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ICGN submission on the OECD's Principles of Corporate Governance draft for public comment-- November 2014

The International Corporate Governance Network (ICGN) is pleased to respond to the OECD's Principles of Corporate Governance (Principles) draft for public comment, dated November 2014. The ICGN is an investor-led network, established 20 years ago, and we have 650 members based in 50 countries, including investors responsible for assets under management in excess of US\$18 trillion. The ICGN shares the OECD's aims to encourage a modern and efficient corporate governance framework globally, and to foster better engagement between companies and investors. Our own mission is to inspire and promote effective standards of governance to support the sustainable long-term success of companies and to advance efficient markets world-wide. We do this by connecting governance professionals at global meetings, informing debate on emerging issues, and influencing the development of good governance policy.

Since their first release in 1999, the OECD Principles have played an important global role in promulgating good governance standards for the benefit of policymakers and regulatory bodies, and they also provide meaningful guidance to companies, investors and other stakeholders seeking to encourage reform and raise governance standards in many markets around the world. There have been many developments in corporate governance globally since the Principles were last revised in 2004, so we agree that a revision of the Principles is timely.

Overview

We are broadly supportive of the revisions in the draft document, and are encouraged to see several new areas come into focus, including the role of stock exchanges, enhancements in shareholder rights, the responsibilities of shareholders, as well as other aspects relating to board effectiveness, disclosure and transparency. The ICGN's own policy framework has gone through a similar journey, perhaps most notably in its revised Global Governance Principles published in 2014¹. The revision of the ICGN Principles added an important new dimension by including an emphasis on shareholder responsibilities, and we note positively that this is also a key area of focus in the revised OECD Principles. We also believe that the OECD's value creation initiative, focusing on growing business to stimulate economic

¹ See ICGN Global Governance Principles, published by the International Corporate Governance Network, 2014: https://www.icgn.org/images/Global_Governance_Principles_2014.pdf



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development², is complementary to the ICGN's focus on building sustainable long-term value in companies – which in turn will benefit institutional investors in their fiduciary duty to support pensioners and beneficiaries of insurance contracts and other long-term liabilities.

In the context of our broad support for the revisions to the Principles, our submission highlights below more specific commentary on some of the key individual changes, which we hope will prove useful as the OECD consolidates the public feedback to this consultation.

I. Ensuring the Basis for an Effective Corporate Governance Framework

Point 1. We think it is useful for OECD to articulate the role played by “soft law” and the principle of “comply or explain”. Soft law allows for the advocacy of specific governance practices that may be inappropriate for black letter law, and provides greater granularity in progressive governance practices than would otherwise be possible. However an effective comply or explain system relies for its legitimacy on external monitoring, by investors or other stakeholders, to ensure a company's non-compliance is appropriate and well-explained. This underscores the importance of the new draft language in the Principles relating to investor responsibilities, including active monitoring and engagement with companies. Without such monitoring, comply or explain runs the risk of allowing for inappropriate governance practices without censure. We believe this risk is possibly greatest in controlled companies, where the controlling owner may have limited regard for the interests of minority shareholders.

Point 3. We welcome the new language that recognises the heterogeneity of companies, and the implicit point that “one size does not fit all”. This is important in the recognition that good governance must be sensitive to national differences, legal structure and industry differences. The reference to company lifecycle is particularly useful, not only to support legitimate flexibility, but also to note that as a company evolves -- in terms of factors which may include ownership, size and geography-- its governance requirements may also stand for revision to ensure they remain relevant and appropriate. As a specific point, noting the prevalence of two-tier board structures in many jurisdictions, the Principles may benefit from a clarification of the roles of members of each board for investor engagement or any substantive discussions with investors.

Point 8. We welcome the renewed focus on the role of stock exchanges in promoting good governance standards. Particularly in the case of for-profit exchanges that generate revenue from new listings, it is entirely appropriate to emphasise the conflicts of interest that such exchanges are exposed to. While there is scope for

² See: <http://www.oecd.org/daf/ca/valuecreation.htm>



managing such conflicts in a responsible manner, a particular concern of investors is to ensure that listing standards are not compromised to allow for new market entrants with low governance standards. A clear separation of the commercial function of exchanges from the supervisory and standard setting function is critical in such cases.

II. The Rights and Equitable Treatment of Shareholders and Key Ownership Functions

Point 15. We welcome the extensions of shareholder rights referenced in this point and elsewhere in the document relating to investor approval of remuneration and material related party transactions. These areas are emerging as important topics, and also featured prominently in the European Commission's proposed revisions to the Shareholder Rights Directive. These enhanced shareholder rights also come with enhanced shareholder responsibilities, which we will comment upon in greater detail in the section on institutional investors.

Point 16. We agree with this point, but recommend that the wording in the sixth sentence be changed from "can be desirable..." to "is desirable...".

Point 18 B. We strongly support the proposed changes about shareholders having the rights of approval regarding fundamental changes as outlined in this point. We suggest that this language also include the term "mergers", so as to not to limit the focus on transactions relating to the sale of companies.

