SONEAN
Connecting The Nodes

SONEAN GmbH | Bleichstrasse 5 | 61476 Kronberg im Taunus | Germany

Telephone +49 (0) 6173 70 27 65-5
Fax +49 (0) 6173 70 27 65-9
Mail info@sonean.com
Internet www.sonean.com

OECD
dafca.contact@oecd.org

cc Alissa Amico
Manager, Middle East and North Africa
Corporate Affairs Division
Organisation for Economic Co-operation and Development

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Comments on the draft "Revised Principles of Corporate Governance"

Dear Madam, Dear Sir

Thanks a lot for the opportunity to comment on the latest draft regarding the "Revised Principles of Corporate Governance" by the OECD.
SONEAN is strategy consultant for the investment industry, having pioneered with its sister entity Funds@Work the systematic application of social network analysis within the sector and analyzing among others the impact of social ties on organizational outcomes.
At SONEAN we focus e.g. on the impact of existing social links between executive and non-executive directors (including independent ones) on corporate governance and company performance providing unique and complementary insights to our clients along their entire investment process.
We thus go beyond traditional financial and non-financial factors (ESG ones) and offer an embedded perspective. As every actor within the corporate ecosystem is part of a more comprehensive social network, that limits but at the same time enhances his/her abilities, we focus on prior and existing ties of corporate decision makers to better understand the drivers behind their actions and spot opportunities and risks alike.
In our recommendations on the draft, we would like to go beyond traditional factors and highlight specifically social network related points that should be included in the overall governance framework to allow for greater transparency and a better identification of related risks and opportunities. This is particularly in our mutual interest as it helps to better spot conflicts of interest, discipline market participants and promote accountability. Greater transparency will ultimately lead to less undesirable outcomes. In our recommendations we draw on the results of a two year, very extensive, analysis of the largest European listed companies and their > 1200 executive and non-executive directors running those institutions (plus employee representatives on the board).

Our views should be seen as vital complementary components to bring greater transparency and thus contribute to a more stable system as traditional governance researchers, have very much neglected the social network element, in their recommendations.

Our latest review of the largest listed 50 European companies (by market capitalization) e.g. shows that in almost one third of the cases there are either prior or existing ties (through university, prior mutual jobs or other institutional ties) among the so called "independent directors" and executive management. This shows that from a social network perspective these independent directors cannot be regarded as independent. Existing and prior academic and professional ties e.g. should be incorporated in the definition of "independence" and transparently communicated. It is therefore not just enough to communicate existing board memberships when joining a new board but more importantly to declare who gave the impetus for joining the board and whether the new director joining has existing ties with either the executive or non-executive board members. This increased transparency will be vital to judge true independence and the objectivity of the hiring process for institutional investors (asset managers, asset owners) but shareholders in general alike.

In the following, we would like to comment on the individual paragraphs and draw your attention to the relevance of social network related aspects being considered in the corporate governance principles:

In II. A. 3. you highlight the importance of obtaining relevant and material information on the corporation on a timely and regular basis. This has to also incorporate social network related data on existing and prior ties between non-executive directors, and specifically independent ones, and executive management as these ties might potentially undermine the independence and objectivity and consequently the control function of directors joining the board. Thus greater transparency will be important for investors and shareholders alike to spot potential dependencies. This information should also be made available in a standardized way on company`s websites for interested third parties. The practice to communicate existing board memberships should thus be extended by also including prior ties.

