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New Stringent Avenues of Corporate Governance

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STRENGTHENING MARKET FOUNDATIONS THROUGH CORPORATE GOVERNANCE REFORM

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1. Introduction

At last year's annual conference in Istanbul, the Emerging Markets Committee of IOSCO recommended that its members use the *OECD Principles of Corporate Governance*[2] as a benchmark[3]. Also at that conference, in a panel discussion similar to the one we are having today, I stressed the importance of sound corporate governance for ensuring the integrity of our financial markets and investor confidence and noted that developments preceding that meeting had revealed serious governance failures in the most advanced markets[4]. Some 17 months later we find that corporate governance concerns continue to be intensively debated in various national, regional and international fora. Further governance failures have emerged, with the problems at the New York Stock Exchange presenting a disturbing case in point. On the positive side,

[1] The views expressed in these remarks in no way commit the OECD or its Member countries.
[2] These can found at www.oecd.org under the "Corporate Governance" theme.
[3] See *Final Communiqué,* http://www.iosco.org/news/pdf/IOSCONEWS5-English.pdf , page 5
[4] http://www.iosco.org/library/annual_conferences/pdf/ac16-23.pdf

major initiatives have been taken to restore market integrity and public confidence[5]. There are signs that investor confidence is strengthening due in part, of course, to improved prospects for economic growth and profits.

I should acknowledge at this point the important achievements of our host country, Korea, as it has done so much to improve its corporate governance regime and is continuing with its efforts. The corporate governance weaknesses revealed in the 1997 crisis had led to an increasingly skewed development and a systematic abuse of investors – and eventually taxpayers as the banking system had to be rescued. The government of Korea is to be commended for its commitment to reform despite considerable backpressure. A number of other OECD countries are only now coming to the conclusion that they face corporate governance challenges that go beyond dealing with fraud and accounting irregularities.

At both the multilateral and national levels and in the most advanced as well as emerging market economies, our experience has demonstrated that the OECD Principles can make a major contribution to the ongoing efforts to improve corporate governance. They have already played a key role in promoting corporate governance worldwide through regional roundtables in Asia, Latin America, Eurasia, South East Europe and Russia which have been organised by the OECD in partnership with the World Bank.[6] Important reasons for these achievements are that the Principles are non-prescriptive, results-oriented, evolutionary and conceived to be adaptable to a variety of national legal situations.

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[5] See also "Survey of Corporate Governance Developments in OECD Countries", OECD, autumn 2003.

[6] "White Papers" presenting regional priorities for corporate governance reform have been developed by the Roundtables and can be found on the OECD website, op. cit.

To continue this role, the OECD Principles have to maintain their relevance and be able to address new challenges. For this reason, the OECD Council Meeting at Ministerial Level in 2002 called for the OECD to survey corporate governance developments in member countries[7], with a view to identifying lessons to be learned and the implications for an assessment/review of the Principles which is to be presented to the Ministers at their meeting in May 2004. This work is being conducted by the Steering Group on Corporate Governance, which comprises the OECD member countries. Other organisations, including the World Bank, the Financial Stability Forum, IOSCO and the two civil society organisations represented at the OECD, the Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC) are participating in this work. In addition, the Steering Group has set up a consultation process with non-member countries and with a broad range of organisations including other international standard setters, representatives of investor groups and various civil society organisations. IOSCO's involvement in this process is particularly important both because of the Emerging Market Committee's endorsement of the Principles and because of the direct relevance of IOSCO's work.

The three sets of issues that I will discuss today are fundamental for underpinning a self-sustaining system of checks and balances and a dynamic corporate governance system. Moreover, the consultations which have taken place for the review have identified them as important topics. They are:

[7] The 30 OECD Members are the following: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Norway, New Zealand, Netherlands, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.

- The role of investors and the exercise of key ownership functions;
- Market integrity, including financial service providers and the role of self-regulatory bodies;
- Implementation and enforcement, which covers the quality, consistency and architecture of the regulatory framework.

