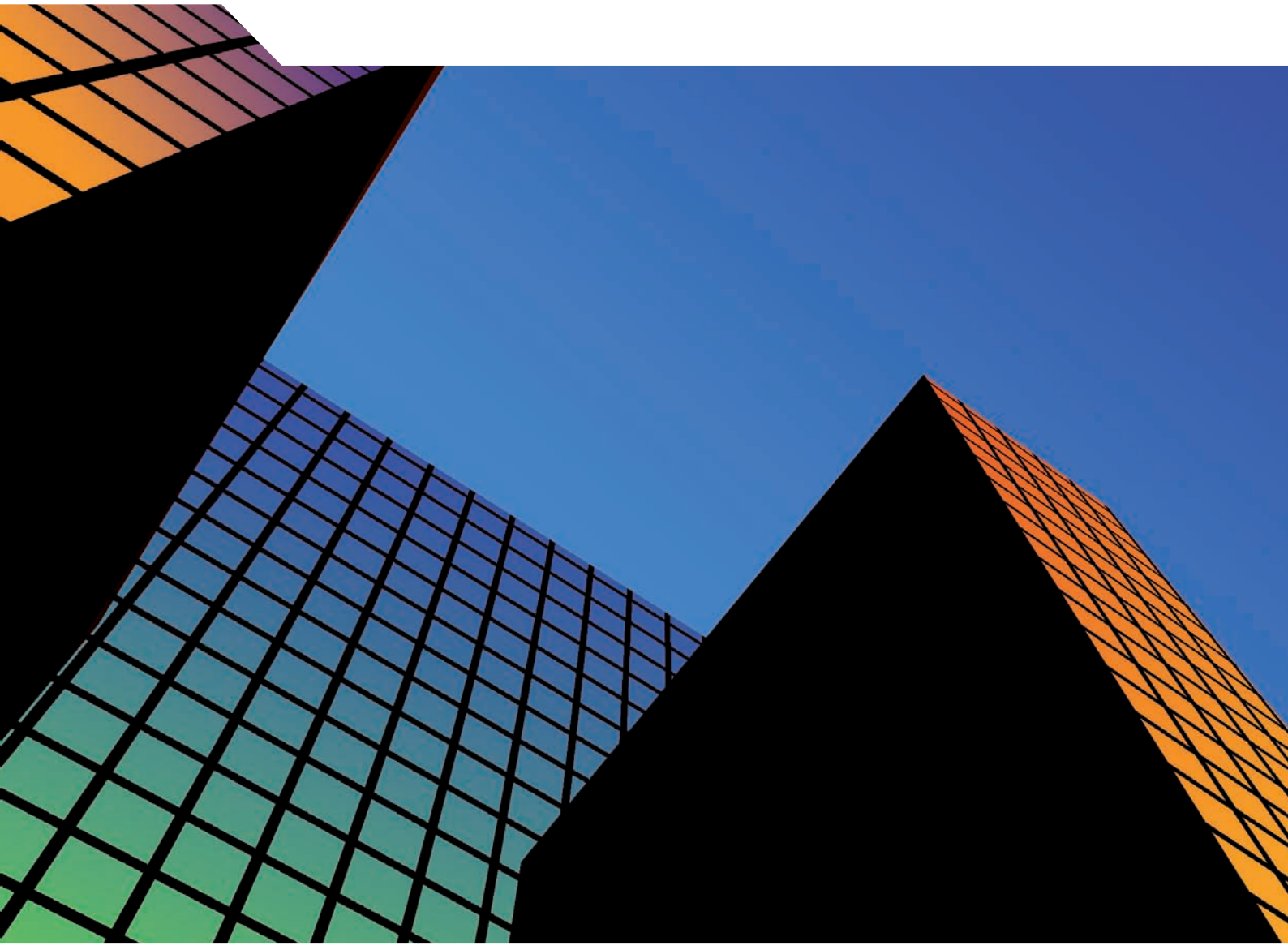
# Board Member Nomination and Election



OECD

# Board Member Nomination and Election



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# *Foreword*

*This report presents the results of the fourth peer review based on the OECD Principles of Corporate Governance. The report is focused on the corporate governance framework and practices that relate to the nomination and election of board members. It covers some 26 jurisdictions, including in-depth reviews of Indonesia, Korea, the Netherlands, and the United States of America.*

*The report is based in part on a questionnaire that was sent to all participating jurisdictions in December 2011. All jurisdictions were invited to respond to a general set of questions so as to provide an overall context within which the review would take place. The four jurisdictions that were subject to the in-depth review were invited to respond to a more extensive set of questions and there was also a visit by the OECD to consult a wider range of market participants.*

*The report first reviews the experience of the four jurisdictions covered by the in-depth analysis of board nomination and election, which is set against a more general review of some 22 jurisdictions. The second part comprises the in-depth reviews of four jurisdictions. The report was prepared by Daniel Blume, Grant Kirkpatrick, Héctor Lehuedé and Akira Nozaki and approved for publication under the authority of the OECD Corporate Governance Committee on the 13 June 2012.*

*The OECD corporate governance peer review process is designed to facilitate effective implementation of the Principles and to assist market participants and policy makers to respond to emerging corporate governance risks. The reviews are forward looking so as to help indentify, at an early stage, key market practices and policy developments that may undermine the quality of corporate governance. The review process is open to OECD and non-OECD jurisdictions alike.*

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# Executive summary

The nomination and election of board members is one of the fundamental elements of a functioning corporate governance system around the world and has accordingly been chosen as the theme for the fourth peer review by the OECD's Corporate Governance Committee. Four jurisdictions have volunteered for an in-depth review – **Indonesia, Korea,** the **Netherlands** and the **United States**. Twenty two participating jurisdictions in the Committee have provided more general background information. As in the past three reviews, the objective is to:

- assess governance practices against the Principles to see how they are implemented and in what way they might need to be improved to better address the reality of different corporate systems and;
- provide advice to policy makers in the reviewed jurisdictions.

The main principles under review include II.A which defines a basic shareholder right to elect and remove board members and principle II.C.3 which calls for the "facilitation" of "effective" shareholder participation in, *inter alia*, the nomination and election of board members. These principles are underpinned by V.A.4 which covers the disclosure of information about board members, including their qualifications, the selection process, other company directorships and their status, particularly whether they are regarded as independent or not by the board. Principle VI.D.5 recommends that the board play an essential role in the nomination process both with regard to process and with respect to determining the desired profile and identifying candidates. There are also relevant principles covering the voting process.

With respect to the jurisdictions under review, shareholders with ten per cent of shares (**Indonesia**), and one per cent in **Korea** and the **Netherlands** can nominate board members, much the same as in other participating jurisdictions although in many there is no threshold. The **United States** is the exception, the board generally having the prerogative of nomination unless it decides otherwise. However, around the world contested elections are rare even though in the **United States** this might be due, in part, to high costs of a challenge. It seems the shareholder right is a bargaining mechanism with boards and controlling shareholders either over corporate policy or to have a board member elected or changed. Indeed, it seems that in a number of jurisdictions, such as the **United States** and the **Netherlands**, shareholders, and especially institutional ones, have significant communications with the company. It is thus hard to say categorically whether shareholders have an "effective" participation, especially in jurisdictions with controlling shareholders which is the typical pattern outside the **United Kingdom** and the **United States**.

Some jurisdictions such as **Italy** and **Israel** have special voting arrangements to facilitate effective participation by minority shareholders. A number allow cumulative voting although, with the exception of **Chile,** it is seldom used, perhaps because it assumes shareholder co-operation that is rare. A number of others such as **Korea** have simply a requirement for the number of independent board members which are necessarily elected by controlling shareholders. This raises questions around the world about what independence means in such circumstances.

A practice that reduces effective participation by shareholders is voting by a show of hands. This is important when there are significant shareholders such as institutional investors. Cross-border voting remains an unresolved issue among a number of jurisdictions. In the **United States**, the ban on brokers exercising their temporary voting rights has improved the overall situation while in the **Netherlands**, since 2004 foundations that have issued depositary receipts must now also issue voting rights except in hostile takeover situations. The possibility for empty voting has thus been reduced.

The board's role in selecting candidates for nomination is changing in many jurisdictions with a greater role for board assessments facilitated by outside advisors who also play a role in locating suitable candidates. In the **United States**, it is not necessary to disclose the selection search advisor, only compensation consultants and any conflicts of interest they may have.

With respect to transparency, **Indonesia** needs to make further improvements especially with respect to disclosure of directors' qualifications and, also in the case of **Korea**, with respect to other board appointments that they may hold. This would serve to clarify any conflicts of interest.

An effective role for shareholders in selecting board members is not an end in itself: the key question is what boards actually do and how selection of members can contribute to effective board performance. The Principles recommend a monitoring board that has authority via its appointment powers: principle VI.D.3 states that the board selects, compensates and, when necessary, replaces key executives and oversees succession planning. Moreover, the functions include "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".

Although the description fits the **United States**, the **United Kingdom** and **Australia** (although the legal powers of the board are quite different in the **United States**), it is doubtful whether the principles describe the situation where there are controlling shareholders and especially, company groups. It might also not be a good normative proposition. As observed in the previous reviews of **India, Italy** and **Sweden,** the company group will often appoint executive management of a group company and determine strategy centrally. This is probably also the case in **Korean** company groups and family run companies in **Indonesia** where the supervisory board appears to be more in the way of an advisory organ.

However, the board of an individual listed company does have a role that it could and should fulfill; overseeing conflicts of interest (*e.g.* related party transactions) and the integrity of the accounting system. This would demand a different type of board member and election process. The largest **Korean** companies need a majority of outside directors who meet certain independence requirements. They comprise two thirds of the audit

committee including its Chair. In similar situations, **Italy** and **Israel** additionally impose special voting arrangements to seek to balance the powers of the controlling shareholder.

Especially in European jurisdictions, the accountability of the board is defined rather widely to include the company and stakeholders. As a result, employees are frequently represented on the board of the company. In the **Netherlands**, in some companies works councils can nominate a third of the board, but the nominees are approved by the meeting of shareholders. This is not the case in **Germany**, thereby dividing the board into shareholder and employee representatives. The modalities are different again in **Sweden** that participated in the first peer review (OECD, 2011a) where two or three employee representatives with their deputies are elected to the board.

In sum, the Principles are a good guide to the outcomes that should be expected from companies with respect to key corporate practices. However, in the context of controlled companies and corporate groups, other outcomes and practices are usual in some jurisdictions and might need to be considered by others.

# *Assessment and recommendations*

Apart from the appointment of a senior management team including the CEO, the next most crucial event for a company is the nomination and election of its board members. Indeed, these two events are interdependent in a critical manner, depending in part on the ownership structure of the company. This peer review deals with how boards are nominated and elected. Four jurisdictions are examined by an in-depth review – I**ndonesia, Korea,** the **Netherlands** and the **United States**. Twenty two participating jurisdictions in the Committee have provided more general background information. As in the past peer reviews, the objective is to:

- assess governance practices against the Principles to see how they are implemented and in what way they might need to be improved to better address the reality of different corporate systems and;
- provide advice to policy makers in the reviewed jurisdictions.

The main principles covering election and nomination of board members under review include II.A which defines a basic shareholder right to elect and remove board members and principle II.C.3 which calls for the "facilitation" of "effective" shareholder participation in, *inter alia*, the nomination and election of board members. These principles are underpinned by V.A.4 which covers the disclosure of information about board members, including their qualifications, the selection process, other company directorships held and their status, particularly whether they are regarded as independent or not by the company. Principle VI.D.5 recommends that the board play an essential role in nominations both with regard to process and with respect to determining the desired profile and identifying such candidates. There are also relevant principles covering the voting process and especially the equitable treatment of shareholders.

Around the world there is a general practice to permit shareholders to present to the board candidates for election. However, three reviewed jurisdiction do have thresholds: ten per cent in **Indonesia** (high by international standards) and one per cent in **Korea** and the **Netherlands**. In the **United States** shareholders generally have the right to nominate candidates for the board of directors and present nominations at the annual meeting, subject to advance notice bylaws. They typically do this through a proxy contest. Shareholders also may submit nominations to the company for consideration to be included in the company's slate of candidates for director. It does not always follow that the board must accept the nominations. In the **United States** this is a question of access to the proxy: the documents that are sent out to shareholders by the company. Federal law does not require inclusion of shareholders nominees, but companies are required to include information about shareholder nominees submitted for inclusion in a company's proxy materials pursuant to applicable state law, foreign law, or a company's governing documents. Without access to the proxy, any nomination taken to a vote by the AGM is costly. In determining access to the proxy it should be noted that shareholders have a

number of additional opportunities to influence the board and hold it accountable, such as via resort to Delaware courts.

A special case is noted in some jurisdictions such as **Italy** and **Israel** where minority shareholders have special nomination and voting procedures. In very few jurisdictions do companies practice cumulative voting even if it is permitted. However, although widely recommended, it is no panacea since it presumes a level of shareholder cooperation which is rare except in cases where there are several block holders. In **Chile,** public pension funds are encouraged to cooperate and moreover can hold stakes up to 7 per cent in a company. Other practices that violate shareholder rights such as voting by a show of hands or counting votes only until an election is reached are widely used. With improved technology and earlier registration of shares to vote, the practice needs to be curtailed. Timely publication of voting results and the counting of all votes such as advocated by principle III.A.5 also needs to be more fully implemented. The practice of holding shareholder meetings in out of the way places and with unclear shareholder rights appear to be much less a problem than in the 1990s.

Nevertheless, contested elections are very rare around the world. As in the **United States**, the associated costs might be a cause but three other factors appear to be important in reviewed jurisdictions and elsewhere. First, there is possibly a discouraged effect in controlled companies such as in **Korea** and **Indonesia** where board members, even independent ones, are nominated and elected by controllers. There is little point in contesting elections, except in contests between block holders. Second, as in the **United States** and the **Netherlands**, there are extensive communications between important shareholders and companies including about board membership. This might be more cost effective than contesting elections. Third, it is more effective to discuss company strategy directly with the company, if necessary supported by a specific motion at the shareholders meeting that does not include board member elections.

Boards around the world are becoming more heterogeneous, with executives, insiders and independent members. Independent board members are now widespread even though questions remain about whether they are really independent, especially when appointed by a controlling shareholder. This is the case in **Korea** and **Indonesia**. Valid questions also remain about their qualifications which would underpin their objectivity. While gender balance remains an issue, particularly in Europe, in other jurisdictions there are other issues such as ethnicity.

If elections and nominations are to be effective there should be full access to information about the candidates along the lines of principle V.A.4. In the **United States** and the **Netherlands**, the principles appear to be fully implemented. Improvements are advisable in both **Korea** and **Indonesia**, particularly about other board positions held by a nominee.

Taken as a whole, do these various facets of the nomination and election process constitute the "facilitation" of "effective" shareholder participation advocated by principle II.C.3? In the **Netherlands** and the **United States**, the outcome appears to be broadly met despite the lack of contested elections. However, in **Korea** and **Indonesia** improvements appear to be desirable especially with respect to transparency about board member qualifications. More broadly, in the controlled environment of many companies thought needs to be given both to specific nomination and election procedures that are better adapted to the control environment.

Principle VI.D.5 calls for the board to ensure a "formal and transparent board nomination and election process". A number of companies in the **United States** and the **Netherlands**, and also in other countries of Europe, are resorting to board evaluations and recruiting agencies in establishing desirable profiles for board membership. These processes are often disclosed. However, the nature of the market for board members will always be imperfect where personal contacts are important. On occasion, this can lead to the so called "old boys' network". In controlled companies the actual role of the board in board nomination makes a judgement more difficult. For example, how are insiders actually chosen and nominated for the board and what is the role of the controlling shareholder in effectively nominating independents? For the largest companies, **Korea** now requires a nomination committee of independents to nominate both "insider" and "outside" board members. The *de facto* arrangements are much harder to discern and are debated in many jurisdictions. More importantly, the arrangements in **Korea** only cover 116 of their largest companies (along with similar requirements for 48 listed and 109 non-listed financial institutions), with few special arrangements for the remaining 1 600 listed companies with predominantly insider boards.

An important aspect of the peer review is to also examine how the election and nomination of board members facilitates the exercise of the board's functions. These are covered by principle VI.D and include, *inter alia*: reviewing and guiding corporate strategy; selecting and compensating key executives; monitoring and managing potential conflicts of interest of management, board members and shareholders; including misuse of corporate assets and abuse in related party transactions; and ensuring the integrity of the corporation's accounting and financial reporting systems.

As noted above, there is a big difference between *de jure* and *de facto* roles of the board that make a judgement difficult even in the reviewed jurisdictions. This is particularly so with respect to strategy and appointing management. In controlled companies as in **Korea** and **Indonesia,** there is a great deal of evidence pointing to central control of these vital corporate decisions. In the case of **Korea**, the board does have formal powers but *de facto* the power is wielded by the corporate group. **Indonesia** is somewhat different since the supervisory board is more in the nature of an advisory body, a situation that requires clarification. However, the management board is also elected, tending to confirm the supervisory board nominations of the CEO and senior managers, a practice also followed by most firms in the **Netherlands**.

In many jurisdictions, the definition and enforcement of director's duties underpins the functioning of the board and might be more important than its election and composition in determining what duties are performed. From this viewpoint, it is important to note that **Korea** has enacted stronger regulation to prohibit self-dealing and requiring stricter reviews of related party transactions. They now require a two-thirds majority approval of the board and strengthened disclosure for transactions involving directors, major shareholders or their families. The largest 300 companies will also be required to have a compliance officer, supplementing the duties of the audit committee and the board.

The **United States** is a special case since company law recognises the predominance of boards as company stewards. However, accountability of the board to the company is provided by strong and enforced fiduciary duties of boards members, although the business judgement rule also gives them a great deal of protection.

If boards of controlled companies have little role in strategic functions and in appointing senior management, they do frequently appear to be used in two key areas: monitoring and managing potential conflicts of interest such as related party transactions (principle VI.D.6); and ensuring the integrity of the corporation's accounting and financial reporting systems (principle VI.D.7). These are two areas where board nomination and election might be crucial, staffing special board committees supported either by listing requirements or company law that define independence. However, special voting and nomination procedures as in **Italy** and **Israel** might still be required.

Finally, by and large the Principles are a valuable guide to what outcomes jurisdictions should be seeking to achieve. However, in the face of controlling shareholders and corporate groups, the appropriate board duties might need to be revised with more emphasis on control functions. The carefully worded principle II.C.3, calling for the "facilitation" of "effective" shareholder participation, remains appropriate in a world where contested corporate elections are rare.

PART I

# Overall situation and lessons from the reviewed economies

PART I

*Chapter 1*

# Implementing the OECD Principles of Corporate Governance in diverse institutional and legal conditions

*This report is the fourth peer review and, as decided by the Committee at its November 2011 meeting, covers board nomination and election practices. As in past reviews, several jurisdictions are discussed in detail –* ***Indonesia****,* ***Korea****, the* ***Netherlands*** *and the* ***United States*** *– while other Committee participants are handled at a more general level. The topic has attracted significant public attention especially in view of the near universal interest in independent board members and the issue of protecting minority rights. Indeed, both the Asian and Latin American OECD Corporate Governance Roundtables have launched work in this area (OECD, 2011c). In addition, the financial crisis raised questions about the quality of board members and the selection/search process for suitable board members.*

*Chapter 1 of the report synthesises the four in-depth studies before considering the wider set of jurisdictions that participate in the work of the Committee. The focus is how jurisdictions and companies implement the Principles (although this is seldom done literally) and how the principles have been (need to be) adapted to widely different institutional and legal conditions.*

## 1.1. The perspective of the principles

The Principles specify the desirable outcomes expected of board behaviour as well as the role of shareholders and the board itself in determining such outcomes. Chapter II states the key principles: principle II.A specifies that a basic shareholder right includes the right to elect and remove members of the board, and principle II.C.3, calls for the "facilitation" of "effective" shareholder participation in key corporate governance decisions, such as the nomination and election of board members. The Annotations note that shareholders should be able to vote on individual nominees or on different lists of them. The principle does not advocate the right of any shareholder to nominate and does not make any distinction between different classes of shareholders.

The Methodology states that a reviewer should establish if there are effective mechanisms enabling shareholders to hold the board to account in case of inadequate performance, such as meaningful opportunities to address shareholder concerns at the shareholders meeting or vote against board members, among others. The review should determine which features of the jurisdiction's nomination and election rules and practices facilitate these mechanisms.

Principle V.A.4 is concerned with transparency of the process and calls for disclosure of information about board members, including their qualifications, the selection process, other company directorships they may hold and whether they are regarded as independent by the board.

Principle VI.D.5, states that the board has an essential role to play in the nomination process, as the board or a nomination committee has a special responsibility to make sure that established procedures are transparent and respected. The Annotations add that the board has a key role 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.

The Annotations recommend full disclosure about the nomination process and about the experience and background of candidates, and briefly describe practices regarding voting by proxy, nomination committees and the role that independent directors may play.

The Methodology offers practical considerations to assess compliance, always with a view to functional equivalence and to achieving desired outcomes, rather than one-size-fits-all recommendations. More importantly, the Methodology argues that it is often not individual principles which are key to overall outcomes but the interaction or consistency of the individual elements of a corporate governance framework.

Chapter VI of the Principles identifies some of the board's key functions which should influence board membership. They include guiding corporate strategy, monitoring managerial performance and achieving an adequate return for shareholders, while managing conflicts of interest, balancing competing demands on the corporation and

overseeing systems designed to ensure that it obeys applicable laws. For this review, the focus is placed on the following key functions:

- Principle VI.D.3: "Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning".
- 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". The Annotations establish that the board must oversee these internal control systems and the Methodology points out that the focus is on board processes and the board's competence to oversee these key corporate activities. The review should determine how the nomination and election frameworks can support the appointment of boards capable of fulfilling these tasks.
- 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." The Annotations add that the board must set and enforce clear lines of responsibility and accountability throughout the organisation, as well as ensuring appropriate oversight by senior management while retaining final responsibility. A review should determine if the nomination and election rules and practices assist shareholders in the task of electing competent board members for these tasks, and provide sufficient incentives for them to adequately pursue these functions.

## 1.2. The perspective of reviewed jurisdictions

In the reviewed jurisdictions and elsewhere, board nomination is influenced by both formal processes and by the use of informal networks. With respect to formal processes, the role of the board and its committees on the one hand, and shareholders on the other, varies across jurisdictions. More recently, greater attention is being given to particular qualities of nominated candidates such as skills, independence and diversity that might be underpinned by the use of advisors and board evaluations.

### *Informal networks*

At a conceptual level, the selection and nomination of board members raises questions about how knowledge markets operate: how are candidates with the desired qualifications and experience located by those responsible for nominating candidates? The traditional approach such as in **Korea** and **Indonesia** essentially revolves around informal networks and personal acquaintances, especially of the controlling shareholders. In the **Netherlands**, personal acquaintances ("old boys' networks") of supervisory board members have traditionally played an important role but use of placement agencies is now common and recent limits on the number of boards individuals may serve on are also increasing board diversity. Even without the predominance of controlling shareholders as in the **United States** and the **United Kingdom**, one study found that "the risk of litigation for lapses of personal integrity is a major reason why boards tend to find directors who are already well known to at least one sitting director when looking for replacements" (Trautman, 2012). At its worst, this practice is often called the "old boys' network" and has led to reduced board diversity and often to locality-based boards (Knyazeva, *et al.*, 2011) when in principle there is a national or even an international market. Of course, what

might be sought in many cases is loyalty to a major shareholder rather than qualities such as objectivity and experience.

However, change is occurring in this market, most clearly with respect to the role of being a CEO as a signalling device. In the **United States**, boards are increasingly tapping directors with other backgrounds than being a CEO: in 2010, only 26 per cent of new directors were active CEOs, down from 53 per cent a decade before (Trautman, page 12 and references therein). In some jurisdictions, institutes of company directors have sought to implement a signalling device for the market by issuing certifications to potential directors.

### *The formal role of boards and shareholders*

In analysing the nomination and election of board members it is necessary to first bear in mind the actual role of boards (*de facto* rather than *de jure*) and not take principles V.D.3, VI.D.6 and VI.D.7 for granted. In the case of **Korea** and **Indonesia**, many companies are tightly controlled by a family group and this raises questions about the role of the board: does it appoint management and oversee strategy as recommended in the Principles? In the case of **Korea** this is often not the case, at least in the large company groups. The CEO, the management team and company strategy will often be determined by the group headquarters with no or limited independent role for the listed subsidiary board. A similar situation was found in **India** and **Israel** in the last peer review (OECD, 2012). In such conditions, board nomination and election must be seen in a different perspective and fulfilling different roles.

The reaction by the **Korean** authorities has been to focus particularly on two aspects of what are normally regarded as board responsibilities: the oversight of related party transactions (conflicts of interest) and the integrity of the accounting system. This has had a marked impact on the procedures for selecting and appointing the board. For the largest 116 companies along with separately regulated financial institutions, there needs to be at least half of the board classified as outside directors who must meet certain requirements for independence. They comprise two thirds of the audit committee including holding the post of chair. These outside directors are also required to serve as a majority on the "outside directors nominating committee" that reviews and screens candidates prior to the board's nomination of all director candidates for AGM consideration, including those for "insider director" positions. Those companies below the threshold are only required to appoint one director. Some 30 of these companies have established voluntarily an outside director nomination committee. However, some 1600 listed companies under the limit have predominantly insider boards.

The legal system in **Indonesia** is quite different even though family control of companies is the same as in many other jurisdictions. The upper tier board (the board of commissioners) is legally speaking an advisory board, not a supervisory one, and is elected by shareholders. Shareholders also elect the management board, which is also the case for most companies in the **Netherlands** (but generally following nomination by the supervisory board). It is doubtful whether shareholders in general should elect management which in the normal course of business will be a highly technical decision. While in **Indonesia** it is purely an academic point given family control, this is not the case in the **Netherlands**. However, the supervisory board in most companies has the power to nominate executives to the management board, followed by their election by the AGM,

which in practice is most often solely a confirmation that is supported by institutional investors.

By contrast, in the **United States** company boards do fulfil the duties specified above by the Principles but the legal role (de jure) of the board is traditionally one of being the steward of the company. This is most clear in Delaware law through the requirement that shareholders can only vote on major decisions presented by the board and not by shareholders. For example, where **United Kingdom** or **Australian** shareholders can decide to close or sell a company and change its charter, the submission of such a vote to the AGM in the **United States** is the prerogative of the board. This is important in a takeover situation. Similarly, the board has the prerogative of nominating the board which is not true in **Australia** and the **United Kingdom**. Boards in the **United States** were traditionally occupied or controlled by the management so that nomination and election were thus under their control.

The **United States** system is, however, evolving leading to improved accountability of the board but also leading to tensions. Over the years, individual shareholders have given way to large institutional shareholders who are much less inclined to accept the judgement of the board as to what is in the best interest of the company. The current robust debate about access to the proxy by shareholders must be seen in this light. In addition, regulation has already changed the structure of **United States** boards, if not their objectives, by specifying independent directors for both the audit and nomination committees.

A key board component in a number of jurisdictions that recognise responsibilities to stakeholders concerns employee representatives. The systems of nomination and election vary significantly (Association Nationale des Société par Actions, 2009). In some jurisdictions such as **Germany**, in large companies employees and unions nominate candidates directly to the Supervisory Board: they are not subject to approval by the general meeting of shareholders. Although its powers have increased over the past decade or so, they are limited in comparison with single tier boards.[1] By contrast in some companies (those in the "structure regime") in the **Netherlands**, the Works Council recommends candidates to the supervisory board that are then subject to election by the shareholders. Once elected they are said to act quite independently and do not regard themselves as workers representative. There is a similar system in **Sweden**.

The **Netherlands** model has been changing in recent years in a dramatic way. Until 2004, supervisory board members under the "structure" corporate law regime (about one third of listed companies) could appoint themselves but this is now a shareholder right. In a number of companies shares were held by a foundation that issued depositary receipts to shareholders that did not provide voting rights. Following changes in 2004 in both the law and to the code, shareholders were granted automatic voting rights (with the exception of takeovers or change in strategy situations) increasing the focus on nomination and election of board members.

### *Greater emphasis on the qualities of board members and board composition*

In some jurisdictions such as the **Netherlands** and the **United States**, companies are more frequently resorting to formal board evaluations to set requirements for potential candidates, and then using advisors to locate them. It is said that such agencies are becoming more active. In the technology start-up area, venture capitalists are very active

in determining what skills a board needs and then locating such talented individuals from their own networks (Wirtz, 2011). In Europe, one study concludes that boards are now using defined competencies to create member profiles rather than simply a CEO/CFO standard background. This is compatible with an increased use of board evaluations, outside consultants and stronger nomination committees. However, there are great differences between jurisdictions (Heidrick and Struggles, 2011, page 33) and also between companies.

In many jurisdictions, the process of appointing boards is now more transparent with full disclosure about the qualifications of nominated board members. Critically this includes memberships of other boards that may point to conflicts of interest. However, **Indonesia** and **Korea** need to make further progress in this area.

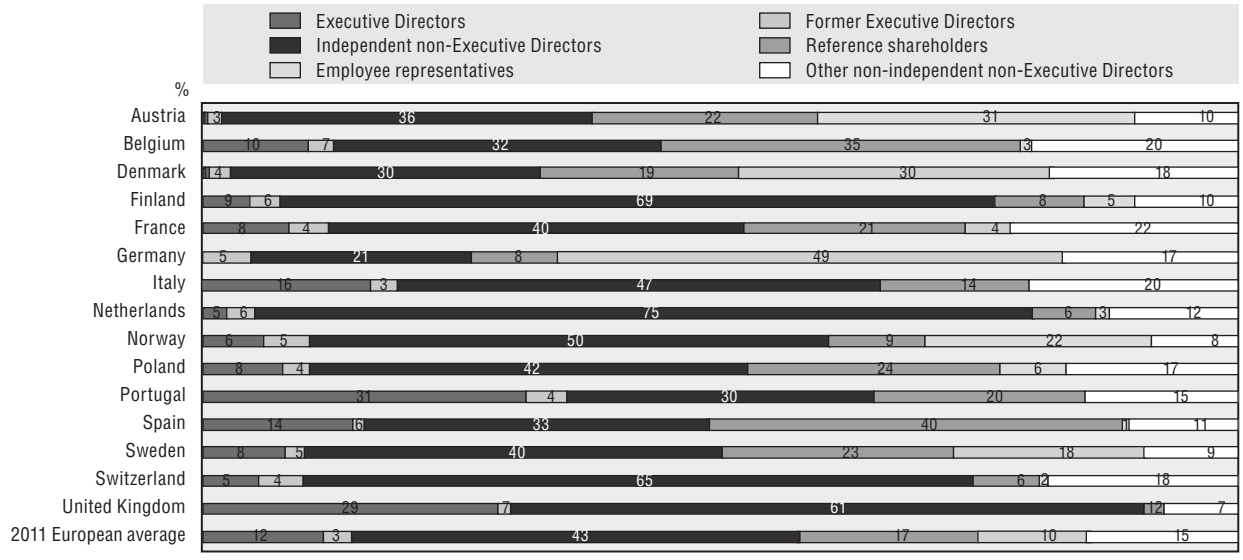
A marked feature of all reviewed jurisdictions and other Committee participants is the greater emphasis on minority protection and the related emphasis on independent board members. This has an effect on the way boards are nominated and elected.