Point 20. We support the proposed additions to the text, and would emphasise the importance of facilitating efficient use of electronic voting practices. This is critical for ensuring the participation and engagement of global shareholders with large and geographically diversified investment holdings. The revised Principles do not speak to practical issues, including shareblocking, powers of attorney or other cumbersome requirements that often result in deterring some institutional investors from exercising their voting rights. While these issues tend to be a matter of individual country legal structures, the OECD may wish to raise these points in the context of their policy advisory remit. We also believe it is important for investors to receive systematic confirmation that their voting instructions have been received and counted, which puts an additional responsibility on companies and their registrars. Moreover issuers should ensure that the correct agendas are distributed to investors ahead of shareholder meetings.

Point 22. We support this point, but would recommend two wording changes. In the sixth sentence we believe that independent directors should have a "majority" role, and that this word should be inserted in place of the word "key" role. On the last sentence we recommend removal of the word "increasingly".

Point 23. We agree that a shareholder right to vote on director remuneration is an important new addition to the Principles. It is also our observation that there is no



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clear investor consensus as to whether a binding vote is preferable to an advisory report, partially in light of concerns that this could provide investors with an operational role that may more legitimately be in the domain of the company's board. However, the OECD may wish to differentiate between an *ex ante* vote on policy and an *ex post* vote on how the remuneration policy has been implemented. This can be an important way to promote dialogue between a company and its investors. While a vote on remuneration might take on different individual forms, its effectiveness will hinge on the ability of investors to devote appropriate attention to this often complex issue in individual companies. Practical experience in countries already making use of a vote on remuneration shows that negative votes in excess of 50% are very rare. To make this vote more effective in such situations, the OECD may wish to consider encouraging companies with a significant "no" vote on pay (above a certain threshold, possibly 10% or 20% of voted shares) to articulate if they have an understanding of investor concerns relating to remuneration and how they might be addressing them. With regard to the reporting on remuneration, this should be in an understandable and transparent format.

Point 25. We support the proposed changes in the text relating to electronic voting, and would like to underscore our concerns about impediments in the cross border voting process. Section 8.4 of ICGN's Global Governance Principles speaks to these same concerns.³

Point 27. We believe that the last sentence of this point is critical in facilitating legitimate investor coordination and collaboration, free of concerns regarding concert party violations.

Point 28. We do not understand why the last sentence on "one share/one vote" is removed. While the Principles do not take a position here, many investors have concerns that unequal voting rights might disenfranchise some shareholders or serve the purpose of entrenching management. It may be useful if the Principles did acknowledge such concerns, even if they do not take a firm stand on this matter.

Point 34. We agree that related party transactions are not intrinsically problematic, but are pleased to see this area under greater scrutiny in the revised Principles, particularly in cases of controlled or group companies. We also agree that independent members of a company's board should be the first line of defence. Accordingly, in the fourth sentence of this point, we believe that "prominent role for independent board members" should be replaced with "determining role for independent board members". This should make it clear that all related party transactions should be vetted independently from parties that may benefit from them. Also, noting that the last sentence of this point speaks to shareholder approval of "certain" transactions, it may be important to emphasize that this should be guided by

³ See ICGN Global Governance Principles, published by the International Corporate Governance Network, 2014: https://www.icgn.org/images/Global_Governance_Principles_2014.pdf



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a materiality threshold for shareholder involvement. While the OECD may not wish to be explicit regarding a quantitative materiality threshold, many investors would wish to vote on related transactions in excess of 5% of a company's assets, and would leave lesser transactions to be overseen by independent directors. But the company policy on the approval process and the role independent director oversight should be clearly disclosed.

III. Institutional Investors, Stock Markets and other Intermediaries

Point 42. We strongly agree with the inclusion of new language articulating shareholder responsibilities, particularly with a view to supporting the interests of the ultimate beneficiaries. We draw your attention to both the ICGN Principles for Institutional Investor Responsibilities⁴ and its Model Mandate⁵ initiative; the latter offers a template of contractual terms for institutional investors to consider when awarding mandates to asset managers. Key areas of focus in the Model Mandate include:

- the timescales over which the investment risk and opportunities are considered;
- Internal risk management;
- Incorporation of ESG factors;
- Appropriate fees, pay and culture;
- Standards of stewardship;
- Commission payments for research; and
- Portfolio turnover.

Point 43. It is important that the OECD recognises and references, as it does in the text, that approaches to voting and engagement will not be uniform by investors. In particular, investors with large numbers of holdings may have practical challenges in engaging with all portfolio companies, and may need to establish a prioritisation process to ensure that companies with the greatest needs or risks are devoted sufficient resources for company engagement.

Point 44. ICGN is supportive of the development of stewardship codes in new jurisdictions, and its Guidance on Investor Responsibilities and Model Mandate initiative are both intended to provide support for responsible investment practices.

⁴ See:

https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/SHREC/ICGN_Principles_Investor_Responsibilities_Guidance_Sept_2013_print.pdf

⁵ See

https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/SHREC/ICGN_Model_Mandate_2012_re-printApr2013_FULL.pdf



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We also support the points made in Point 44 A and in Point 47 calling for public disclosure of investor voting practices.