2. The role of investors and the exercise of key ownership functions

It is often said that the board – which has the fiduciary duty to represent the best interests of the shareholders (investors) – is the final line of defence against management actions that are not consistent with shareholders' interests. Yet recently in a number of countries there are concerns that boards have often appeared to have been surprised by adverse developments or have shown little critical behaviour vis-à-vis the CEO/Chairman, resulting in problems ranging from remuneration packages which do not appear to have been negotiated at arms length to designs by CEOs for expansion bordering on self-aggrandisement. The policy response in a number of cases has been provisions to increase the number of "independent" board members and to strengthen their role. The OECD Principles of Corporate Governance do not call for independent directors *per se* but for directors "capable of exercising independent judgement" and for boards able to "exercise objective judgement on corporate affairs, independent, in particular from management". Will "independent" directors be able to do this and under what conditions? While individuals may start as "independent", there must be reason to doubt that they can be expected to remain so (except formally) after they have become members of the board "team". Indeed most Chairmen/CEOs seek to establish a collegial team, an approach deemed to be important from the efficiency point of view. What is crucial is the incentive for a director to retain independence of judgement and this would appear to come down to how they are selected or nominated in the first place, as well as the strength of the reputation effect.

In almost all corporate governance systems investors have, de jure, fairly extensive rights, but in practice the ability to exercise them is often restricted. Company by-laws and corporate practices can severely limit questions being posed to the board and the power to propose, or to oppose, individual members of the board is practically non-existent. Doing more to open board elections would finally clear the way for a more effective exercise of ownership rights. But the ability of shareholders to demand accountability of the board also needs to be improved by making it easier to ask questions of the board and to put forward proposals to the general meeting of shareholders. Moreover, resolutions passed by shareholders should be more binding on the board than is currently the case in many countries. Last week the SEC opened what will be a heated debate in the US with its proposed amendments to the proxy rules.[8]

These are controversial ideas, raising for some the spectre of shareholders running riot and destroying the carefully planned operation of a company. Let me, therefore, make it clear that the fundamental and proven strength of the corporation – professional management – needs to be preserved. Moreover, second guessing business judgements by directors also needs to be strenuously avoided. The business judgement rule needs to be defended. Nevertheless, the board and the company should be accountable to the investors, and held to higher standards than in the past. Policy-

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[8] http://www.sec.gov/news/press/2003-133.htm

makers, therefore, will have to consider techniques to avoid disruptive behaviour – such as excessive class actions and litigation—while at the same time not taking their eye off the real objective of encouraging more effective owners.

An important feature of the current structure of shareholding is the increased presence of institutional investors. Such institutions take many forms: some such as mutual funds and pension funds act in a fiduciary capacity while others, including insurance companies and investment banks, act in their own right. In many cases, fiduciary and non-fiduciary holdings occur in the same company, such as when an investment bank sells their own mutual funds to the market while also trading on its own account. Although the two activities are formally separated, other links such as bonuses cutting across activities are the norm in many cases.

Institutional investors have become the main players in the capital market. They are the major owners of corporate equity. By 1999 insurance company, collective investment scheme (mutual fund) and pension fund assets were some 144% of the GDP of OECD countries, while in 1980 they represented only 38% (Chart 1). The significance of institutional investors does not relate just to their resources and share of the market but also because they have become "delegated monitors": they own shares on behalf of millions of other investors. This is most true for institutions acting in a fiduciary capacity such as pension funds, mutual funds and other collective investment schemes. To a certain extent it is also true of other institutions.

Institutional investors have an important role to play both in monitoring company performance and in conveying their concerns to the board and management of companies. Institutional investors can challenge or support the board through voting at the general meetings of shareholders and they are also in a good position to take their concerns directly to the board of a company and to propose a course of action. Although an increasing number of institutional investors are actively using these possibilities to exercise an informed ownership function, a number of issues have arisen. At the outset, it is important to recognise that there are significant differences in what can be expected from different types of institutional investors, for example, from pension funds in comparison with mutual funds, even though both act in a fiduciary capacity. Also any one institution might not hold a very large stake in a company due to prudential and other regulatory considerations or to the investment strategy, a situation which reduces their incentives to monitor that company. Such disincentives can be reduced by coordinated action among shareholders in exchanging information and plans, and in some cases pooling their shares to reach thresholds for action. This is now happening in some countries. However, in a number of cases there are regulatory restrictions on what can be done. Institutional investors may also suffer from a conflict of interest with respect to exercising their ownership functions: other commercial relations with the firm may take precedence over what might be a desirable course of action from an ownership perspective. Finally, some institutions – for example, hedge funds - might hold shares only for a very short period, making the exercise of ownership rights impractical.

