsibilities. The chair is required to walk a narrow line – he or she must be sufficiently informed, engaged, alert and able to intervene when required, but must avoid becoming too involved with the business of the company. Board dysfunction is likely to result when the roles of the CEO and chair are not properly understood or observed.

Board dysfunction may also result if the chair is not sufficiently focused on board performance. The chair is responsible for working with the board to ensure that it is a high-performing team comprised of the right people. The chair should coach individual directors by providing continuous feedback and assigning them to work with others to improve board dynamics and teamwork.

The chair should be prepared to speak openly with the CEO when attempting to come to a shared view with respect to an issue. If the CEO and chair are not able to reach agreement and the chair feels strongly about his or her position, the CEO should be cautious in going against that position and should pick his or her battles wisely – it is sometimes said that the chair either supports the CEO 100 percent or not at all."

Niall FitzGerald

"Where the top posts are split, the CEO and the chair are the centres of authority on a board. The nature of their authority is, however, different. CEOs carry the personal authority which is delegated to them by their boards. Chairs, on the other hand, carry the collective authority of the boards which appointed them. Chairs may act between board meetings, but they then do so in the name of their boards. Their authority derives from the trust which their fellow board members have in them. Their position depends on their retaining that confidence, a reason why their selection is so important to board effectiveness."

Adrian Cadbury

"The chair is key to any board structure. Complete clarity as to his or her role vis-à-vis the role of the CEO is essential and should be reduced to writing as a list of responsibilities. As a general rule, the CEO runs the company and the chair leads the board and the independent directors; however, determining who is responsible for what can be difficult if the CEO and chair are struggling for the same space, and they may find themselves reaching an uneasy truce.

The chair may be viewed within the company as representing the board between board meetings and as able to speak with people who may wish to ask the opinion of the chair on various issues. During a typical week, a chair may meet with the CEO a couple of times, meet with public relations people and stay in touch with the independent directors about issues that might arise. A CEO may meet with the chair to gauge how the independent directors feel about an issue that the CEO wishes to bring before the board – this process allows the CEO to be informed as to any potential problems and also empowers the independent directors, who may feel more comfortable raising issues with the chair than with the CEO. The chair may also provide useful 'air cover' to the CEO by working with independent directors with respect to matters that are important to the CEO."

Anonymous Contributor

"In a recent merger, the CEO of the acquiring company became the chair of the merged company and the CEO of the acquired company became the CEO of the merged company. The risk in this designation of offices was that the new chair would overly influence the agenda of the new CEO; however, the board wanted to ensure that the new chair continued to be a significant face of the merged company to the capital markets. The board then embarked on an exercise to identify in detail the responsibilities of the new chair and the new CEO, respectively, and to monitor the relationship closely to ensure that there were no conflicts and that the relationship was functioning effectively."

Peter Dey

"The chair has a critical role in getting the best out of the board – the chair should be like an orchestra leader."

Paul Desmarais, Jr.

The role of the chair of a state-owned enterprise:

"The chair of a state-owned enterprise is responsible for protecting the interests of all shareholders by establishing governance structures that encourage transparency, and communicating information to the board with respect to recent developments and company operations.

The chair should strive to avoid conflicts between government policy and the interests of majority and minority shareholders by balancing all interests when considering particular plans or proposals and continually communicating with the government about those decisions. Government policy is generally developed to further the interests of the economy as a whole and should therefore also protect the interests of all shareholders."

Zhang Chunjiang

"Independent chairs of state-owned enterprises should work with the government to improve corporate governance and performance where required.

For example, the chair of a state-owned enterprise may wish to replace government appointees on the board with directors with business experience. To achieve this, the chair may need to convince the government that a professional board can enhance corporate performance. Another example of change that may be initiated by the chair could include moving from a fixed, ten-year strategy, to bi-annual strategic development sessions with monitoring and re-evaluation of the company's strategic direction throughout the year. The chair should consider whether the government's policies with respect to withdrawing cash from the company are compatible with the long-term development needs of the company, and should seek change where required.

The chair should adopt a pragmatic approach to achieving change at a state-owned enterprise, such as co-opting the government by involving key people in agenda development at regular meetings. If the company is controlled by the state but has some public shareholders, the chair should disclose that such meetings are taking place where *appropriate, bearing in mind that equal treatment of shareholders is one of the cornerstones of good governance.*

It is essential that the chair have the trust and support of key members of government to achieve change at a state-owned enterprise. The chair should recognise that politicians may be tempted to sacrifice the long-term economic interests of the enterprise for short-term political gain. A chair who seeks change that is not forthcoming should consider resigning."

Leonardo Peklar

Board leadership and board composition in controlled companies:

"Many family-controlled companies combine the roles of CEO and chair. Where family-controlled companies are concerned, it may be best to combine the roles, while ensuring that the remainder of the board is independent."

Laura Cha

"A controlling shareholder who is also the CEO can send a very strong signal to the market about his or her commitment to good governance by having the board appoint an independent director as chair."

Peter Dey

Annotation to OECD Principle VI.E:

The designation of a lead director is also regarded as a good practice alternative in some jurisdictions. Such mechanisms can also help to ensure high quality governance of the enterprise and the effective functioning of the board.

The relationship between the CEO/chair, the lead director and the board:

"It is essential that the lead director and CEO/chair are in synch on major issues, especially when a company is recovering from wrongdoing. The CEO/chair should seek the advice of the lead director and use the lead director to communicate with the board. There should be a community of interest between the CEO/chair and the board in working together, rather than 'lip-service' by the CEO/chair. The relationship between the CEO/chair and the board is primarily dependent on the attitude of the CEO/chair – if he or she views the board as a necessary evil and prefers a 'show' board, a 'show' board is what he or she will get."

Jack Krol

Board leadership and the former CEO:

"In some countries, the chair is often a former CEO who retains a large degree of influence over the company. The roles of the CEO and chair should be clear, for example, the CEO may be responsible for managing 'certain' things according to a ten-year plan, while the chair may be responsible for managing 'uncertain' things."

Anonymous Contributor

"In some countries, a former CEO of the company often becomes the chair when the CEO/chair positions are separated. This decision may be based on a perception that a chair from outside the company will not know enough about the company and also because new outside chairs sometimes oust the new CEO so as to appear proactive."

Guylaine Saucier

Annotation to OECD Principle VI.E:

The Chairman or lead director may, in some countries, be supported by a company secretary.

The role of the corporate secretary:

"The corporate secretary of a company plays a key role in informing the board. Boards should consider appointing a corporate secretary who reports solely to the chair to ensure that directors receive information in a timely way without reliance on management. A board with its own secretariat will generally be in a stronger position to demand information than a board whose corporate secretary is part of/reports to the executive who may find him- or herself conflicted between the chair and the CEO."

Alison Dillon

"Some companies provide the chair with a corporate secretary to support the work of the board. It is essential that the corporate secretary have the full support of the chair. The corporate secretary should ideally report to the chair (not the CEO) and another executive should fill the position of general counsel where possible. The corporate secretary may be responsible for providing the board with information and ensuring that the board is functioning appropriately, for example, by notifying the chair when management is slow to act on an issue. Corporate secretaries gather information from various sources, including informal networks within the company. For example, a corporate secretary's team may include company veterans who have access to information via links throughout the company."

Anonymous Contributor

Annotation to OECD Principle VI.E:

In the case of two tier board systems, consideration should be given to whether corporate governance concerns might arise if there is a tradition for the head of the lower board becoming the Chairman of the Supervisory Board on retirement.

The manner in which board objectivity might be underpinned also depends on the ownership structure of the company. A dominant shareholder has considerable powers to appoint the board and the management. However, in this case, the board still has a fiduciary responsibility to the company and to all shareholders including minority shareholders.

The variety of board structures, ownership patterns and practices in different countries will thus require different approaches to the issue of board objectivity. In many instances objectivity requires that a sufficient number of board members not be employed by the company or its affiliates and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being board members. In others, 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. This has led to both codes and the law in some jurisdictions to call for some board members to be independent of dominant shareholders, independence extending to not being their representative or having close business ties with them. In other cases, parties such as particular creditors can also exercise significant influence. Where there is a party in a special position to influence the company, there should be stringent tests to ensure the objective judgement of the board.*

The role of independent directors generally:

"Independent directors add value based on their outside experience and ability to raise difficult questions. Independent directors should be more or less generalists, and able to use common sense based on understanding of the industry and the company. It is possible for management to be blindsided, particularly at the operational level. For example, independent directors may query the need for a new branding strategy to raise the profile of a company's brand, whereas management may have mistakenly believed that the brand was well known in the market."

Laura Cha

"Independent directors can bring a new viewpoint and challenge existing thought-processes on a board; however, it takes time for newly-elected independent directors to learn enough about the business to make a real contribution. Orientation programmes are useful."

Alison Dillon

"The role of the independent director is to provide leadership and oversight of the company, particularly in developing markets. Some companies seek the assistance of independent directors in management functions such as implementing internal controls and other best practices; however, independent directors should not be involved in operational functions or take on a consultant role to add value in these areas. Independent directors should instead ensure that the executive team is taking the correct steps and is using the best resources. It is important to make the responsibilities of non-executive directors clear from the start."

Maria Voskresenskaia

"Familiar relationships are important in some cultures, so it can be uncomfortable hiring independent directors as they are not fully trusted at the beginning. However, independent directors can benefit a company through different perspectives and questioning, and improved board capabilities. For example, an independent director of a controlled company who asks questions about the level of guarantees with respect to joint venture partners may discover that guarantees exceeding the company's interest in the joint venture have been provided. Once highlighted, these practices can be modified to better protect minority interests."

Anonymous Contributor

"Independent directors may be used as leverage when change is required to take place. Independent directors may carry more value and responsibility with respect to positive governance changes such as fostering a winning mentality and increasing workplace satisfaction."

Leonardo Peklar

"Directors should understand what their role is and what their duties are when they join a board. For example, an ex-CEO who joins a board may be tempted to behave like a manager by rolling up his or her sleeves and fixing things perceived to be wrong at the company. It is important for such a director to behave like an independent director and not like management."

Anonymous Contributor

"Independent directors should be encouraged to stand on the same level as other directors and express their opinions. This requires courage."

Anonymous Contributor

The role of independent directors in controlled or state-owned companies:

"Independent directors of controlled companies are appointed for the purpose of counselling senior management and controlling shareholders with respect to gut issues such as succession and compensation, as well as to protect the interests of minority shareholders. It is essential that independent directors have the trust of controlling shareholders."

Adrian Cadbury

"Independent directors sitting on the board of a controlled company represent ALL shareholders of the company – they become responsible to the entire shareholder population when elected to the board. Independent directors should consider the interests of minority shareholders, but should avoid adopting an antagonistic position against a controlling shareholder just because that shareholder is dominant. For example, if a controlling shareholder proposes a transaction with a subsidiary, such as a merger, divestment or a contract to provide head office services, the independent directors of the subsidiary should safeguard minority interests by ensuring that the transaction is on reasonable commercial terms. This may require the independent directors to question the controlling shareholder about its valuation and obtain an independent valuation if necessary. Asking such questions can be difficult – especially in some cultures – but it is essential that independent directors stand up for the equity of the matter and ask."

Dr. N. Balasubramanian

"Independent directors should instinctively protect minority interests and are the key to building investor confidence in state-owned enterprises. Independent questions will help the board of directors to think thoroughly when making key decisions."

Zhang Chunjiang

"Independent directors of controlled companies are required to balance the interests of majority and minority shareholders. The protection of the minority becomes more important where there is a supermajority owner and a risk that minority interests will be ignored or misappropriated."

Anonymous Contributor

"When a contentious issue arises that causes an independent director to consider resigning, it may be useful for him or her to discuss the issue with the other independent directors outside the boardroom to determine whether the directors should 'die on that particular bridge.'"

David Beatty

"When an independent director of a controlled or state-owned company objects to a board decision in favour of the controlling shareholder or the state, his or her vote will generally be defeated. However, in such circumstances, the director should consider asking the chair to declare the director's vote and the reasons for the vote, and record the declaration in the minutes of the meeting. The chair should support this endeavour, which may encourage the controlling shareholder or the state to consider the reasons for the director's decision and potentially alter its course."