Among the reviewed jurisdictions there is a general requirement as to the proportion of independent members on the board and this requirement is reflected in the composition of the nominations committee. Motivations, however, differ. In the **United States**, the greater resort to independent directors as well as their role in nomination and audit committees can be seen as redressing the balance of a board/management centric system and independence is defined mainly in relation to management. However, there might have been an over-emphasis by nominating committees (and shareholders) on independence to the neglect of qualifications. To address this possibility, the **Dutch** Corporate Governance Code issued in 2003 recommends that the profile that the supervisory board or its nominating committee prepares regarding board size and composition take account of the nature of the business, its activities and the desired expertise and background of the supervisory board members. Revised in 2008, the code now recommends that the profile deal with aspects of diversity in the composition of the supervisory board that are relevant to the company, and that it state what specific objective is pursued by the board in relation to diversity. Diversity issues, especially concerning gender, are increasingly being urged on nomination committees to resolve.[2]

In other reviewed jurisdictions such as **Korea** and **Indonesia**, independence revolves around the relation of a candidate with controlling shareholders. In these two jurisdictions no special arrangements are made for nomination and election so that independents need to be appointed with the explicit or implicit approval of the controlling shareholder. The review of **India** (OECD, 2012) reported evidence that in these circumstances independent board members might regard themselves as advisors to the controlling shareholders. However, the previous review of **Italy** and **Israel** (OECD, 2012) documented special arrangements for nomination and voting (see Box 1.1) to address the issue.

Taking an overall view, the composition of boards varies a great deal across jurisdictions and also between large and small firms where regulations are often quite different. This is illustrated for Europe by Figure 1.1 that shows, *inter alia*, the widely different role of executives and former executives. Equally important is the choice of Chairman of the board. Some three quarters of chairmen in the **Netherlands** and the **United Kingdom** are independent non-executives but only around a quarter in other European countries (Heidrick and Struggles, 2011, page 52). In **Hong Kong (China)**, **India** and **Singapore**, the relatively high percentage of companies with an executive chairman or with a CEO who is also the chairman is a reflection of the dominance of companies with

Figure 1.1. **European board composition (by category of director)**




*Source:* Heidrik and Struggles, 2011, *Challenging Board Performance: European Corporate Governance Report 2011*, Figure 35.

families and founders owning significant stakes who are also managing the companies (Korn Ferry, 2012, Page 13). **China**, where most listed companies are state owned, has a strong separation of roles.

### *The election process*

Voting for board members is not the same as in other elections where it is taken for granted that legitimacy is determined by having more than one candidate. As noted in the **United States** review, contested elections are rare and this seems to be the case around the world though the causes are probably different. In the **United States** it is very expensive to launch a challenge and access to the company proxy materials is subject to corporate law limitations. This is not true in some other countries yet contested elections are still the exception. In the case of many companies, a dominant shareholder makes the process pointless unless, as in **Chile**, **Italy** and **Israel,** there are special arrangements for non-controlling shareholders (Box 1.1). In the case of the **United States** and the **Netherlands**, it is clear that shareholders can often be in direct contact with companies to solve issues directly. This might lead to different board nominations but it will be unobservable for outsiders. Campaigns in the **United States** and elsewhere against some board members by abstaining from voting can also ultimately have the same effect. In other jurisdictions there may be no contestable election but low voting for some members conveys the same information. This is why the Principles advocate the ability to vote for individual candidates and for the results to be published.

The actual voting process nevertheless remains a problem in many jurisdictions and is especially pronounced with cross-border voting. The issues have been dealt with in the Committee's second peer review (OECD, 2011b). Moreover, in the **Netherlands** some companies made use of foundations that issued depositary receipts that enabled the foundation to retain the voting rights without the economic interest in the underlying shares. The potential for such "empty voting" has been reduced since 2004 when underlying shareholders were given the right to provide voting instructions, and the

### Box 1.1. **Nominating and voting systems for independent directors: some examples of special procedures**

**Italy**

Minority shareholders can nominate candidates to their own slate. At least one board member must be elected from the minority slate that received the largest number of votes and who is not linked in any way, even indirectly to the shareholders who presented or voted the list that came first by number of votes. Some companies such as privatised ones (must be a fifth of the board) have reserved a higher number of board places for the minority slate. Company by-laws establish the mechanisms according to which board seats are distributed among the slates presented. More often than not, companies grant a majority premium to the slate receiving the highest number of votes, which takes all board seats but the quota reserved for minorities (one seat). However, a few companies adopt a proportional multi-winner system where any slate takes a number of board seats proportional to the votes it received.

Attributing the votes a slate receives to individual candidates is commonly undertaken using the quotient method: the votes received by each candidate are the result of the ratio between the total number of votes received by the relevant slate and the ordinal number associated to the candidate (the first candidate receives the total number of the slate's votes; the second candidate receives one half of total slate's votes; the third candidate receives one third of total slate's votes, etc). The quotients resulting from these calculations are progressively attributed to the candidates and those with the highest quotients are appointed, with a possible exception in order to meet legal or regulatory requirements for board composition.

**Israel**

The Companies Law provides specifically for the appointment to the board of at least two independent directors, including at least one "outside director" who must be both independent and have special qualifications, *i.e.* accounting or finance expertise. If one outside director with such expertise is already in place, other professional qualifications are also acceptable to be designated as an "outside director." To be classified either as independent or outside directors, they must also not possess any connection to the company or hold any position that gives rise to a conflict of interest, including economic or family relations to corporate management or major shareholders (OECD 2011). Outside directors play a crucial role in chairing the Audit Committee.

The 2011 Company Law amendments also increased the percentage of non-controlling shareholder votes required to appoint outside directors from one-third to at least half (or that the total number of votes opposing the appointment from among the non-controlling shareholders is less than 2 per cent of the total voting rights in the company). While these "majority of the minority" provisions apply to appointment of outside directors, independent directors do not require such minority shareholder approval, but they must meet the above described criteria for independence. Outside director elections are further facilitated by the fact that directors are elected individually, rather than as part of a slate. The controlling shareholder is also no longer able to prevent the appointment of an outside director for a further 3-year term, if a majority of minority shareholders approve the appointment. There must also be at least one independent director on all board sub-committees other than audit.

*Source:* OECD, 2012

**Chile**

The Chilean capital market is characterized by six large pension funds which are encouraged to work with other minority shareholders, particularly in relation to voting for independent directors. As each fund cannot hold more than 7 per cent of a company's equity, they are allowed by law to vote as a group to maximize the number of independent directors on the board: there is a cumulative voting system. To obtain the support of a pension fund, he or she must be included on a register maintained by the securities regulator. Those candidates have to satisfy the minimum standards in terms of academic qualifications, and inform of any conflict of interest with the company to which they are nominated. Pension funds are

Box 1.1. **Nominating and voting systems for independent directors: some examples of special procedures** *(cont.)*

forbidden to vote for a candidate related to the main shareholders. The pension funds appear to be supported by other minority shareholders since they have elected one or two directors in 60-70 per cent of companies renewing their boards.

*Source:* OECD, 2011b

**Latin America**

Some jurisdictions establish cumulative voting as the default mode of voting but give companies the option to establish a regular voting mechanism. However, if companies do so, they need to guarantee the representation of minorities. For example, the Colombian stock market law allows companies to adopt any type of voting system as long as it increases the number of representatives of minority shareholders, such as by the largest remainder method. In Brazil and Mexico, regular voting is the norm even though cumulative voting is permitted. However, the vast majority of elections are for a slate of candidates rather than individuals.

*Source:* OECD, 2011c.

foundations in other cases are still required to vote in the interests of the shareholders and/or in the interests of the company.

In a number of jurisdictions, elections might be by show of hands rather than by polling. This is not in the spirit of the *Principles* which recommend that all shareholders should be treated equally. Moreover, the Annotations to principle V.A.8 note that "as a matter of transparency, procedures for shareholders meetings should ensure that votes are properly counted and recorded, and that a timely announcement of the outcome is made". With respect to the latter, for example, show of hands or applause at AGMs in **Japan** are not counted and therefore the numerical results covering all votes cannot be disclosed. Votes received prior to the meeting by whatever means, and which in most cases result in a majority for board nominations, are disclosed. Electronic voting will hopefully lead to curtailing show of hands voting at shareholder meetings. Even though cumulative voting is often permitted (especially in Latin America), in practice it is not widely used (with the exception of **Chile**), perhaps due to the absence of shareholder cooperation which is presumed. It is more useful when there are block holders with say 5 or 10 per cent of the voting shares (see Box 1.1).

A special type of voting system was in place for some time in the **United States** that is now changing: plurality voting. Under this system even one vote in favour would be enough for election of a candidate on the voting list where there are no other candidates with more votes in favour who are not otherwise also elected to the board. More than 70 per cent of the S&P 500 companies now have some form of majority voting while a decade ago hardly any varied from the prevailing plurality voting standard. This is less marked in smaller firms. Another key change to the voting system is the elimination of broker discretionary voting in director elections.

## 1.3. The perspective of other jurisdictions

Committee participants display a wide variety of procedures for election and nomination but there is convergence in some major areas. Perhaps the key factor concerns the widespread move to demanding independent directors driven by several scandals in

some countries (*e.g.* Parmalat) and more general reactions in other jurisdictions to them (IOSCO, 2007). Table 1.1 illustrates the spread of board independence requirements. However, as illustrated by Figure 1.1, board composition is in fact quite complex, with independent directors mixing with external directors, executives and representatives of controlling shareholders.

Table 1.1. **Board Independence**

The keys in the columns of NED ID denote 1) law/regulation 2) listing rule, and 3) recommendation respectively

| | Board structure | Non-executive directors (NED) | | Independent directors (ID) | | Data |
|---|---|---|---|---|---|---|
| **Australia** | One-tier | - | - | 3 | Majority | **ID: 49.6%** of director positions in 1614 listed firms (**69.6%** in the top ASX 200)<br>**CEO:** 5 firms in the top 100 have executive chairman |
| **Belgium** | One-tier | 3 | Majority | **1** | – At least **1 independent director** in Audit committee<br>– **Majority** of members in remuneration committee<br>– **3 independent directors** comprise the committee for evaluating RPTs beforehand | - |
| **Brazil** | One-tier | **1** | Minimum **2/3** | **2** | Minimum **20%** for listed firms in the Novo Mercado | **NED: 87%** of director positions in major listed firms (230)<br>**ID: 20%** of director positions in major listed firms (23% out of NED) |
| **Canada** | One-tier | - | - | **1** | Minimum **2 members** (minimum board: 3 members) | - |
| **Chile** | One-tier | - | - | **1** | At least **1 independent member** for large capitalisation and diversified ownership firms (minimum board size of 7 members) | - |
| **Czech Republic** | Two-tier | - | - | - | - | - |
| **Estonia** | Two-tier | 3 | No more than 2 former management members shall be members of the supervisory board | 3 | Majority | - |
| **Finland** | One-tier | - | - | 3 | – Majority<br>– At least 2 IDs must be independent of significant shareholders | **NED:** the boards of listed companies mainly consist of NEDs |
| **France** | One-tier<br>Two-tier | - | - | 3 | Majority (for companies with dispersed ownership and no controlling shareholders) | - |
| **Germany** | Two-tier | **1** | Two year cooling-off period for former CEOs (if not nominated by SHs with more than 25% shareholding) | **1**<br>3 | At least **1 member** must be an **independent** financial expert<br>No more than 2 former members of the management board shall be members of the supervisory board | - |
| **Greece** | One-tier | **1** | Minimum **1/3** | **1** | At least **2 independent members** out of non-executive members[1] | - |
| **Hungary** | One-tier<br>Two-tier | - | - | **1** | **Majority** | - |
| **Indonesia** | Two-tier | - | - | **2** | Minimum: **30%** independent directors in the supervisory board<br>Minimum: one unaffiliated director in the management board | **ID:** 39% of director positions in the supervisory board of all listed companies |
| **Italy**[2] | One-tier<br>Two-tier<br>Traditional | - | - | **1**<br>3 | At least **1** (2 for board with more than 7 members) **independent member** in the **statutory board of auditors**<br>Minimum: 1/3 and 2 independent members in the board of directors | **NED: 1/4** of the total number of directors<br>**ID: 8%** (1/3 out of non-executive directors are independent) |

## Table 1.1. **Board Independence** *(cont.)*

The keys in the columns of NED ID denotes 1) law/regulation 2) listing rule, and 3) recommendation respectively

| | Board structure | Non-executive directors (NED) | | Independent directors (ID) | | Data |
|---|---|---|---|---|---|---|
| **Japan** [3] | One-tier Tradi-tional | - | - | **1** | **Majority** of **external members** in the **statutory board of auditors** | **ID:** 2.5 out of 3.8 members are external auditors on average (TSE listed firms with statutory auditors) |
| | | | | **2** | At least **1 independent director or statutory auditor** (TSE-listed firms) | **ID:** 47.6% of TSE listed firms have at least one external director<br>**ID:** 8.8% of TSE listed firms have more than 1/3 independent directors |
| **Korea** | One-tier | - | - | **1** | **Majority** (at least **3 members**) must be **outside directors** (listed large firms)<br>At least **1/4** (at least 1 member) must be **outside directors** (other listed firms) | - |
| **Mexico** | One-tier | - | - | **1** | Minimum **25%** | **NED:** The chairman and CEO are the same person in 47% of listed firms |
| **Netherlands** | One-tier<br>Two-tier | - | - | 3 | All members of the supervisory board ( except 1) | - |
| **Poland** | Two-tier | - | - | - | - | - |
| **Portugal** [4] | One-tier<br>Two-tier (1)<br>Two-tier (2) | **1** | (One-tier in audit committee)<br>All members must be non-executive directors | **1** | (One-tier of members in audit committee)<br>Majority | **NED:** 51.7% on average in listed firms (52.1% in two-tier Latin model, 35.2% in one-tier)<br>**ID:** Only 42% of the listed companies comply with the recommendation of minimum 25% |
| | | 3 | (All categories)<br>Minimum: 1/3 members on the board of directors | 3 | (All categories)<br>Minimum: 25% members on the board of directors | |
| **Singapore** | One-tier | **1** | At least 2 non-executive directors are independent | **1** | Minimum 2 non-executive directors who are independent | - |
| | | | | 3 | Minimum 1/3 | - |
| **Slovenia**[5] | One-tier<br>Two-tier | - | - | (3)[6] | Majority | - |
| **Sweden** | One-tier | 3 | All members (with the exception of 1) | 3 | Majority. 2 IDs must also be independent from the large shareholder (> 10%) | **NED:** 50% of listed companies have one executive on the board |
| **Switzerland** | One-tier[7] | 3 | Majority | 3 | Majority of members in audit and remuneration committee | **NED:** 86% of the 100 largest listed companies separate functions of the president of the board and the CEO<br>**NED:** 90% of listed company directors are non-executive<br>**ID:** 73% of public company board members are independent |
| **Turkey** | One-tier | (1)[8] | Majority | (1)[8] | Minimum: 1/3 and 2 members | **NED:** CEO is commonly a member of the board but not the chair<br>**ID:** 4 out of ISE 30 companies (excl. 7 banks) have 1/3 of board members independent |
| **United States** | One-tier | - | - | **2** | – **Majority**<br>– All members of the audit, compensation and nominating committees are independent | - |

1. This is not mandatory when representatives of minority shareholders are defined explicitly and participate as a member in the board.
2. The Italian legislation allows for 3 types: traditional, two-tier, and one-tier. Since the traditional model with a board of directors and a board of statutory auditors is the most prevalent, this table refers to "traditional model".
3. Listed companies may adopt either "company with statutory auditors" model (traditional) or "company with committees" model (traditional). 97% of TSE-listed companies are with statutory auditors (two-tier).
4. The Portuguese Company Law provides 3 structures: one tier board of directors and a separate audit board (Latin model: two-tier); one-tier board of directors with a mandatory audit committee set up within the board of directors (Anglo-Saxon model: one-tier); a conventional two-tier model (Dualist model). Listed firms usually adopt either Latin model (76%) or Anglo-Saxon model (20%).
5. In Slovenia 90% of listed companies have two-tier boards and 10% have one-tier boards (2010).
6. It is now under the process of revising relevant codes.
7. The Company Law provides for a one-tier board model, but in practice, day-to-day management is typically delegated from the board to the executive management and thus leading to a two-tier board structure.
8. It is now in the process of revising relevant rules and codes.

*Source:* Responses to OECD Questionnaire

There are two implications of the changes: shareholder nominations and the widespread move to nomination committees that are often combined with a remuneration committee or corporate governance committee.

In a number of jurisdictions shareholders with a certain threshold have the right to nominate board members although whether they are included on the proxy at the company's expense is important (Table 1.2). However, despite these possibilities,

Table 1.2. **Nomination by shareholders before the AGM**

| | Nomination or proposal of candidates by shareholders (SHs) Conditions | |
|---|---|---|
| **Australia** | Allowed | – No requirement for shareholders<br>– The firm must accept the request by SHs up to at least **35 business days** before the AGM[1] |
| **Belgium** | Allowed | – No requirement for shareholders |
| **Brazil** | Allowed | – No requirement for shareholders |
| **Canada** | Allowed | – Minimum threshold to submit a proposal: **5%** shareholding |
| **Chile** | Allowed | – Minimum threshold of shareholding: **1%**<br>– The nomination of an independent director should take place at least **10 days** before the AGM |
| **Czech Republic** | Allowed | – The request shall be sent at least **5 working days** before the AGM (the incumbent board must publish the counter proposal at least 3 working days before the AGM) |
| **Estonia** | Allowed | – Minimum threshold of shareholding: **5%**<br>– The request shall be sent at least **15 days** before the AGM |
| **Finland** | Allowed | – The request shall be sent well in advance of the AGM so that the matter can be mentioned in the notice |
| **France** | Allowed | – Minimum threshold of shareholding: **0.5-5%**[2]<br>– No requirement for shareholders to propose at the GSM |
| **Germany** | Allowed | – No requirement for shareholders<br>– A company must publish the proposal if it reaches **14 days** before the AGM |
| **Greece** | Allowed | – Minimum threshold of shareholding: **5%** |
| **Hungary** | Allowed | – Minimum threshold of shareholding: **1%** |
| **Indonesia** | Allowed | – Minimum threshold to call a EGM: **10%** shareholding |
| **Italy** | **Required** | – Directors are elected by the GM on the basis of **slates of candidates presented by shareholders** owning a minimum threshold[3] of the company's share capital<br>– At least 1 board member shall be elected from the minority slate |
| **Japan** | Allowed | – No requirement for shareholders |
| **Korea** | Allowed | – Minimum threshold of shareholding: **3%** for listed firms (0.5% for shares held for more than six months for large listed firms)<br>– Candidate list by shareholders should be delivered to the board or nomination committee at least **6 weeks** before the AGM |
| **Mexico** | Allowed | – Minimum threshold of shareholding: **10%** |
| **Netherlands** | Allowed | – Minimum threshold of shareholding: **1%** |
| **Poland** | Allowed | – Candidates to the board are usually proposed directly by shareholders |
| **Portugal** | Allowed | – Minimum threshold of shareholding: **2%**<br>– The request shall be sent within **5 days** following the disclosure of the AGM notice (at least 21days before AGM) |
| **Singapore** | Allowed | – No requirement for shareholders<br>– A company must circulate AGM resolutions proposed by shareholders<br>*a)* minimum threshold of shareholding: **5%**<br>*b)* minimum number of shareholders: **100** (not less than $500 per each) |
| **Slovenia** | Allowed | – No requirement for shareholders |
| **Sweden** | Allowed | – No requirement for shareholders |
| **Switzerland** | Allowed | – Minimum threshold of shareholding: a nominal value of 1 million Swiss francs or 10% |
| **Turkey** | Allowed | – No requirement for shareholders |
| **United States** | Allowed | *a)* Proxy contests:<br>– must provide proxy materials to shareholders<br>*b)* Shareholders may submit nominations through the company's nominations process<br>*c)* Shareholders may present nominations at the shareholders meeting, subject to advance notice pursuant to by-laws. |

1. The firm must circulate a written statement of the candidates nominated by SHs with at least 5% votes or 100 members.
2. The Commercial Code provides that the amount of capital to be represented is reduced to 4% when capital is 750 000 EUR, 2.50% up to 7.5 million EUR, 1% up to 15 million EUR, and 0.50% for capital exceeding 15 million EUR.
3. The minimum threshold is yearly determined by the Consob, taking into account the capitalization, free float and ownership structure (from 0.5% to 4.5%).

*Source:* Responses to OECD Questionnaire.

incidences of contested elections are rare around the world. It is known that in many cases discussions might be held with the board or the dominant shareholder resulting possibly in changes to board nominations that are unobserved. Special voting mechanisms might also make more general provisions moot (Box 1.1).

Another key feature has been the tendency to set up nomination committees often charged with specifying a profile of directors desirable for the board. They can be combined with a remuneration committee or corporate governance committee. In most jurisdictions, establishment of independent nomination committees is recommended, but the situation with implementation varies among jurisdictions (Table 1.3). However, special voting mechanisms also curb their coverage of board nominations.

Table 1.3. **Nomination committee**

| | Establishment | Composition |
|---|---|---|
| **Australia** | Recommended<br>*Poorly implemented* | – at least 3 members<br>– a majority and the chair should be independent |
| **Belgium** | Recommended | – a majority shall be independent non-executive<br>– The chairman should be the chairman of the board or other non-executive director |
| **Brazil** | - | - |
| **Canada** | Recommended<br>*Fully implemented* | – fully independent |
| **Chile** | - | - |
| **Czech Republic** | Recommended<br>*Poorly implemented* | - |
| **Estonia** | - | - |
| **Finland** | Recommended[1]<br>*Partly implemented* | – a majority shall be independent<br>– the managing director or other executive may not be appointed |
| **France** | Recommended | – a majority of independent directors |
| **Germany** | Recommended | – composed exclusively of shareholder representatives |
| **Greece** | - | - |
| **Hungary** | Recommended<br>*Not implemented* | – at least 3 members<br>– a majority shall be independent |
| **Indonesia** | Recommended<br>*Poorly implemented* | – chaired by an independent member of supervisory board |
| **Italy** | Recommended[2]<br>*Poorly implemented* | – a majority of independent directors |
| **Japan** | **Required for one-tier board**[3] | – at least 3 directors<br>– a majority of outside directors |
| **Korea** | **Required to establish outside director nomination committee for large firms**[4] | – a majority of outside directors |
| **Mexico** | **-** | - |
| **Netherlands** | Recommended<br>*Partly implemented* | – a maximum of one member may not be independent |
| **Poland** | - | - |
| **Portugal** | Recommended<br>*Poorly implemented* | (Candidate for non-executive members shall be nominated so as to prevent interference by executive members) |
| **Singapore** | Recommended | – at least 3 directors<br>– a majority and the chair should be independent |
| **Slovenia** | Recommended | – composed of external members and the president of the supervisory board<br>– at least one member is an expert in company law<br>– at least one member is an expert in corporate governance |
| **Sweden** | Recommended<br>*Fully implemented* | – majority of the largest owners or representatives from these owners |
| **Switzerland** | Recommended<br>*Fully implemented* | - |

Table 1.3. **Nomination committee** *(cont.)*

| | Establishment | Composition |
|---|---|---|
| **Turkey** | (Required)[5] | – The chairman should be an independent director<br>– CEO or the general manager cannot be a member |
| **United States** | **Required for NYSE and Nasdaq listed companies** | – NYSE: all the members are independent<br>– Nasdaq: either a committee of independent directors or a decision made by a majority of independent directors in executive session |

1. If the general meeting or supervisory board has established a "nomination board" consisting of shareholders or representatives of shareholders in order to prepare the election of directors, instead of a nomination committee, the company shall disclose the election process, composition and operations of the nomination board.
2. The role of a nomination committee is limited in the Italian context, where the slate voting directly entrusts shareholders.
3. Listed companies may adopt either "company with statutory auditors" model (traditional) or "company with committees" model (traditional). 97% of TSE-listed companies are with statutory auditors (two-tier).
4. In addition to the 116 largest companies where it is required, 30 firms have established the committee voluntarily.
5. It is now under the process of revising relevant rules and codes.

KEY: *Fully implemented* (80-100%), *partly implemented* (50-80%), *poorly implemented* (10-50%), *not implemented* (0-10%).
*Source:* Responses to OECD Questionnaire.

As noted in Box 1.1 special voting mechanisms have been introduced in a number of jurisdictions. They are often in response to the judgement that independent directors nominated and voted by controlling shareholders might not bring objective independent judgement to the board as recommended by the Principles. Cumulative voting, while permitted in many jurisdictions, is in practice not widespread.

Table 1.4. **Voting mechanisms**

| | Issuing shares with limited right to vote for board members[1] | Voting for: individual candidates / list | Cumulative voting | Voting for separate list by minority shareholders |
|---|---|---|---|---|
| **Australia** | **Allowed**<br>(Preferred shares) | **Required individual** | n.a. | n.a. |
| **Belgium** | **Allowed** | **Allowed both** | **Allowed** | |
| **Brazil** | **Allowed**<br>(The limit is 50% of the total shares) | **Allowed both**<br>*Commonly for list* | **Required**<br>(if required by SHs of certain % of voting shares) | **Allowed**<br>(1-2 members of the board may be elected separately by minority shareholders)<br>*28% of board members are recommended by minority SHs* |
| **Canada** | **Allowed** | **Allowed both**<br>*Slate voting still exists in contested elections* | **Allowed** | n.a. |
| **Chile** | **Allowed**<br>(Preferred shares) | **Required individual** | **Allowed** | **Required**<br>– At least **1 independent member** shall be elected for large capitalization and diversified ownership firms |
| **Czech Republic** | **Allowed**<br>(Preferred shares) | **Required individual** | **–** | n.a. |
| **Estonia** | **Allowed**<br>(Preferred shares) | **Required individual** | **Allowed** | **Allowed**<br>Not more than half of the members of the supervisory board can be elected/ appointed in a different manner |
| **Finland** | **Allowed** | **Allowed both** | **Allowed** | **Allowed** |
| **France** | **n.a.** | n.a. | n.a. | n.a. |
| **Germany** | **Allowed**<br>(Preferred shares) | **Recommended individual** | **Allowed** | n.a. |
| **Greece** | **Allowed**<br>(Preferred shares) | **Allowed both** | n.a. | n.a. |

Table 1.4. **Voting mechanisms** *(cont.)*

| | Issuing shares with limited right to vote for board members[1] | Voting for: individual candidates / list | Cumulative voting | Voting for separate list by minority shareholders |
|---|---|---|---|---|
| **Hungary** | **Allowed** (Preferred shares) | **Recommended individual** | **Not allowed** | n.a. |
| **Indonesia** | **Allowed** | **Allowed both** *Commonly for list* | **Allowed** | n.a. |
| **Italy** | **Allowed** (Preferred shares: The limit is 50% of the total shares) | **Required slate voting** | **Not allowed** | **Required** At least 1 board member shall be elected from the slate of candidates presented by shareholders owning a minimum threshold[2] of the company's share capital |
| **Japan** | **Allowed** | **Required individual** (one individual vote per seat on the board) | **Allowed for directors** (not for statutory auditors) | n.a. |
| **Korea** | **Allowed** (Preferred shares: The limit is 50% of the total shares) | **Allowed both** *Commonly for individual* | **Allowed** [Firms can preclude(*1)] | n.a. |
| **Mexico** | **Allowed with the prior authorisation by CNBV** (The limit is 25% of the total shares) | **Allowed both** | **Allowed** | n.a. |
| **Netherlands** | **Prohibited** | **Allowed both** *Commonly for individual* | **Allowed but limited** | n.a. |
| **Poland** | **Allowed** (Preferred shares) | **Allowed both** *Commonly for individual* | **Allowed** (Group voting can be requested by shareholders representing at least 1/5 of capital) | n.a. |
| **Portugal** | **Allowed** (Preferred shares) | **Required to vote for separate competing lists** (A single vote for separate competing lists) | **Not allowed** | **Allowed** – For maximum 1/3 of board members, **isolated appointment** may be made from candidates proposed by group of shareholders (10-20% shareholding) – Minority represents at least 10% of the share capital may appoint at least one director |
| **Singapore** | **Allowed** (Preferred shares) | **Required individual** (one individual vote per seat on the board) | **Not allowed** | n.a. |
| **Slovenia** | **Allowed** (Preferred shares: The limit is 50% of the total shares) | **a single vote for lists** | n.a. | n.a. |
| **Sweden** | - | **Required individual** | **Not allowed** | |
| **Switzerland** | **Prohibited** | **Allowed both** | **Allowed** | **Allowed** Where more than 2 different share classes, the shareholders of each class shall be entitled to elect at least one representative to the board |
| **Turkey** | **Allowed** | **Allowed both** | **Allowed** | **Allowed** Where more than 2 different share classes, the shareholders of each class can elect their representative to the board |
| **United States** | **Allowed** | **Shareholders can vote for, against, or abstain for each nominee for director** | **Allowed** | |

1. Issuing shares with limited rights normally requires formal procedures, as the Principle III.A.1 calls for "Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected".
2. The Commercial Act offers a company an option to reject the shareholder's proposal of cumulative voting system through its articles of incorporation. 1 457 out of 1 531 listed companies ruled out a cumulative voting system in 2010.
*Source:* Responses to OECD Questionnaire.

### *Notes*

1. Traditionally half the board comprising shareholder representatives have met alone ahead of a full board meeting. More recently, the full board is now required to approve executive compensation. The board has only limited powers to change the management board once it is appointed for fixed terms of five years.
2. In a number of jurisdictions diversity might also concern ethnicity. See Korn Ferry Institute, 2012.

