Commentary on the OECD Principles of Corporate Governance
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Overview

The authors have written the following commentary on the 2014 Review of the OECD Principles of Corporate Governance (the “Draft Principles”) to contribute to the ongoing discussion about the role of corporate governance in promoting healthy, innovative and sustainable companies over the long-term. The commentary analyses the strengths and shortcomings of the current approach to corporate governance set out in the Draft Principles and recommends a number of amendments.

Shareholder Primacy

Many of the changes we propose are intended to remedy the repeated references to shareholders as owners of public companies; it appears that the Draft Principles’ almost exclusive focus on the role of shareholders is based on the incorrect belief that shareholders own corporations. This assumption is reflected in the frequent mention of shareholders as 'owners', for example at ¶3 and ¶13. In law, corporations are legal persons or entities, which means they have an independent personality and cannot be owned by anyone. Shareholders own their own shares, which give them certain organisational, control and economic rights in relation to the company. This means the shareholders’ relationship with the company is analogous to the relationship between the company and other stakeholders, including employees, creditors and bondholders.

Another pervasive myth is that directors are the agents of shareholders; this is not true under the company law of any jurisdiction (see The Modern Corporation 2014; Sjåfjell et al 2015). Directors have a duty to act in the best interests of the company. While shareholders should and normally will benefit from a company's success, directors do not as a matter of law owe a duty directly to shareholders. The Draft Principles recognize this distinction at ¶132, although earlier at ¶41 and ¶102 they incorrectly refer to an obligation towards both the company and shareholders on equal terms.

Beyond ownership, a common argument is that shareholders should be prioritized because they are the only residual claimant. This is not the case. Legal scholar Margaret Blair (1995) has established that employees who make investments in firm-specific human capital are also residual claimants. Furthermore, many stakeholder groups are dependent upon, or affected by, company decisions either because their contracts are incomplete (Becht et al 2005, p. 9) or because they are not in a contractual relationship with the corporation at all, and so have no opportunity to protect their interests. The Draft Principles should therefore state clearly that shareholders exercise certain rights of participation and control without holding property rights.

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1This commentary was written by Paige Morrow (Head of Brussels Operations, Frank Bold) and Professor Andrew Johnston (Professor of Company Law and Corporate Governance at the School of Law, University of Sheffield), with significant assistance from Professor Beate Sjåfjell (Professor in the Department of Law, University of Oslo and Head of the Sustainable Companies Project), Dr Jeroen Veldman (Senior Research Fellow at Cass Business School, City University London) and Filip Gregor (Head of Responsible Companies, Frank Bold).

2The recommended changes are underlined and followed by an explanation of the rationale behind the proposed wording, where clarification is needed.
because that is the position under every legal system.

**Stakeholder Participation**

There is increasing evidence that 'good' corporate governance as it is understood by the Principles, for example the separation of the roles of the Chair and the CEO, will not on its own achieve the objectives of long-term firm performance and sustainability (Thomsen 2006, pp. 846-51). As a complement to the existing provisions of the OECD Principles, the authors suggest that the important role of stakeholders other than shareholders in corporate governance should be emphasised. To this end, the authors suggest that the Draft Principles be revised to encourage companies to engage with stakeholders voluntarily where this is not required by law.

I. Ensuring the basis for an effective corporate governance framework

**Recommended change to the heading preceding ¶1:** The corporate governance framework should promote the responsible and efficient allocation of resources, as well as transparent, efficient and fair markets. It should be consistent with the rule of law and ensure effective supervision and enforcement, with the aim of aligning the interests of individuals, corporations, and society.

**Comment:** The Draft Principles appear to have adopted a shareholder primacy oriented model of corporate governance that focuses exclusively on market performance. The authors support a more holistic understanding of corporate governance that recognizes the broader economic and social context in which companies operate.

Sir Adrian Cadbury, chair of the Cadbury Committee in the UK, provided a more fulsome definition: “Corporate governance is defined as holding the balance between economic and social goals and also between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interest of individuals, corporations, and society. The incentive to corporations is to achieve the corporate aims and to attract investment. The incentive for states is to strengthen their economies and discourage fraud and mismanagement.” Similar understandings of the role of corporate governance have been put forward by others, including Charles Handy (2002).

The broader definition of corporate governance continues to recognize the important role of shareholders while placing them in equilibrium with the long-term interests of the company itself and society as a whole.