José Monforte

"It is critical for boards of enterprises with state ownership to include directors who are truly independent and have excellent reputations, experience and networks. A person who feels confident and strong in his or her function is better able to step into discussions, stand up for the interests of the company and raise questions when state-nominated directors act as instructed by the state.

The role of independent directors is not always sufficiently developed to allow them to veto a decision. However, an independent director's lack of support for a particular decision may attract the attention of investors and give rise to a negative inference."

Maria Voskresenskaia

"Independent directors of state-owned enterprises may wish to consider depositing resignation papers before beginning negotiations with respect to decisions that would favour the government but would not be in the best interests of all shareholders. Taking such steps requires integrity on the part of those directors."

Leonardo Peklar

The role of directors in a state-owned enterprise:

"State-nominated directors need have the ability to participate in discussions and take responsibility for decisions, without pre-clearance from the state. Directors should work to build trust at the board and ownership levels – they should not give orders from day one, but they may have more freedom to push on issues such as dividend policy once trust is established."

Lars Johan Cederlund

Executive sessions:

"Independent directors should meet on a regular basis without senior management present (in 'executive session') to discuss any contentious or sensitive issues. Companies hold executive sessions before or after the full board meeting (or sometimes both). If the independent directors meet before the board meeting, their views can be communicated to the full board without individual attribution by the chair of the executive session. The practice of holding executive sessions should be generalised, to avoid the perception of anything amiss at a particular meeting."

Dr. N. Balasubramanian

Annotation to OECD Principle VI.E:

In defining independent members of the board, some national principles of corporate governance have specified quite detailed presumptions for non-independence which are frequently reflected in listing requirements. 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.*

Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisitions and the audit function. In order for them to play this key role, it is desirable that boards declare who they consider to be independent and the criterion for this judgement.

The definition of "independence" and independence guidelines:

"Independent directors are professional and knowledgeable enough to know what questions to ask. They should have credibility and be ready to challenge management, controlling shareholders and other board members, and not just give in. Technical definitions of 'independence' may be useful, but it is more important for directors to be able to stand on their own and be ready to walk away."

Jesus Estanislao

"'Independence' may be defined simply as economic independence from the company and an absence of political connections. A system of independent directors is the essence of the listed company, but to work as designed, independent directors should keep their independence in all respects."

Zhang Chunjiang

"Director independence guidelines can be developed through real-world examples addressing how directors exercise responsibilities with respect to particular stakeholders. For example, a bank director's discomfort while sitting on the board of a client of the bank may indicate that such arrangements can raise a conflict of interest."

Charnchai Charuvastr

Director independence requirements – the "regulatory jumpstart":

"Regulators should take a heavy hand in 'jumpstarting' corporate governance in developing countries, for example, by introducing director independence requirements. Markets take time to digest new requirements, so while the first batch of independent directors at many companies may have been 'decorative' in nature, they will evolve over time with experience."

Laura Cha

Extended board service and independence:

"Boards should comprise people with different perspectives and experience. Board renewal is important to ensure a flow of new ideas. Age limits may be required to ensure that this renewal occurs."

Jack Krol

"Extended service on a board by an independent director is sometimes thought to negatively impact director independence. Whether or not this is the case will depend on the individual director. A director who serves on a board for an extended period should still be considered independent if that director possesses strength of character and is willing and able to challenge management. In-depth knowledge that comes with experience on a board increases a director's ability to analyse and challenge decisions so that the longest-serving directors on a board may also be the most effective."

Alison Dillon

"A long period of service on a board may lead to enhanced expertise with respect to that company's business; however, it may also potentially impair a director's independence. Boards may benefit from implementing a director rotation policy through the fresh perspectives new additions to the board can provide. Rotation policies should be structured in a way that ensures some continuity of knowledge, for example, a company with three directors may wish to rotate one director every three years."

Maria Voskresenskaia

"A director who has chaired the board for an extended period of time is likely to become too involved with the company. Such a director should, as a general rule, not be considered independent."

Anonymous Contributor

Employee directors on a two-tier board:

"Employee directors on the supervisory board are 'independent' by definition as they are generally protected from dismissal. Employee directors should be able to stand up and vote against decisions that are not in the long-term best interests of the company, the company's workforce and/or minority shareholders. Employee directors should represent the interests of all workers of the company – not just workers from the company's home country – and supervisory boards should consider taking steps to include representatives of foreign subsidiaries. Where the interests of various segments of the workforce conflict, it is generally the responsibility of the union representative on the board to find a common solution amongst the various attitudes of the workforce."

Dr. Roland Koestler

Employee directors on a unitary board:

"Employee representation on the board may have the effect of stifling discussions with respect to strategy where the board culture is such that information leaks are feared; however, many boards do not have such cultural issues and conduct open discussions on issues affecting the company's employees."

Guylaine Saucier

Chapter 13

Board Committees

OECD Principle VI.E.1: Boards should consider assigning a sufficient number of non-executive directors 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 directors and key executives, and board remuneration.

Annotation to OECD Principle VI.E.1:

While the responsibility for financial reporting, remuneration and nomination are frequently those of the board as a whole, independent non-executive board members can provide additional assurance to market participants that their interests are defended. The board may also consider establishing specific committees to consider questions where there is a potential for conflict of interest. These committees may require a minimum number or be composed entirely of non-executive members. In some countries, shareholders have direct responsibility for nominating and electing non-executive directors to specialised functions.

Independent committees in controlled companies:

"Independent directors of controlled and state-owned companies can often make a difference by exercising due diligence and asking questions. Independent directors may wish to form committees to facilitate discussions with management outside regular board meetings in relation to particular areas such as budgeting and risk management.

Independent committees can be particularly effective in countries where there may be cultural sensitivities about raising potentially contentious issues in the boardroom. In such *countries, board meetings are often scripted and staged, with few (if any) questions asked. In a committee environment, however, directors are better able to lay down their cards and ask for explanations."*

Jesus Estanislao

Connected transactions at state-owned enterprises:

"Connected transactions at some state-owned enterprises require approval by an independent board committee. The major role of independent directors in this situation is to safeguard the interests of minority shareholders. Material connected transactions may also require shareholder approval."

Zhang Chunjiang

Special investigation committees:

"When a company may be facing a restatement, it is critical to establish the most effective process to respond to the inevitable inquiries from securities regulators. Provided the process is acceptable to the regulator, the board may be permitted to conduct its own investigation instead of an investigation by the regulator. For this process to be acceptable, the regulator will need to be satisfied as to the objectivity of the board committee, the terms of the mandate given to the committee and the resources available to the committee. In assuming responsibility for the investigation, the company may be able to exercise more control over the timing of the investigation and minimise interference with the day-to-day operations of the company."

Peter Dey

OECD Principle VI.E.2: When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

Annotation to OECD Principle VI.E.2:

While the use of committees may improve the work of the board they may also raise questions about the collective responsibility of the board and of individual board members. In order to evaluate the merits of board committees it is therefore important that the market receives a full and clear picture of their purpose, duties and composition. Such information is particularly important in the increasing number of jurisdictions where boards are establishing *independent audit committees with powers to oversee the relationship with the external auditor and to act in many cases independently. Other such committees include those dealing with nomination and compensation. The accountability of the rest of the board and the board as a whole should be clear. Disclosure should not extend to committees set up to deal with, for example, confidential commercial transactions.*

Committee charters:

"It is the responsibility of the board to ensure that the correct processes and frameworks are in place to allow the components of the governance system to operate properly. For example, it may be more appropriate to frame committee charters in terms of overarching tasks for the committee to accomplish, rather than detailed terms of reference. Terms of reference may be convenient for regulators because they spell out each thing a committee is required to do, but they can be limiting. In contrast, framing responsibilities as tasks can empower the committee because they allow it to go wherever it needs to go to complete those tasks."

Anonymous Contributor

Chapter 14

Time Commitment, Agenda, Training and Evaluation

OECD Principle VI.E.3: **Directors should be able to commit themselves effectively to their responsibilities.**

Annotation to OECD Principle VI.E.3:

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. Some countries have limited the number of board positions that can be held. Specific limitations may be less important than ensuring that members of the board enjoy legitimacy and confidence in the eyes of shareholders. Achieving legitimacy would also be facilitated by the publication of attendance records for individual board members (e.g. whether they have missed a significant number of meetings) and any other work undertaken on behalf of the board and the associated remuneration.

Time commitment:

"Directors should limit the number of boards they sit on if they wish to do the job right – no one is Superman in this respect! For example, the role of chairman at a large company can require four times as much work as regular board service and could be anything from 40-90 days per year for a company that is not in crisis."

Leonardo Peklar

Scheduling board meetings and the sanctity of dates:

"Board meeting dates should be ironclad where possible. It is a common complaint of independent directors at state-owned enterprises and companies where the government has a large stake that there is no sanctity of board meeting dates – this can result in poor attendance when dates are changed. Meeting dates may become fluid because of changes to the schedule of senior government officials sitting on the board. Moreover, sanctity of dates is not part of the culture in some countries."

Laura Cha

Setting the board's agenda:

"The board should prepare a calendar each year that sets forth and schedules the issues to be discussed during the year. Substantive issues such as CEO performance evaluation, succession planning and operational oversight issues such as product quality, should be prioritised over formalistic issues. Confrontation may be avoided by scheduling potentially sensitive issues in advance and before such issues become critical."

Claude Lamoureux

"When a company has a lead director and a CEO/chair, the agenda is still usually set by the CEO/chair and only discussed with the lead director. At many companies, it would be unusual for the lead director to insist that an item be added to the agenda. This misses one real benefit of separating the chair and CEO."

Ira M. Millstein

"The board agenda should reflect the board mandate. The agenda can be used to ensure that the board does not spend an excessive amount of time on compliance-related issues. If the board spends more than 15 percent of its time on compliance, it should examine its processes to ensure that committees are fulfilling their compliance-related responsibilities properly.

For example, the board may include the following items on the agenda for consideration at each regular meeting:

- *Report on operational and financial performance and progress against the plan;*
- *Update on markets, competitors, customers and investors;*
- *Progress on strategic issues;*
- *Developments on important people issues;*
- *Review in depth one key strategic issue;*
- *Short presentation from one senior/high potential leader; and*
- *Other matters that the CEO believes need the engagement of the board.*

The board may also discuss the following items on a periodic basis:

- *The strategic framework;*
- *The brand;*
- *The mission;*
- *People and succession plans;*
- *Longer term scenario development;*
- *Reports from audit and compensation committees; and*
- *Assessment of its own performance."*

Niall FitzGerald

"A board that has a separate chair will usually set its agenda in a number of ways. First, the chair can include on the agenda items that he or she thinks the board should be considering – this can occur with or without the support of the CEO. The chair may discuss these issues with the independent directors and the corporate secretary to determine if they are ripe for board consideration. Committee chairs may follow a similar process with respect to setting committee agendas. For example, an audit committee chair may identify risks in the company's annual plan that require discussion at the committee level and include those risks on the committee's agenda to ensure that risks are systematically reviewed and monitored. Second, issues may arise at the company that warrant board consideration and prompt action at the highest level, for example, an oil spill. Third, the agenda should include routine items that are required to be addressed by the board throughout the year, such as approving financial statements, reviewing reports from investor relations and appraising risk. Finally, it is possible that items may be added to the agenda at the last minute after informal discussions over dinner between directors the night before a board meeting."

Anonymous Contributor

Annotation to OECD Principle VI.E.3:

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.

Chartered directors:

"Some countries are moving towards a system of chartered directors. To become qualified as a chartered director, a director may be required to fulfil certain educational requirements (such as attending a certified director education course) and may be prohibited from engaging in full-time employment at any organisation. In these countries, each board should include a number of chartered directors with the time and commitment to board service. Chartered directors may also be well-suited to driving the process of implementing board best practices through creating and encouraging appropriate board processes as well as advocating public policy change."