While certain companies e.g. go the extra mile in portraying CV data about their board members in a systematic and chronological order, highlighting at the same time prior and existing jobs, ties to industry associations, universities and the like, others on the other hand withhold very relevant data about their members of their executive management and board of directors on their websites. A standardization of data disclosure of board members and their prior as well as existing functions will allow shareholders and stakeholders alike to see interdependencies between board members better and understand how members are tied to each other. We would be pleased to provide you with recommendations when it comes to this standardization. The latest reshuffle of a major German bank's board of directors is a very good example of a company driven by a strong tie network of people strongly connected to each other through either academic, professional and friendship ties at the non-executive board level, giving the Chairman considerable power to drive outcomes. You also highlight in the latest draft that without

SONEAN GmbH
Bleichstrasse 5
61476 Kronberg im Taunus
Germany

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Fax +49 (0) 6173 70 27 65-9
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Internet www.sonean.com

appropriate checks and balances there is room for abuse and in line with our argument greater network transparency will help to reduce this clearly. We are not arguing that prior ties are per se negative, we just want to highlight that this additional transparency will have clear effects on executive as well as non-executive board members` actions and discipline them accordingly.

II. 22. states that shareholders should be able to participate in the nomination of board members and vote on individual nominees or on different lists on them. Furthermore independent board members should have a key role in nomination committees. Understanding how new nominees are socially connected to existing executive and non-executive directors can help in this process greatly and allow shareholders to see the bigger picture. Being independent from a social network perspective furthermore, i.e. not being historically tied as an independent director to executive directors, can increase the objectivity of the selection process and even have clear impact on remuneration. The example of a major Swiss bank`s CEO hiring a new executive board member (based on prior ties) with a double digit million USD welcome bonus is certainly an outcome of such interconnectedness. Social network related heterogeneity which comes through hiring people that are not already tied to existing board members can be beneficial both for remuneration and company performance. Transparency over existing ties furthermore will discipline board members to be better aligned with shareholders` interests.

In II. 34. you refer to the potential abuse of related party transactions which was clearly addressed recently in a letter by a Danish pension fund to a company and its CEO asking for insights into the dealings of the company with an advertising agency owned by the son of the CEO. These related party transactions (which we define broader than just having a stake in the respective company) should also incorporate existing and prior social ties from a network perspective as empirical research shows that being connected can affect even merger & acquisition (M&A) activities of companies. Most M&A transactions are actually carried out by connected parties (buyer and seller being historically tied to each other through mutual education or prior jobs). These prior ties can impact the due diligence, the price (valuation) as well as the commitments given to the selling party and its board members, at the expense of shareholders. It should be transparently laid out (in transactions) where there are existing ties between parties, as greater transparency will help to achieve more realistic market prices. Latest research even shows that a group of connected and alike people can actually impact market prices in a negative manner at the expense of the greater community and drive assets significantly beyond their fair value. In this paragraph the emphasis is again on the independent director who, based on prior ties with existing executives or non-executives (who themselves are tied to executive directors), could potentially act in the interests of management rather than shareholders. For shareholders to know these existing ties will help to identify interests, ask the right questions and as highlighted earlier discipline directors to act in the best interest of shareholders.

II. 36. foresees members of the board and key executives to inform the board where they have a business, family or other special relationship outside of the company that could affect their judgement. As highlighted earlier this should be extended to include prior or existing ties (e.g. academic,

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professional or other institutional ones) among board members and executive management too as these might have a particular impact on the overall governance structure.

In III. D. you rightly highlight the role of analysts, brokers, rating agencies, and others that provide analysis or advice relevant to decisions by investors to disclose and minimize conflicts of interests that might compromise the integrity of their analysis and advice. Here it should be made transparent whether the people behind those entities giving advice are historically tied to companies and their management which they cover. Empirical research shows that better connected fund managers who are linked to corporate executives (through mutual education) e.g. can enjoy substantial outperformance (based on US S&P 500 data) and there is lots of anecdotal evidence of ties between investment banks and corporates (but also startup companies) which investors are not aware of but which can potentially affect valuations of stocks. The latest case of an investment bank representative in Germany who left the bank to join a startup incubator which was then analyzed and valued by the same investment bank with an almost 2-3 times higher target price is an example of that. Knowing that the same investment bank also had business ties to the shareholders of the incubator are all network related insights which should be made transparent so that investors can better judge the role of social ties in the valuation process.