Point 48. We strongly agree with the new language that custodians holding shares for nominees should not vote unless they are specifically instructed to do so by the beneficial owner or by the owner's asset manager.

Point 52. We support the proposed new language calling for transparent fee structures throughout the investment chain.

Points 53-55. Proxy advisors can play a useful role in supporting the electronic voting process by institutional investors. We believe that transparency about process and methodology is important to support their recommendations, and can contribute to the mitigation of any conflicts of interest.

Point 59. We support the language in this draft calling for equal, timely and cost effective access to market information by investors. This is relevant for all companies, but arguably particularly so in the case of controlled companies, to avoid an inequitable asymmetry of information between controlling shareholders and minority shareholders.

IV. The Role of Stakeholders in Corporate Governance

Point 60. We agree that the long-term commercial success of companies – and ultimately returns to shareholders—are influenced by stakeholder relations. Executive management and boards must ensure they are sensitive to ways in which their companies impact stakeholder or social interests more broadly, not just as a matter of corporate responsibility, but also to avoid potentially damaging reputational, operational and financial risks that might arise from poor stakeholder relations.

Points 66 and 67. While the language relating to creditors and creditor rights faces few new drafting changes, we would observe that as a matter of good governance companies should seek to ensure positive relations with creditors to maintain access to cost-effective debt finance. While the interests of creditors and shareholders can sometimes diverge, we believe that companies should be transparent about their financial policies and how the balance between creditor and shareholder concerns is managed.

V. Disclosure and Transparency

Point. 73. We would note that while financial statements are commonly used in the valuation of companies, their primary purpose is not in valuing a company in terms of its market value.

Points 76 and 77. We support greater reporting on so-called “non-financial” information, particularly to the extent this reporting is integrated with financial



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reporting-- to provide users with a more holistic understanding of a company's risks and opportunities. The importance of non-financial information is articulated in detail in Point 7.5 of the ICGN Global Governance Principles.⁶ At the same time we note that use of the term "non-financial" can be problematic, insofar as the relevance of such non-financial information (which need not be limited to environmental or social issues) for many investors relates to the linkage of such information to ultimate financial outcomes. This implies a materiality threshold that should be considered, which might differentiate a company's integrated reporting from its sustainability reporting.

Point 78. We agree that disclosure of ownership data regarding beneficial owners is critical, and that the underlying beneficial owner should not be obscured through holdings in nominee accounts. However, as a practical matter, we believe that such disclosure should be triggered by passing ownership thresholds. There must be an appropriate balance to ensure that cumbersome and immaterial disclosure requirements are avoided.

Point 88. We support more information about key stakeholders, but note that in an integrated report linking non-financial issues (including stakeholder issues) with financial performance, the primary audience of such a report is the company's investor base. In such reports stakeholder information should be presented that is material to the company's operational and financial performance.

VI. The Responsibilities of the Board

Point 106. We believe that it is useful for the Principles to add the proposed language relating to tax policy. From a governance perspective tax should not be a technical issue reserved for specialists. Boards must appreciate the reputational and legal risks relating to potentially questionable tax strategies, and should ensure that a company's tax policies are prudent and sustainable in light of increasing scrutiny in this area.

Point 112. We welcome the new language on *malus* and claw-back provisions, which are becoming increasingly commonplace in remuneration structures. While their application would certainly relate to matters of fraud and financial misstatements, the Principles might consider articulating a broader definition of what might prompt the recovery of compensation. This might extend to aspects of gross negligence or inappropriate conduct that may not fit precisely within the parameters of fraud or financial restatement.

⁶ See ICGN Global Governance Principles, published by the International Corporate Governance Network, 2014: https://www.icgn.org/images/Global_Governance_Principles_2014.pdf



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Point 113. We agree with the new proposed language, and suggest you may wish to specifically consider advocating individual director elections, as opposed to elections by block or slate, which are still common in some markets.

Points 115-117. We support the new language placing greater emphasis on company ethics, including enhanced controls over ethical issues-- which might include anticorruption, taxation and human rights. Boards should monitor company behaviour in these areas, and must be aided by robust risk management systems to allow for both executives and boards to identify potential areas of weakness.

Point 129. We welcome the new language advocating regular board evaluations, as we believe this can contribute positive to overall board effectiveness.

Point 130. We agree that diversity can contribute to board effectiveness. While rigid quotas may not be appropriate in all cases, greater transparency with regard to targets and policies may help to stimulate positive change over time. Gender diversity is clearly an area requiring greater focus in the board nominations process; however other factors may be relevant as well, including nationality, sectoral knowledge, technical skills, or possibly even psychometric indicators.

Points 132 and 133. When employees are represented on company boards, we strongly agree that employee directors should have the same duties and responsibilities as other directors to promote the long-term commercial success of the company, in the interests of both shareholders and other stakeholders. In this context, the Principles might benefit by specifying training in fiduciary responsibility as an essential component of their indoctrination as directors.

We hope that this commentary on the specific points of the revised Principles is useful for the OECD in its deliberations, and we encourage you to contact us in the event you would like to discuss any of these issues in greater detail.

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