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PART II

# Country reviews of the corporate governance framework of listed companies and board nomination and election practices

PART II

*Chapter 2*

# Indonesia: Review of board nomination and election practices

*This chapter on Indonesia describes the ownership structure of listed companies and then considers the board nomination and election processes including disclosure practices and obligations. The board nomination and election process is placed within the context of the overall corporate governance framework.*

## 2.1. Introduction

This review of Indonesia seeks to ascertain to what extent its board nomination and election policies and practices are consistent with relevant recommendations of the *OECD Principles of Corporate Governance,* including:

- Principle II.C.3, which calls for the facilitation of effective shareholder participation in key corporate governance decisions;
- Principle V.A.4, which calls for disclosure of information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board; and
- Principle VI.D.5, which states that the board has an essential role to play in the nomination process, as the board or a nomination committee has a special responsibility to make sure that established procedures are transparent and respected. The Annotations add that the board has a key role 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.

The review is intended to further address whether the nomination and election system contributes effectively to the establishment of a board able to fulfil some of the key board functions identified in the Principles, including:

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

Corporate governance problems were identified as a major contributor to the Indonesia's economic crisis in 1997, and the Letter of Intent signed by Indonesia government and the IMF clearly stated that continued financial assistance by the IMF was contingent on the improvement of corporate governance (IMF, 2000). The concept of corporate governance was formally introduced in 1999 when the government established the National Committee on Corporate Governance (reorganised as the National Committee on Governance (NCG) in 2004), through which the Code of Good Corporate Governance (CGCG) was created in 2000 and revised in 2006. While the Code addresses main elements including the board nomination and election process, its application is voluntary with no binding force and companies are required neither to disclose whether they comply nor explain if not.

This assessment first describes the corporate governance framework including ownership concentration, company law reforms and board structures. It then reviews board nomination processes including disclosure and the role of shareholders. Conclusions and recommendations are presented in the final section.

## 2.2. Corporate governance framework

The number of listed companies in Indonesia has been growing steadily since the late 1980s and reached 443 by the end of 2011. While the capital market in Indonesia had been characterised as relatively small in comparison with OECD countries and other regional peers until recently (OECD, 2010), its size in relation to GDP has increased from 36 per cent in 2009 to 51 per cent in 2010 and market capitalisation has increased by 61 per cent during the same period. Market concentration is high and liquidity low (OECD, 2010). As of March 2011, 50 leading companies (including 11 banks) accounted for 80 per cent of total market capitalization, while the average free float among these companies was 23 per cent.

### *Ownership structure*

Indonesian-listed companies were characterised by concentrated ownership in the hands of controlling families and controlling family involvement in the boards. Prior to the economic crisis in 1997, when corporate governance was first identified as an area in need of improvement, concentration of ownership was the highest in Southeast Asia: ten families controlled over half the corporate sector and 16.6 per cent of the total value of listed corporate assets could be traced to the ultimate control of a single family (Claessens et al, 2000). The analysis of board composition of listed companies for 1997 and 2001 revealed a high percentage (59.8 per cent and 40.7 per cent respectively) of companies having boards with two or more family members (Tabalujan, 2002).

A study after the 1997 crisis revealed that family controlled groups often acted as conglomerates with holdings in many industry sectors. Large Indonesian groups typically used a group-specific financial institution, which left the lending bank with less independence to monitor loans (Patrick, 2001), and this feature became more pronounced as their borrowing increased (Khanna and Yafeh, 2007). Under the weak institutional environment (Patrick, 2001), companies were able to disguise their financial position, overstate profitability and continue to operate even after they were no longer financially viable (IMF, 2006).

Although the degree of ownership concentration observed prior to the crisis in 1997 has moderated significantly, a case study of prominent Indonesian groups shows that corporate responses such as less family influence and reduced network ties has not occurred, and companies still retain a high level of secrecy surrounding their activities (Dieleman, 2009). A study of 186 listed companies with data for 2006 and 2007 shows that the proportion of shares held by controlling shareholders is 70 per cent on average, and 58 per cent of the sample are family-controlled (Darmadi, 2011). A recent survey of 330 listed companies shows that 98 companies (29.7 per cent) are identified as a family group company, and 53.1 per cent of total market capital is held by firms that belong to a family business group (the second highest percentage behind **Korea** out of 45 countries) (Masulis *et al.*, 2011). As of July 2011, the proportion of shares held by controlling shareholders was more than 50 per cent in 38 out of 50 leading companies.

The Indonesian government has taken measures to change the situation. The new Income Tax Law of 2008 provides a 5 percentage points rate reduction of the corporate income tax rate for publicly listed companies where at least 40 per cent of shares are traded in the local stock exchange market (*i.e.* a free float of 40 per cent) (OECD, 2010). The purpose of this measure is to discourage concentrated ownership and promote public offerings, but the threshold of 40 per cent is regarded as too high for listed companies with extremely concentrated ownership to change the current structure. The rule on takeovers was changed in 2008 and now requires a higher threshold (50 per cent; previously 25 per cent) for a mandatory tender offer. The new rule also requires the acquirer to issue 20 per cent of its shares to the public within 2 years after a tender offer is completed. Although the impact of these measures has not yet been assessed, World Bank (2010) noted that some market participants considered that the amendment might act as a deterrent to new listings and keep marginal companies on the exchange.

Indonesia's corporate governance framework was assessed in 2004 and 2010 by the World Bank under the Reports on Observance of Standards and Codes (ROSC) (World Bank 2004, 2010). The World Bank (2004) called into question whether independent members of the supervisory board act independently from the controlling shareholders and exercise effective oversight. The report acknowledged the fact that board nomination is usually made by management (or controlling shareholders), and urged a strengthening of the process for nomination and election of independent members on the supervisory board (Board of Commissioners). Most of these weaknesses still remain unsolved according to the recent assessment of World Bank (2010).

The other aspect of ownership structure is the significant presence of foreign investors. Indonesia has an emerging capital market that has attracted a large number of foreign investors, since the limit of share ownership by foreign investors (a maximum of 49 per cent of total listed shares) was eliminated in 1997 (in 1999 also for banks). From January 2002 to August 2007, foreign institutions held almost 70 per cent of the free-float value of the Indonesian equity market, or 41 per cent of the total market capitalization (Rhee and Wang, 2008). At the end of 2009, foreign investors of which accounted for 67 per cent of the value of shares traded on the IDX (Bapepam-LK, 2010). Another feature is that state-control has long been significant and the national government controls 114 companies, 16 of which were listed on the Indonesia Stock Exchange (IDX) as of January 2010 (World Bank, 2010).

### *Recent corporate governance reform*

A new Company Law came into force in 2007 (hereafter "Company Law") replacing the previous one of 1995. The Company Law took an important step by clearly articulating board liability and introducing provisions supporting electronic voting at shareholder meetings. However, some crucial corporate governance requirements concerning board practices, such as the role and structure of boards, board nomination and election processes, are not clearly addressed in the Law and are left to the discretion of the articles of association of each company. The main substance of articles of association of listed companies is delineated in the regulations by Bapepam-LK, the securities and non-bank financial institutions regulator. While the most recent regulations issued in 2008 address the requirements concerning the role and structure of boards, board nomination and election processes have remained untouched.

The recent corporate governance reforms are generally applicable to all public companies both listed and unlisted. This is based on the perception that listed companies

should be treated as a subset, rather than as a prime target, within a comprehensive program of corporate governance reform that extends to family-run private companies and state enterprises, considering the fact that, except for a few cases, every listed company is intricately connected with a powerful business group (Simanjuntak).

With regard to financial institutions, sector-specific codes such as the Banking Sector Code (2004) and the Insurance Sector Code (2006) have been developed by the NCG. In 2006, Bank Indonesia introduced corporate governance regulation (8/4/PBI/2006), applicable to both listed banks (24 banks including 4 state-owned banks as of 2010) and non-listed banks (99 banks as of 2010), and the board nomination and election process in the banks is now under its surveillance through a fit and proper test that all the board members and controlling shareholders need to undergo (Bank Indonesia Regulation 12/23/PBI/2010; Bank Indonesia Circular Letter 13/8/DPNP/2011).

### *Two-tier board model*

The Company Law specifies a two-tier board model stating that there are three organs in a company comprising the general meeting of shareholders (GMS), the board of commissioners (BOC) which corresponds to the supervisory board, and the board of directors (BOD). Remarkably, the members of both BOC and BOD are elected in the GMS, and the BOC is not endowed to appoint and/or dismiss members of the BOD.

The BOD is defined as the company organ with full authority and responsibility for the management of the company, and the BOC is defined as the company organ with the task of supervision and giving advice to the BOD respectively (Article 1). Under the Company Law, the two-tier board system is compulsory for limited liability companies, regardless of size, listing or type, which can be described as "one size fits all" (Kamal, 2008). This is significantly different from the other two-tier board countries, where the system is optional or compulsory only for listed companies.

Table 2.1. **Number of commissioners and directors on the boards**

| Number of commissioners in the board | Number of listed companies (%) | | Number of directors in the board | Number of listed companies (%) | |
|---|---|---|---|---|---|
| 2 | 55 | (12.44) | 2 | 50 | (11.31) |
| **3** | **163** | (36.88) | **3** | **106** | (23.98) |
| 4 | 68 | (15.38) | 4 | 95 | (21.49) |
| 5 | 78 | (17.65) | 5 | 86 | (19.46) |
| 6 | 39 | ( 8.82) | 6 | 43 | ( 9.73) |
| 7-13 | 39 | ( 8.82) | 7-13 | 62 | (14.03) |
| Total | 442 | | Total | 442 | |

*Source:* Bapepam-LK 2010 data.

The members of the BOC are classified into three ways, but the Company Law does not require any specific composition and leaves it to companies to decide [Article 120(1)]. The first is an "independent commissioner", a person unaffiliated with main shareholders, member of the BOD and/or the other members of the BOC [Article 120(2)]. The second is a "delegated commissioner" who is appointed on the basis of a resolution of a meeting of the BOC [Article 120(3)]. The third is an "ordinary" commissioner. The listing rules set additional requirements about the minimum ratio of the number of independent

commissioners in the BOC, and at least one must be an unaffiliated director in the BOD (III.1.5).

Besides the general task of the BOC to supervise and give advice to the BOD, the Company Law specifies specific tasks of the BOC such as: to approve or analyse an annual plan prepared by the BOD based on the articles of association of a corporation; to analyse and sign an annual report; to approve the proposal of interim dividend prepared by the BOD; decide the remuneration of the BOD subject to the authorisation by the GMS; and to approve the merger or takeover of the company. Despite all the tasks set out in the Law, the effective monitoring of the BOD by the BOC is hardly ensured in the current framework where the structural and functional counterbalance between the BOC and BOD is substantially delegated to articles of association of each company. A study shows that founding families used to maintain its control of ownership and management, either through vesting significant powers to the BOC in the original articles of association and placing a family member as chair of the BOC, or through limiting the power of the BOC and placing retired government officials on it and controlling management as chair of the BOD (Sato, 2003). Simanjuntak states that "the majority owner may choose a non-related executive to chair the Executive Board and/or the Supervisory Board, but the chosen professional must have demonstrated an unquestionable loyalty to the majority owner".

The power to appoint and dismiss a director (a member of the BOD) is not endowed to the BOC. The BOC may suspend a director, but this decision must be confirmed by the GMS in 30 days or otherwise it becomes void (Article 106). This Indonesian framework is distinct from other jurisdictions (*e.g.* Germany) with the two-tier board system, where the supervisory board has power to appoint and dismiss (for cause) the members of the management board. This is not consistent with the Annotations to the Principles stating that the supervisory board should be responsible for appointing the management board in two-tier board systems (VI.D.3). The lack of power to nominate and dismiss a director deprives the BOC of its function to supervise the BOD (Kamal, 2008). The World Bank (2010) put this as "Electing directors by GMS can limit the ability of the BOC to oversee management and hold them accountable. It also requires the GMS to have the technical expertise to choose top managers directly". The division of management tasks and authority between directors shall be determined by a GMS (Article 92), which may weaken the supervisory function of the BOC and inhibit agile management by the BOD.

The two-tier board system precludes the direct interlocking of supervisory and management boards in each company. Given that family ownership is predominant and controlling shareholders have decisive influence over board elections, the indirect interlocking via controlling shareholders still happens. Simanjuntak notes that "interlocking directorship is almost universal among large business groups".

### *Board independence*

As principle VI.E states, the board should be able to exercise objective independent judgement on corporate affairs. To ensure board independence, a sufficient number of board members will need to be independent of management. With regard to independent commissioners, listing rules enacted in 2001 require that public companies should have at least 30 per cent "independent" commissioners (III.1.4). For the banking sector, at least 50 per cent of the total membership of the BOC must be independent commissioners (8/4/PBI/2006). Independence is defined by Bapepam-LK regulation, where a commissioner has neither *i)* any direct/indirect ownership in issuers or companies, *ii)* any affiliation with

issuers and companies, commissioners, directors, or majority shareholder of the issuers or companies, nor *iii)* any direct/indirect business relationship which relates with business activity of issuers or companies is allowed (IX.I.5).

Most listed companies follow the requirement of a minimum ratio. According to Bapepam-LK (2010) data, out of 1,814 commissioner posts there were 716 (39 per cent) independent commissioners. Regarding the 50 leading companies, as of July 2011, 45 per cent of members of BOC were independent, and 22 out of 50 have more than 50 per cent independent members in the BOC. However, the chairman of the BOC is normally not independent. According to the Indonesian Institute for Corporate Directorship (IICD) survey in 2008 dealing with 329 listed companies, only 17 per cent of companies have an independent commissioner as chairman. A study of the 11 largest companies showed that 4 companies have independent commissioners comprising a majority of the BOC, but no company has an independent chairman (ACGA 2010).

The Bapepam-LK rule regarding annual reports requires a brief biography of each board member (X.K.6.2.e), but it does not require disclosure of the relationships that independent commissioners might have with the company. Without specific details on this point, it is hardly possible for market participants to analyse and judge their independence, even though most listed companies claim in their annual reports that they have a sufficient number of independent commissioners in the BOC.

An empirical study using 190 listed companies in Indonesia reveals that the proportion of independent members on the board exhibits an insignificant relationship with firm performance (Prabowo and Simpson, 2011). This result could be driven by the lack of institutional reforms in recent years in relation to the appointment of directors. Given the predominant family ownership, the independent commissioner arguably represents the interest of the controlling family, which potentially reduces the commissioner's independence in performing the role of supervising the BOD. To put it another way, the role of independent commissioners is severely limited, in providing a check on the right of the owner-manager to have the final say in decision making, even without having an explicit managerial position (Sato, 2003). It has also been noted that independent commissioners appear to face several kinds of constraints in their access to information about board meeting agendas and to outside professional services (ADB, 2005).

In terms of the delegated commissioner, who is a member of the BOC and appointed on the basis of a resolution of the BOC, the tasks and authority are not clearly stated in the Company Law and entrusted entirely to articles of association. An example of the duties of such delegated commissioners is the duty of daily supervision and daily contact with the BOD. This would enhance hands-on supervision by the BOC (Tumbuan, 2005), but may blur the distinction of the two-tier board system that preclude the interlocking between BOCs and BODs (Kamal, 2008).

With regard to the composition of the management board, listing rules require that public companies should have at least one unaffiliated director in the BOD (III.1.5). This requirement ensures that each listed company have a management director without any affiliate relation with any member of the BOC (III.1.6.2). The definition of "unaffiliated director" also precludes any affiliate relation with the controlling shareholder of the relevant listed companies (III.1.6.1), which is justified in Indonesia by the ownership structure. However, an ultra short cooling-off period of no more than 6 months makes this requirement a mere façade. It is hardly evaluated by market participants whether this

requirement is appropriately implemented in each company, since there is no mandatory disclosure concerning how the criteria are met in the light of the definition of "unaffiliated director".

### *Board qualification and composition*

With regard to the qualification of commissioners and directors, the Company Law stipulates only conventional requirements including those who in the 5 years before their appointment were not: *i)* declared bankrupt; *ii)* members of a BOD/BOC who were declared to be at fault causing a company's bankrupcy; or *iii)* sentenced for crimes which caused financial losses to the state and/or which were related to the financial sector [Article 93(1) and 110(1)]. The Bapepam-LK rules add to this requirement by including general criteria such as: *a)* good character and probity; and *b)* legal competence (IX.I.6.1).

The CGCG recommends that the board is professional in terms of possessing the integrity, experience and capability necessary for carrying out their duties. In addition, the code states that all members of the board shall be domiciled in Indonesia, at a place where they can execute their daily management functions. Listing rules require that members of a BOD/BOC of listed companies should be professionals with good reputations, but there is no tangible criteria for this requirement except for regulated industries such as banks.

Table 2.2. **Educational background of commissioners and directors**

| Educational background | Total number of commissioners (%) | | Total number of directors (%) | |
|---|---|---|---|---|
| Lower than under graduate | 69 | (3.80) | 52 | (2.59) |
| **Under graduate** | **739** | (40.74) | **962** | (47.84) |
| Post graduate | 490 | (27.01) | 638 | (31.73) |
| Doctorate degree | 154 | (8.49) | 34 | (1.69) |
| Unknown | 362 | (19.96) | 325 | (16.16) |
| Total | 1,814 | | 2,011 | |

*Source:* Bapepam-LK 2011.

Listed companies are required to disclose in their annual report the director training program (X.K.6.2.g.2.d). Several institutions offer board member training, for example the Indonesian Commissioners and Directors Institute (*Lembaga Komisaris dan Direksi Indonesia*) and the IICD institute offers a one-day training and certification programme. However, the IICD survey in 2008 shows that 92 per cent of 329 listed companies had never sent their board members to corporate governance training.

There is no rule promoting diversity or gender quotas. According to the Bapapem-LK data dealing with all listed companies, the average percentage of women on boards is 10.1 per cent (the BOC) and 11.2 per cent (the BOD), respectively. Regarding nationality diversity, foreigners on the board in the sampled 169 companies account for an average 8.9 per cent of board seats (Darmadi, 2011). This proportion can be partly attributable to the high proportion of foreign ownership in some companies.

### *Board evaluation*

The CGCG suggests to establish a mechanism and criteria for self-assessment regarding performance of each member of the BOC (VII.3.1). For a comprehensive and overall evaluation of boards, self-assessments or using the service of an independent

external party to ensure continuous implementation of CGCG is recommended, accompanied by the disclosure of its outcome in the annual report (VIII.2.5).

The Bapepam-LK introduced a rule requiring companies to disclose director performance assessments by the BOC and discussion of the BOC task performance (X.K.6.2.c.1, g.1.a). However, the IICD survey in 2008 shows that only 5 per cent and 3 per cent out of the 329 listed companies conducted an annual performance assessment of the BOD and annual self-assessment of the BOC, respectively. There is no company in which external experts conduct an independent evaluation of board performance, or where the board evaluations are communicated to shareholders that might influence board composition.

## 2.3. Board nomination processes and shareholders' rights

### *Board nomination process*

Members of BOD and BOC are elected by the GMS for a fixed period with the possibility of re-appointment. Companies are free to set the terms of the board members in their articles of association, but cannot exceed 5 years (Bapepam-LK IX.J.1 13b). There is no requirement that companies have a formal nomination process. The Company Law requires that articles of association shall stipulate procedures for the appointment, replacement, and dismissal of members, but establishing a nomination process in the articles is not mandatory (Article 94 and 111).

Some state-owned companies set out the nomination process in the articles to guarantee the government a special privilege of nominating a board member, but no company ensures that minority shareholders have a right to nominate members. A survey reveals that retired or active government officials are commonly appointed to a BOC, presumably for the company to gain access to the respective government institution (CFA Institute, 2008). In fact, there is no regulation which prohibits retired government officials from taking seats on the boards of the companies that they have regulated for a certain time of period.

The World Bank (2010) states that, in practice, the BOC in a number of companies does play a role in director nomination, but key decisions are made by the controlling shareholders. By and large, the nomination process is still informal, based on consensus by the network of the controlling shareholders. Family-controlled companies typically have strong preferences for family continuity. Such preferences may be the result of private benefits derived from having close relatives influencing decisions (Baker *et al.*, page 380). The disclosure requirement for a brief biography of every board member (Bapepam-LK Rule X.K.6.2.e) can reduce the possibility of nepotism or cronyism in management and board representation. However, in a weak institutional environment without strong requirements for board nomination and election it remains a problem. The principle of family spirit (*asas kekeluargaan*) is widely respected and consideration of this principle is clearly stated in the preamble of the Company Law.

For some regulated industries (*e.g.*, banks, insurance companies, securities companies), the regulator conducts fit and proper person tests, but there is no equivalent for other listed companies.

There is no mechanism that allows minority shareholders to nominate board members, except that shareholders with more than 10 per cent of shares in aggregate can call a shareholders meeting for the election of their candidate (Article 79(2)), but it is rarely

found in practice. This is partly because there is no reason for minority shareholders to contest the board's slate by adding additional nominees to the agenda of the GMS (Enriques *et al.*, 2009), since these insurgent candidates can seldom be elected in the GMS without any mechanisms such as proportional representation or cumulative voting (discussed below). Concerning the nomination of independent commissioners, the CGCG recommends that opinions of minority shareholders are to be obtained and considered in the process, but there is no requirement.

### *Nomination committee*

While the Company Law is silent with regard to nomination processes, public companies are recommended by the CGCG to establish a nomination committee and to evaluate candidates for the BOC prior to the GMS (IV.C.1.4). However, the Code is not binding, and only 21 per cent of listed companies as of 2010 comply with the CGCG in establishing the committee (Bapepam-LK data).

The CGCG does not recommend a majority of independent members in the nomination committee. The committee should be chaired by an independent commissioner but a specific background is not required in public companies other than banks (IV.C.4.2). This leaves market participants sceptical whether commissioners could play an effective role on the committee without outside assistance (World Bank, 2010).

Regarding the function of a nomination committee, the CGCG recommends that *i)* the process of evaluating candidates for the BOC shall be conducted by the committee, and *ii)* the appointment of an independent commissioner shall have considered the opinion of the minority shareholders which shall be obtained through the committee (IV.C.1.4). However, it does not recommend that a nomination committee should have powers to present the slate of nominees by itself or to modify the slate prepared by the incumbent members of the BOC.

The Bapepam-LK rule requires the companies with a nomination committee to disclose the relevant information, such as independence of the committee member, task description and responsibility, and briefly report on its performance (X.K.6.2.g.4). However, the degree of disclosure in practice is poor as the IICD found in 2008 more than 80 per cent of surveyed companies with a nomination committee did not disclose the relevant information: 83, 95, and 89 per cent of companies did not disclose information concerning roles and responsibility, independence, and performance/attendance, respectively. Without sufficient disclosure, how a nomination committee is functioning in each company remains veiled in a haze. Combined with the lack of a legal or regulatory framework that empowers the nomination committee, the current framework gives little thought to the possibility that shareholders can effectively participate in the board nomination and election process.

The framework of a nomination committee discussed above preserves the power of controlling shareholders. Even though these weaknesses can be overcome, there still remain fundamental doubts whether the committee constitutes a significant step toward effective board nomination and election. As Umakanth pointed out, an independent nomination committee may not achieve its intended goals where shareholding in companies tends to be concentrated. He states, "Although a nomination committee may recommend candidates to begin with, the election of such candidates is still subject to voting at shareholders' meetings where controlling shareholders can wield significant

influence. Due to this reason, the nomination committee is likely to pick candidates who have the tacit acceptance of the controlling shareholders so that the successful outcome of election of such candidates is not in doubt", and he concludes that the committee does not mitigate the influence of controlling shareholders in the election of board members, particularly that of independent members (Umakanth, 2011).

## 2.4. Shareholders' right to elect board members

### *Voting process*

At the GMS, voting is normally conducted for the entire slate of candidates following a majority voting rule. Majority voting is required in the Bapepam-LK rule (IX.J.1.15.c). Cumulative voting and proportional representation are types of voting methods that enhance the ability of minority shareholders to elect a board member under some circumstances. There are no such mechanisms that allow it in Indonesia (World Bank, 2010) and it is usually not acknowledged in corporate articles of association (ADB, 2005). For independent commissioners who are generally expected to protect the rights of minority shareholders, it is worth considering the process of electing them separately from the slate by using other methods.

The Company Law introduced provisions supporting electronic voting at the GMS in 2007, but the World Bank (2010) noted that adoption of this technology appeared to be in its early stages. Shareholders can vote in absentia, and such proxy voting is widely used. There is no rule against proxy solicitation (World Bank, 2010) but proxy contests are rarely held.

Another important aspect of the voting system comprises the rules that regulate the distribution of voting power among classes of shares (Enriques *et al*., 2009). While the Company Law embraces the default rule of one-share one-vote in general (Article 52), it permits the articles of association to determine the classification of shares including shares without voting rights and those with special rights to nominate members of the BOD and/or the BOC (Article 53).

A major exception to the one-share one-vote provision is the *dwiwarna* share, which is based on a shareholders' agreement between privatised state-owned enterprises and the government. This golden share held by the government enjoys veto rights with respect to the election and removal of directors and commissioners, and to amendments to the articles of association (OECD, 2010). Terms and conditions of *dwiwarna* shares are described in the articles of association, which are not usually disclosed to public. The disclosure of shareholder agreements is not required in Indonesia (Nenova, 2005). OECD principle II.D recommends that they should be disclosed, given the capacity of such agreements to redistribute the influence of shareholders on company policy.

With regard to cross-shareholdings which can cause capital dilution (Ferrarini, 2000), the Company Law 2007 introduced an article to deprive the voting right of shares owned by the company itself or its related companies (Article 84(2)). How this restriction is implemented in each company is difficult to assess without disclosure of voting results and transparency pertaining to repurchase by a company of its own shares, and circular voting structures. The other control enhancing mechanism, such as voting caps, which redistribute control and may affect the incentives for shareholder participation in shareholder meetings, are not banned but may be prescribed by the articles of association.

Share ownership structures that have effects identical to those of dual-class shares, such as corporate pyramids, are predominant in Indonesia. A recent survey reports that 13.9 per cent of all listed companies are identified as family group firms controlled through a pyramid (the sixth highest out of 45 countries) (Masulis *et al.*, 2011). The divergence between control rights and cash-flow rights creates an incentive for controlling shareholders to expropriate the wealth of non-controlling shareholders, and this expropriation can be more easily conducted by, among other means, having board members who might work more for the interests of controlling shareholders than for the interests of the companies. Indonesian companies display considerable divergence between control rights and cash-flow rights: a recent study shows that the largest controlling shareholders' voting rights exceed cash-flow rights in 65 out of 119 surveyed companies (54.6 per cent: second highest behind **Singapore** out of 8 countries/jurisdictions), and the mean (median) difference in voting and cash-flow rights among these 65 companies is 12.5 per cent (10.0 per cent) (Chong, 2010).

### *Shareholders' participation in the GMS*

Minority shareholders have little power to contest the slate prepared by the company by adding additional nominees to the agenda of the GMS, except that they can call a shareholder meeting (10 per cent of capital required) [Article 79(2)] or have the unanimous consent of all shareholders [Article 75(4)]. The threshold of 10 per cent capital is quite high compared to other regional peers but has remained unchanged for decades. Taking into account the degree of ownership concentration in Indonesia, these requirements in effect prevent minority shareholders from putting any items on the agenda. All the above factors leave no alternative to shareholders than to approve the whole package presented by the incumbent board (World Bank, 2004), and there is generally no opposing slate of candidates (World Bank, 2010).

A few global institutional investors vote their holdings, as do some of the larger domestic pension funds, such as Jamsostek. However, as the Asian Corporate Governance Association (ACGA) points out, there is very limited engagement of institutional investors, if any, with listed companies (ACGA 2010). The barriers preventing shareholders' engagement in the GMS include: that the announcement of the meeting is not properly distributed giving each shareholder sufficient time to analyze the proposal; and that the information provided regarding the agenda is limited.

### *Board removal*

An extraordinary general meeting can be used to remove a board member, but two-thirds of the total voting shares must be present at the shareholders' meeting to do so, which makes it difficult for shareholders to remove a board member outside of the GMS (CFA Institute, 2008).

## 2.5. Degree of disclosure about the nomination and election process

All listed companies are required to produce annual reports including a board report with statements on corporate governance (Bapepam-LK Rule X.K.6). However, the provision regarding the content of reports on corporate governance does not include the nomination and election process, except for the description of a nomination committee (Bapepam-LK Rule X.K.6). This results in a mere reiteration of relevant code and rules in annual reports giving no sufficient information on the nomination and election process in most cases.

To enable shareholders to assess the qualifications of board member candidates, it is important to disclose the background and professional experience of the candidates prior to the GMS. Shareholders are expected to receive an invitation to the GMS more than 14 days before the meeting via an advertisement in newspapers (Article 82). The announcement of the GMS shall be made at least 14 days before the invitation (Bapepam-LK Rule IX.J.1.15.b.1). The content of the invitation includes the date, time, location, agenda and notification that the materials to be discussed in the GSM are available at the company's office (Bapepam-LK Rule IX.J.1.15.b.4). This does not ensure that the invitation includes the names of the candidates, let alone sufficient information regarding candidates' qualifications, and accordingly, most listed companies in practice fail to provide such fundamental information about board election before the GMS.

There is no mandate for listed companies to maintain a company website and therefore no rules with respect to publishing material information on the website. In the 2008 IICD study, it was observed that only 13.6 per cent of surveyed companies published notices of a shareholder meeting on the website. Some of these companies post on their website the invitation to the GMS and the agenda including board election but without a candidate list, and requiring shareholders to come to its office during business hours if they want to review the meeting materials.

The CGCG provides the framework of enhancing disclosure and public relations by recommending listed companies to have a corporate secretary. Its function is to ensure: a sound communication between the company and its stakeholders; and the provision of information in accordance with the proper need of stakeholders. The Bapepam-LK rule duplicates this basic function (IX.I.4) and requires companies to disclose the job description and function of the corporate secretary in the annual report (X.K.6.2.g.5). The 2008 IICD study observed that 72.7 per cent of surveyed companies provided contact details for a specific investor relations person or unit that are easily accessible to outside investors.

After the GMS, listed companies must submit the minutes of the meeting to Bapepam-LK within two working days, and publish it in newspapers (Bapepam-LK Rule IX.I.1). The minutes include meeting agenda and decisions taken, but the number of votes for board member election is not disclosed.

As a whole, the Indonesian approach described above can be viewed as not transparent, whereby shareholders and investors are expected to acquire the relevant information through directly accessing the company's contact person represented by the corporate secretary, rather than through public disclosure.