In III. 59. you underline the importance of stock markets to provide equal, timely and cost effective access to market information as essential for effective governance. This from our perspective can only function if the stock markets also determine a minimum standard for information about executive and non-executive directors and their prior ties (as stated earlier) and make the data available in a standardized way. Focusing on financial data alone will no longer be sufficient to understand the complexity of relationships in which actors are embedded. Stock markets can play a special role in driving greater transparency by ensuring that listed companies and new board members joining communicate their social and prior ties with existing board members and the executive management as well as the impetus behind their application (e.g. were they asked by the company`s current CEO or executive board members to join the board? Where did the initiative come from?).

As you correctly point out in V. 71. a strong disclosure regime can help to attract capital and maintain confidence in the capital markets therefore it is crucial to go beyond mere financial data to also include social network related data about the people involved in running the company and their supervisory boards (or the board) to better spot conflicts of interests that might affect not just the hiring process itself (selecting people on the basis of prior ties) but also control functions, remuneration etc. As you also correctly point out insufficient or unclear information may hamper the ability of the markets to function, increase the cost of capital and result in poor allocation of resources.

In V. 74. you mention that failure of governance can often be linked to the failure to disclose the "whole picture". The whole picture cannot be actually formed without the consideration of social ties between executive and non-executive directors and their connections to organizations outside the company. In order to form a "whole picture" it is essential to go beyond the current recommendations and include

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social network relates aspects, as a relevant jigsaw in the puzzle would otherwise be missing. Understanding in which social networks people are embedded will help in getting closer "to the whole picture" and complement existing information. Shareholders and stakeholders thus should not look at companies in isolation but from a connected perspective which allows them to understand in which networks the actors are embedded and how it can potentially affect governance, decisions as well as performance of the company.

In V.2. you highlight the importance of non-financial information. It should be clear that social network (ties) related transparency will help decision makers to better judge financial and non-financial factors but more importantly look at the organization from an embedded perspective. Creating transparency around those ties and pro-actively asking new board members to declare existing ties to executive and non-executive board members will be of crucial assistance.

In V. 4. Remuneration policy, one should consider again the importance of connectedness on remuneration. Shareholders should be aware of how the potential new board member is tied to existing ones (through prior academic or professional work having studied or worked together) and how it can potentially affect remuneration. Empirical research shows that connected people generally get considerably higher salaries and as mentioned earlier there is substantial anecdotal evidence of bonus, welcome payments to new recruits as mentioned earlier in the case of a major Swiss bank. Knowing existing ties will allow shareholders to better react and engage with the companies in which they invest and ensure that selection, as highlighted in V. 5, is more objective and in the company`s best interest.

V.81. states that investors require information on individual board members and key executives in order to evaluate their experience and qualifications. Furthermore however shareholders need standardized data about prior and existing ties that bind potential new hires to existing executive and non-executive board members to truly determine their independence. If new hires, no matter whether they are men or women, are strongly tied to existing board members, it will not add much to network heterogeneity in the company which is crucial for innovation and performance. This actually also affects the current discussion about women in boards as women without prior ties to existing board members, who objectively seen might be more suitable and add greater network diversity, have difficulties to join boards due to their lack of ties. Many of the women joining today are historically connected to other board members through prior academic or professional ties and thus enjoy a clear relative advantage in the selection process.

In V. 82. the definition of "independence" should clearly be framed to also include social network related independence as otherwise one cannot truly claim to be independent. As mentioned earlier, where independent directors have prior ties to executive directors they cannot be claimed independent as existing ties might potentially undermine their independence.

In V.7. you envision the disclosure of sufficient and comprehensive information to fully inform investors

Sitz der Gesellschaft:
Kronberg im Taunus
Amtsgericht Königstein:
HRB-Nr. 8413

Geschäftsführer:
Dr. Murat Ünal

SONEAN GmbH
Bleichstrasse 5
61476 Kronberg im Taunus
Germany

Telephone +49 (0) 6173 70 27 65-5
Fax +49 (0) 6173 70 27 65-9
Mail info@sonean.com
Internet www.sonean.com

of material and foreseeable risks. The inclusion of social network related data will definitely allow investors to better spot or anticipate such risks as well as opportunities and thus underlines again the inclusion.

