

Improving corporate governance standards: the work of the OECD and the Principles

Organisation for Economic Cooperation and Development

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Development and diffusion of the OECD Principles

Good corporate governance underpins market confidence, integrity and efficiency, and hence promotes economic growth and financial stability. In promoting better corporate governance, the Organisation for Economic Cooperation and Development (OECD) has since 1999 taken a two-track approach, involving the development of benchmark principles and the active promotion of their use. The OECD Principles of Corporate Governance were issued in 1999 with the purpose of assisting governments in their efforts to evaluate and improve their frameworks for corporate governance, and providing guidance for regulators and, more broadly, participants in financial markets. The Principles have in turn formed the framework for the establishment of regional corporate governance roundtables in cooperation with the World Bank in Asia, Latin America, Russia, Southeast Europe and Eurasia. Building on the Principles, these roundtables have now published white papers establishing priorities to improve corporate governance in each region.

The process of dissemination has also been underpinned by the endorsement of the Principles as one of the Financial Stability Forum's 12 key standards considered essential for financial stability, and which form the basis for the World Bank's Review of Observance of Standards and Codes. These reviews have mainly covered non-OECD countries. Member countries, on the other hand, have introduced a number of corporate governance measures including codes based largely on the Principles.

The numerous high-profile cases of corporate governance failure have focused the minds of governments, regulators, companies, investors and the general public on the weaknesses in corporate governance systems and the associated threat posed to the integrity of financial markets. In response, OECD ministers called for an assessment of the OECD Principles by 2004. To support this work, the ministers requested a survey of corporate governance developments in OECD countries with a view to identifying lessons to be learned and possible implications for the assessment of the Principles. The review process also covered the experience gained in non-OECD countries, which were included in the consultation process.

The revised Principles, which have emerged from the review process, take account of national experiences and changed circumstances since the Principles were formulated in 1999. The effectiveness of the revised Principles now calls for their active use by governments, regulators and private parties, as well as for continuing international policy dialogue and the sharing of experiences with successful implementation policies. This chapter first outlines the review process before highlighting the major changes to the Principles. It concludes by considering how the next phase of dialogue might evolve.

The review process

The assessment was carried out under the responsibility of the OECD Steering Group on Corporate Governance with the active participation of observers from key international institutions, notably the Bank for International Settlements, the International Monetary Fund, the World Bank, the Financial Stability Forum, the International Organisation of Securities Commissions and the Basel Committee. BIAC and TUAC – the business and trade union advisory committees associated with the OECD – also participated in the steering group's meetings on an *ad hoc* basis.

In undertaking its review, the steering group organised comprehensive and transparent consultations. The assessment process included broad consultations with the private sector, labour and civil society at large. Three major consultative meetings with broad participation were held in conjunction with the steering group's meetings. In addition, the secretary general convened two informal roundtable meetings with senior representatives from key international organisations, business and labour.

Consultations with non-member partners were a product of the 25 meetings of the five regional corporate governance roundtables, through which the OECD promotes corporate governance reform in partnership with the World Bank. Additional input was obtained from a special meeting attended by 43 non-member countries at the end of 2003.

In January 2004, a draft of the revised Principles was posted on the Internet for comments from the general public. Around 80 submissions were received from private individuals, professional associations, business and trade unions, and where permission was given, they were posted on the OECD website for public access.

The steering group also issued a questionnaire to member countries requesting information about corporate governance issues, the forces at work and proposed policy measures. The responses, together with a review of practices in member countries, formed the basis of the Survey of Corporate Governance Developments in OECD Countries and informed the discussions of the steering group. Another paper, entitled "Experiences from the OECD Regional Corporate Governance Roundtables", was also prepared and published.

The revised Principles

Reflecting the great heterogeneity in both OECD and non-OECD countries, the new Principles retain their non-binding, principles-based approach, which recognises the need to adapt implementation to varying legal, economic and cultural circumstances. Although it was evident that the annotations needed to avoid excessive prescription, the revision responds to the many requests that they should also offer more guidance as to how the Principles could be implemented and enforced through references to evolving practices and perceptions of what constitutes good practice.

Responding to experience, the Principles have been advanced in three main areas:

- ensuring the basis for an effective corporate governance framework which was before largely implicit;
- the effective exercise of ownership; and
- dealing with conflicts of interest.

With respect to the first area, a new chapter deals with the regulatory system which is seen as a

major barrier to fostering improved corporate governance in many countries. It also covers the situation more usual in many OECD countries where reforms are of a more marginal nature, but where the analysis of the costs and benefits of policy initiatives is nevertheless important for effective public policy. The chapter sets out broad principles for governments to follow when they review the corporate governance framework which is necessary for them to achieve the objectives or outcomes advocated by the Principles. Broad principles have been developed covering effective and efficient implementation and enforcement, and the mechanisms which should be established for parties to protect their rights. The major elements of this new chapter are as follows:

- 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;
- 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 legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable;
- The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served; and
- 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.

There is widespread agreement that corporate governance weaknesses in many OECD countries can be attributed to an important extent to a lack of effective ownership. While the original Principles dealt at length with shareholder rights, on the matter of effective participation they simply noted that all investors, including institutions, should consider the costs and benefits of voting. The revised Principles are more specific, taking the perspective that the costs of voting can and should be reduced, and the benefits in terms of what can actually be achieved from ownership participation must also be improved. The elements which seek to strengthen investor voice include the following:

- The section on shareholder rights has been amended to cover the central issue of board and key executive remuneration. Boards are now expected to formulate and disclose a remuneration policy highlighting the link between remuneration and performance in the long term. Shareholders should be able to make their views known about this policy and any equity component should be subject to their approval;
- Shareholders should be able to remove board members, and their effective participation in the nomination and election processes should be facilitated;
- Institutional investors acting in a fiduciary capacity should disclose their corporate governance policies, how they decide on the use of their voting rights and how they manage conflicts of interest that may compromise their voting. Restrictions on consultations between shareholders, including institutional investors, about their voting intentions should be eased, subject to control of some potential abuses; and
- Impediments to cross-border voting should be eliminated.