## 2.6. Overall functioning

The Indonesian government has taken a number of measures to improve corporate governance since the economic crisis in 1997, but board nomination and election practices have been left intact. As described in the previous sections, the legal and regulatory framework concerning board nomination and election is virtually non-existent, and practices are mostly delegated to the articles of association of each company. According to the agreement with the IMF after the economic crisis, the Indonesian government pushed forward the Code of Good Corporate Governance, including the recommendation to establish a nomination committee chaired by an independent member of the supervisory board. However, since the application of the Code is voluntary and without the "comply or

explain" approach, most listed companies can easily neglect its recommendations. The Code has been losing its influence, since the financial support from the government to the standard setting body of the Code, the National Committee on Governance, was cut off in 2008.

Indonesian-listed companies are characterised by concentrated ownership in the hands of controlling families. This characteristic remains even as the number of listed companies has grown by 45 per cent in the last 10 years. Under the circumstances where there is no *ex ante* legal or regulatory requirements regarding formal board nomination and election, controlling shareholders can easily establish articles of association to facilitate and maintain their powers, and board nomination and election remains solely the prerogative of controlling families.

In the aforementioned situation, a strong disclosure regime that promotes real transparency becomes a central issue. However, the framework that ensures disclosure and transparency of board nomination and election process does not exist. Each company's articles of association where the board election process is stipulated are not generally disclosed. The exception is that the Bapepam-LK rule requires listed companies to disclose the structure of a nomination committee established voluntarily by the company. In the process, shareholders are often not informed of even the names of candidates, let alone their qualifications. Minority shareholders may inquire about information concerning the candidates, but within a limited period of time (14 days), there is little chance for them to contest the slate prepared by the incumbent board members who are in favour of the controlling families.

Even though there are some exceptional companies which follow good practice by establishing a nomination committee, their board nomination and election process through the committee remains unclear. Weak disclosure and opaque practices, which are commonly found in Indonesian-listed companies, can contribute to unethical behaviour and to a loss of market integrity, not just to the company and its shareholders, but also to the economy as a whole. The following comment made by Simanjuntak is still worth considering: "Filling a board exclusively with family members, as is still the situation found in most firms, may be good from the point of view of safety; but it is likely to lead to a dull board. (…) Diverse educational backgrounds, cultures of origin, and ages are likely to be an asset rather than a liability to a board. To secure such diversity, recruitment of members to the boards should, therefore, be made an important affair. Majority owner should unlearn the habit of appointing board members in a casual way. Good board composition requires a thorough selection, which in turn is best left to a committee" (Simanjuntak, 2000).

## 2.7. Assessment and conclusions

The Indonesian Code of Good Corporate Governance, which was created in 2000 and revised in 2006, intended to cover the main elements dealt with in the OECD Principles, including the board nomination and election process. There remain several weaknesses. The implementation of the Code is voluntary, and consequently listed companies give it little attention. While many of its recommendations have been adopted in Bapapem-LK rules and thus are mandatory for all listed companies, the issues relating to board nomination and election remain uncovered. Therefore, it is hard to situate the Code as a basis for the assessment.

The Company Law offers a glimpse of the role and responsibilities of the BOC (supervisory board) and BOD (management board), but the structural and functional counterbalance between the BOC and BOD is substantially delegated to articles of association of each company. Under this framework, the effective monitoring of management by the BOC is not ensured, and the main function of the BOC is more like an advisory board. Putting more emphasis on the supervisory function of the BOC is essential, especially in the weak institutional environment, and to ensure that end, the powers and authorities of the BOC over the BOD need to be examined. Without a clear description of role and responsibilities of the BOC and BOD, it is hard to nominate and elect the right person for the right position on the board.

The legal and regulatory framework gives great flexibility to the board nomination and election process without requiring disclosure. It is necessary to tighten the legal and regulatory framework to ensure effective shareholder participation in decisions regarding board nomination and election. One of the highest priorities is to provide shareholders sufficient and timely information. It should put an end to the situation where minority shareholders are firstly informed of the names of the candidates in the place of GMS without any explanation of their qualifications. It is also important to enhance the minority shareholders' participation in the process of nominating and electing independent members of the BOC. Ensuring disclosure and transparency of the board nomination and election process is the most pressing issue. Besides information concerning the formalities, such as the structure of nomination committees, it is worth enhancing transparency in more practical and substantive matters, such as how effectively and independently the nomination committee has validated the qualification of candidates to their required mandate, in the light of the corporate strategy.

Concerning the Principles' main recommendations directly addressing board nomination and election systems (II.C.3, V.A.4 and VI.D.5),

- Principle II.C.3, on whether shareholders can *effectively* participate in the board nomination and election process, is a key concern. Under the circumstances where most listed companies are characterized by concentrated ownership in the hands of controlling families, and there is no formal and transparent process concerning board nomination and election in laws and regulations, it cannot be expected that minority shareholders are appropriately incentivised to participate in the process by exercising their voting rights.
- Principle V.A.4, on the disclosure of material information about board members, including their qualifications, the selection process, and independence, is a serious concern. Bapepam-LK has further developed market transparency by updating the disclosure requirement of annual report, but the disclosure of board nomination and election process remains untouched, and the process which each company follows is still shrouded in darkness to market participants.
- Principle VI.D.3, on the role of the board in replacing key executives, poses another concern. The board of commissioners, a supervisory board, is not endowed with powers to appoint and dismiss directors in the Company Law. This raises a serious concern of the effective monitoring of management by the board.
- Principle VI.D.5, dealing with the board function of ensuring a formal and transparent board nomination and election process, is not addressed in the legal and regulatory

framework. Setting up the process is mainly delegated to each company's articles of association, which are not required to be disclosed.

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PART II

*Chapter 3*

# Korea: Review of board nomination and election practices

*This chapter on Korea describes the ownership structure of listed companies and then considers the board nomination and election processes including disclosure practices and obligations. The board nomination and election process is placed within the context of the overall corporate governance framework.*

## 3.1. Introduction

This review of Korea seeks to ascertain to what extent its board nomination and election policies and practices are consistent with relevant recommendations of the *OECD Principles of Corporate Governance,* including:

- Principle II.C.3, which calls for the facilitation of effective shareholder participation in key corporate governance decisions;
- Principle V.A.4, which calls for disclosure of information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board; and
- Principle VI.D.5, which states that the board has an essential role to play in the nomination process, as the board or a nomination committee has a special responsibility to make sure that established procedures are transparent and respected. The Annotations add that the board has a key role 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.

The review is intended to further address whether the nomination and election system contributes effectively to the establishment of a board able to fulfil some of the key board functions identified in the Principles, including:

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

Korea's current corporate governance system has been strongly influenced by its experience during the 1997 Asian financial crisis. Leading up to the crisis, Korea had experienced one of the most successful economic transformations in the world, emerging from a poor, agriculturally-based economy in the 1950s to an industrial economy led by its diversified, family-controlled conglomerates (known as *chaebols)*. However, many of these same conglomerates also played a large part in Korea's economic collapse during the Asian financial crisis due to weak operational performance, over-leveraging and vulnerabilities exacerbated by Korea's falling currency. Considering corporate governance as a highly relevant factor in the crisis across Asia, the IMF agreed to provide a bail-out to the Korean government only after calling for certain conditions that included reforms to improve

board practices, disclosure, creditor rights, and accountability to shareholders through strengthened minority shareholder rights.

As the following section on Korea's corporate governance framework makes clear, the Korean government responded by adopting significant corporate governance reforms that led to major improvements in Korean corporate governance in the years immediately following the crisis. Among other reforms, Korea established requirements for its largest company boards, which are single-tiered, to have a majority of "outside directors" who must meet specific criteria for independence. These and other reforms appear to have had a significant and positive impact. On the other hand, it appears clear that minority shareholders continue to face barriers that constrain their ability to influence board nominations and elections. These constraints on minority shareholder participation raise questions about how effective incentives may be for Korean boards to serve as monitors against controlling shareholder abuse, one of the main corporate governance concerns considering the Korean market structure (principle VI.D.6).

## 3.2. Corporate governance framework

To evaluate Korea's board nomination and election system, it is important to understand its basic market structure, ownership characteristics and the recent evolution of its corporate governance framework. Korea's stock market consists of two listing segments – the KOSPI, featuring Korea's largest listed companies, and KOSDAQ which focuses on small and medium-sized enterprises and younger technology-oriented firms. Of Korea's approximately 1,822 listed companies, 791 are listed on the KOSPI market (as of 2011). Market capitalisation for the two exchanges totalled USD 1,092 billion at the end of 2010, or 110.7 per cent of GDP, according to data from the World Federation of Exchanges.[1] Trading is active, with a market turnover ratio of 168.9 per cent as of 2010.[2]

Korea's listed companies tend to have relatively dispersed ownership paired with concentrated control. The Korean market is particularly known for the predominance of its *chaebols,* characterized by family-based controlling owners who make use of pyramid structures and circular and/or interlocking ownership structures within affiliated companies to maintain control despite relatively low direct cash flow rights. The largest 10 conglomerate groups, including such well-known and highly diversified groups as Samsung, Hyundai Motors, LG, and SK, have seen the market capitalization of their 90 listed affiliates grow from 47.2 per cent of the KOSPI market cap in 2008 to 52.3 per cent as of January, 2012.[3] The conglomerates' role in the economy extends well beyond listed affiliates to a much larger number of non-listed companies. As of April 2011, the 38 company groups with family ownership considered to be *chaebols* (out of 55 company groups overall) owned 1,364 companies, of which 213 are listed. On average, the family-owned shares comprised just 4.47 per cent, and the affiliate company-owned shares totalled 47.36 per cent, giving controlling shareholders an average of 51.83 per cent overall control. Control may be further enhanced through the legal right of listed companies to issue non-voting shares of up to 50 per cent of total shares. Overall, 460 listed companies on the KOSPI market have a shareholder with at least 10 per cent of a company's shares, including related ownership.[4]

Foreign investors have also played a growing role in Korea, rising from a 13 per cent share of market capital in 1996 to 37 per cent in 2006. Foreign investors are the largest shareholders in many "blue chip" companies, according to the Korean Corporate

Governance Service (KCGS), a research and advisory service for the government and stock exchange.

Institutional investors, with a few exceptions such as the Korean Corporate Governance Fund and Allianz Korea, generally are not active on corporate governance issues. They accounted for 13.45 per cent of the total market capitalization as of 2010, according to KCGS. The state-owned pension fund, the National Pension Service, is Korea's largest institutional investor, accounting for 5.5 per cent of market capitalization. Although NPS has established voting guidelines and exercises its voting rights, it has not been active in initiating shareholder proposals such as nominations to the board, due to a concern within the market against having direct government intervention in private companies.

Following the 1997 crisis, and as one of the IMF's conditions, Korea adopted a range of important corporate governance reforms aimed at increasing corporate transparency, oversight and accountability. These included sharp reductions in the ownership thresholds for shareholder actions (which dropped from a 5 per cent minimum threshold for derivative actions to a current threshold of just 0.01 for shares held for longer than six months). This reform has allowed for the filing and successful challenges to several of Korea's largest companies for their abuses of minority shareholder rights, signalling that board members would be held liable for failure to exercise their fiduciary duties. Shareholders of listed companies with at least 1.5 per cent of shares held for longer than six months may also now call an extraordinary general meeting.

Concerning the more specific focus of this report on board nomination and election, the post-crisis reforms included a key requirement that companies with assets above KRW 2 trillion (about USD 1.8 billion based on 2012 exchange rates) appoint a majority of "outside directors," who must meet certain requirements for independence. These Korean companies are also required to have audit committees with at least two-thirds outside directors, including in the chairing role. At least one of the outside directors on the audit committee must also have financial or accounting expertise. These outside directors also are required to serve as a majority on the "outside directors nomination committee" that reviews and screens candidates prior to the board's nomination of all director candidates for AGM consideration, including those for "inside director" positions.

While outside directors are customarily elected by the votes of the controlling shareholders, and nominations of directors by minority shareholders are rare, outside directors must nevertheless meet independence criteria including having no family or economic relationship to management or to the controlling shareholder or other affiliated companies within the last two years. Some stakeholders have suggested that a significant number of these directors lack real independence, for example, in the case of academics who have received or potentially may receive funding from conglomerates' research institutes, or for board members whose relationships with the company date back beyond the 2-year threshold established under the requirement. Nevertheless, the outside director requirements represent a significant improvement over the pre-crisis corporate governance framework. Researchers studying changes over time and differences between companies in use of outside directors have shown a correlation in Korea between higher firm values and higher numbers of outside directors, suggesting that the reforms have had a positive impact.[5]

The outside director majority requirement applies only to Korea's 116 largest companies above the KRW 2 trillion threshold. In addition, 48 listed and 109 non-listed

financial institutions falling under the jurisdiction of the Financial Services Commission are required to appoint not less than one-half of the board as outside directors (and a majority of outside directors in the case of banks). These financial institutions are also required to establish outside director nominating committees and audit committees. Other listed companies are only required to appoint one outside director (comprising at least 25 per cent of the board), with no requirement for outside director nominating committees or audit committees (whose function is replaced by a statutory auditor separately elected by the shareholders). A small number of companies below the threshold have appointed a majority of outside directors voluntarily, with some 30 Korean companies also voluntarily establishing outside director nomination committees (generally former state-owned enterprises, financial institutions or companies with large foreign ownership), according to the Korean authorities. Overall, among KOSPI listed companies, Korea's boards in 2010 had an average of 6.7 members, with an average of 2.3 outside directors, according to KCGS data.

However, there remains some scepticism among market participants regarding the effectiveness of the "outside director" system, both from activist investors who suggest that more should be done to reinforce outside director independence, and from the perspective of Korean business interests who question the benefits provided by outside directors and suggest that it is a costly, US-type corporate governance concept that may not fully fit Korea's particular market characteristics. The Ministry of Justice has decided to establish a task force to look at the issue of outside directors with a view to developing possible proposed adjustments to the system by mid-2012, including consideration of ways to increase the use of cumulative voting to strengthen minority shareholders' ability to influence board election outcomes. Further details of the Korean board nomination and election system and potential adjustments are addressed later in this report.

### *Recent Korean Corporate Governance Reforms*

In recent years, Korea's Ministry of Justice has undertaken a comprehensive review of its Commercial Act, which after four years of consideration by Parliament ultimately led to the 2011 enactment of amendments to 250 articles of corporate law. Two major corporate scandals attracted public attention in 2011 and helped motivate the Parliamentary actions. In the first case, Taekwang Group's chairman was indicted on charges of embezzlement and breach of trust, and ultimately fined KRW 2 billion and sentenced to 4½ years in prison. Lee was found guilty of embezzling KRW 20.8 billion (USD 18.5 million) through accounting manoeuvres, and causing damage to the company worth KRW 300 million (USD 266 000) by selling the company's golf clubs at below-market prices and by extending loans to its affiliates without collateral.[6] In the second case involving the Hyundai group, Hyundai Motor's Chairman was ordered to pay KRW 82.6 billion in compensation to his own company for inflicting damages on the company through unfairly supporting one of its affiliates.[7] These cases helped to build public support for stronger regulation to prohibit self-dealing and stricter review of related party transactions. Some of the key amendments, which took effect on 15 April, 2012, include:

- requiring a two-thirds majority approval of the board and strengthened disclosure for transactions involving directors, major shareholders or their family;
- making directors liable for using company information or other opportunities to obtain company profits for their benefit that cause the company to suffer damage. To make such cases easier for the plaintiff to prove, the amendment includes a provision

specifying that the damage shall be presumed to be the amount of the profit gained by the director, meaning that the plaintiff no longer has to prove an exact amount based on hypothetical lost corporate opportunities, which can be more difficult to prove;

- Korea's 300 largest companies must develop "compliance guidelines" for their executives and employees to comply with the law, and to "appropriately manage the company". These companies' boards must also appoint a "compliance officer" meeting certain professional qualifications to monitor compliance and report to the board;
- An implementing Presidential decree also limits the number of boards of directors on which outside directors may serve to no more than two additional boards including those of non-listed companies.

Complementary to the clarified framework for assessing damages for self-dealing cases, the Act also includes a separate provision, applied to cases of "light negligence", limiting directors' liability for neglecting to perform their duties or failure to follow the law to six times the level of the director's salary for inside directors, and three times the salary level for outside directors.

The Financial Services Commission (FSC) is also preparing a number of reform proposals but these have not yet been submitted to Parliament. One proposal applying to all financial institutions above KRW 2 trillion would not only require that at least a majority of outside directors serve on the boards of all financial institutions, but also that only outside directors serve on their outside director nominating committees. The requirement for accounting, financial or other specialized expertise would also extend to any outside director for a financial institution board.

Another reform would streamline the current process required of shareholders to obtain FSC approval for proxy solicitations. Companies are not required to disclose information on the AGM until two weeks before the meeting, meaning that current waiting periods of five working days for FSC approval left less than one week to seek shareholder support through such proxy solicitations. Under the proposal, the FSC review period for proxy solicitation would be reduced to just two days, which could make a significant difference considering the short time available to minority shareholders to publicize proxy solicitations.

A final FSC proposal would eliminate the practice of "shadow voting" by 2015 for all listed companies. Shadow voting is a practice in Korea under which companies can request shares registered with the Korean Securities Depositary to vote in the same proportion as voters that are present at the AGM (unless the beneficial owners have issued other voting instructions). Shadow voting can be important to meet quorum requirements of approval by at least one-fourth of all shares with voting rights for a measure to be adopted. However, these practices can be manipulated to favour controlling shareholders, *i.e.*, management can request shadow voting for initiatives supported by the controlling shareholder and management, but decline to request shadow voting for minority-shareholder-initiated agenda items.

## 3.3. Board nomination processes

Korea's system of board nomination with more stringent requirements for larger companies provides for outside director nomination committees to identify and recommend outside director candidates for the board to formally nominate. There is no uniform practice for how this is done. A minority of such committees (perhaps 10-12,

according to the KCGS) seek advice from expert advisers or advisory committees. While the outside director nomination committee maintains formal responsibility to propose outside director candidates, management or controlling shareholders can also play a role in suggesting candidates. "Inside directors" who generally are managers from within the company or other parties related to the company or controlling shareholder, tend to be proposed by management or the controlling shareholder and confirmed by the board. In the case of smaller Korean companies, which are only required to have 25 per cent of the board as outside directors and no nominating committee, it is the full board's role to determine board nominations, which may also be based on management or controlling shareholder suggestions.

Shareholders have the right to nominate candidates no later than six weeks before the AGM, if they hold at least 3 per cent of the company's shares, or not less than 1 per cent if they have held the shares for the most recent six months or longer (or just 0.5 percent of the shares for companies with book equity greater than KRW 100 billion (about 900 million USD)). For companies with assets of at least KRW 2 trillion, the outside directors nomination committee is required to include candidates nominated by shareholders in the candidate list that will be submitted to the shareholder meeting by the Board of Directors, subject to reviewing their qualifications to ensure that all nominated candidates meet the detailed legal requirements to be designated as outside directors.[8]

There are no provisions for "special directors" other than the requirements for outside directors. For companies above the KRW 2 trillion threshold, at least one outside director serving on the audit committee must have accounting or finance expertise. Companies below this threshold are not required to have an audit committee but must appoint a "statutory auditor," who is elected by the general meeting to participate in board meetings as a non-voting member, and who has broad responsibilities similar to the audit committee to "audit the board's decisions and its decision-making processes", according to the Korean authorities. If either the audit committee or the statutory auditor considers that the board has acted contrary to its fiduciary duties, they have the authority to file a derivative lawsuit representing the company against the responsible directors. The audit committee and statutory auditor have separate functions from the external auditor, who remains responsible for the annual audit of accounts.

## 3.4. Shareholders' right to elect board members

Typically the same number of candidates are nominated as the number of slots that are available for election to the board. If a minority shareholder has proposed a candidate that the controlling shareholders do not support, then there may be a contested election with more candidates than available slots. Such minority shareholder nominations are submitted on average about 10 times per year, according to the KCGS, and may typically involve disputes among family members or cases in which the second largest shareholder uses minority shareholder votes to challenge the largest shareholder.

However, cases in which a minority-shareholder nominated candidate was elected to the board are rare. One 2006 case was noted in which two foreign investors, Icahn Partners and Steel Partners, nominated three outside directors to the KT&G board, and secured one seat. In a few other cases, minority shareholders have succeeded in getting a candidate on the ballot through negotiations rather than through a contested process. Cumulative voting, which could provide minority shareholders with the ability to concentrate their

votes in support of a single candidate, may be proposed by a minority shareholder with at least one per cent of shares, but has only rarely been applied due to restrictions that most companies have imposed in their articles of incorporation. As of 2010, 1,457 out of 1,531 listed companies (95.2 per cent) reported opting out of cumulative voting, according to the KCGS 2011 ESG evaluation survey. However, it is recognized that cumulative voting is not a panacea since it does not prevent strategic behaviour by majority shareholders to maintain control of board elections, and assumes a high level of co-ordination among minority shareholders. While examples can be found where it has been used successfully to strengthen minority shareholder rights to influence board appointments, such as in Chile, such requirements were accompanied by conditions such as a small number of active pension funds with experience in co-ordinating their votes, to effectively use such voting mechanisms.

Board members are typically elected to staggered three-year terms, meaning that in light of Korea's relatively small board size, there generally will not be more than one or two outside director slots up for election in any given year. These circumstances may limit the impact of minority shareholders even in cases where concentration of minority shareholder voting power through cumulative voting is allowed.

A rule aimed at strengthening minority shareholder rights caps the voting rights of shareholders for the election of outside directors to the audit committee to no more than 3 per cent per individual shareholder. A stricter, aggregate 3 per cent cap – applied to controlling shareholders and their affiliated parties limiting their combined voting power to a maximum of 3 per cent – is applied for the election of statutory auditors and inside directors to the audit committee.

However, minority shareholders in Korea rarely contest any items on the agenda of Korea's AGMs. According to a review of AGM data from 2005-2009 by the Economic Reform Research Institute (ERRI), there were only on average 19 cases a year of proxy challenges, representing 1.1 per cent of all listed companies. An average of only four cases a year was identified in which the largest shareholder did not win.

A range of mechanisms are used in Korea that can discourage minority shareholder voting, including barriers to proxy voting. Because management may request the Korean Securities Depository to cast votes on behalf of non-participating shareholders in the same proportion as the overall vote proportion of the AGM ("shadow voting"), a quorum can be reached relatively easily without the need for minority shareholder votes. Companies have less incentive to encourage proxy voting through electronic voting or other means, and in some cases companies actively discourage it through such practices as scheduling most AGMs on the same two days of the year, prohibiting non-shareholders from serving as legal representatives to cast proxy votes, bundling multiple resolutions into a single vote, and refusing to provide or delaying provision of information from the shareholders' registry to dissident shareholders. Restrictions on the time available for proxy solicitations also limit shareholder ability to conduct effective proxy solicitations. This has impeded minority shareholders' ability to influence the selection of board members.

## 3.5. Degree of disclosure about the nomination and election process

Information about candidates' backgrounds must be published by the company at least 2 weeks prior to the AGM, including the candidate's name, career information, qualifications, the nomination process, the recommender, the relationship between the

recommender and the candidate, the relationship between the candidate and the largest shareholder, and the reason for the nomination. This information is made available to all shareholders and the public via the Financial Supervisory Service's Data Analysis, Retrieval and Transfer (DART) system and the Korea Exchange's "KIND" on-line information system. There is no requirement to disclose which other boards that candidates serve on or to limit their number, except that they do not qualify as an outside director if they are also on the board of an affiliated company. A recent Presidential decree also prohibits outside directors from serving on more than two other boards of directors, including those of non-listed companies.

Beyond the above information, there are no specific requirements to assist shareholders in screening candidates. Korean companies are not required to post percentage voting results from their AGMs, but are required to publish whether each measure was approved or not, and may (but are not required to) disclose more detailed information at the request of shareholders.

## 3.6. Overall functioning

An assessment of how well Korea's board nomination and election system is functioning requires an analysis of what has worked well and what have been the main corporate governance problems in Korea. Most academic research in this regard analyses separately how corporate governance has functioned in the family-controlled conglomerates versus other Korean companies, which in many cases have a stronger foreign ownership component. In response to the failure of a large number of conglomerates during the Asian financial crisis due to over-leveraging, vulnerability to currency fluctuations and declining performance, reforms mainly focused on the strengthening of minority shareholder protection and the improvement of accounting and disclosure. Several high-profile court cases and enforcement actions since then have also focused on instances of mismanagement, fraud or expropriation of shareholder wealth (see Box 3.1).

Public concern about market abuses and the need for further reforms continues to be debated in Korea. A report by Tongyang Securities argued that Korean shares suffer from a "Korean discount" that results in undervaluing of Korean stocks due to structural problems with the governance of Korean conglomerates, citing concerns about tunnelling, propping up of poorly performing affiliates, and expropriation of wealth to family members within the conglomerates.[9] Another report cited a ranking of Korea's share price-to-earnings ratios as eighth out of nine Asian markets as further evidence that investors are discounting Korean shares (*The Economist,* 11 February, 2012).[10] In this context, Korean reforms appear to have been particularly geared towards ensuring credible, independent monitoring of conglomerates while also addressing other large Korean companies.

Considering more specifically the Principles highlighted as most relevant for this review, Korean reforms to establish independent outside directors, outside director nominating committees and audit committees with a majority of outside directors may be seen as aimed at least in part at addressing principle VI.D.6 on enhancing the role of the board to monitor and manage potential conflicts of interest of management, board members and controlling shareholders; and principle VI.D.7 on ensuring the integrity of the corporation's accounting and financial reporting systems including independent audit, with appropriate systems of control and compliance. However, only 116 of Korea's 1,822

Box 3.1. **Corporate governance-related enforcement relevant to board duties and appointments**

1. Following post-Asian crisis legal reforms that reduced thresholds for shareholder legal actions, at least 40 derivative suits were filed and adjudicated between 1997 and 2006, and 17 of these were decided in favour of the plaintiff, according to a 2007 study by the group Solidarity for Economic Reform (SER) (Kim and Kim 2008).
2. These cases have shown private enforcement actions to be a credible threat to enforce director liability, with some notable cases increasing the attention given to Korean boards' monitoring and control role (Principles VI.D.6 and VI.D.7). For example, successful derivative suits brought against Korea First Bank and Samsung Electronics and their inside directors in the late 1990s were followed by a surge in the purchase of directors' liability insurance, as the threat of being found liable for violating fiduciary or other director duties became more real.
3. One more recent case which raised a concern about the board appointment process also involved Samsung. Samsung Electronics' Chairman Kun-Hee Lee, the controlling shareholder of Samsung Group, was granted a pardon (in relation to a tax evasion conviction) at the end of 2009 by Korea's President. Mr. Lee was never formally reappointed to Samsung Electronics' board but a report by CLSA and the Asia Corporate Governance Association (CG Watch 2010) raised concerns due to Lee's return to participate in board discussions as "Chairman" and controller of the company, although the formal and legal chairman of the board remained Yoon-woo Lee, despite his title of "vice-chairman" in terms of his company rank.

listed companies (those with more than KRW 2 trillion in assets) and an additional 48 listed and 109 non-listed financial institutions under other legal requirements must follow this system, with another 30 doing so voluntarily. Even within the larger companies, some questions have been raised as to how independent outside directors can be expected to be in light of the controlling shareholders' role in electing them and the relatively weak influence of minority shareholders in this regard. Furthermore, below the KRW 2 trillion threshold, no companies are required to have an audit committee but rather the general meeting must elect a statutory auditor to monitor board processes. On the other hand, new legislation due to take effect in April 2012 will significantly reinforce corporate monitoring mechanisms by strengthening board procedures in relation to related party transactions and self-dealing, and by requiring Korea's 300 largest listed companies to appoint "compliance officers" to ensure companies' legal compliance.

Principle VI.D.3 on the board's selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning would appear to be a lower priority within the Korean system. Reviews of Korean conglomerates in particular have found that they are usually managed at the top level by members of the founding family, and the central office maintains strict control over strategy and monitoring the performance of operating units.[11] Even though this central control is formally ratified by the board, it would appear to indicate that the board's role is probably limited in relation to key decisions concerning management. This centralized control can be seen to apply across a range of Korean companies, according to a survey published by "Sangjang" in 2007, which found that top management or dominant shareholders nominate audit committee members in almost 90 per cent of the cases.[12]

Assessing whether Korea's corporate governance system facilitates effective shareholder participation in key corporate governance decisions and in particular with regard to board nomination and election (principle II.C.3) also requires consideration of a wider range of factors. Research on the impacts of the Korean reforms has found evidence of both corporate governance improvements and of continuing weaknesses relevant to effective shareholder participation. One 2008 study by Kim and Kim tracked corporate governance practices among Korea's largest corporations (those with assets above KRW 2 trillion or about USD 1.8 billion) from 1998 to 2004, evaluating five attributes of corporate governance: 1) shareholder rights; 2) board structure; 3) board procedures; 4) disclosure; and 5) ownership parity. The study concluded that corporate governance practices had jumped from a score of 30.78 to 69.64 out of a possible 100 (Breakdowns of progress within individual sub-categories were not reported).[13]

On the other hand, a more recent 2010 evaluation by CLSA and the Asian Corporate Governance Association found that Korea's overall level had declined relative to other Asian countries since its previous report in 2007. While Korea was praised for improvements in accounting and auditing, including its convergence to International Financial Reporting Standards, it was criticized for weaknesses in corporate governance rules and enforcement, and in its political and regulatory institutions (see Box 3.1).[14]

Consistent with its improvements in financial disclosure, Korea appears to have established effective disclosure systems for providing information on candidates' backgrounds (principle V.A.4), with the exception of disclosure of detailed voting results and information concerning candidates' positions on other boards.

Assessment of its effectiveness in implementing principle VI.D.5 on the board's role in the nomination process is more complex, particularly in judging, as the Annotations suggest, whether the board or its nominating committee identifies and nominates members "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." While data on the actual practices of Korean boards, for example the amount of time they spend on different directors' duties, was not obtained for this review, there is relatively comprehensive data available on board composition. According to one study (Choi *et al*., 2007) of 457-464 Korean firms tracked from 1999-2002,[15] 31.8 per cent of board members in the sample were classified as outside directors. The study classified approximately two-thirds of these directors as "independent," with the other third labelled as "gray directors", defined as outside directors who appear to have current or potential business ties with the firm by virtue of their professions, such as lawyers, accountants, consultants or bank executives. Outside directors most commonly were either executives from non-affiliated firms (22.6%) or academics (20.3%), followed by executives of financial institutions (15.7%), accountants, lawyers or "others" (about 10% each), followed by former politicians or government officials (6.2%) and lastly executives of affiliated firms (5.4%). However, conglomerates were found to make greater use of outside directors with political connections, lawyers, and executives affiliated within their groups.

