

**METHODOLOGY FOR ASSESSING  
THE IMPLEMENTATION OF THE  
OECD PRINCIPLES  
OF CORPORATE GOVERNANCE**



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

## **ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

Pursuant to Article 1 of the Convention signed in Paris on 14<sup>th</sup> December 1960, and which came into force on 30<sup>th</sup> 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 (28<sup>th</sup> April 1964), Finland (28<sup>th</sup> January 1969), Australia (7<sup>th</sup> June 1971), New Zealand (29<sup>th</sup> May 1973), Mexico (18<sup>th</sup> May 1994), the Czech Republic (21<sup>st</sup> December 1995), Hungary (7<sup>th</sup> May 1996), Poland (22<sup>nd</sup> November 1996), Korea (12<sup>th</sup> December 1996) and Slovak Republic (14<sup>th</sup> December 2000). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).

This work is published under the responsibility of the OECD Steering Group on Corporate Governance.

---

© OECD 2007

Permission to reproduce a portion of this work for non-commercial purposes or classroom use should be obtained through the Centre français d'exploitation du droit de copie (CFC), 20, rue des Grands-Augustins, 75006 Paris, France, Tel. (33-1) 44 07 47 70, Fax (33-1) 46 34 67 19, for every country except the United States. In the United States permission should be obtained through the Copyright Clearance Center, Customer Service, (508)750-8400, 222 Rosewood Drive, Danvers, MA 01923 USA, or CCC Online: <http://www.copyright.com/>. All other applications for permission to reproduce or translate all or part of this book should be made to OECD Publications, 2, rue André-Pascal, 75775 Paris Cedex 16, France.

---

## *Table of Contents*

### **Part A. Methodological issues and procedures**

<b>1. Introduction and Background</b> .....	7
1.1. The Use and Scope of this Methodology.....	8
1.2 How to Assess Outcomes .....	10
Making an informed judgement.....	10
A qualitative assessment scheme .....	12
1.3 The Reviewer and the Assessment Process .....	15
1.4 The Structure of this Methodology.....	16

### **Part B. The Corporate Governance Landscape – Necessary Institutional Information**

1.1 The structure of ownership and control.....	20
1.2 The legal and regulatory framework.....	22
1.3 Historical influences on the current corporate governance system.....	22

### **Part C. Chapters of the Principles**

<i>Chapter I.</i> <b>Ensuring the Basis for an Effective Corporate Governance Framework</b> .....	25
1.1 Introduction .....	27
1.3 Issues and Assessment Criteria.....	27
1.3.1 Principle I.A.....	27
1.3.2 Principle I.B.....	29
1.3.3 Principle I.C.....	31
1.3.4 Principle I.D.....	32

---

<b>Chapter II. The Rights of Shareholders and Key Ownership Functions ...</b>	<b>35</b>
2.1 Introduction .....	35
2.3 Issues and Assessment Criteria.....	36
2.3.1 Principle II.A .....	36
2.3.2 Principle II.B.....	41
2.3.3 Principle II.C.....	44
2.3.4 Principle II.D: .....	50
2.3.5 Principle II.E.....	52
2.3.6 Principle II.F. ....	57
2.3.7 Principle II.G .....	59
<b>Chapter III. The Equitable Treatment of Shareholders .....</b>	<b>61</b>
3.1 Introduction .....	61
3.3 Issues and Assessment Criteria.....	62
3.3.1 Principle III.A .....	62
3.3.2 Principle III.B .....	69
3.3.3 Principle III.C .....	71
<b>Chapter IV. The Role of Stakeholders in Corporate Governance .....</b>	<b>73</b>
4.1 Introduction .....	73
4.3 Issues and assessment criteria.....	73
4.3.1 Principle IV.A.....	73
4.3.2 Principle IV.B .....	74
4.3.3 Principle IV.C .....	75
4.3.4 Principle IV.D.....	76
4.3.5 Principle IV.E .....	77
4.3.6 Principle IV.F .....	78
<b>Chapter V. Disclosure and Transparency .....</b>	<b>81</b>
5.1 Introduction .....	81
5.3 Issues and assessment criteria.....	82
5.3.1 Principle V.A .....	82
5.3.2 Principle V.B .....	92
5.3.3 Principle V.C .....	95
5.3.4 Principle V.D .....	98
5.3.5 Principle V.E.....	99
5.3.5 Principle V.F.....	101
<b>Chapter VI. The Responsibilities of the Board .....</b>	<b>103</b>
6.1 Introduction .....	105
6.3 Issues and Assessment Criteria.....	106
6.3.1 Principle VI.A.....	106
6.3.2 Principle VI.B .....	109

---

6.3.3 Principle VI.C .....	110
6.3.4 Principle VI.D .....	112
6.3.5 Principle VI.E .....	123
6.3.6 Principle VI.F .....	129

**Part D.**  
**Forming policy options and recommendations**

1.1. Forming an assessment about policy options and priorities .....	134
<i>Annex</i> <b>Indicators of the Corporate Landscape .....</b>	139

**Tables**

Table 1.      Summary of Assessment Scheme.....	14
---	----



*Part A*

**METHODOLOGICAL ISSUES AND PROCEDURES**

## **1. Introduction and Background**

Following the revision of the OECD Principles in 2004, the OECD Steering Group on Corporate Governance decided to establish an ongoing dialogue to support their implementation. This dialogue would be both country-specific and thematic. For this purpose, the development of a coherent analytical framework was considered necessary.

The OECD Principles (Principles) are one of the Twelve Key Standards for Sound Financial Systems adopted by the Financial Stability Forum (FSF). Most standard setters have developed an associated methodology that, together with the standards, forms the basis for the voluntary assessments undertaken by the IMF/World Bank either in the form of a Review of Observance of Standards and Codes (ROSC) or as part of the Financial Sector Assessment Programme (FSAP). One exception to this development has been the OECD Steering Group on Corporate Governance, which never developed an assessment methodology for the Principles, with the World Bank developing its own procedures for assessment purposes. At its October 2004 meeting, the Steering Group decided that the analytical framework, which would underpin its dialogue on implementation of the Principles (henceforth termed Methodology), should be developed so that it could also serve as the methodology for the ROSCs that use the Principles as the reference standard.

### **1.1. The Use and Scope of this Methodology**

This Methodology is intended to underpin an assessment of the implementation of the Principles in a jurisdiction and to provide a framework for policy discussions. The ultimate purpose of an assessment is to identify the nature and extent of specific strengths and weaknesses in corporate governance, and thereby underpin policy dialogue that will identify reform priorities leading to the improvement of corporate governance and economic performance. Since the Principles are concerned in part with company law, securities regulation and the enforcement/legal system, the term “jurisdiction” rather than country is used in the

---

Methodology. Reviewers should note that because sometimes a country may be characterised by several different geographical jurisdictions with separate regulations, a country level assessment, if indeed this is meaningful, would need to take this factor fully into account.

Reflecting the Principles, the Methodology places emphasis on “**outcomes**” and, therefore, on “**functional equivalence**”. By the latter is meant that there are many different ways, institutions, laws etc, for achieving the “outcomes” advocated by the Principles. Thus, it is recognised in the preamble to the Principles that implementation needs to be adapted to national circumstances. For example, the protection and enforcement of minority shareholder rights might be achieved via private arrangements, such as by majority shareholders agreeing to restrict the use of their powers to appoint the whole board, special investigation procedures and/or class enforcement procedures. Many of these perhaps imperfect alternatives are deeply rooted in legal and social traditions.

The criteria to judge whether a principle has been implemented, therefore, have to be selected in a way that does not imply a value judgement about the “means” as such, but rather about the effectiveness and efficiency of current arrangements in terms of achieving the outcome. The Methodology does, however, recognise that the relative costs and benefits of alternative “means” of implementation might vary over time as, *inter alia*, the composition of listed companies and the structure of ownership and control in the jurisdiction evolves. The need for a dynamic perspective for policy dialogue is thereby recognised. To underpin policy dialogue, the Methodology like the Principles treats countries consistently, despite their widely different institutional structures and traditions. This feature is intended to facilitate a discussion about different remedies for similar problems and the transferability of experience between jurisdictions.

The Methodology does not, however, encourage any summary ranking of countries/jurisdictions against each other or the construction of a single, overall rating. Rather, it is intended to assess qualitatively countries against what they could and should achieve in relation to the Principles and to provide a framework for identifying policy options to improve corporate governance.

## 1.2 How to Assess Outcomes

### *Making an informed judgement*

The outcome oriented nature of the Principles together with their scope means that a number of individual principles are by themselves unobservable to a reviewer and that what is being assessed is a combination of legal framework and other implementation measures, enforcement, corporate practices, and the functioning of markets. For example, forming an assessment about whether boards are diligent is likely to depend on judgements about the implementation of other principles, such as those covering shareholder rights, transparency and the efficacy of the enforcement mechanism. An assessment about whether the Principles are implemented in a jurisdiction is therefore necessarily a matter of informed judgement based on a variety of sources of information. The fact that the methodology is focused on jurisdictions and not on individual companies also gives rise to some specific challenges. As companies in a jurisdiction usually vary in their own governance practices, there is a question as to how widespread should be a practice, or how egregious should be any abuse, for the jurisdiction as a whole to be considered as implementing or not implementing the Principles. It is difficult to set out clear-cut guidelines and check lists to cover such a widespread situation. Perhaps the best approach to assessing implementation therefore is to rely on “a reasonable assessor” or “reasonable observer” type procedure, the practicalities of which are developed further in section 1.3.

The scope of the Principles, which cover a number of different aspects of the corporate governance system, means that individual principles might often be closely related to others, the outcome being similar but from a different perspective. This implies that informed judgements about a given principle might at least be checked for consistency with the judgement for other similar principles. To aid the reviewer and to restrict the room for *ad hoc* judgement in an individual case, the Methodology therefore includes a number of cross references to related principles that form the basis for a consistency check.

An assessment must be in sufficient depth to allow a judgement about whether a principle is fulfilled in practice, not just in concept. This will involve examining both implementation and enforcement issues. With respect to implementation, some aspects of the Principles will be set out in law and regulations but other provisions are also prevalent such as guidelines, self-regulation, instructions and other documents, and company policies. A mandatory company law system might appear to ease the task of the reviewer in that all companies must adopt the same arrangements, but the reviewer must still form a judgement about company compliance and

---

about whether the mandated features are consistent with the Principles. In more enabling company law systems, the reviewer will need to form a judgement about the balance of actual practices and whether these might lead to the Principles not being implemented.

Enforcement is here taken to mean actions taken by organs of the state such as the securities regulator, public prosecutor, company registrar etc, as well as by institutions exercising devolved authority such as self-regulatory organisations (SRO), as well as procedures for shareholders/stakeholders to seek redress. Effective enforcement requires the availability of effective, proportionate and dissuasive sanctions in the event of non-compliance. Enforcement might not be effective if, for example, rights of enforcement reside only with a regulator or company registrar who may not have the right incentives or resources to enforce the law. Enforcement can also be through effective means of redress for shareholders/stakeholders. In some countries, individual shareholders have extensive rights of redress, but in others such rights might reside with the general meeting of shareholders. For the reviewer, it is important to form a judgement about how effectively these rights can be exercised. Judging whether enforcement is effective or deficient in a given situation will require not only an examination of the record of enforcement, the fines and redress actually imposed and the number of cases dismissed on procedural grounds at lower courts, but also understanding the viewpoint of investors. Foreign investors with experience of other systems might be particularly important as they are likely to be sensitive to procedural difficulties and the costs of enforcement activities. There are also an increasing number of indicators attempting to measure enforcement that could assist a reviewer to form an overall judgement.

It is also necessary to form a judgement about the strength and effectiveness of market forces (market disciplines, including competitive financial and product markets and an active media) in promoting implementation of the Principles. Market forces will vary considerably from country to country and not only on account of the legal/regulatory environment, which may be more or less market friendly. For example, disclosure about corporate governance arrangements might be effectively enforced by the market itself in systems with capital markets that are attuned to examining such disclosures and pricing company shares accordingly. Effective shareholder rights might stimulate companies to adopt policies and by-laws that result in improved corporate governance standards. However, relying on market forces might be entirely ineffective in systems characterised by concentrated ownership and shallow capital markets, so that other enforcement mechanisms might be required including, for example, monitoring by the capital markets regulator of corporate governance reports and practices.

### *A qualitative assessment scheme*

The approach of the Methodology to making an assessment is principally qualitative: although the Methodology may take into account certain quantitative measures (e.g. the structure of company pyramids), the assessment cannot be reduced to a quantitative score or set of quantitative scores. No use is made of indicators based on the number of “yes” and “no” answers for the reason that the importance of some responses will be quite different across countries depending on such variables as company law, ownership concentration and company groups. And counting “yes” and “no” answers is dependent on agreement about the number of elements judged to be important (even if the indicator is expressed as a percentage) and the relationship between the individual questions. This does not preclude the development of statistical indicators once there is consensus about what is to be measured and how, and in the context of functional equivalence.

To aid the process of assessment, the Methodology follows an assessment scale similar to that used by the other FSF standard setters and by the World Bank, which classify according to observed/implemented, broadly observed/implemented, partly observed/implemented and not observed/implemented. The classification also reflects a judgement about the effectiveness of enforcement and the operation of markets. For each principle, “essential criteria” are specified that seek to make the principle’s outcome more specific and easier to verify by a reviewer for effective evaluation of implementation, while preserving functional equivalence. The “essential criteria” also provide important guidance for detailed fact finding questions and how responses can be used to form a judgement. However, the essential criteria are an aid to making an assessment and are not a substitute for a careful judgement about actual outcomes.

For the purpose of policy dialogue, the assessment will often be less important than the reasons advanced by the reviewer. This is particularly so for the classification “partly implemented”. In particular, it is important for the reviewer to note whether partial implementation predominantly reflects an inadequate legal framework, poor enforcement by the authorities, lack of private redress mechanisms, weak market mechanisms or limited private sector observance, or a combination of all these. In some cases, the legal and regulatory framework might be so new that the influence on corporate practices cannot yet be properly assessed. In other cases, the essential criteria associated with a principle involve the assessment of complex and specialised topics (e.g. the operation of central securities depositories, creditor rights) that might stretch the resources of a reviewer. Nevertheless, a reviewer is still expected to form a reasoned judgement after consulting with relevant specialists, although the uncertainty and preliminary nature of

the assessment will need to be noted. To enhance its use as an analytical tool, it is also important for the reviewer to take note of any trend, current and proposed developments concerning each principle, although they should not form part of the assessment. Such information is essential for prioritising policy recommendations and when considering the potential need for complementary policy actions.

To avoid excessive repetition, throughout the Methodology reference is made in the description of “essential criteria” to the corporate governance framework. The corporate governance framework comprises legislation, regulation, standards including case law or judicial decisions, codes and principles and business practices. They are the result of a country’s specific circumstances, history and tradition so that the desirable mix will therefore vary from country to country. To preserve functional equivalence between mandatory and other more facilitating systems, essential criteria are usually written in the form “the corporate governance framework requires or encourages...” followed by a description of a series of verifiable actions, behaviour, restrictions etc. The key issue for the reviewer is whether “require” or “encourage” are effective in ensuring the outcome advocated by the principle (i.e. implementation of the principle). Reflecting the above discussion with respect to enforcement and the operation of market mechanisms, essential criteria usually conclude with a general statement; *Where[ ] is required, there are effective mechanisms for enforcing the requirement and effective remedial mechanisms for those who are harmed by inadequate performance. Whether it is required or encouraged, the [action etc] is widespread.* The meaning of “effective” enforcement has been discussed above. In practice, a reviewer will have to arrive at a careful judgement whether one method of enforcement outweighs the weakness in another approach, and of course whether market forces are strong enough by themselves to reduce the need for supporting measures. For example, the question might have to be asked whether in a jurisdiction with weak courts, the enforcement activities of a regulator constitute an effective substitute.

Even if a jurisdiction might be implementing the individual principles or the Principles as a whole, there may be considerable room for improvement. Indeed, the preamble to the Principles notes that “they are not intended to substitute for government, semi-government or private initiatives to develop more detailed “best practice” in corporate governance”. Such action might be especially important in those jurisdictions where the corporate governance arrangements adopted by companies vary widely and where narrowing this distribution could improve overall economic performance. These issues are not covered explicitly by the Methodology although they should form an important component of policy dialogue.

**Table 1. Summary of Assessment Scheme**

Fully Implemented	The OECD Principle is fully implemented in all material respects with respect to all of the applicable Essential Criteria. Where the Essential Criteria refer to standards ( <i>i.e.</i> practices that should be required, encouraged or, conversely, prohibited or discouraged), all material aspects of the standards are present. Where the Essential Criteria refer to corporate governance practices, the relevant practices are widespread. Where the Essential Criteria refer to enforcement mechanisms, there are adequate, effective enforcement mechanisms. Where the Essential Criteria refer to remedies, there are adequate, effective and accessible remedies.
Broadly Implemented	<p>A Broadly Implemented assessment is likely appropriate where one or more of the applicable Essential Criteria are less than fully implemented in all material respects, but, at a minimum:</p> <ul style="list-style-type: none"> <li>• all of the applicable Essential Criteria are implemented to some extent;</li> <li>• the core elements of the standards are present (<i>e.g.</i> general standards may be in place although some of the specific details may be missing); and</li> <li>• incentives and/or disciplinary forces are operating with some effect to encourage at least a majority of market participants, including significant enterprises, to adopt the recommended practices.</li> </ul>
Partly Implemented	<p>A Partly Implemented assessment is likely appropriate in the following situations:</p> <ul style="list-style-type: none"> <li>• One or more core elements of the standards described in a minority of the applicable Essential Criteria are missing, but the other applicable Essential Criteria are fully or broadly implemented in all material respects (including those aspects of the Essential Criteria relating to corporate governance practices, enforcement mechanisms and remedies);</li> <li>• The core elements of the standards described in all of the applicable Essential Criteria are present, but incentives and/or disciplinary forces are not operating effectively to encourage at least a significant minority of market participants to adopt the recommended practices; or</li> <li>• The core elements of the standards described in all of the applicable Essential Criteria are present, but implementation levels are low because some or all of the standards are new, it is too early to expect high levels of implementation and it appears that the reason for low implementation levels is the newness of the standards (rather than other factors, such as low incentives to adopt the standards).</li> </ul>

---

Not Implemented	<p>A Not Implemented assessment likely is appropriate where there are major shortcomings, e.g. where:</p> <ul style="list-style-type: none"> <li>• The core elements of the standards described in a majority of the applicable Essential Criteria are not present; and/or</li> <li>• Incentives and/or disciplinary forces are not operating effectively to encourage at least a significant minority of market participants to adopt the recommended practices.</li> </ul>
Not Applicable	<p>This assessment is appropriate where an OECD Principle (or one of the Essential Criteria) does not apply due to structural, legal or institutional features (e.g. institutional investors acting in a fiduciary capacity may not exist).</p>

---

Many individual principles are broken down into tiers or sub-principles, examples being principles II.A and II.C. While there are 32 principles, there are 63 principles and sub-principles. The Methodology focuses on the sub-principles since they better reflect the operational outcomes that are regarded as important for the principle. Where the reviewer considers it important to form a judgement about the principle as a whole, in the absence of good arguments to the contrary, the overall judgement should reflect the weakest sub-principle. For example, with respect to principle V.A, there might be adequate implementation of sub-principle V.A.1 regarding financial disclosure, but if there is inadequate disclosure about major shareholdings and voting rights (sub-principle V.A.3), the principle should not be considered as implemented. The more detailed assessment is more useful than an overall assessment since deficiencies are clearly identified and an implicit weighting scheme on the part of the reviewer is avoided at the first stage of an assessment, and made transparent in the summary stage.

### 1.3 The Reviewer and the Assessment Process

The process of assessing each of the principles requires a judgemental weighting of numerous elements that only qualified assessors with practical experience can provide. Many reviewers of standards seek to ensure both this and inter-jurisdiction consistency by including in their teams members with broad international experience. Under all circumstances, in-depth consultations with individuals and constituencies having first-hand experience of the assessed jurisdiction is an absolute necessity and may, in addition to relevant authorities, also include market participants, such as accountants/auditors, board members, and investors as well as researchers, academics and rating agencies. Moreover, in view of the complexity of corporate governance systems, an iterative process between the reviewer and

the authorities and other parties is required in order to deepen the basis of the assessment and a consideration of policy priorities.

In the experience of the OECD, both in Regional Corporate Governance Roundtables and in other work such as the 2004 review of the Principles, it is valuable to augment national debate and national expertise with experience from other jurisdictions. This process can take several forms, one end of the spectrum being full peer reviews, the other being a policy-dialogue hosted by international fora, such as the OECD Steering Group on Corporate Governance. An assessment should not be seen as a static exercise but should form the basis for a policy dialogue that can identify reform priorities and support the reform process. The Regional Corporate Governance Roundtables are using two forms: a follow-up on the specific recommendations of the Regional White Papers and a more detailed scrutiny of individual aspects, which are treated in separate policy briefs. In its other activities, the OECD uses other techniques such as organising follow-up seminars and discussions in the jurisdictions concerned. The World Bank might also include technical assistance and training in any follow-up to a ROSC.

#### 1.4 The Structure of this Methodology

Part B discusses the various kinds of institutional information that are essential for putting the assessment into a national/jurisdictional context. By mapping, for example, the ownership structure, dominating categories of owners and the institutional structure, the reviewer will also acquire a first sense of the national corporate governance agenda.

Part C deals with each of the six chapters of the OECD Principles. The treatment of each chapter of the Principles follows a common pattern and comprises two main parts:

- Introduction
- Issues and Assessment Criteria

The **Introduction**, discusses the general understanding of the overarching principle that opens each chapter of the Principles. Building on the annotations to the principle, the introduction also discusses special concerns and aspects that are intended to be taken into account when considering implementation of the principle. The main section of each chapter in Part C is the **Issues and Assessment Criteria**, where each individual principle is treated under a separate heading. After briefly outlining the intent of the principle or sub-principle, a section follows

*(Likely practices to be examined)* that briefly discusses the actual situation and practices that might confront a reviewer. Guidance is given as to how actual situations might be assessed against the outcome recommended by the principle/sub-principle. Related principles, which can be used as a consistency check, are also noted. In line with the discussion and the intent of the principle, an associated set of *essential criteria* are specified. A guide to the specific questions a reviewer might want to ask is provided by the World Bank's ROSC questionnaire.

Part D deals with how all the chapters of the Principles and associated assessments should be drawn together in a final assessment, including a discussion of policy priorities and specific measures that might be considered. This Part draws heavily on chapter I of the Principles, *Ensuring the basis for an effective corporate governance framework*. The assessment would cover not just the assessed strengths and weaknesses of individual principles but also indicate how they serve to determine the operation and efficiency of the overall corporate governance system. In discussing policy priorities, the assessment also needs to consider the presence of "complementarities" whereby some policy measures might be ineffective until accompanied by other initiatives, either by companies or by the authorities.



*Part B*

**The Corporate Governance Landscape – Necessary  
Institutional Information**

This Part outlines the type of information that a reviewer will need both to form an assessment about the importance of individual principles for the corporate governance framework in a jurisdiction, as well as in forming questions relevant for a judgement about the essential criteria. The information covers the structure of ownership and control in a jurisdiction, the general features of the legal and regulatory system, and the historical factors and experiences that have contributed to the current corporate governance system and that still play an important role. Analysis of past crises and corporate collapses/scandals will also be necessary so as to allow the reviewer to understand the *realpolitik* of companies in a jurisdiction.

### **1.1 The structure of ownership and control**

Theoretical and applied work on corporate governance systems point to the importance of the structure of ownership and control in setting the background for the corporate governance issues that can arise in reality. Three aspects need to be considered: (i) the structure of ownership and its concentration; (ii) the instruments of control; and (iii) the exercise of control.

With respect to (i), it is important to understand the concentration and identity of owners such as foreigners, other domestic companies, financial institutions and institutional investors. An overall picture will need to be drawn from a number of sources, including qualitative assessments by the relevant authorities, investors, academics etc. Aggregate indicators of ownership concentration and dispersion, and ownership might also be available. Technical details about the construction of summary indices that are useful for a reviewer to gain an overall understanding are presented in Annex I. The statistical base is, however, not always sound and this would have to be taken into consideration by the reviewer (e.g. is the data drawn from company corporate governance statements or from dated declarations to the authorities such as the securities regulator or a company registrar). In some jurisdictions, shares in listed companies might be held through private companies so that without further information, statistical indicators of concentration and the identity of the owners might be distorted.

Instruments of control over companies used by shareholders include block shareholdings formed either alone or through shareholder agreements. With respect to statistical indicators listed in Annex I, thresholds would have to be examined for their relevance to corporate control in the jurisdiction, reflecting the wide-ranging possibilities for control that are often available, both *de jure* and *de facto* (e.g. key patents and brands effectively transferring control outside the company). Controlling blocks are often

formed through instruments such as multiple voting shares, caps on voting rights and by shares with special powers such as the ability to appoint the board. For a number of jurisdictions, information about the overall use of such instruments is available from different sources including rating agencies and in some cases measures of the extent to which cash flow rights and voting rights differ might also be available. Where not available at least in a general form, there is a *prima facie* case that disclosure aspects of the Principles might not be implemented. Another widespread instrument of control covered in Annex I concerns company groups and especially those that are organized in a pyramid where the difference between voting and cash flow rights can be particularly extreme. Indicators identified in Annex I that a reviewer should seek include the typical number of layers in a group, and the difference between cash flow and voting rights for the controllers of the group. It is important that cross holdings of companies in the group, including the existence of private companies, are also taken into account in order to know the type of principle/agent incentive structure the corporate governance framework will have to adequately address.

