Public Consultation on Draft Revisions to the G20/OECD Principles of Corporate Governance

Responses to draft in public consultation by

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October 19, 2022

Preliminary considerations

We consider very useful that this review of CG Principles is based on a large spectrum of issues papers and background documents and on the empirical findings emerging from OECD CG Factbook 2021.
However, in our opinion, this choice, while gives a robust foundation on recent international research and widespread practices from OECD countries, **could limit the crucial role of these Principles**:

1. to be forward-looking: current empirical findings could make these Principles contingent and prone to specific objectives (important today but not necessarily in the future) or to theoretical perspectives, with the consequence to forget their higher core-purpose. For example, the following principle: *I.A. The corporate governance framework should be developed with a view to its impact on corporate access to finance, overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and well-functioning markets* (p.11) seems to be related to the Factbook 2021 empirical findings about the global trends in stock markets and listed company and decreasing IPO trends (see §§ 1.2 and 1.3). However, in our opinion, corporate governance must not be intended to serve financial markets or financial intermediaries, and these CG Principles shouldn't support the storytelling (not univocal in literature) that some corporate financing channels are better than others. In addition, many corporate failures teach us that the supposed matching principle-adoption = more investors/funds cannot be a correct incentive;
2. to trigger potential more virtuous behaviors in terms of CG practices, both from operators and regulators/supervisory authorities. The best practices of CG currently applied might not represent the reachable "potential best", that these Principles should try to identify and stimulate to address. In many points of this review, the best CG practices among those adopted in the analyzed countries are considered by default as the benchmark to be achieved, also when many improvements or changing perspectives could be proposed.

Focus of these comments/suggestions

In consideration of the large spectrum of corporate governance topics discussed in the OECD Principles, we limit our analysis and consequent critical contribution to the following topics:

1. Conflicts of interests
2. Independence of board members, in general and with particular attention to related-party transactions (hereinafter RPTs)
3. Effectiveness of comply-or-explain framework.

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Our contribution is based both on our scientific/research activity as scholars in CG field[1] and our practical expertise as board members and/or consultants.

1. <u>Conflicts of interests</u>

The term conflicts of interest often appear in *"Principles of Corporate Governance"* established by the OECD in 2015. In particular, the issue is addressed with reference to:

1) the importance of corporate governance to limit the damaging impacts of conflict of interests[2];
2) the impact on markets by systemic conflicts of interest[3];
3) the authority, integrity, and resources that supervisory, regulatory and enforcement authorities should have to fulfil their duties in a professional and objective manner[4];
4) the management of conflicts of interest implicit in business relationships with related parties[5];
5) the fiduciary activities carried out by Institutional Investors[6];
6) producers of data and information relevant to investor decisions[7];

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1 See, for example, our recent publication on conflicts of interest and CG practices: *Conflitti di interessi e finanza - Come individuarli e prevenirli*, McGraw Hill, 2021

2 OECD, Principles of Corporate Governance, p. 15: "If these conditions are met, the corporate governance framework is more likely to avoid over-regulation, support the exercise of entrepreneurship and **limit the risks of damaging conflicts of interest** in both the private sector and in public institutions."

3 OECD, Principles of Corporate Governance, p. 14. "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, for example in terms of incentive structures, the efficiency of self-regulatory systems and dealing with **systemic conflicts of interest**."

4 OECD, Principles of Corporate Governance, p. 16: "Supervisory, regulatory and enforcement responsibilities should be vested with bodies that are operationally independent and accountable in the exercise of their functions and powers, have adequate powers, proper resources, and the capacity to perform their functions and exercise their powers, including with respect to corporate governance. Many countries have addressed the issue of political independence of the securities supervisor through the creation of a formal governing body (a board, council, or commission) whose members are given fixed terms of appointment. If the appointments are staggered and made independent from the political calendar, they can further enhance independence. **These bodies should be able to pursue their functions without conflicts of interest** and their decisions should be subject to judicial or administrative review.

5 OECD, Principles of Corporate Governance, p. 27: "**1. Conflicts of interest inherent in related-party transactions should be addressed.** The potential abuse of related party transactions is an important policy issue in all markets, but <u>particularly in those where corporate ownership is concentrated, and corporate groups prevail.</u> Banning these transactions is normally not a solution as there is nothing wrong per se with entering into transactions with related parties, provided that the conflicts of interest inherent in those transactions are adequately addressed, including through proper monitoring and disclosure. This is all the more important where significant portions of income and/or costs arise from transactions with related parties. Jurisdictions should put in place an effective framework for clearly flagging these transactions. They include broad but precise definitions of what is understood to be a related party as well as rules to disregard some of these transactions when they are not material because they do not exceed ex ante thresholds, can be regarded as recurrent and taking place at verifiable market terms or taking place with subsidiaries where no specific interest of a related party is present. Once the related party transactions have been identified, jurisdictions set procedures for approving them in a manner that minimizes their negative potential. In most jurisdictions, great emphasis is placed on Board approval, often with a prominent role for independent Board members, or a requirement for the Board to justify the interest of the transaction for the company. Shareholders may also be given a say in approving certain transactions, with interested shareholders excluded."