The composition of inside directors was not reported in the study but typically includes either executives of the company or non-executives who fail to meet the legal criteria to qualify as outside directors. Conglomerates often appoint an inside director from an affiliated or parent company in addition to management from within the company.

Other information concerning the composition of Korean boards includes a 2011 comparative report on the proportion of women on boards of directors by Governance Metrics International supplemented by other OECD sources, which found that Korea ranked 33rd among 34 countries, just ahead of Japan. There are also no provisions in Korea for election of employee representatives to the board, and it was reported that non-executive employees have only been elected to the board in rare cases, despite the frequency of employee stock ownership plans.

In sum, it is clear that Korea has made substantial progress in transforming its board from a fully insider-dominated structure before the Asian financial crisis to one that includes more formal and transparent processes aimed at ensuring consideration of a wider set of actors, further reinforced by recent Commercial Act amendments to reinforce the board's monitoring and control role. However, Korean boards often remain driven by the interests of management and/or their controlling owners, and may in some cases lack the ability and motivation to independently monitor or control management or shareholder abuse.

## 3.7. Assessment and conclusions

Concerning the Principles' main recommendations directly addressing board nomination and election systems (II.C.3, V.A.4 and VI.D.5), Korea has established several legal mechanisms to support their implementation, but review of information on actual practices, while incomplete, suggests that further improvements are needed to ensure their practical implementation.

- Principle II.C.3, on whether shareholders can *effectively* participate in the board nomination and election process, is a key concern. Although legal mechanisms provide clear rights for minority shareholders to nominate board members and to participate in board elections as other shareholders, the structure of ownership and control in Korea allows for controlling shareholders with relatively small direct share ownership to exercise control through mechanisms such as non-voting shares and circular or interlocking group ownership structures. Barriers to effective participation by proxy also appear to disproportionately limit minority shareholder participation in some cases.
- Principle V.A.4 appears to be largely implemented due to clear requirements and systems to inform all shareholders about board candidates (except with respect to their service on other boards), while Principle VI.D.5 also is addressed through clear legal procedures providing for the board or outside director nominating committee to recommend and screen outside director candidates for nomination to the board, and to establish clear and transparent procedures. However, it remains difficult to assess how effectively this Principle is implemented, considering the absence of outside director nominating committees for all but the largest Korean companies and the dominant role played by top management and controlling shareholders in selecting both inside and outside directors in practice.
- Principle VI.D.3 on the role of the board in selecting and arranging for the succession of executives is probably not implemented due to the company group structure.
- Principles VI.D.6 and 7, although given higher priority than VI.D.3 in the Korean framework, are partially implemented. While board nomination and election procedures and requirements are in place that attempt to support effective board monitoring and control systems for companies with assets above KRW 2 trillion (USD 1.8 billion) along

with financial institutions, some weaknesses in these systems have been identified. For the remaining more than 1,600 listed companies with insider-dominated boards who control the nomination process, the board nomination and election system does not appear to reinforce the effective exercise of these responsibilities.

On the other hand, Korea has enacted other legal requirements and protection for minority shareholders which may help to compensate for the partial implementation of recommendations related to board nomination and election. Rights *inter alia* to file derivative action suits, class actions, requirements for compliance with International Financial Reporting Standards, audit committees and "compliance officers" for large companies, and statutory auditors for smaller companies, provide minority shareholders with some tools to inform themselves and to act (or to sell their shares) if they feel that their rights are inadequately protected or violated. Considering the Korean market's structure of ownership and control, these measures may be more effective or more feasible to improve corporate governance in the Korean context than measures aimed at influencing the composition of the board through minority shareholder actions.

Other reforms that could be considered and that could have a direct impact on the effectiveness of board nomination and election systems could include:

- Extending requirements for outside director nominating committees, audit committees and a majority of outside directors to a larger universe of Korea's 1,822 listed companies (not just the 116 largest listed companies with assets above KRW 2 trillion and financial institutions under the authority of the Financial Services Commission).
- Supporting more active minority shareholder engagement in companies, by facilitating electronic voting and cumulative voting, and extending the disclosure period for information on AGMs from two weeks to three weeks in order to allow increased time for proxy solicitation or other co-ordination among minority shareholders prior to the AGM. Enacting the FSC proposal to eliminate "shadow voting" by 2015 would also increase the incentive to allow electronic voting and to take other steps to facilitate shareholder voting (such as, for example, not scheduling most AGMs on the same days), because in some cases wider shareholder participation would become necessary to meet quorum requirements.
- Improving disclosure related to board nomination and election processes, for example by requiring disclosure of information on the number and identity of boards a candidate serves on, and by requiring disclosure of AGM voting percentage results.
- Strengthening requirements for independence of outside directors, for example by lengthening the current 2-year limit during which an outside director must not have had an economic relationship to the company, its management, controlling shareholder or related companies; or considering limits on pay, length of service or number of terms which an outside director may serve to maintain his or her qualification as an outside director.

### *Notes*

1. See *www.world-exchanges.org/statistics/annual-statistics-reports*.
2. See World Development Indicators, *http://databank.worldbank.org/ddp/home.do*
3. Korea Herald, "Chaebols' economic dominance increases", 6 February, 2012.
4. Data obtained from the Korean Corporate Governance Service questionnaire response.

5. A study by Black *et al*. (2005) linking performance on a Korean Corporate Governance Index with share values, using Tobin's Q, implies a 160 per cent increase in share values between the best and worst companies in the rankings. Looking at board composition alone, Korean firms with at least 50% outside directors (either due to requirements or voluntarily) were found to have a 40% higher average share price. However, no significant correlation was found between outside directors and operating profits. A study by Choi, Park and Yoo (2007) of non-financial firms in Korea also found a higher Tobin's Q for firms with higher numbers of outside directors and a positive correlation also with foreign ownership.
6. See Korea Herald, "Taekwang chairman indicted for corruption", January 31, 2011, and TBS, "Taekwang Group's Former Chairman Gets Prison Term for Embezzlement", February 21, 2012.
7. Korea Herald, "Chung Mong-koo ordered to pay Hyundai Motor $73 mln for unfair practice", February 25, 2011.
8. Any person falling under any of the following criteria is prohibited from becoming or continuing as an outside director:

   *a)* A person who together with any specially related persons holds the largest number of stocks on the basis of the total number of stocks with voting rights of a particular corporation;

   *b)* The major shareholder (referring to the major shareholder who holds more than 10% of the total outstanding stocks) of the concerned company and that person's spouse and lineal ascendant and descendant.

   *c)* A person who was an officer or an employee (referring to a person who worked full-time) of the concerned company or its affiliate or worked as an officer or employee for such relevant securities company within the preceding two years.

   *d)* The spouse or lineal ascendant and descendant of an officer of the concerned company.

   *e)* The officer or employee of a corporation that has an important business relationship with a relevant corporation company, a competitive relationship or a cooperative relationship with such company or was an officer or employee for such corporation within the preceding two years.

   *f)* The officers or employees of a company in which an officer or employee of the concerned company was a non-full-time director.

   *g)* A person who is an outside director of two (2) different public corporations, non-full-time director or non-full-time auditor.

   *h)* A person who renders services to the concerned company in accounting, taxation, legal, or management consulting.

   i) A person who holds more than 1/100 of the total outstanding stocks or holds stocks more than KRW 300 million (fair market value at the time of purchase) to the concerned company.

   *j)* A person who has more than KRW 100 million of accounts receivable or accounts payable with the concerned company. Other legal restrictions on eligibility for a board relate to the person's competency, connection with bankruptcy, breaches of the law, or imprisonment within the last 2 years.
9. Korea Herald, "Korea Discount stems from *chaebol* governance: report", 4 December, 2011.
10. See The Economist, "Minority report: Corporate governance explains South Korea's low stock market ratings", 11 February 2012. Bloomberg is cited as the source for 2012 forecasted price-to-earnings ratios for Japan, India, Philippines, Chinese Taipei, Singapore, Indonesia, Hong Kong, Korea and China, ranked in that order.
11. See for example Channon, (1998) and Yanagimachi (2004).
12. See Choi *et al*. (2011).
13. See Kim and Kim (2008), p. 49. Black *et al*. (2005) reach similar conclusions.
14. See CLSA (2010), pages 82-87.
15. See Choi, Park and Yoo (2007).

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PART II

*Chapter 4*

# The Netherlands: Review of board nomination and election practices

*This chapter on the Netherlands describes the ownership structure of listed companies and then considers the board nomination and election processes including disclosure practices and obligations. The board nomination and election process is placed within the context of the overall corporate governance framework.*

## 4.1. Introduction

This review of the Netherlands seeks to ascertain to what extent its board nomination and election policies and practices are consistent with relevant recommendations of the *OECD Principles of Corporate Governance,* including:

- Principle II.C.3, which calls for the facilitation of effective shareholder participation in key corporate governance decisions;
- Principle V.A.4, which calls for disclosure of information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board; and
- Principle VI.D.5, which states that the board has an essential role to play in the nomination process, as the board or a nomination committee has a special responsibility to make sure that established procedures are transparent and respected. The Annotations add that the board has a key role 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.

The review is intended to further address whether the nomination and election system contributes effectively to the establishment of a board able to fulfil some of the key board functions identified in the Principles, including:

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

Corporate governance in the Netherlands is characterised by supervisory and management boards that have traditionally maintained relatively strong control of their companies. Up until 2004, supervisory board members nominated and appointed themselves to supervise and advise the management board through a so-called co-optation system in many of the Netherlands' largest companies, known as "structure regime" companies. Management boards, which have the primary role in developing and implementing company strategy, played such a strong role that they often informally determined the composition of the supervisory boards themselves. Since 2004, shareholders in "structure regime" companies have gained the right to elect and dismiss supervisory board members. Moreover, for two-thirds of Dutch listed companies not subject to the "structure regime", shareholders have the power to elect and dismiss both

the supervisory and management boards. In all listed companies since 2004, shareholders with at least one per cent of shares have also gained the right to nominate board members.

Shareholder use of these rights has sometimes sparked tensions – particularly in battles related to corporate strategy or takeovers – with companies maintaining that their actions are based on their duty to the interests of the company and its stakeholders, while shareholders assert their rights to hold members of both boards accountable to their interests as owners. This review examines the current state of the law, practices, and debates relevant to the nomination and election of board members in the Netherlands.

## 4.2. Corporate governance framework

The Netherlands has an active capital market for its size, with 101 Netherlands-based listed companies. The Euronext Amsterdam Exchange's market capitalization of EUR 490 billion as of 1 February 2012 comprises approximately 80 per cent of GDP. The 25 most actively traded companies (including five not counted among the 101 because they are statutorily based outside of the Netherlands) comprise the AEX index. The Exchange also has an AMX index for the next 25 largest companies, while the AScX index lists 25 small cap companies.

The Netherlands has a more dispersed ownership structure than most continental European countries, which has contributed to a relatively stronger position of management and the supervisory boards *vis-à-vis* shareholders. Within the most traded companies on the AEX index, the largest shareholder held less than 10 per cent of voting rights in 62 per cent of listed companies, and only 19 per cent had a shareholder with more than 30 per cent of voting rights, according to 2010 data provided by Eumedion, the Dutch institutional investor association.

However, assessment of the degree of concentration of voting rights in the Netherlands is more complex, due to the role played by "Trust Offices" (*"administratiekantoor")* and "Anti-takeover Foundations" (also known as "Continuity Foundations"). Once shares are placed in a trust office, investors receive depository receipts that are detached from voting rights. Since 2004, the Trust Office is legally required to grant proxy voting rights to certificate holders who request it (except in hostile take-over situations). Otherwise, the trust office makes the determination how to vote, subject to its governing board. According to one study,[1] in most cases, the trust offices are friendly to the incumbent management and therefore exert their voting rights in such a way as to support managerial control. Less frequently, the trust office is set up by a controlling shareholder. About 15 Dutch listed companies have issued all or a large proportion of their common shares to a trust office. More details concerning best practice provisions of the Dutch Corporate Governance Code for the functioning of these trust offices is provided later in this chapter. Table 4.1 highlights the more concentrated control structure that is apparent when trust offices are included among the largest shareholders.

In addition, anti-takeover foundations, which exist in about 60 per cent of large (AEX) Dutch listed companies, can be established in a company's articles of association, typically, at least formally, to ensure the independence and continuity of the company, with a view to safeguarding the interests of the company and its various stakeholders. To do this, a company may furnish its anti-takeover foundation with a call option to issue preference shares at par value that do not need to be fully paid up, which may be exercised in response to hostile take-over initiatives or attempts by shareholders to change company strategy

Table 4.1. **Company share voting concentration in Dutch AEX companies**

| Largest shareholder (%) | Excluding Trust Offices (depositary receipts, %) | Including Trust Offices (depository receipts, %) |
|---|---|---|
| ≥ 30 voting rights | 19 of companies | 38 of companies |
| 10-30 voting rights | 19 | 14 |
| 5-10 voting rights | 52 | 43 |
| < 5 voting rights | 10 | 5 |

Figures are for the largest companies ("AEX-companies") on 1 October 2010. Source: Eumedion.

(which may include efforts to dismiss or replace the board of directors). The call option enables the foundation to obtain a large voting block cheaply, and to vote in opposition to a hostile bidder or activist shareholder, thus in effect diluting their actual or anticipated voting power.[2] Thus, in the special case of a hostile takeover, 90 per cent of AEX Dutch companies have a shareholder with at least 30 per cent of voting rights, when including both anti-takeover foundations and trust offices among these shareholders.

The Netherlands' corporate governance structure has a distinctive stakeholder focus. The legal duty of the supervisory board is to supervise the policies of the management board and the company and its affiliated enterprises' general affairs, as well as to assist the management board by providing advice, guided by the interests of the company and its affiliated enterprises, taking into account the relevant interests of the company's stakeholders. The management board's mandatory duty is to manage the company, also guided by the interests of the company and its affiliated enterprise. The Netherlands' "apply or explain" Corporate Governance Code notes that while Dutch boards' consideration of the company's interests encompasses consideration of a range of stakeholders including employees, shareholders, creditors, suppliers, customers, the public sector and civil society, the stakeholders are not in principle guided exclusively by the interests of the company and its affiliated enterprises. Shareholders, for example, "can give priority to their own interests with due regard for the principle of reasonableness and fairness. The greater the interest which the shareholder has in a company, the greater is his responsibility to the company, the minority shareholders and other stakeholders", according to the Code.

Reactions to the 2003 accounting scandals involving Royal Dutch Ahold as well as other companies outside of the Netherlands led to significant changes in the Dutch corporate governance framework. First, 2004 legal reforms gave shareholders increased rights, including the right to approve major transactions that will have a material impact on the nature of the company; a right for those with at least 1 per cent of share capital or shares with a market value of EUR 50 million to place items on the AGM agenda (including to nominate one or more candidates for the board); and the right within companies operating under the Netherlands' "structure regime" to appoint supervisory board members (who previously appointed themselves) and to dismiss the supervisory board as a whole (Box 4.1).

A second major development was the issuance of the "apply or explain" Dutch Corporate Governance Code, known as the "Tabaksblat Code" in 2003 (and amended in 2008). Since 2004, the Netherlands has implemented a well-elaborated system for reviewing and reporting on compliance with the code, *i.e.*, all listed companies report annually on their application or divergence from the code's recommendations, and a Corporate Governance Code Monitoring Committee issues annual reports highlighting key

### Box 4.1. **Board structures and appointment rights in the Netherlands**

1. Historically, Dutch corporations have operated under a 2-tier board structure, ever since the world's first publicly traded company, VOC (the Dutch East India Trading Company), established a 2-tier board in 1623 in response to governance concerns. Currently, 97 of the Netherlands' 101 listed companies use a two-tier structure, while only one large listed company (Unilever NV) and three smaller listed companies use a one-tier board (which must follow similar board nomination and election processes). New legislation passed in June 2011 provides clarifications aimed at facilitating company adoption of one-tier boards, but it is unclear at this stage what impact this may have.
2. There are several variations in structures and related requirements for two-tier boards. In the majority of Dutch listed companies, the supervisory board nominates and shareholders elect both the supervisory board and the management board. The arrangement for shareholder appointment of the management board is unusual, only found elsewhere in the Czech Republic and Indonesia in the course of this review. However, according to the Dutch authorities, in practice the supervisory board generally determines the composition of the management board through its nominating rights, while the AGM appointment tends to function more as a formal ratification except in the case of hostile takeover situations. This requirement applies to companies with less than EUR 16 million in share capital and reserves, or due to their status as a financing or holding company with the majority of their employees and those of their group located outside of the Netherlands. Within this category, works councils (which are statutorily required in Dutch companies with more than 50 employees in the Netherlands) have the right to present their opinion to the general shareholders meeting on the nomination, suspension or dismissal of a board member, but they do not have specific rights to recommend candidates for nomination to the board.
3. The remaining 37 Dutch listed companies follow a "structure regime" (34 based on legal requirements and three voluntarily adopting the structure regime), required for companies with more than EUR 16 million in capital and at least 100 employees based in the Netherlands. Within this regime, the shareholders appoint the supervisory board, while the supervisory board appoints the management board. The works council (representing company employees) has an "enhanced right of recommendation" for the supervisory board's nomination of one-third of its members, to then be confirmed by the vote at the AGM.
4. Two of these 37 companies are required to follow a "mitigated structure regime," applied when a majority of the issued share capital of the company is held by a legal entity that has most of its employees located outside the Netherlands. Two additional companies follow this regime voluntarily. This regime has similar requirements for involving works councils, but instead of the supervisory board, the general shareholder meeting may appoint, suspend or dismiss the management board.
5. Finally, it is worth noting that some observers refer to Dutch boards as "one-and-a-half-tier boards" because of the frequency with which the management and supervisory boards meet together (except with respect to certain supervisory board agenda items to be considered without the management board's presence, such as when evaluating its members). Nevertheless, the distinctions between the two tiers are important both statutorily (in terms of associated nomination and election requirements and procedures) and in their differing duties elaborated in the Dutch Civil Code and Corporate Governance Code.

corporate governance issues under debate in the country, noting where companies have least applied the best practice recommendations, and also noting the extent to which explanations of non-appliance were inadequate, in other words, non-compliant. Within this definition, Netherlands' listed companies have been reported as 95 per cent compliant,[3] but the Dutch Private Shareholders Association VEB has issued a report asserting that based on less than satisfactory explanations, they consider compliance to be only 63 to 65 per cent over the last several years.[4]

Although the principles and best practices of the code are not required by law (companies may deviate from them as long as they explain why), the code is considered to have a stronger influence on practices than in some other countries because of the active role played by the Enterprise Chamber of the Amsterdam Court of Appeal. Various stakeholders (shareholders with at least EUR 225,000 in capital or 10 per cent of shares, trade unions and the Public Prosecutor) may request an Enterprise Chamber inquiry in instances where they consider that the standard of reasonableness and fairness is not being applied. In assessing whether a company, its boards or its shareholders are acting reasonably and fairly, the Chamber takes into account the extent to which the Dutch Corporate Governance Code recommendations are followed, and may also reach conclusions concerning corporate mismanagement. If so, the Chamber can decide to remove members from the boards or to make temporary appointments to the management board, supervisory board or both to rectify the situation.

Relatively active shareholders, led by the Private Shareholders Association (VEB) and Eumedion, a group of more than 60 institutional investors of which more than half are Dutch pension funds, are also seen as important for the influence of the code and the enforcement of shareholder rights, including their rights to nominate and elect board members. Dutch institutional investors accounted for 7 to 9 per cent of share ownership of AEX companies, while foreign ownership in the market was 76 per cent as of the end of 2010, according to Eumedion. Overall, approximately 87 per cent of the shares of the Dutch AEX companies were held by institutional investors (pension funds, asset managers, mutual funds and insurance companies).

However, experiences from the financial crisis and controversial disputes between shareholders and management involving the takeover of ABN AMRO and takeover attempts of Stork and ASMI have led to some political backlash and criticism of "activist investors" for emphasising short-term profit motives over the longer-term interests of companies (Box 4.2). This has influenced the political environment, leading to some pending legislative proposals that would scale back some aspects of shareholder rights. The Frijns Bill (which is intended to implement recommendations of the Corporate Governance Committee issued under its former Chair, Jean Frijns, in 2007), would lower the threshold for disclosing initial ownership from 5 per cent to 3 per cent, while increasing the threshold for share ownership to place items on the agenda from 1 per cent to 3 per cent.

A much debated proposal would require shareholders with more than 3 per cent of shares in a company to indicate whether they object to the corporate strategy, which the company would be required to publish on its web site. According to the explanatory memorandum for the bill, the only shareholders that should announce their objection are those who "have the intention now or in the future to actively pursue this, for instance by using their shareholder rights to try to amend the strategy or to replace members of the management or supervisory board by persons who do support their vision".[5] Shareholders

### Box 4.2. **The Role of the Judiciary in Shareholder-Company Disputes in the Netherlands**

1. Several recent cases involving hedge fund or other shareholder efforts to take over or change strategy of Dutch companies have attracted widespread attention. In each case, the disputes have sparked debate over whether the shareholders were overly emphasizing short-term profit interests over the longer-term interests of the company. Two cases described here, involving efforts to dismiss the supervisory board of Stork and both the supervisory and management boards of ASMI, highlight the important role that Dutch courts have played in such cases. Their decisions have helped both to clarify the roles of the management and supervisory boards and the legitimacy of anti-takeover foundations to resist shareholder efforts to dismiss the board.
2. In the 2007 case of Stork, a "structure regime" conglomerate with three pillars, a conflict arose involving two hedge funds, Centaurus and Paulson, who together owned more than 20 per cent of the shares, which sought to dismiss the supervisory board following disagreement between the hedge funds and the board (supported by the Works Council and other shareholders including VEB and pension funds) over the strategy of the company. Centaurus and Paulson sought to split up the conglomerate and proposed to dismiss the supervisory board on the agenda of the general meeting. However, Stork had established an anti-takeover foundation which exercised its call option to take preference shares, enabling it to become the largest shareholder in Stork and to announce its intent to vote against the proposals of Centaurus and Paulson at the AGM. In response, Centaurus and Paulson requested the intervention of the Enterprise Chamber, arguing that a resolution to dismiss the supervisory board did not in itself constitute a hostile take-over or raid. The day before the AGM, the Enterprise Chamber ordered an inquiry into the company's affairs, a withdrawal of the preference shares of the foundation, disallowed a vote upon the dismissal of the supervisory board, and appointed three supervisory board members with special powers. The court concluded that the mere intended use by a major shareholder of the statutory right to dismiss the entire supervisory board of a company subject to the structure regime did not qualify as an unsolicited takeover. The court also asserted that it is the management board which determines the strategy, the supervisory board's role to supervise, and the AGM can express its opinion through exercising its legal and statutory rights, including the right to dismiss the supervisory board.
3. The question of who has the power to determine corporate strategy was also the subject of actions by the Enterprise Chamber and Dutch Supreme Court in the ASMI case. In this case, similar actions were taken by the company, including the exercising of its anti-takeover foundation call options for preference shares to oppose shareholder attempts to change the company strategy through dismissal of the supervisory and management boards. The courts again intervened. First, the Enterprise Chamber was asked by the concerned shareholders (Hermes and Fursa) to prohibit the anti-takeover foundation from exercising its voting rights. The Chamber ordered an inquiry in August 2009, and through a series of interim actions managed to maintain the status quo so that the two sides could continue talking. The Chamber criticized the supervisory board for lack of sufficient transparency and openness towards the external shareholders, and found that the high thresholds for the appointment and dismissal of management board and supervisory board members, in combination with founder Arthur Del Prado's large minority interest, his informal position as "adviser" to the supervisory board, the disproportionate power of the management board chairman (Arthur Del Prado's son Chuck Del Prado) and the far-from-critical-attitude of the supervisory board and its chairman all contributed to this situation.
4. However, the Supreme Court in response to an appeal by the foundation together with ASMI's founder and major shareholder, rejected the grounds for the Enterprise Chamber's actions. The court held that the intended use by a major shareholder of the right to replace certain members of the management board, including the CEO, as well as the entire supervisory board, *did* qualify as a raid, and therefore justified the exercise of the anti-takeover foundation's option right. The management board, which has the primary responsibility for setting company strategy, was not obliged to involve the shareholders in advance of the decisions on the strategy to be pursued. The Supreme Court also held that the Dutch Corporate Governance Code is an expression of a general conviction in the Netherlands which fleshes

Box 4.2. **The Role of the Judiciary in Shareholder-Company Disputes in the Netherlands** *(cont.)*

out the legal concept of reasonableness and fairness in the Dutch Civil Code. The Court also ruled that the supervisory board of a company is not *per se* obliged to mediate in disputes between the management board and shareholders. Finally, the Court emphasised in its ruling that the management board is obliged to respect the right of shareholders to obtain information during the general meeting of shareholders.

*Source:* Foreword of the Corporate Governance Committee Monitoring report 2010, p. 5-6; van Bekkum *et al*, 2010; and Raaijmakers and Prinsen, 2010

have raised concerns that the requirement's implications are unclear. They have expressed concern that a statement of support of the company strategy may limit a shareholder's manoeuvring room to oppose specific strategy-related items on the agenda. Some institutional investors have indicated they may feel compelled to pre-emptively announce opposition to the corporate strategy to ensure that their voting rights are not somehow limited by their announced position. They have expressed concern that an increase in announced opposition to corporate strategies could in turn harm the Dutch market. On the other hand, the explanatory memorandum for the bill also recognizes that an investor may change its position concerning the company strategy and in that case must correct its disclosure to reflect its changed position. As of May 2012, the bill was pending in the second Chamber of Parliament and an amendment had been introduced to delete the above-mentioned requirement.

## 4.3. Board nomination processes and shareholders' rights

In the Dutch system, the supervisory board plays the main role in shaping the composition of the supervisory and management boards, through its nomination of candidates for AGM approval. Until this year, companies through their articles of association could require that at least two persons be nominated for each board position to give shareholders a choice at the AGM, but for those companies that adopted this practice, the second candidates were not given serious consideration, leading to a repeal of this provision that was supported by consensus of shareholders as well as issuer associations. The repeal is scheduled to take effect on 1 July, 2012.

In most cases, a board nomination sub-committee prepares the ground for board nomination decisions, as recommended in the Corporate Governance Code for companies with more than four supervisory board members: 75 per cent of these companies report to have followed this recommendation in 2010. For the other 25 per cent, the functions of the nominating committee are typically combined with another committee such as the remuneration committee.[6] The Code recommends that the committee:

*a)* draw up selection criteria and appointment procedures for supervisory board members and management board members;

*b)* periodically assess the size and composition of the supervisory board and the management board, and make a proposal for a composition profile of the supervisory board;

*c)* periodically assess the functioning of individual supervisory board members and management board members, and report on this to the supervisory board;

*d)* make proposals for appointments and reappointments; and

*e)* supervise the policy of the management board on the selection criteria and appointment procedures for senior management.

Shareholders with more than 1 per cent of shares in a company (or shares with market value of at least EUR 50 million) also have the right to nominate candidates, but this has rarely occurred in practice (perhaps six or seven cases since 2004, according to Eumedion). In 11 Dutch companies, large shareholders generally with holdings of 11 to 15 per cent (and in a few cases, controlling owners with larger holdings), have secured specific nomination rights for one or two members of the supervisory board. Although it is not legally required to disclose shareholder agreements, in practice the provisions for specific nomination rights are publicly disclosed either through shareholder agreements or provisions in the company's articles of association. Two of these cases (ING Group and SNS Reaal) involve state ownership, providing the government special rights to nominate two supervisory board members, and to also exercise specific veto powers. In most other cases involving institutional investors with smaller holdings, the appointments of board members are said to be most influenced through informal discussions with the company or its supervisory board, rather than through formal nomination processes.

Nomination decisions are also influenced by the Dutch Corporate Governance Code recommendation that all but one member of the supervisory board shall be independent. The Code's independence criteria stipulate that the member or his wife, partner, other life companion, foster child or relative by blood or marriage up to the second degree *may not*:

- have been an employee or member of the management board of the company (including associated companies) within the five years prior to the appointment;
- receive personal financial compensation from the company or associated company other than payment for work as a supervisory board member;
- have had an important business relationship with the company or a company associated with it in the year prior to the appointment;
- be a member of the management board of a company in which a member of the management of the company which he supervises is a supervisory board member;
- hold at least 10 per cent of the shares in the company (including the shares held by natural persons or legal entities which co-operate with him under an express or tacit, oral or written agreement);
- be a member of the management board or supervisory board – or be a representative in some other way – of a legal entity which holds at least 10 per cent of the shares in the company, unless such entity is a member of the same group as the company;
- have temporarily managed the company during the previous 12 months where management board members have been absent or unable to discharge their duties.

The Code Monitoring Committee's two most recent reports do not list recommendations related to independence on their lists of most frequently explained items, implying that divergence from such recommendations are rare, and that application of independence recommendations has been at least 90 per cent over the last four years. This marks an improvement over divergence from the recommendations by 16 of 108 companies reported in the 2009 Monitoring Committee report.

Within this framework, the one-third of Dutch listed companies following the structure regime are required to consider the recommendations of their Works Councils for

the appointment of one-third of the members of the supervisory board (usually no more than two, since the average size of a Dutch supervisory board is five members). Technically the board and the general meeting are not required to accept these recommendations, but it was reported that their recommendations are "hardly ever" voted down. Rejection by the supervisory board must be justified by a finding that the works council nominee would be "unfit" or that acceptance would cause the supervisory board to diverge from the desired or required profile. One study (covering both listed and unlisted structure regime companies) found that Works Councils "under-use" their rights, and that only about 40 per cent of Works Councils actually get involved in the board selection process. Others cited the complexity and international organization of the company, lack of management receptiveness, lack of understanding of their rights or their own lack of initiative for not becoming more involved.[7]

Like other members of the board, Works Council-recommended appointees are also subject to criteria for independence, meaning to apply Code best practice provisions, they are not employees of the company and cannot be members of a trade union involved in collective bargaining. Considering that all board members including Works Council-recommended board members are required under the Civil Code to represent the interests of the company and not just those of its employees, Works Council-recommended candidates are encouraged to "blend in", in order to contribute effectively to the board's deliberations, according to the Federation of Netherlands Trade Unions.