With respect to the exercise of control, Annex I identifies several indicators such as the number of companies controlled through shares with special rights and staggered boards that could be used by the reviewer. Rating agencies and analysts have also found it informative to examine the percentage of the free float (i.e. excluding controlling shareholders) that participate in the general meeting of shareholders and they have also constructed indicators of shareholder rights. As noted in Annex I these should be used with care. The incidence of voting/participation is often regularly monitored by stock exchanges and regulators so that a great deal of aggregate information could be available which might be indicative of how the corporate governance system is functioning. Other indicators point more to the consequences of corporate governance arrangements but although widely used rely on a number of critical assumptions and therefore should be used judiciously. They are briefly discussed in Annex I.

In sum, qualitative information could, depending on the jurisdiction, be augmented by statistical information including:

- Concentration and dispersion of share ownership
- Distribution of ownership among different categories of owners such as institutions, private, foreign
- Incidence of companies with different classes of shares, voting and ownership ceilings etc

- Incidence of block and controlling shareholdings, the ratio between cash flow and voting rights, types of control mechanisms such as shareholder agreements
- Indicators of company groups and the potential problems associated with them: ratio of cash flow rights to control rights, average number of layers in company pyramids
- The use of different types of board structure, incidence of board members not appointed at the general meeting of shareholders
- Average free float, market liquidity, percentage of free float participating in general shareholder meetings

## **1.2 The legal and regulatory framework**

As part of the institutional information for an assessment, it is also important to present a general overview of the company law and securities regulation system (including self-regulation) that goes beyond the civil law/common law distinction, together with information about codes and principles and the degree of compliance with them by companies. With respect to company law, it is necessary to understand the approach to the distribution of powers in the jurisdiction (i.e. what is the power of the assembly of shareholders vis-à-vis the board) and the incidence of “bright lines” such as prohibiting a company from issuing different classes of shares, establishing voting caps etc, specifying the operation and organisation of boards, and closely defining the duties of board members. The approach to redress mechanisms also needs to be understood. In some systems, redress is more oriented towards initiation by the individual and recourse to courts is required. In other systems, it is often the case that there is some collective element such as allowing only the meeting of shareholders to initiate actions, or there needs first to be an official investigation by, for example, a court or the securities regulator.

## **1.3 Historical influences on the current corporate governance system**

The current corporate governance system has been determined by a number of historical factors and it is important to note whether such forces are still exercising an influence in considering feasible policy options and priorities. A historical account of corporate governance in a country is not intended. Among the most important forces to be considered would appear to be the recent pattern of privatisation (especially in transition economies), industrial policy and especially protection against imports, all of which have

often led to highly concentrated and leveraged ownership and control, together with tight interest group representation, an emphasis on good contacts with some authorities (often termed rent seeking behaviour), and weak minority rights. Other influences include the tax treatment of inter-company dividends and capital gains if company investments are liquidated, the tax treatment of capital gains and dividend distributions to shareholders by companies, and the nature of inheritance taxes. Thus the absence of taxes on inter-company dividends has facilitated the development of corporate groups and especially those taking the form of pyramids in many jurisdictions, while in others taxes have been used to discourage the formation of such groups. The development of corporate groups might also have been influenced by policy with respect to sharing of tax losses and provisions making easier and more efficient the movement of capital or goods between and among member companies. Other policy-related systemic factors include the legal and regulatory provisions governing the ownership and control relationships of listed companies with banks and other financial institutions and institutional investors that also set the backdrop to what are likely to be the key corporate governance issues.



*Part C*

**Chapters of the Principles**



## *Chapter I*

# **Ensuring the Basis for an Effective Corporate Governance Framework**

### **1.1 Introduction**

The overarching principle states that “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”. Countries seeking to implement the Principles are recommended “to 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.

### **1.3 Issues and Assessment Criteria**

#### ***1.3.1 Principle I.A***

Principle I.A states that “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 principle advocates that the authorities consider both the costs and benefits of proposed and current legal and regulatory measures. Thus the annotations note that “...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". An important implication is that an assessment of the individual principles also needs to consider the efficiency of the regulatory and legal requirements and their impact on incentives for market participants.

#### Likely practices to be examined

The principle focuses on the overall corporate governance framework, but this should be properly part of the overall assessment, discussed in Part D. However, to make the task manageable for a reviewer, two aspects of principle I.A can be reviewed independently. The first aspect concerns the need to form a judgment about the operation of the equity markets including market integrity, transparency and efficiency. Many of the elements -will be covered by the assessment of the principles dealing with insider trading and abusive self-dealing (principle III.B and principle III.C) as well as by the principles covering transparency (chapter V). This principle is more concerned with how the markets and the corporate governance framework functions as a whole, which includes many other factors such as the operation of the stock exchange, market surveillance etc. Above all, the question is the type of incentive structure they might help create. The essential criteria are thus intended to call attention to broader issues that might otherwise be overlooked. To form an assessment, the reviewer will need to consult with all categories of market participants and the authorities paying particular attention to whether they regard the capital market as particularly risky and opaque so that it could be viewed as inefficient. In forming a judgment a number of indicators might prove useful. Country risk premiums or discounts can reflect macroeconomic conditions although they usually also reflect the quality of the corporate governance framework. Jurisdictions where there is a high ratio of estimates of informal to formal activity can also reflect a pattern of incentives (e.g. property confiscations, high tax and social contributions) leading to widespread concealment of economic activities. Under these circumstances, there is a *prima facie* case that principle I.A is either not or only partly implemented.

The second aspect of principle I.A concerns process. In practice it will not be possible for a reviewer to form a judgment about the efficiency of the corporate governance framework and whether it contributes to improved economic performance. However, the process of decision making regarding laws, regulations and other policy issues should provide a more relevant and observable guide in many cases, as will statements and actions on the part of the authorities that indicate the importance they attach to corporate governance issues. The views of the corporate sector with respect to how they rate the flexibility of the corporate governance framework (e.g. is it regarded as too much “one size fits all” and as not addressing the specific needs of business) will also be useful in forming an assessment.

Such practices and the intent of the principle suggest the following essential criteria:

1. The operation of the capital market is viewed by participants on both sides of the market as reasonably transparent. Investors regard company disclosures, the way in which they are made and the operation of relevant regulations, as comprising the basis for an acceptable level of market integrity associated with no abnormal country/jurisdictional risk.
2. The authorities and legislatures in a jurisdiction develop policy, laws and regulations etc, for the corporate governance framework on the basis of effective and ongoing consultation with the public, corporations and shareholders including their representative organisations, and other stakeholders. To be effective, such a process needs to be given an adequate consultation period and the authorities should also make all comments publicly available and justify why some have or have not been taken into account in the final decision. In making such decisions there should be an indication that there is a consideration of likely costs and benefits of the proposed changes including a focus on the perceived effects on economic performance and the efficacy of dealing with the relevant corporate governance weaknesses.

### ***1.3.2 Principle I.B***

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

### Likely practices to be examined

A reviewer might typically only be able to make an informed judgment after first examining the implementation of the other principles. In assessing individual principles, the reviewer should consider the quality of laws and regulations and especially if they are enforceable and indeed enforced. In many jurisdictions, it has been observed that laws and regulations might be loosely formulated and not enforceable, or even well understood. Sometimes procedural rules such as discovery powers, pleading rules and rules governing the allocation of legal costs might render enforcement difficult, if not impossible. The reviewer should note the incidence of significant laws and regulations which have never, or only occasionally, been tested in the courts and the occurrence of temporary decrees. This is particularly so in the areas of board member and auditor liability, including the duties of board members and controlling shareholders vis-à-vis the company and shareholders. In some cases, laws and regulations associated with individual principles are necessarily general or incomplete. In these cases, the reviewer should investigate whether provision has been made for courts, regulators, etc, to interpret and complete them effectively. Where important areas of law and regulation discussed above are on the books but only seldom if at all enforced, the jurisdiction should be noted as partly implementing the Principles and the primary causes noted. An assessment concerning whether the authorities have established a consistent and transparent regulatory system is covered by principle I.D and procedures influencing the regulatory system more generally are covered in principle I.A.

A key issue in some cases concerns the rule of law. While there are numerous definitions of what this means, in the corporate governance context (i.e. excluding civil rights issues) it will be important for the reviewer to note whether there is a general and marked distrust of the judiciary and the authorities, and a lack of consistency and transparency in the exercise of discretion granted to the authorities in enforcing and interpreting the regulatory system that undermines confidence and trust in the rule of law and, therefore, the development of a rule-based system. Arbitrary actions or questionable use of law and regulation not subject to independent review involving corporate issues such as confiscation of property or repudiation of contracts and agreements should, for example, lead a reviewer to conclude that the system is not compatible with the rule of law. Since lack of transparency and enforcement do not constitute grounds in themselves for assessing this one aspect of the principle as not fully implemented, a separate essential criteria has been specified. Where it is assessed as not implemented, this assessment should carry a heavy weight in the overall assessment of the principle.

Corporate governance objectives are also formulated in voluntary codes and standards that do not have the status of law or regulation. While such codes can play an important role in improving corporate governance arrangements, there should be no uncertainty concerning their status and implementation. The reviewer will need to be familiar with the specific requirements of the code and their status, and have a good understanding of how widely it is applied. In examining the individual principles, the status and operation of the codes/voluntary standards should be kept in mind by the reviewer since they may vary according to the principle involved.

Such practices and the intent of the principle suggest the following essential criteria:

1. The legal and regulatory requirements that are crucial in affecting corporate governance practices and outcomes are: (a) generally well understood by economic participants; (b) are reasonably foreseeable and not subject to important temporary decrees and back-dated amendments; and (c) have been sufficiently enforced in an efficient, consistent and even handed manner so as to constitute a transparent system.
2. The authorities have not used the legal and regulatory framework, or other aspects of the corporate governance framework, in an arbitrary or grossly inconsistent manner incompatible with general norms about what constitutes the rule of law.
3. When codes and principles are used as a standard or as an explicit substitute for legal or regulatory provisions, their status in terms of coverage, implementation, compliance and possible sanctions (e.g. market or regulatory) should be clearly specified.

### ***1.3.3 Principle I.C.***

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

#### **Likely practices to be examined**

Effective enforcement 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. For example, the securities market regulator may share powers with other sectoral regulators (for instance, banking and insurance supervisors, and company registrar/company regulator) resulting in either over-regulation or

ineffective enforcement/oversight such as where information cannot be exchanged between institutions. In some cases, the division of responsibilities may create gaps although the reviewer would also have to examine whether incentives, disciplinary forces or standards are already effective in dealing with the situation. Overlapping and perhaps contradictory regulations between different regulatory authorities within a jurisdiction is also an issue that should be monitored as well as any significant inconsistencies between legal domains that hamper enforcement. An issue of particular concern to a reviewer is the applicability of corporate governance codes for companies. Some codes apply to companies listed in a jurisdiction while others only apply to companies incorporated in a jurisdiction so that a listed company might not be covered by any code.

When regulatory responsibilities or oversight are delegated to non-public bodies such as professional organisations or private entities such as a central depository, 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. The reviewer should consider these issues after forming a judgment about the audit and accounting system, other gatekeepers and the stock exchanges. These bodies are covered by principles V.B, V.C, V.D and V.F. The role of the stock exchange is covered implicitly by a number of principles but the reviewer will nevertheless need to consider it in an overall context in principle I.A.

Such practices and the intent of the principle suggest the following essential criteria:

1. The reviewer should form a judgement about: (a) whether there is a clear division of responsibilities between different authorities in a jurisdiction; (b) that there is an effective system of cooperation between them in place; (c) there are no significant inconsistencies between key laws and regulations; (d) the cost of compliance is not regarded as excessive; and (e) that non-public bodies which have been delegated responsibilities for parts of the corporate governance framework are effective, transparent and encompass the public interest.

#### ***1.3.4 Principle I.D***

Principle I.D states that the “Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained”. The annotations note that regulatory responsibilities should be vested with bodies that can pursue their

---

functions without conflicts of interest and that are subject to judicial review. Such bodies will have a significant demand for fully qualified staff to provide effective oversight and investigative capacity and will therefore need to be appropriately funded.

#### Likely practices to be examined

Although background information about the supervisory, regulatory and enforcement authorities can be gathered ahead of a review, a judgment should also be influenced by the assessments of the individual principles and also by reference to the work of other standard setters and any associated review mechanisms. With respect to the latter, standards relating to the authority and integrity of supervisory and regulatory authorities have been formulated by IOSCO, the Basel Committee on Banking Supervision and by the International Association of Insurance Supervisors and reviewed in some cases by the IMF and the World Bank, and by some standard setters themselves. In forming a judgment about the individual principles, a reviewer might often note a lack of institutional capacity including inadequate funding and staff resources that might contribute to inadequate or ineffective enforcement and supervision. However, regulatory, supervisory and enforcement resources are always likely to be in short supply making it important to use those resources effectively. This will usually involve allocating them to where they will have the greatest impact on the regulatory system. The question for the reviewer is whether the institutions are in fact permitted to do this, and if so, whether such an economic use of resources is in fact undertaken. The reviewer should also note cases where new laws, regulations, etc, do not take into account at the outset the limited resources available, a point incompatible with the implementation of principle I.A. Using limited resources effectively will also require that market forces are used as much as possible and that there is not a systematic tendency to substitute them for regulatory intervention.

Of perhaps even greater significance than resources is whether the authorities have sufficient integrity and authority. Clear authority is an important complement of principle I.C which is a necessary though not sufficient condition for the implementation of principle I.D. This is not a judgment that a reviewer can make *ex-ante* but only after extensive consultations with market participants and in forming a judgment about individual principles when the actual behaviour of the authorities might be better observed. With respect to integrity, it is necessary to form a judgement about whether the authorities are free of commercial and political interests (i.e. regulatory capture). This may be reflected in the composition of the governing bodies of the institutions and also in their observed

behaviour. It might also be reflected in the funding arrangements for the authorities that leave them vulnerable to special interests. Funding arrangements to help ensure integrity are often associated with accountability mechanisms. Such arrangements are compatible with full implementation of the principle. Judicial review is one such accountability mechanism and annual reports on objectives and activities to the legislature another.

The authorities also have a great responsibility to help underpin principle I.B that calls for a transparent and predictable legal and regulatory framework. This should be achieved through a process ensuring that rulings are “*timely, transparent and fully explained*”. The reviewer should check to see that the authorities are releasing to all market participants explanations for their decisions so as to establish transparent rules of the game. Such systems might also include advisory notes to market participants and a wide dissemination of response to frequently asked questions. The reviewer will also need to gather the views of market participants about whether the practices amount to clear and consistent rules, the outcome advocated by the principle.

Such practices and the intent of the principle suggest the following essential criteria:

1. The reviewer should form a judgement about: (a) whether the supervisory, regulatory and enforcement authorities have the authority, and integrity to be effective and not subject to commercial and political influences; (b) have sufficient resources to fulfil their objectives and on conditions that will not compromise their integrity and authority; (c) have established in the view of market participants a reputation for being transparent and consistent; and (d) whether they allocate scarce resources effectively to maximise regulatory impact or whether there are barriers in the form of either inefficient legislation and regulation which prevent such an allocation.

## *Chapter II*

### **The Rights of Shareholders and Key Ownership Functions**

#### **2.1 Introduction**

The overarching principle to Chapter II of the Principles states that: “*The corporate governance framework should protect and facilitate the exercise of shareholder’s rights*”. The outcome advocated by this principle covers what are agreed to be fundamental shareholder rights to ensure the integrity and efficiency of equity markets. Basic rights include the right to influence the corporation (voice), the right to information, the right to sell or transfer shares (exit) and the right to participate in the profits or earnings of the corporation (economic rights). These rights also define the nature of publicly traded companies which are the focal point of the Principles. Shareholders’ rights to influence the corporation (voice) 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 and other basic issues. However, it is also important to note that the Principles contemplate that different classes of shares may confer different rights.

In some jurisdictions shareholder rights are very closely defined and there is little room for variation across companies. This makes an assessment easier. In other jurisdictions, shareholder rights might only be generally specified in the law and jurisprudence and are essentially determined by company charters and by-laws. The assessment will therefore need to take into account the occurrence of various practices in a jurisdiction and whether the majority of companies implement the shareholder rights provisions of the Principles.

## 2.3 Issues and Assessment Criteria

### 2.3.1 Principle II.A

Principle II.A states that “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”.

Principle II.A should be checked for consistency with the assessment of principle II.C which strengthens and further refines the basic rights of shareholders.

#### 2.3.1.1 Principle II.A (1): Secure methods of ownership registration

##### Likely practices to be examined

The experience of the Regional Corporate Governance Roundtables is that “secure methods of ownership registration” can well be lacking in some jurisdictions. There have been cases of new shareholders appearing overnight, while in other cases investors have discovered that their shares had not been registered. Where such practices appear to be relatively common, or too easy to perpetrate, the principle should be assessed as either not, or as only partly, implemented. In other cases, companies have discovered that the register of record shareholders has exceeded the total shares issued by the company due, for instance, to double booking by brokers that indicates a systemic flaw. A number of countries also permit bearer shares which can bring other issues such as their *prima facie* acceptance at a shareholders meeting and knowledge on the part of other shareholders that such shares have been issued. In many jurisdictions, shares are held by a chain of intermediaries and custodians. Companies need to have confidence in the ability of intermediaries to maintain accurate records and shareholders confidence that their property is properly protected.

Such practices and the intent of the principle suggest the following essential criteria:

1. Public companies are required to (and do, in fact) maintain, either by themselves or through an agent, a register of record shareholders (or in the case of bearer shares, a register of shares issued) and any shareholder or a party acting on the shareholder’s behalf can inspect the

list of shareholders to verify their holdings. There are effective means of redress if the records are not accurate.

2. If shares are held on behalf of shareholders by custodians, the rights of shareholders in such shares are sufficiently protected and custodians are required to (and do, in fact) safeguard customers' assets.<sup>1</sup>
3. Where securities can be dematerialised (i.e. electronic form) and transferred by book entry, the system is widespread and reliable. Minimum performance standards should exist for registrars/transfer agents, such as recordkeeping rules, as well as the possibility of inspection and examination of registrars/transfer agents by the authorities. Companies or their agents are liable for maintaining an accurate register of shareholders.

### *2.3.1.2 Principle II.A (2): Convey or transfer of shares*

#### Likely practices to be examined

As a general matter, shareholders should expect to be able to freely transfer their shares and this right usually needs to be underpinned by an effective clearing and settlement framework. The reviewer should solicit the opinions of market participants to judge whether or not the clearing and settlement framework functions effectively. This is a highly complex area with its own set of international standards (e.g. CPSS/IOSCO) so that a reviewer might also benefit from any specialised review already conducted according to these standards.

In practice, many jurisdictions permit public companies to restrict the transfer of shares such as where they have been pledged as collateral. Some jurisdictions also allow a company to refuse registration unless it knows the identity of the new owner and in some jurisdictions the transfer can be restricted in the charter and bylaws of a company. The Principles take a nuanced position on the question of disclosing beneficial ownership. Where refusal to register share transfers can be part of a company's charter and is widespread, the jurisdiction should be assessed as either not implementing the principle or as only partly implementing (if such provisions are possible but seldom used).

---

1 . See also Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Security Regulation, Principle 23 (especially, but not limited to, Key Question 6). While the recommendations of IOSCO are likely to be relevant to an assessment of principle II.A.1 they are much more prescriptive than the Principles, specifying the mechanism to be used to obtain the objective.

The authorities also have a legitimate interest in being able to restrict or prohibit the transfer of shares. This is particularly so in the case of financial institutions where the prudential requirements for a fit and proper owner might need to be enforced by limiting transferability. The enforcement of competition policy and takeover rules are also legitimate reasons for the authorities to be able to prevent transfers. Some securities regulators may place restrictions on shareholders' ability to resell their securities in the public markets if the securities were sold in the first instance pursuant to certain exemptions from securities registration requirements. The existence of such restrictions should therefore not lead to an assessment of non-implementation of the principle.

A number of jurisdictions have restrictions on ownership by foreigners either in general or in particular sectors such as those involving national security. In some cases, there are requirements that no more than a particular percentage of outstanding shares can be owned by foreigners. Such policy action should not form part of an assessment: "*The Principles support equal treatment for foreign and domestic shareholders in corporate governance. They do not address policies to regulate foreign direct investment (p. 40)*". However, the concern of the Principles to ensure effective corporate governance, which includes contestable control, would indicate a need by the authorities to assess the benefits of the investment policy against the side effects on corporate governance. This issue could be taken up in the final report as a policy issue to be discussed.

Such practices and the intent of the principle suggest the following essential criteria:

1. Either as a consequence of laws, listing requirements and/or market discipline, public companies do not in general restrict the transfer or conveyance of shares. Restrictions widely regarded as legitimate in the international community (see above) may be imposed by the authorities subject to transparent rule making and workable appeals procedures.
2. The security depositaries are adequately staffed and funded, independent of special interests and are accepted by market participants. The clearing and settlement framework is regarded by market participants as functioning effectively.

---

*2.3.1.3 Principle II.A (3): Obtain relevant and material information on the corporation on a timely and regular basis*

Likely practices to be examined

Shares are often held on behalf of shareholders by intermediaries so that the issue in practice arises whether they are required to (and do, in fact) transmit material received from companies to shareholders in a timely manner (unless shareholders have expressly requested that such material not be transmitted to them). Nevertheless, companies have an obligation to make relevant and material information available directly to shareholders or their representatives, including through web sites to reach those for whom they have no address. In some jurisdictions, it has been observed that companies might restrict access by having shareholder meetings on an irregular basis. Where this is widespread, the jurisdiction should be assessed as either not or only partly implementing the principle.

Such practices and the intent of the principle suggest the following essential criteria:

1. Internal procedural or legal mechanisms available to companies are not used to impede shareholders or their representatives from obtaining relevant and material company information without undue delay and cost. The type of information that should be readily available includes company charters/articles/bylaws, financial statements, minutes of shareholder meetings and the capital structure of the company.

*2.3.1.4 Principle II.A (4): Participate and vote in general shareholder meetings*

The assessment of this principle should be consistent with that for principle II C.2.

Likely practices to be examined

Some jurisdictions permit classes of shares that exclude the holders of those shares from participating and voting in the general meeting of shareholders, restricting any participation to extra-ordinary meetings. The existence of such classes of shares does not imply that the principle is not implemented since the Principles do foresee different classes of shares and is not prescriptive about the respective rights. However, where such share classes are widespread and classes with voting rights very restricted, the reviewer might raise it as a policy issue since the structure could contribute

to the underdevelopment of corporate governance standards and might be closely associated with the non-implementation of other principles.

Of more direct concern to a reviewer are cases where shareholder participation and voting is impeded by the misuse of procedural rules and bylaws such as voter pre-registration and share blocking rules. The reviewer should consult the investor community, securities regulator, stock exchange, etc, about such practices. Where they are used by a significant minority of companies, including very large and prominent companies, the reviewer should be inclined to view that the principle is only partly implemented due to a deficient legal framework and/or enforcement.

Such practices and the intent of the principle suggest the following essential criteria:

1. Procedural and/or legal mechanisms available to a company do not permit it to impede entitled shareholders from participating and voting in a general shareholder meeting. Effective means of redress are available for those whose rights have been impeded or violated.

#### *2.3.1.5 Principle II.A (5): Elect and remove members of the board*

The assessment of this principle should be consistent with that for principle II C.3.

#### Likely practices to be examined

Some jurisdictions permit classes of shares that exclude the holders of those shares from electing and removing members of the board, restricting any participation to extra-ordinary meetings. The existence of such classes of shares does not imply that the principle is not implemented since the Principles do foresee different classes of shares and is not prescriptive about the rights. However, where such shares are widespread, the reviewer should raise it as a policy issue since they may contribute to the underdevelopment of corporate governance standards and might be closely associated with the non-implementation of other principles.

Of more concern to a reviewer is whether there is widespread resort to procedures, etc that are designed to restrict the legitimate rights of shareholders. The reviewer should consult the investor community, securities regulator, stock exchange, etc, about such practices. Where they are used by a significant minority of companies, including very large and prominent companies, the reviewer should be inclined to view that the principle is only partly implemented due to a deficient legal framework and/or enforcement.

---

Such practices and the intent of the principle suggest the following essential criteria:

1. Procedural and/or legal mechanisms available to a company do not permit it to impede entitled shareholders from electing and removing members of the board. Effective means of redress are available for those whose rights have been impeded or violated.

#### *2.3.1.6 Principle II.A (6): Share in the profits of the corporation*

##### Likely practices to be examined

Different classes of shares have a different priority of claims with respect to the profits of a corporation. Many jurisdictions permit the issuance of a class of shares (e.g. preference shares) with a right to a fixed dividend as a priority in comparison with other shareholders. The mere existence of such shares should not lead the reviewer to conclude that the principle is not observed or only partly observed. The reviewer should, however, be aware of cases where dividends have been paid on a more or less *ad hoc* basis to individual shareholders and the procedures or lack of enforcement that have facilitated such behaviour.

Company laws vary greatly with respect to who decides on the distribution of profits and the Principles are neutral as regards the system. To cover all eventualities, a general criterion is useful, emphasising the absence of effective barriers and a transparent process.

Such practices and the intent of the principle suggest the following essential criteria:

1. Shareholders in the same class are treated equally and in accordance with the rights of the respective share classes with respect to the distribution of profits. Effective means of redress are available for those whose rights have been violated.
2. There is a transparent and enforceable legal framework defining how decisions are made about distributing profits.