**Comment on ¶1:** [...] The legislative and regulatory elements of the corporate governance framework can usefully be complemented by soft law elements based on the “comply or explain” principle such as corporate governance codes in order to allow for flexibility and address specificities of individual companies. [...]  

**Comment:** It is positive that the Principles note that self-regulation should be a
complement to, not a replacement of, hard law requirements. The UK experience is indicative. It has been a soft law requirement in the UK for institutional investors to publish their policy on shareholder engagement since the adoption of the 2002 Institutional Shareholders’ Committee (ISC) Principles. The obligation was endorsed by reference in the UK Corporate Governance Code in 2003, and has been a “comply or explain” requirement since the introduction of the 2009 ISC Code, which evolved into the Stewardship Code in 2010. The objective of this requirement has been to foster engagement by institutional shareholders, which are considered to have a longer-term approach to corporate governance. After more than a decade, it seems clear that this soft law requirement has been insufficient to promote long-termism in UK markets given the multiple corporate governance failures since then (see Keay 2012; Johnston and Morrow 2014; Spira and Slinn 2013).

Recommended change to the heading preceding ¶3: A. The corporate governance framework should be developed with a view to its impact on long-term, overall economic performance and sustainability, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets, cognizant of the potential for market distortions to be generated through financial engineering and share buy-backs.

Comment: The Principles take an approach exclusively focused on the role of corporations and markets in creating growth. They should reference the responsibilities of corporations to long-term prosperity and sustainability. The Principles should also reference the capital market pressure on publicly listed companies to generate short-term returns, which may lead to financial engineering and share buy-backs, and the corresponding need for a robust state response (Mayer 2013; Gamble and Kelly 2001; Lazonick 2010).

Recommended change to ¶3: […] Corporate governance frameworks should in particular take into account the size of limited companies and ensure proportionality. Other factors that may call for flexibility include the company's ownership shareholding structure, geographical presence, and where it finds itself in the corporate lifecycle. […]

Comment: The proposed change clarifies that shareholders do not own public companies, which hold juridical personality, as further explained on p. 1 of this Commentary.

Recommended change to the heading preceding ¶8: D. Stock markets should be regulated in a way that supports effective corporate governance and systemic economic and financial stability.

Comment: Stock markets should be organised and monitored to support system-wide stability, in addition to effective corporate governance. The monitoring function of stock markets is based on the efficient markets hypothesis, an idea that has been repeatedly empirically refuted (Engelen et al. 2011; Quiggin 2010 at ch. 2).

Recommended change to ¶8: The functioning of stock markets plays a pivotal role for the quality of corporate governance. This is where stocks and voting rights change hands and one of the places where the economic value of governance efforts is manifested. […]
Comment: The value of corporate governance is also reflected in other places, including employee wages, environmental performance, consumer satisfaction and voluntary engagement with affected groups.

Recommended change to heading II. (p. 7): The rights and equitable treatment of shareholders and key ownership control functions

Recommended change to ¶13: Equity investors have certain property organizational, control and economic rights against public companies. For example, an equity share in a publicly traded company. They own their shares, and shares in a publicly traded company can be bought, sold or transferred. However, equity investors do not own public companies, which are independent entities with their own interests. An equity share also entitles the investor to participate in the profits of the corporation, with liability limited to the amount of the investment. In addition, ownership of an equity share provides a right to information about the corporation and a right to influence the corporation, primarily by participation in general meetings of shareholders and by voting. Through the exercise of these rights, shareholders can play an important role in corporate governance.

Comment: The proposed revision clarifies the legal status of equity investors.

Recommended change to the heading preceding ¶19: [...] A. Basic shareholder rights should include the right to: [...] (6) share in the profits of the corporation, subject to the decision of the Board of Directors as to whether those profits should be distributed or retained in order to finance expansion of the corporation’s business.

Comment: The claim of shareholders to the profits of the company are limited, being subject to the vote of the board. The shareholders’ claim to profits is also limited in that it stands behind claims by other stakeholders. In most jurisdictions, the primary duty of directors is to act in the best interest of the company as a separate entity. Shareholders are only one of the company’s constituencies, and it is the function of the directors to mediate between those different constituencies (Blair and Stout 1999; Stout 2012). The recommended change reflects the pivotal role of directors in determining the appropriate allocation of profits between a range of alternatives, including investment in research and development, improvement of working conditions or salaries, distribution of profits to employees, as well as payment of dividends.

