OECD Request For Public Comment On Its Draft Revised Principles of Corporate Governance

Statement By The Trade Union Advisory Committee To The OECD (TUAC) January 2004

Background

The TUAC welcomes the decision by the OECD to request public comments on its draft revised Principles of Corporate Governance. So as to help maximise a response we have posted this initiative on the TUAC web site, with a link to other web sites of the international labour movement.

TUAC welcomes the fact that public comments received will be taken into account in subsequent drafts presented for consideration to the OECD Steering Group on Corporate Governance. That body comprises the government officials with ultimate authority to decide on the contents of the new Principles. We hope that comments received will be included on the OECD web site to ensure transparency.

TUAC's perspective on the current draft of the revised Principles

The OECD Steering Group on Corporate Governance is fast approaching a cross roads with the Review. The expectation is that a new set of Principles will be presented for adoption to the 13-14 May 2004 meeting of the OECD Council at Ministerial level.

Senior government officials will have to decide whether to recommend to their Ministers that the Review has reached a point that the outcome will meet the public's expectations, and that of key actors including responsible institutional shareholders, as well as organised labour. Public expectations are that the revised Principles must set a new and higher standard of corporate governance. They must be a key tool for governments to implement in stamping out the corporate abuses that appear on a daily basis. For the Review and the OECD itself to have credibility and to show their relevance to the current situation they must meet this expectation.

It is against this background that we urge that the following TUAC comments be taken into consideration. They have been prepared following an examination of the new draft Principles posted for public comment, in comparison with previous drafts.

TUAC was of the view that the first draft of June 2003 represented a useful starting point from which to proceed. In general some improvements have been made as regards shareholder responsibilities, and on executive remuneration, and the need for auditors to have a duty of care to the company. Welcome as these revisions are, they either fall short of what is required in major areas; are a watered down version of what was originally proposed; or they are buried within the annotations and lack clarity. Furthermore, the Stakeholder chapter remains an empty box.

We would urge the Steering Group to significantly strengthen the Principles along the lines set out below. However, if the outcome to be presented for adoption by Ministers in May falls short of that required to achieve a high standard of corporate governance and accountability, we will urge a further period of deliberation by OECD governments.

Outstanding issues around the current draft

"The Principles should be renewed in the light of significant changes in circumstances."

"The Principles are intended to assist OECD and non-OECD governments."

"The Principles represent broad features that the Steering Group considers essential for the development of good governance practice."

"They are intended to be concise, understandable and accessible to the international community."

Those quotes are drawn from the draft of the revised Principles posted for public comment. They are a useful standard by which to judge the revised text. In TUAC's view:

- The revised text does not reflect the changes needed to accommodate the "significant changes in circumstances" that have taken place in the past three years, including the ongoing series of corporate scandals and collapses. In particular: it fails to meet the needs of those institutional investors seeking to exercise responsible stewardship over those companies, within which they have invested workers retirement income or savings. The revised text does not help those pension fund trustees wishing to see their investment managers taking a more active oversight role over the companies whose equity they hold.

- The revised text does not adequately reflect the needs of developing countries aiming to raise their standards of corporate governance. The World Bank-OECD Global Forum on Corporate Governance held a meeting in Paris in November 2003, at which TUAC participated. The discussions showed a clear desire among participants for a deeper and stronger set of Principles. Furthermore, the majority of speakers saw the need for a more concise and stronger Stakeholder chapter. Those views have not been reflected in the current text.

- The revised text does not adequately represent those "broad features considered essential for the development of good governance practice". Our concern is that the current draft is too weak on for example: curbing inappropriate levels of executive remuneration, delivering shareholder responsibility, curbing excesses of power of "imperial CEOs", ensuring the accountability of BoDs, and giving real rights to stakeholders.

- The current draft is not "concise, understandable and accessible to the international community". Our concern here is that much of the text is unnecessarily hesitant and imprecise, lacks focus, and is hedged with too many caveats. In the current draft, some principles – such as Principle V.E – are more concerned with public governance principles, and not specifically about corporate governance. Furthermore, many of the action points are buried in the annotations to the Principles.

- Beyond that the Preamble to the posted text (paragraph 6) correctly indicates that employees and other stakeholders have a role within corporate governance frameworks. However, the Steering Group as a whole has failed to take on board the revisions needed to the text so as to ensure that employees and other relevant stakeholders can play an effective role in helping to stamp out corporate abuses.