#### *2.3.2 Principle II.B*

The principle states that 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 principle addresses the most basic issues surrounding a company. Company law and practices, however, differ markedly around the world: some jurisdictions give full rights to shareholders to propose and to change the governing documents of a company, in others they can only vote on a proposal of the board and in some it depends on the charter of the company. In other jurisdictions, boards can decide on the changes themselves. In some jurisdictions it is common for boards to be delegated authority to substantially increase the shares outstanding (often in connection with anti-takeover defences) while in others, strong pre-emption rights and the need for shareholder approval results in limited board authority.

In forming an assessment of whether the sub-principles are observed, it is important to bear in mind that the principle calls for shareholder “participation” and that they be “sufficiently” informed about these fundamental decisions. Thus a situation where they can only vote on a recommendation of the board should be considered as a case where the principle is implemented. The same situation applies to the other two sub-principles. Where they cannot vote at all, the principle should be assessed as not implemented. The second aspect, that shareholders be “sufficiently” informed, is based on two fundamental aspects of the Principles: shareholders should be informed when taking decisions and they should also have full *ex-ante* information about aspects limiting their rights that would normally be factored into the price of the security. Surprises and the capacity for *ad hoc* action are a concern of the Principles. Effective mechanisms for challenging corporate actions could include, *inter alia*, court proceedings, administrative proceedings and arbitration that is used in some jurisdictions as a complementary measure. Effective remedies could include, *inter alia*, enjoining, unwinding or mandating corporate actions, fines or penalties, damages or restitutionary awards, or enforceable rights to have one’s shares purchased at a fair value determined without giving effect to the corporate action about which the shareholders have complained.

#### *2.3.2.1 Principle II.B (1): "Amendments to the statutes, or articles of incorporation or similar governing documents of the company".*

##### Essential criteria

1. The legal framework gives either exclusive power to the shareholder meeting or requires the board to seek shareholder approval of change to the basic governing documents of the company. Procedural rules

---

adopted by companies do not frustrate the exercise of these rights and material information must be provided sufficiently in advance of meetings to permit considered decisions.

2. Shareholders can challenge actions concerning fundamental corporate changes either if: (a) the action required shareholder authorisation and such authorisation was either not obtained or shareholders were improperly denied the opportunity to participate in the decision; or (b) shareholders did not receive sufficient and timely information about the proposed action. There are effective mechanisms for challenging such actions and effective remedies.

#### *2.3.2.2 Principle II.B (2): The authorisation of additional shares*

##### Essential criteria

1. The corporate governance framework gives either exclusive power to the shareholder meeting (delegation of this authority for a limited period to the board could be permitted) or requires the board to seek shareholder approval of changes to the authorised capital of the company. Procedural rules adopted by companies should not frustrate the exercise of these rights and full information must be provided sufficiently in advance of the meeting to permit considered decisions. There are effective means of redress where procedures have not been followed.

#### *2.3.2.3 Principle II.B (3): Extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.*

##### Essential criteria

1. The corporate governance framework gives either exclusive power to the shareholder meeting or requires the board to seek shareholder approval of extraordinary transactions, including transfer of all or substantially all assets, which in effect result in the sale of the company. Material information about the proposed transaction must be provided sufficiently in advance of the meeting to permit considered decisions. There are effective means of redress where procedures have not been followed.

### 2.3.3 Principle II.C

Principle II.C states that “shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, which govern general shareholder meetings”.

#### Likely practices to be examined

In practice, numerous procedures might be used to reduce the effectiveness of shareholder participation, especially those that can be manipulated on an *ad hoc* basis and therefore would not be incorporated into the share price of a company by informed investors. Studies done by both the World Bank as part of the ROSC and the OECD as part of the Regional Corporate Governance Roundtables report numerous instances of *ad hoc* devices intended to mute shareholder voice such as voting by show of hands without the right to demand a ballot, only a limited number of entry cards granted to custodians, delayed information and even the place for the meeting of shareholders being out of the way – or indeed even unknown! Many of the rules and procedures are only in part determined by law and regulation. They are rather often heavily influenced by the board through corporate charters and bylaws. The reviewer must therefore be aware of general practices in the country and take these into account when forming an assessment about whether the principle is implemented.

*2.3.3.1 Principle II.C.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.*

The assessment of Principle II.C.1 should be checked for consistency with principle II.A.3.

#### Likely practices to be examined

In many countries, law or regulation specifies a minimum notice period such as five or ten days prior to the meeting. There is, however, nothing to stop companies from increasing the notice period and many codes and principles do in fact call for longer periods than the legal minimum. What is appropriate will in part depend on the gravity of the issues to be decided as well as on the nature of the shareholding structure. With respect to the issues for decision, research indicates that materials sent to shareholders might not be very informative, in some cases shareholders only discovering the day of

the meeting the importance of issues covered by summary descriptions. With many shares now held through a chain of intermediaries there seems to be a consensus that a longer period is necessary for shareholders both to make their decisions and then to communicate their decisions to the company through the chain of intermediaries. However, one size does not fit all and the availability and use of electronic means for the delivery of material and for voting will also need to be taken into consideration. More and more public companies make shareholder meeting material available for free on their websites and/or there is a free, internet-based and easily accessible public register of public companies' meeting material. Considerable judgement will therefore be required of reviewers to determine the situations where companies are in fact manipulating shareholder rights through insufficient time and insufficient information for shareholders to form a judgement. This will involve extensive discussions with investors to see if they are comfortable with the general behaviour of companies in a jurisdiction.

Another practice that has often been observed and that reduces shareholder participation involves uncertainty about a meeting date. In some jurisdictions that specify quorums for a general meeting of shareholders, companies may make a first announcement of a meeting but will then change it at short notice to another date if it feels that there will not be a quorum. While this is legitimate, it can also be used to dissuade some shareholders from participating.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to provide sufficient advance notice of shareholder meetings and to deliver meeting material covering the issues to be decided that is adequate for shareholders to make informed decisions. The standard generally is observed in the jurisdiction and investors generally acknowledge that notice and information provided by companies is adequate. There are effective means of redress for shareholders where required procedures are not followed.

*2.3.3.2 Principle II.C.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.*

#### Likely practices to be examined

Research has indicated that shareholders are often effectively prevented from posing questions to the board through techniques such as written notice being required a long time in advance of a meeting of shareholders and through unreasonably high (relative to the average size of companies) individual or collective shareholding requirements for questions. Share blocking or registration periods may also be used to effectively prevent questions. The assessor will have to form a judgement about whether actual practices are on balance fair or are used to prevent accountability of the board to all shareholders, a key requirement of chapter III.

The situation with respect to placing items on the agenda and proposing resolutions is considerably more complex and the assessment will need to adapt to the legal and structural features of the jurisdiction. In some jurisdictions, shareholders can through an ordinary or extraordinary meeting of shareholders control the actions of the board. Certain matters are viewed as more appropriate for board decision making in other jurisdictions, rather than shareholder consideration, and this dichotomy is often reflected in legal requirements. The annotations to the principle note that ... “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”. The intent of the principle is that this threshold should be able to include a number of co-operating shareholders, an intent given specific form through principle II.G.

The method of appointment of an external auditor varies widely with the board or a committee of the board (more often now, an independent committee) making appointments in some jurisdictions and shareholders in others. Questions directly proposed to auditors are allowed in some jurisdictions especially where they have been appointed by the AGM. The principle takes the general position that accountability of the board requires that shareholders should be able to ask questions of the board about the external audit.

---

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to: (a) facilitate shareholders asking questions of the board; and (b) permit shareholders to propose items for discussion on the agenda or to submit proposals/resolutions for consideration at the meeting of shareholders regarding matters viewed as appropriate for shareholder action by applicable law. There is an effective means of appeal on procedural grounds. Where voluntary, the standard is widespread.
2. Thresholds for share ownership establishing the right of individual shareholders, or groups of shareholders, to pose questions, to place items on the agenda or to submit proposals/resolutions for consideration at the meeting of shareholders regarding matters viewed as appropriate for shareholder action by applicable law should not be restrictive and should take into account the concentration of ownership in the jurisdiction and the average size of companies.

*2.3.3.3 Principle II.C.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”.*

#### Likely practices to be examined

Key to interpreting these two principles in practice is the meaning of “elect” and “effective shareholder participation... should be facilitated”. In some jurisdictions, shareholders can only cast a vote in favour or abstain from the whole list of candidates for the board and not for or against individuals or lists of individuals. The annotations to the principle II.C.3 state that “... for the election process to be effective ... shareholders should be able to ... vote on individual nominees or on different lists of them”. A jurisdiction in which a large number of firms practice such a system should be classified as not implementing the principle.

The facilitation of effective shareholder participation is taken up in a number of complementary principles covering both voting and counting procedures. They include principles II.C.4, III.A.3, III.A.4 and III.A.5 and a final assessment will need to come to an overall consistent view. An

important factor facilitating shareholder participation concerns access to the company's proxy materials. Shareholders in a number of jurisdictions have such access although sometimes subject to conditions to prevent abuse. How restrictive these conditions are in practice will need to be assessed after consultations with investors, custodians etc. Exclusion from the proxy process imposes very costly burdens for those challenging the accountability of the board.

A key issue is how to judge in practice whether shareholder participation is indeed effective. One indicator might be to look at the number of board members formally declared as independent or, in some jurisdictions, as nominated and elected by minority shareholders. Another might be to examine the number of contested elections in a jurisdiction, although if a company feels that a nomination might not be acceptable it might simply be withdrawn or not even considered. The judgement of the investor community will in any case need to remain an important input. For shareholder participation to be effective, it is also important for shareholders to be informed about the nominated board members. Principle V.A.4 calls for full disclosure of the experience and background of candidates for the board and the nomination process. Where there is not adequate disclosure, the assessment of II.C.3 might need to be adjusted accordingly.

The procedures for the nomination of candidates vary widely and in this area there are a number of functional equivalents that the reviewer might need to consider. In some jurisdictions where ownership is characterised by a number of large shareholdings, formal or informal talks might be held between the chairman of the board and the major shareholders to determine a list. In other countries with concentrated shareholding and powerful owners, several positions might be reserved for minority shareholders. In other jurisdictions, especially those where management or the board itself have traditionally controlled board nomination, it is increasingly regarded as good practice for independent board members to have a key role in nomination, often through comprising the majority of a nomination committee.

Board and executive contracts are usually not an appropriate subject for approval by the general meeting of shareholders, but the principle advocates there should be a means by which they can express their views. However, in some countries board compensation (usually in aggregate) is approved by the general meeting of shareholders. The means for shareholders to express their views might be by an advisory vote or by some other method. In many jurisdictions the principle (especially with respect to executives) is probably not as yet implemented. This is not the case with equity-based incentive schemes especially in those jurisdictions with strong pre-emption rights. The principle calls for equity schemes to be approved either for individuals or for

the scheme as a whole. They should not be subsumed under general approval for a potential increase in issued equity, a practice that should be classified as partial or non-implementation of the principle. In an increasing number of jurisdictions, any material changes to existing schemes must also be approved and in these cases the principle should be assessed as fully implemented.

Such practices and the facilitating intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to facilitate the effective participation of shareholders in nominating and electing board members. The practice of facilitating participation is widespread including through formalised procedures in company charters and by-laws. Where effective participation is a listing requirement, it is enforced by the listing authority.
2. The corporate governance framework requires or encourages companies to present the opportunity for shareholders to make their views known either at the meeting of shareholders or by equivalent means about the compensation policy for board members and key executives. There are provisions for shareholders to explicitly approve equity-based compensation schemes and this power is not delegated to the board.

*2.3.3.4 Principle II.C.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.*

#### Likely practices to be examined

With respect to voting in absentia, it is important 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. The former aspect is crucial. In some jurisdictions only blank proxies can be sent to the firm. In this case, the principle should be regarded as not implemented. Only where a shareholder can mandate a proxy for or against any resolution can the principle be assessed as fully implemented. Where proxies are held by the board or management for company pension funds and for employee stock ownership plans, the voting records should be kept and be available to plan fiduciaries and regulators as needed to ensure that an equal effect is given to all votes.

Some proxy systems are based on the concept of power of attorney but nevertheless allow a shareholder to vote in absentia. Voting in absentia might also take place through an authorised representative which is quite common in many jurisdictions. Another alternative to proxies is simply sending a vote by mail or by electronic means. These are cases of functional equivalence so long as, consistent with implementation of the principle, so long as such votes are given equal effect. Some mechanisms may prove in practice to be cumbersome and costly, an issue taken up in principle III.A.5.

In a number of jurisdictions, voting mechanisms are only generally specified by company law and securities regulation and a great deal will depend on company charters, by-laws and practices. In forming a judgement about implementation of the principle, a reviewer might be able to make use of the numerous surveys now being conducted by proxy agents and investor groups about the actual practices adopted by companies.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework permits shareholders to vote in absentia (including postal voting and other procedures) and that this vote can be for or against a resolution, and fully equivalent to the possibilities allowed to those shareholders present. Shareholders have an effective remedy against the company if it does not provide the options prescribed by law. Adoption of one or more of the functionally equivalent range of options by companies is widespread.

### ***2.3.4 Principle II.D:***

The principle states that capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

The assessment of Principle II.D needs to be checked for its consistency with the assessment of principle V.A.3 (*Disclosure should include, but not be limited to, material information on ... major share ownership and voting rights*)

#### **Likely practices to be examined**

The Principles do not take a position on “one share, one vote” but instead rely on disclosure in order for shareholders to be clear about both the control of a company and the role of privileged shareholders. In many jurisdictions and in a large number of companies, there is a shareholder or group of shareholders in a controlling position that is not closely related to

their equity ownership. The devices that a reviewer will need to investigate include multiple voting rights, share caps, and investing some shares with rights to elect a majority of the board. The reviewer will, however, need to define the category of control instruments widely and ensure that they do not escape transparency requirements through regulatory loopholes.

Control disproportionate to the equity ownership is also exercised by shareholder agreements. They allow groups of shareholders to act in concert so as to constitute an effective majority, or at least the largest single block of shareholders. In some jurisdictions it is necessary to disclose at least the governance aspects of the agreements (otherwise they may be legally void) and their duration is limited through regulation. If there are no effective (i.e. enforceable and enforced) provisions to disclose the governance aspects of such agreements, the principle should be assessed as not implemented. Responsibility to disclose can be with the company as soon as it becomes aware of a shareholder agreement or with the shareholder. Disclosure should also extend to informal agreements although enforcement might prove difficult. Shareholder agreements should not be confused with the right of shareholders to consult with each other, so long as by doing so they are not exercising or seeking to obtain control over the company (see principle II.G).

An important case where the degree of control is often disproportionate to equity ownership concerns company groups and especially those organised as a pyramid structure. Research indicates that control is particularly opaque in such groups, in part because private companies about which little is known are integral to the pyramid. Many jurisdictions might therefore be assessed as not or only partly implementing this aspect of the principle. Cross shareholdings between companies are also common but are frequently limited by law (in order to protect the notion of company capital) to no more than a fixed percentage of capital (often 10 per cent). Transparency is often poor in this area, although analysts and informed investors can often obtain the basic information from, *inter alia*, company registrars. The reviewer should also pay attention to principle V.A.3, where the annotations note that shareholders also have a right to information about the structure of a group of companies and intra-group relations.

The disclosure of capital structures is so fundamental that the criterion does not foresee a voluntary disclosure requirement. Information about corporate groups and the difficult area of shareholder agreements are treated as in the more general form of the other criteria: the framework requires or encourages disclosure. The disclosure requirements can often be frustrated by dividing disclosure between many different documents such as company charters and statutes, and prospectuses. These can be difficult to access and can be used to avoid transparency: shareholders can never be sure that they

have the whole picture. A reviewer should not regard the principle as fully implemented unless companies generally disclose the required information at least annually in a comprehensive, easy to access and easy to use format so that interested persons can obtain a clear picture of the relevant capital structures. Disclosure obligations should also apply at the moment of material changes to the arrangements.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires the disclosure on a continuing basis to shareholders of all capital structures that allow certain shareholders to exercise a degree of control disproportionate to their cash flow rights. These would include, inter alia, voting caps, multiple voting rights, golden shares, pyramid structures and any associated cross shareholdings. There are effective mechanisms for enforcing disclosure requirements.
2. The corporate governance framework requires or encourages companies to disclose the structure of company groups and the nature of material intra-group relations. There are effective mechanisms for enforcing requirements and there is widespread implementation of the standard.
3. The corporate governance framework requires or encourages the disclosure of shareholder agreements by either the company or the shareholders concerned covering, inter alia, lock-ins, selection of the chairman and board members, block voting and right of first refusal. There are effective mechanisms for enforcing requirements and there is widespread implementation of the standard.
4. The corporate governance framework requires or encourages disclosures to be made in an easy to access and easy to use format so that interested persons can obtain a clear picture of the relevant capital structures and other arrangements. Information is updated on a timely basis if there is any change. There are effective mechanisms for enforcing requirements and there is widespread implementation of the standard.

### ***2.3.5 Principle II.E***

Principle II.E states that “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”.

Principle II.E is concerned with ensuring an efficient allocation of resources subject to procedures to ensure that other aspects of the Principles concerning shareholder rights are protected. An effective market for corporate control makes it possible for those who can use the corporate resources best to acquire control over them. Equity markets will thus make a contribution to structural change. However, such transactions can involve questions about the equal treatment of shareholders, particularly the treatment of minority shareholders, which is an important aspect of the Principles. The principle is also concerned with the control power exerted by insiders (e.g. entrenched management) that serves to raise a number of corporate governance issues (e.g. increase agency costs).

In setting the background for an assessment, the reviewer will need to first look at the recent history in the market for corporate control. Hostile takeovers are the exception in many jurisdictions but mergers, agreed takeovers and sales of control blocks are more common. Different ownership structures are in part responsible for this disparity so that a comparative lack of takeover activity should not be construed as a *prima facie* case for non-implementation of the principle.

*2.3.5.1 Principle II.E.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.*

#### Likely practices to be examined

The rules and procedures governing the acquisition of corporate control (including transfer of control through sales of substantial portions of the assets) might vary considerably between companies in a jurisdiction depending on company charters and by-laws, the structure of ownership and listing regulations. Some jurisdictions have take-over codes or laws specifying procedures quite closely, including the establishment of toe-holds to support a take-over bid. They usually include provisions to protect

minority shareholders by requiring bidders to offer to purchase shares at a particular price (i.e. mandatory tender offer rules) and there might also be thresholds at which minority shareholders can require the majority to buy their shares, and/or a threshold at which the outstanding shareholders can be squeezed out. The principle does not set an absolute standard for the nature of the rules and procedures, but the reviewer should be satisfied that arrangements are clearly articulated, disclosed and implemented so that the rights can be incorporated into the price of different classes of shares. The reviewer should therefore look at cases of *ad hoc* or unexpected actions by controlling shareholders and boards, which because they could not have been adequately foreseen, are to the detriment of other shareholders.

In the many jurisdictions where control rights are concentrated, hostile takeovers are rare but transfers of control nevertheless do occur through private sales. The concern is that controlling shareholders will act in their own self-interest to the detriment of other shareholders thus breaking the principle of equal treatment within the same class of shares. Such action could involve a related party transaction as when assets are sold to another company controlled by the same shareholder. The principle therefore advocates transparent prices and conditions to protect minority shareholders and the reviewer will need to examine how this is being achieved in practice. In some jurisdictions, emphasis is on the role of independent members of the board in assessing the fairness of the transaction. Redress mechanisms might also be available to shareholders in principle, but experience often shows that the process of discovery can be limiting. A special case involves privatisations when the government first makes an IPO to the public and then at a later stage sells a remaining control block to a group of investors. Privatisation law will in these cases often override the usual takeover rules such as mandatory tender offers. For the principle to be fully implemented, the reviewer should be satisfied that the initial IPO prospectus has made it quite clear to investors that they will not benefit from any control premium.

De-listing a company is another special aspect of the market in corporate control and might be particularly damaging to some shareholders and to stakeholders such as creditors. Laws and regulations covering de-listing vary greatly: in some countries it is a decision to be taken by a qualified majority of the shareholders, in others it is an issue for the board to decide. The listing authority may also impose conditions such as specifying a maximum number of shareholders for a delisting to be approved by the authority. It is essential that the corporate governance framework includes provisions to protect minority shareholders and to ensure that transactions occur at transparent prices and under fair conditions. Tender offers and squeeze-out provisions are areas to be examined by a reviewer as well as

any obligations on the board to obtain an independent opinion about the valuation. The assessment of both principles III.A.2 and VI.B should also be examined for consistency.

Such practices and the intent of the principle suggest the following essential criteria:

1. To prevent creeping acquisition of corporate control, there are requirements for timely disclosure to shareholders and the regulator of a substantial acquisition of shares, often in the form of thresholds, and these are effectively enforced by the listing authority, financial market supervisor or by easy and timely access to the courts by shareholders.
2. The corporate governance framework covering the market in corporate control (as well as the procedures to be followed in the event of delisting) is well articulated and ensures that shareholders of a particular class are treated in the same manner as controlling/majority shareholders in terms of the price they receive for their shares. There should be effective enforcement (by the authorities or through inexpensive private action, either individually or collectively) and remedial systems. Where the arrangements depend on individual corporate charters, the standard is widely applied.
3. To underpin price transparency and fair conditions in the market for corporate control, the corporate governance framework requires that the plans and financing of the transaction are clearly known to both the shareholders of the offering enterprise when it is a public company as well as to those of the target company. There is sufficient time and information for shareholders to make an informed decision.

#### *2.3.5.1 Principle II.E.2 .2: Anti-take-over devices should not be used to shield management and the board from accountability.*

The annotation to the principle notes that 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. The principle is thus closely related to principle VI.A that specifies the fiduciary responsibilities of the board.

#### Likely practices to be examined

The principle is particularly important to jurisdictions and companies where shareholdings are dispersed so that the market in corporate control

can be potentially restricted by a number of barriers to an investor gaining control. The difficulty for the reviewer is to judge their ultimate impact since many techniques may never be used to shield management and the board from accountability, either because they are not permitted in a company's charter or because a company has already pre-committed not to use them for this purpose. Some devices may be a useful tool during negotiations of a take-over price, shifting the balance of bargaining power to the target company and its shareholders, but others might be used simply to protect and entrench management and the board. It is therefore not possible to form a judgement based on the types of instruments that might be used. More direct evidence of management and board entrenchment might also be considered such as whether turnover of chief executives and boards is related to company performance together with the views of market participants, although such information must be interpreted in context.

In some cases, there are also breakthrough rules once a potential bidder reaches a certain level of ownership allowing them to set aside the anti-takeover measures and in a number of countries there are also take-over codes or laws, stock exchange requirements etc, which might regulate use of various barriers. An assessment will have to therefore seek to determine first what is the actual situation or potential in a jurisdiction for a market in corporate control, and then to determine the role of the barriers. A judgement will also need to consider that firms often differ widely in a jurisdiction in their objectives and use of barriers.

The implementation status of other principles will need to be taken into account in forming a judgement. Clearly, the greater are the direct powers of shareholders as specified in Principles II.B and II.C, the greater is the likelihood that restrictions will be used as bargaining devices rather than as barriers to the operation of a market for corporate control. Similarly, the stronger is the fiduciary duty of the board, principle VI.A, and the ability of the board to exercise objective independent judgement on corporate affairs, principle VI.E, the greater is the likelihood that a market in control will exist and that barriers will be used as negotiating instruments. If the board can act without regard to the interests of shareholders or where the concept of duty to the company is very broad and frequently cited to reject offers, the jurisdiction should be noted as not having implemented the principle. In many instances, the assessment of other principles in this chapter might have to be reconsidered to make the assessments consistent.

Such practices and the intent of the principle suggest the following essential criteria:

1. There should be a well defined concept of the duty of loyalty owed by the company's board members and officers to the company and

---

shareholders generally which in the case law or jurisprudence of the jurisdiction extends to the consideration of a take-over proposal received by the company. There should be effective enforcement (by authorities or through inexpensive private action, either individually or collectively) and remedial systems.

2. Market participants judge that management and boards are subject generally to sufficient market pressure so as to be de facto, as well as de jure, accountable for their stewardship of companies.

### ***2.3.6 Principle II.F.***

Principle II.F states that: 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.

The principle is primarily, though not exclusively, oriented to one class of institutional investor that invests in equities on behalf of its clients. Such institutions might not exist in some jurisdictions. In others, the laws and regulations, and even court judgements in common law countries, might not yet have adapted to viewing the exercise of voting rights as contributing to the stewardship of funds held in trust (i.e. the fiduciary duty).

*2.3.6.1 Principle II.F (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*

#### **Likely practices to be examined**

One factor which research has shown does not facilitate the use by institutional investors of their voting rights is the practice of share-blocking prior to a meeting of shareholders. Other systems are available such as using a record date although there are several versions that might be functionally equivalent. In some, the record date is not set too close to a meeting so as to allow the transfer of information to recorded shareholders. In some other jurisdictions, the date is set close to the meeting date so that only actual

shareholders more or less on the day of the meeting can vote and documents are sent to all shareholders. Some others freeze the pool of shareholders some time before the meeting and send documents only to them.

Such practices and the intent of the principle suggest the following essential criteria:

1. Procedures adopted by companies to determine voting rights are not considered by investors, both domestic and foreign, to constitute a disincentive to the exercise of ownership rights.
2. The legal and regulatory system, including court rulings, clearly recognise the duty of institutional investors acting in a fiduciary capacity to consider whether and under what conditions they should exercise the voting rights attaching to the shares held on behalf of their clients.
3. The corporate governance framework requires or encourages the disclosure of voting policies and of the procedures in place to decide on the use of these rights. Where disclosure is required there are effective mechanisms for enforcement. Where disclosure is encouraged, the standard is widely observed.