Charnchai Charuvastr

First-time board service:

"Directors serving on boards for the first time should try to capture the board experiences of others by reading books and articles and talking with respected directors if possible (for example, through roundtables or one-on-one meetings). Board experiences in the director's own country are usually the most hands-on and relevant, while international perspectives may also be useful. Capturing real board experience is not easy, however, as good corporate governance can be likened to sex during the teenage years – everyone seems to be talking about it, but few people are actually doing it! Preparing for first-time board service is essential but once board service commences, it will be 'sink or swim' for the particular director."

Leonardo Peklar

Orientation and continuing education:

"The extent of director orientation provided by a company indicates how serious that company is about the role of independent directors. Director orientation is also essential to providing independent directors with the informational building blocks they need to effectively engage in strategic oversight.

For example, some companies provide directors with a whole day of orientation and allow directors to meet one-on-one with senior management for an extended period (45 minutes to an hour is common). Other companies, particularly in developing countries, may not provide adequate director orientation (if any) – this may be the case where a company is unaccustomed to having independent directors on the board or where orientation is irrelevant due to long-tenured directors. In this situation, incoming directors should request one-on-one meetings with senior management where the director can ask questions to get a feel for the dynamics of the board and the issues it faces. Meetings with analysts may be useful for new directors to determine the company's position in the context of the industry. New directors should also ask for the opportunity to meet fellow board members in advance of the first board meeting. A request for orientation by a new director sends a strong signal that the director is serious about his or her role on the board."

Laura Cha

"Independent directors in countries with relatively new director independence requirements should ensure that they attend director education courses to enable them to better understand their roles and responsibilities. For example, in one developing country, 60 percent of directors who attended a director education course for the first time had never heard of fiduciary duties and 80 percent did not know what fiduciary duties require.

New directors often lack a reference point before attending training and board service for them is like playing golf in the desert – they do not know where the green is or where to hit the ball. However, once directors know the rules and regulations and understand their liability as directors, they can see the fairway, the green, the hazards and the areas that are out-of-bounds. They also learn appropriate etiquette, which makes board service easier."

Charnchai Charuvastr

"At some companies, it may be appropriate for directors to receive training similar to that provided to journalists with respect to how to handle ethical dilemmas. As part of the training, directors may be required to discuss real dilemmas they have faced and how they handled them."

Anonymous Contributor

Board and director evaluations:

"Board evaluations should be designed to elicit an honest discussion about what is going right and what is going wrong on the board. The evaluation may encompass the efficiency of the board's committee structure, whether directors are asking the right questions and whether board discussions are frank. The board should use the results of board evaluations to improve its performance. For example, if a board evaluation indicates that the chair asks the board 'who is against?' each major decision, the board may decide that it would be more conducive to effective decision-making for the chair to instead ask 'who is in favour of?' each decision.

Supervisory board evaluations may be conducted in a number of different ways. Some boards retain outside consultants to examine the qualifications and behaviour of each director. Employees may also suggest ways of improving board efficiency. At some companies, the chair evaluates the board by asking whether people are happy with the board's performance. Evaluation by the chair is often viewed as a 'box-ticking' exercise that does not effectively analyse board or director performance."

Dr. Roland Koestler

"Boards can carry out the evaluation process in different ways, for example, by requiring directors to fill out a form or retaining consultants to speak to board members, then hosting a dinner to discuss the results. Plenty of time should be allowed so that people do not feel rushed in their evaluation discussions. Board evaluations are important but they should be kept fresh to ensure that evaluation forms do not become another form to fill out. Boards should work on ways to energise the process."

Jack Krol

"There are many ways to assess individual directors, including self evaluations, third party facilitations, and peer reviews prior to re-election to the board. Some of these peer evaluations are conducted by the nominating committee. When evaluating an individual director, the committee should consider asking that director to leave the room while the evaluation is being discussed. Feedback to the director can then be provided by the committee chair or third party facilitator. This is occurring in some boardrooms, but takes courage by the board. The chair or lead director should also be able to provide individual directors with feedback as needed so as to encourage self-improvement."

Michele Hooper

"Some boards measure board effectiveness using a behavioural psychologist who spends time with each board member eliciting their (hopefully unadulterated) views about the CEO, the chair and their colleagues on the board. The psychologist can then produce a report that includes unattributed quotes, which can then be used to facilitate discussion of the themes that have emerged from the interviews. Such a process can be a useful way of flushing out issues that might have gone unsaid in the normal course of events – the process may also cause discomfort for some directors.

The chair should assess executive directors with respect to their performance as directors, while the CEO should assess them in their role as executives. In evaluating such directors, the chair should bear in mind that it can take time for executive directors to develop enough confidence to look beyond their individual specialities when discussing issues before the board. For example, a CFO on the board may be initially reticent to discuss non-financial issues such as advertising policy and climate change, but should be encouraged by the chair to do so."

Niall FitzGerald

"A strong independent chair should be able to assess the performance of each director. However, a chair that is too close to management may penalise directors who are critical of management – this type of evaluation will not be constructive and should be avoided."

Alison Dillon

"The board evaluation process may be simple, such as the chair interviewing each director based on a series of questions including assessments of individual directors. The chair may then be required to advise each director of any suggestions arising from the interview process and to report to the board on its effectiveness."

Peter Dey

"From a chair's point of view, any appraisal discussion with individual directors tends fairly rapidly to change direction and become an appraisal of the chair. Directors may well feel that the limitations on their ability to participate effectively in the board's work lie in the hands of their chair. They may consider that the lack of timely, relevant information, or the way in which discussions are handled and decisions made, make it difficult for them to contribute as well as they might. Chairs cannot improve their chairmanship without this kind of honest, constructive feedback. Appraisal interviews with individual directors are an excellent way for chairs to appraise themselves."

Adrian Cadbury

Driving reform through director training and performance evaluation:

"Every country needs an engine or catalyst to stimulate corporate governance reform. In some countries, the push may come from shareholders who act as a proxy for the common good. In other countries, especially those with dominant controlling shareholders, the drive towards reform may occur through enforcement of minority shareholder rights (such as cumulative voting) through an efficient court system.

In the Philippines, where controlling shareholders are dominant but the legal system is inefficient, the catalyst for reform is the Institute of Corporate Directors (IOD). The IOD is comprised of professional directors and is independent of government and any business interest. The IOD provides compulsory director orientation and training programmes, but recognises that training alone is not enough – too many directors attend and are very polite, but go back to their boards and do nothing differently.

To complement its training programmes, the IOD also evaluates companies using a scoring system called the 'governance scorecard,' which is based on the OECD Principles. In developing the questionnaire used to rate companies, the IOD adopted a public process, seeking input from regulatory authorities and the business community. The IOD is not paid to conduct these ratings. In addition, companies in the Philippines are required to submit reports to the appropriate regulatory authority, which evaluates performance. The IOD works with regulators to formulate questions for performance evaluation and provides other relevant training.

The IOD's governance scorecard incentivises good boardroom behaviour by 'praising' or 'shaming' companies. Regulatory authorities support the IOD's performance evaluation process and follow up those evaluations by asking questions based on IOD guidance.

The IOD utilises a similar methodology to evaluate state-owned enterprises (SOEs), working with SOEs to develop a disclosure-based questionnaire modelled on the OECD Guidelines on Corporate Governance for State-Owned Enterprises. At the beginning of the SOE evaluation process, the standard was set low so that every company passed. At the beginning, the IOD only named the top five or ten SOEs. In each subsequent year, the bar was raised – this drove SOEs to improve, especially as every SOE and its rank was named. The scorecard and ranking system effectively 'shamed' the SOEs with lower scores into performing better in subsequent years. The IOD's efforts with respect to enhancing SOE performance are particularly important because of the political nature of SOE director appointments in the Philippines.

The IOD model could be replicated in other countries with controlled companies, provided the organisation in question is comprised of peers and is credible and voluntary. Support from regulatory authorities and dedicated people within government would also be required. However, the reform process should be tailored to the particular circumstances of the country in question."

Jesus Estanislao

Chapter 15

Directors' Access to Information

OECD Principle VI.F: In order to fulfil their responsibilities, directors should have access to accurate, relevant and timely information.

Annotation to OECD Principle VI.F:

Board members require relevant information on a timely basis in order to support their decision-making. Non-executive board members do not typically have the same access to information as key managers within the company. The contributions of non-executive board members to the company can be enhanced by providing access to certain key managers within the company such as, for example, the company secretary and the internal auditor, and recourse to independent external advice at the expense of the company. In order to fulfil their responsibilities, board members should ensure that they obtain accurate, relevant and timely information.

Board information:

"Key areas of essential information for the board may include financial and qualitative data relating to:

- *Company performance, including cash flow, capital expenditures, working capital, research and development and stock price;*
- *Routine compliance matters;*
- *Evaluation of compliance systems and processes;*
- *Customer acquisition and retention;*
- *Market Development and market share;*

- *Technology developments;*
- *Staff retention and attrition levels;*
- *Senior management arrivals and separations;*
- *Shareholder grievances;*
- *Whistleblower developments and actions;*
- *Emerging regulatory and legislative measures that may impact the business;*
- *Trends in business consolidations and technological obsolescence;*
- *Environmental developments and challenges; and*
- *Compensation trends."*

Dr. N. Balasubramanian

Requests for information by directors:

"It is the board's responsibility to decide what information it wants. For example, at one company, the board was accustomed to receiving mostly backward-looking information before board meetings, such as financial statements. After a problem surfaced at the company, the board realised that it had not been receiving sufficient information in relation to particular risks facing the company. The board then prepared a list of issues that it wanted to focus on, listed in order of priority. It presented the list to management and insisted that management provide it with the information it needed relating to those issues. Board meetings, which were previously dominated by management presentations of backward-looking information, became opportunities for directors to discuss issues on the focus list."

Ira M. Millstein

"Directors should be proactive – not reactive – with respect to requesting desired information from management. For example, if the board is discussing a merger, the directors should ensure that they obtain information relating to the potential impact of the merger on the company."

Laura Cha

"In a two-tier system, the supervisory board is usually responsible for requesting information from management to enable the board to fulfil its functions – this responsibility may be included in the board's mandate. The supervisory board should define the information it needs, at what time and from what perspective, and be proactive in communicating its information needs to management."

Dr. Roland Koestler

Director preparation and information:

"The worst sound an executive director might hear at the beginning of a board meeting is the sound of non-executive directors ripping the envelope containing board materials sent to them before the meeting. In addition, non-executive directors dislike executives delivering new materials at the meeting, particularly when those executives then try to pressure the non-executive directors into making a quick decision."

Anonymous Contributor

Obtaining information from outside the boardroom:

"Directors may wish to supplement the information they receive from management with information from other channels, such as site visits without the CEO present and industry reports prepared by analysts."

Michele Hooper

Informal communications outside the boardroom:

"It may be useful for directors to meet informally where appropriate with major shareholders, managers, directors and auditors to more fully understand developments at the company. In communicating with shareholders, the board should ensure that it treats all shareholders equally and disseminates information throughout the market where required.

For example, an independent director of a company that is in the process of acquiring another company may wish to understand why issues such as marketing and branding of the combined entity are not being accorded higher priority by the board. The director should consider meeting with management to find the answer – it may be that management is concerned about becoming a takeover target but has not yet shared that information with the board."

Leonardo Peklar

Retention of experts by the audit committee:

"When an audit committee of a manufacturing company is asked to review an industrial safety and protection standard, it should consider hiring industry experts to help explain the issues that standard might raise for the company and associated risks."

Laura Cha

Annex 1.

SUMMARY – OECD PRINCIPLES OF CORPORATE GOVERNANCE (1999, REVISED 2004)

The *OECD Principles*, adopted in 1999 and expanded in 2004, describe the basic elements of an effective corporate governance framework for corporations that seek to attract capital from equity investors:

- Promoting transparent and efficient markets, which are consistent with the rule of law and which clearly articulate the division of responsibilities among supervisory, regulatory and enforcement authorities;

- Protecting and facilitating the exercise of shareholders' rights;

- Ensuring the equitable treatment of all shareholders, who should also have the opportunity to obtain effective redress for violation of their rights;

- Recognising the rights of stakeholders established by law or through mutual agreements and encouraging active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises;

- Ensuring that timely and accurate disclosure is made on all material matters regarding the corporation, including its financial situation, performance, ownership and governance; and

- Ensuring the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.