In V.97. you highlight the practice that external auditors are recommended by an independent audit committee of the board or an equivalent body. Here, it is crucial to check whether members of the committee hold prior ties to external auditing companies based on mutual academic, professional or other related links. A transparent disclosure will allow to better judge whether there are potential conflicts of interests arising due to such prior ties and ensure that such members abstain from voting. *As highlighted before and stated in V. 98. company websites provide the opportunity for improving information dissemination.* Hereby it is crucial though to define a common disclosure standard when it comes to executive and non-executive members detailed CVs (including existing board memberships) and furthermore highlight prior social ties that link them to executive and non-executive directors. This added transparency will be of great value and we would be pleased to recommend specific formats.

As communicated in VI. 101. the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest. Being independent from a social network perspective can greatly enhance this responsibility while being strongly connected can diminish control functions and have impact on innovativeness and/or performance. The board has a duty to act in the company's and its shareholders` best interests, a point that can be truly achieved by ensuring social network related independence.

In VI. E. you mention that board independence usually requires that a sufficient number of board members will need to be independent of management and should again consider that independence includes social network related independence where board members clearly declare prior or existing ties with the management which can potentially undermine their independence. As long as you don`t include this we will have a situation where almost a third of current independent directors (117) among the top 50 largest European companies (or even more if full network data was available) e.g. will have existing or prior ties linking them to the management. This cannot be seen as true independence and might affect these people`s roles in all kinds of committees. This is especially true since you highlight the role of "independent directors" providing additional assurance to market participants and that their interests are safeguarded. Independence thus needs to be clearly defined, including social network related independence and not left to the discretion of companies to define what independence is.

In VI. 130. you raise the importance of voluntary targets, disclosure requirements and private initiatives that enhance greater gender diversity on boards.
Unfortunately hiring women might not necessarily add diversity to the board as they might be extensions (social ties) of the existing male and female board member networks and thus don`t add much heterogeneity. We strongly encourage more women on boards, specifically executive boards, and non-executive ones but also realize that those without existing ties may be disadvantaged. Furthermore

we also see that the quota is mainly pushed by women who come in through co-determination (employee representatives) which should be seen different from women joining the non-executive board. Typically employee representatives on boards are relatively less well trained and less international than non-executive board members. This is not per se negative but should be clearly taken into consideration. This is also reflected in our data.

In VI. G. where you highlight employee representation on board and mechanisms you should clearly bear in mind that based on our data again, average duration of employee representatives in the largest European companies reaches almost 10 years with some people occupying their positions for up to 20 years. Here rotation or staggered boards should be implemented to ensure greater diversity when it comes to employee representatives. Long durations might affect their judgements and their distance from the executive management and also avoid greater diversity and access of other employees to the board. This is particularly visible in countries such as Germany.

We hope that these insights will show you the importance of going beyond the established rules and clearly incorporate information about social network related data (prior and existing academic, professional and institutional ties that people hold). The latest governance rules by the OECD should consider the importance of social ties in the corporate decision making process and its impact on governance and thus lay the basis for principles which will be prepared to meet the challenges of the years to come. **Without social network and ties related insights investors and shareholders alike will be missing a very important perspective and it will not allow them to see the “whole” picture as you rightly propagate**. We will also share our views with the public in January and make our feedback available to you now hoping that the OECD will be farsighted enough to incorporate the people`s factor as men and women in organizations embody their companies and thus organizations cannot be seen separate from the people running them. These prior ties provide social capital and shareholders should be aware of them as they have shown to also negatively affect outcomes and potentially create conflicts. Again, the mere disclosure of those ties in a standardized way would be a great step forward providing institutional investors and of course shareholders in general a more comprehensive tool set to make better decisions.

Thanks a lot for your farsightedness

Dr Murat Ünal M.B.A LL.M.
Chief Executive SONEAN *

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