*2.3.6.2 Principle II.F. (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.*

#### Likely practices to be examined

Institutional investors acting in a fiduciary capacity might often be a subsidiary or an affiliate of another financial institution, and especially an integrated financial group. In these cases they might be subject to conflicts of interest as, for example, when a fiduciary votes its clients' proxies in favour of a proposal that would benefit the business of its affiliate. A great deal will depend on the financial structure of a jurisdiction. Normal laws of fiduciary duty might not be strong enough in such situations or any breaches might be difficult to detect and effectively enforced. In part as a result, in some jurisdictions industry codes are often used, calling for the development and disclosure of policies to control conflicts of interest. In others, conflicts of interest and breach of fiduciary duty might be areas already covered by an industry regulator so that the reviewer will need to examine their practices in forming a judgement about the implementation of the principle.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework encourages or requires institutional investors acting in a fiduciary capacity to: (a) develop a policy for dealing with conflicts of interest that may affect their decisions regarding the exercise of key ownership rights; and (b) disclose the policy to their clients together with the nature of the actions taken to implement the policy. Where disclosure is required there are effective mechanisms for enforcement. Whether required or encouraged, the standard is widely observed.

### ***2.3.7 Principle II.G***

The principle states that 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.

The co-ordination problems facing dispersed shareholders are well documented and can result in under-monitoring of boards and management (i.e. agency costs). The annotations to the principle note that shareholders 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 putting questions to the board and management. More generally, shareholders should be allowed to communicate with each other without having to comply with the formalities of proxy facilitation.

#### **Likely practices to be examined**

Shareholder co-operation or co-ordination can also be used to manipulate markets and to obtain control over a company without being subject to take-over regulation. For this reason, in some countries the ability of shareholders to cooperate on their voting strategy is either limited or prohibited. The lack of shareholder and investor groups might indicate that the current system is highly constraining and individuals and organisations should be consulted to see if this is the case. The challenge for the reviewer and for policy dialogue is to ensure that the balance between the two concerns allows sufficient room for legitimate shareholder activity. A well functioning take-over market, with clearly defined rules about what constitutes seeking control, will go a long way to alleviating concerns about undermining take-over rules and market manipulation. The reviewer will need to examine this particular situation when assessing essential criteria 1.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework establishes clear rules for proxy solicitation which are not so encompassing as to prevent shareholders consulting with each other over the use of their basic rights, for example, to elect and remove board members.
2. Market trading rules should prevent market manipulation but still be flexible enough to permit and encourage consultations between shareholders.

## Chapter III

### The Equitable Treatment of Shareholders

#### 3.1 Introduction

The overarching principle of chapter III of the Principles states that “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”. The outcome advocated by the principle is to preserve the integrity of capital markets by protecting non-controlling shareholders from potential abuse such as misappropriation by boards, managers and controlling shareholders. Investors’ confidence that their interests will not be subject to abuse will reduce the risk premium they will demand for making an investment, lower capital costs and raise, *ceteris paribus*, the value of equity.

In providing protection to investors, the annotation to the principle notes that a distinction can usefully be made between *ex-ante* and *ex-post* shareholders rights, and this distinction can be usefully applied during an assessment. *Ex-ante* rights are, for example, pre-emptive rights and qualified majorities for certain decisions. *Ex post* rights cover access to redress once rights have been violated. The annotations note that the balance between *ex-ante* and *ex-post* rights will likely vary between jurisdictions so that a reviewer will need to be particularly sensitive to functional equivalence in forming a judgement about whether the principle has been implemented. This is particularly so with respect to whether shareholders can obtain redress for grievances at a reasonable cost and without excessive delay. In forming a judgement about this *ex-post* aspect of the principle, attention will also need to be paid to the avoidance of excessive litigation. Many countries protect management and board members from the abuse of litigation in the form of tests for sufficiency of shareholder complaints through safe harbours such as the business judgement rule. A reviewer will need to examine such

rules that might be unsuitable legal implants from another legal system and not reflect the structure of ownership and control in a jurisdiction. It is the overall consistency of the corporate governance system that is crucial.

The reviewer will also need to examine the experience with methods of enforcement other than litigation by shareholders. Many jurisdictions are based on the view that alternative adjudication procedures, such as administrative hearings or arbitration procedures organised by the securities regulators or other regulatory bodies, are an efficient method of dispute settlement, at least in the first instance.

### 3.3 Issues and Assessment Criteria

#### 3.3.1 Principle III.A

Principle III.A states that “*all shareholders of the same series of a class should be treated equally*” while the sub-principles, which are important in forming a judgement about implementation, specify in more detail the different dimensions that “unequal treatment” might take in practice.

*3.3.1.1 Principle III.A.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 principle recognises that many countries and jurisdictions permit companies to issue shares with different rights and does not take a position on “one share, one vote”. However, variations in rights should not arise in an *ad hoc* manner. With full information about the class and series of shares available at the time of purchase, the share price should normally reflect the different balance of rights and risk.

#### Likely practices to be examined

Actions detrimental to one group of shareholders could include the board deciding by itself to issue a new class or series of shares or altering the rights of an existing series or class of shares. If this is a widespread practice, the reviewer should assess the principle as partly or not implemented. In some cases, shares might acquire increased voting rights after a period of time. To be assessed as fully implemented, such practices

must be transparent, non-discriminatory, and included in company charters and/or approved by shareholders. In some jurisdictions it might only be possible for investors to obtain information via the charters/company statutes. To meet the intention of the principle and essential criteria 2, such access should be inexpensive otherwise the principle should be judged to be either not or as only partly implemented. The latter would be the case if the company updated the material attributes of its share capital regularly such as at an annual meeting of shareholders. Anti-takeover devices might also represent such an abuse so that an assessment would need to be consistent with those for principles II.E and II.D.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages that proposals to change the voting rights of different series and classes of shares should be submitted for approval at a general meeting of shareholders by a specified majority of voting shares in the affected categories. Where approval is required, there should be effective means of redress if procedural rules such as adequate notice of a meeting are not followed. Whether required or encouraged, the standard is widely observed.
2. The corporate governance framework requires companies to disclose sufficient, relevant information about the material attributes of all of the company's classes and series of shares on a timely basis to prospective investors so that they can make an informed decision about whether or not to purchase shares. An updated summary description of the material attributes of the company's share capital should be made available for listed companies on a regular basis. Where these requirements are simply recommendations, there should be widespread adherence for the principle to be classed as implemented. Where the requirement is mandatory, there should be effective redress (e.g. the right to rescind the share purchase transaction or damages).

*3.3.1.2 Principle III.A.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.*

Likely practices to be examined

The potential for abuse is higher 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. The reviewer will need to be aware that abuse of minority shareholders can be carried out in various ways, including the extraction of direct benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, systematic biases in business decisions and a change in the capital structure through special issuance of shares favouring the controlling shareholder.

Abuse of minority shareholders is most pronounced in those countries where the legal and regulatory framework does not establish a clearly articulated duty of loyalty of board members and officers to the company and to all its shareholders that is required by principle VI.A. In the absence of such a clear duty, redress might prove more difficult. A particular issue requiring investigation by a reviewer 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 the receipt of a corresponding benefit from other companies of the group. The experience with such arrangements will need to be carefully assessed since a number have only been in force for a short time so that judicial interpretations might be limited and redress ineffective.

*Ex-ante* provisions to protect minority shareholders that are relevant for the essential criteria include pre-emptive rights in relation to share issues and qualified majorities for certain shareholder decisions including majority-of-the-minority approval for transactions so that related shareholders can be treated differently from unrelated shareholders. The ability of minority shareholders to convene a meeting of shareholders (e.g. an extraordinary meeting) is also a potentially important mechanism to protect minority shareholders. Some have advocated cumulative voting for electing members of the board but where this option is voluntary it has not been widely used by companies. In some companies and jurisdictions, several board members (or members of an audit board or similar body) might be appointed by the minority but the practice is not widespread. *Ex-post* means of redress include derivative and class action law suits, and enforcement/investigation by the regulatory authorities. The balance between *ex-ante* and *ex-post* protection will vary from one jurisdiction to another and the absence of one kind or another doesn't necessarily mean that a reviewer should regard the principle as less than fully implemented.

In forming an assessment for jurisdictions characterised by controlling shareholders, the reviewer will need to examine the evidence for abuse of minority shareholders and how effective the different enforcement

mechanisms have been in practice. Barriers to effective enforcement include thresholds for shareholder action that can be easily manipulated and poor powers of discovery if a resort is made to litigation. The assessment will also need to be consistent with VI.A and VI.D.6 which deal with the fiduciary duties of the board and with the control of related party transactions respectively. Weaknesses in the implementation of any of these associated principles will need to be reflected in the assessment of this sub-principle.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework provides either ex-ante mechanisms for minority shareholders to protect their rights that have proved effective and/or ex-post sanctions against controlling shareholders for abusive action taken against them. There are effective means of redress for minority shareholders and adequate remedies.

*3.3.1.3 Principle III.A.3: Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.*

#### Likely practices to be examined

Consistent with the intent of the principle, the trend in many 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: the basis of the explicit or implicit contract between the custodian or nominee and the beneficial owner has been clarified. 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. For the reviewer to assess the principle as implemented, 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.

The principle requires that 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 depository, 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 depository or trust office holds on their behalf for the principle to be fully implemented. In some countries, such rights are restricted to normal company issues such as electing boards, thereby excluding the right to vote about takeover offers and other extraordinary transactions. Where this is the case, the principle should be assessed as partly implemented. It should be noted that the assessment is with respect to the jurisdiction under review and to the institutions domiciled therein. The fact that domestic shareholders may not be able to exercise such rights in another country is outside the scope of the assessment.

In some cases, such as with respect to American Depository Receipts (ADR), voting rights can only be established if a deposit agreement exists that includes as a party the foreign private issuer whose securities underlie the ADR. In those cases, a mechanism exists for the depository to distribute shareholder communications at the request of the foreign private issuer, and to act as proxy for the ADR holders. When the foreign private issuer is not a party to the deposit agreement, no such mechanisms exist and the ADR holders are not able to vote. In these cases, the voting terms of the ADR should be made clear to the purchasers of the ADR.

Such practices and the intent of the principle suggest the following essential criteria

1. The legal framework or private contracts establish that the relationship between custodians and nominees, and their clients makes clear: (a) the rights of beneficial shareholders to direct the custodian or nominee as to how the shareholder's vote should be cast; (b) that votes will be cast in accordance with any instructions provided by the beneficial shareholder; and (c) the custodian or nominee will disclose to the shareholder how they would vote shares for which no instructions were given. There are effective enforcement mechanisms to ensure compliance with the wishes of shareholders. Trustees or other persons operating under a special legal mandate, such as bankruptcy receivers and estate executors, would not be covered by this criterion.
2. The legal framework requires that depository receipt holders can issue binding voting instructions on all issues with respect to their shares to depositories, trust offices or equivalent bodies. There are effective enforcement mechanisms to ensure compliance with these requirements. Where depository receipts without voting rights can be established, the lack of voting rights should be disclosed clearly to the holder of the depository receipt.

*3.3.1.4 Principle III.A.4: Impediments to cross border voting should be eliminated.*

Likely practices to be examined

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 result in 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 particular, there is often confusion about who is legally entitled to control the arrangements that govern the voting of shares. This has led some jurisdictions to define an “ultimate investor” or beneficial owner and to clarify that they have a legally enforceable right to determine how shares are voted, a measure compatible with implementation of the Principles.

The complex holding chain together with business practices and regulations, which provide only a very short notice period (see principle II.C.1 and the associated assessment criteria), often leaves shareholders 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. For the assessment, the reviewer is only concerned with domiciled institutions and domestic regulations and practices, and not with foreign practices. Thus a jurisdiction might be regarded as implementing the principle even though foreign shareholders continue to experience problems due to deficiencies in other jurisdictions. For example, disputes between foreign shareholders and their global custodian are likely to be adjudicated outside the local market and should not be considered by the reviewer, even if information is available.

Such practices and the intent of the principle suggest the following essential criteria:

1. The legal framework should clearly specify who is entitled to control the exercise of voting rights attaching to shares held by foreign investors through a chain of intermediaries and, if necessary, simplify the effect of the chain in the jurisdiction.
2. The corporate governance framework requires or encourages companies to provide sufficient notice of meetings to enable foreign investors to have opportunities similar to those of domestic investors to exercise their voting rights. There is timely and effective enforcement where

needed of such standards and foreign investors have effective remedies where there appears to have been non-compliance with standards. Whether required or encouraged, the standard is widely observed.

3. Companies are required or encouraged to make use of secure and effective processes and technologies that facilitate voting by foreign investors.

*3.3.1.5 Principle.III.A.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 intent of the principle is that all shareholders are entitled to participate at the general meeting of shareholders in accordance with the rights of the respective share class. Rights might vary between the general and extraordinary meetings but this practice is within the meaning of the Principles.

#### Likely practices to be examined

Management and controlling investors have been observed at times to discourage non-controlling and foreign investors from trying to influence the direction of the company. Some companies have charged fees for voting and share-blocking might also create a similar disincentive (see principle III.A.4 for consistency). In some other jurisdictions, bonuses and payments to some for voting also have been used. Impediments include prohibitions on proxy voting (or at least severe limitations on who can exercise a proxy) and the requirement for personal attendance at general shareholder meetings to vote. Still other procedures may make it practically impossible or cumbersome 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 (see principle II.A.3 and principle II.C.1 for a consistency check), and the use of a poll or show of hands at the meeting without the right to demand a ballot devalues ownership rights. Depending on how widespread the practices are judged to be, the reviewer should conclude that the principle is only partly implemented. In making an assessment, the reviewer should seek the opinions and experience of, *inter alia*, proxy agencies and investors.

In some companies and jurisdictions, it is the practice at general shareholder meetings to obtain the voting intentions of the largest shareholders first, and as soon as there is a clear majority the remainder are disregarded and are not counted. For the principle to be judged as

implemented, it is important that the corporate governance framework ensures that all votes cast are counted equally and that the results of all votes cast in whatever form are registered. Many investors would like to see results communicated to shareholders and this is standard practice in some jurisdictions and companies.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to: (a) facilitate voting by minimising the costs involved to shareholders; (b) use voting methods at shareholder meetings that ensure the equitable treatment of shareholders; and (c) make voting results available to shareholders on a timely basis. There is timely and effective enforcement, as needed, of such standards, and there are effective mechanisms enabling shareholders to raise concerns about compliance with standards and obtain adequate remedies where there has been no compliance. Whether required or encouraged, the standard is widely observed.

### **3.3.2 Principle III.B**

The principle states that *insider trading and abusive self-dealing should be prohibited*. The principle reaffirms that it is reasonable for investors to expect that the abuse of insider power 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 and can include unreasonable managerial perquisites, loans from the company on non-market terms and abusive related party transactions.

#### **Likely practices to be examined**

As insider trading entails manipulation of capital markets it is often prohibited by securities regulations, company law and /or criminal law in many jurisdictions. Sometimes it is covered by market abuse regulation and law. Either way, the principle calls for prohibition and further implies the need for effective, proportionate and dissuasive sanctions for violations. In some jurisdictions, the definition of insider trading can be rather narrow so that the intent of the principle might not be implemented. Indeed, in some jurisdictions there has never been a case even though legislation has been on the books for quite some time. In forming a judgement, a reviewer should review the record of vigorous enforcement including prosecutions and successful prosecutions. Where there have been few or even no successful

prosecutions, the reviewer should be inclined to the judgement that the principle is only partly implemented and the main cause identified.

The annotations for principle III.B call for abuses to be specifically forbidden by law and for effective enforcement. The key issue appears to be enforcement and indeed the IOSCO methodology places quite specific restrictions on what is required for legislation to be effective and should form a guide for the reviewer.<sup>2</sup> It should also be noted that the IOSCO principles address a broader category of behaviour many of which are still within the spirit of the OECD Principles. The essential criteria draw on the IOSCO standard giving attention to the actual process of enforcement. Should all elements not be fulfilled, the jurisdiction should be assessed as not or only partly implementing the principle, but attention should also be paid to the assessment of principle VI.D.6 and V.E.

Abusive self-dealing covers another aspect of persons close to a company exploiting the relationship to the detriment of the company and the investors but is usually more complex. As a consequence, self-dealing *per se* is often not prohibited (although some transactions such as material loans might be prohibited) but is rather subject to laws and regulations and company arrangements of a different form from those associated with insider trading. To obtain a complete picture for what is a widespread problem, the reviewer needs to take a number of principles into account. Principle III.C covers declaration of interest in a transaction, while principle VI.D.6 advocates a major role for the board to control self-dealing: *The board should fulfil certain key functions including... monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.* Principle III.A.2 complements the duty of the board with a more general protection of minority shareholders from abuse by controlling shareholders. Ethical policies adopted by companies often include principles to deal with self-dealing (principle VI.C). An assessment as to whether principle III.B is implemented will therefore need to be consistent with a number of individual principles and involve a judgement about whether they constitute, as a whole, an effective safeguard for investors against abusive insider self-dealing. In this case, the criterion can be classified as fully implemented even though the principle calls for prohibition.

Such practices, the IOSCO standard and the intent of the principle suggest the following essential criteria:

---

2. IOSCO Principle 28.3

1. The corporate governance framework prohibits improper insider trading and similar abusive conduct by insiders such as market manipulation. The definition of insider trading is not so narrow as to be easily evaded. There is an effective enforcement regime to deter and detect insider trading and similar abusive conduct and the regime imposes effective, proportionate and dissuasive sanctions for violators.
2. The corporate governance framework provides for continuous collection and analysis of trading data (e.g. by the stock exchange, the regulator) and timely reporting by insiders (including board members, senior officers and significant shareholders) of transactions (either direct or indirect) in listed companies' securities. There is effective enforcement of these requirements.
3. The corporate governance framework provides effective protection for investors against abusive self-dealing by insiders. There are effective transparency standards covering different types of self-dealing including significant private benefits not included in compensation.

### ***3.3.3 Principle III.C***

The principle states that 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. Whereas principle III.B is concerned with actions which can be regarded as abusive, principle III.C covers a more general situation that could be abused and therefore needs to be underpinned by strong standards of transparency. It should also be evaluated in conjunction with the effective exercise of duties by the board.

#### **Likely practices to be examined**

Members of the board and key executives should 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 judgment with respect to a particular transaction or matter affecting the company. Such an obligation is also implied by the duty of loyalty, covered in principle VI.A, so that there is a need to ensure that the judgements are consistent. Where a material interest has been declared, the annotation to the principle notes that it is good practice for that person not to be involved in any decision involving the transaction or matter.

Practices vary considerably both between jurisdictions and companies. There are cases where thresholds are set rather high for disclosure thereby

undermining the intention of the principle. In other documented cases, a majority vote by shareholders may decide to exclude a wide variety of transactions from disclosure, effectively undermining implementation of the principle. In many other documented cases, it is also normal for the board to use its delegated powers and not to exclude conflicted persons from being involved in the decision making process. The interaction of controlling shareholders with a permissive company law and financial regulatory system appears to be a common cause in the above mentioned cases. In some jurisdictions, the practice of having such issues decided by the majority of the minority appears to be effective and the reviewer might want to more closely examine the situation in a given jurisdiction.

Such practices and the intent of the principle suggest the following essential criteria:

1. Legislation and/or jurisprudence: (a) requires board members and key executives to disclose on a timely basis to the board that they, directly or indirectly, have a material interest in a contract or other matter affecting the company; and (b) to the extent that there are exemptions from (a), such exemptions are discretionary and granted only by the majority of the minority shareholders, a regulatory authority or a court drawing on statutory provisions and/or jurisprudence.
2. The board's duty of loyalty should clearly encompass the principle that the board is responsible for effectively monitoring and managing the activities of board members and key executives who have an interest in a contract, transaction or other matters affecting the company. There should be effective mechanisms for enforcement and redress.

## *Chapter IV*

### **The Role of Stakeholders in Corporate Governance**

#### **4.1 Introduction**

The chapeau principle states that “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”. The concept of stakeholder refers to resource providers to the corporation including employees, creditors and suppliers. Relations between these resource providers will in part be established by the legal system but the principle recognises that the relationship is often contractual. Hence the annotations note that 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 company.

#### **4.3 Issues and assessment criteria**

##### ***4.3.1 Principle IV.A***

Principle IV.A states that “*The rights of stakeholders that are established by law or through mutual agreements are to be respected*”. The rights of stakeholders are normally established by labour, business, commercial and insolvency laws as well as by contractual relations supported by these legal frameworks. The principle is also reflected more generally in principle VI.C which calls for the board to take into account the interests of stakeholders. The enforceability of stakeholder rights is dealt with by principle IV.B.

### Likely practices to be examined

The principle represents a particular challenge for a reviewer since jurisdictional practices vary widely and the language used in the laws is often ambiguous. For example, some jurisdictions define the objectives of companies and the accountability of the board to include stakeholders but this is left vague and the jurisprudence is often scarce. In others, the boards are held liable if, for example, labour law and creditor rights are not respected. The reviewer should be familiar with court rulings and regulatory decisions where appropriate.

Even in areas where stakeholder interests are not legislated, many firms make additional commitments to stakeholders out of concern over corporate reputation and also as part of a corporate strategy to promote a productive co-operative environment.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework provides: (a) for the enforcement of established legal rights for various stakeholders; (b) remedial mechanisms for those whose rights have been violated and which have proved to be broadly effective; and (c) an environment favourable to the respect of mutual agreements.

#### ***4.3.2 Principle IV.B***

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

### Likely practices to be examined

In a number of jurisdictions a common complaint from stakeholders (especially employees but sometimes also business partners and suppliers) is that while their legal rights might be well established, the laws are either not enforced or, because of procedural and other rules such as the difficulty to communicate with other stakeholders, are unenforceable and redress is unobtainable. In many cases, especially those concerning employees, enforcement and redress might be handled by special courts and institutions such as arbitration tribunals. In forming a judgement, the reviewer should examine the effectiveness of such institutions and their achievements. The case of creditors is handled separately in principle IV.F.

---

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework includes: (a) effective mechanisms for enforcing the legal rights of stakeholders; and (b) remedial mechanisms for those whose rights have been violated and which have proved to be broadly effective.

### ***4.3.3 Principle IV.C***

Principle IV.C states that “*Performance-enhancing mechanisms for employee participation should be permitted to develop*”. The intent of the principle is that the corporate governance framework facilitates or at least does not prevent the development of mechanisms to improve performance through employee participation and must be read in conjunction with principle IV.A, which states that the rights of stakeholders that are established by law or through mutual agreements are to be respected. The annotations note that examples of mechanisms for employee participation may include employee representation on boards and governance processes such as works councils, and that performance enhancing mechanisms include stock ownership plans and other profit sharing mechanisms. Pension commitments can also be an element of the relationship between the company and its past and present employees. The annotations note that “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”.

#### **Likely practices to be examined**

The degree to which employees participate in corporate governance depends on national laws and practices, and may vary from company to company as well. Examples of mechanisms for employee participation, which are mandated in some jurisdictions, include employee representation on boards and governance processes such as works councils that consider employee viewpoints in certain key decisions. When such arrangements are not mandated, there should be no legal barriers to their adoption if the principle is to be assessed as fully implemented. The rights associated with such mechanisms vary widely but the assessment of the principle need not take this into consideration unless the terms are so restrictive as to render the intent of the principle meaningless. Where only a particular mechanism is mandated, the reviewer will still need to examine whether the corporate governance framework permits other mechanisms for the principle to be assessed as fully implemented. Examples of performance enhancing

mechanisms, which are often the result of private arrangements and collective bargaining, include employee stock ownership plans or other profit sharing mechanisms. They are in practice often facilitated by favourable fiscal or other measures that should be noted by the reviewer in forming an assessment.

In some jurisdictions, pension funds have been established with both the company and the employees contributing. However, in many cases the company has retained control over the fund choosing to invest in the shares of the company itself and to assign the voting rights to a member of the company, usually the chairman or CEO. While these arrangements have been justified by the need to prevent commitments being made on behalf of the company without its permission, official reports in several jurisdictions have indicated that more balance in the oversight of the pension funds is needed. Where no provision is made for company pension funds due, for example, to exclusive reliance on a publicly funded system, the associated criterion should be assessed as not applicable.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework permits (e.g. does not prevent or inhibit) the development of different forms of employee participation, including financial participation.
2. Where the jurisdiction either requires or encourages company-based pension funds, the corporate governance framework requires or encourages the funds that are established by companies on a participatory basis with employees, to be overseen by trustees capable of exercising judgement independent of the company and charged with the task to manage the fund for the benefit of all beneficiaries.

#### ***4.3.4 Principle IV.D***

Principle IV.D states that “where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis”.

##### **Likely practices to be examined**

Where laws and practice of corporate governance systems provide for participation by stakeholders access to information is either mandated or is an accepted practice. In many jurisdictions, there are no such provisions so that the reviewer will need to note the principle as not applicable.

---

Such practices and the intent of the principle suggest the following essential criteria:

1. In those cases where stakeholders participate in the corporate governance process, the corporate governance framework requires or encourages the provision of sufficient and reliable information to facilitate their participation. Where access is required, there are effective mechanisms for enforcing such access and effective remedial mechanisms for those who are harmed by inadequate access.