A question arising in our discussions is the following: If the exercise of an ownership right can be considered part of the inherent value of a share, shouldn't institutional investors acting in a fiduciary capacity be required to disclose how they use such a right

– their policies with respect to their ownership right and how they used them? I sense growing support for such disclosure.

3. Market integrity

The exercise of shareholder rights as a check and balance on the operations of the board does presume that investors are suitably informed; hence, there should be a minimum level of transparency and disclosure by companies. The whole process has been placed under examination, from internal preparation of financial reports and internal controls through to the role of the board in approving the disclosure, the accounting standards being used and the integrity of the external audit process. The responsibility of boards and their audit committees (or similar bodies) have been tightened and a number of countries have now introduced public oversight of the setting of accounting and audit standards. This process places professional self-monitoring under tighter oversight. The recent work of IOSCO has made an important contribution to these reforms.[9] In an increasing number of countries auditors are being restricted in the non-audit services that they can perform in order to avoid incentives structures which might lead to diminished independence in the enforcement of audit standards. Some form of auditor rotation is also being introduced.

However, information available to the market and to investors is not simply a function of disclosure by the company concerned. Information of importance for key corporate governance decisions is also processed by intermediaries such as brokers, analysts and

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[9] See http://www.iosco.org/news/pdf/IOSCONEWS2.pdf

rating agencies. With respect to these institutions, a number of questions have arisen about their independence, conflicts of interest and transparency.

These intermediaries in many cases are overseen by stock exchanges which are themselves self-regulatory bodies. The latter increasingly are including corporate governance rules as part of their listing requirements which are then often taken as representing best practice by the listed companies. Recently, with respect to these professions there have been discussions about the desirability of strengthening self-regulation and supplementing it with public oversight bodies. For example, IOSCO has been looking at the position of security analysts[10] and rating agencies[11]. Less discussed up to the present has been the self-regulatory nature of stock exchanges, although where they have been “de-mutualised”, the question has become more pressing as they are setting their trading and listing rules while trading in their own shares.

For market intermediaries and processors of corporate information, the issue has not just been self-regulation but the changing nature of incentives due to evolving customer demand, technological innovation and the formation of new institutions, in particular, integrated financial companies. One approach to addressing situations where there are inappropriate incentives to breach the trust of clients would be to require providers of information about corporations to disclose any material conflict of interest. Would this be sufficient, or should more be done in the areas of regulatory oversight and structural remedies such as separation of activities into independent units along the lines of the recent trend to separate audit and consultancy functions? And we should not forget the

[10] See http://www.iosco.org/news/pdf/IOSCONEWS58.pdf
[11] See http://www.iosco.org/news/pdf/IOSCONEWS59.pdf

responsibilities of management to avoid entering into relationships that have inherent conflicts of interest.

Market integrity is also a concern with respect to executive remuneration and the effects of distorted incentive structures. In a number of countries, executive remuneration is not only a political and equity issue but also an economic one since there is evidence that the incentive structure of executive remuneration has influenced corporate behaviour in ways that are not in the longer term interests of either the company or most of the shareholders. There is strong evidence that the market for executive pay is not one characterised by arm's length bargaining, and that market forces are not strong. Rather, it appears that executives can substantially influence the process via control of the board and by the selection of remuneration consultants.

This is one of the market integrity concerns that underlines the importance of improving the operation of boards, which, it is widely considered, have not adequately performed their oversight role. It is the responsibility of the board to ensure that the remuneration package aligns incentives with the longer run interests of the shareholders and the company. In addition to the response indicated earlier, taking steps to increase the number of "independent" board members, there has also been in several countries efforts to improve their quality by both training and by the use of more systematic recruitment. The proper role of shareholders in determining executive and board remuneration is also under discussion. Should they be allowed only an advisory vote on the remuneration policy or should their rights be more extensive, allowing a formal say in terms of structure and size of the remuneration package? Or alternatively is this a matter that should be left to the technical expertise of a compensation committee comprised of independent board members?

4. Implementation and enforcement

The issue of implementation and enforcement has entered the debate in two ways. One perspective starts with the observation that some of the problems observed over the last year or two were in fact already under existing rules and standards either at best highly unethical or at worst illegal. Improved enforcement through increased criminal penalties and enhanced ethical and technical standards with greater public oversight seem appropriate policy prescriptions in such cases. A second perspective is reflected in the concerns of a number of policy-makers and business people alike that the current round of reforms might produce a lot of “box ticking”, that is, mechanical references to requirements to see that they have been met, but that the desired outcomes would not necessarily be achieved. Clearly a balance between the two points of view is required, the nature of which will depend on institutions, legal systems, history etc.