6 OECD, Principles of Corporate Governance, punto C, p. 33: "C. **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 incentives for intermediary owners to vote their shares and exercise key ownership functions may, under certain circumstances, differ from those of direct owners. Such differences may sometimes be commercially sound but may also arise from conflicts of interest which are particularly acute when the fiduciary institution is a subsidiary or an affiliate of another financial institution, and especially an integrated financial group. When such conflicts arise from material business relationships, for example, through an agreement to manage the portfolio company's funds, such conflicts should be identified and disclosed. At the same time, institutions should disclose what actions they are taking to minimize the potentially negative impact on their ability to exercise key ownership rights. Such actions may include the separation of bonuses for fund management from those related to the acquisition of new business elsewhere in the organization. Fee structures for asset management and other intermediary services should be transparent."

7 OECD, Principles of Corporate Governance, punto D, p. 34: "D. **The corporate governance framework should require that proxy advisors, analysts, brokers, rating agencies and others that provide analysis or advice relevant to decisions by investors, disclose and minimize conflicts of interest that might compromise the integrity of their analysis or advice.** The investment chain from

7) the need to have information relating to the beneficial owners[8] and to an in-depth knowledge of the members of the Board[9];
8) the supervisory roles of the Board[10];
9) the composition of the Committees that define the remuneration policies of the members of Board and management[11];
10) the Board's explicit supervisory duties on conflicts of interest[12];

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ultimate owners to corporations does not only involve multiple intermediary owners. It also includes a wide variety of professions that offer advice and services to intermediary owners. Proxy advisors who offer recommendations to institutional investors on how to vote and to sell services that help in the process of voting are among the most relevant from a direct corporate governance perspective. In some cases, proxy advisors also offer corporate governance related consulting services to corporations. Other service providers rate companies according to various corporate governance criteria. Analysts, brokers, and rating agencies, perform similar roles and face the same potential conflicts of interest. Considering the importance of – and sometimes dependence on – various services in corporate governance, the corporate governance framework should promote the integrity of professions such as analysts, brokers, rating agencies, and proxy advisors. When managed appropriately, these can play an important role in shaping good corporate governance practices. At the same time, conflicts of interest may arise and affect judgement, such as when the provider of advice 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. Many jurisdictions have adopted regulations or encouraged the implementation of self-regulatory codes designed to mitigate such conflicts of interest or other risks related to integrity and have provided for private and/or public monitoring arrangements. Providers of proxy advisory services should, where appropriate in each context, disclose publicly and/or to investor clients the process and methodology that underpin their recommendations, and the criteria for their voting policies relevant for their clients."

8 OECD, Principles of Corporate Governance, p. 43: "Particularly for enforcement purposes, and to identify potential conflicts of interest, related party transactions and insider trading, information about record ownership needs to be complemented with current information about beneficial ownership. 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. In addition, the OECD template Options for Obtaining Beneficial Ownership and Control Information and the Financial Action Task Force's Guidance on Transparency and Beneficial Ownership can be useful in this regard."

9 OECD, Principles of Corporate Governance, p. 44: "5. **Information about Board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the Board. Investors require information on individual Board members and key executives in order to evaluate their experience and qualifications and assess any potential conflicts of interest that might affect their judgement.** For Board members, the information should include their qualifications, share ownership in the company, membership of other Boards, other executive positions, and whether they are considered by the Board to be an independent member. It is important to disclose membership of other Boards not only because it is an indication of experience and possible time pressures facing a member of the Board, but also because it may reveal potential conflicts of interest and makes transparent the degree to which there are inter-locking Boards. National principles, and in some cases laws, lay down specific duties for Board members who can be regarded as independent and recommend that a significant part, in some instances a majority, of the Board should be independent. It should be incumbent on the Board to set out the reasons why a member of the Board can be considered independent. It is then up to the shareholders, and ultimately the market, to determine if those reasons are justified. Several countries have concluded that companies should disclose the selection process and especially whether it was open to a broad field of candidates. 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."