#### ***4.3.5 Principle IV.E***

Principle IV.E states that “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”. Assessment of the principle should also be consistent with VI.D.6 where the annotations note that, “...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”.

#### **Likely practices to be examined**

Research indicates that the principle is not implemented in many jurisdictions including those with advanced legal systems. Individuals reporting unethical or illegal conduct often lose their jobs and find it difficult to find employment in other companies, which appear to wish to avoid “trouble makers”. Redress is therefore important if the principle is to be implemented. For the principle to be assessed as implemented it is not necessary that every complaint is directed immediately to the board but that it has established procedures under the supervision of someone independent on the board. In a number of companies the point of access is often a member of the ethics or audit committee.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to adopt a mechanism that: (a) permits individual employees and their representative bodies to communicate confidentially their concerns about illegal or unethical practices to the board or its representative ; and (b) protects those who use the mechanism in good faith from any

adverse responses that might be taken by the company. There is widespread adherence to this practice and there are remedial systems for those whose rights are affected.

#### ***4.3.6 Principle IV.F***

Principle IV.F states that “The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights”. Companies are typically dependent for their operations on credit from various institutions such as suppliers and banks, using different financial instruments that vary according to the rights conferred on the creditors. The terms and conditions for the supply of credit are important for the continued operations of the company.

##### **Likely practices to be examined**

The framework for corporate insolvency varies widely across countries although a reviewer can use as a benchmark the generally accepted international standards. However, the reviewer should be aware that knowledgeable observers judge that there is often a substantial gap between law and practice, both of which are taken into account by this Methodology. Market participants such as banks, investors and credit rating agencies should be consulted about practices and how they deal with difficulties. The principles do not take a position on the appropriate balance between debtors and creditors in insolvency proceedings. This varies by jurisdiction and over time, and in some cases board members might even owe a fiduciary duty to creditors as a company nears insolvency. The reviewer is not called upon to make such a fundamental decision about the balance but to ensure that the system is effective (i.e. actually functions in a manner acceptable to market participants), and is efficient in the sense of incorporating the conflicting interests of both sides. The reviewer is referred for assistance in forming a judgement to widely used indicators as a guide, such as the time required for insolvency proceedings to be settled, the residual value and the relative role of debtors and creditors as opposed to courts in the final settlement. Where residual value is comparatively low, the time taken for the proceedings regarded by investors as inordinately long, and creditors only play an insignificant role, the principle should be assessed as partly implemented.

Creditor rights vary, ranging from secured bond holders to unsecured creditors. Effective enforcement of creditor rights is often reported as a key problem both for secured and unsecured creditors. Foreclosure can often be time consuming and expensive with collateral yielding considerably less than expected and for unsecured creditors the situation can be worse.

Information on borrowing rates and risk premiums in a jurisdiction, collection costs and the time for collection might provide the reviewer with an informative indicator about the situation. The ease with which assets can be diverted from the debtor firm prior to foreclosure should also form part of the assessment.

Such practices and the intent of the principle suggest the following essential criteria:

1. The insolvency system: (a) clearly defines the rights of different classes of creditors and allows them a constructive role in restructuring decisions to be taken by the insolvent company; and (b) does not involve excessive delay because of time consuming court and other procedures which effectively reduce the recovery value for creditors. Creditor rights are clearly defined and are enforceable without undue cost and uncertainty to be borne by the creditor. Subject to the rules and regulations of the insolvency system, collateral is protected and can be reclaimed effectively or the creditor can be compensated if the collateral is already diverted from the debtor company.



## *Chapter V*

### **Disclosure and Transparency**

#### **5.1 Introduction**

The overarching principle for Chapter V states that “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”. The outcome advocated by the chapter is transparency which is central to (i) “shareholders ability to exercise their ownership rights on an informed basis”; (ii) market integrity; and (iii) the accountability of the company to its shareholders. The principles covered by the chapter specify the type of material information which should be disclosed, how and to whom this information should be communicated and the processes by which confidence in the quality of the information can be ensured. They reflect the responsibilities of the board which are covered in chapter VI.

Experience in countries with large and active equity markets shows that disclosure can 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.

Key to the operational nature of the chapter is the concept of materiality which is often incorporated into regulatory and legal systems; material

information can be defined as information whose omission or misstatement could influence the economic decisions taken by users of information. Disclosure requirements are not expected to place unreasonable administrative or cost burdens on enterprises unless the information is material. Nor are companies expected to disclose information that may endanger their competitive position unless disclosure is necessary to fully inform the investment decision by shareholders and to avoid misleading the investor.

### **5.3 Issues and assessment criteria**

#### ***5.3.1 Principle V.A***

Principle V.A states that “*Disclosure should include, but not be limited to, material information on...*” while the sub principles, which are important for an assessment of implementation, specify in more detail those elements that should be disclosed. The essential criteria refer to inadequate or misleading disclosure and call for remedial mechanisms. The latter might be difficult to implement since proof of loss by investors might be required. So long as there are at least effective and enforced disclosure standards, the principle should be regarded as implemented even if remedial mechanisms for investors are either absent or seldom used.

##### *5.3.1.1 Principle V.A.1: The financial and operating results of the company.*

The sub-principle refers particularly to 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). The assessment should be consistent with that for principle II.A, which specifies as a basic shareholder right, access to relevant and material information.

#### **Likely practices to be examined**

It has become increasingly common for periodic financial statements to be accompanied by a discussion/analysis by management and/or the board of operations and financial results. These are also increasingly future-oriented, encompassing principle V.A.6 that covers potential risks. A policy issue that should be noted by the reviewer for policy discussion, but that should not form part of the assessment, concerns whether the more future

oriented parts of the statements are covered by safe harbours with respect to board member liability, the intention being to encourage more disclosure.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires listed companies to provide audited financial statements to shareholders at least annually and these should include: (a) the balance sheet, profit and loss statement, cash flow statements and notes to financial statements clarifying the financial position of the company; (b) a statement of changes in ownership equity; and (c) consolidated accounts where the company controls other enterprises. There are effective mechanisms for enforcing such disclosure standards, effective remedial mechanisms for those who are harmed by inadequate or misleading disclosure, and there is widespread implementation of such disclosure standards.
2. The corporate governance framework requires listed companies to provide to shareholders at least annually a narrative discussion and analysis prepared by management and approved by the board of the company's financial condition and results of operation. Such disclosure should explain: (a) management's assessment of the factors that affected the company's financial condition and results of operation over the period covered by the financial statements; and (b) known trends that are reasonably likely to have a material effect on the company's financial condition and results of operations in the future. There are effective mechanisms for enforcing such disclosure standards, effective remedial mechanisms for those who are harmed by inadequate or misleading disclosure, and there is widespread implementation of such disclosure standards.

### *5.3.1.2 Principle V.A.2: Company objectives*

#### Likely practices to be examined

In a few jurisdictions, company law requires companies to state their objectives and not just in the most general form such as "pursuing commercial opportunities" which is the practice elsewhere. In others, the disclosure of specific commercial objectives is often regarded as essential to narrative reporting. Companies might also have a number of other objectives including environmental and philanthropic ones that may be important for investors to know. The sense of the Principle is that companies should also disclose commercial and non-commercial objectives. The importance of such objectives is likely to vary widely between companies.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires companies to disclose material information on their commercial and non-commercial objectives. There are effective mechanisms for enforcing such disclosure standards, effective remedial mechanisms for those who are harmed by inadequate disclosure, and there is widespread implementation of such disclosure standards.

#### *5.3.1.3 Principle V.A.3: Major share ownership and voting rights.*

The annotations note that 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.

#### Likely practices to be examined

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.

However, empirical work indicates that in a number of jurisdictions, a large number of firms fail to report ownership data and in particular share ownership by management and members of the board. Moreover, enforcement can be weak and regulations unclear. The legal recourse of minority investors can therefore also be frustrated: “grey” cases may require considerable resources to prove that a regulation has been violated.

Company groups are a feature of the corporate governance landscape in many jurisdictions despite usually not having any legal identity. In many cases a group will also include private companies, and cross shareholdings, which makes control of the listed company very opaque. Since group structures might be used to transfer resources to the detriment of minority shareholders, a number of jurisdictions are moving to require improved disclosure and thereby improve implementation of the principle.

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 some jurisdictions also termed ultimate owner). 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 reviewer will need to examine whether such arrangements have in fact been effective and to this end the OECD template *Options for Obtaining Beneficial Ownership and Control Information* can serve as a reference point. If the arrangements appear effective, criterion 2 can be assessed as fully implemented.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires disclosure about the recorded owner and holdings of persons who individually or collectively own a substantial (well below controlling) ownership interest in a company: (a) at least annually (e.g. annual report or shareholder meeting information circular); and (b) on a timely basis as soon as the ownership threshold requiring disclosure has been passed. The disclosure requirement is sufficiently broad enough to apply to complex ownership structures and arrangements, including those that may have been designed to conceal control. There are effective enforcement and remedial mechanisms, and there is widespread implementation of the requirements.
2. The regulatory system ensures that information about the beneficial owners should be obtainable at least by regulatory and enforcement agencies and/or through the judicial process and there is no evidence that such processes have proved ineffective.
3. The corporate governance framework requires or encourages companies to provide sufficient, timely disclosure about company group structures, significant cross shareholdings and intra-group relations to enable shareholders to understand the control mechanisms of the company. When disclosure is required, there are effective mechanisms for enforcing such standards and effective remedial mechanisms for those who are harmed by inadequate disclosure. Whether it is required or encouraged, disclosure is widespread.

*5.3.1.4 Principle V.A.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.*

Likely practices to be examined

Implementation of principle V.A.4 is likely to vary widely between companies and jurisdictions. With soft law such as codes and principles being particularly important in this area, the assessor will have to form a judgement about whether implementation of the sub-principle by companies is widespread and about the effectiveness of market forces in encouraging disclosure. Experience in some jurisdictions suggests that only the most rudimentary of information about board members might be known before the meeting of shareholders in which case this principle should be assessed as not implemented. The assessment of principle II.C.3 would also need to be examined for consistency.

A number of national principles, and in some cases laws, lay down specific duties for board members who can be regarded as independent. In many countries, it is incumbent on the board to set out the reasons why a member of the board can be considered to be independent, for example, in corporate governance statements (see also principle V.A.8). It is then up to the shareholders, and ultimately the market, to determine if those reasons are regarded as acceptable. This is the intent of the principle.

Disclosure about the selection process and especially whether it was open to a broad field of candidates appears to be much less developed in many jurisdictions. 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.

Of particular interest to shareholders is the link between board and executive remuneration and company performance. The annotations of the principle state that companies are 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. However, they do not specifically call for disclosure on an individual basis even though such disclosure (including termination and retirement provisions) is increasingly regarded as good practice and is now mandated in a number of 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. However,

disclosure on an individual basis is not necessary for the principle to be assessed as implemented. Where aggregate remuneration, defined to include all sources including future payments, is disclosed but not the remuneration policy, essential criterion 3 should be viewed as broadly implemented. However, the overall assessment would depend on how the other two essential criteria are assessed.

Even though it is not explicitly stated in the principle, the intent of the Principles (for example VI.D.6) clearly covers the need for disclosure of market trading in the company's shares and securities by board members and key executives, including their close family members and associates, but only where they have an economic interest in the transaction.

Such practices and the intent of the principle suggest the following essential criteria:

The corporate governance framework requires or encourages full and timely disclosure to shareholders (e.g. in annual reports, shareholder meeting circulars) about board members: (a) their qualifications and other board memberships; (b) the selection process; (c) whether they are regarded as independent and the criteria used by the company for the assessment; and (d) other material information. Where disclosure is required, there are effective mechanisms for enforcing such disclosure standards and effective remedial mechanisms for those who are harmed by inadequate or misleading disclosure. Whether required or encouraged, there is widespread implementation of the disclosure standards.

The corporate governance framework requires board members and key executives to publicly disclose: (a) on a timely basis any transactions in the company's securities by them, and their close family members or associates if they have an economic interest in the transactions ; and (b) on a periodic basis (e.g. in annual reports or shareholder meeting information circulars) the beneficial holdings of each board member and key executive (in each case taking into account beneficial ownership of the company's securities by the individual's close family members and associates only if they have an economic interest in those holdings). Where disclosure is required, there are effective mechanisms for enforcing such disclosure standards and effective remedial mechanisms for those who are harmed by inadequate or misleading disclosure. Whether required or encouraged, there is widespread implementation of the disclosure standard.

The corporate governance framework requires or encourages full and timely disclosure about the remuneration of board members and key executives including: (a) the link between remuneration and company performance; and (b) policy with respect to different forms of remuneration such as pension benefits and deferred remuneration. Where disclosure is

required, there are effective mechanisms for enforcing such disclosure standards and effective remedial mechanisms for those who are harmed by inadequate or misleading disclosure. Whether it is required or discouraged, there is widespread implementation of the requirement.

#### *5.3.1.5 Principle V.A.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.

#### Likely practices to be examined

In a number of jurisdictions, the disclosure of related party transactions is already a legal requirement and/or part of the accounting standards. 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. 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. Administrative penalties are often used to support the disclosure regime. This should not absolve the firm from maintaining its own monitoring, which is an important task for the board.

Jurisdictions and companies differ widely with respect to how and when related party transactions need to be approved and this will affect the disclosure standard. The essential criteria thus need to be broad enough to cope with these essential differences.

However, in many jurisdictions, the regulatory framework is incomplete and enforcement is difficult. Indeed, related party transactions are frequently reported as one of the most serious breaches of good corporate governance around the world, and the issue has figured prominently in all Regional Corporate Governance Roundtables and World Bank ROSCs. It appears that the definition of related party can be very loose and the criteria for being such a party easily avoided. The reviewer should investigate the definition and ensure that it is based on the concept of control (and not simply a

defined position such as chief accountant) and is not easily evaded. Where it is not, the principle may either be classified as not observed or only partly observed. The reviewer should also be aware that in some jurisdictions, transactions with affiliated companies might not be regarded as a related party transaction (and so not disclosed) if so decided by a majority of shareholders and made a part of the company charter. The reviewer will need to investigate such possibilities and whether they are widely used. Where widespread use is made of such loop-holes, the principle should be assessed as not implemented.

Given the nature of related party transactions, enforcement might often prove difficult. This is particularly the case if the burden of proof rests with minority shareholders and there are only restricted powers of discovery. “Bright line” rules in the regulatory framework might assist private enforcement.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires timely, comprehensive and public disclosure of related party transactions. In this context, timely and comprehensive disclosure means; (a) in respect of transactions that should be subject to shareholder approval requirements in the jurisdiction, disclosure provided in sufficient time to enable minority shareholders to make an informed decision; (b) in respect of proposed related party transactions that would likely have a material impact on the price or value of the company’s shares but do not require shareholder approval, in sufficient detail to enable minority shareholders to express concerns to management, authorities and the courts before the transaction is implemented; and (c) in respect of routine and/or less significant transactions, there should be at least annual disclosure (e.g. in financial statements or annual reports). There are timely and effective mechanisms for enforcing such disclosure standards, effective remedial mechanisms for those who are harmed by inadequate disclosure, and there is widespread implementation of such disclosure standards.
2. The definition of “related party” is sufficiently broad to capture the kinds of transactions in the jurisdiction that present a real risk of potential abuse, it is not easily avoided and is effectively enforced.

#### *5.3.1.6 Principle V.A.6: Foreseeable risk factors.*

The principle addresses the needs of market participants for 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.

#### Likely practices to be examined

It is becoming increasingly common to require companies to complement financial reports with non-financial or narrative reporting that takes a more forward looking perspective for discussing risks. What is regarded as a material risk, and any associated quantitative measures, will vary enormously from company to company, making hard and fast rules and regulations difficult to formulate and implement. This area is, therefore, often covered by codes and principles although some countries have legislation in place covering disclosure of certain risks. An assessment will also need to take account of principles VI.D.1 and VI.D.7 that call on the board to establish a risk policy and to implement appropriate management systems, respectively. It is normally expected that firms should disclose general information about internal controls in place to manage risks. In view of the early stage of development of such reporting and the fact that its importance will depend in great measure on the types of companies operating in a jurisdiction, the reviewer should make a broad interpretation of implementation.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to disclose reasonably foreseeable material risks and the procedures that have been established to manage such risks. Where disclosure is required, there are effective mechanisms for enforcing such disclosure standards and effective remedial mechanisms for those who are harmed by inadequate or misleading disclosure. Whether required or encouraged, there is widespread implementation of the disclosure standards.

#### *5.3.1.7 Principle V.A.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.

### Likely practices to be examined

Such reporting is still not widespread (although it is mandated in some jurisdictions) and given the lack of standards in this area is often handled by principles and codes. Disclosure may include management/employee relations, programmes for human resource development and training, and relations with other stakeholders such as creditors, suppliers, and local communities.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to publicly disclose information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company. Where disclosure is required there are effective mechanisms for enforcing such disclosure standards and effective remedial mechanisms for those who are harmed by inadequate disclosure. Whether required or encouraged, there is widespread implementation of the disclosure standard.

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

### Likely practices to be examined

In some jurisdictions a number of corporate governance practices are mandatory such as the structure and functioning of the board while in other systems little may actually be specified by company law and regulation, and arrangements are left to the discretion of the company and its shareholders. In both cases, many jurisdictions have now introduced supplementary codes or principles of corporate governance and almost all foresee some form of reporting about corporate governance practices. The codes and principles of corporate governance vary greatly and their status will need to be also considered by a reviewer. A number are now on a “comply or explain” basis but they vary as to whether this is also a regulatory requirement and also whether corporate governance reports are monitored by either the regulatory authority or left exclusively to market participants. A “comply or explain” requirement is not *per se* necessary for a positive assessment of the principle, although it should contribute to transparency about how the code or policy is implemented and therefore underpin implementation of the principle. Other codes are on a purely voluntary basis so that the principle should not be regarded as implemented by a reviewer unless reporting about

their implementation status is widespread. Empirical work indicates that the information content of governance reports often varies widely between companies, some doing the bare minimum while others are very informative. Some codes apply to companies listed in the jurisdiction while others apply only to companies registered in the jurisdiction. The principle therefore calls for disclosure about which code or set of principles is followed by a company.

It would be consistent with the principles to expect a corporate governance statement to include, *inter alia*, information about the ownership structure, the board structure, the qualifications of board members including who are regarded as independent, the procedures adopted by the board including the selection procedures for board members, and any code of corporate governance followed and how it has been implemented. Many of these elements might be included elsewhere in company reports. As they have been already addressed in other principles they are not repeated in the essential criteria for this principle. However, if the respective principles are assessed as not implemented, the assessment for this principle should be adjusted accordingly.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to publish, at least annually, a corporate governance report that, *inter alia*: (a) describes the structure and operation of the board; and (b) describes how the company has implemented corporate governance practices recommended in any corporate governance code that has been adopted by a relevant authority and applying to the company, or any code that the company has adopted. Where required, there are effective mechanisms for enforcing such disclosure, including reliance on market mechanisms, and effective remedial mechanisms for those who are harmed by inadequate or misleading disclosure. Whether required or encouraged, there is widespread implementation of the disclosure standard.

### **5.3.2 Principle V.B**

The principle states that information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.

Principle V.B underpins a great deal of principle V.A: high quality standards will often mandate disclosure about a number of the requirements specified above. The application of high quality standards is an important

---

public policy and 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.

#### Likely practices to be examined

The reviewer will need to examine whether domestic standards are in force and the circumstances under which high quality internationally accepted standards are used by listed companies (e.g. optional, only for consolidated accounts). High quality domestic standards can be achieved by making them consistent with one of the internationally recognised accounting standards. However, in practice, the World Bank notes that many countries remain far from high quality international standards while nevertheless asserting that domestic ones are “based on” or “compatible with” such standards. A key problem appears to be a lack of effective accounting and audit regulation but also a lack of effective institutions and high powered incentives on the part of the private sector to enforce standards. This is a judgement generally shared by researchers although some see a greater role for private litigation in improving standards as being a priority.

For the assessment of this principle it is neither necessary nor possible for the reviewer to make a detailed assessment of the quality of the national accounting and disclosure standards. Other international organisations are better placed to provide such an assessment and should be consulted. Nevertheless, a preliminary judgement is necessary and will need to be based on consultations with various market participants such as analysts, the accountancy profession and the regulatory authorities. In some cases, judgements about equivalence might already have been made by bodies in other jurisdictions. Emphasis also needs to be given to processes: how well functioning is institutional oversight of the various standards, including self-regulation, and how effective is enforcement. Domestic standards (if in use or running in parallel with international 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. If international standards are in use, they should faithfully reflect the original standard meaning that adequate resources will need to be devoted to translation, including public processes to ensure faithful translation. Jurisdictions will, nevertheless, often retain a body charged with bringing international standards into local law.

Important from the perspective of public policy and the preservation of market integrity, is the effective enforcement of the financial reporting standards, whether domestic or international. The experience in some

jurisdictions has been that public oversight of the implementation of reporting standards has been weak. In many jurisdictions, the first line of enforcement is the accounting and audit profession (gatekeepers), an arrangement which has not always worked according to expectation. It is important to ensure that a body, which could be the listing authority, the stock exchange, and/or the financial markets supervisor, has both the mission and resources to enforce the adoption of financial reporting standards. An additional means of enforcement, which needs to be considered by the reviewer, is the potential for investors to take action against the company should reports not meet the accepted standards in the jurisdiction.

With respect to non-financial disclosure, standards are often developed by the respective securities market regulator that by definition can be regarded as acting in the public interest. However, for criterion 2 to be viewed as fully implemented, the reviewer should be satisfied that the standard setting body has the powers and the funding to carry out its duties.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework provides for an organisation(s) (either domestic and/or international) that is responsible for the development and interpretation of accounting standards. The standard setting and interpretation processes should be transparent and the standard-setting activities should provide for effective consultation with the public. Where this organisation is domestic, its standard setting and interpretations processes should be subject to the oversight of a body that acts in the public interest, that has an appropriate charter of responsibilities and powers, and that has adequate funding to carry out its oversight responsibilities. The accounting and disclosure standards are regarded by a wide body of market participants and experts as high quality and consistent with internationally accepted standards.
2. The corporate governance framework provides for the development of non-financial statement disclosure standards by an organisation that either acts in the public interest (such as a securities regulator), or whose standard setting and interpretation processes are, subject to the oversight of a body that acts in the public interest, has an appropriate charter of responsibilities and powers, and has adequate funding to carry out its oversight responsibilities. The organisation's standard setting and interpretation processes should be transparent and its standard-setting activities should provide for effective consultation with the public.
3. There are effective mechanisms for enforcing disclosure and accounting standards, effective remedial mechanisms for those who are harmed by

---

inadequate or misleading disclosure, and there is widespread implementation of such disclosure standards.

### 5.3.3 Principle V.C

The principle states that 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. Apart from the need for external auditors to be independent, competent and qualified, the annotations go on to note that to certify 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.

The annotations note the importance for implementation of the principle of IOSCO's *Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence* which 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".

#### Likely practices to be examined

In forming an assessment of the principle, the assessor will need to examine institutions and processes that should ensure implementation of the principle, rather than examining the principle itself, such as whether external auditors are competent and independent. The reviewer will need to examine how audit standards are developed including the influence of any high quality internationally accepted standards. Important sources of information and judgements for the assessor are provided by the accounting and audit ROSCs of the World Bank and by reports of other international organisations (e.g. IOSCO).

Many countries have introduced measures to improve the independence of auditors and to tighten their accountability to shareholders. To deal with, *inter alia*, self-review, a number of countries are tightening audit oversight, along the lines of the *Principles of Auditor Oversight* issued by IOSCO in 2002, through an independent entity. The Principles recognise that other methods might also achieve the same result (i.e. functional equivalence is an issue) and indeed IOSCO has reported widely varying practices. Whether

they are functionally equivalent is a matter for the judgement of the reviewer after examining how procedures and institutions are working in practice.

There is concern in a number of jurisdictions to better control potential conflicts of interest on the part of the external auditor. 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. This will require a clear definition of such services in the jurisdiction. The intent of the principle is that disclosure should be required for the principle to be judged as implemented.

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 the audit team, 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. The reviewer will need to be aware of these practices and to what extent they seem well adjusted to local conditions. The question of whether they are regarded as an efficient response to the perceived weakness should also be explored by the reviewer.

An issue that has arisen in some jurisdictions concerns the pressing need to ensure the competence of the audit profession and the quality of audits. 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. With respect to quality assurance programmes, many jurisdictions have relied on self-regulation by the profession itself. However, in an increasing number of cases, public interest bodies have been established to oversee the task or to perform quality reviews itself. Whatever institutional choice is made, it is important for the reviewer to be satisfied that the body has the appropriate authority (including enforcement powers) and resources to undertake a credible quality assurance programme.

Board room procedures to ensure auditor competence and independence are taken up in principle VI.E.1. A final assessment about the implementation of principle V.C should take the assessment of board room practices into account. The essential criteria and the associated annotation to the principle note that such responsibilities are assigned to various bodies

including an audit committee of the board, an “audit board” which is separate from the board and sometimes includes representatives of minority shareholders, and in other cases by “statutory auditors” who are also non-voting members of the board. The reviewer will need to be familiar with the way each system actually functions and whether they are able to fulfil the requirements of the principle and the essential criteria.