The Dutch Corporate Governance Code recommends that the profile that the supervisory board or its nominating committee prepares regarding board size and composition take account of the nature of the business, its activities and the desired expertise and background of the supervisory board members. The Code recommends that the profile deal with aspects of diversity in the composition of the supervisory board that are relevant to the company, and that it state what specific objective is pursued by the board in relation to diversity. Insofar as the existing situation differs from the intended situation, the supervisory board is expected to account for this in its report and to indicate how and within what period it expects to achieve this aim. In this context, the issue of gender balance has attracted considerable attention in the Netherlands. The Corporate Governance Code Committee's 2011 report cited a "disappointing" lack of progress in increasing the number of women on boards during 2010, with an average of 18 per cent in the AEX companies, and a 10 per cent average overall. Supervisory boards were also criticized for failing to report specific objectives for diversity in 83 per cent of the cases. Concern about lack of progress also led to a new legislative requirement for Netherlands' largest companies,[8] expected to take effect in July 2012, setting a target objective of at least 30 per cent of each gender on both the management and supervisory boards on an apply-or-explain basis. Companies not reaching the target must explain how they intend to meet the requirement in the future.

The new law also establishes limits on the number of Dutch listed company supervisory board positions that an individual may hold. Executives of a large legal entity may occupy up to two supervisory positions in other large legal entities so long as none of these are chairing positions. Supervisory Board members are limited to five board member positions within listed companies, with chairing positions counted as two.

The Netherlands' authorities and stakeholders consulted for this report indicated it is common practice to use head-hunters or consultants to recruit candidates.

## 4.4. Shareholders' right to elect board members

As explained in greater detail in Box 4.1, shareholders have the right to elect supervisory board members in "structure regime" companies (about one-third of listed companies), whereas they elect both the supervisory and management boards in other Dutch listed companies. They also have the right to elect the board for the four listed companies with single-tier boards.

However, a number of practices remain that nevertheless enable the supervisory board and management to maintain the main role in this process. One recent trend in the Netherlands has been to reduce the size of the management board to just two members – generally the CEO and CFO – who are legally accountable for management board decisions, while other members of management who traditionally have served on the management board now join the CEO and CFO on an executive committee that is not subject to shareholder election, and to which many decisions are delegated by the management board. Following the announcement of four Dutch AEX companies during the last two years, half of the Dutch AEX companies now have this system, according to Eumedion.

In addition, despite the shareholder right to formally appoint management board members, supervisory board members maintain the right to formally appoint senior management, and generally publicly announce such appointments independent of the AGM, subject to formal confirmation by the supervisory board following the AGM election of the senior managers to the management board. According to Eumedion, in roughly 99 per cent of cases the management board is confirmed by shareholders with 95 to 99 per cent of the votes, but there remain exceptional cases which provide shareholders with "an emergency brake" to contest board appointments in the event that they are dissatisfied with the functioning of the board.

The supervisory board's role is further reinforced through a system of "binding nominations" that in certain cases makes it more difficult for shareholders to reject nominations. In the event of rejection, the supervisory board must submit a new nomination. For companies outside the structure regime, binding nominations may be made for both supervisory and management board members. The law allows these companies to set thresholds required to reject these nominations as high as a two-thirds majority of votes cast representing at least 50 per cent of issued capital. The Dutch Corporate Governance Code recommends as a best practice that thresholds for rejection of binding nominations should be no higher than an absolute majority of votes cast (similar to the requirements for structure regime companies). However, 23 Dutch companies were reported to have deviated from the code recommendation, making it more difficult for shareholders to reject the supervisory board's nominations for both the supervisory board and management board. Two companies take advantage of a legal exception allowed for companies that have had a binding appointment system in place since before 1928, that prevents binding nominations from being overturned by shareholders in hostile takeover situations. In the case of structure regime companies, the "binding nomination" of supervisory board members can be rejected by a simple majority of votes cast, representing at least one-third of issued capital.

A Dutch Corporate Governance Code best practice provision also notes a supervisory board role in determining cases in which "a supervisory board member shall retire early in the event of inadequate performance, structural incompatibility of interests, and in other instances in which this is deemed necessary by the supervisory board". The supervisory

board role does not preclude shareholders from also seeking dismissal of board members, but such dismissal attempts have tended to involve broader disputes over strategy or corporate control between activist shareholders and the interests of the company as represented by the supervisory and management boards.

The role of "management-friendly" trust offices has been described earlier in this chapter. Trust offices are able to concentrate voting control through use of voting rights for shares issued as non-voting depository receipts. The Dutch Corporate Governance Code calls for the trust office to issue proxies to depositary receipt holders who so request in all circumstances (including hostile takeover situations), who may also issue binding voting instructions to the trust office in respect to the shares which the trust office holds on their behalf. All but four of the 15 trust offices reported following these recommendations. According to Eumedion, typically voter turnout among certificate holders exercising this right is 50 to 60 per cent, leaving trust offices in charge of voting the remaining 40 to 50 per cent. The Code recommends that the management of the trust office shall be present at the general meeting and shall, if desired, make a statement about how it proposes to vote. It is recommended that the trust office shall be guided in its votes "primarily by the interests of the depository receipt holders, taking the interests of the company and its affiliated enterprises into account." However, two companies have articles of association that reverse the priority for criteria to guide their voting, primarily considering the interests of the company, while taking into account the interests of the depository receipt holders.

With a presence in 60 per cent of AEX Dutch companies, Anti-Takeover Foundations are more prevalent than trust offices, but only come into play when a company faces a hostile takeover or shareholder-initiated change in corporate strategy, which may include efforts to dismiss or replace the supervisory board, and in the case of non-structure regime companies, also the management board. Box 4.2 describes specific cases where the anti-takeover foundations have been used to resist initiatives by major shareholders to dismiss the board.

While the trust offices and anti-takeover foundations are the most visible means that management or the supervisory board may use to influence AGM outcomes, including board elections, the Netherlands also allows for other mechanisms to provide certain shareholders with more concentrated voting power than others. Six of the 50 largest Dutch companies have issued financing preference shares, which have been offered especially to Dutch banks and insurance companies with dividends that are tax-free when these blocks of shares exceed 5 per cent of a company's equity capital. These preference shares have the same voting rights as common shares but are normally traded at nominal value, at a lower rate than the market value for common shares. This means that the banks and insurance companies for a given level of investment can purchase greater voting rights through preferred shares than they would be able to obtain for the same amount in common shares, providing them with disproportionately larger voting rights. While the Dutch corporate governance code recommends that the voting rights of these shares should be based on their fair market value instead of the nominal value, two companies reportedly diverge from this best practice.

Procedures are in place to allow for electronic and proxy voting, with necessary information made available at least 42 days prior to the general meeting. A "Shareholders Communication Channel" has been established to enable companies to send shareholders

information such as the annual report, agenda, and documents containing information on important developments such as issues of securities, mergers and takeovers. The channel also offers a mechanism for casting remote votes. Such votes may be cast no earlier than the "record date" of 28 days before the meeting by either electronic means or by letter. Some difficulties were reported in ensuring that votes are cast and counted due to sometimes complex intermediary chains and validation processes for use of proxy voting rights within some annual general meetings, but this is also reportedly improving.

In part due to Dutch corporate governance code recommendations and European Union initiatives that encourage institutional investors to vote, voter participation in general meetings has been rising, from 30 per cent in 2003 to 50 per cent in 2010, and nearly 60 per cent in 2011, according to Eumedion. The Corporate Governance Monitoring Committee also conducted interviews with Dutch institutional investors for its most recent report and found growing attention to assessment and determination of votes, independent of voting advisory services (although this finding cannot necessarily be generalized to foreign institutional investors).

## 4.5. Degree of disclosure about the nomination and election process

The Dutch Civil Code sets out clear requirements for the provision of information about board candidates, including: age, profession, the amount of shares the candidate holds in the company, and other relations or experience relevant to the candidate's functioning as a board member (which is understood to include their service on other listed company boards). The motivation for the recommendation or nomination must also be disclosed, and generally includes an explanation of how the candidate complies with the profile of skills and experience being sought for the board. In case of reappointment, the candidate's functioning as a board member must be taken into account. These legal requirements are supplemented by the Corporate Governance Code recommendations previously described concerning independence and other matters.

Each board candidate is voted on individually. Listed companies are required to report on their web site within 15 days of the general meeting for each resolution, the number of shares for which votes have been validly cast, the proportion of the share capital represented by those votes, the total number of votes validly cast, the number in favour, the number against, and where applicable, the number of abstentions.

Dutch Institutional investors are obliged by law to report on their compliance with Dutch Corporate Governance Code best practice provisions that they publish annually their policy on the exercise of the voting rights for shares they hold in listed companies; how they have implemented their policy on the exercise of the voting rights in the year under review; and to report at least once a quarter on whether and, if so, how they have voted as shareholders at the general meeting.

## 4.6. Overall functioning

Considering relevant OECD Principles more specifically, the 2004 enactment of a number of shareholder rights in the Netherlands along with a range of recommendations in the Dutch Corporate Governance Code would appear to facilitate effective shareholder participation in the nomination and election of board members, as called for in principle II.C.3. An issue still subject to debate and to a number of court cases highlighted in this report is the question of the appropriate balance between shareholder rights and

the interests of the company including the full range of its stakeholders in cases involving takeovers or changes in corporate strategy. In these cases, the use of trust offices and anti-takeover foundations in the Netherlands gives boards a stronger hand than shareholders in determining the composition of the board and in some aspects limiting effective shareholder participation. However, it is beyond the scope of this report to assess this balance in the context of takeovers.

The Netherlands' implementation of principle V.A.4 is more straight-forward to assess, as both legal requirements and Dutch Corporate Governance Code recommendations appear to clearly set out expected disclosure of background information about board candidates consistent with the Principle recommendation. The practice of assessing the board's composition, desired profile of skills and experience, and reporting on the motivation behind the selection of each candidate appears to be well developed, and shareholders indicate satisfaction with the transparency of the system.

While the Dutch Code definition of independence is clear in most respects and companies report information on which board members are considered independent, the 2008 Code revision included one more ambiguous new provision. While stipulating that board members should not be considered independent if they serve on another board of a company that owns 10 per cent or more of the shares of that company, the code makes an exception allowing the board member to be considered independent when the two company boards are part of the same group. Although an argument can certainly be made as to the value of having board members serve on different boards within the same group, it is hard to understand why such a board member would be subject to an exception enabling him to be considered independent. While this practice is not widespread, reportedly involving just a few investment funds in the Netherlands, it nevertheless blurs the Code's distinction of what may normally be considered independence as reported to the market.

In assessing principle VI.D.5, it appears that supervisory boards generally take well-elaborated steps to ensure that established procedures are transparent and respected, including through widespread use of nominating committees or other committees with similar responsibilities that review the board's needs and develop a profile and transparent process for consideration of board nominations. The common use of head-hunting firms and consultants to help identify candidates would suggest that efforts are being made in the Netherlands to widen the circle of participation to the board. There remain some differences between company practices and diversity objectives sought by the Parliament and Corporate Governance Monitoring Committee, as demonstrated by recent legislation to set a 30 per cent minimum target for gender balance on boards, but such debates are occurring within a transparent system.

The supervisory board has clear responsibilities, elaborated in detail in Corporate Governance Code best practice provisions, for the selection, compensation, monitoring and, when necessary, replacing of key executives and overseeing of succession planning (principle VI.D.3). A key recommendation of the Code, III.1.7, states that the supervisory board shall discuss at least once a year without the management board being present both the functioning of the management board as an organ of the company and the performance of its individual members, and the conclusions that must be drawn on the basis thereof. The nomination committee's responsibilities include "periodically assessing the functioning of the individual supervisory board members and management board

members, and reporting on this to the supervisory board; making proposals for appointments and reappointments; and supervising the policy of the management board on the selection criteria and appointment procedures for senior management," according to the Code.

Assessing how the board nomination and election system contributes to the exercise of board responsibilities for addressing conflicts of interest (principle VI.D.6) is more difficult, depending in part on the confidence one has in the system to ensure election of board members capable of acting with independent, objective judgement. Shareholders have the opportunity to influence board appointments, though in most cases it is the supervisory board (and to a lesser extent works councils) that mainly influence the composition of the board. Cases in which certain shareholders have come into conflict with board members and company management involving their attempts to dismiss the supervisory board have not been in relation to conflicts of interest, but rather over broader issues of strategy. The Netherlands' approach to dealing with board conflicts of interest also includes a new legal provision expected to take effect in July 2012 prohibiting a director from taking part in the deliberation and decision-making if he or she has a direct or indirect personal interest that is contrary to the interest of the company. The Dutch Corporate Governance Code is quite detailed in setting out best practice provisions for dealing with conflicts of interest, particularly at the management board level. For example, decisions to enter into transactions under which management board members would have conflicts of interest that are of material significance to the company and/or to the relevant management board member require the approval of the supervisory board.

The Code also sets out supervisory board responsibilities in relation to oversight of internal controls (principle VI.D.7), including a number of responsibilities assigned to the audit committee. According to the Code, the audit committee may not be chaired by the supervisory board chair or by a former member of the management board of the company. At least one member of the audit committee shall be a financial expert. The audit committee shall meet with the external auditor as often as it considers necessary, but at least once a year, without management board members being present.

## 4.7. Assessment and conclusions

The Netherlands' corporate governance system, as noted in the first part of this report, is distinctive for a number of reasons that contribute to the generally positive functioning of its board nomination and election system. Complementing mandatory provisions of the Dutch Civil Code, the Dutch Corporate Governance Code sets out detailed best practice provisions for board nomination and election that are generally consistent with the OECD Principles. It is mandatory for companies to "apply-or-explain" the recommendations of the Code. Although companies not following a certain provision are required to explain why, they appear to be largely followed, encouraged through the Dutch Corporate Governance Monitoring Committee annual reports and a relatively active set of institutional investors within the market. Adoption of Code provisions is further reinforced through the Enterprise Chamber, which takes these practices into account in responding to inquiries from shareholders, companies or other stakeholders within the market as to whether companies or their stakeholders have acted in a reasonable and fair manner. The importance of the Code in providing concrete guidance to flesh out the Dutch Civil Code's legal concept of reasonableness and fairness was further affirmed by the Supreme Court in its recent review of the ASMI case (see Box 4.2).

In this context, the Netherlands appears to have broadly implemented principles II.C.3, V.A.4 and VI.D.5 to ensure effective shareholder participation in board nomination and election processes, transparent processes for provision of information about candidates, and that the supervisory board generally takes the steps necessary to ensure that established processes are transparent and respected. However, some cases have been identified in which companies dilute shareholders' ability to influence elections (albeit legally), by diverging from best practice provisions of the Dutch code (for example, in relation to Trust Offices, and through the use of higher than recommended thresholds for shareholders to reject "binding nominations" of board members). Some of the most notable exceptions in which boards have been criticised for failing to act transparently *vis-à-vis* shareholders have occurred when activist shareholders have sought to dismiss the board. In these cases, the Enterprise Chamber of the Amsterdam Appeals Court has played an active role in trying to ensure attention to good corporate governance practices. However, the Supreme Court's findings in the ASMI case that included the rejection of some of the Enterprise Chamber's criticisms show that the debate over the appropriate balance between shareholder and company interests is a continuing one in the Netherlands.

The nomination and election system, complemented by a range of provisions in law and in Dutch Corporate Governance Code, appears to be supportive of the board carrying out its responsibilities as recommended in principles VI.D.3, 6 and 7. Relevant provisions of the law and code that support fulfilment of these functions have been highlighted in the previous section on overall assessment, and companies report to widely follow them. However, information at the level of actual practices is not sufficient to reach firm conclusions concerning the link between the Dutch nomination and election system and the effective implementation of these board responsibilities.

While the current system for board nomination and election appears to function well overall, in view of some of the exceptions to these practices highlighted in this report (for example in divergences from best practices related to effective shareholder participation referred to in this section), the Dutch Corporate Governance Code Monitoring Committee is encouraged to continue giving strong attention to monitoring and encouraging compliance with best practices relevant to board nomination and election processes in future reports.

### *Notes*

1. See Pacces, page 130.
2. See van Bekkum *et al.* (2010), page 23.
3. The 2008 Corporate Governance Code Monitoring Committee Report indicated overall compliance of 95 per cent, whereas subsequent reports have provided compliance analysis only for specific priority issues or less applied provisions. The 2011 report cited the rate of application among AEX companies as "close to 100 per cent", while reporting that among studied provisions, the application rate in 2010 increased over 2009 for about half the companies, remained steady for more than one-fourth, and fell for just under one-fourth.
4. See Jasper.
5. See Allen and Overy (2009).
6. According to Heidrick and Struggles, "European Corporate Governance Report 2011 on Challenging Board Performance", 96 per cent of Dutch AEX companies (largest 25) established nominating committees either individually or in combination with another sub-committee.
7. See Goodijk (2010), page 16.

8. The gender targets and limits for "large entities" apply to companies with at least two of the following: net assets of more than EUR 17.5 million, net turnover of more than EUR 35 million, or more than 250 employees.

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PART II

*Chapter 5*

# United States of America: Review of board nomination and election practices

*This chapter on the United States describes the ownership structure of listed companies and then considers the board nomination and election processes including disclosure practices and obligations. The board nomination and election process is placed within the context of the overall corporate governance framework.*

## 5.1. Introduction

This country report of the United States of America (hereinafter the "US") is part of a peer review series implemented by OECD Corporate Governance Committee following the financial crisis that aims to assess country's implementation of the OECD Principles of Corporate Governance. The peer review addresses the extent to which nomination and election practices are implementing principles II.C.3, V.A.4 and VI.D.5, as well as how they facilitate the formation of a board that is able to fulfil some of the key board functions identified in principles VI.D.3, VI.D.6 and VI.D.7.

The relevant OECD Principles of Corporate Governance for this review are:

- II.C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures that govern general shareholder meetings: (…) 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.
- V.A. Disclosure should include, but not be limited to, material information on: (…) 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.
- VI.D. The board should fulfil certain key functions, including: (…) 3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning. (…) 5. Ensuring a formal and transparent board nomination and election process. 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. 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.

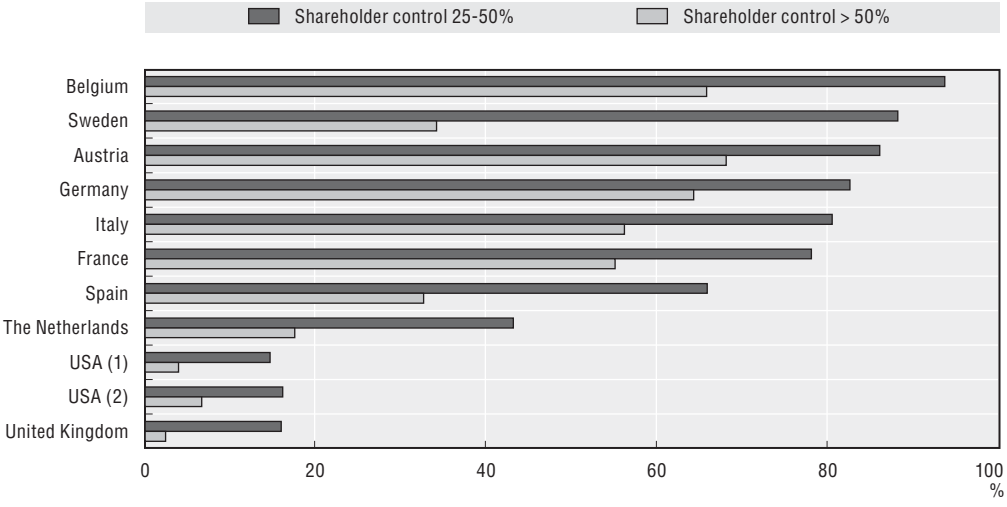
The aim of this peer review assessment is first to describe the rules and practices of the nomination and election framework in the US using the OECD Principles as a reference point. It then maps how this framework facilitates the exercise of the board's functions. The report was prepared on the basis of the answers prepared by the Securities and Exchange Commission (hereinafter "SEC") staff to the peer review questionnaire issued by the Corporate Governance Committee, a review of the literature and interviews with key authorities, stakeholder representatives, practitioners and academics conducted by the Secretariat.

## 5.2. Corporate governance framework

The process by which candidates are nominated and elected to the boards of listed companies is perhaps one of those key areas, within corporate governance, where the rules and practices in the US are not only different from those of many other OECD countries, but perhaps also are not well understood outside the US. In large part this is due to the differences in the corporate landscape between the US and most other countries, but it is also caused by the significant evolution of those rules and practices in the US in recent years.

The ownership structure of listed companies in the US is remarkably different from continental Europe, Latin America, Asia and almost everywhere else other than the UK. One study analysed in detail the ownership and control of US listed companies and showed (Figure 5.1) that the average size of the largest voting block was about 15% of total voting rights (Pacces, 2007). It also showed that control enhancing mechanisms, such as dual class shares, were used in less than 8% of listed firms, making voting power *per se* generally insufficient as corporate control mechanism. The average largest shareholder in the US was also found to be weak relative to other large shareholders, and could easily be outmanoeuvred by a coalition of the second and third largest shareholders (Pacces, 2007). This, however, is not really an issue in the US, as listed companies are infrequently under the control of a major shareholder but rather subject to managerial control, as is further discussed in Section 5.6.

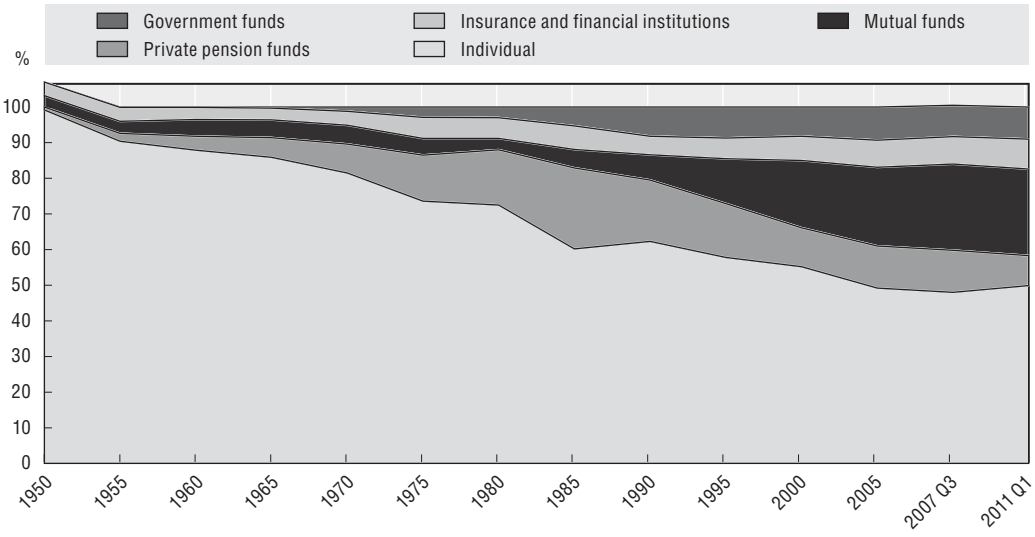
Figure 5.1. **Incidence of shareholder control**




*Source:* Pacces, Control Matters (2007).[1]

A prominent feature of the US listed company landscape is the strong presence of institutional investors, mainly mutual funds, private pension funds and insurance or other financial institutions. In a recent study from Case Western Reserve University that analyzed Federal Reserve data since 1950 for all publicly traded companies in the US, ownership shows a significant shift from individual shareholders to institutional investors, which were almost irrelevant only 60 years ago (Figure 5.2) (Pervits, 2012). In the case of the largest and most highly traded firms, the participation of institutional investors reaches

Figure 5.2. **Evolution of corporate ownership in the United States**




*Source:* G. J. Pervits, Case Western Reserve University 2012, based on US Federal Reserve data (Table Z1).[2]

some 70%, with mutual funds like Blackrock or PIMCO being the largest owners with individual stakes of around 5% of total shares.

At the company level, corporate governance in the US is structured in a decision-making hierarchy. Management, responsible for the day-to-day decisions of the corporation, is at the bottom, "though some CEOs don't always seem to realize this" (Glassman, 2006, p. 2). Then there is the board of directors. It has a broad mandate to direct management, to preserve the corporation's assets and to safeguard the interests of the shareholders while fulfilling two broad fiduciary duties, of care and loyalty, to all the corporation shareholders. Shareholders are, in turn, at the top of the hierarchy and should generally have a say on the most important corporate matters.

This hierarchy is established by the laws of the 50 states (and the District of Columbia) governments and court decisions (that comprise each state's "common law" and have established key components of their frameworks), as well as from the listing requirements of stock exchanges. Corporate governance requirements, such as those related to the formation of the board, are generally within the purview of the states and of the exchanges.

Delaware is the most influential state on corporate law since the majority of US listed companies have elected to incorporate there and because Delaware's well-developed corporate law statutes and jurisprudence are followed closely by other states. In turn, the New York Stock Exchange ("NYSE") and the Nasdaq electronic exchange are the most relevant stock exchanges. This review will therefore focus on Delaware law and on the listing requirements of those two exchanges.

## 5.3. Board nomination processes and shareholders' rights

In the US, the board of directors of listed companies are single-tiered that may comprise both executive and non-executive directors, each of whom must be a natural person, and which number shall be fixed in the company's governing documents.[3] Under Delaware corporate law, the board is responsible for the oversight of the management of

the corporation's business and affairs,[4] and in doing so it is able to, being consistent with its governing documents, appoint committees having a broad range of power and responsibilities,[5] as well as selecting the company's executive officers if so provided in the bylaws.[6] Directors have a broad range of fiduciary duties (duty of care and loyalty subject to the business judgement rule) [7]and may not delegate their duties to non-directors.

According to a recent survey by Spencer Stuart, an executive search firm, of companies included in the Standard and Poor's 500 index ("S&P500"), which includes a selection of 500 listed companies chosen mostly for market size, liquidity and industry grouping, boards in the US have between 10 and 11 members. On average, those directors are 62-year old men (only one would be female) and mostly US nationals (only one would have a non-US background). These directors have been with the board for over 8 years and a large majority of them are regarded as independent under applicable rules.[8] Their backgrounds mainly include former or current executive positions, financial, academic, accounting and legal experience (Table 5.1).

Table 5.1. **Independent director backgrounds**

| New independent director backgrounds | Year (%) | | |
|---|---|---|---|
| | 2001 | 2006 | 2011 |
| CEO/chair/president/COO/vice chair | 59 | 40 | 43 |
| Other corporate executives | 9 | 15 | 21 |
| Financial backgrounds | 17 | 24 | 18 |
| Academics/non-profit | 4 | 8 | 7 |
| Consultants | 6 | 5 | 4 |
| Lawyers | 4 | 2 | 1 |
| Others | 1 | 6 | 6 |

*Source:* Spencer Stuart Board Index 2011.

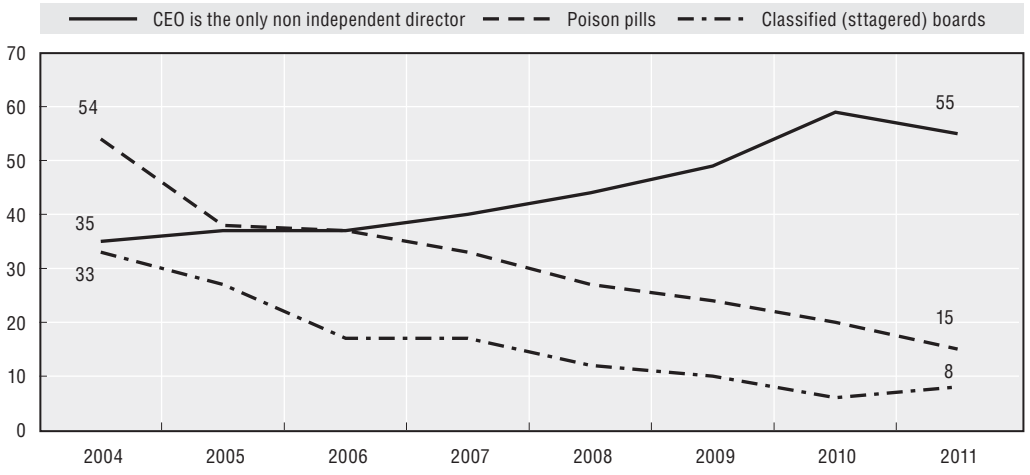
Under NYSE rules, a listed company must adopt corporate governance guidelines that require an annual self-evaluation of the performance of the board of directors and its committees to ensure that they are functioning effectively, although the results of the self-evaluation are not disclosed publicly.

In terms of tenure, there are no federal, state or exchange rules limiting a board member's tenure on the board of directors, but companies can adopt limitations in their governing documents. Many companies have adopted corporate governance guidelines voluntarily or to fulfil exchange listing requirements that include such requirements.[9] Under Delaware law, a director shall hold office until the director's successor is elected and qualified or until the director resigns or is removed.[10]

State law governs the frequency of board elections, and Delaware law requires the annual election of directors.[11] Exchange rules also require annual shareholders' meetings.[12] A company's governing documents often establish one-year terms for board members, but terms may vary and classified[13] (staggered) boards are permitted.[14] In a classified board structure, only members of a particular class of the board may be up for renewal every year, but not the entire board. Delaware law permits the creation of up to three classes of directors that are elected triennially. This is echoed in the NYSE rules that prohibit the listing of companies with more than three classes of board members[15]and require classes to be of roughly the same size and with terms not exceeding three years.[16]

However, staggered boards are becoming less frequent among the largest US listed companies, as shown in Figure 5.3, in large part as a result of shareholder activism that claims they are only useful as a management entrenchment device.

Figure 5.3. **Recent trends in NYSE and Nasdaq Top 100 companies**




*Source:* Shearman and Sterling Survey 2011.[19]

One of the characteristic traits of US boards is the high level of independent directors, which under exchange rules is determined in relation to the management of the company. According to a recent survey of the top 100 companies listed on the NYSE and Nasdaq by Shearman and Sterling, a law firm, the search for independence has reached a point where the CEO is the only non-independent member of the board in more than a half of the companies in the sample (Figure 5.3). Seven years before, that was the case only in one third of them.