10 OECD, Principles of Corporate Governance, p. 51: "Together with guiding corporate strategy, the Board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, **while preventing conflicts of interest** and balancing competing demands on the corporation. In order for Boards to effectively fulfil their responsibilities they must be able to exercise objective and independent judgement."

11 OECD, Principles of Corporate Governance, p. 54: "In large companies, it is considered good practice that remuneration policy and 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 and excluding executives that serve on each other's remuneration committees, which could lead to conflicts of interest. The introduction of malus and claw-back provisions is considered good practice. They grant the company the right to withhold and recover compensation from executives in cases of managerial fraud and other circumstances, for example when the company is required to restate its financial statements due to material noncompliance with financial reporting requirements."

12 OECD, Principles of Corporate Governance, punto 6, p. 55: "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.** It is an important function of the Board to oversee the internal control systems covering financial reporting and the use of corporate assets and to guard against abusive related party transactions. These functions are often assigned to the internal auditor which 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, it is important for the Board to encourage the reporting of unethical/unlawful behavior 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

11) the independence of judgment required to the members of the Board[13];
12) the presence of independent directors to whom assign certain tasks[14];
13) the presence of employee representatives in the Board[15].

The current version of the Principles established by the OECD have underpinned and supported the supervision of conflicts of interest in a very widespread way by highlighting, without any doubt, that their management is one of the main problems that governance must be able to address and resolve in the interest of all stakeholders of an organization.

The revised version of the Principles:

- does not explicit a definition of conflict of interest and, in particular, does not consider the importance to detail all sub-topics connected to the principal issue – conflicts of interests, conflicts of duties, corporate opportunities, multiple directorships, competing directorships, nominee directorships, and unauthorized profits – leaving room for practices that could destroy value for Investors;
- does not explicit yet – and it would easily complete the (absent) definition and the (absent) requirements of "duty of loyalty" as stated in paragraph V.A. (p. 36), as well as inserted in paragraph V.D.7 - the fiduciary role of each member of the board of directors, which should serve "*… in good faith in the interests of the company. Directors should be wary of (and, in appropriate circumstances, disclose) any factor - whether self-interest or the interests of a third party or stakeholder - which inhibits them in a not insignificant way from considering, and then acting, in good faith in what they consider to be the best interests of the company. Directors' fiduciary mandate is to act in what they consider to be the best interests of the company and it is this core mandate (…).*[16]"
- does not modify point 1 but has stressed the importance of Institutional Investor. It would then be useful to explicate their fundamental role in also addressing the analysis of potential, damaging, conflict of interests;

individuals concerned. A contact point for employees who wish to report concerns about unethical or illegal behavior that might also compromise the integrity of financial statements should be offered by the audit committee or by an ethics committee or equivalent body."

13 OECD, Principles of Corporate Governance, punto E, p..56: "E. **The Board should be able to exercise objective independent judgement on corporate affairs.** In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the corporation, it is essential that the Board is able to exercise objective judgement. In the first instance this will mean independence and objectivity with respect to management with important implications for the composition and structure of the Board. Board independence in these circumstances usually requires that a sufficient number of Board members will need to be independent of management."

14 OECD, Principles of Corporate Governance, punto 1, p. 58: "1. **Boards should consider assigning a sufficient number of nonexecutive 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. While the responsibility for financial reporting, remuneration and nomination are frequently with the Board as a whole, independent non-executive Board members can provide additional assurance to market participants that their interests are safeguarded. The Board should consider establishing specific committees to consider questions where there is a potential for conflict of interest. These committees should require a minimum number or be composed entirely of non-executive members. In some countries, shareholders have direct responsibility for nominating and electing non-executive directors to specialized functions."

15 OECD, Principles of Corporate Governance, punto G, p. 61: "G. When employee representation on the Board is mandated, mechanisms should be developed to facilitate access to information and training for employee representatives, so that this representation is exercised effectively and best contributes to the enhancement of Board skills, information, and independence. When employee representation on Boards is mandated by the law or collective agreements, or adopted voluntarily, it should be applied in a way that maximizes its contribution to the Board's independence, competence, and information. Employee representatives should have the same duties and responsibilities as all other Board members and should act in the best interest of the company. Procedures should be established to facilitate access to information, training and expertise, and the independence of employee Board members from the CEO and management. These procedures should also include adequate, transparent appointment procedures, rights to report to employees on a regular basis – provided that Board confidentiality requirements are duly respected – training, and clear procedures for managing conflicts of interest. A positive contribution to the Board's work will also require acceptance and constructive collaboration by other members of the Board as well as by management.