Such practices, the intent of the principle and the relevant IOSCO standard suggests the following essential criteria:

1. The corporate governance framework requires: (a) companies to have their annual financial statements audited by an external auditor in accordance with a comprehensive body of auditing standards that are consistent with, or faithfully reflect, high quality internationally accepted standards; (b) requires the external auditor to be independent of management, board members and controlling shareholders; and (c) requires or encourages the process of selecting the external auditor to be overseen by a body such as the shareholders or a group of independent board members (e.g. an audit committee or equivalent), that is independent of management.
2. The corporate governance framework requires auditors of listed companies to be licensed and the framework for licensing of such auditors: (a) requires auditors to meet specified qualification and competency criteria before being licensed and to maintain specified standards of professional competency; and (b) provides for withdrawal of authorisation to audit listed companies if specified qualifications and competency criteria are not maintained or there is non-compliance with ethical standards or audit control standards.
3. The corporate governance framework provides for an organisation to enforce audit standards (i.e. a quality assurance programme) that is: (a) independent of (or subject to the oversight of a body that is independent of) the audit profession; (b) has an appropriate membership, an adequate charter of responsibilities and powers, and adequate funding; and (c) employs processes for its public interest activities that are transparent and provide for public consultation with respect to the development of its procedures and principal operational policies.
4. The corporate governance framework provides for an organisation, domestic or international, that is responsible for developing and interpreting audit standards, as well as standards for the ethical behaviour of auditors. . Where the institution is domestic, it should: (a) be independent of (or subject to the oversight of a body that is independent of) the audit profession; (b) have an appropriate membership, an adequate charter of responsibilities and powers and

adequate funding; and (c) employ processes for its public interest activities that are transparent and provide for public consultation with respect to the development of its standards.

5. The corporate governance framework requires or encourages the board, audit committee or equivalent body to report to shareholders on: (a) the actions it has taken and the bases upon which it has concluded that the auditor was independent and qualified; (b) the actions it has taken and the bases on which it has concluded that the external auditor has acted with due professional care; and (c) the value of any non-audit work undertaken for the company by the external auditor. Where the standard is required, there are effective mechanisms for enforcement and there are effective remedial mechanisms for those who are harmed by inadequate adherence to the requirements. Whether it is required or encouraged, there is widespread implementation of the standard.

#### ***5.3.4 Principle V.D***

The principle states that the 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 key outcome advocated by this principle is that the external auditor understands that they are not responsible to the management (with whom they often have day-to-day collegial contact) but to the company (in the form of the board) and to the shareholders. This is independent from whether the requirements of an external audit are specified in either company or securities laws.

#### **Likely practices to be examined**

In a number of jurisdictions, external auditors are appointed by the shareholders' meeting directly (sometimes on advice by the board) and this practice has the advantage that the accountability to shareholders is clear. In the many other cases where the auditor is appointed by the board, the situation can be opaque. In these circumstances, the annotations to the principle notes that good practice is to require an independent audit committee of the board or an equivalent body to recommend an external auditor. 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.

A key issue concerns liability of external auditors for professional care in the conduct of the audit. There are many national approaches, depending in part on the size of the market for auditors and what is actually expected of

the audit so that it is not possible at this stage to make broad generalisations that can be incorporated in the essential criteria for assessing the implementation of the principle.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework clearly provides that external auditors are accountable to the company's shareholders in respect to the performance of their audit functions.
2. The corporate governance framework provides for proportionate, effective and dissuasive sanctions, penalties and/or liabilities for external auditors who fail to perform their audit functions to the company with due professional care.

### ***5.3.5 Principle V.E***

The principle states that channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

#### **Likely practices to be examined**

The assessment of principle V.E should also be consistent with that for principle II.A.5 which defines as a basic shareholder right the receipt of relevant and material information on a timely and regular basis. Of equal if not more importance, the principle specifies equal access to material information. It thereby addresses one of the major channels for insider trading and the abuse of minority shareholders: selective access to market sensitive information by some shareholders or parties. Conclusions with respect to principle III.B, "*insider trading and abusive self-dealing should be prohibited*" are therefore relevant for forming a judgement as to the implementation of this principle.

With respect to equality, many countries have quite specific regulations concerning how and under what conditions market sensitive information can be passed to shareholders and investors. This is crucial for market integrity and for the equal treatment of shareholders. Exceptions with respect to the prohibition on selective disclosure are often made for an issuer's communications with the press, rating agencies, and in the ordinary course of business communications with customers and suppliers. Without such exceptions, the regulatory system could prove unenforceable and inefficient. Enforcement can, however, be a problem with regulatory institutions sometimes lacking either the means of discovery or the incentive to allocate

scarce resources to this aspect of regulatory enforcement. Private enforcement action might also be difficult given the need often to establish proof.

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. However, at this stage the use of such systems is not essential for assessing whether the principle is implemented.

With respect to timeliness, a number of countries have introduced provisions for ongoing disclosure (often prescribed by law or by listing rules) that include periodic disclosure and continuous or current disclosure which must be provided on an *ad hoc* basis. With respect to continuous/current disclosure, widely accepted standards 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. In some cases, the reviewer might find that the materiality test is applied in an arbitrary manner that leads to excessive regulatory intervention. The *IOSCO Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities* set forth common principles of ongoing disclosure and material developments reporting for listed companies.

Such practices, the intent of the principle and the relevant IOSCO standard suggests the following essential criteria:

1. The corporate governance framework prevents selective disclosure by companies, board members, and other insiders of material non-public information except for clearly defined exceptions. There are effective enforcement and remedial mechanisms, and there is widespread compliance with the standard.
2. The corporate governance framework requires listed companies to comply with an ongoing disclosure obligation to make timely disclosure on a non-selective basis of all information that would be material to an investor’s investment decision. There are effective mechanisms for enforcing such disclosure standards, effective remedial mechanisms for those harmed by inadequate or misleading disclosure, and there is widespread implementation of such disclosure standards.

3. The corporate governance framework requires or encourages companies to make all information identified by the Principles easily accessible by investors and potential investors at no more than a minimal cost.

### ***5.3.5 Principle V.F***

The principle states that 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. The principle recognises the key role 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 of interest and with integrity, can play an important role in providing incentives for company boards to follow good corporate governance practices and underpin capital market integrity.

#### **Likely practices to be examined**

Concerns have arisen in a number of jurisdictions in response to evidence that conflicts of interest often arise for those providing analysis or advice and this may affect their judgement. This could be the case when the provider of a service 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 has chosen to manage them. Particularly important will be disclosure about how the entity is structuring the incentives of its employees in order to eliminate or minimise any potential conflict of interest. Such disclosure allows investors to judge the risks involved and the likely bias in the advice and information: a market based control. A number of jurisdictions have adopted such disclosure procedures while some ban particular types of remuneration schemes such as commissions related to other aspects of an entity's operations and not tied directly to the advice or rating of an employee. Mechanisms for controlling conflicts of interest may take the form of government regulation, regulations imposed by an independent, non-governmental statutory regulator, binding rules imposed by a self-regulating organisation and/or by industry codes of conduct that contribute to increased

market pressures. Whatever the balance, a reviewer must be satisfied that enforcement and/or market pressures are effective in eliminating, managing and disclosing conflicts of interest.

IOSCO has developed a statement of principles covering rating agencies (*IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies*) and these have now been supplemented by the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies*. Among the elements important for the assessment of principle V.F is the provision that credit rating agencies (CRA) should disclose to the public their code of conduct and describe how the provisions of the code fully implement the provisions of the IOSCO standards (*IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies* and *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies*). Reporting lines for employees of credit rating agencies and their compensation arrangements should be structured to eliminate or effectively manage actual and potential conflicts of interest. The internal company codes should also state that a rating analyst will not be compensated or evaluated on the basis of the amount of revenue that the agency derives from issuers that the analyst rates or with which the analyst regularly interacts. Where the company code of conduct deviates from the IOSCO provisions, the agency should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions.

As the IOSCO standard and principle V.F share a common objective, the reviewer can draw on any work related to the implementation status of the former standards in a jurisdiction. A key element of the assessment will be to examine whether rating agencies have published their codes of conduct and disclosed whether their codes comply with the IOSCO provisions, thereby relying entirely on market mechanisms for enforcement. The four major CRA's are globally active and it makes sense for their home jurisdiction to take the lead in supervision and for the reviewer to focus on locally based firms. An appropriate way to form a judgement about whether the principle is being implemented is to determine if market participants, particularly shareholders and bond holders, have encountered any problems with respect to conflicts of interest that have resulted in inappropriate ratings or if they are unhappy with the level of disclosure being provided by CRA's in the jurisdiction being reviewed. The presence of one bad CRA in a jurisdiction in a context of alternatives should not necessarily result in a not implemented judgement.

The actual and potential conflicts of interest faced by securities analysts (i.e. sell-side securities analysts) differ by jurisdiction and from firm to firm so that companies, regulators and self-regulating organisations may decide that some conflicts of interest are better managed through limitations or

prohibitions, while others are better addressed through disclosure. The *IOSCO Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest* should form the basis of an assessment since they are adapted to a wide range of situations and have been accepted by the IOSCO membership. The reviewer is not interested in all aspects of the IOSCO standard but only in those areas concerned with conflict of interest and should consult with IOSCO and the jurisdiction's member of IOSCO to see whether an assessment of compliance has been undertaken. The reviewer's assessment should accordingly reflect this work.

Such practices, the intent of the principle and the relevant IOSCO standard suggests the following essential criteria:

1. The corporate governance framework is complemented by an effective approach, either market based or regulatory, addressing the conflicts of interest of credit rating agencies highlighted in the IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies, and credit rating agencies generally incorporate the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies into their codes of conduct.
2. The IOSCO Statement of Principles for Addressing Sell-side Securities Analyst Conflicts of Interest have been fully implemented in the jurisdiction. The methods chosen for implementation and enforcement adequately reflect the market structure in which analysts operate, the regulatory and enforcement system and the likely conflicts of interest and other sources of distortion which the analysts might face.
3. The corporate governance framework requires or encourages those in the business of providing analysis or advice that is relevant to decisions by investors to disclose conflicts of interest and how they are managed. The methods chosen for implementation and enforcement should adequately reflect the market structure in which they operate, the regulatory and enforcement system and the likely conflicts of interest and other sources of distortion that they might face.



## *Chapter VI*

### **The Responsibilities of the Board**

#### **6.1 Introduction**

The overarching principle for chapter VI states that “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”. The outcome advocated is that companies are professionally managed but subject to effective oversight by the board so as to prevent self-dealing and to ensure that the interests of shareholders are taken into account by the management. In other words, the board’s role is to contain the agency problem associated with professionally managed, public companies.

The principle is sufficiently general to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management. In a two tier board system this is typically the “supervisory board” composed of non-executive board members while in unitary systems there are also typically executives on the board. In either case, the principle recognises that the board is chiefly responsible for monitoring managerial performance and achieving an adequate rate of return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. However, in doing this they are expected to take due regard of, and deal fairly with, other stakeholder interests.

This chapter represents a particularly difficult challenge for a reviewer to form a judgement about implementation of the principles. Even where jurisdictions explicitly articulate the responsibilities of the board and those for which management is accountable, the law and associated regulation is by the very nature of the subject incomplete, and in many respects the board is left to establish its own modalities. In other jurisdictions, company law

and other regulations are even more general, leaving essential details to be established by the company itself. As a result, the actual structure and operation of boards in any given jurisdiction is likely to vary widely between companies and in some cases, the board might hardly function at all despite a clear legal framework. The reviewer is therefore in the difficult situation of having to judge what is the predominant mode of behaviour in determining the implementation status of the principle.

An important guide to actual board behaviour, and thereby the implementation status of the principles in this chapter, is provided by the judgements formed about principles in other chapters, particularly those in chapters II and III, dealing with shareholder rights, and chapter V, dealing with transparency and disclosure. Judgements formed about the quality of shareholders rights, the actual powers of shareholder meetings, and about the various elements of disclosure and transparency will be an important input into understanding actual board behaviour and about the implementation status of this chapter of the principles. That being said, favourable assessments about shareholder rights and transparency should be seen by the reviewer more in the way of a necessary though not sufficient condition for implementation of the principles in this chapter by boards.

## **6.3 Issues and Assessment Criteria**

### ***6.3.1 Principle VI.A***

Principle VI.A states that “Board members should act on a fully informed basis, in good faith, with due diligence and care and in the best interests of the company and its shareholders”. The outcome sought by the principle is a board which is informed and objective in its oversight of professional management. It is arguably the most important individual principle of the Principles. Indeed, if it were fully implemented and enforced in a jurisdiction there would be little need for other individual principles. In many ways, a number of the other principles are intended to ensure that the principle is implemented as effectively as possible.

The principle states the two key elements of the duty of board members: the duty of care and the duty of loyalty. With respect to the former, 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. Information and compliance systems are explicitly stated as a board responsibility in principle VI.D.7.

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 and managing 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 should be to the company and all its shareholders and not to the controlling company of the group. The duty of loyalty is taken up more explicitly by principle VI.D.6.

#### Likely practices to be examined

The implementation status of principle VI.A is by itself unobservable by those outside the boardroom so that the reviewer will need to monitor the 'inputs'. The first input to check concerns whether the jurisdiction is in fact characterised by laws, regulation, jurisprudence and practices defining the duty of care and duty of loyalty as key aspects of the duties of a board member. This may not be true in many jurisdictions even though there might be a tradition of using case law from another jurisdiction. It should, however, be noted that the laws and practice in a jurisdiction may well be less demanding in defining duties than the Principles which are more 'aspirational' in character. In these cases, the reviewer should be inclined to a judgement of either 'broadly implemented' or 'partly implemented' if the duties are particularly vague or untested.

Observed behaviour is also important to take into consideration. The duty of loyalty is fundamental to implementation of chapter III, and especially principles III.A.2, III.B and III.C. If the reviewer has doubts about the full implementation of these principles, the assessment of principle VI.A might need to be accordingly adjusted. However, the reviewer also needs to consider other implementation and enforcement issues concerning the principle.

Three issues are apparent from studies about implementation of the duty of loyalty that an assessment will need to address. First, enforcement via

either class actions or derivative suits is often difficult, and in some cases depends on a prior investigation by some regulatory body. Moreover, procedural rules can be often very restrictive as, for example, with respect to proving related party transactions (the discovery issue and access to information). Indeed, in many cases the reviewer might find no history of enforcement actions making a judgement difficult. However, the widespread use of board member liability insurance can be taken by the reviewer as an indication that there is at least some threat of enforcement action so that the principle might be at least partly implemented. Many of these issues are related to principle III.A.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*) so that there should be some consistency between the two assessments.

Second, even where cases can be brought, there is the question of the appropriate level of sanctions. High nominal liability with a low real probability of conviction might be optimal from a theoretical perspective but may also be the result of chance rather than purposeful design. Existing studies of countries around the world as to the actual stance of board member liability could assist in forming an assessment. Enforcement in the sense of reputation damage might also be important. However, in some countries with concentrated ownership, it appears that reputation may be less important. Reputation is likely to matter more where there is a broader shareholder input to elections for the board and also a deeper pool of companies offering employment opportunities.

Third, company groups often lead to some significant weakening of the duty of loyalty for board members to their specific company if they are also obliged to follow group strategies. Unless there are compensating mechanisms, the principle should be assessed as either not implemented or as only partly implemented. The existence of controlling owners further serves to confuse to whom the duty is due. This issue has also been taken up by the essential criteria for principle III.A.2 so that some consistency in the assessments is necessary.

Experience around the world has been that the duty of care is exceedingly difficult to enforce, especially when there is some business judgement rule in place. This situation makes it all the more important for shareholders to be able to monitor board member characteristics, and be able to take effective action as advocated by several principles. Where the judgement of the reviewer is that these principles (V.A.1 and II.C.3) are not, or are only partly, implemented, there is a *prima facie* case that principle VI.A might not be implemented.

Other approaches to ensuring the implementation of principle VI.A, which an assessment would need to consider, include any requirement for independent board members and the role of shareholders in actually electing board members. The former is taken up in VI.E. A great deal will depend on how board member independence is actually implemented. There are numerous cases of definitions being subverted as where board members come from related companies since the law only specified they could not come from subsidiaries. Where principle VI.E is assessed as less than fully implemented, the assessment of principle VI.A should not receive a more favourable rating.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework defines the duties of board members so that there is a well defined concept of the duty of loyalty owed by the company's board members and officers to the company and shareholders generally. There should be effective enforcement (by authorities or through widely accessible private action, either individually or collectively) and remedial systems. Where the board's duty of loyalty is loosely defined and can extend to other companies in a group, there are clear and effective safeguards to protect the interests of the first company and its shareholders.
2. The corporate governance framework defines the duties of board members so that there is a well defined concept of the duty of care owed by the company's board members to the company and all its shareholders. Such a duty should recognise the need for the board to be able to exercise its business judgement without the risk of having each and any of its decisions second-guessed with the benefit of hindsight by authorities, shareholders or courts, while providing sufficient guidance on the kinds of processes that boards should employ to ensure that they can make an informed decision. There is effective enforcement (by authorities or through widely accessible private action, either individually or collectively) and remedial systems.

### **6.3.2 Principle VI.B**

Principle VI.B states that “*Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly*”. The principle is a complement to chapter III, but extends the coverage of principle III.A (*All shareholders of the same series of a class should be treated equally*). The outcome advocated by the principle is that regardless of who has elected board members (e.g. controlling shareholders),

when they assume their responsibilities they carry out their duties in an even-handed manner with respect to all shareholders. It is thus also complementary to VI.A, underpinning the duty of loyalty and care, and underpins principle III.A.2 covering minority shareholders.

#### Likely practices to be examined

The situation in practice can be one where individual board members feel that they are representatives for particular constituencies. A special case concerns controlling shareholders who can normally select all board members. Although this power is legitimate, the principle requires that upon appointment, the board members accept their duty of loyalty to all shareholders. The assessment status of principle III.A.2 should have a large bearing on the assessment of VI.B.

With respect to enforcement, there may not be a well established history of judgements for the reviewer to form a judgement about whether it is effective. The widespread use of board member liability insurance may be a useful indicator in such circumstances that the threat of action is considered to be a real possibility. Where the duty is clearly specified in the law or by standards but there is not a great history of enforcement although the threat is credible, the principle could be judged as broadly implemented. Where the duty is not clearly specified but there is some threat of action, it should be classed as partly implemented with a further note as to the nature of the weakness, etc.

Such practices and the intent of the principle suggest the following essential criteria:

1. Board members are required or encouraged to take into account the possibility that board decisions may affect different shareholder groups differently and to refrain from acting in a way that is oppressive or unfairly prejudicial to any group of shareholders. There should be effective enforcement (by authorities or through widely accessible private action, either individually or collectively) and remedial systems.

#### **6.3.3 Principle VI.C**

Principle VI.C states that: “*The board should apply high ethical standards. It should take into account the interests of stakeholders*”. The principle makes it clear that the board is responsible for establishing the “tone at the top”, not only by its own actions, but also in appointing and overseeing key executives and consequently management in general. An

overall framework for ethical conduct goes beyond compliance with the law, which should always be a fundamental requirement.

The implementation status of the principle is not observable by those outside the board room so that an evaluation will need to be based on institutions and processes. The reviewer will also have to take account of conclusions reached in the review of chapter IV of the Principles.

#### Likely practices to be examined

To make their ethical standards clear and operational, many companies have found it useful to develop company-wide codes of conduct, setting the framework for the exercise of judgement in dealing with varying and often conflicting constituencies. A general description of the code in place should normally be made available by the company, either independently or as part of its corporate governance statement. However, the existence of such codes is neither a necessary nor sufficient condition for implementing the principle.

In some jurisdictions, case law and company law requires the board to take into account the interests of stakeholders and specifies generally what this might mean in practice. For example, in some jurisdictions the board can, and in fact does, reject a takeover offer citing the broader interest of stakeholders, although sometimes this can be used as an excuse to entrench management. In others it appears that the interest of the company in maintaining its independence has to be considered. In some jurisdictions, codes and principles are used to set aspirational standards in this area and often closely follow the wording of this principle. However, it should also be noted that minimum standards for the treatment of stakeholders are also often mandated such as through laws governing protection of creditors (see principle IV.F) and regulations concerning mass and individual dismissals and changes to labour contracts. Principle V.A.7 calls for information covering issues regarding stakeholders to be disclosed and in practice a judgement about principle VI.C should rely on the judgement formed about disclosure. Given the inherent uncertainty with this aspirational principle, it is best for the reviewer to form a very broadly-based judgement.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to develop under the board's supervision a code of ethical behaviour covering, inter alia, compliance with the law and professional standards, and setting clear limits on the pursuit of private interests by employees. The board reports regularly on compliance with the code by board

members and employees, and the implementation actions taken by the company. Where disclosure is required, there is effective enforcement of the standard. Whether required or encouraged, there is widespread disclosure.

2. The corporate governance framework requires or encourages boards to take into account the interests of stakeholders and publicly disclose how it is doing so in relation to significant matters. Where the standard is mandatory, the requirements are backed by effective enforcement mechanisms and adequate remedies. Whether required or encouraged, there is widespread disclosure about how stakeholder issues are being handled.

### ***6.3.4 Principle VI.D***

Principle VI.D gives content to the aspirational nature of principle VI.A by specifying the key functions to be fulfilled by the board. These duties are also reflected in chapter V on disclosure and transparency. Where companies are not judged to be fulfilling the disclosure requirements of the principles, there are strong grounds for a reviewer to judge the sub-principles of principle VI.D, and therefore the principle itself, as also not being fully implemented.

*6.3.4.1 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.*

The sub-principle specifies the key elements which are required for the fulfilment of principle VI.A and underlines that the purpose of the board is not to run the company on a day-to-day basis but to oversee management.

#### **Likely practices to be addressed**

The explicit duties of a board may be specified in company law, or be reflected in unwritten standards developed through jurisprudence or similar means. They might also be reflected in corporate governance codes. The latter is especially true of the responsibility for risk policy which is closely related to corporate strategy.

The reality appears, however, to be that boards have often not played a central and strategic role in number of jurisdictions and companies. As in

other principles, the essential criteria call for “widespread implementation of the principle”. This is particularly difficult for the reviewer to judge. In forming a judgement, a reviewer should examine recent cases of corporate scandal and collapse which have in many cases led to revelations that the board has, for example, not in fact conducted due diligence about significant expenditures and acquisitions and/or has only had the most general notion of the desired risk profile for the company. Such indicators would need to be supported by more general observations from the business community about what might be normal practice in a jurisdiction and what is widely regarded as good practice. One such check might be to examine the nature of disclosure to investors about board processes leading to major acquisitions, capital expenditures and divestitures. Where absent or perfunctory, it might indicate that the principle is not in practice implemented. The reviewer is therefore called upon to make an assessment based on discussions with, *inter alia*, board members, regulators, investors and other professional bodies about actual board practices.

Consideration of enforcement is also difficult with this principle. In some jurisdictions there may be recourse against the board if it fails to fulfil these duties (duty of care) but as noted above under principle VI.A in practice such dereliction of duties might be hard to prove. More important might be the ability to remove boards that are not performing but in reality this will depend both on effective shareholder rights and on the concentration of ownership. The reviewer should base a judgement here on the level of actual threat of enforcement even though there might be little sign of active enforcement in the past.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework specifies clearly the key functions of the board to include the specific requirements of the principle. There are indications that, on the whole, boards play a central and strategic role in the jurisdiction.

#### *6.3.4.2 Principle VI.D.2: Monitoring the effectiveness of the company’s governance practices and making changes as needed.*

The sub-principle is a reflection of V.A.8 which requires disclosure of “governance structures and policies, in particular the content of any corporate governance code or policy and the process by which it is implemented”. The sub-principle reflects the duty of care described in principle VI.A: board members should act on a fully informed basis, meaning that they should be satisfied that key corporate information and

compliance systems, including governance practices, are fundamentally sound and underpin the key monitoring role of the board advocated by the Principles. Monitoring of governance by the board includes regularly reviewing the internal structure of the company to ensure that there are clear lines of accountability for management throughout the organisation.

#### Likely practices to be examined

Some jurisdictions mandate such monitoring and some go so far as to recommend or mandate self-assessment by boards of their performance as well as performance reviews of individual board members and an assessment of senior executive officers. Some codes also call on boards to identify areas for improvement and this is also often advocated by investor groups.

As noted under V.A.8, many companies now report corporate governance practices, but the reviewer is in this case forced to go behind the disclosure standard to assess the boardroom process. Given the aspirational nature of this principle as well as the well known tendency for self-assessments to err on the positive side, the reviewer is forced to make a judgement based on all the information available about board practices, and not just rely on self-assessments.

The judgement by the reviewer should in the first instance be based on the assessment of V.A.8, the disclosure of governance structures and policies, and whether such reporting is widespread and considered by investors as meaningful. In jurisdictions where a corporate governance code is either recommended or is mandatory, the reviewer can use as an input any jurisdiction-wide reports summarising the implementation statements of companies, including the incidence of compliance. Where corporate governance practices are mandated, there should be an effective enforcement mechanism.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework should require or encourage the board to take responsibility for corporate governance practices by: (a) overseeing compliance with mandatory corporate governance practices including any code mandated by a relevant authority; (b) implement and oversee any (but not mandatory) corporate governance practices recommended in any corporate governance code adopted by a relevant authority and applying to the company, or any code that the company has adopted; (c) if the company has not implemented certain recommended corporate governance practices specified in such a code,

the board should explain why it has not adopted such recommended practices; and (d) monitor the structure and operation of the board and other corporate governance practices. Where the corporate governance practices are required, there are effective mechanisms for enforcing such a standard. Whether the practices are required or encouraged, there is widespread reporting about implementation of such a governance standard.