Increased board independence started as a trend in the 1970s and aimed to improve directors' monitoring of management to prevent misconduct. The Sarbanes-Oxley reform significantly increased the independence requirements for audit committees and the stock exchanges have also adopted listing standards demanding more independent majorities, even though exceptions are available for foreign issuers[17] and companies with large controlling shareholders.[18] Some critics, however, argue that increased independence has not prevented new scandals or increased company returns. A former Commissioner of the SEC described these concerns,

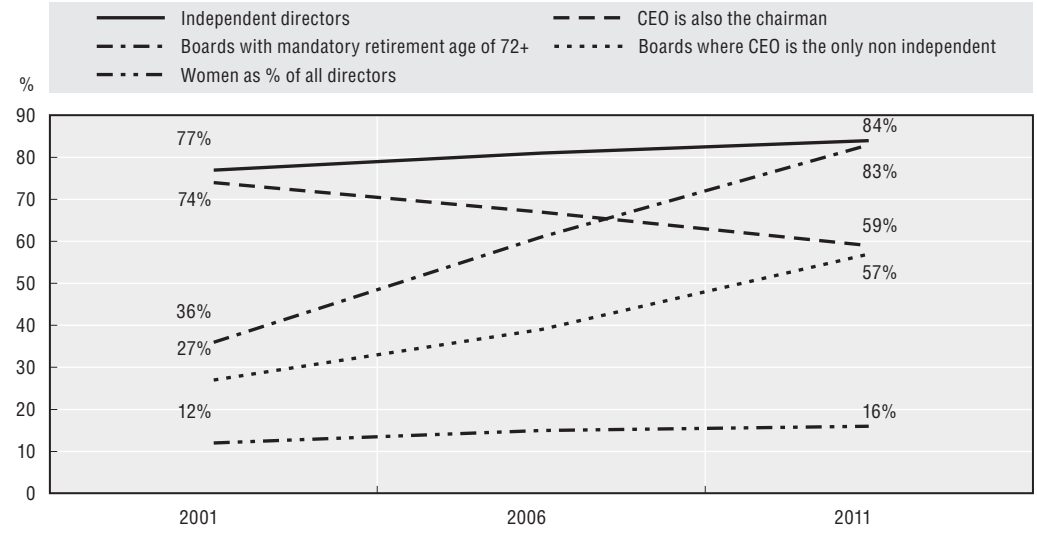
> "Yet, each time a crisis erupts, we require more board independence. I am also concerned that this trend creates the tendency to treat director independence as a substitute for other critical qualities of directors, such as experience, knowledge and diligence" (Glassman, 2006).

Increased independence is one example of the many areas where corporate governance rules and practices have evolved among US companies in recent years. As shown in Figure 5.3, situations that were often considered as characteristic of the US corporate landscape are no longer the norm, such as the presence of classified or staggered boards. That is also the case with "poison pills", but in this case it is also true that judicial

precedents have now established that they can be deployed after a takeover threat, so many companies keep them ready to be used, in case of need.

But changes to board structures have also affected larger samples, as shown in Spencer Stuart's survey of the S&P500 (Figure 5.4). In the last ten years, changes have spread rapidly in some areas, like mandatory retirement age for directors, while in others there is no significant change, such as with female participation on boards.

Figure 5.4. **Recent trends in S&P 500 companies**




*Source:* Spencer Stuart Board Index 2011.[22]

Nominating committees (that in the US are often also in charge of all corporate governance issues) are not required by either Delaware law[20] or the federal securities laws. As a general matter, it is stock exchanges listing requirements that specify the requirements for nominating committees or an equivalent review of nominees by independent members of the board.[21] NYSE and Nasdaq rules also require that the members of these committees are independent, as defined by exchange rules. The NYSE also requires companies to adopt a written charter for its nominating committee that discloses the committee's purpose, responsibilities and an annual performance evaluation. The nominating committee charter must be available on or through the company's website and the website address should be disclosed in its annual proxy statement.

If a company has a nominating committee, it is normally responsible for identifying and evaluating board nominees. Nominating committees are permitted to use executive search advisors or consultants to recruit candidates, and SEC rules require disclosure of their use and fees paid to them. Likewise, a company must disclose in their proxy statement certain information about its director nomination process, including whether it has adopted a policy with regard to the consideration of shareholder nominee proposals.

In the US, each company determines the manner in which the board of directors or nominating committee receives suggestions for candidates, including from shareholders, as determined by the companies governing documents (bylaws or nominating committee's charter) in accordance with state law and exchange requirements. The company's nominating committee process will determine the relevant procedures for shareholders to

nominate candidates for director, such as to whom and when the shareholder should submit a nominee. SEC regulations require companies to disclose the nominating committee processes when a company solicits proxies and prescribe that a nominee or person chosen to become a director must consent to being nominated and to serve if elected.[23]

Generally, state laws do not require board members to have specific qualifications. Delaware law permits companies to specify qualifications for directors in its governing documents,[24]such as share ownership, and does not require companies to have employee or other stakeholder representatives, unless they choose to voluntarily do so. Those instances are often the result of negotiations with investors based on significant ownership levels or in connection with the issuance of certain securities. In terms of diversity, there are no federal, state or exchange requirements that promote diversity or establish gender quotas for boards of listed companies. Companies can voluntarily adopt diversity policies as part of the NYSE-required corporate governance guidelines, but are not often found as evidenced by the low level of female participation on boards (Figure 5.4). Certain institutional investor groups have policies calling for companies in which they invest to promote diversity on their boards of directors.[25] The SEC's proxy disclosure rules require companies to disclose whether and, if so, how, diversity is considered in identifying nominees for director. Disclosure about the implementation of such policies and an assessment of its effectiveness is also required.

Exchange rules establish requirements regarding the qualifications of board members of listed companies, the most common one being independence. Exchange rules generally require that the majority of the members of the board of directors are independent,[26] which is defined under both NYSE and Nasdaq rules as independence from the company.[27] Under NYSE rules, furthermore, a listed company is also required to disclose its corporate governance guidelines, which include director qualification standards. Exchange listing rules also generally require that all members of the audit, compensation and nominating committees are independent.[28] Furthermore, NYSE rules ask for all members of the audit committee to be financially literate or to become financially literate within a reasonable period of time after appointment,[29] and at least one member of the audit committee is required to have accounting or related financial management expertise. Nasdaq rules have similar requirements.[30]

The federal securities laws can require the exchanges to adopt listing standards that include certain director qualification requirements and require companies to disclose their board member and nominee qualifications in the proxy statement for shareholder meetings.[31] Recent SEC rules have significantly increased the areas of disclosure and added noteworthy requirements, such as why a director or nominee is considered to be qualified for the job (see Section 5.5 for more details).

Until relatively recently, federal law did not address board or committee member qualifications. In 2002, the Sarbanes-Oxley Act imposed qualifications for audit committees.[32] As a result of the adoption of the Dodd-Frank Act on July 2010,[33] the SEC has proposed to require exchanges to also adopt listing standards relating to qualifications for the compensation committee.[34]There are, however, no such requirements for the nominations committees.

## 5.4. Shareholders' right to nominate and elect board members

In the US, state laws permit ownership to be structured with one or more classes of shares with diverse voting or non-voting rights.[35] Although dual class shares are not common among publicly listed companies in the US (Pacces, 2007), they are found in some large and successful new companies like Google, the Internet search engine, and also now for the listing of Facebook, the social networking company. In both cases, the founders have retained control of the company by holding a large stake of the shares with increased voting rights (see Box 5.3). Exchange rules apply to the voting rights of these shares after the IPO.[36]

Treasury shares (shares of a company's own capital stock held by the company), as well as shares of a company held by one of its subsidiaries, are not allowed to be voted under Delaware law.[37] These shares are also not counted for determining a quorum. The Dodd-Frank Act of 2010 introduced changes that require exchanges to prohibit brokers from voting uninstructed shares in the election of directors, as well as on issues related to executive compensation or any other significant matters, as determined by the SEC rules.[38] The SEC had already adopted a similar rule but only for director elections.[39]

Shareholders have different options to influence the nomination and election process for the board, some within and some outside of the proxy process. Shareholders may submit nominations for director to a company for consideration by the nominating committee or board. If the company declines to include the nomination in the company's slate of candidates for directors, shareholders may attend the shareholder meeting and present a candidate, subject to the company's advance notice bylaw. However, without having a candidate listed in the proxy statement and proxy card, success would be difficult. Within the proxy process (Box 5.1), shareholders have the right to vote for the candidates included in the proxy statement, which will normally include only those candidates nominated by the nominations committee or by the board, where there is no nominations committee. If shareholders are not satisfied with such candidates, they may vote against the company's nominees in full or part. They may also, at their own expense, opt to challenge the company's nominations and start a proxy contest to obtain votes in favour of different candidates. This is not done frequently.

In the vast majority of director elections among listed companies in the US, the nominees equal the number of board positions to be elected (Harris, 2010). This feature makes most elections closer to a shareholder ratification process than a real contest for the board seats, as is the case in contested elections (elections where shareholders have decided to challenge the candidates proposed by the nominations committee or board and started a proxy contest).

Pursuant to Delaware law, director elections take place in a single vote, where shareholders have one vote per share unless the company's certificate of incorporation provides otherwise,[40] and directors are elected by a plurality of the votes of the shares present (in person or represented by proxy) at the meeting and entitled to vote.[41] Companies are permitted by state law to adopt cumulative voting for the election of directors, but that is not a common feature among US listed companies. Listed companies with more than 2 000 shareholders are required to appoint one or more inspectors to oversee the ballot counting at the shareholder meeting.[42] They must take and sign an oath to faithfully execute their duties with strict impartiality and according to the best their ability.[43] Shareholder voting is confidential and is subject to these ballot counting procedures.

### Box 5.1. **The proxy process**

Through its rules, the SEC seeks to assure that the proxy process functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders. This is particularly important because the proxy process has become the primary way for shareholders to learn about the matters to be decided by the shareholders and to make their views known to company management. As most shareholders do not attend public company shareholder meetings in person, a large percentage of voting takes place by the use of proxies solicited before the shareholder meeting. If a publicly-listed company solicits proxies from shareholders, these proxy solicitations are required to comply with the federal proxy rules.

Under Delaware law, a company sets a record date in advance of a shareholder meeting, and holders of record on the record date are entitled to notice of the meeting and to vote at the meeting. Under Delaware law, the record date can be set no more than 60 days before the date of the meeting.[1] The notice must include the place, date and hour of the meeting, the means of remote communications, if any, by which stockholders and proxy holders may be deemed to be present in person and vote at such meeting, the record date for determining the stockholders entitled to vote at the meeting, if such date is different from the record date for determining stockholders entitled to notice of the meeting, and, in the case of a special meeting, the purpose or purposes for which the meeting is called. Delaware law generally requires that the written notice of any meeting be given not less than 10 days nor more than 60 days before the date of the shareholder meeting.[2]

The SEC has stated that proxy materials "must be mailed sufficiently in advance of the meeting date to allow five business days for processing by the banks and broker-dealers and an additional period to provide ample time for delivery of the material, consideration of the material by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker-dealer to the tabulator."[3] The NYSE "recommends that a minimum of 30 days be allowed between the record and meeting dates so as to give ample time for the solicitation of proxies."[4]

The SEC has a "notice and access model" for proxy statement delivery.[5] Under these rules, shareholders may choose the means by which they access proxy materials – either in paper or on the Internet. Issuers and other soliciting persons are required to post their proxy materials on an Internet website and provide shareholders with a notice of the Internet availability of the materials at least 40 days in advance of the meeting.[6] The issuer or other soliciting person may choose to furnish paper copies of the proxy materials along with the notice it provides to shareholders. If the issuer or other soliciting person chooses not to furnish a paper copy of the proxy materials along with the notice, a shareholder may request delivery of a copy at no charge to the shareholder and the issuer must send the paper copy within three business days after receiving the request. Under either method used for proxy delivery for an annual meeting, shareholders will have access to the issuer's proxy statement, annual report required by Rule 14a-3(b) under the Exchange Act and the means to vote – either a proxy card or a website address, toll-free telephone number or printable or downloadable proxy card.

1. 8 Del. C. § 213(a) (2011).
2. 8 Del. C. § 222(b) (2011).
3. Timely Distribution of Proxy and Other Soliciting Material, Release No. 34-33768 (16 March, 1994) [59 FR 13517].
4. NYSE Listed Company Manual Section 401.03.
5. See Shareholder Choice Regarding Proxy Materials, Release No. 34-56135 (Jul. 26, 2007) [72 FR 42222] and Rule 14a-16 under the Exchange Act.
6. Rule 14a-16(a)(1) under the Exchange Act.

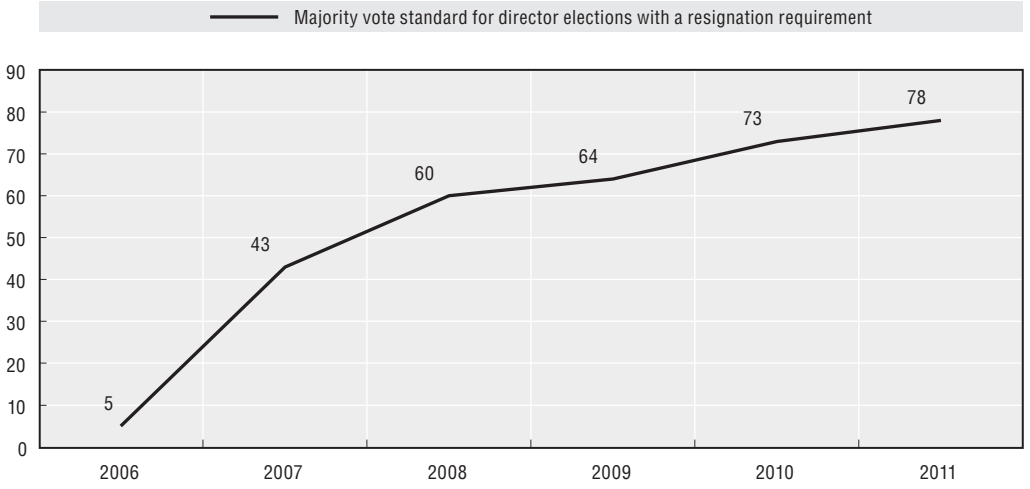
*Source:* US response to the questionnaire.

Listed companies are required to allow shareholders to withhold authority to vote for each nominee. They must have the option to vote for or against the slate with the nominated candidates, but also the ability to vote for the slate but withhold approval for specific candidates.[44] In uncontested elections and with a plurality vote rule, in which the

nominee with the greatest number of votes is elected, the ability to withhold authority to vote in the proxy process renders a result equal to that of cumulative voting. It is, nevertheless, not very useful since it cannot prevent nominated candidates to become directors. Provided a candidate receives even one vote, the nominee will be elected. For this reason and as a result of the urging of institutional investor organizations, many of the largest listed companies in the US have recently adopted majority voting rules for director elections. These voting rules require a director to receive at least a majority of the votes cast to be elected in an uncontested election.[45] If they do not receive enough votes, they could be required to resign. Company by-laws define whether their resignation is mandatory or voluntary, and if the board has to accept it or not.

A recent survey by Shearman and Sterling shows that by 2011, 78% of the top 100 NYSE and Nasdaq companies have adopted a majority vote rule with a resignation requirement (Figure 5.5).[46] Anecdotal evidence collected for this report shows that this trend is not equally present among medium and small-cap listed firms, where there is a stronger opposition from boards to adopt a majority vote rule.

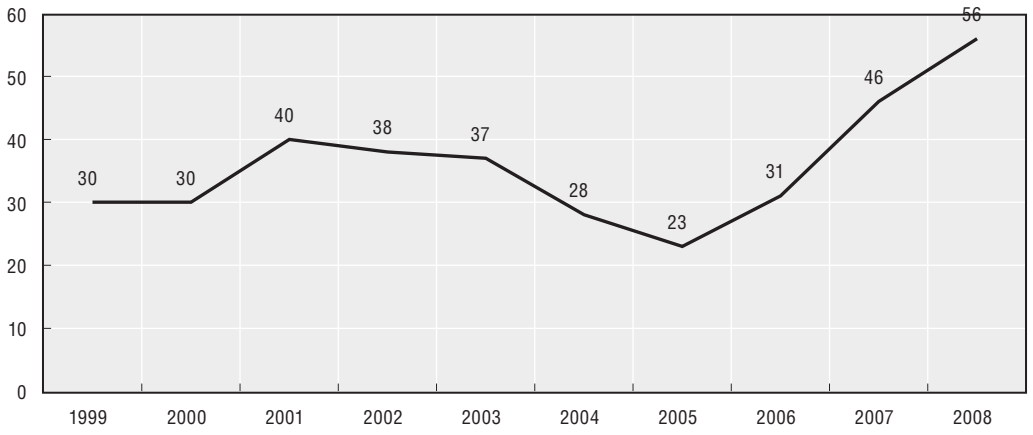
Figure 5.5. **Majority vote in US companies**




*Source:* Shearman and Sterling Survey 2011.

Contested elections in the US are not common, with Bebchuk (2007) estimating an average of 30 proxy challenges per year over a ten-year period (1996-2005). In those, a challenger (often an institutional investor and more rarely an individual shareholder) launches a campaign to collect proxies in support of a slate of nominees alternative to that proposed by the company. In a proxy contest, shareholders may submit individual candidates or entire lists of candidates.[47] Looking into evidence from public filings from 2006 to 2008, Harris (2010) confirmed that shareholder-led campaigns to elect directors occur rarely (Figure 5.6) and in them incumbents have the advantage. Harris (2010) also shows that even when considering partial settlements as a successful result, proxy contests in recent years have a success ratio of 48%.[48] Unofficial figures collected by US experts interviewed for this paper and blog commentators suggest that the numbers have not significantly increased in 2010-2011, with about 40 contests per year and around a third of them settled before reaching the shareholders meeting (DealLawyers, 2011).

Figure 5.6. **Contested elections in the US**




*Source:* Harris 2010. NYSE and Nasdaq.

According to Harris, two of the key factors that explain these results are that incumbents can use the corporate treasury to fund their campaign and that shareholder-led campaigns are often initiated by the same small (and unsuccessful) group of activists. Engaging in a proxy contest is also an expensive process for shareholders, who must prepare and disseminate their own proxy materials that comply with the SEC proxy rules and run a public campaign to obtain votes. A large part of the cost is raised in order to reach the thousands of individual shareholders and beneficiaries that have the right to vote, a service that is provided by specialized intermediaries. Roe (2011) argues that the cost of a proxy contest as well as the liability risk involved deter most shareholders from acting, even against the boards of troubled companies. Moreover, even if they succeed, the challenging shareholders cannot be sure that these costs will be reimbursed by the company.

> "This sharp asymmetry in expense-bearing is at the core of the power allocation in the American public corporation. It puts corporate power disproportionately in the hands of incumbent directors, not stockholders" (Roe, 2011, p. 8).

Pursuant to SEC proxy rules, contested proxy solicitations must ensure that all investors receive information that will enable them to make informed voting decisions. For that, any party conducting a proxy solicitation in the case of an election contest must file with the SEC, and furnish to each person solicited, a proxy statement containing information on numerous specified disclosures and on director nominees.[49] These proxy disclosures are subject to a prohibition on making a solicitation containing false or misleading statements or omissions.[50]

In 2008 the SEC adopted amendments to its proxy rules to facilitate the use of electronic shareholder forums,[51] clarifying that participation in an electronic shareholder forum that could potentially constitute a solicitation subject to the proxy rules is exempt from most of the proxy rules if some conditions, including timing limitations, are satisfied. These rules also establish that a shareholder, issuer or third party acting on behalf of a shareholder or issuer that establishes, maintains or operates an electronic shareholder forum, is not liable under the federal securities laws for any statement or information provided by another person participating in the forum.

Beyond starting a proxy contest, shareholders have options to voice their dissatisfaction with the board of directors and the functioning of the company, including submitting a proposal to the company for inclusion in the company's proxy materials and engaging in dialogue with the board or the nominations committee. They can recommend a candidate to a company's nominating committee or board and, in certain cases, nominate directors at the annual meeting, subject to the requirements of state corporate law and the company's governing documents. And there is the "Wall Street rule", where shareholders can sell their shares if they do not like the company.

Shareholders in the US have argued that each of these options suffers from some drawbacks and asked for changes in the law at the federal level.[52] The SEC's shareholder proposal rules, Rule 14a-8 in particular, provides an opportunity for a shareholder to submit a proposal for inclusion in a company's proxy materials. For that, they need to have continuously held at least USD 2 000 in market value or 1% of a company's securities entitled to vote, for at least one year before the proposal. The rule requires a public company to include the proposal in its proxy materials unless the shareholder has not complied with the rule's procedural requirements or the proposal falls within one of the substantive bases for exclusion.

Among the substantive bases upon which a company may exclude a shareholder proposal under Rule 14a-8 there is the "election exclusion." The interpretation of this exclusion was debated for some time, with an ongoing argument about whether this "exclusion only excluded voting on new directors, not voting on election rules, such as rules to give insurgents access to the company's voting machinery in future elections" (Roe, 2001, p. 10). In 2006, a court decision ruled that a company could not rely on this exclusion to reject a proposal seeking to amend a company's bylaws to establish a procedure under which a company would be required to include shareholder nominees for director in the company's proxy materials. After the court decision, the SEC sought public comment on two proposals for redrafting its norms: one moving the rules towards more shareholder access and the other explicitly allowing the exclusion of shareholder proposals to establish procedures for inclusion of shareholder nominees in the company proxy materials. In December 2007, it was the exclusion version which was adopted.

The SEC had been considering the question of proxy access for many years, as far back as 1942, and had considered revising its proxy access rules in order to grant shareholders access to nominate and elect directors of their choice. The objective of the initiative, in line with OECD principle II.C, was to effectively facilitate shareholder activism in shaping the composition of the board as a way to better monitor management and make boards more accountable. As Roe (2011) explains, however, "easy access proved controversial, as scandals faded from memory and the media" (p. 8) and the rules went up and down in the priorities of the regulator, being announced and withdrawn, and accumulated numerous opinions and research both in favour and against. The topic has generated great interest over the years and widely varying views, ranging from the effects it may have to the appropriateness of rules being issued at the federal rather than the state level, as well as on the insignificance of the entire discussion considering that having access to the proxy materials would reduce only a small fraction of the cost of challenging the company nominees (Kahan and Rock, 2011).

As mentioned before, Delaware state corporate law heavily influences the making of corporate law in the US. Delaware law is widely considered as biased in favour of

managerial positions and was naturally seen as hostile to shareholder access.[53] The Delaware state legislature did not act for many years on the issue of proxy access, but in April 2009 it adopted a new shareholder voting statute expressly providing that a company's by-laws may allow for shareholders' nominations to be included in the company's proxy materials. In addition, it expressly provided that the by-laws may include a provision to reimburse a shareholder for the expenses incurred in soliciting proxies in connection with an election of directors. Section 112 states:

> "The bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required (…) to include in its proxy solicitation materials (….) in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder." [54]

The new Delaware statute was regarded by voices considered to be managerial-friendly as more than enough for satisfying the demands of shareholders (Lipton *et al.*, 2009) and thereby making the SEC's proposed rules "a mistake, or at least redundant" (Roe, 2011). In practice, however, the new statute did not make shareholder access that easy. Shareholders first had to amend the by-laws of the company. Doing that would require them to initiate a proxy contest to change the bylaws and, if they succeed, then start another campaign the next year to actually try to challenge the board nominees.

> That is, to obtain a structure that would allow a *cheap* proxy contest, the insurgents need first to launch, pay for, and win an *expensive* proxy contest of approximately the same sort that they are seeking to avoid. An earlier generation would recognize this as a *Catch-22*" (Roe, 2011, p. 16).

As described in Box 5.2, the SEC issued its own proxy access rules. The new Rule 14a-11 was however never applied, as it was eventually struck down by judicial review in a decision that was not based on normative grounds (the court did not take a position as to the substance of the rule), but rather on procedural issues of the rulemaking process. Only changes to Rule 14a-8 are in effect.

The stage is now set for shareholders to be able to submit shareholder proposals to establish proxy access procedures at individual companies – a process known as "private ordering". Private ordering has the potential, over time, to bring about a system where more companies allow shareholders to include their nominees in the company's proxy, enhancing engagement between boards and shareholders. How many companies will adopt this system is yet to be seen. Under rule 14a-8, about 20 proxy access proposals had been announced at the time of writing this report to be discussed in the 2012 proxy season. Most are promoted by shareholders asking to amend the by-laws of the companies in order to have access to the proxy materials, but a few of those initiatives are driven by the companies themselves.

In the aftermath of the proxy access litigation, however, commentators pointed out that it was not entirely clear why such a big controversy had been created considering that Rule 14a-11 had qualifications that would make it very hard for shareholders to use (3% holding for at least three years; access to nominate only a quarter of the board), and that it also would have only saved shareholders a small part of the cost of collecting the votes in support of their candidates (printing and mailing their own proxy card). For some, "stripped to its essentials, aside from cost savings, proxy access is the ability to have a universal proxy card" (Keller, 2011). Institutional investors interviewed for this paper said, nonetheless, that having all candidates on the same proxy card was important enough, as

Box 5.2. **The proxy access litigation**

Despite Delaware´s anticipation, and in part due to the sentiment against Wall Street boards after the financial crisis that had moved Congress to grant express authority to the SEC to act on the matter via the Dodd-Frank Act, the SEC adopted rules to facilitate director nominations by shareholders in August 2010.[1]

On the one hand, the SEC amended Rule 14a- 8 so that companies would no longer be permitted to exclude shareholder proposals seeking to establish proxy access procedures. On the other, Rule 14a-11 was a "universal" proxy access rule, which would have required, under certain circumstances, a company's proxy materials to provide shareholders with information about, and the ability to vote for, a shareholder's, or group of shareholders', nominees for director.

Under Rule 14a-11, a shareholder or group that owned at least 3% of the voting power of the company's securities entitled to be voted at the meeting and who had held the qualifying amount of securities continuously for at least three years, would have been able to require a company to include director candidates for not more than 25% of the board in the company's proxy materials, provided that applicable state law or the company's governing documents did not include a provision against it.

The SEC explained that Rule 14a-11 could create "potential benefits of improved board and company performance and shareholder value" sufficient to "justify potential costs" and argued that a voluntary provision, where each company would decide to adopt Rule 14a-11 in the by-laws or not, "would not be as effective and efficient" in facilitating shareholders' right to nominate and elect directors (75 Fed. Reg. 56,759–60).

In a lawsuit initiated by the Business Roundtable and joined by numerous parties supporting either side, the SEC rule was challenged mainly on the grounds of the costs it would cause and whether they had been properly assessed by the regulator. In July 2011, the D.C. Circuit Court of Appeals vacated rule 14a-11.

See Facilitating Shareholder Director Nominations, SEC Release No. 33-9136 (Aug. 25, 2010) [75 FR 56668] ("Proxy Access Release"), portions of which were vacated in Business Roundtable, *et al*. v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

*Source:* Business Roundtable, *et al*. v. SEC.

with separate cards it is impossible in most cases for shareholders to split their votes between candidates of different lists, unless they attend the meeting in person.

## 5.5. Disclosure about the nomination and election process

The SEC's rules on disclosure cover a broad range of issues related to the nomination and election of directors. The proxy notice and proxy statement materials filed by all public companies are available on the SEC's website through the EDGAR database.[55] The disclosure requirements have been enhanced in recent years and are one of the most efficient policy tools at the disposal of the federal authorities. In a country with high levels of litigation such as the US, what companies are required to disclose persuades them to treat the underlying issues with care, as what they say in their filings may actually *be used against them in court*. The SEC rules are complemented by the exchange rules, which the SEC can also influence. The NYSE requires listed companies to adopt and publish corporate governance guidelines on the company's website.[56]

The SEC's disclosure rules require specified disclosures about the nominating committee or committee performing similar functions.[57] These include whether and, if so, how, a nominating committee considers diversity in identifying nominees for director.[58] If the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, disclosure is required of how the policy is implemented, as well as about the assessment of the effectiveness of such policy. The SEC disclosure rules do not define diversity and companies are permitted to do so as they consider appropriate.

The SEC rules require a high level of disclosure regarding the nomination and election process, including:

*i)* a discussion of the charter of the company's nominating committee, if it has one;

*ii)* a statement about whether the nominating committee has a policy regarding shareholder-recommended director candidates and a description of the material elements of that policy, such as whether the committee will consider shareholder-recommended director candidates;

*iii)* a statement that the company does not have a policy regarding shareholder recommendations for director nominees, if applicable, and the basis for the board of directors' view that it is appropriate for the company not to have such a policy;

*iv)* a description of the procedures shareholders must follow to submit director recommendations;

*v)* the specific minimum qualifications that the nominating committee believes must be met by a nominee, and any specific qualities or skills that the nominating committee believes are necessary for one or more of the company's directors to possess;

*vi)* the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by shareholders, and any differences regarding how the nominating committee evaluates nominees for director based on whether a shareholder recommends the nominee, and whether diversity is considered in identifying director nominees;

*vii)* a statement identifying the party who recommended the director nominee, such as a shareholder, non-management director, chief executive officer, other executive officer, third-party search firm, or other specified source;

*viii)* a description of any fees the company pays to any third party or parties to identify or evaluate or assist in identifying or evaluating potential nominees, and disclosure regarding the function performed by each such third party; and

*ix)* identification of any shareholder-recommended nominee by a shareholder or group that beneficially owned more than 5% of the company's voting common stock and disclosure regarding the recommending shareholder.

The rules also require disclosure regarding whether the directors and committee members are independent, the number of board and committee meetings attended by members, disclosure about a company's audit committee, including whether the audit committee has an independent audit committee financial expert, and specified disclosure about a company's compensation committee.[59]

Board candidate's background and experience must also be disclosed under SEC rules for each director and director nominee. This information must be included in the proxy statement of the company and provided to shareholders before the company's annual

meeting. The company must provide the name, age, positions and offices held by each director or director nominee at the company, term of office at the company, and the person's business experience. The business experience disclosure covers two areas: background and directorships. Companies must also discuss the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director at the time that the disclosure is made, in light of the company's business and structure.

In terms of background, the disclosure must address the business experience of each director and nominee, including the person's principal occupations and employment during the past five years; the name and principal business of any corporation or other organization in which such occupations and employment were carried on; and whether such corporation or organization is a parent, subsidiary or other affiliate of the company. If material, this disclosure should cover more than the past five years, including information about the person's particular areas of expertise or other relevant qualifications.

The disclosure of directorships must indicate any other board positions held, including any other directorships held during the past five years, by each director or person nominated or chosen to become a director in any public company. Companies are also required to provide disclosure about each director and director nominee with respect to their involvement in certain legal proceedings that occurred during the past ten years and that are material to an evaluation of the ability or integrity of any director or director nominee (as the filing of a bankruptcy petition, for example).[60]

Within four business days from the date of the meeting, companies are required to report the results of an election, including the election of directors.[61] Companies report the number of votes for and against, as well as the number of abstentions and shares held by brokers for which there was no authority to vote, for each candidate.[62] This information does not identify the names of the shareholders that voted and the number of votes they cast for each candidate. The disclosed information is available on the SEC's website through the EDGAR database and through the company's website, if it has one.