Annex 2.

EXCERPT – OECD PRINCIPLES OF CORPORATE GOVERNANCE (1999, REVISED 2004)

VI. The Responsibilities of the Board

> The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

A. Directors 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.

B. Where board decisions may affect different shareholder groups, differently, the board should treat all shareholders fairly.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
2. Monitoring the effectiveness of the company's governance practices and making changes as needed.
3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

5. Ensuring a formal and transparent board nomination and election process.

6. Monitoring and managing potential conflicts of interest of management, directors and shareholders, including misuse of corporate assets and abuse in related party transactions.

7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

8. Overseeing the process of disclosure and communications.

E. The board should be able to exercise objective independent judgement on corporate affairs.

1. Boards should consider assigning a sufficient number of non-executive directors 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 directors and key executives, and board remuneration.

2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

3. Directors should be able to commit themselves effectively to their responsibilities.

F. In order to fulfil their responsibilities, directors should have access to accurate, relevant and timely information.

Annex 3.

EXCERPT – OECD GUIDELINES ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES (2005)

VI. The Responsibilities of the Boards of State-Owned Enterprises

The boards of state-owned enterprises should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.

A. The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance. The board should be fully accountable to the owners, act in the best interest of the company and treat all shareholders equitably.

B. SOE boards should carry out their functions of monitoring of management and strategic guidance, subject to the objectives set by the government and the ownership entity. They should have the power to appoint and remove the CEO.

C. The boards of SOEs should be composed so that they can exercise objective and independent judgement. Good practice calls for the Chair to be separate from the CEO.

D. If employee representation on the board is mandated, mechanisms should be developed to guarantee that this representation is exercised effectively and contributes to the enhancement of the board skills, information and independence.

E. When necessary, SOE boards should set up specialised committees to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration.

F. SOE boards should carry out an annual evaluation to appraise their performance.

Appendix

The OECD Principles of Corporate Governance and Annotations to the Principles

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OECD Principles of Corporate Governance

The *OECD Principles of Corporate Governance* were originally developed in response to a call by the OECD Council Meeting at Ministerial level on 27-28 April 1998, to develop, in conjunction with national governments, other relevant international organisations and the private sector, a set of corporate governance standards and guidelines. Since the Principles were agreed in 1999, they have formed the basis for corporate governance initiatives in both OECD and non-OECD countries alike. Moreover, they have been adopted as one of the Twelve Key Standards for Sound Financial Systems by the Financial Stability Forum. Accordingly, they form the basis of the corporate governance component of the World Bank/IMF Reports on the Observance of Standards and Codes (ROSC).

The OECD Council Meeting at Ministerial Level in 2002 agreed to survey developments in OECD countries and to assess the Principles in light of developments in corporate governance. This task was entrusted to the OECD Steering Group on Corporate Governance, which comprises representatives from OECD countries. In addition, the World Bank, the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) were observers to the Group. For the assessment, the Steering Group also invited the Financial Stability Forum, the Basel Committee, and the International Organization of Securities Commissions (IOSCO) as *ad hoc* observers.

In its review of the Principles, the Steering Group has undertaken comprehensive consultations and has prepared with the assistance of members the *Survey of Developments in OECD Countries*. The consultations have included experts from a large number of countries which have participated in the Regional Corporate Governance Roundtables that the OECD organises in Russia, Asia, South East Europe, Latin America and Eurasia with the support of the Global Corporate Governance Forum and others, and in co-operation with the World Bank and other non-OECD countries as well. Moreover, the Steering Group has consulted a wide range of interested parties such as the business sector, investors, professional groups at national and international levels, trade unions, civil society organisations and international standard setting bodies. A draft version of the Principles was put on the OECD website for public comment and resulted in a large number of responses. These have been made public on the OECD web site.

On the basis of the discussions in the Steering Group, the *Survey* and the comments received during the wide ranging consultations, it was concluded that the 1999 Principles should be revised to take into account new developments and concerns. It was agreed that the revision should be pursued with a view to maintaining a non-binding principles-based approach, which recognises the need to adapt implementation to varying legal economic and cultural circumstances. The revised Principles contained in this document thus build upon a wide range of experience not only in the OECD area but also in non-OECD countries.

Preamble

The Principles are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The Principles focus on publicly traded companies, both financial and non-financial. However, to the extent they are deemed applicable, they might also be a useful tool to improve corporate governance in non-traded companies, for example, privately held and state-owned enterprises. The Principles represent a common basis that OECD member countries consider essential for the development of good governance practices. They are intended to be concise, understandable and accessible to the international community. They are not intended to substitute for government, semi-government or private sector initiatives to develop more detailed "best practice" in corporate governance.

Increasingly, the OECD and its member governments have recognised the synergy between macroeconomic and structural policies in achieving fundamental policy goals. Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. 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. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.

Corporate governance is only part of the larger economic context in which firms operate that includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can also have an impact on its reputation and its long-term success.

While a multiplicity of factors affect the governance and decision-making processes of firms, and are important to their long-term success, the Principles focus on governance problems that result from the separation of ownership and control. However, this is not simply an issue of the relationship between shareholders and management, although that is indeed the central element. In some jurisdictions, governance issues also arise from the power of certain controlling shareholders over minority shareholders. In other countries, employees have important legal rights irrespective of their ownership rights. The Principles therefore have to be complementary to a broader approach to the operation of checks and balances. Some of the other issues relevant to a company's decision-making processes, such as environmental, anti-corruption or ethical concerns, are taken into account but are treated more explicitly in a number of other OECD instruments (including the *Guidelines for Multinational Enterprises* and the *Convention on Combating Bribery of Foreign Public Officials in International Transactions*) and the instruments of other international organisations.

Corporate governance is affected by the relationships among participants in the governance system. Controlling shareholders, which may be individuals, family holdings, bloc alliances, or other corporations acting through a holding company or cross shareholdings, can significantly influence corporate behaviour. As owners of equity, institutional investors are increasingly demanding a voice in corporate governance in some markets. Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from controlling shareholders and management. Creditors play an important role in a number of governance systems and can serve as external monitors over corporate performance. Employees and other stakeholders play an important role in contributing to the long-term success and performance of the corporation, while governments establish the overall institutional and legal framework for corporate governance. The role of each of these participants and their interactions vary widely among OECD countries and among non-OECD countries as well. These relationships are subject, in part, to law and regulation and, in part, to voluntary adaptation and, most importantly, to market forces.

The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. Of particular relevance is the relation between corporate governance practices and the increasingly international character of investment. International flows of capital enable companies to access financing from a much larger pool of investors. If countries are to reap the full benefits of the global capital market, and if they are to attract long-term “patient” capital, corporate governance arrangements must be credible, well understood across borders and adhere to internationally accepted principles. Even if corporations do not rely primarily on foreign sources of capital, adherence to good corporate governance practices will help improve the confidence of domestic investors, reduce the cost of capital, underpin the good functioning of financial markets, and ultimately induce more stable sources of financing.

There is no single model of good corporate governance. However, work carried out in both OECD and non-OECD countries and within the Organisation has identified some common elements that underlie good corporate governance. The Principles build on these common elements and are formulated to embrace the different models that exist. For example, they do not advocate any particular board structure and the term “board” as used in this document is meant to embrace the different national models of board structures found in OECD and non-OECD countries. In the typical two tier system, found in some countries, “board” as used in the Principles refers to the “supervisory board” while “key executives” refers to the “management board”. In systems where the unitary board is overseen by an internal auditor’s body, the principles applicable to the board are also, *mutatis mutandis*, applicable. The terms “corporation” and “company” are used interchangeably in the text.

The Principles are non-binding and do not aim at detailed prescriptions for national legislation. Rather, they seek to identify objectives and suggest various means for achieving them. Their purpose is to serve as a reference point. They can be used by policy makers as they examine and develop the legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.

The Principles are evolutionary in nature and should be reviewed in light of significant changes in circumstances. To remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices so that they can meet new demands and grasp new opportunities. Similarly, governments have an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow markets to function effectively and to respond to expectations of shareholders and other stakeholders. It is up to governments and market participants to decide how to apply these Principles in developing their own frameworks for corporate governance, taking into account the costs and benefits of regulation.

The following document is divided into two parts. The Principles presented in the first part of the document cover the following areas: I) Ensuring the basis for an effective corporate governance framework; II) The rights of shareholders and key ownership functions; III) The equitable treatment of shareholders; IV) The role of stakeholders; V) Disclosure and transparency; and VI) The responsibilities of the board. Each of the sections is headed by a single Principle that appears in bold italics and is followed by a number of supporting sub-principles. In the second part of the document, the Principles are supplemented by annotations that contain commentary on the Principles and are intended to help readers understand their rationale. The annotations may also contain descriptions of dominant trends and offer alternative implementation methods and examples that may be useful in making the Principles operational.

Part One

The OECD Principles of Corporate Governance

I. Ensuring the Basis for an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

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.

B. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.

C. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.

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.

II. The Rights of Shareholders and Key Ownership Functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

A. Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation.

B. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:

1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.

2. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.

3. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated.

Shareholders should be able to make 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.

4. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

E. Markets for corporate control should be allowed to function in an efficient and transparent manner.

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

2. Anti-take-over devices should not be used to shield management and the board from accountability.

F. 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.

G. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

III. The Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A. All shareholders of the same series of a class should be treated equally.

1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.

2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.

3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

4. Impediments to cross border voting should be eliminated.

5. 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.

B. Insider trading and abusive self-dealing should be prohibited.

C. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

IV. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

C. Performance-enhancing mechanisms for employee participation should be permitted to develop.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

V. Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.

2. Company objectives.

3. Major share ownership and voting rights.

4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.

5. Related party transactions.

6. Foreseeable risk factors.

7. Issues regarding employees and other stakeholders.

8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

F. 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.

VI. The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

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.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

2. Monitoring the effectiveness of the company's governance practices and making changes as needed.

3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

5. Ensuring a formal and transparent board nomination and election process.

6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

8. Overseeing the process of disclosure and communications.

E. The board should be able to exercise objective independent judgement on corporate affairs.

1. 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.

2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

3. Board members should be able to commit themselves effectively to their responsibilities.

F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

Part Two

Annotations to the OECD Principles of Corporate Governance

I. Ensuring the Basis for an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

To ensure an effective corporate governance framework, it is necessary that an appropriate and effective legal, regulatory and institutional foundation is established upon which all market participants can rely in establishing their private contractual relations. This corporate governance framework typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition. The desirable mix between legislation, regulation, self-regulation, voluntary standards, etc. in this area will therefore vary from country to country. As new experiences accrue and business circumstances change, the content and structure of this framework might need to be adjusted.

Countries seeking to implement the Principles should monitor their corporate governance framework, including regulatory and listing requirements and business practices, with the objective of maintaining and strengthening its contribution to market integrity and economic performance. As part of this, it is important to take into account the interactions and complementarity between different elements of the corporate governance framework and its overall ability to promote ethical, responsible and transparent corporate governance practices. Such analysis should be viewed as an important tool in the process of developing an effective corporate governance framework. To this end, effective and continuous consultation with the public is an essential element that is widely regarded as good practice. Moreover, in developing a corporate governance framework in each jurisdiction, national legislators and regulators should duly consider the need for, and the results from, effective international dialogue and cooperation. If these conditions are met, the governance system is more likely to avoid over-regulation, support the exercise of entrepreneurship and limit the risks of damaging conflicts of interest in both the private sector and in public institutions.

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.

The corporate form of organisation of economic activity is a powerful force for growth. The regulatory and legal environment within which corporations operate is therefore of key importance to overall economic outcomes. Policy makers have a responsibility to put in place a framework that is flexible enough to meet the needs of corporations operating in widely different circumstances, facilitating their development of new opportunities to create value and to determine the most efficient deployment of resources. To achieve this goal, policy makers should remain focussed on ultimate economic outcomes and when considering policy options, they will need to undertake an analysis of the impact on key variables that affect the functioning of markets, such as incentive structures, the efficiency of self-regulatory systems and dealing with systemic conflicts of interest. Transparent and efficient markets serve to discipline market participants and to promote accountability.

B. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.

If new laws and regulations are needed, such as to deal with clear cases of market imperfections, they should be designed in a way that makes them possible to implement and enforce in an efficient and even handed manner covering all parties. Consultation by government and other regulatory authorities with corporations, their representative organisations and other stakeholders, is an effective way of doing this. Mechanisms should also be established for parties to protect their rights. In order to avoid over-regulation, unenforceable laws, and unintended consequences that may impede or distort business dynamics, policy measures should be designed with a view to their overall costs and benefits. Such assessments should take into account the need for effective enforcement, including the ability of authorities to deter dishonest behaviour and to impose effective sanctions for violations.

Corporate governance objectives are also formulated in voluntary codes and standards that do not have the status of law or regulation. While such codes play an important role in improving corporate governance arrangements, they might leave shareholders and other stakeholders with uncertainty concerning their status and implementation. When codes and principles are used as a national standard or as an explicit substitute for legal or regulatory provisions, market credibility requires that their status in terms of coverage, implementation, compliance and sanctions is clearly specified.

C. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.

Corporate governance requirements and practices are typically influenced by an array of legal domains, such as company law, securities regulation, accounting and auditing standards, insolvency law, contract law, labour law and tax law. Under these circumstances, there is a risk that the variety of legal influences may cause unintentional overlaps and even conflicts, which may frustrate the ability to pursue key corporate governance objectives. It is important that policy-makers are aware of this risk and take measures to limit it. Effective enforcement also requires that the allocation of responsibilities for supervision, implementation and enforcement among different authorities is clearly defined so that the competencies of complementary bodies and agencies are respected and used most effectively. Overlapping and perhaps contradictory regulations between national jurisdictions is also an issue that should be monitored so that no regulatory vacuum is allowed to develop (i.e. issues slipping through in which no authority has explicit responsibility) and to minimise the cost of compliance with multiple systems by corporations.

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.

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.

Regulatory responsibilities should be vested with bodies that can pursue their functions without conflicts of interest and that are subject to judicial review. As the number of public companies, corporate events and the volume of disclosures increase, the resources of supervisory, regulatory and enforcement authorities may come under strain. As a result, in order to follow developments, they will have a significant demand for fully qualified staff to provide effective oversight and investigative capacity which will need to be appropriately funded. The ability to attract staff on competitive terms will enhance the quality and independence of supervision and enforcement.

II. The Rights of Shareholders and Key Ownership Functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

Equity investors have certain property rights. For example, an equity share in a publicly traded company can be bought, sold, or transferred. An equity share also entitles the investor to participate in the profits of the corporation, with liability limited to the amount of the investment. In addition, ownership of an equity share provides a right to information about the corporation and a right to influence the corporation, primarily by participation in general shareholder meetings and by voting.

As a practical matter, however, the corporation cannot be managed by shareholder referendum. The shareholding body is made up of individuals and institutions whose interests, goals, investment horizons and capabilities vary. Moreover, the corporation's management must be able to take business decisions rapidly. In light of these realities and the complexity of managing the corporation's affairs in fast moving and ever changing markets, shareholders are not expected to assume responsibility for managing corporate activities. The responsibility for corporate strategy and operations is typically placed in the hands of the board and a management team that is selected, motivated and, when necessary, replaced by the board.

Shareholders' rights to influence the corporation centre on certain fundamental issues, such as the election of board members, or other means of influencing the composition of the board, amendments to the company's organic documents, approval of extraordinary transactions, and other basic issues as specified in company law and internal company statutes. This Section can be seen as a statement of the most basic rights of shareholders, which are recognised by law in virtually all OECD countries. Additional rights such as the approval or election of auditors, direct nomination of board members, the ability to pledge shares, the approval of distributions of profits, etc., can be found in various jurisdictions.

A. Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation.

B. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

The ability of companies to form partnerships and related companies and to transfer operational assets, cash flow rights and other rights and obligations to them is important for business flexibility and for delegating accountability in complex organisations. It also allows a company to divest itself of operational assets and to become only a holding company. However, without appropriate checks and balances such possibilities may also be abused.

C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:

1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.

2. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.

In order to encourage shareholder participation in general meetings, some companies have improved the ability of shareholders to place items on the agenda by simplifying the process of filing amendments and resolutions. Improvements have also been made in order to make it easier for shareholders to submit questions in advance of the general meeting and to obtain replies from management and board members. Shareholders should also be able to ask questions relating to the external audit report. Companies are justified in assuring that abuses of such opportunities do not occur. It is reasonable, for example, to require that in order for shareholder resolutions to be placed on the agenda, they need to be supported by shareholders holding a specified market value or percentage of shares or voting rights.

This threshold should be determined taking into account the degree of ownership concentration, in order to ensure that minority shareholders are not effectively prevented from putting any items on the agenda. Shareholder resolutions that are approved and fall within the competence of the shareholders' meeting should be addressed by the board.

3. **Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make 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.**

To elect the members of the board is a basic shareholder right. For the election process to be effective, shareholders should be able to participate in the nomination of board members and vote on individual nominees or on different lists of them. To this end, shareholders have access in a number of countries to the company's proxy materials which are sent to shareholders, although sometimes subject to conditions to prevent abuse. With respect to nomination of candidates, boards in many companies have established nomination committees to ensure proper compliance with established nomination procedures and to facilitate and coordinate the search for a balanced and qualified board. It is increasingly regarded as good practice in many countries for independent board members to have a key role on this committee. To further improve the selection process, the Principles also call for full disclosure of the experience and background of candidates for the board and the nomination process, which will allow an informed assessment of the abilities and suitability of each candidate.

The Principles call for the disclosure of remuneration policy by the board. In particular, 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. Although board and executive contracts are not an appropriate subject for approval by the general meeting of shareholders, there should be a means by which they can express their views. Several countries have introduced an advisory vote which conveys the strength and tone of shareholder sentiment to the board without endangering employment contracts. In the case of equity-based schemes, their potential to dilute shareholders' capital and to powerfully determine managerial incentives means that they should be approved by shareholders, either for individuals or for the policy of the scheme as a whole. In an increasing number of jurisdictions, any material changes to existing schemes must also be approved.

4. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

The Principles recommend that voting by proxy be generally accepted. Indeed, it is important to the promotion and protection of shareholder rights that investors can place reliance upon directed proxy voting. The corporate governance framework should ensure that proxies are voted in accordance with the direction of the proxy holder and that disclosure is provided in relation to how undirected proxies will be voted. In those jurisdictions where companies are allowed to obtain proxies, it is important to disclose how the Chairperson of the meeting (as the usual recipient of shareholder proxies obtained by the company) will exercise the voting rights attaching to undirected proxies. Where proxies are held by the board or management for company pension funds and for employee stock ownership plans, the directions for voting should be disclosed.

The objective of facilitating shareholder participation suggests that companies consider favourably the enlarged use of information technology in voting, including secure electronic voting in absentia.

D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

Some capital structures allow a shareholder to exercise a degree of control over the corporation disproportionate to the shareholders' equity ownership in the company. Pyramid structures, cross shareholdings and shares with limited or multiple voting rights can be used to diminish the capability of non-controlling shareholders to influence corporate policy.

In addition to ownership relations, other devices can affect control over the corporation. Shareholder agreements are a common means for groups of shareholders, who individually may hold relatively small shares of total equity, to act in concert so as to constitute an effective majority, or at least the largest single block of shareholders. Shareholder agreements usually give those participating in the agreements preferential rights to purchase shares if other parties to the agreement wish to sell. These agreements can also contain provisions that require those accepting the agreement not to sell their shares for a specified time. Shareholder agreements can cover issues such as how the board or the Chairman will be selected. The agreements can also oblige those in the agreement to vote as a block. Some countries have found it necessary to closely monitor such agreements and to limit their duration.

Voting caps limit the number of votes that a shareholder may cast, regardless of the number of shares the shareholder may actually possess. Voting caps therefore redistribute control and may affect the incentives for shareholder participation in shareholder meetings.

Given the capacity of these mechanisms to redistribute the influence of shareholders on company policy, shareholders can reasonably expect that all such capital structures and arrangements be disclosed.

E. Markets for corporate control should be allowed to function in an efficient and transparent manner.

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

2. Anti-take-over devices should not be used to shield management and the board from accountability.

In some countries, companies employ anti-take-over devices. However, both investors and stock exchanges have expressed concern over the possibility that widespread use of anti-take-over devices may be a serious impediment to the functioning of the market for corporate control. In some instances, take-over defences can simply be devices to shield the management or the board from shareholder monitoring. In implementing any anti-takeover devices and in dealing with take-over proposals, the fiduciary duty of the board to shareholders and the company must remain paramount.

F. The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.

As investors may pursue different investment objectives, the Principles do not advocate any particular investment strategy and do not seek to prescribe the optimal degree of investor activism. Nevertheless, 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.

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.

It is increasingly common for shares to be held by institutional investors. The effectiveness and credibility of the entire corporate governance system and company oversight will, therefore, to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest. While this principle does not require institutional investors to vote their shares, it calls for disclosure of how they exercise their ownership rights with due consideration to cost effectiveness. For institutions acting in a fiduciary capacity, such as pension funds, collective investment schemes and some activities of insurance companies, the right to vote can be considered part of the value of the investment being undertaken on behalf of their clients. Failure to exercise the ownership rights could result in a loss to the investor who should therefore be made aware of the policy to be followed by the institutional investors.

In some countries, the demand for disclosure of corporate governance policies to the market is quite detailed and includes requirements for explicit strategies regarding the circumstances in which the institution will intervene in a company; the approach they will use for such intervention; and how they will assess the effectiveness of the strategy. In several countries institutional investors are either required to disclose their actual voting records or it is regarded as good practice and implemented on an "apply or explain" basis. Disclosure is either to their clients (only with respect to the securities of each client) or, in the case of investment advisors to registered investment companies, to the market, which is a less costly procedure. 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. The additional information provided by a company would normally therefore include general background information about the markets in which the company is operating and further elaboration of information already available to the market.

When fiduciary institutional investors have developed and disclosed a corporate governance policy, effective implementation requires that they also set aside the appropriate human and financial resources to pursue this policy in a way that their beneficiaries and portfolio companies can expect.

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 incentives for intermediary owners to vote their shares and exercise key ownership functions may, under certain circumstances, differ from those of direct owners. Such differences may sometimes be commercially sound but may also arise from conflicts of interest which are particularly acute when the fiduciary institution is a subsidiary or an affiliate of another financial institution, and especially an integrated financial group. When such conflicts arise from material business relationships, for example, through an agreement to manage the portfolio company's funds, such conflicts should be identified and disclosed.

At the same time, institutions should disclose what actions they are taking to minimise the potentially negative impact on their ability to exercise key ownership rights. Such actions may include the separation of bonuses for fund management from those related to the acquisition of new business elsewhere in the organisation.

G. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

It has long been recognised that in companies with dispersed ownership, individual shareholders might have too small a stake in the company to warrant the cost of taking action or for making an investment in monitoring performance. Moreover, if small shareholders did invest resources in such activities, others would also gain without having contributed (i.e. they are "free riders"). This effect, which serves to lower incentives for monitoring, is probably less of a problem for institutions, particularly financial institutions acting in a fiduciary capacity, in deciding whether to increase their ownership to a significant stake in individual companies, or to rather simply diversify. However, other costs with regard to holding a significant stake might still be high. In many instances institutional investors are prevented from doing this because it is beyond their capacity or would require investing more of their assets in one company than may be prudent. To overcome this asymmetry which favours diversification, they should be allowed, and 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. More generally, shareholders should be allowed to communicate with each other without having to comply with the formalities of proxy solicitation.