2. The corporate governance framework encourages boards to assess, at least annually, the performance of the board as a group and its standing committees, as well as the performance of each board member and the senior executive officers, and to identify areas for improvement together with a plan for such an improvement. Such assessments should play a role in determining remuneration policy. The standard is widely implemented.

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

Likely practices to be addressed

In a number of jurisdictions and companies, the tradition has been for the CEO/Chairman to take the lead in appointing his successor, a practice not compatible with implementation of the sub-principle. The principle is oriented to preventing such entrenchment but is not intended to extend to the case of companies with controlling shareholders who might have a major role in appointing key executives.

In forming an assessment, the reviewer might want to make use of data from corporate governance rating agencies and from executive placement agencies so as to determine the customary practices in the jurisdiction with respect to the selection and dismissal of CEOs and other key executives. In two tier systems, the supervisory board is usually responsible for appointing the management board, which will normally comprise most of the key executives. However, even here there are cases where the reverse is often true. Where the supervisory board does not appoint the management board, the principle should be assessed as not implemented.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages the board to take responsibility for selecting, compensating, monitoring and, when

necessary, replacing key executives and overseeing succession planning. There are effective mechanisms enabling shareholders to hold the board to account for inadequate performance of this responsibility, such as meaningful opportunities to address shareholder concerns at the shareholders meeting, put items on the meeting agenda, vote against board members, and/or an effective market in corporate control. Whether required or encouraged, there is widespread adherence to the standard.

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

The annotations to the principle make clear that the concern is with process rather than with a specific outcome: with remuneration policy as well as setting the level and conditions of compensation.

Likely practices to be examined

Along the lines of principle V.A.4, in an increasing number of jurisdictions 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 should specify the relationship between remuneration and performance, and include measurable standards (some of these might involve short term objectives) that emphasise the longer run interests of the company. Where remuneration is not sufficiently closely tied to the long run considerations of the company, the principle should not be judged as fully implemented.

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. Principle II.C.3 states that “*the equity component of compensation schemes for board members and employees should be subject to shareholder approval*”. Remuneration policy may also cover 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. Information about the arrangements should be an important component of corporate governance disclosure. The essential criteria refer to the use of non-executive board members capable of exercising independent judgement. While not part of this principle, it is a recommendation set out in principle VI.E.1, at least for board members.

In terms of enforcement, this is an area usually best left to shareholders (and thus the importance of principle II.C.3) although in some jurisdictions there might also be a breach of the duty of care or loyalty to the company and other stakeholders if the processes are not followed.

In forming a judgement about the implementation of the principle, a reviewer might want to make use of information and examples provided by remuneration consultants and corporate governance rating agencies.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages boards to:  
(a) develop and publicly disclose a remuneration policy covering key executives and board members that aligns, and explains how it aligns, remuneration with the longer term interest of the company and its shareholders; (b) ensure that the policy's development, ongoing application and the setting of actual remuneration is overseen by a sufficient number of non-executive board members capable of exercising independent judgement. There are effective mechanisms enabling shareholders to hold the board to account for inadequate performance of this responsibility and, whether required or disclosed, there is widespread adherence to these standards.

#### *6.3.4.5 Principle VI.D.5: Ensuring a formal and transparent board nomination and election process.*

The sub-principle is a complement of principle II.C.3 which states that “effective shareholder participation in key corporate decisions, such as the nomination and election of board members should be facilitated” and is also an essential requirement for principle V.A.4 (Disclosure should include ...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). The board has an essential role to play in ensuring the implementation of the two principles through formal and transparent nomination and election processes. The assessment of VI.D.5 will need to depend closely on judgements about the other two

related principles which are more directly observable for those outside the board.

The annotations to principle VI.D.5 also note a key role for the board 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.

#### Likely practices to be examined

As noted in the comments to principles II.C.3 and V.A.4, practices in many jurisdictions and companies can be very opaque and the election process highly restrictive as when a list of candidates is presented for election with no possibilities to oppose individuals or to propose other lists. In some jurisdictions, there are prohibitions on management and the board acting improperly in soliciting proxies (e.g. paying shareholders for their proxies). Companies with a controlling shareholder and/or block-holders can also be opaque even though it is within their rights to appoint the board.

Some jurisdictions are moving to encourage or mandate the use of nomination committees comprising at least a majority of independent board members. Such committees are especially important in jurisdictions where the CEO/Chairman or executive board members have traditionally selected new members of the board and the shareholding structure has been diffuse. In other jurisdictions, major and/or controlling shareholders have frequently been directly involved in the nomination and election process so that the need for an independent nomination committee is less pressing, but the need for transparency is all the more greater. Given the fact that company law may be unsuitable in mandating transparent procedures, a number of jurisdictions have found it appropriate to use codes/principles to call for open transparent election processes.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages boards to:
  - (a) adopt procedures that ensure a formal and transparent board nomination process in which potential conflicts of interest are appropriately managed;
  - (b) adopt procedures for the election of board members that ensure effective shareholder participation in the nomination and election process; and
  - (c) disclose to shareholders the nomination procedures including the role and composition of any nomination committee. Any change or variation from this policy should

be disclosed and justified by the board. There are effective mechanisms enabling shareholders to hold the board to account for inadequate performance of this responsibility, and whether required or encouraged there is widespread adherence to the standard.

*6.3.4.6 Principle VI.D.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.*

Principle VI.D.6 can be seen as specifying more closely what is required of the duty of care and loyalty, advocated by principle VI.A. It is also an essential counterpart of principle III.A.2 concerning the protection of minority shareholders, principle III.B concerning the prohibition of insider trading and abusive self-dealing and principle III.C requiring disclosure by members of the board and key executives of their material interest in any transaction or matter directly affecting the corporation. The disclosure of related party transactions is also advocated by principle V.A.5.

The annotations to sub-principle VI.D.6 therefore make clear that the focus here is on board processes. The board should oversee an internal control system covering financial reporting and systems to monitor and manage related party transactions and the use of corporate assets. These control functions are sometimes assigned to the internal auditor who 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 the board should also encourage the reporting of unethical/unlawful behaviour without fear of retribution. This requirement is fully covered in principle IV.E.

#### Likely practices to be examined

In forming a judgement about the implementation of this principle, the reviewer will need to examine the evidence about self-dealing and related party transactions in the jurisdiction and the *de facto* and *de jure* role of the boards. The principle does not define what is meant by “management” of conflicts of interest, misuse of corporate assets and abusive related party transactions. Several functionally equivalent practices are widely observed. At a minimum, the board must review the disclosure of related party transactions (principle V.A.5). In some jurisdictions, the board (or a committee of it) must also approve related party transactions while in others it must submit material transactions to shareholder approval. The intent of

the Principles (especially chapter III) is that such a vote should exclude interested shareholders and it would also be expected that interested board members would abstain from approving a transaction. Where there is simply a disclosure obligation and means of recourse are weak, the reviewer should be inclined to a judgement that the principle is either not or only partly implemented.

In systems in which controlling shareholders predominate, the experience has been that it is the controlling shareholders who will abuse related party transactions and they will also have an important position on the board. While internal controls are still important, the experience has often been that the board or committees of the board have found it difficult to judge the fairness or otherwise of related party transactions and the use of company assets, so that measures additional to formal internal controls such as those discussed above might also be needed for the board to fulfil its duty.

Internal controls are of major importance in ensuring that the ethical code of the company is followed and also to ensure compliance with applicable laws and regulations covering self-dealing and related party transactions. There is a long tradition of internal control standards in some jurisdictions that need to be examined by a reviewer. The practice has been often for the internal control organ to report to the CEO rather than to the board. More recently, there has been a move for such internal systems to be responsible to the board regarding matters dealt with in this principle. Such developments need to be noted by the reviewer. An audit committee of the board, or equivalent body, has often been named as the responsible body. Rather than just note the existence of such bodies, the reviewer should also be satisfied that the evidence on balance suggests that they function effectively in the way envisaged. In some cases, such bodies are hampered by procedural rules and by their membership.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages the board to oversee a system of internal controls designed to facilitate monitoring and managing potential conflicts of interest, the use of corporate assets, and the terms of related party transactions. The mechanism and the associated sanctions should be disclosed as part of the board's duty to report on governance structures and policies, and related party transactions (principles V.A.5 and V.A.8). Where required, there are effective mechanisms for enforcing the board's duty to establish procedural rules. Whether required or encouraged, there is widespread implementation of the standard.

2. The corporate governance framework requires or encourages the board to manage self-dealing and related party transactions consistent with the duty of board members to act in the best interests of the company and its shareholders. There are effective mechanisms for enforcing such standards, effective remedial mechanisms for those harmed by the transactions, and there is widespread implementation of the standard.

*6.3.4.7 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.*

Principle VI.D.7 can be seen as specifying more closely what is required of the duty of care and loyalty, advocated by principle VI.A. It is also an essential counterpart of principle V.A, V.B and V.C concerning disclosure and an independent audit. As with principle VI.D.6 it is concerned with processes and goes further than financial and accounting controls to include risk management and operational controls more generally: internal controls in general. It is complemented by principle VI.E.1 which specifies the type of board members who should oversee the process.

The annotations note that 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.

#### Likely practices to be examined

Several jurisdictions have now introduced codes covering principles of risk management and financial and operational control. These are normally

associated with comply or explain obligations with respect to a corporate governance code incorporating such principles. In one case, reporting the effectiveness of internal controls involved with financial reporting is mandated as are declarations by executives and the need for an audit opinion as to their adequacy. If generally implemented by companies, such codes should be treated as functionally equivalent with mandated systems, even though the former are often much broader.

Through either principles/codes or, in an increasing number of jurisdictions by secondary market regulation, the board is required to manage the relations with the external auditor so as to ensure an independent audit. This means managing the overall relationship with the auditor including other work they undertake for the company which might compromise their independence. Further comments about what might be implied for managing the relationship are discussed under principle V.C which covers what is required of transparency.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages the board to oversee the administration of internal controls designed to ensure: (a) the integrity of the corporation's accounting and financial reporting systems; and (b) that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control. The mechanism should be disclosed as part of the board's duty to report on governance structures and policies (principle V.A.8). There are effective mechanisms for enforcing the standard. Whether required or encouraged, there is widespread implementation of the standard.
2. The corporate governance framework requires the board to manage the overall relationship with the external auditors so as to be reasonably satisfied that the audit of the financial statements has been conducted in an independent and competent manner. There are effective enforcement mechanisms covering the board's duty to establish procedural rules and widespread implementation of the standard.
3. The corporate governance framework should require or encourage boards to set up internal programmes and procedures to promote compliance with applicable laws, regulations and standards, including the company's ethical code. The programmes should ensure that compliance is rewarded and breaches of law are met with dissuasive consequences or penalties. Compliance programmes should also extend, where possible, to subsidiaries.

#### *6.3.4.8 Principle VI.D.8: Overseeing the process of disclosure and communications.*

The sub-principle should be seen as a reflection of chapter V covering disclosure and transparency, and assigns responsibility for fulfilling principle V.E to the board. It is also the process underpinning principles II.A, II.B, II.C which specify access to timely and relevant information about a company as a basic shareholder right.

#### Likely practices to be examined

In many jurisdictions there is information collected by rating agencies and others concerning the quality of disclosure and communications that could aid a reviewer to form a judgement. However, the process of communications with investors is often more subtle and can take place on a bilateral basis. The reviewer should thus seek to determine the judgement of investor groups about the quality of communications in the jurisdiction. In some companies there is now an investment relations officer who reports directly to the board and in others codes/principles call for a board member to play a significant role in the process.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires the board to: (a) oversee the disclosure of material information about the company; and (b) take responsibility for the company's communications strategy with the shareholders. There should be effective enforcement mechanisms and widespread implementation of the procedure.

#### **6.3.5 Principle VI.E**

Principle VI.E states that “*The board should be able to exercise objective independent judgement on corporate affairs*”. It is an important complement to principle VI.A but will still call for a separate judgement to be formed by the reviewer. The principle is probably also one of the most difficult for reviewers to form a judgement.

The annotations note that the variety of board structures, ownership patterns and practices in different countries will require different approaches to the issue of board objectivity. The primary concern in some countries is with independence and objectivity with respect to the management. Board independence in these circumstances usually requires that a sufficient number of board members will need to be independent of management: 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 a board member from also being a shareholder. In others, independence from controlling shareholders or another controlling body will need to be emphasised, in particular when 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. Where there is a party in a special position to influence the company, the intent of the principle is that there should be stringent tests to ensure the objective judgement of the board.

*6.3.5.1 Principle VI.E.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.*

Principle VI.E.1 makes the connection from the board being able to exercise objective independent judgement to the actual process via the use of certain board members capable of exercising independent judgement. It therefore complements and implements a number of considerations about process noted in principle VI.D. The annotations note that 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.

#### Likely practices to be examined

With respect to principle VI.E, jurisdictions vary widely in how they implement “objective independent judgement” requiring the reviewer to examine a number of aspects in detail. Many jurisdictions focus on the concept of the “independent” board member, encouraging or mandating a certain percentage of the board to be independent and not just non-executive. However, even where mandated, the definition has sometimes been so narrow as to be easily evaded. For example, although board members from a subsidiary could not be classed as independent in one

jurisdiction, those from related companies have been classed as independent. In some cases, the concept has been implemented almost in the form of a legal transplant and, unlike the annotations of the principle, not adapted to the board and ownership structure of the country. In some jurisdictions, the looser concept of an outside board member has been utilised but similar issues as with independent board members have arisen. Where not mandatory but recommended or encouraged, board members have also been classed as independent by companies based on the most favourable interpretation of criteria. The question for the reviewer is not only the definition and whether it is appropriate, but also whether it is applied in practice.

A key question for the reviewer is the incentive structure for board members to want to be, or remain, independent and objective. In a number of jurisdictions there are expectations that outside or independent board members will monitor potentially wayward or corrupt managers and controlling shareholders, and that the threat of liability will enhance their incentives to be vigilant. The reviewer will have to understand the liability system that applies to board members of a jurisdiction, but it is probably too much to expect it to be an effective incentive, and this appears indeed to be the experience around the world. The reviewer should therefore give greater weight to judgements about: the role of shareholders and in particular principle II.C.3; the transparency about board members and in particular V.A.4; and general board processes as covered by VI.D.5 and VI.D.6.

Another area that needs to be considered and for which data should be available from corporate governance reports concerns 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 board members. 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. Even if separation is not mandated, many companies appear to adopt the separation rule. Where the practice is widespread, the reviewer should be inclined to the judgement that the principle is implemented. However, this judgement would be dependent on the ownership structure in a jurisdiction and on the state of minority rights (principle III.A.2), and disclosure (V.A.5) and control of (VI.D.6) related party transactions.

In some jurisdictions, principle VI.E.1 is implemented indirectly via the courts which give the benefit of the doubt to the decisions of the board when it is clear that board members capable of independent judgement have been closely involved in a disputed decision. Here the decision is often based on a

full consideration of the circumstances rather than *ex-ante* tests of independence. This is often the case, for example, with related party transactions and with the sale and acquisition of assets. In other cases, the use of board members classified as independent by the board is sometimes mandated.

With cross reference to principle VI.D.7, 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. The audit committee or an equivalent body is often specified as providing oversight of the internal audit activities and is 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. Some jurisdictions now mandate such a role for independent board members while in others it is often a key element of codes/principles.

Since companies are often obliged to provide details of board arrangements including who they regard as independent, a number of rating agencies have collected data on the level of company compliance with VI.E.1, which will be of use for a reviewer in forming a judgement. However, the judgement will also have to take into account the definition of independence in the jurisdiction and the actual experience. For example, even where a sub-committee might comprise a majority of independent board members, if it is also chaired by the CEO/chairman the group as a whole might not be capable of objective independent judgement. The overall legal context also matters. For example, in some jurisdictions, transactions with related companies might not be classed as related party transactions if so decided by a majority of shareholders, rendering objective independent decisions inoperable.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages: (a) a proportion of the board to be independent; (b) sets out criteria for independence that address the primary agency conflicts that arise because of the ownership and control structures in the jurisdiction and are not easily by-passed; and (c) places the onus on companies to declare who they regard as independent and the reasons. There are effective mechanisms enabling shareholders to hold the board to account for inadequate performance of this responsibility, such as meaningful opportunities to address shareholder concerns at the shareholders meeting, put items on the meeting agenda, vote against board members,

and/or an effective market in corporate control. There is widespread adherence to the standard.

2. The corporate governance framework requires or encourages a sufficient number of non-executive board members capable of exercising independent judgement to oversee tasks where there is a potential for conflict of interest including: (a) oversight of the integrity of financial and non-financial reporting including external audit; (b) review and management of related party transactions and self-dealing; (c) nomination of board members and key executives; and (d) board and executive remuneration. Where the standard is mandatory, the requirements are backed by effective enforcement mechanisms and adequate remedies. Where the standard is not mandatory or otherwise enforced, there are effective mechanisms enabling shareholders to hold the board to account for inadequate performance of this responsibility, such as meaningful opportunities to address shareholder concerns at the shareholders meeting, put items on the meeting agenda, vote against board members, and/or an effective market in corporate control. There is widespread adherence to the standard.

*6.3.5.2 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.*

As noted above, the role of independent board members is often exercised via board committees and not just via their membership of the board in general. 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 disclosure is also covered by principle V.A.8 covering governance structures and policies so that the judgement by a reviewer of VI.E.2 should be compatible with this principle.

#### Likely practices to be examined

The disclosure advocated by the principle is particularly important in the increasing number of jurisdictions where boards are establishing standing 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.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework encourages or requires full disclosure of the mandate, composition and working procedures of the most important standing and ad hoc board committees. Such disclosure should form an essential component of the company's report on its corporate governance practices. There are effective enforcement mechanisms, including shareholder rights to request the information. Whether required or encouraged, there is widespread implementation of the standard.

*6.3.5.3 Principle VI.E.3: Board members should be able to commit themselves effectively to their responsibilities.*

The principle is intended to underpin the board's ability to exercise objective independent judgement. In particular, service on too many boards can interfere with the performance of board members. The annotations also state that the principle covers board training and board member qualifications in general. It is thus a complement to VI.D.5, which touches on the responsibility of the board to identify potential members for the board with appropriate knowledge, competencies and expertise.

**Likely practices to be examined**

Some jurisdictions have limited the number of board positions that can be held by an individual. 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. Such transparency is advocated by principle V.A.4 which calls for disclosure of information about board members including their qualifications.

An increasing number of jurisdictions are now encouraging companies to engage in initial and ongoing training for board members 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.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires or encourages companies to provide comprehensive disclosure about each board member's activity including: (a) the member's length of service as a board member and their tenure on various board committees; (b) basic information about primary employment, if any; (c) other board positions held concurrently; (d) attendance records at board and committee meetings; and (e) any other work undertaken on behalf of the board and the associated remuneration. There is effective enforcement of requirements. Whether required or encouraged there is widespread implementation of the standard.
2. The corporate governance framework requires or encourages boards to provide for board members initial and ongoing training relevant to the performance of their individual duties. Each board member's training needs are re-assessed periodically and additional training is provided to address any needs to enhance the board member's capabilities. Whether required or encouraged, there is widespread implementation of the standard.

### **6.3.6 Principle VI.F**

Principle VI.F states that "*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, but it is their responsibility and that of the board as a whole to ensure that they obtain accurate, relevant and timely information. This is an essential condition for fulfilling their duty of care. However, the principle also extends to executive board members.

#### **Likely practices to be examined**

There are numerous instances around the world of boards not being informed by management of all the facts and being requested to make important decisions without adequate time for consideration and without adequate information. The situation makes it impossible for the board and its members to fulfil its duty of care. The reviewer should review recent public

cases and interview market participants for indications that the board is treated in this manner by management and/or controlling shareholders. Where there is evidence that the practice is common the principle should be assessed as only partly implemented. The assessment of principle VI.A should also be consistent with this judgement.

Increased resort to non-executive board members has raised the issue of their access to information commensurate with their responsibilities in a number of jurisdictions. In some jurisdictions there are no direct references in either the law or codes to board access to information but also no evidence of any problem. In these cases, the reviewer should be inclined to a judgement of partly implemented. Some jurisdictions require or recommend providing them with 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.

A special case concerns proposed transactions or activities that fall outside the company's routine course of business. In some jurisdictions, boards are provided with timely advice, at no cost to them, from qualified advisors (e.g. lawyers, accountants, financial advisors as appropriate) about the processes they should follow and factors they should consider in fulfilling their duties of loyalty and care to the company in the context of the transaction or activity. The process is made clear in filings about the decision making process. The reviewer will need to rely on such disclosures. Where they are not forthcoming, and in combination with other information about the functioning of boards, the reviewer should be inclined to assessing the principle as either not or as only partly implemented.

Such practices and the intent of the principle suggest the following essential criteria:

1. The corporate governance framework requires both executive and non-executive board members to be provided with access to information that they consider relevant for the fulfilment of their responsibilities. The company's code of ethics prohibits the withholding or delayed disclosure of relevant information to the board and there are effective enforcement mechanisms for ensuring that information is not withheld from the board. Whether required or encouraged, there is widespread implementation of the standard.
2. In connection with proposed transactions or activities that fall outside the company's routine course of business, company disclosures indicate that the boards have been provided with timely advice, at no cost to them, from qualified advisors (e.g. lawyers, accountants, financial advisors as appropriate) about the processes they should follow and factors they should consider in fulfilling their duties of loyalty and care

to the company in the context of the transaction or activity. Company disclosures indicate that board members who are asked to participate in independent committees are able to retain independent advisors as they see a need, and such advice is paid for by the company. There is widespread adoption of these practices.



*Part D*

**Forming policy options and recommendations**

This Methodology is intended to underpin an assessment that will identify the nature and extent of specific strengths and weaknesses of the corporate governance framework and therefore help identify reform priorities through policy dialogue so as to ultimately improve economic performance. The emphasis is on how the corporate governance framework actually functions as a whole or as a system: the whole can be greater than the sum of the parts which is important to take into account when considering policy priorities.

Although the Methodology has implications for the form of a written review, the format is open to the choice of the user of the Methodology. However, at a minimum a report should include a short executive summary including a summary of key findings and recommendations. The main body of the accompanying documentation would also include a table summarising the assessments of each principle and sub-principles. It should be noted that the World Bank's ROSCs follow a quite specific format. If the intention of the user is to request a ROSC designation, the World Bank should be consulted about their requirements.

The concern in this Part is with the content and process of deriving conclusions and establishing policy options and priorities rather than the format of a written report. Three inter-related elements need to be taken into consideration and presented in a transparent manner by the reviewer: the corporate governance landscape; summarising what has been learnt from the assessment of individual principles; forming a judgement about the resulting policy implications and priorities.

### **1.1. Forming an assessment about policy options and priorities**

*The corporate governance landscape:* The reviewer needs to identify the nature and extent of corporate governance problems in the jurisdiction by considering the corporate structure, current ownership and control systems, and how these have become established and have evolved in recent years. The forces underlying the current situation might include recent privatisations, past industrial and trade policies, past decisions to implant legal ideas from abroad, and a history of uncertainty due to, for example, property confiscations. Current forces for change also need to be considered, including international agreements that have implications for corporate law etc. To maintain transparency of the review process, the legal, regulatory and enforcement structures would be considered and the lessons drawn from any recent "scandals" discussed. In short, this element of the review process would identify how the major corporate governance issues (i.e. agency

costs) are arising and why the situation, covered in more detail as part of the assessment of some principles, has arisen.

*Summarising what has been learnt from the assessment of implementation:* The review needs to provide a summary of assessments for each principle together with the main reasons for the assessment (e.g. inadequate laws, poor enforcement, not a widespread company practice). In some cases it will be useful to specify which essential criterion is the primary reason of the assessment. Such a comprehensive process serves to make clear that the jurisdiction has been reviewed against the Principles as a whole, and minimise any chance of overlooking important elements. Not all principles need to be covered in the same detail depending on the judgement about their importance. The latter is related to the corporate governance landscape and the corporate governance issues that need to be dealt with in a jurisdiction. The essential interrelationship (complementarity) between principles would also be considered. For example, the effective exercise of shareholder rights is related to assessments about transparency and the functioning of the board. The review would also consider those areas where the jurisdiction is judged to have broadly or fully implemented the Principles, and indeed might have gone beyond the requirements of the Principles and is now developing “good practices”. Areas of strength as well as weaknesses would thus be taken into account. Detailed assessments for each principle and the corresponding essential criteria with brief notes may or may not form part of any report depending in part on whether confidential information has been used in forming an assessment of an essential criterion. However, they are an essential input for the reviewer in forming a judgement about priorities.

*Forming a judgement about policy implications and priorities* This part of the process involves moving from individual assessments of each principle to developing policy options and priorities. For the reviewer, a judgement that a principle is only partly or even not-implemented carries by itself little information about what measures might be required, and about the relative importance of each “deficiency”. Chapter I of the Principles offers importance guidance to the reviewer in this situation. The reviewer should, after taking into account the assessment of all the principles of chapters I-VI, form a judgement about where and how corporate governance weaknesses are likely to impact on overall economic growth and stability and the promotion of transparent and efficient markets. Potential policy options and priorities should be formed with due regard to the interaction with other aspects of the corporate governance framework and the likely cost/benefit relation or overall impact, emphasising those measures first with the greatest likely benefits and the lowest likely costs, both direct and indirect. This distinction should not be confused with the division between

short term and long term. Reforming the judiciary and the court system might take a long time to be effective, but should nevertheless be undertaken as a priority if the regulatory impact promises to be great. However, the lesson is that other measures taken in the meantime should not be grounded on the assumption that the court system might function well anytime soon. Time consistency of policy is necessary. Put another way, in considering the likely costs and benefits of potential policy actions, principle I.A implies that the presence or absence of complementary features of the corporate governance system should be taken into consideration.