Ironically, while the Review has taken an excessively cautious line, many national regulatory changes have emerged that go far beyond the revisions being contemplated by the Steering Group. Furthermore, many global corporations have unilaterally implemented their own corporate governance reforms, currently rejected by the Steering Group including strengthening the independence and the accountability of the board, shareholders' approval of individual remuneration packages, suppression of stock options, and separation of Chair and CEO functions. But as welcome as these reforms are they are piece meal and there is not a level playing field.

Comments by chapter

TUAC has made extensive comments and proposals as regards previous drafts of the revised Principles. Those comments and proposals are in most cases still valid. For now, we limit our comments to the new proposals and to a few core issues.

<u>Chapter I "The rights of shareholders and key ownership functions"</u>

- **Title of the chapter "The rights of shareholders <u>and key ownership functions</u>"**

The proposed change of title is moving in the right direction and reflects the need for shareholders to have rights and responsibilities in corporate governance. However, for the title to be clear and concise it should simply be stated as: **"The rights and responsibilities of shareholders"**. We are also concerned that the ensuing Principle (I.C.3) is too weak:

- **Principle I.C.3: "<u>Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members should be facilitated. Shareholders should also be able to make their views known on the remuneration policy for board members. The equity component of compensation schemes for board members and key executives should be subject to shareholder approval</u>".**

The softening of the text regarding the participation of shareholders in the remuneration process lags far behind best practice emerging in Member countries. A clear trend is discernible toward shareholder approval of total remuneration packages, rather than merely having their views known. The reference to shareholder approval for the "equity component" further lags behind best practice. The deletion of any reference to shareholders having access to the "proxy process" further undermines the credibility of the Principles.

<u>Chapter III "The role of stakeholders in corporate governance"</u>

TUAC has previously informed the Steering Group of our deep concerns at their lack of political will to bring the chapter in to line with current best practices. We have also submitted new text for the chapter. Here, we will limit our comments to the current draft.

- **Include a generalised right to stakeholder representation**

The current text of chapter III is another example where the Principles do not focus on specific outcomes of corporate governance. To respect the rights of stakeholders "as established by law" is a requirement of good public governance (in the header of the chapter, and Principles A & B). It does not inform corporations as regards the rights and the responsibilities of the stakeholders. It is essential that the revision calls for a generalised right to stakeholder representation:

- The title of the chapter should be **"The rights and responsibilities of stakeholders"**.

- The header of the chapter should by revised to adopt the June 2003 proposal of the OECD Secretariat, that is **"The corporate governance framework should recognise the established rights of stakeholders ~~as established by law~~"**.

- Principle III.A should be drafted as follows: **"The corporate governance framework should include stakeholder representation ~~assure that the rights of stakeholders that are protected by law are respected~~".**

These changes are required to ensure that the chapter reaches a minimal level of relevance for OECD countries – and in particular to reflect the European model of social dialogue – and for the developing world. Furthermore, the current text includes a conceptual misunderstanding regarding the participation of stakeholders and the distinction between representation and performance enhancing mechanisms:

- **No consideration for continental European worker participation and non-OECD countries.** The credibility of the chapter and its relevance to many OECD countries within continental Europe, and also developing and transition countries is at stake. This chapter is at odds with the Continental tradition on social dialogue: the European Works Council directive, the directive on generalised information and consultation rights for employees, the European Company Statute, and lately the proposed take-over directive that specifically includes a model for employee consultation (article 14). We strongly urge the EU members and the European Commission participating in the Steering Group to consider the consistency of their positions on the stakeholder participation in corporate governance within that OECD forum and the various EU commitments.

- **Conceptual misunderstanding about stakeholder participation and performance enhancing mechanisms.** The text does not distinguish between performance enhancing mechanisms and representation of stakeholders. In short employees share ownership schemes (ESOPs), and employee representation (e.g., works councils, board level employee representation) are separate issues within the corporate governance framework. ESOPs are company specific, and subject to change. Employee representation does target corporate performance but is not confined to that objective. It also targets employees' participation at the board level (a voice in all major corporate decisions), and over safety and health issues, and importantly participation in restructuring processes, all of which are not strictly performance-related matters. Where should the practice of employee representation then appear in the chapter? The other employee related Principles: B, D, and E address the issues in part. But none of them encompasses the principle of employee representation in the corporate governance framework.

- **Other comments**

- We are concerned by the proposal to change the annotations of the header. We propose to draft the annotation as follows: **"Corporate governance is also concerned with finding ways to encourage the various stakeholders in the firm to undertake socially <u>and economically optimal</u> ~~efficient~~ levels of investment in firm-specific human and physical capital."**

- The proposed change on pension commitments in the annotations of Principle III.C is in some respects welcome. It nonetheless reflects the insufficient nature of the Review. TUAC has suggested stronger language that goes beyond merely requiring the independence of what should in practice be independent bodies.