It must be recognised, however, that co-operation among investors could also be used to manipulate markets and to obtain control over a company without being subject to any takeover regulations. Moreover, co-operation might also be for the purposes of circumventing competition law. For this reason, in some countries, the ability of institutional investors to co-operate on their voting strategy is either limited or prohibited. Shareholder agreements may also be closely monitored. However, if co-operation does not involve issues of corporate control, or conflict with concerns about market efficiency and fairness, the benefits of more effective ownership may still be obtained. Necessary disclosure of co-operation among investors, institutional or otherwise, may have to be accompanied by provisions which prevent trading for a period so as to avoid the possibility of market manipulation.

III. The Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

Investors' confidence that the capital they provide will be protected from misuse or misappropriation by corporate managers, board members or controlling shareholders is an important factor in the capital markets. Corporate boards, managers and controlling shareholders may have the opportunity to engage in activities that may advance their own interests at the expense of non-controlling shareholders. In providing protection to investors, a distinction can usefully be made between *ex-ante* and *ex-post* shareholder rights. *Ex-ante* rights are, for example, pre-emptive rights and qualified majorities for certain decisions. *Ex-post* rights allow the seeking of redress once rights have been violated. In jurisdictions where the enforcement of the legal and regulatory framework is weak, some countries have found it desirable to strengthen the *ex-ante* rights of shareholders such as by low share ownership thresholds for placing items on the agenda of the shareholders meeting or by requiring a supermajority of shareholders for certain important decisions. The Principles support equal treatment for foreign and domestic shareholders in corporate governance. They do not address government policies to regulate foreign direct investment.

One of the ways in which shareholders can enforce their rights is to be able to initiate legal and administrative proceedings against management and board members. Experience has shown that an important determinant of the degree to which shareholder rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay. The confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated. The provision of such enforcement mechanisms is a key responsibility of legislators and regulators.

There is some risk that a legal system, which enables any investor to challenge corporate activity in the courts, can become prone to excessive litigation. Thus, many legal systems have introduced provisions to protect management and board members against litigation abuse in the form of tests for the sufficiency of shareholder complaints, so-called safe harbours for management and board member actions (such as the business judgement rule) as well as safe harbours for the disclosure of information. In the end, a balance must be struck between allowing investors to seek remedies for infringement of ownership rights and avoiding excessive litigation. Many countries have found that alternative adjudication procedures, such as administrative hearings or arbitration procedures organised by the securities regulators or other regulatory bodies, are an efficient method for dispute settlement, at least at the first instance level.

A. All shareholders of the same series of a class should be treated equally.

1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.

The optimal capital structure of the firm is best decided by the management and the board, subject to the approval of the shareholders. Some companies issue preferred (or preference) shares which have a preference in respect of receipt of the profits of the firm but which normally have no voting rights. Companies may also issue participation certificates or shares without voting rights, which would presumably trade at different prices than shares with voting rights. All of these structures may be effective in distributing risk and reward in ways that are thought to be in the best interests of the company and to cost-efficient financing. The Principles do not take a position on the concept of "one share one vote". However, many institutional investors and shareholder associations support this concept.

Investors can expect to be informed regarding their voting rights before they invest. Once they have invested, their rights should not be changed unless those holding voting shares have had the opportunity to participate in the decision. Proposals to change the voting rights of different series and classes of shares should be submitted for approval at general shareholders meetings by a specified majority of voting shares in the affected categories.

2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.

Many publicly traded companies have a large controlling shareholder. While the presence of a controlling shareholder can reduce the agency problem by closer monitoring of management, weaknesses in the legal and regulatory framework may lead to the abuse of other shareholders in the company. The potential for abuse is marked where the legal system allows, and the market accepts, controlling shareholders to exercise a level of control which does not correspond to the level of risk that they assume as owners through exploiting legal devices to separate ownership from control, such as pyramid structures or multiple voting rights. Such abuse may be carried out in various ways, including the extraction of direct private benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, systematic bias in business decisions and changes in the capital structure through special issuance of shares favouring the controlling shareholder.

In addition to disclosure, a key to protecting minority shareholders is a clearly articulated duty of loyalty by board members to the company and to all shareholders. Indeed, abuse of minority shareholders is most pronounced in those countries where the legal and regulatory framework is weak in this regard. A particular issue arises in some jurisdictions where groups of companies are prevalent and where the duty of loyalty of a board member might be ambiguous and even interpreted as to the group. In these cases, some countries are now moving to control negative effects by specifying that a transaction in favour of another group company must be offset by receiving a corresponding benefit from other companies of the group.

Other common provisions to protect minority shareholders, which have proven effective, include pre-emptive rights in relation to share issues, qualified majorities for certain shareholder decisions and the possibility to use cumulative voting in electing members of the board. Under certain circumstances, some jurisdictions require or permit controlling shareholders to buy-out the remaining shareholders at a share-price that is established through an independent appraisal. This is particularly important when controlling shareholders decide to de-list an enterprise. Other means of improving minority shareholder rights include derivative and class action law suits. With the common aim of improving market credibility, the choice and ultimate design of different provisions to protect minority shareholders necessarily depends on the overall regulatory framework and the national legal system.

3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

In some OECD countries it was customary for financial institutions which held shares in custody for investors to cast the votes of those shares. Custodians such as banks and brokerage firms holding securities as nominees for customers were sometimes required to vote in support of management unless specifically instructed by the shareholder to do otherwise.

The trend in OECD countries is to remove provisions that automatically enable custodian institutions to cast the votes of shareholders. Rules in some countries have recently been revised to require custodian institutions to provide shareholders with information concerning their options in the use of their voting rights. Shareholders may elect to delegate all voting rights to custodians. Alternatively, shareholders may choose to be informed of all upcoming shareholder votes and may decide to cast some votes while delegating some voting rights to the custodian. It is necessary to draw a reasonable balance between assuring that shareholder votes are not cast by custodians without regard for the wishes of shareholders and not imposing excessive burdens on custodians to secure shareholder approval before casting votes. It is sufficient to disclose to the shareholders that, if no instruction to the contrary is received, the custodian will vote the shares in the way it deems consistent with shareholder interest.

It should be noted that this principle does not apply to the exercise of voting rights by trustees or other persons acting under a special legal mandate (such as, for example, bankruptcy receivers and estate executors).

Holders of depository receipts should be provided with the same ultimate rights and practical opportunities to participate in corporate governance as are accorded to holders of the underlying shares. Where the direct holders of shares may use proxies, the depositary, trust office or equivalent body should therefore issue proxies on a timely basis to depository receipt holders. The depository receipt holders should be able to issue binding voting instructions with respect to the shares, which the depositary or trust office holds on their behalf.

4. Impediments to cross border voting should be eliminated.

Foreign investors often hold their shares through chains of intermediaries. Shares are typically held in accounts with securities intermediaries, that in turn hold accounts with other intermediaries and central securities depositories in other jurisdictions, while the listed company resides in a third country. Such cross-border chains cause special challenges with respect to determining the entitlement of foreign investors to use their voting rights, and the process of communicating with such investors. In combination with business practices which provide only a very short notice period, shareholders are often left with only very limited time to react to a convening notice by the company and to make informed decisions concerning items for decision. This makes cross border voting difficult. The legal and regulatory framework should clarify who is entitled to control the voting rights in cross border situations and where necessary to simplify the depository chain. Moreover, notice periods should ensure that foreign investors in effect have similar opportunities to exercise their ownership functions as domestic investors. To further facilitate voting by foreign investors, laws, regulations and corporate practices should allow participation through means which make use of modern technology.

5. **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 right to participate in general shareholder meetings is a fundamental shareholder right. Management and controlling investors have at times sought to discourage non-controlling or foreign investors from trying to influence the direction of the company. Some companies have charged fees for voting. Other impediments included prohibitions on proxy voting and the requirement of personal attendance at general shareholder meetings to vote. Still other procedures may make it practically impossible to exercise ownership rights. Proxy materials may be sent too close to the time of general shareholder meetings to allow investors adequate time for reflection and consultation. Many companies in OECD countries are seeking to develop better channels of communication and decision-making with shareholders. Efforts by companies to remove artificial barriers to participation in general meetings are encouraged and the corporate governance framework should facilitate the use of electronic voting in absentia.

B. Insider trading and abusive self-dealing should be prohibited.

Abusive self-dealing occurs when persons having close relationships to the company, including controlling shareholders, exploit those relationships to the detriment of the company and investors. As insider trading entails manipulation of the capital markets, it is prohibited by securities regulations, company law and/or criminal law in most OECD countries. However, not all jurisdictions prohibit such practices, and in some cases enforcement is not vigorous. These practices can be seen as constituting a breach of good corporate governance inasmuch as they violate the principle of equitable treatment of shareholders.

The Principles reaffirm that it is reasonable for investors to expect that the abuse of insider power be prohibited. In cases where such abuses are not specifically forbidden by legislation or where enforcement is not effective, it will be important for governments to take measures to remove any such gaps.

C. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

Members of the board and key executives have an obligation to inform the board where they have a business, family or other special relationship outside of the company that could affect their judgement with respect to a particular transaction or matter affecting the company. Such special relationships include situations where executives and board members have a relationship with the company via their association with a shareholder who is in a position to exercise control. Where a material interest has been declared, it is good practice for that person not to be involved in any decision involving the transaction or matter.

IV. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A key aspect of corporate governance is concerned with ensuring the flow of external capital to companies both in the form of equity and credit. Corporate governance is also concerned with finding ways to encourage the various stakeholders in the firm to undertake economically optimal levels of investment in firm-specific human and physical capital. The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, and suppliers. Corporations should recognise that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies. It is, therefore, in the long-term interest of corporations to foster wealth-creating co-operation among stakeholders. The governance framework should recognise that the interests of the corporation are served by recognising the interests of stakeholders and their contribution to the long-term success of the corporation.

A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

In all OECD countries, the rights of stakeholders are established by law (e.g. labour, business, commercial and insolvency laws) or by contractual relations. Even in areas where stakeholder interests are not legislated, many firms make additional commitments to stakeholders, and concern over corporate reputation and corporate performance often requires the recognition of broader interests.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

The legal framework and process should be transparent and not impede the ability of stakeholders to communicate and to obtain redress for the violation of rights.

C. Performance-enhancing mechanisms for employee participation should be permitted to develop.

The degree to which employees participate in corporate governance depends on national laws and practices, and may vary from company to company as well. In the context of corporate governance, performance enhancing mechanisms for participation may benefit companies directly as well as indirectly through the readiness by employees to invest in firm specific skills. Examples of mechanisms for employee participation include: employee representation on boards; and governance processes such as works councils that consider employee viewpoints in certain key decisions. With respect to performance enhancing mechanisms, employee stock ownership plans or other profit sharing mechanisms are to be found in many countries. Pension commitments are also often an element of the relationship between the company and its past and present employees. Where such commitments involve establishing an independent fund, its trustees should be independent of the company's management and manage the fund for all beneficiaries.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

Where laws and practice of corporate governance systems provide for participation by stakeholders, it is important that stakeholders have access to information necessary to fulfil their responsibilities.

E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.

Unethical and illegal practices by corporate officers may not only violate the rights of stakeholders but also be to the detriment of the company and its shareholders in terms of reputation effects and an increasing risk of future financial liabilities. It is therefore to the advantage of the company and its shareholders to establish procedures and safe-harbours for complaints by employees, either personally or through their representative bodies, and others outside the company, concerning illegal and unethical behaviour. In many countries the board is being encouraged by laws and or principles to protect these individuals and representative bodies and to give them confidential direct access to someone independent on the board, often a member of an audit or an ethics committee. Some companies have established an ombudsman to deal with complaints. Several regulators have also established confidential phone and e-mail facilities to receive allegations. While in certain countries representative employee bodies undertake the tasks of conveying concerns to the company, individual employees should not be precluded from, or be less protected, when acting alone. When there is an inadequate response to a complaint regarding contravention of the law, the *OECD Guidelines for Multinational Enterprises* encourage them to report their *bona fide* complaint to the competent public authorities. The company should refrain from discriminatory or disciplinary actions against such employees or bodies.