16 Definition by Rosemary Teele Langford, *Company Directors' Duties and Conflicts of Interest*, Oxford Press, 2019.

- does not modify point 2; however, since "corporate access to finance" has been included, it would be then necessary to consider not only "systemic conflicts of interests" in general, but also specific systemic conflicts of interests concerning finance, as IOSCO has recently done[17] (since IOSCO has been cited in other parts of the Principles of Corporate Governance);
- strongly modifies point n. 3, and it's really well done!
- strongly modifies point n. 4 (well done, too), but it should be considered that in many cases the material threshold – or, as stated in Chapter IV and in paragraph IV. A. 7., the "materiality" of an information – would not be enough to protect the organization, not only when multiple related party transactions are fragmented (that should not be permitted, as stated in paragraph IV. A. 7.) but also when the effective market price applied to those transactions would be different from those initially defined (e.g., operations involving financial instruments) or from the evolution of markets prices (e.g., supply chain of energy from a related party), determining a reduction of profits and free cash flows;
- does not modify point 5, but it should be considered that Institutional Investors could have multiple and connected conflicts of interests, related to the composition of their portfolios. It means that it is not enough to consider the single conflict of interest related to any single investment, but that supervisor should have the power to investigate if any transaction has been performed by the Institutional Investors not on behalf of their fiduciary mandate and to contribute to market integrity but, on the contrary, on a premeditated strategy to use their placing power to directly influence the performance (revenues, managers or partnerships) of two or more organizations only indirectly related;
- modifies point 6, and it's well done (but please, consider what has been proposed in the previous section, that means to be as severe on conflict of interest with Institutional Investor as Principles are with all other "regulated entities");
- does not modify point 7, but it should be useful: *i)* to specify the conditions to permit a shareholder to access data and information (stored in centralized company register) which regard beneficial owners; *ii)* to extend the approach beyond disclosure of conflict of interests of board members, that, as known, is not enough to discourage anti-competitive practices in a Board[18];
- point 8 has not been changed (but board member would find useful to find in the Principles some suggestions on how to "prevent conflict of interests", something very different from disclosure or from comply-or-explain);
- point 9 has not been changed (but the reference to conflict of interests here seems so obviously that it could seem irrelevant);
- point 10 has not been changed, but paragraph V.D.7. – the most important from the perspective of conflicts of interests – should be extended if organization would protect their performance from conflict of interests and misuse of corporate assets. The introduction of a whistleblowing policy is not enough. The analysis, management, and alignment of conflict of interests should become an ordinary duty for the board of directors and a cognitive approach would be mandatory, beyond code of ethics, policy of related party operations and whistleblowing policies;
- also point 11 would benefit from the presence of suggestions on what it means to prevent conflict of interest (as done in the previous point 8);
- point 12 has not been changed, and it's ok;
- point 13 has not been changed but, in consideration of the mounting pressure of ESG standards, it would be useful to introduce a definition of what kind of conflicts of interests should be particularly observed when employee representatives are present in the board.

We also noted that in the new version of Principles has been added an item related to the protection of board members (V.A.1.), that makes explicit the great importance of the absence of any conflict of interest. Due to

[17] IOSCO, 2018, "Conflicts of interest and associated conduct risks during the equity capital raising process", FR16/2018 and IOSCO, 2020, "Conflicts of interest and associated conduct risks during the debt capital raising process", Final Report, FR08/2020.

[18] G. Loewenstein, Cass R. Sunstein, R. Golman, 2014, "Disclosure; Psychology Changes Everything", Annual Review of Economics, 2014, 6:391-419.

the importance of that proof in any kind of litigation, and more generally for the reputation of the company, it would be then useful to insert in the Principles, as suggested before, a comprehensive definition of conflict of interests.

2. Independence of board members and RPTs

The independence of board members is very important, and we appreciate the relevance that this Principles review assigns to this aspect. However, we note that the focus is mainly **on the formal requirements** (in positive or negative form) to define "independent" a board member.

In this area, we consider very appropriate to point out (as in II.C.5) the importance of complete and transparent information to shareholders about the adopted independence criteria. In our experience, corporate reports on CG often do not explicate these criteria ex-ante, but they refer in a general and vogue manner to the country CG code requirements. We think that this recall to the transparency on this point towards shareholders **can promote an ex-ante statement of these criteria by the companies.**

However, in our opinion OECD Principles should also consider and point out the concept of "independence of mind" (see EBA-ESMA Guidelines, 2017 [19]), which means "*…having the courage, conviction and strength to effectively assess and challenge the proposed decisions of other members...to ask questions…to resist group-think*".