<u>Chapter IV "Disclosure and transparency"</u>

- **Principle IV.A.7 "Disclosure should include, but not be limited to, information on: […] Material issues regarding the employees and other stakeholders"**

We note that the annotations do not refer to social and environmental impact assessments commissioned by the board as a good corporate practice, although it is our understanding that the inclusion was previously agreed by the Steering Group.

<u>Chapter V "The responsibilities of the board".</u>

- **Principle V.C "The board should <u>apply high ethical standards</u> ~~ensure compliance with applicable law~~. <u>It should</u> ~~and~~ take into account the interests of stakeholders".**

This proposed Principle lacks focus and is imprecise. The two issues should be distinct and separate Principles.

- **Principle V.E "The board should be able to exercise objective judgement on corporate affairs independent~~, in particular,~~ from management<u>, controlling shareholders and others in a special position to influence the company</u>"**

The changes in the Principle E are symptomatic of the unwillingness of the Steering Group to take a proactive stance on the accountability of the board. To exercise "objective judgement" is not a specific outcome of good corporate governance; it is a general principle of good governance. At the same time the annotations refer to specific outcomes of corporate governance. The criteria to choose independent directors and the separation of the Chair and the CEO functions – which are included in the annotations – are specific corporate governance reform outcomes. They should be stand-alone principles. The length of the annotations, one page long, further indicates the unwillingness of the Steering Group to tackle directly issues of board accountability.
We also note the absence of the proposal to include stakeholders in the list of areas where independent directors "can play an important role". Similarly, it our understanding that it was previously agreed to include language on the practice of interlocking directors and cross directorships as a concern for independence of board and conflict of interests. That appears to have been dropped from the new draft.

We propose to replace existing Principle V.E with the following two principles:

"The organisation of the board should ensure separation of supervisory and management functions of the company"

Annotation:
"In a number of countries with single tier board systems, the objectivity of the board and its independence from management may be considered to be impaired when the role of Chief Executive and Chairman are combined. Separation of the two posts ~~may be regarded as~~ is 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. Separation can also increase the capacity of the Chairman to ensure high quality governance of the enterprise and the effective functioning of the board. The Chairman may in some countries, be supported by a company secretary.
Where the two roles of Chief Executive and Chairman are not separated, other methods to establish appropriate checks and balances may be necessary and might include the appointment of a lead non-executive director and by meetings from time to time of only the non-executives of the board. In the case of dual board systems, analogous conflict of interest issues might arise if there is a tradition of the Chief Executive becoming the Chairman of the Supervisory Board on retirement."

"The board should be sufficiently independent from management, dominant shareholders and others in a position to influence the company, while remaining accountable to relevant stakeholders"

Annotation:
"Independence of the board from management has a number of implications for both the composition of the board and for the characteristics of its members. To have non-executive board members may be a necessary but not sufficient criteria for effective independence. The variety of board structures and practices in different countries will require different approaches to the issue of independent board members. Board independence usually 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 including service on the boards of other companies, such as customers and suppliers for whom the relationship of the company is material. This does not prevent shareholders from being board members. 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 regarded as independent can usefully be complemented by 'positive' examples of qualities that will increase the probability of effective independence. In countries characterised by controlling shareholders who are able to determine the composition of the board, the concept of independence is usually extended to also consider the relationship with such shareholders. This is particularly important in jurisdictions where the duty of the board and individual members to the company and to all its shareholders is not well developed or enforced. Some jurisdictions have also experienced cases where creditors have exercised undue influence over the board. 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 taking account of the interests of stakeholders or in areas where the interests of management, employees, the company and 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 companies declare who they consider to be independent and the criteria for this judgement.

Proposed new chapter on implementation and enforcement?

We welcome the inclusion of a separate section on implementation and enforcement. But we are concerned that the draft does not formally distinguish the text as a new stand alone chapter. And, as drafted it fails to prioritise the role of corporate governance laws and regulations to achieve effective implementation and enforcement. Worryingly, the annotations place too much emphasis on concerns about over-regulation. To rectify this the chapter should be titled "Effective Implementation and Enforcement". The current title: "Ensuring an effective corporate governance framework" should be deleted. To give effect to the title the text should include stronger language on the need for corporate governance frameworks to be built upon a solid legal and regulatory framework, with clear penalties for the violations of such laws and rules.