III. Institutional investors, stock markets, and other intermediaries

Recommended change to ¶23: [...] Shareholders also have an interest in how remuneration and company performance are linked and in particular the time frames they set for directors and executives when they assess the capability of the board and the qualities they should seek in nominees for the board. The different forms of say-on-pay (binding or advisory vote, ex-ante and/or ex-post, board members and/or key executives covered) play an important role in conveying the strength and tone of shareholder sentiment to the board without endangering employment contracts. These rights also reflect the fact that incentives linked to the company’s share price can create a danger of short-termist decision-making, which runs contrary to the interests of long-term shareholders and the company itself. In the case of equity-based schemes, their potential to dilute shareholders’ capital and to powerfully determine managerial incentives means that they should be approved by shareholders, either...
for individuals or for the policy of the scheme as a whole. Shareholder approval should also be required for any material changes to existing schemes. Other stakeholders who have a long-term interest in the company also have an interest in remuneration practices. As a matter of best practice, companies should invite those stakeholders to express their views on remuneration schemes and their effects on the long-term interests of the company.

Comment: The authors suggest the Draft Principles' discussion of say-on-pay should highlight the importance of connecting remuneration to sustainable long-term corporate performance. It would also be advisable for employees to be represented on remuneration committees as a method of promoting long-term alignment between directors' incentives and the interests of the company.

Recommended change to ¶41: […] In some instances, take-over defences can simply be devices to shield the management or the board from shareholder monitoring. In other instances, they allow directors to make long-term credible commitments to employees and other stakeholders. 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.

Comment: Directors do not owe fiduciary duties to shareholders. Instead, the board of directors owes a duty to the company as a separate legal entity. Furthermore, directors may elect to use anti-take-over measures to preserve aspects of the company that might be jeopardized by a change of control (see Johnston 2010).

Recommended change to ¶42: […] In many jurisdictions, the real world of corporate governance and ownership control is no longer characterised by a straight and uncompromised relationship between the performance of the company and the income of the ultimate beneficiaries of shareholdings. […]

Recommended change to ¶43: […] The ability and interest of institutional investors and asset managers to engage in corporate governance varies widely. For some, engagement in corporate governance, including the exercise of voting rights, is a natural part of their business model. Others may offer their beneficiaries and clients a business model and investment strategy that does not include or motivate spending resources on active ownership shareholder engagement. If ownership shareholder engagement runs contrary to the institution's business model and investment strategy, mandatory requirements to engage, for example through voting, may be ineffective and lead to a box-ticking approach.

Recommended change to ¶44: The Principles recommend that institutional investors disclose their policies with respect to corporate governance. Voting at shareholder meetings is, however, only one channel for ownership shareholder engagement. Direct contact and dialogue with the board and management represent other forms of ownership shareholder engagement that are frequently used. In recent years, some countries have begun to consider adopt of so-called “stewardship codes” that institutional investors are invited to sign up to on a voluntary basis.

Comment: This provision picks up the requirements that currently exist in the UK and Australia and are being considered in the EU in the form of amendments to the
Shareholder Rights Directive. The shortcoming of relying on stewardship by institutional investors lies in the diversity of this group, which runs the gamut from pension funds to hedge funds, and from long-term locally-embedded investors to short-term off-shore investors. Research has shown that traditional institutional investors may face regulatory barriers or internal constraints making activism less profitable than for hedge funds; the risk is that activist hedge funds will successfully pressure target companies to make strategic and significant changes to unlock short-term payoffs at the expense of long-term corporate performance (Kahan and Rock 2007).

Additionally, as explained in the comment to ¶13, the Draft Principles should clearly reflect that shareholders do not own public companies.

IV. The role of stakeholders in corporate governance

**Recommended change to ¶61:** The rights of stakeholders are often established by law (e.g. labour, business, commercial and insolvency laws) or by contractual relations that companies must respect. Nevertheless, even in areas where stakeholder interests are not legislated, many firms make additional commitments to stakeholders, and concern over corporate reputation and corporate performance often requires the recognition of broader interests, including through consultation with stakeholders on matters that affect them. Best practice calls for implementation of internationally recognised agreements and verification through due diligence procedures, notably as provided for in the general principles on due diligence in the OECD Guidelines for Multinational Enterprises and its general principles on due diligence the UN Guiding Principles on Business and Human Rights.