The assessment of the independence of mind of board members cannot refer to "hard criteria" but needs an **in-depth analysis of the "actual behaviors"**, in terms of: *i)* board member's actual activism/effectiveness in monitoring/assessing the proposed decisions of leading members of the management body; *ii)* strength/consistency/continuity/qualification of his/her argumentations against the group-think; *iii)* active and critical contribution to the decision making or monitoring process.
How to verify these criteria is not a simple task; however, transparency and information to shareholders about this kind of independence should be required, at least in some events, as for example when the independent member is firstly appointed or during the periodical board suitability self-review. Direct channels could be activated (and therefore suggested by OECD Principles) with shareholders and supervisory authorities, as for example publication of some board meeting minutes (those where strategic issues are discussed), periodical interviews to independent members (or their representatives, as for example LIDs) by shareholders or supervisory institutions, etc... Establishing/suggesting these channels of information provision could trigger (when it is recognized as a "modus operandi" of the competent authorities) better practices from members of management/supervisory boards.

As for as the RPT procedure is concerned (Principle IV.A.7), the independence of members of both board and RPT committee assumes a critical relevance. We appreciated **the change of term** from **non-independent** to **non-interested** in Principle II.F.1. In Italy, some listed companies confuse these terms (probably, since the CG code doesn't point out the difference) and allow their RPT committee to be composed and even chaired by members defined independent (moreover, as result of a misleading application of term "significant shareholder") but closely connected to shareholders who are related parties in some transactions.

Moreover, what means "significant" or "substantial" shareholders should be better defined. **OECD Principles should provide strict guidelines in this area** (to supervisory authorities and their CG codes): Principle V.E. reports that minimum thresholds are common, but it should be considered that they are not obliged and vague definitions of the term (as for example in Italian CG code) allow companies to fix rules and procedures that substantially violate the principle of an unbiased decision-making process, free from conflicts of interests.

[19] Joint EBA-ESMA Guidelines on the assessment of the suitability of members of the management body and key function holders, 2017

As regards the Principle V.F. *In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information*, it is known that timely information, which also means the statement of minimum terms in an ex-ante and tight/cogent manner, is one of the code principles less complied by the Italian companies (as Consob reports every year) and the explanations of non-compliance to this principle the most concealed/weasel ones: probably, less vague principles on this point could favor more virtuous behaviors by operators.

3. Effectiveness of the comply-or-explain approach

In many parts of the draft the comply-or-explain approach is discussed and considered valid (for example in Principle IV.A.9). However, in our opinion/experience, the compliance to the CG Code by companies often seems to be (at least in some areas) more formal than substantial/effective, producing a sort of *box-ticking* behaviors in CG Code compliance and, therefore, *box-checking* related behaviors by supervisory institutions (in particular, to CG Code requirements more easily applicable/verifiable).

In this scenario, OECD Principles should/could:

- **stress this critical point** and highlight the related risks;
- suggest **the ways to verify the "effective compliance" toward the "formal compliance"** (see for example the "actual behaviors" cited above about the independence requirements);
- **highlight the importance to analyze the quality of explanations** (for example by using content analysis programs) in cases of non-compliance to CG codes. Some international studies (for example, Shrives-Brennan, 2017)[20] produce taxonomies of rhetorical strategies of non-compliance observed in various samples and analyze their opacity-transparency level (in a continuum). The underlying rationale is that the **explanation analysis** could be a **better way to assess the effective quality of CG** rather than checking the formal compliance (that is the most used approach by the usual excellence indexes, as for example the European House Ambrosetti *EG index*). This analysis could identify recurrent explanation formulas, connect them to the more frequently non-complied code principles, classify them in a comprehensive taxonomy of rhetorical strategies, assess their opacity level, identify mimic behaviors, and so on;
- ask for the various country CG codes **to specify not only the means but also the ends**, in particular for sets of principles more focused on the process framework (formal requirements to comply to: for example, percentages of independent/female members, number/type of internal board committees, etc.) and therefore orienting companies to a procedural application and supervisory authorities/regulators to a procedural assessment. It is not a simple task, but if companies are requested or stimulated to define, measure, and monitor over time the virtuous impacts of their compliance to these principles in terms of performance, decision-making quality, risk decrease, etc., it is likely that a less formal and more effective application of them could be favored.

[20] Shrives P.J., Brennan N.M., 2017, Explanations for corporate governance non-compliance: A rhetorical analysis, *Critical Perspectives on Accounting*, 49, pp. 31-56