A key element of effective enforcement and implementation is a regulatory system which ensures that the potential for damaging conflicts of interest remains limited and that there is a level playing field among the major participants in corporate governance (for example, through investor protection). Effective implementation and enforcement in turn requires that laws and regulations are designed in a way that makes them possible to implement and enforce in an efficient and credible fashion. Moreover, the division of authority between agencies and supervisory bodies should be well defined and they need to pursue their function in an unbiased and even-handed manner without serious conflicts of interest.

Such a system, however, requires precious manpower; hence, the resources set aside for supervision, regulation and enforcement are likely to be always under strain — even more so as the number of corporate events and the volume of disclosures increases. This makes it all the more important to create and rely on market mechanisms which serve to economise on the use of such scarce resources. Market mechanisms include reinforcing reputation effects through setting standards and demanding disclosure, and giving individual investors and stakeholders the ability to defend their interests and to fashion corporate governance arrangements to suit changing conditions.

5. Concluding remarks

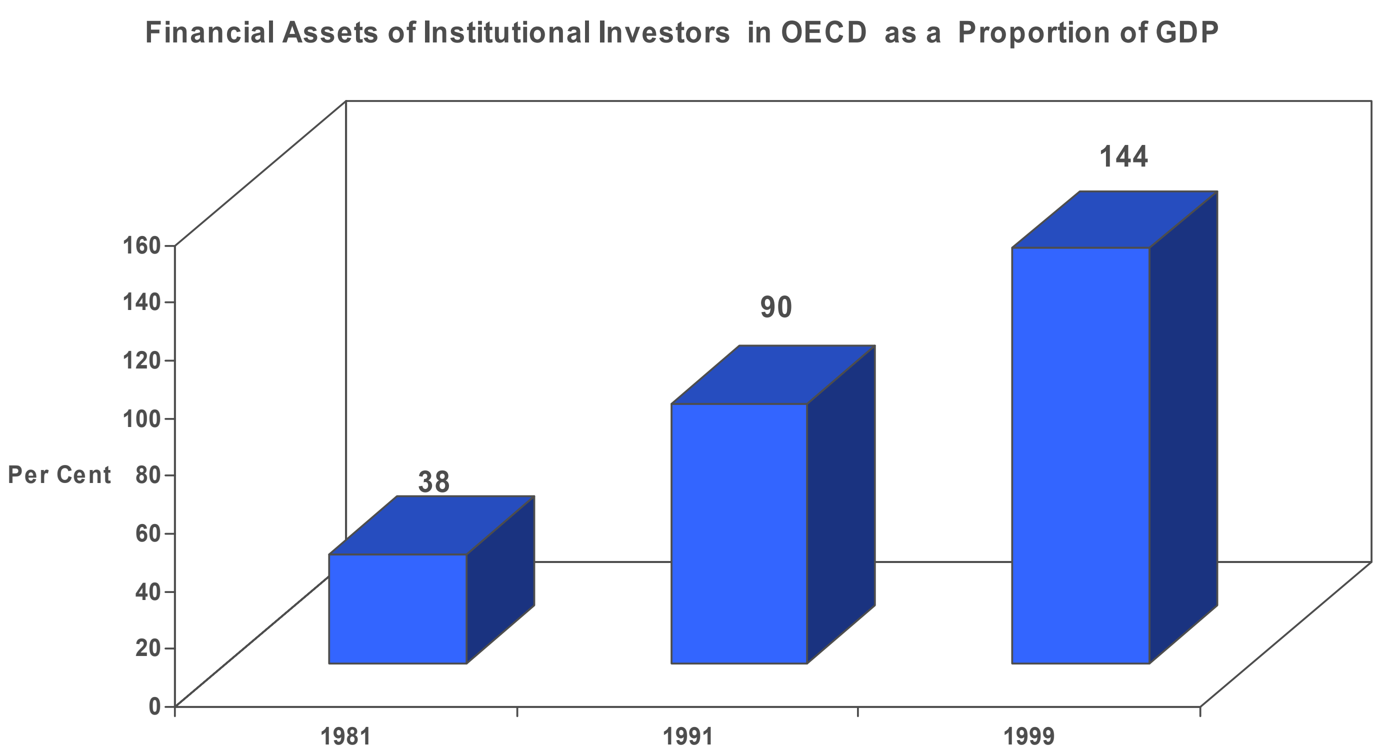
To rebuild confidence on a lasting basis, market participants, supervisors and policymakers will have to join forces to develop a better framework for financial market integrity and transparency while avoiding overregulation. In this context, reliance on surveillance and sanctions will need to be supplemented by sounder incentive structures towards better governance, risk management, disclosure and education. At the end of the day, restoring public confidence in financial institutions and markets will be key in enabling them to perform efficiently again their allocative and monitoring functions – which are indispensable for the resumption of sustained growth in the future.