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

Especially in emerging markets, creditors are a key stakeholder and the terms, volume and type of credit extended to firms will depend importantly on their rights and on their enforceability. Companies with a good corporate governance record are often able to borrow larger sums and on more favourable terms than those with poor records or which operate in non-transparent markets. The framework for corporate insolvency varies widely across countries. In some countries, when companies are nearing insolvency, the legislative framework imposes a duty on directors to act in the interests of creditors, who might therefore play a prominent role in the governance of the company. Other countries have mechanisms which encourage the debtor to reveal timely information about the company's difficulties so that a consensual solution can be found between the debtor and its creditors.

Creditor rights vary, ranging from secured bond holders to unsecured creditors. Insolvency procedures usually require efficient mechanisms for reconciling the interests of different classes of creditors. In many jurisdictions provision is made for special rights such as through "debtor in possession" financing which provides incentives/protection for new funds made available to the enterprise in bankruptcy.

V. Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

In most OECD countries a large amount of information, both mandatory and voluntary, is compiled on publicly traded and large unlisted enterprises, and subsequently disseminated to a broad range of users. Public disclosure is typically required, at a minimum, on an annual basis though some countries require periodic disclosure on a semi-annual or quarterly basis, or even more frequently in the case of material developments affecting the company. Companies often make voluntary disclosure that goes beyond minimum disclosure requirements in response to market demand.

A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis. Experience in countries with large and active equity markets shows that disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in the capital markets. By contrast, weak disclosure and non-transparent practices can contribute to unethical behaviour and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. Insufficient or unclear information may hamper the ability of the markets to function, increase the cost of capital and result in a poor allocation of resources.

Disclosure also helps improve public understanding of the structure and activities of enterprises, corporate policies and performance with respect to environmental and ethical standards, and companies' relationships with the communities in which they operate. The *OECD Guidelines for Multinational Enterprises* are relevant in this context.

Disclosure requirements are not expected to place unreasonable administrative or cost burdens on enterprises. Nor are companies expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform the investment decision and to avoid misleading the investor. In order to determine what information should be disclosed at a minimum, many countries apply the concept of materiality. Material information can be defined as information whose omission or misstatement could influence the economic decisions taken by users of information.

The Principles support timely disclosure of all material developments that arise between regular reports. They also support simultaneous reporting of information to all shareholders in order to ensure their equitable treatment. In maintaining close relations with investors and market participants, companies must be careful not to violate this fundamental principle of equitable treatment.

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.

Audited financial statements showing the financial performance and the financial situation of the company (most typically including the balance sheet, the profit and loss statement, the cash flow statement and notes to the financial statements) are the most widely used source of information on companies. In their current form, the two principal goals of financial statements are to enable appropriate monitoring to take place and to provide the basis to value securities. Management's discussion and analysis of operations is typically included in annual reports. This discussion is most useful when read in conjunction with the accompanying financial statements. Investors are particularly interested in information that may shed light on the future performance of the enterprise.

Arguably, failures of governance can often be linked to the failure to disclose the "whole picture", particularly where off-balance sheet items are used to provide guarantees or similar commitments between related companies. It is therefore important that transactions relating to an entire group of companies be disclosed in line with high quality internationally recognised standards and include information about contingent liabilities and off-balance sheet transactions, as well as special purpose entities.

2. Company objectives.

In addition to their commercial objectives, companies are encouraged to disclose policies relating to business ethics, the environment and other public policy commitments. Such information may be important for investors and other users of information to better evaluate the relationship between companies and the communities in which they operate and the steps that companies have taken to implement their objectives.

3. Major share ownership and voting rights.

One of the basic rights of investors is to be informed about the ownership structure of the enterprise and their rights vis-à-vis the rights of other owners. The right to such information should also extend to information about the structure of a group of companies and intra-group relations. Such disclosures should make transparent the objectives, nature and structure of the group. Countries often require disclosure of ownership data once certain thresholds of ownership are passed. Such disclosure might include data on major shareholders and others that, directly or indirectly, control or may control the company through special voting rights, shareholder agreements, the ownership of controlling or large blocks of shares, significant cross shareholding relationships and cross guarantees.

Particularly for enforcement purposes, and to identify potential conflicts of interest, related party transactions and insider trading, information about record ownership may have to be complemented with information about beneficial ownership. In cases where major shareholdings are held through intermediary structures or arrangements, information about the beneficial owners should therefore be obtainable at least by regulatory and enforcement agencies and/or through the judicial process. The OECD template *Options for Obtaining Beneficial Ownership and Control Information* can serve as a useful self-assessment tool for countries that wish to ensure necessary access to information about beneficial ownership.

4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.

Investors require information on individual board members and key executives in order to evaluate their experience and qualifications and assess any potential conflicts of interest that might affect their judgement. For board members, the information should include their qualifications, share ownership in the company, 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.

A number of national principles, and in some cases laws, lay down specific duties for board members who can be regarded as independent and in some instances recommend that a majority of the board should be independent. In many countries, it is incumbent on the board to set out the reasons why a member of the board can be considered independent. It is then up to the shareholders, and ultimately the market, to determine if those reasons are justified. Several countries have concluded that companies should disclose the selection process and especially whether it was open to a broad field of candidates. Such information should be provided in advance of any decision by the general shareholder's meeting or on a continuing basis if the situation has changed materially.

Information about board and executive remuneration is also of concern to shareholders. Of particular interest is the link between remuneration and company performance. Companies are generally expected to disclose information on the remuneration of board members and key executives so that investors can assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to company performance. Disclosure on an individual basis (including termination and retirement provisions) is increasingly regarded as good practice and is now mandated in several countries. In these cases, some jurisdictions call for remuneration of a certain number of the highest paid executives to be disclosed, while in others it is confined to specified positions.

5. Related party transactions.

It is important for the market to know whether the company is being run with due regard to the interests of all its investors. To this end, it is essential for the company to fully disclose material related party transactions to the market, either individually, or on a grouped basis, including whether they have been executed at arms-length and on normal market terms. In a number of jurisdictions this is indeed already a legal requirement. Related parties can include entities that control or are under common control with the company, significant shareholders including members of their families and key management personnel.

Transactions involving the major shareholders (or their close family, relations etc.), either directly or indirectly, are potentially the most difficult type of transactions. In some jurisdictions, shareholders above a limit as low as 5 per cent shareholding are obliged to report transactions. Disclosure requirements include the nature of the relationship where control exists and the nature and amount of transactions with related parties, grouped as appropriate. Given the inherent opaqueness of many transactions, the obligation may need to be placed on the beneficiary to inform the board about the transaction, which in turn should make a disclosure to the market. This should not absolve the firm from maintaining its own monitoring, which is an important task for the board.

6. Foreseeable risk factors.

Users of financial information and market participants need information on reasonably foreseeable material risks that may include: risks that are specific to the industry or the geographical areas in which the company operates; dependence on commodities; financial market risks including interest rate or currency risk; risk related to derivatives and off-balance sheet transactions; and risks related to environmental liabilities.

The Principles do not envision the disclosure of information in greater detail than is necessary to fully inform investors of the material and foreseeable risks of the enterprise. Disclosure of risk is most effective when it is tailored to the particular industry in question. Disclosure about the system for monitoring and managing risk is increasingly regarded as good practice.

7. Issues regarding employees and other stakeholders.

Companies are encouraged, and in some countries even obliged, to provide information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company. Disclosure may include management/employee relations, and relations with other stakeholders such as creditors, suppliers, and local communities.

Some countries require extensive disclosure of information on human resources. Human resource policies, such as programmes for human resource development and training, retention rates of employees and employee share ownership plans, can communicate important information on the competitive strengths of companies to market participants.

8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

Companies should report their corporate governance practices, and in a number of countries such disclosure is now mandated as part of the regular reporting. In several countries, companies must implement corporate governance principles set, or endorsed, by the listing authority with mandatory reporting on a "comply or explain" basis. Disclosure of the governance structures and policies of the company, in particular the division of authority between shareholders, management and board members is important for the assessment of a company's governance.

As a matter of transparency, procedures for shareholders meetings should ensure that votes are properly counted and recorded, and that a timely announcement of the outcome is made.

B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.

The application of high quality standards is expected to significantly improve the ability of investors to monitor the company by providing increased reliability and comparability of reporting, and improved insight into company performance. The quality of information substantially depends on the standards under which it is compiled and disclosed. The Principles support the development of high quality internationally recognised standards, which can serve to improve transparency and the comparability of financial statements and other financial reporting between countries. Such standards should be developed through open, independent, and public processes involving the private sector and other interested parties such as professional associations and independent experts. High quality domestic standards can be achieved by making them consistent with one of the internationally recognised accounting standards. In many countries, listed companies are required to use these standards.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

In addition to certifying that the financial statements represent fairly the financial position of a company, the audit statement should also include an opinion on the way in which financial statements have been prepared and presented. This should contribute to an improved control environment in the company.

Many countries have introduced measures to improve the independence of auditors and to tighten their accountability to shareholders. A number of countries are tightening audit oversight through an independent entity. Indeed, the *Principles of Auditor Oversight* issued by IOSCO in 2002 states that effective auditor oversight generally includes, *inter alia,* mechanisms: "…to provide that a body, acting in the public interest, provides oversight over the quality and implementation, and ethical standards used in the jurisdiction, as well as audit quality control environments"; and "...to require auditors to be subject to the discipline of an auditor oversight body that is independent of the audit profession, or, if a professional body acts as the oversight body, is overseen by an independent body". It is desirable for such an auditor oversight body to operate in the public interest, and have an appropriate membership, an adequate charter of responsibilities and powers, and adequate funding that is not under the control of the auditing profession, to carry out those responsibilities.

It is increasingly common for external auditors to be recommended by an independent audit committee of the board or an equivalent body and to be appointed either by that committee/body or by shareholders directly. Moreover, the IOSCO *Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence* states that, "standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation".

The audit committee or an equivalent body is often specified as providing oversight of the internal audit activities and should also be charged with overseeing the overall relationship with the external auditor including the nature of non-audit services provided by the auditor to the company. Provision of non-audit services by the external auditor to a company can significantly impair their independence and might involve them auditing their own work. To deal with the skewed incentives which may arise, a number of countries now call for disclosure of payments to external auditors for non-audit services. Examples of other provisions to underpin auditor independence include, a total ban or severe limitation on the nature of non-audit work which can be undertaken by an auditor for their audit client, mandatory rotation of auditors (either partners or in some cases the audit partnership), a temporary ban on the employment of an ex-auditor by the audited company and prohibiting auditors or their dependents from having a financial stake or management role in the companies they audit. Some countries take a more direct regulatory approach and limit the percentage of non-audit income that the auditor can receive from a particular client or limit the total percentage of auditor income that can come from one client.

An issue which has arisen in some jurisdictions concerns the pressing need to ensure the competence of the audit profession. In many cases there is a registration process for individuals to confirm their qualifications. This needs, however, to be supported by ongoing training and monitoring of work experience to ensure an appropriate level of professional competence.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

The practice that external auditors are recommended by an independent audit committee of the board or an equivalent body and that external auditors are appointed either by that committee/body or by the shareholders' meeting directly can be regarded as good practice since it clarifies that the external auditor should be accountable to the shareholders. It also underlines that the external auditor owes a duty of due professional care to the company rather than any individual or group of corporate managers that they may interact with for the purpose of their work.

E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

Channels for the dissemination of information can be as important as the content of the information itself. While the disclosure of information is often provided for by legislation, filing and access to information can be cumbersome and costly. Filing of statutory reports has been greatly enhanced in some countries by electronic filing and data retrieval systems. Some countries are now moving to the next stage by integrating different sources of company information, including shareholder filings. The Internet and other information technologies also provide the opportunity for improving information dissemination.

A number of countries have introduced provisions for ongoing disclosure (often prescribed by law or by listing rules) which includes periodic disclosure and continuous or current disclosure which must be provided on an *ad hoc* basis. With respect to continuous/current disclosure, good practice is to call for "immediate" disclosure of material developments, whether this means "as soon as possible" or is defined as a prescribed maximum number of specified days. The IOSCO *Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities* set forth common principles of ongoing disclosure and material development reporting for listed companies.