Additional information about the voting of certain shareholders may be obtained from the disclosure required by the SEC from management investment companies registered under the Investment Company Act. They must disclose annually how they voted proxies relating to portfolio securities, including the election of directors.

## 5.6. Overall functioning

The various elements discussed in this chapter illustrate some of the special factors at work in the US, where the framework for nominating and electing board members is a very sophisticated, yet highly debated component of the national corporate governance arrangements. Widespread ownership has been a key feature in the past but this has given way to increased institutional ownership that nevertheless remains weak *vis-à-vis* companies. The US also shows a diversity of rulemaking authorities (federal, state, exchange) as in many other federal countries, but also a unique political economy in the interactions between the state and federal level. The effect of the state of Delaware in shaping US corporate law is hugely important. Through it, managers of listed companies have influenced legislation that is admittedly skewed towards managerial/board control rather than shareholder authority, but not so much as to call for the US Congress to have reason to issue an overriding federal law. Boards in this context are extremely powerful, but

shareholders have tools and techniques available to hold directors accountable when shareholders are sufficiently motivated to do so.

The power of the board in the US is enormous and their *de jure* role goes perhaps beyond that of boards in most countries. As shown in the previous sections, it is very difficult for shareholders to appoint board members of their choice if they disagree with the board candidates, and prominent cases show that it could be even harder to replace a non-performing board if they decide to entrench themselves. Shareholders are simply not strong enough and the rules are not designed to help them overcome their weakness at the expense of the managers/board. The legal system simply seems to trust boards more than shareholders. As Roe has recently described in an op-ed (2011),

> "American law gives more authority to managers and corporate directors than to shareholders. If shareholders want to tell directors what to do – say, borrow more money and expand the business, or close off the money-losing factory – well, they just can't. The law is clear: the corporation's board of directors, not its shareholders, runs the business. (…) Perhaps this is good. Even some capital-oriented thinking says that shareholders are better off if managers make all major decisions. And often the interests of shareholders and managers are aligned."

Moreover, the anti-takeover measures available to boards in the US are possibly stronger and grant more discretion to directors than in many other countries. Under anti-takeover practices and state law principles, for example, courts will accept that a board can prevent (at least until such board is up for re-election, which may be a long time with a staggered board) a majority of the shareholders from deciding the fate of a takeover or merger proposal on the grounds that it is the directors who are in a better position to know what is best for both the company and its shareholders in the long term. This alone perhaps makes the US framework quite different and hard to reconcile with typical views of shareholders' rights.

At the same time, however, the US framework has other features that aim to offset this power granted to the board by making it accountable in ways other than the election process. Independent directors, nomination committees with only independent directors, majority vote rules, board retirement age and many other measures taken both by the exchanges and companies are just a few examples. This US framework is also supported by three reinforcing elements: robust disclosure pursuant to SEC regulations; strong fiduciary duties under Delaware statutes and judicial decisions; and vigorous enforcement in both these areas by private parties and regulators, which is facilitated by a well-working judiciary that offers the possibility of redress on corporate disputes within times that are still reasonable for businesses needs. There may be a fourth element as well, since shareholders have formal and informal avenues to express their concerns.

Moreover, the rules and practices to appoint the board have themselves been, and will probably remain, at the centre of the academic and policy making debate in the US, and differences in views are obvious when reviewing the corporate governance principles of the key actors in this debate (annex). Whether access to the company proxy materials will become an accessible route for greater shareholder influence in the formation of boards is yet to be seen, but it is safe to say for now that this is clearly not a resolved issue.

Proponents of proxy access argue that board and managerial control was probably the only reasonable choice in the ownership scheme of 70 years ago, with scattered and unsophisticated or less knowledgeable retail investors, but not anymore. This is argued to

be particularly clear after several examples where despite the opposition of professional shareholders, boards succeeded in holding on to power in badly managed companies.As Roe (2011) mentions,

> (…) "there is considerable evidence that when managers are at odds with shareholders, managerial discretion in American firms is excessive and weakens companies. Managers of established firms continue money-losing ventures for too long, pay themselves too much relative to their and the company's performance, and too often fail to act aggressively enough to enter new but risky markets."

One of the common responses is that managerial predominance still makes sense today, precisely in view of the still scattered and contradictory preferences of the new professional institutional investors. Left to their own devises, it is argued, many of them would push boards into measures that would jeopardise the future of a company in order to secure a short gain, even in a company that was performing well under a sound management (Strine, 2010). For example, investors have pushed harder for increasing share buy-back plans than for R&D or sustainable long-term planning.

The alternative model to shareholder predominance that some voices propose is a broad stakeholder model, where shareholders are just one of the constituencies that have legitimate interests in the business of the company. A powerful board might be a good arbitrator of interests, although more in the way of a necessary though not sufficient condition. It might also be important in the circumstances of firms dominated by intangible capital (Box 5.3).

In the end, both sides of the debate in the US want strong boards and companies committed to long-term value (The Aspen Institute, 2009: Millstein *et al.*, 2011: Lipton *et al.*, 2011). The question is how to address those marginal cases, where the board is not only strong, but also wrong and destroying value. Proxy access was viewed as the solution by many, as it would force entrenched boards to become accountable if they were not voluntarily willing to respond to shareholder pressure. The claim is that this rule would have probably reduced the time it takes shareholders to make boards react in some prominent cases. But for many others it would have also become a way to bring the wrong kind of shareholder pressures on perfectly functional boards. Even the largest institutional investors, it is claimed, do not always look after the long-term value of companies, clouded by short-termism, political agendas[63] or following the advice of conflicted proxy advisors.

## 5.7. Assessment and conclusions

The OECD Principles are concerned with outcomes and not at imposing specific rules and practices. Even though principle II.A states that the election and removal of the board are among key shareholder rights, principle II.C.3 is careful in choosing words and states that effective shareholder participation in the nomination and election of the board should be *facilitated* (OECD Methodology, p. 48).

In line with principle II.C, there is no doubt that shareholders in the US have the opportunity to participate and vote in general shareholder meetings, are well informed of the rules, including voting procedures, that govern general shareholder meetings and about many other relevant aspects through the well-developed disclosure framework. Those disclosure rules, in turn, well cover the requirements of principle V.A.4 and SEC rulemaking in 2009 has significantly increased the transparency of the selection process and qualifications of board nominees.

### Box 5.3. **Boards under founders' control**

Zingales (2000) has described the emergence of a "new firm", opposed to the "modern corporation" of Bearle and Means, where *i)* physical assets are less unique and do not command rents (as there is better access to capital and to communications); *ii)* increased competition demands high levels of innovation and product improvements that depend on talent, and *iii)* human capital is more movable, less specific and working within decreasing levels of hierarchical authority. In this context, the firm is understood as a nexus of specific investments, the most important of which could be those made by managers and employees by committing their creativity and talent into the company. Retaining those key managers and employees becomes the key to the company's sustainable development.

The challenge for corporate governance in the "new firm" becomes to allocate the residual right of control over incomplete contracts. Zingales suggests such rights should be given to the group most needed of protection from ex-post expropriation but with less control over specialization of capital investment - which reduces alternatives uses of capital. One way of achieving this is to give control to the shareholders, but remove their ability to determine the degree of specialisation of investments the company will have (otherwise shareholders will want to keep the assets liquid and available for alternative uses). For that, shareholder power has to be delegated to an independent agent that can decide in the best interest of all stakeholders (particularly talented managers and employees), and that agent is the board (Rajan and Zingales, 1998).

This description fits the structure of some companies in the Internet industry or with predominance of intellectual capital, where founders have retained disproportionate control over board nomination and election though dual class shares. The corporate structure chosen for Facebook forthcoming IPO is a good example. Google's 2004 founders' letter to potential investors stated that they believe a dual class voting structure would enable Google, as a public company, to retain many of the positive aspects of being private: "*We understand some investors do not favor dual class structures. Some may believe that our dual class structure will give us the ability to take actions that benefit us, but not Google's shareholders as a whole. We have considered this point of view carefully, and we and the board have not made our decision lightly. We are convinced that everyone associated with Google-including new investors-will benefit from this structure. However, you should be aware that Google and its shareholders may not realize these intended benefits*".

Investors have been willing to buy this dual class shares despite not having a chance to replace the board essentially because they trust founders being key to the sustainable development of the company. In the past, this model was also used for media companies as a way to isolate the boards, responsible for setting editorial line of the newspaper on TV channel, from the pressure of shareholders that may interfere with journalistic integrity. Unfortunately, in cases such as Rupert Murdoch's News Corporation recent corporate scandal, shareholders have discovered that these arrangements may also have significant disadvantages.

Looking more closely at principle II.C.3, it is also true that in general shareholder participation in key corporate governance decisions, such as the nomination and election of board members, is facilitated. The issue is that it could be a matter of debate, and in fact it is, whether such participation is facilitated in a way that makes it *effective*. Similarly, it is an issue of debate whether further facilitation may potentially detract from the role of the board of directors to oversee corporate management in a manner consistent with the promotion of shareholder value. For the larger firms the ability to withhold authority to vote together with a majority vote rule has made shareholder participation more effective than in the recent past. However, smaller companies (beneath the S&P500) appear not to have moved in this direction voluntarily.

An effective nomination and election system is not an end in itself but rather a means to obtain a well functioning board, one that does, for the purposes of this review, properly

deal with key functions identified in principles VI.D.3 (responsibilities over key management), VI.D.6 (responsibilities over conflicts of interests), and VI.D.7 (responsibility over integrity of reporting and control). By and large, boards in US listed companies function well and companies are well managed, successful and competitive. Shareholders in the US report their frustration with not having a more direct way to influence the election and nomination of boards, but do not complain about boards or management of companies in general. They are thinking of specific cases and circumstances, where for good or bad reasons, boards simply do not listen to shareholders and entrench themselves.

Looking at one of the biggest US corporate crisis in the last decade, the Enron case clearly brought attention to problems with the implementation of principle VI.D.7, and the response by the US was to tighten auditing standards, internal control and independence requirements of board members and of committees, among other things. The recent financial crisis showed severe weaknesses in the boards of some financial companies, many of them dealing with incentives and remuneration of key executives (principles VI.D.3 and 6). The US response was a massive body of regulation that, on issues related to this review, involve "say-on-pay" votes and requirements for the compensation committee. In both cases one of the possible responses was to facilitate effective shareholder participation in the formation of the board. In both cases, in the end, that did not happen. At the same time, it would be unfair to claim that the boards of these companies would have done better if the respective shareholders would have had a stronger role in their nomination and election. In fact, particularly before the financial crisis, shareholders were generally quite happy with the management of those companies and some of them even demanded more leverage.

The evidence of academic studies and views of market participants generally indicate that the US framework implements the Principles. It is tempting to argue that something else should be done to address the marginal cases, but there is no obvious solution to the problem of bad boards that would not risk jeopardising the equilibrium under which many boards function in a manner consistent with what the Principles expect of them. Although not required by hard or soft law, many boards and shareholders work towards constructive engagement on a wide variety of issues, participating in a dialogue that promotes an open airing of points if views even if no agreement is reached on the substance of the issues.

Board member associations and corporate secretaries raise issues like the proper composition of the boards, where it is certainly desired to promote a combination of skills, experience and personality to contribute to cohesive board work, which could be at risk if the nominations committee loses control of the process or if directors are selected for reasons other than the best interest of the company. On the other hand, some boards would insist on nominating candidates that have failed a majority vote rule, to the frustration of shareholders. Many shareholder rights activists think that the risks claimed to be associated with larger shareholder intervention are overstated and used as excuses to preserve management power.

Measures have been taken and will probably continue to be on the agenda. Companies have voluntarily adopted ways to better facilitate shareholders influence and communication. Beyond proxy access, the SEC has promoted the use of electronic means as a way to ease shareholder voting and communication among each other, like the electronic shareholder forums. A step in the right direction would be perhaps to facilitate means for shareholders to be able to vote for candidates of competing lists despite them

being contained in separate proxy materials. These are clearly promising ways that could offer options to facilitate proxy contests under the current proxy rules, which remain restricted, or through the adoption of by-law amendments under Delaware's Section 112.

Given that the so-called private ordering regime has just started, it will be interesting to see if shareholders and activists actually use it and what its consequences will be. The first step will be the issuing of proposals, but more important will be the ensuing vote where shareholders will have to decide to approve or reject the private ordering resolutions granting shareholders direct access to the ballot. The next step will be to assess if these resolutions are in fact useful for making boards more accountable without weakening board dynamics or creating a few too powerful shareholders in the context of shareholders generally. This is a new stage for board nomination and election in the US and the results will play out over a long period of time.

### *Notes*

1. Pacces, Control Matters (2007). Pacces explains that data for the United States comes from two separate sources. USA (1) reports data based on the country chapter of Barca-Becht (2001), aggregating information about the two major national exchanges, the NYSE and the Nasdaq. Statistics for USA (2) are calculated from a 'cleaned' database provided by Dlugosz *et al.* (2006) with hand-picked information about ultimate holders of voting power, corrected with information about firms with a dual class security-voting structure taken from Gompers *et al.* (2004); the correction factor is 8.19% and it is based on the frequency of firms with dual class shares reported by Lang *et al.* (2005).
2. Federal Reserve Board Releases Z.1 "Flow of Funds Accounts of the United States", available at: *www.federalreserve.gov/releases/z1/current/data.htm*.
3. 8 Del. C. § 141(b) (2011).
4. 8 Del. C. § 141(a) (2011).
5. 8 Del. C. § 141(c) (2011).
6. 8 Del. C. § 142 (2011).
7. When determining whether a company's directors have fulfilled their fiduciary duties, US courts generally apply the business judgment rule, imposing a presumption that when making a business decision, directors have acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. A plaintiff may rebut this presumption by proving that the directors breached their duty of care or loyalty or acted in bad faith.
8. These board members meet about 8 times a year, not counting additional committee meetings (with most listed companies having auditing, nominations/corporate governance and compensation committees), and devote an average of 6 hours per meeting. For this work they receive an all-in average annual compensation of about USD 232 000 (Spencer Stuart, 2011).
9. These guidelines are not required to, but may, address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession. NYSE Listed Company Manual Section 303A.09. The NYSE rules also require a listed company to have a nominating or corporate governance committee composed entirely of independent directors and to adopt a written charter for this nominating committee that discloses the committee's purpose and responsibilities. NYSE Listed Company Manual Section 303A.04.
10. 8 Del. C. § 141(b) (2011).
11. See, *e.g.*, 8 Del. C. § 211(b) (2011).
12. NYSE Listed Company Manual Section 302.00 and Nasdaq Rule 5620.
13. Board classification involves the creation of more than one class of directors, and it often leads to the staggered annual election of directors.
14. 8 Del. C. § 141(d) (2011).

15. NYSE Listed Company Manual Section 304.00. Nasdaq rules do not prohibit classified boards of directors, but a company with more than three classes of directors may raise concerns under NASDAQ's voting rights and public interest rules.

16. NYSE Listed Company Manual Section 304.00.

17. Listed companies organized outside of the US that qualify as "foreign private issuers" (as defined in Rule 3b-4(c) under the Exchange Act) are required to comply with most of the listing standards regarding audit committees (with certain variations where home country requirements differ), but generally need not comply with any other provision that conflicts with home country practices. Foreign private issuers are required to provide certain disclosures if they choose to follow home country requirements instead of those required to be followed by domestic companies under applicable listing standards.

18. "Controlled companies" (companies in which more than 50% of the voting power for the election of directors is held by an individual, a group or another company) need not comply with the listing standards regarding majority board independence or the independence requirements relating to certain compensation and nominating decisions and, in the case of the NYSE, corporate governance committees. Reliance on the controlled company exemption must be disclosed in the company's annual proxy statement (or, if the company does not file a proxy statement, in its annual report on Form 10-K) along with the basis for the determination that the exemption applies, in accordance with the requirements of Item 407(a) of Regulation S-K.

19. Shearman (2011) reviewed the corporate governance practices of 100 of the largest US public, non-controlled companies that have equity securities listed on the NYSE or Nasdaq. These companies were selected based on a combination of their latest annual revenues and market capitalizations.

20. 8 Del. C. § 141(c) (2011).

21. NYSE Listed Company Manual Section 303A.04 and Nasdaq Rule 5605(e). Nasdaq rules require each company to certify that it has adopted a formal written charter or board resolution that addresses the nominations process and such related matters as may be required under the federal securities laws.

22. SpencerStuart (2011) is based on the S&P 500 index as of 15 May, 2011. Data was collected from the most recent proxies released as of May 15, 2011.

23. Rule 14a-4(d) under the Exchange Act.

24. 8 Del. C. § 141(b) (2011).

25. See the Council for Institutional Investors (CII), California Public Employees' Retirement System (CALPERS) and TIAA-CREF corporate governance policies and principles.

26. NYSE Listed Company Manual Section 303A.01 and Nasdaq Rule 5605(b)(1).

27. See NYSE Listed Company Manual Section 303A.02 and Nasdaq Rule 5605(a)(2).

28. NYSE Listed Company Manual Sections 303A.07, 303A.05 and 303A.04 and Nasdaq Rules 5605(c)(2), 5605(d) and 5605(e). Nasdaq rules require independent director oversight of executive officer compensation and director nominations. A board's independent directors may fulfil that role in lieu of either a specifically designated compensation committee or nominating committee.

29. NYSE Listed Company Manual Section 303A.07 commentary.

30. Nasdaq Rule 5605(c)(2).

31. See Item 7 of Schedule 14A under the Exchange Act and Item 401 of Regulation S-K.

32. Section 301 of the Sarbanes-Oxley Act of 2002 and Rule 10A-3 under the Exchange Act prohibits national securities exchanges from listing any security of a company unless each member of the company's audit committee is independent according to specified criteria above and beyond the general director independence requirement in the listing standards.

33. See Section 952 of the Dodd-Frank Act.

34. Listing Standards for Compensation Committees, SEC Release No. 33-9199 (30 March, 2011) [76 FR 18966].

35. 8 Del. C. § 151(a) (2011).

36. The exchanges have adopted rules governing the voting rights of listed companies. The NYSE voting policy establishes that voting rights of existing shareholders cannot be disparately reduced or restricted through any corporate action or issuance (NYSE Listed Company Manual Section

313.00). The rules permit the listing of a company's voting common stock if it also has outstanding non-voting common stock as well as the listing of non-voting common stock. The class of non-voting stock must meet all original listing requirements and the rights should be substantially the same as those of the voting stock, including the access to all communications, including proxy materials, sent generally to the voting stockholders.

37. 8 Del. C. § 160(c) (2011).

38. Section 957 of the Dodd-Frank Act.

39. See New York Stock Exchange Rule 452.11(19) and Listed Company Manual Section 402.08(B)(19); SEC Release No. 34-60215 (July 1, 2009), [74 FR 33293] (10 July, 2009) (SR-NYSE-2006-92).

40. 8 Del. C. § 212 (2011).

41. 8 Del. C. § 216 (2011).

42. 8 Del. C. § 231 (2011). The inspectors shall perform the following duties: *i)* ascertain the number of shares outstanding and the voting power of each; *ii)* determine the shares represented at a meeting and the validity of proxies and ballots; *iii)* count all votes and ballots; *iv)* determine and retain for a reasonable period a record of the disposition of any challenges made to any determination by the inspectors; and *v)* certify their determination of the number of shares represented at the meeting, and their count of all votes and ballots.

43. 8 Del. C. § 231(a) (2011).

44. Rule 14a-4(b)(2) under the Exchange Act. This is achieved by means of: *i)* a box opposite the name of each nominee which may be marked to indicate that authority to vote for such nominee is withheld; *ii)* an instruction in bold-face type which indicates that the security holder may withhold authority to vote for any nominee by lining through or otherwise striking out the name of any nominee; *iii)* a designated blank space in which the security holder may enter the names of nominees with respect to whom the shareholder chooses to withhold authority to vote; or *iv)* any other similar means, provided that clear instructions are furnished indicating how the security holder may withhold authority to vote for any nominee.

45. For example, see the CII Corporate Governance. In contested elections, however, institutional investor organizations generally endorse plurality voting.

46. In recent years the US have also adopted a number of "advisory votes", where shareholders are required to inform the board and management of their preferences in a non-binding manner. The Dodd-Frank Act introduced a requirement for companies to provide shareholders with an advisory vote on executive compensation at least once every three years, as well as an advisory vote on the frequency of advisory votes on executive compensation at least every six years. These are generally referred to as "say-on-pay" votes and are also subject to SEC rules. Similar advisory votes are required for certain "golden parachute" arrangements in connection with a merger, acquisition, or a substantial disposition of assets. On April 5, 2012, the Jumpstart Our Business Start-ups Act of 2012 (the "JOBS Act") was enacted. The JOBS Act created a new category of issuer – the "emerging growth company". Under the JOBS Act, an emerging growth company will be subject to a phase-in period before it will be required to comply with the advisory "say-on pay" and "golden parachute" votes.

47. A company's nomination procedures are governed by state law.

48. The recent Airgas dispute is a good example of a proxy contest. It revolved around the validity of Airgas's poison pill as an appropriate anti-takeover defence where the Airgas board, in the face of a hostile tender offer from Air Products, found the price to be inadequate. Air Products fought to nominate and elect three new board members to Airgas board in the hope they would help it turn around the opposition of Airgas board to the takeover. Air products succeeded in its proxy contest and managed to appoint the new members to Airgas board, but finally failed, as all three of them agreed with the rest of the Airgas board and also opposed the deal. Commentators pointed out that this was a triumph of independence and fiduciary duties to all shareholders. The testimony from the Air Products' nominees during the supplemental evidentiary hearing is one of the key elements of the court decision on the case. (Air Products and Chemicals Inc. v. Airgas, Inc., *et al.*, C.A. No. 5249-CC (Del. Ch. Feb. 15, 2011) and Delaware Corporate and Commercial Litigation Blog available at *www.delawarelitigation.com/2011/02/articles/chancery-court-updates/constrained-by-delaware-supreme-court-precedent-chancellor-chandler-upholds-airgass-use-of-poison-pill/*).

49. Items 4(b), 5(b) and 17 of Schedule 14A.

50. Rule 14a-9.

51. Rule 14a-17 and Electronic Shareholder Forums, SEC Release No. 34-57172 (Jan. 18, 2008) [73 FR 4450] available at *www.sec.gov/rules/final/2008/34-57172.pdf*.

52. They have argued voting with their feet they would simply not be able to benefit from any future changes in board direction and that such sale may require the recognition of a loss. Also, that this is not always a practical option for large institutional shareholders and for those that follow a passive or indexing investment strategy. In terms of the possibility to nominate directors at the annual meeting, shareholders complain that it generally proves impractical as most shareholders vote by granting a proxy before the meeting rather than voting in person, so a nominee presented at that time has little chance of garnering sufficient votes. Moreover, companies often have pre-registration and advance notice requirements that make this unfeasible. Finally, in relation to proposals or suggestions they could present to the companies, some shareholders claim that companies (and particularly management) are often unresponsive to a shareholder's efforts to advance a nominee through a company's nominations process. They also point out that board formation is an area excluded from general shareholder proposals.

53. In a 2005 paper, Roe explains the political economy of corporate law making in the US by describing the relation between the legislature of state of Delaware and the federal power in Washington, DC. In this federal-state public choice story, Roe shows that Delaware's franchise tax (the fee that companies pay for being registered in Delaware and which makes up to 25% of the state´s budget) is at the foundation. In order to gain the tax revenue, Delaware offers companies what they want, and since it is managers who tell Delaware what companies want, Delaware law takes a managerial view. Roe shows that because Delaware can often act first, "its interest groups can create a fait accompli that differs from what Congress would do if it had acted first", but it is often strong enough to prevent further action by Congress. So Delaware law prevails. See Roe, Mark, Delaware Politics, 2005.

54. The proxy rules include disclosure requirements that apply when a shareholder seeks to include a nominee for director in the company's proxy materials pursuant to procedures established under state law, foreign law, or a company's governing documents. See Exchange Act Rule 14a-18, and Item 7(f) of Schedule 14A.

55. Available at *www.sec.gov/edgar/searchedgar/webusers.html* .

56. NYSE Listed Company Manual Section 303A.09.

57. Item 407(c) of Regulation S-K.

58. See Proxy Enhancements Release and Item 407(c)(2)(vi) of Regulation S-K.

59. Item 407 of Regulation S-K.

60. Item 401(f) of Regulation S-K defines the specific legal proceedings addressed in the rule.

61. This is done via a Form 8-K filed with the SEC and available at the EDGAR database.

62. Item 5.07 of Form 8-K.

63. "Some institutional investors may have political or other agendas, tangentially related or even wholly unrelated to maximizing returns for fund shareholders from a particular investment" (Glassman, 2006).

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# ANNEX

## *Comparison of US principles equivalent to reviewed OECD principles*

| ALI Principles/ Recommendations[1] | Business Roundtable Principles[2] | NACD Report[3] | Conference Board Recommendations[4] |
|---|---|---|---|
| The nominating committee should:<br>1) Recommend to the board candidates for all directorships to be filled by the shareholders or the board.<br>2) Consider, in making its recommendations, candidates for directorships proposed by the chief executive officer and, within the bounds of practicality, by any other senior executive or any director or shareholder. (§ 3A.04(b))<br><br>The board of directors has five primary functions, [one of which is to] [s]elect and recommend to shareholders for election an appropriate slate of candidates for the board of directors.... (§ 3.02, Comment a.4)<br><br>[T]he purpose of § 1.34 [which defines significant relationships or impediments to director independence – see is only to set forth minimum objective standards. These standards should then be complemented through a more individualized review by the nominating committee, which should attempt to make up a slate of directors that meets not only the letter but the spirit of § 3A.01 [that boards have a majority of directors free from any significant relationship with management]. (§ 3A.01, Comment d). | The corporate governance committee . . . should select and recommend to the board qualified director candidates for election by the corporation's shareholders. (p. 3)<br><br>It is the responsibility of the board, through its corporate governance committee, to nominate directors and committee members and to oversee the composition, independence, structure, practices and evaluation of the board and its committees. (p. 10)<br><br>See Business Roundtable, The Nominating Process And Corporate Governance Committees: Principles And Commentary (April 2004). | Boards should establish a wholly independent committee that is responsible for... nominating directors for board membership... (p. 3)<br><br>Creating an independent and inclusive process for nominating...both directors and the CEO will ensure board accountability to shareholders and reinforce perceptions of fairness and trust between and among management and board members. (p. 4)<br><br>Boards should involve all directors in all stages of the CEO and board member selection and compensation processes. (p. 4)<br><br>Boards should institute as a matter of course an independent director succession plan and selection process, through a committee or overseen by a designated director or directors. (p. 5)<br><br>In selecting members, the board must assure itself of [their] commitment to:<br>• Learn the business of the company and the board<br>• Meet the company's stock ownership requirements<br>• Offer to resign on change of employment or professional responsibilities, or under other specified conditions, [and]<br>• Devote the necessary time and effort. (p. 20) | [T]he nominating / governance committee should recommend to the full board of directors... an appropriate slate of qualified nominees for election to the board that they have identified and evaluated. (Part 2, Principle IV, Best Practice 1)<br><br>Shareowners, particularly long-term shareowners, should act more like owners of the corporation. As shareowners, they should have the ability to participate more readily in the corporation's election process through involvement both in the nomination of directors and in proposals in the company's proxy statement about business issues and shareowner concerns regarding governance of the corporation. (Part 2, Principle VIII)<br><br>Boards of directors should develop procedures to receive and to consider shareowners' nominations for the board of directors.... (Part 2, Principle VIII, Best Practice 1)<br><br>The procedures for receiving shareowner nominations and proposals should include, where appropriate, meetings of shareowners with the nominating/ governance committee or its representatives. (Part 2, Principle VIII, Best Practice 3) |

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*Source:* Cited sources and Weil, Gotshal and Manges LLP Memorandum, Comparison of Corporate Governance Principles and Guidelines: United States, January 2012.

| CalPERS Principles[5] | CII Policies[6] | TIAA-CREF Policy Statement[7] | AFL-CIO Voting Guidelines[8] |
|---|---|---|---|
| With each director nomination recommendation, the board should consider the issue of continuing director tenure, as well as board diversity, and take steps as necessary to ensure that the board maintains openness to new ideas and a willingness to critically re-examine the status quo. (III.B.2.2.c)<br><br>Shareowners should have effective access to the director nomination process. (III.A.8)<br><br>[The Independent Chair should] [i]nterview, along with the chair of the nominating committee, all board candidates, and make recommendations to the nominating committee and the board. (Appendix C: Independent Chair/ Lead-Director Position Duty Statement) | Shareowners should have... meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation. (§1.5)<br><br>Boards should establish clear procedures to encourage and consider board nomination suggestions from long-term shareowners. The board should respond positively to shareowner requests seeking to discuss incumbent and potential directors. (§ 2.8a)<br><br>See § 2.8d (Absent compelling and stated reasons, directors who attend fewer than 75 per cent of board and board-committee meetings for two consecutive years should not be re-nominated.). | The Nominating and Governance committee oversees the company's corporate governance practices and the selection and evaluation of directors. (p. 19)<br><br>Boards should establish and disclose the process by which shareholders can submit nominations to be considered by the board. If the nomination is not accepted, the board should communicate to that shareholder a reason for not accepting the nomination. (p. 17) | [K]ey committees [include the] nominating committee... (Guideline IV.A.1)<br><br>The trustees support shareholder proposals to enhance the ability of long-term shareholders to cost effectively nominate and elect directors to represent their interests, so long as these efforts do not provide a tool that can be used to facilitate hostile takeovers by short-term investors. (Guideline IV.A.6)<br><br>The trustees believe that competing slates should be evaluated based upon the personal qualifications of the candidates, the quality of the strategic corporate plan they advance to enhance long-term corporate value, and their expressed and demonstrated commitment to the interests of shareholders and other key constituents... (Guideline IV.A.2)<br><br>Proxy voting is the main form of rank-and-file shareholder involvement in corporate matters such as director elections... (Guideline V.D.2) |

5. California Public Employees' Retirement System (CalPERS), Corporate Governance Principles and Guidelines – United States, 1998, (revised and renamed, Global Principles of Accountable Corporate Governance, 2011).
6. Council of Institutional Investors (CII), Corporate Governance Policies, 1998 (revised 2011).
7. Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA-CREF), Policy Statement on Corporate Governance, 1997 (revised 2011).
8. American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), Exercising Authority, Restoring Accountability – AFL-CIO Proxy Voting Guidelines, 1997 (revised 2003).

*Source:* Cited sources and Weil, Gotshal and Manges LLP Memorandum, Comparison of Corporate Governance Principles and Guidelines: United States, January 2012.

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