International cooperation will be essential to this process in view of the increased integration of markets. The OECD is responding in a number of ways to these challenges in order to keep abreast of changing circumstances. Many of the issues I have discussed are figuring prominently in discussions on the review of the *OECD Principles*. We are also reviewing the guidelines that we developed several years ago for the management of pension funds[12] and are developing guidelines, in conjunction with regulators, for collective investment schemes. And our extensive efforts with emerging market and transition economies - in partnership with the World Bank - are moving from the identification of regional reform priorities to implementation.

The most important role is, however, probably still ahead of us. It is fair to say that many of the current reforms are to some extent experimental and that there will be a need for countries to be able to compare their experiences and to assess where they are against an ambitious benchmark. This is the type of service the OECD provides in many fields for its members. There will likely be problems concerning the international implications of domestic corporate governance policy as well as possibly issues arising from regulatory competition. I look forward to continued cooperation with IOSCO as we proceed with this challenging work.

[12] http://www.oecd.org/dataoecd/22/2/2767694.pdf

Chart 1



Financial Assets of Institutional Investors in OECD as a Proportion of GDP
Per Cent
0
20
40
60
80
100
120
140
160
38
90
144
1981
1991
1999

ANNEX

THE OECD'S RESPONSE TO CORPORATE GOVERNANCE

- The OECD Principles of Corporate Governance were developed in the aftermath of the 1997 financial crisis and issued in 1999.

- Since then, the Principles have become a global point of reference for international policy-dialogue and have been adopted by the Financial Stability Forum (FSF) as one of its twelve key standards to promote a sound financial system.

- The Principles have also been recognised by a range of other international organisations, including the International Organisation of Securities Commissions (IOSCO) Emerging Markets Committee, and form the basis for a number of national principles on corporate governance. They are also used as the standard for reviews of corporate governance by the World Bank and the framework for OECD-World Bank Regional Corporate Governance Roundtable for Asia, Latin America, Russia, South East Europe, and Eurasia.

- The Principles are intended to assist countries in efforts to benchmark and improve the legal, institutional and regulatory framework for corporate governance and to provide guidance and suggestions for stock exchanges, investors, corporations and others that have a role in the process of developing good corporate governance.

- In a response to corporate governance developments in the last two years, significant policy initiatives are either coming into place or are under consideration. A number of countries are also involved in reviewing their company law.

- Against this background, the OECD Council Meeting at Ministerial Level in 2002 called for an assessment of the Principles to be completed in 2004. This work is now being undertaken by the OECD Steering Group on Corporate Governance.

- As part of this work, the OECD is undertaking a comprehensive survey of corporate governance developments in OECD countries since 1999, and a summary of experiences in non-OECD countries. This Survey will be available shortly.

- While the ultimate responsibility for the review of the Principles rests with the Steering Group, the work is carried out through an inclusive process that engages a multitude of private and public sector interests from both the OECD and non-OECD regions.

- The review process has already included several major consultation events, including representatives from key international organisations, such as the World

Bank, IMF, Financial Stability Forum, IOSCO, the International Chamber of Commerce, the business community, labour organisations and stakeholders, including investor groups. Another round of consultations is planned for early November.

- In November, there will also be a consultation with non-member countries. Representatives who have participated in the OECD Regional Corporate Governance Roundtables will take part.

- Before completing the review with a submission to our ministers, the OECD will place the new set of Principles on the world-wide web, inviting comments from the broader public.

- The OECD Principles and further information, including Regional Corporate Governance White Papers and background materials are available from http://www.oecd.org/daf/corporate-affairs/ . The above mentioned Survey will be posted on this site in the near future.