**Comment:** The authors support the new text on due diligence in the Draft Principles, which will now reference the OECD Guidelines for Multinational Enterprises. It would also be appropriate to cite the UN Guiding Principles on Business and Human Rights, which similarly reference the duty of due diligence at Principle 15. The Draft Principles should also promote giving a voice to stakeholders through consultation.

**Recommended change to ¶63:** The degree to which employees participate in corporate governance depends on national laws and practices, and may vary from company to company as well. In the context of corporate governance, employee participation may benefit companies directly as well as indirectly through the readiness of employees to invest in firm specific skills. […]

**Comment:** The authors strongly agree that employee participation through mechanisms such as having employee-elected board members and/or stock ownership by employees is beneficial both to the staff and the company itself. The Draft Principles delete the previous reference to employee participation as 'performance enhancing' either directly or indirectly. This text should be left in as there is extensive research showing a correlation between employee participation and firm performance (see Conchon and Waddington 2011; Fauver and Fuerst 2006). The improvement to corporate performance is a direct benefit that exceeds simply employee willingness to acquire specialised expertise. Furthermore, having employee-elected board members may offer a counter-balance to the short-term pressures of capital markets and to foster long-termism in decision-making.
V. Disclosure and Transparency

**Recommended change to the heading preceding ¶68:** 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 control, and governance of the company.

**Recommended change to ¶76:** In addition to their commercial objectives, companies are encouraged to disclose policies relating to business ethics, the environment, human rights, including where relevant within their supply chain, and other public policy commitments. Such information may be important for investors and other users of information stakeholders to better evaluate the relationship between companies and the communities in which they operate and the steps that companies have taken to implement their objectives.

**Comment:** The authors support disclosure of a range of information on ethical, environmental and human rights matters. The Draft Principles should make it clear that a range of stakeholders in the company are entitled to relevant information.

**Recommended change to ¶80:** Information about board and executive remuneration is also of concern to shareholders and other stakeholders as this sets the short- or long-term orientation of a company's corporate governance. […]

**Comment:** The authors suggest that the proposed change to ¶80 would clarify that the aim of the Draft Principles is to foster both long-termism and the value of recognizing a range of stakeholder interests. It also emphasizes that excessive and/or short-term focused executive remuneration poses a threat not only to shareholders but also to all other stakeholders who have long-term, illiquid interests in companies.

**Recommended change to ¶86:** Users of financial information, and market participants and other stakeholders need 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 the environment.

**Comment:** The Principles should explicitly foster disclosure of information to a range of stakeholders to facilitate informed participation in corporate governance, whether this is required by law or put in place voluntarily by companies.

**Recommended change to ¶88:** Companies should provide information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company. Disclosure may include management/employee relations, including remuneration, the ratio between average executive director pay and average employee pay, collective bargaining coverage, and mechanisms for employee representation, and relations with other stakeholders such as creditors, suppliers, and local communities.

**Comment:** The authors support the new text of the Draft Principles, which encourage
additional disclosure of material information to stakeholders. We suggest that the pay ratio between average executive directors and average employee salaries should be added to the list to bring it into line with the proposed amendments to the Shareholder Rights Directive. This will also facilitate the best practice suggestion above that companies allow employees to express their views on executive remuneration practices.

VI. The responsibilities of the board

Recommended change to ¶101: [...] In some countries, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable. Countries may also wish to allow companies to specify in their constitutional documents their long-term purpose, which may be to further environmental, social or scientific goals.

Comment: The Principles should recognize that companies may choose to specify their long-term purpose in their constitutional documents. The statements of purpose may cover varied objectives relating to the environment, social development, science or other goals. Statements of purpose may promote clear business vision and strategy that promotes innovation and sustainability. Companies may further wish to lock-in their purposes against changes by short-term shareholders that are against the long-term interest of the company through techniques such as requiring a supermajority to amend the purpose clause.

The authors observe that the aim of this provision is to promote a split between the oversight functions of the board and the executive functions of management in one-tier board systems. It is worthwhile to note that many countries have successfully adopted two-tier board systems to split these functions (Cremers et al. 2012).

Recommended change to ¶102: The board is not only accountable in law to the company and its shareholders in general meetings but also has a duty to act in the best interests of the company. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context.