Two further examples are useful to illustrate the process of forming options and priorities. An initiative to increase the flexibility of companies with respect to financing and decision making by boards might be judged a positive development. However, seen from a systems-wide perspective, this judgement might appear misleading. In a situation of concentrated ownership, strong board control of shareholder meetings and poor minority protection, such an increase in flexibility might actually result in a deterioration of corporate governance standards. The methodology outlined in principle I.A calls for the reviewer to focus attention on where the agency costs can occur and the existence of complementarities. In the case where the reviewer considers that private benefits of control is the issue, the focus will need to be on strengthening minority rights starting with the most cost/benefit efficient measures. This is where the reviewer needs to move from identifying broad priorities to considering policy options.

In the case of minority rights, improved transparency is one option together with clearly defining and, if necessary, widening the responsibilities of the board. At the other end of the cost/benefit scale would be majority-of-the-minority approval for related party transactions and the ability of minority shareholders with only a low threshold of votes to call a meeting of shareholders or to initiate litigation on an individual shareholder basis. With these latter measures there is a potential cost in terms of reduced entrepreneurial flexibility, but the benefits might also be great if the initial situation is highly distorted. Complementarities are an important factor. In this example, the lack of active capital markets or means of either public or private enforcement might make increased transparency a not very effective response; the corporate landscape and existing institutions need to be considered. On the other hand, where capital markets are active and enforcement a credible threat, increased transparency might prove highly effective.

Where corporate governance problems are most apparent through poor investment and resource allocation, the options are considerably more complicated and need to be more capital market driven. Increasing the scope of transparency, such as requiring details about the rate of return in group

companies, etc, might be the most cost efficient instrument, with measures such as restrictions on inter-company shareholdings and investments at the other end of the spectrum. However, the reviewer should note that other elements of the legal and regulatory environment such as tax policy might represent an even more cost effective solution in dealing with corporate governance issues.

In presenting a range of policy options, the reviewer might also refer to the experience in other jurisdictions. However, the transferability of experiences from other jurisdictions would need to be carefully considered including whether required complementarities (e.g. particular institutions) are present in the current corporate governance framework. The principle of functional equivalence needs to be part of the review process.

Principle I.D is particularly important for an overall assessment aiding the reviewer to avoid the “fallacy of composition”. Considering policy priorities from the assessment of individual principles on a case by case basis could lead, for example, to thirty different recommendations for more enforcement and more resources for regulatory and enforcement authorities. Viewed from the system perspective, the regulatory cost could be heavier than anticipated by individual recommendations. With respect to regulatory resources, the key question should also involve prioritisation by the authorities: the allocation of scarce resources effectively to maximise regulatory impact.



## *Annex*

### **Indicators of the Corporate Landscape**

A requirement of the Methodology is that a reviewer has a good understanding of the corporate landscape: the structure of ownership and control, the techniques in place to ensure control of companies by some entities, and the likely corporate governance consequences of the arrangements. Rather than rely solely on anecdotal evidence to form a generalisation about a jurisdiction, a reviewer might be able to underpin a judgement through the judicious use of statistical indicators. The availability of such statistics varies widely across jurisdictions, but any lack of availability should not influence the assessment by a reviewer.

#### **Measures of ownership concentration**

Ownership concentration is a measure of the distribution of power between major shareholders and dispersed shareholders. It is an indicator of whether some shareholders can influence company management and whether control is contestable. High ownership concentration is associated with an active role of shareholders in the management of the company, notably through the appointment of board members, and with a limited contestability of control (no contestability if the largest shareholders hold more than 50% of voting rights). A low ownership concentration entails a greater independence of board members and especially of executive board members from shareholders and, at the same time, a greater possibility of control changes through (friendly or hostile) take-overs.

Concentration of ownership can be computed with reference both to direct stakes and to voting blocks. The latter is a preferable measure since ownership is known to be concentrated and exercised through various corporate vehicles, foundations etc. However, the information demands are greater than for measures of direct stakes.

A direct stake is the share of voting capital that is owned by a company's direct shareholder. In the example of Figure.1 we have 3 direct stakes in the listed company Y, held respectively by the beneficial owner X (5%), by company D (25%) and by company C (21%). In the example of Figure.2, we have 3 direct stakes in the listed company Z, held respectively by beneficial owner E (10%), by company F (15%) and by beneficial owner G (6%).

A voting block is the share of voting rights that is owned by a company's beneficial owner directly or indirectly (namely by companies controlled by him or by other subjects whose voting rights in the listed company are attributed to the beneficial owner). In the example of Figure.1, we have only one voting block in the listed company Y, held by the beneficial owner X (51%, 5% held directly and 46% indirectly through controlled companies). In the example of Figure.2 we have 3 voting blocks in the listed company Z, held respectively by beneficial owner E (10%), by beneficial owner W (15%) and by beneficial owner G (6%).

Disclosure rules concerning ownership are usually based on the concept of voting block, i.e., a beneficial owner of a voting block larger than a specific threshold (defined major shareholder) has to disclose the ownership of the block (as well as any relevant change of the voting block) to the market. The threshold and the relevant changes to be disclosed vary among countries (e.g. the threshold is 5% in the European Union and the United States). Where possible, summary statistics should be based on the voting blocks exceeding the 5% threshold, but the threshold and the definition of ownership (direct stakes or voting block) adopted by national legislation should be made clear in the documentation and its economic significance assessed against what is known about the jurisdiction.

It would be extremely relevant to compute ownership concentration indices for both voting blocks and direct stakes. In order to define concentration indices, the following steps are required.

### **VOTING BLOCKS**

For each listed or publicly traded company:

- Identify the voting blocks ( $v$ ) held by all major shareholders (1,2,...,  $n$ ) and order them by "size";
- define  $v_1$  as the voting block held by the largest shareholder,  $v_2$  as the voting block held by the second largest shareholder, ...  $v_n$  as the voting block held by the  $n$ -th largest shareholder.

- compute the HERFINDAL index ( $\sum v_n^2$ )<sup>3</sup>
- For all listed or publicly traded companies:
- $C_1$  = Average voting block held by the largest shareholder  $s_1$  (simple average and weighted average)
- $C_n$  = Average of the sum of the voting blocks held by the  $n$  largest shareholders  $\sum s_n$  (simple average and weighted average)
- $C_{all}$  = Average of the sum of the voting blocks held by all major shareholders (simple average and weighted average)
- Floating = Average voting block held by the market (100 -  $C_{all}$ ) (simple average and weighted average)
- HERFINDAL = Average of individual HERFINDAL indices
- Threshold index = ratio (in percentage) of companies where  $C_n$  is > a specific threshold (the most widely used Threshold index in the economic literature is: number of companies where  $C_1 > 20\%$ ) but this should depend on knowledge about the jurisdiction.

Applying the methodology to the examples of Figures.1 and 2, and assuming that they are the only companies listed in a country, we have:

For Company Y:

- $v_1 = 51\%$
- Herfindal =  $(51\%)^2 = 0.26$
- For Company Z:
- $v_1 = 15\%$ ,  $v_2 = 10\%$ ,  $v_3 = 6\%$
- Herfindal =  $(15\%)^2 + (10\%)^2 + (6\%)^2 = 0.04$
- For all companies:
- $C_1 = 33\%$
- $C_3 = 41\%$
- Call = 41%

- 
3. By squaring the voting block,  $v_n$ , the Herfindal index weighs more heavily the large voting blocks, which makes economic sense. Operationally, the weighting scheme makes it unimportant whether one has precise data on the voting shares of small shareholders, but it is more important for the larger blocks.

- Floating = 59%
- Herfindal = 0.15
- Threshold index = 50% for  $C_1 > 20\%$

### **DIRECT STAKES**

For each listed or publicly traded company:

- Identify the direct stakes (s) held by all major shareholders. In the example of fig.1;
- define  $s_1$  as the larger direct stake,  $s_2$  as the second direct stake, ...  $s_n$  as the n-th direct stake.
- calculate the HERFINDAL index ( $\sum s_n^2$ )
- For all companies:
- $C_1$  = Average stake held by the first major shareholder  $s_1$  (simple average and weighted<sup>4</sup> average)
- $C_n$  = Sum of the average stakes held by the first n major shareholders  $\sum s_n$  (simple average and weighted average). Usually  $C_3$  is used.
- $C_{all}$  = Sum of the average stakes held by all major shareholders (simple average and weighted average)
- Floating = Average stake held by the market ( $100 - C_{all}$ ) (simple average and weighted average)
- HERFINDAL = Average of individual HERFINDAL indexes
- Threshold index = number of companies where  $C_n$  is  $>$  a given threshold. The most used Threshold index in the economic literature is the number of companies where  $C_1 > 20\%$ , but this should also depend on knowledge about the jurisdiction.

Applying the methodology to the examples of Figures.1 and 2, and assuming that they are the only companies listed in a country, we have:

For Company Y:

- $v_1 = 25\%$ ,  $v_2 = 10\%$ ,  $v_3 = 6\%$

---

4. Weighted averages are calculated by “weighting” direct stakes and voting blocks with the market value of the ordinary share capital for each company

- Herfindal =  $(25\%)^2 + (10\%)^2 + (6\%)^2 = 0.08$
- For Company Z:
- $v_1 = 15\%$ ,  $v_2 = 10\%$ ,  $v_3 = 6\%$
- Herfindal =  $(15\%)^2 + (10\%)^2 + (6\%)^2 = 0.04$
- For all companies:
- $C_1 = 38\%$
- $C_3 = 46\%$
- $C_{\text{all}} = 46\%$
- Floating = 54%
- Herfindal = 0.6
- Threshold index = 50% for  $C_1 > 20\%$

### Estimating the Free float

It is often useful for the assessment of both the operation of capital markets and the use of control arrangements to know the proportion of shares that could be traded on the market. In many jurisdictions, there are restrictions on the minimum level of a free float for both an IPO, as well as to remain listed on an exchange. The proportion of votes from the free float being cast at shareholders meetings is also suggestive of the degree of shareholder activism and might also indicate the importance of barriers to participation such as short notice of meetings.

The most general definition is that the free float factor is the percentage of shares remaining after the block ownership and restricted shares adjustments have been applied to the total number of shares:

Free float factor (%) =  $100\% - [\text{Maximum (block ownership (\%)); restricted shares adjustment (\%)}]$

The free float market capitalisation is the portion of a stock's total market capitalisation that is available for trading:

Free float market capitalisation = free float factor · full market capitalisation

The adjustment for block ownership of shares is applied if blocks of at least 5% of a company's total stock are held in:

- Cross-ownership: stock owned either by the company itself, in the form of treasury shares, or owned by other companies.
- Government ownership: stock owned by either governments or their agencies.
- Private ownership: blocks of shares owned by either individuals or families and therefore not likely to be available for trading.
- This block ownership adjustment is not applied if:
  - The blocks comprise less than 5% of the total stock as these might be small enough to be tradeable.
  - The blocks are held by — but not limited to — custodian nominees, trustee companies, mutual funds and pension fund holdings, investment companies with short-term investment strategies and pension funds.

In addition, the total number of shares is also adjusted by the restricted shares, i.e. either those that cannot be traded during a certain period or those that have a foreign ownership restriction. Either the block ownership adjustment or the restricted shares adjustment is applied, whichever produces the higher result.

In this Annex, a simpler approach is utilized:

Floating = Average voting block held by the market (100 - C<sub>all</sub>) (simple average and weighted average)

where:

C<sub>all</sub> = Average of the sum of the voting blocks held by all major shareholders (simple average and weighted average) and defined above.

Considering that it is difficult to obtain information about restricted shares, this is a good proxy of a free float. For each company the free float is 100- sum of "relevant" voting blocks where a "relevant" voting block is those exceeding 5% of voting capital. If it is possible, a "relevant" voting block should not include those exceeding 5% but held by custodian nominees, trustee companies, mutual funds and pension fund holdings, investment companies with short-term investment strategies and pension funds, since they are considered not stable and therefore tradable.

## CONTROL MODELS

All listed companies could be classified according to their control model that is associated with statistical indicators:

- *majority control* where the voting block held by the first major shareholder (s1) is > 50%
- *working control (de-facto control)* where the voting block held by the first major shareholder (s1) is < 50% but, according to the definition of control applicable in the national legislation, the latter controls the company, alone or with *related parties*<sup>5</sup> (for instance, if voting block is large enough to have the majority of the AGM or to appoint the majority of directors or there are by-law or other legal or contractual provisions enabling the exercise of a dominant position over the listed company<sup>6</sup>);
- *joint control*, where the sum of voting block held by a group of major shareholders linked by a formal agreement is > 50% (majority

- 
5. The definition of *related parties* will need to be based on country specific conditions. The definition might include: (i) relatives, (ii) not-for-profit organizations where the controlling shareholder, alone or with *related parties*, contributed at least 30% of total donations, (iv) not-for-profit organizations where the controlling shareholder, directly or through related parties, has a controlling influence over the appointment of directors or business activities, (v) any company whose business is controlled *de facto* by the controlling shareholder, and (vi) agents of the controlling shareholder or his related parties, including senior managers.
  6. The definition of *de facto control* will need to be based on country specific conditions. The following criteria can be used: (i) a shareholder, alone or with *related parties*, owns more than a specific threshold (e.g., 30% or 40%) of voting shares issued and is the largest shareholder, (ii) a shareholder appoints the representative director or at least half of the directors, (iii) a shareholder directly or through *related parties* has a controlling influence over corporate strategy decisions, (iv) the company concerned and another company *de facto* controlled by a shareholder have a personnel exchange program in place, (v) the company and a shareholder or its *related parties* conduct transactions of funds, assets, goods, services, or debt guarantees above a normal level, (vi) the company can be reasonably considered under social norms to be an affiliate of the business group controlled by a shareholder (for example, using similar trademarks).

joint control) or is < 50% but is sufficient to control the company (working or de-facto joint control);

- *managerial control*, a residual class where no major shareholder or group of major shareholders controls the company according to the definitions adopted in the previous points.

Applying these definitions to the examples of Figures.1 and 2, assuming that they are the only companies listed in a country, we have:

- company Y is under majority control;
- it is not possible to classify company Z only on the basis of ownership information. We need to know whether the Beneficial Owner W (who held the largest voting block) is able to have a working control of the company Z (for example, has the power to appoint the majority of directors according to the company by-law or other legal provisions). If this is not the case, we need to know if company Z's major shareholders are linked by a shareholder agreement, and if their aggregate voting block (31%) is sufficient to control the company.

In order to compute statistics on control models, information is needed on:

- ownership structure
- shareholder agreements
- actual control power allocation (this could be presumed on the basis of ownership concentration assuming that a voting block - single or aggregate - exceeding a given threshold, for instance 30%, corresponds to a control position).

---

## DISTRIBUTION OF OWNERSHIP AMONG DIFFERENT CATEGORIES OF OWNERS

The distribution of ownership among different categories of owners provides useful information about the corporate governance structure of different countries. For example, jurisdictions where banks and insurance companies are dominant owners raise a number of corporate governance issues for the reviewer (e.g. what are the rules on related lending, do these institutions enjoy the full legal rights of other shareholders). The distribution can be computed with reference both to direct stakes and to voting blocks (defined above).

Firstly, the owners of direct stakes and voting blocks have to be classified according to a standard taxonomy of investors' categories. A possible taxonomy is the following:

### Domestic investors

Families/individuals

Non-financial Firms

Financial Intermediaries

Of which:

- Banks
- Insurance
- Collective investment companies (including mutual funds, pension funds and other collective financial investment companies)

Public sector (including Government, local authorities and others public sector bodies)

Foundations

### Foreign Investors

In principle it should be useful to adopt the same distribution adopted for domestic investors, but also an aggregate value could be sufficient.

Secondly, direct stakes and voting blocks of each category of investors have to be averaged over all companies (both simple and weighted average).

## INSTRUMENTS FOR SEPARATION BETWEEN OWNERSHIP AND CONTROL

Many instruments can be used to separate ownership from control, depending on the legal framework and market practices of the country. Only a few of these instruments can be easily evaluated through statistical indicators.

### The use of shares with different voting rights

In many jurisdictions, listed companies can issue different categories of shares, having different voting rights. A possible taxonomy of shares, according to their voting rights is the following:

- ordinary shares (giving one voting right per share in every general meeting)
- multiple voting shares (giving more than one voting right per share in every general meeting)
- preference share (giving voting rights only in specific situations)
- non-voting shares (giving no voting rights)

With reference to that taxonomy, the following statistical indicators could be computed:

- VC1 = the percentage of listed companies having different classes of shares (giving different voting rights).
- VC2 = the share of capital of all listed companies represented by each class of shares (average share of capital of each class of shares);
- VC3 = for the subset of listed companies with different classes of shares, the average share of capital represented by each class of shares.

Assuming that there are 10 listed companies, whose capital is composed as described in table 1:

- VC1 = 60% (6 companies with different classes of shares out of 10)

- VC2 = 66% for ordinary shares, 17% for preference shares, 10% for multiple voting shares and 7% for non voting shares
- VC3 = 43.3% for ordinary shares, 28.3% for preference shares, 16.7% for multiple voting shares and 11.7% for non voting shares

Indicators of shareholder rights are becoming more widely available, often in the form of scorecards, and often with the type of classification described above. Before using such indicators, the reviewer should be satisfied that they meet the test of preserving functional equivalence and are compatible with the Principles. A number are based on the principle of one share-one vote-one dividend, properties not advocated by the Principles. In general, disaggregated indices should be preferred since the weighting schemes for aggregation are at best often untested.

## Company groups

Several key aspects of corporate groups have been identified in the literature including the number of layers and the difference between voting and cash flow rights. The position of a firm in a pyramid will affect the incentive structure it faces. In the case of the simple company group illustrated in Figure.1, listed company Y is in the third layer of a pyramid and companies D and C might also be listed. Company Y might also hold shares in these other companies (i.e. cross shareholding).

Definitions of the difference between control and cash flow rights differ between studies often reflecting the circumstances in the countries of interest. Crucial here is the concept of control. In some cases control may not require 50 per cent or more of the issued voting equity and in some cases shareholding might not even be necessary to control a company. Some studies therefore set the level of control using a number of other indicators.<sup>7</sup> Important is also whether private companies, about which little information needs to be disclosed, are embedded in a company group.

### *Controlling Shareholder*

The first step in computing control over voting rights is to identify the controlling shareholder for each listed company, according to the

---

7. This section draws heavily on the work of Woochan Kim, *What determines the ownership structure of business conglomerates?: On the cash flow rights of Korea's chaebol*, Paper delivered to the KDI Conference on Corporate Governance of Groups, Seoul, 2004

considerations outlined in “control models” above. Where a controlling shareholder can be identified, either in the form of majority control or in the form of working control (*de facto* control), it is possible to analyze the separation between ownership and control, by computing for each controlling shareholder a measure of voting rights he controls and a measure of cash flow rights he holds.

### ***Control Over Voting Rights***

Control over voting rights (hereafter voting rights) is defined as the sum of direct share ownership held by the controlling shareholder and its *related parties* (corresponding to voting block above). Assume that  $d_i$  is the direct share ownership held by the controlling shareholder in firm  $i$ . Assume also that  $r_i$  is the direct share ownership held by the *related parties*, including all subjects who are considered to be such in a specific legislation. Lastly, assume that  $s_{ij}$  is the direct share ownership in firm  $i$  held by firm  $j$ , which is under the controlling shareholder's influence. Then, a voting right for firm  $i$  can be defined by equation (1).

$$vr_i = d_i + r_i + \sum_{j=1}^n s_{ij} \quad (1)$$

where  $n$  is the number of firms under the controlling shareholder's influence. When computing the fraction of shares, it might also be necessary to adjust for treasury stocks, if they do not have any voting rights.

Two points should be mentioned that have been emphasised by researchers. First, it may be important to differentiate between the concept of *control* and *control over voting rights*. The concept of control, as explained earlier, may include not only share ownership, but also other routes of control, such as the appointment of directors, personnel exchange, abnormal transaction levels, and so on. Control over voting rights, on the other hand, only refers to share ownership. Hence, it is a narrower concept. Although the controlling shareholder might *control de facto* all the affiliated firms, this does not mean he controls 100% of the voting rights. When computing measures of separation between ownership and control (see paragraph below on *Disparity*), the concept of voting rights is used. In the case of the simple example given in Figure.1, control over voting rights is  $5\% + 21\% + 25\% = 51\%$ .

### **Cash-Flow Rights**

Cash-flow rights are defined as the sum of the products of ownership stakes held by the controlling shareholder,<sup>8</sup> and *related parties* along the voting right chain. Assume that  $f_i$  is the direct share ownership held by the controlling shareholder's and *related parties* in firm  $i$ . Thus, cash flow rights in firm  $i$  can be computed by equation (2):

$$cfr_i = d_i + f_i + \sum_{j=1}^n s_{ij} (d_j + f_j) + \sum_{j=1}^n s_{ij} \sum_{k=1}^n s_{jk} (d_k + f_k) + \dots$$

(2)

The first two terms are direct ownership levels of the controlling shareholder and his family members and *related parties*. The subsequent terms are the indirect ownership levels of the controlling shareholder and his family members and *related parties* through affiliated for-profit firms. To be more specific, the third term is indirect ownership in firm  $i$  through firm  $j$  ( $j$  can take values from 1 to  $n$ ). The fourth term is indirect ownership in firm  $i$  through firm  $k$  and firm  $j$  ( $k$  can also take values from 1 to  $n$ ).

In the case of the simple example in Figure.1, the cash flow rights are:  
 $5\% + 51\% \cdot 25\% \cdot 51\% + 51\% \cdot 21\% \cdot 51\% = 17\%$

### **Disparity**

Studies differ markedly about how the separation of ownership and control is presented. Some use voting rights minus cash flow rights ( $51\% - 17\% = 34\%$ ), and others use cash flow rights divided by voting rights ( $17\% / 51\% = .33$ ). Others normalise for econometric purposes, using a variable such as voting rights minus cash flow rights all divided (i.e. normalised) by voting rights ( $34\% / 51\% = .67$ ). Other studies use the concept of cash flow rights leverage which is computed as management group control rights divided by management group cash flow rights and include both pyramid and non-voting equity effects. Care is thus required in making international comparisons.

The most intuitive measures of separation are:

- control leverage, which expresses the units of capital controlled for each unit of cash flow rights held. Given that controlling shareholder controls all the assets of the company, it is computed as 100% divided by the cash flow rights ( $100\% / 17\% = 5.9$ , which

---

8. See Kim for further discussion on this difficult area.

means that beneficial owner X controls 5.9 units of capital of listed company Y for each unit of cash flow rights held);

- voting leverage, which expresses the voting rights controlled for each unit of cash flow rights held. It is computed as voting rights divided by the cash flow rights ( $51\% / 17\% = 3$ , which means that beneficial owner X controls 3 voting rights of listed company Y for each unit of cash flow rights held).

An aggregate figure can be calculated for an entire group weighting each company by its capitalisation or assets. For the economy, the mean and median indicators can be derived either weighted by market capitalisation or un-weighted.

**Table 1**  
**Capital Structure of Listed Companies**

Company	Class of Shares			
	Ordinary	Preference	Multiple voting	Non Voting
A	100			
B	50	50		
C	50		50	
D	100			
E	50			50
F	10	90		
G	100			
H	50	30		20
I	50		50	
L	100			

Figure 1.

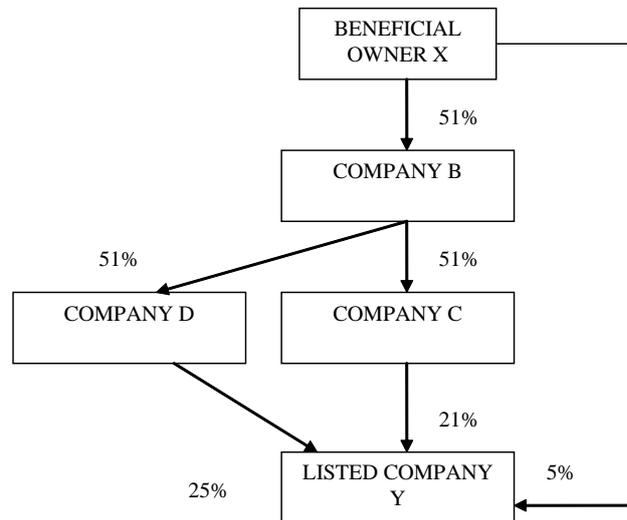
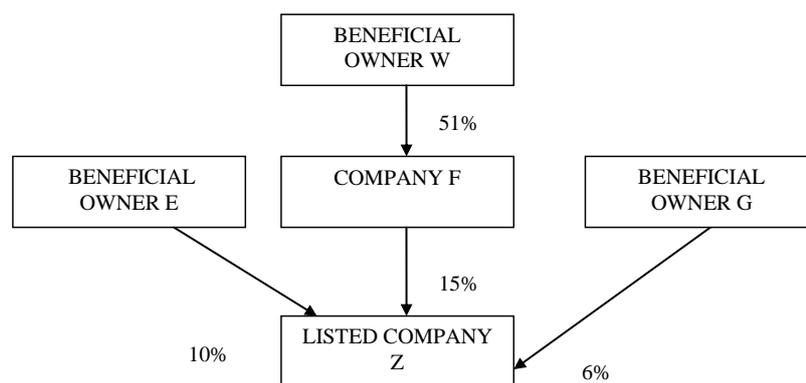


Figure 2.



OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16

PRINTED IN FRANCE

2007