One of the most striking lessons of recent years is that conflicts of interest are widespread and can be quite pernicious. Conflicts of interest, which can

and often do lead to actions to the detriment of shareholders, investors and stakeholders, take many different forms, so they are dealt with in several chapters of the Principles. In general, the Principles now advocate not only disclosure, but also statements by the parties involved as to how the conflict is being managed. The special conflicts between controlling shareholders and minority shareholders, which are particularly pronounced in a number of developing and emerging market economies, are also explicitly addressed. The provisions include the following:

- The principles covering disclosure have been strengthened, particularly with respect to conflicts of interest and related-party transactions;
- A new principle recognises the role of various providers of corporate information, such as rating agencies and analysts, whose advice should not be compromised by conflicts of interest;
- The duties of the auditor have been strengthened, and include accountability to shareholders and a duty to the company to exercise due professional care in the conduct of the audit. Greater attention is paid to ensuring auditor independence, including steps to manage and minimise potential conflicts of interest; and
- Greater attention is paid to the protection of minority shareholder rights.

The Principles are unique in having a separate chapter devoted to stakeholders and in recognising that a productive relationship is necessary to create value, and that this might involve some form of stakeholder participation in the corporate governance process. The approach taken is an enabling one: private parties should not be encumbered in establishing the modalities of cooperation which suit them best. The new issues take up some quite specific stakeholder issues. Particularly important is a new principle to ensure protection for whistleblowers, including institutions through which their complaints/

allegations might normally be registered. The chapter on the duties of the board also makes provision for confidential access to someone on the board. The role of employees as a stakeholder is also complemented by new principles calling for an ethical code to be established by the board, and for effective rewards and penalties to be established in order to ensure compliance with relevant laws and standards. These principles thus serve to establish a clear role for employees in the corporate governance process.

The stakeholder chapter also breaks with the earlier version in explicitly recognising the role and rights of creditors. In a number of countries, the experience has been that poorly defined and ineffectively enforced creditor rights have distorted corporate governance, particularly in the presence of controlling shareholders. A new principle states that the corporate governance framework should be complemented by an effective, efficient insolvency framework, and by effective enforcement of creditor rights.

Finally, the principles covering the structure, operation and duties of the board have been strengthened. Responsibilities have been more clearly specified to cover corporate ethics, compliance with laws and standards, and oversight of internal control and financial reporting systems. The principle covering board and director independence has been extended to cover situations characterised by block and controlling shareholders, and not just independence from management. A new principle has been included to the effect that the mandate, working procedures and composition of board committees should be disclosed. The overall responsibility of the board should not thereby be diminished. In the controversial area of the separation of the CEO and chairman posts, the annotations note that this is increasingly regarded as good practice.

Use of the revised Principles

The OECD Principles are deliberately focused on broad corporate governance features rather than detailed prescriptions. This approach to an

international benchmark has clear advantages in a field where implementation needs to be adapted to varying legal, economic and social conditions. The success of the Principles therefore relies on their active use in financial markets and the active sharing of experiences regarding effective implementation strategies and good practice interpretation of them. A number of forums have emphasised the role of the OECD in promoting the active use of the Principles. The dissemination of experiences with implementation has also been noted as an important comparative advantage of OECD work, not replicated elsewhere.

Endorsement of the revised Principles by OECD members should reassure market participants and non-OECD partners that member countries are committed to a sustained dialogue and cooperation regarding effective measures which can be used by those wishing to implement the OECD Principles. As a consequence, the OECD's future work will be developed to meet four key objectives:

- Support wide dissemination and active use of the Principles through sustained policy dialogue among OECD as well as non-OECD countries;
- Increase the understanding and use of effective implementation policies to support better corporate governance;
- Provide a forum for sharing and disseminating policy, analytical and empirical work; and
- Advance understanding of the links between corporate governance, economic growth and financial stability.

In many ways, the future agenda of the OECD is already underway. The regional roundtables organised in cooperation with the World Bank and other international partners have now moved to the next stage of considering implementation strategies for the regional white papers. For example, the Russian roundtable has now established taskforces to develop a roadmap for the introduction of international financial reporting standards, and to develop a policy options paper examining alternative measures to deal with related-party transactions and the reporting of beneficial ownership. These discussions bring together experts from OECD countries and those from Russia. The Asia and Latin America roundtables are evolving in a similar manner, although focused on other issues.

Two key features are already apparent. First, by incorporating a wider set of experience, the revised Principles are set to remain a key framework for analysis and structured discussions. Second, the potential for dialogue with non-OECD countries will benefit to a great extent from sustained dialogue and cooperation between OECD countries. OECD countries will also benefit from the broadened exchange of experience. In these multiple ways, the OECD will seek to improve corporate governance in the global economy, and with it improved growth performance and financial stability.

The views expressed in this chapter are those of the author and do not necessarily reflect those of the OECD or its member countries.

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Prior to his responsibilities with Corporate Affairs, Mr Kirkpatrick was head of both the Japan and German Desks in the Economics Department of the OECD, duties which involved a considerable amount of structural policy analysis and advice, in addition to macroeconomic analysis. From 1989 to 1995 he worked in most of the European transition economies for the OECD, contributing to a wide range of the organisation's publications. Before joining the OECD, Mr Kirkpatrick worked at universities and research centres in Germany, the United Kingdom and Australia.

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