F. 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.

In addition to demanding independent and competent auditors, and to facilitate timely dissemination of information, a number of countries have taken steps to ensure the integrity of those professions and activities that serve as conduits of analysis and advice to the market. These intermediaries, if they are operating free from conflicts and with integrity, can play an important role in providing incentives for company boards to follow good corporate governance practices.

Concerns have arisen, however, in response to evidence that conflicts of interest often arise and may affect judgement. This could be the case when the provider of advice is also seeking to provide other services to the company in question, or where the provider has a direct material interest in the company or its competitors. The concern identifies a highly relevant dimension of the disclosure and transparency process that targets the professional standards of stock market research analysts, rating agencies, investment banks, etc.

Experience in other areas indicates that the preferred solution is to demand full disclosure of conflicts of interest and how the entity is choosing to manage them. Particularly important will be disclosure about how the entity is structuring the incentives of its employees in order to eliminate the potential conflict of interest. Such disclosure allows investors to judge the risks involved and the likely bias in the advice and information. IOSCO has developed statements of principles relating to analysts and rating agencies (*IOSCO Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest; IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies*).

VI. The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Board structures and procedures vary both within and among OECD countries. Some countries have two-tier boards that separate the supervisory function and the management function into different bodies. Such systems typically have a "supervisory board" composed of non-executive board members and a "management board" composed entirely of executives. Other countries have "unitary" boards, which bring together executive and non-executive board members. In some countries there is also an additional statutory body for audit purposes. The Principles are intended to be sufficiently general to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management.

Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. In order for boards to effectively fulfil their responsibilities they must be able to exercise objective and independent judgement. Another important board responsibility is to oversee systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws. In some countries, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable.

The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context.

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.

In some countries, the board is legally required to act in the interest of the company, taking into account the interests of shareholders, employees, and the public good. Acting in the best interest of the company should not permit management to become entrenched.

This principle states the two key elements of the fiduciary duty of board members: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. In some jurisdictions there is a standard of reference which is the behaviour that a reasonably prudent person would exercise in similar circumstances. In nearly all jurisdictions, the duty of care does not extend to errors of business judgement so long as board members are not grossly negligent and a decision is made with due diligence etc. The principle calls for board members to act on a fully informed basis. Good practice takes this to mean that they should be satisfied that key corporate information and compliance systems are fundamentally sound and underpin the key monitoring role of the board advocated by the Principles. In many jurisdictions this meaning is already considered an element of the duty of care, while in others it is required by securities regulation, accounting standards etc. The duty of loyalty is of central importance, since it underpins effective implementation of other principles in this document relating to, for example, the equitable treatment of shareholders, monitoring of related party transactions and the establishment of remuneration policy for key executives and board members. It is also a key principle for board members who are working within the structure of a group of companies: even though a company might be controlled by another enterprise, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

In carrying out its duties, the board should not be viewed, or act, as an assembly of individual representatives for various constituencies. While specific board members may indeed be nominated or elected by certain shareholders (and sometimes contested by others) it is an important feature of the board's work that board members when they assume their responsibilities carry out their duties in an even-handed manner with respect to all shareholders. This principle is particularly important to establish in the presence of controlling shareholders that *de facto* may be able to select all board members.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

The board has a key role in setting the ethical tone of a company, not only by its own actions, but also in appointing and overseeing key executives and consequently the management in general. High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only in day-to-day operations but also with respect to longer term commitments. To make the objectives of the board clear and operational, many companies have found it useful to develop company codes of conduct based on, *inter alia*, professional standards and sometimes broader codes of behaviour. The latter might include a voluntary commitment by the company (including its subsidiaries) to comply with the *OECD Guidelines for Multinational Enterprises* which reflect all four principles contained in the *ILO Declaration on Fundamental Labour Rights*.

Company-wide codes serve as a standard for conduct by both the board and key executives, setting the framework for the exercise of judgement in dealing with varying and often conflicting constituencies. At a minimum, the ethical code should set clear limits on the pursuit of private interests, including dealings in the shares of the company. An overall framework for ethical conduct goes beyond compliance with the law, which should always be a fundamental requirement.

D. The board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

An area of increasing importance for boards and which is closely related to corporate strategy is risk policy. Such policy 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.

2. Monitoring the effectiveness of the company's governance practices and making changes as needed.

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. In addition to requiring the monitoring and disclosure of corporate governance practices on a regular basis, a number of countries have moved to recommend or indeed mandate self-assessment by boards of their performance as well as performance reviews of individual board members and the CEO/Chairman.

3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

In two tier board systems the supervisory board is also responsible for appointing the management board which will normally comprise most of the key executives.

4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.

In an increasing number of countries 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 longer run interests of the company over short term considerations. Policy statements generally tend to set conditions for payments to board members for extra-board activities, such as consulting. They also often specify terms to be observed by board members and key executives about holding and trading the stock of the company, and the procedures to be followed in granting and re-pricing of options. In some countries, policy also covers the payments to be made when terminating the contract of an executive.

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 either wholly or a majority of 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 interest.

5. Ensuring a formal and transparent board nomination and election process.

These Principles promote an active role for shareholders in the nomination and election of board members. The board has an essential role to play in ensuring that this and other aspects of the nominations and election process are respected. First, while actual procedures for nomination may differ among countries, the board or a nomination committee has a special responsibility to make sure that established procedures are transparent and respected. Second, 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 improve its value-adding potential for the company. In several countries there are calls for an open search process extending to a broad range of people.

6. **Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.**

It is an important function of the board to oversee the internal control systems covering financial reporting and the use of corporate assets and to guard against abusive related party transactions. These functions are sometimes assigned to the internal auditor which should maintain direct access to the board. Where other corporate officers are responsible such as the general counsel, it is important that they maintain similar reporting responsibilities as the internal auditor.

In fulfilling its control oversight responsibilities it is important for the board to encourage the reporting of unethical/unlawful behaviour without fear of retribution. The existence of a company code of ethics should aid this process which should be underpinned by legal protection for the individuals concerned. In a number of companies either the audit committee or an ethics committee is specified as the contact point for employees who wish to report concerns about unethical or illegal behaviour that might also compromise the integrity of financial statements.

7. **Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.**

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. One way of doing this is through an internal audit system directly reporting to the board. In some jurisdictions it is considered good practice for the internal auditors to report to an independent audit committee of the board or an equivalent body which is also responsible for managing the relationship with the external auditor, thereby allowing a coordinated response by the board. It should also be regarded as good practice for this committee, or equivalent body, to review and report to the board the most critical accounting policies which are the basis for financial reports. However, the board should retain final responsibility for ensuring the integrity of the reporting systems. Some countries have provided for the chair of the board to report on the internal control process.

Companies are also well advised to set up internal programmes and procedures to promote compliance with applicable laws, regulations and standards, including statutes to criminalise bribery of foreign officials that are required to be enacted by the *OECD Anti-bribery Convention* and measures designed to control other forms of bribery and corruption. Moreover, compliance must also relate to other laws and regulations such as those covering securities, competition and work and safety conditions. Such compliance programmes will also underpin the company's ethical code. To be effective, the incentive structure of the business needs to be aligned with its ethical and professional standards so that adherence to these values is rewarded and breaches of law are met with dissuasive consequences or penalties. Compliance programmes should also extend where possible to subsidiaries.

8. Overseeing the process of disclosure and communications.

The functions and responsibilities of the board and management with respect to disclosure and communication need to be clearly established by the board. In some companies there is now an investment relations officer who reports directly to the board.

E. The board should be able to exercise objective independent judgement on corporate affairs.

In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the corporation, it is essential that the board is able to exercise objective judgement. In the first instance this will mean independence and objectivity with respect to management with important implications for the composition and structure of the board. Board independence in these circumstances usually requires that a sufficient number of board members will need to be independent of management. 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 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. Separation 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 designation of a lead director is also regarded as a good practice alternative in some jurisdictions. Such mechanisms can also help to ensure high quality governance of the enterprise and the effective functioning of the board. The Chairman or lead director may, in some countries, be supported by a company secretary. In the case of two tier board systems, consideration should be given to whether corporate governance concerns might arise if there is a tradition for the head of the lower board becoming the Chairman of the Supervisory Board on retirement.

The manner in which board objectivity might be underpinned also depends on the ownership structure of the company. A dominant shareholder has considerable powers to appoint the board and the management. However, in this case, the board still has a fiduciary responsibility to the company and to all shareholders including minority shareholders.

The variety of board structures, ownership patterns and practices in different countries will thus require different approaches to the issue of board objectivity. In many instances objectivity requires that a sufficient number of board members not be employed by the company or its affiliates and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being board members. In others, 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. This has led to both codes and the law in some jurisdictions to call for some board members to be independent of dominant shareholders, independence extending to not being their representative or having close business ties with them. In other cases, parties such as particular creditors can also exercise significant influence. Where there is a party in a special position to influence the company, there should be stringent tests to ensure the objective judgement of the board.

In defining independent members of the board, some national principles of corporate governance have specified quite detailed presumptions for non-independence which are frequently reflected in listing requirements. 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.

Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisitions and the audit function. In order for them to play this key role, it is desirable that boards declare who they consider to be independent and the criterion for this judgement.

1. **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.**

   While the responsibility for financial reporting, remuneration and nomination are frequently those of the board as a whole, independent non-executive board members can provide additional assurance to market participants that their interests are defended. The board may also consider establishing specific committees to consider questions where there is a potential for conflict of interest. These committees may require a minimum number or be composed entirely of non-executive members. In some countries, shareholders have direct responsibility for nominating and electing non-executive directors to specialised functions.

2. **When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.**

   While the use of committees may improve the work of the board they may also raise questions about the collective responsibility of the board and of individual board members. In order to evaluate the merits of board committees it is therefore important that the market receives a full and clear picture of their purpose, duties and composition. Such information is particularly important in the increasing number of jurisdictions where boards are establishing independent audit committees with powers to oversee the relationship with the external auditor and to act in many cases independently. Other such committees include those dealing with nomination and compensation. The accountability of the rest of the board and the board as a whole should be clear. Disclosure should not extend to committees set up to deal with, for example, confidential commercial transactions

3. **Board members should be able to commit themselves effectively to their responsibilities.**

   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. Some countries have limited the number of board positions that can be held. Specific limitations may be less important than ensuring that members of the board enjoy legitimacy and confidence in the eyes of shareholders. Achieving legitimacy would also be facilitated by the publication of attendance records for individual board members (e.g. whether they have missed a significant number of meetings) and any other work undertaken on behalf of the board and the associated remuneration.

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.

F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

Board members require relevant information on a timely basis in order to support their decision-making. Non-executive board members do not typically have the same access to information as key managers within the company. The contributions of non-executive board members to the company can be enhanced by providing access to certain key managers within the company such as, for example, the company secretary and the internal auditor, and recourse to independent external advice at the expense of the company. In order to fulfil their responsibilities, board members should ensure that they obtain accurate, relevant and timely information.

Using the OECD Principles of Corporate Governance

A BOARDROOM PERSPECTIVE

This book offers practical advice on how to implement the OECD Principles of Corporate Governance in the boardroom. By giving voice to the experiences of business leaders around the world it provides practical help for boards that navigate their way from principles to practice. Their reflections are frank and illuminating – and their conclusions are not simple or without challenge to conventional wisdom. The contributors share their experience to demonstrate that good boardroom practice requires more than law, regulation and codes of conduct. It is often the essential qualities of effective leadership which make the difference: judgement, diplomacy and integrity.

The *Boardroom Perspective* is developed by a Business Sector Group and is based on numerous interviews and discussions with peers from around the world and from different sectors. The purpose has not been to write a code or checklist of what the board of directors should do. The aim is rather to describe how they can practice good corporate governance in reality. The initiative reflects the importance that the OECD attaches to the private sector as a force in implementing good corporate governance.

For any comments, questions or suggestions concerning the *Boardroom Perspective* please contact the Corporate Affairs Division of the OECD at: corporate.affairs@oecd.org. For more information about OECD's work on corporate governance please visit ***www.oecd.org/daf/corporate/principles***.

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