Comment: As explained in greater detail in the comment to ¶41, in almost all jurisdictions boards of directors have a duty to act in the best interest of the company as a whole, not shareholders. Many legal systems create mechanisms of accountability of the board to shareholders, but this does not change the legal and equitable duties owed by the board to the company as a separate legal entity.

Recommended change to ¶104: [...] In nearly all jurisdictions, the duty of care does not extend to errors of business judgment so long as board members are not grossly negligent and a decision is made with due diligence etc., or to an obligation to pursue aggressive tax avoidance.

Comment: The Draft Principles should clearly reflect that there is no legal obligation
on directors to avoid tax, let alone aggressively (Sikka 2010).

Comment on ¶106: [...] Similarly, jurisdictions are increasingly demanding that boards oversee the tax planning strategies management is allowed to conduct, thus discouraging practices that do not contribute to the long term interests of the company and its shareholders, and can cause legal and reputational risks.

Comment: The authors support the new text in ¶106 and the recognition that tax avoidance may have deleterious effects on firm health due to, for example, reputational damage and the weakening of public infrastructure. Tax plays a critical role in sustaining companies and the long term development of the jurisdictions in which they operate (The Modern Corporation 2012).

Recommended change to ¶111: 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 specify the relationship between remuneration and performance, and include measurable standards that emphasize the longer run interests of the company over short term considerations, including non-financial metrics such as environmental, social and governance factors.

Comment: Contrary to economic theory, recent experience (e.g. the collapse of Enron and the Global Financial Crisis) suggests that it is impossible in practice to draft an incentive contract that will bring the interests of executives into perfect alignment with the long term interests of the company and its shareholders (Johnston 2014, p. 22). With that caveat in mind, it is nevertheless possible to improve the alignment of executive and board incentives to strengthen corporate governance. Poorly aligned incentives have high costs, including firm failure and systemic failures, such as the financial crisis (Johnston 2014; Keay 2013).

The introduction of non-financial metrics to remuneration policies could promote a range of interests that are not captured by stock price, including innovation; environmental, social and governance matters; and innovation. In this regard, it may be useful for firms to adopt or reference existing reporting standards such as integrated reporting (<IR>) or the Drucker Index (under early development by the Drucker Institute at Claremont Graduate University).

Comment on ¶112: [...] The introduction of malus and claw-back provisions is considered good practice and a key aspect of the remuneration committee's duty to act in the best interests of the company and with reasonable care and skill. These clauses are essential to protect companies, shareholders and stakeholders against fraud and sharp accounting practices. They grant the company the right to withhold and recover compensation from executives in cases of managerial fraud and other circumstances, such as when the company is required to restate its financial statements due to material noncompliance with financial reporting requirements.

Comment: The authors support the reference to claw backs in instances of mismanagement or fraud. Employee representation on remuneration committees is an additional good practice to foster long-term alignment between directors' incentives
and the interests of the company.

Comment on ¶130: Measures such as voluntary targets, disclosure requirements and private initiatives that enhance gender diversity on boards and in senior management should be encouraged.

Comment: The authors support the promotion of gender diversity both as a good in itself and as a means to enhanced corporate governance performance (see Sjåfjell 2014).

Recommended change to the heading preceding ¶132: G. When employee representation on the board is mandated, Where there are employee-elected members on the board, mechanisms should be developed to guarantee that also these board members’ rights and duties are exercised effectively and contributes to the enhancement of board skills, information and independence.

Recommended change to ¶132: When the election of board members by employees is mandated or adopted voluntarily by the law or collective agreements, it should be applied in a way that maximises its contribution to the board’s independence, competence and information. It should be emphasized that employee-elected board members should have the same duties and responsibilities as all other board members, that they should act in the best interest of the company and treat all shareholders equitably.

Comment: The Draft Principles should be amended to reflect instances where there may be voluntary systems with employee-elected board members, both in the heading preceding and at ¶ 132. Employee participation may be strengthened by the election of board members, as well as through information and consultation rights (Cremers et al 2012). There is a general need to develop board skills, information and independence, both for employees and for other board members.

The reference in this paragraph to the duty of directors to act in the best interest of the company is correct and should be used consistently throughout the Draft Principles. This wording should replace that found in ¶41 and ¶102, where mention is made of a duty to consider both the interest of the company and shareholders.
Bibliography


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