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International Developments in Corporate Governance

In her regular column on corporate governance issues, Holly Gregory examines international developments that US boards and their advisors should be aware of as potential harbingers of additional regulatory and shareholder pressures in the US.

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As the world struggled to overcome the effects of the Asian financial crisis 15 years ago, the Organization for Economic Cooperation and Development (OECD) adopted its Principles of Corporate Governance (OECD Principles) to provide member nations (including the US) with a basic regulatory framework for improving corporate governance.

Roughly a decade earlier, a wave of deregulation and the fall of command and control political and economic systems had unleashed private sector corporate activity in a rapidly expanding global business environment. The OECD Principles were designed to provide a framework for regulators as they considered how to promote corporate activity by building investor confidence while also protecting other important societal interests.

The OECD Principles have played a key role in encouraging regulatory reform in developing and emerging markets and providing a benchmark for developed nations. They have been incorporated by the Financial Stability Board as one of the 12 key standards for international financial stability, and serve as the framework for numerous national corporate governance codes.

Recently, the OECD has begun the process of considering updates to the OECD Principles. The OECD's discussions will help frame the future of corporate governance-related reform efforts around the globe. It will likely echo the significant interest in Europe and other parts of the world in:

- Expanding shareholder voting rights with respect to compensation and audit issues.
- Enhancing disclosure.
- Improving board diversity, specifically, gender diversity.
- Encouraging corporate social responsibility.

Against this backdrop, this article explores:

- Fundamental issues of corporate governance common to all publicly traded companies, regardless of jurisdiction.
- The interrelated forces that are expanding expectations and pressures for boards.
- Corporate governance areas that are likely to be discussed as the OECD undertakes a review of the OECD Principles.
- Points that should guide the consideration of any revisions to the OECD Principles and of regulatory efforts generally to ensure that boards can remain focused on corporate strategy and performance.

EFFECTIVE GOVERNANCE SYSTEMS: A GLOBAL PERSPECTIVE

The global landscape in which companies operate is expected to shift considerably in the next decade, according to research from McKinsey Global Institute, as the proportion of Fortune Global 500 companies in emerging markets is projected to climb from 17% in 2010 to approximately 46% in 2025. More than half of that growth is expected in the greater China region, including China, Hong Kong, Macau and Taiwan (*The Shifting Global Corporate Landscape, McKinsey Quarterly, 2013 Number 4*).

This shift will bring stiffer global competition for a host of resources, including investment capital. It is also likely to further drive efforts around the world to improve both the regulatory framework for corporate governance and the effectiveness of governance systems in publicly traded companies.

Effective corporate governance systems position boards to make timely and objective decisions in support of successful corporate performance, while preventing the individual self-interest of any participant (manager, director or owner) from influencing outcomes to the detriment of the company's and shareholders' collective interests.

Certain fundamental issues in corporate governance are common to all publicly traded companies, whether they are organized in the US or elsewhere, and whether they are widely held or family or state controlled. These issues include how to:

- Ensure that the board and corporate management are accountable for performance of the company and the protection of corporate assets.
- Provide shareholders with adequate information and influence in keeping with their rights.

Of course, governance challenges manifest in different ways depending on the structure and concentration of share ownership:

- **Companies with a large controlling shareholder.** Their primary governance challenge relates to ensuring the protection of minority shareholders, since the controlling shareholder will typically have the power to select and replace, and therefore influence, directors and managers. In particular, a controlling shareholder may seek to cause family members to be hired or transactions to be engaged in that are at terms less favorable to the company than in an arms-length transaction.
- **Companies in which the state is a large and influential shareholder.** Their primary governance challenge relates to ensuring that the state does not apply corporate assets to pursue social or political goals at the expense of the ability of the company to compete, which would damage the interests of the company and its shareholders as a whole.
- **Companies with widely dispersed shareholders.** Their primary governance challenge relates to ensuring that the board and management use corporate assets in the best interests of the company and its shareholders as a whole, without over compensating themselves or engaging in transactions from which they benefit at the expense of shareholders.

In any of these scenarios, the governance structure needs to be designed to ensure that the board can develop objective judgment regarding management proposals, and performance and conflicts will be identified and handled appropriately. Accomplishing this requires having some directors on the board who do not have material business and family ties with senior management and are likely, therefore, to be free from conflict.

These are the fundamental issues and policy objectives that the OECD Principles, in fact, sought to address when issued in 1999 and updated in 2004 (see *Box, The Millstein Report and OECD Principles*).

INTERRELATED FORCES FOR CHANGE

There has been great change in corporate governance in the past 15 years, and boards continue to face expanding expectations and pressures. In addition to the increasing competition from companies in emerging markets, more change is likely to come as a result of powerful interrelated forces.

In the wake of the recent financial crisis and corporate scandals, public concern about the role of the company is growing, while trust in both corporate executives and government officials is declining. This public concern was evidenced by the Occupy Wall Street movement in the US and demonstrations in other parts of the world.

In reaction to financial crisis and corporate scandals, regulation of corporate governance is expanding. New regulation often reflects growing expectations about the ability of the board to prevent problems ranging from wrongdoing to product failures, environmental disasters and poor corporate performance.

The Millstein Report and OECD Principles

In 1998, a high-level Business Advisor Group to the OECD, chaired by Ira M. Millstein, recommended that government regulation of corporate governance should be light-handed and would more likely be effective if it focused on attracting capital through four basic principles:

- Fairness.
- Transparency.
- Accountability.
- Responsibility.

(*OECD, Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets, A Report to the OECD by the Business Sector Advisory Group on Corporate Governance (1998)* (Millstein Report)).

The Millstein Report also recommended that the OECD create a set of principles to guide governments in setting the regulatory framework for corporate governance, resulting in the highly influential OECD Principles (see comparison chart below).

In 2004, the OECD Principles were amended to add a new first principle emphasizing that the corporate governance framework should:

- Promote transparent and efficient markets.
- Be consistent with the rule of law.
- Clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

MILLSTEIN REPORT (1998)	OECD PRINCIPLES (1999)
Fairness: Ensuring the protection of shareholder rights, including the rights of minority shareholders and foreign shareholders.	**Principles I and II:** Protect Shareholder Rights; Treat Minority and Foreign Shareholders Equitably
Transparency: Timely disclosure of adequate, clear, and comparable information about corporate financial performance, governance and ownership.	**Principle IV:** Timely, Accurate Disclosure on Financial Situation, Performance, Ownership & Governance
Accountability: The role of the board in ensuring that the shareholders' assets are used as contemplated.	**Principle V:** Effective Monitoring of Management by the Board and Board Accountability to the Company and its Shareholders
Responsibility: Making sure that the company complies with the laws and regulations that the society has decided reflect its values.	**Principle III:** Cooperation with Stakeholders in Creating Wealth, Jobs and Sustainability of Financially Sound Enterprises

Depending on the region of the world, the influence of large institutional investors (and their proxy advisors) in corporate affairs is expanding. This development has raised concerns about how this influence is exercised and, in particular, whether it will be exercised responsibly to support the long-term interests of the company.

AREAS FOR POTENTIAL REVISION

As the OECD undertakes a review of the OECD Principles, discussions and potential revisions are likely to focus on the following areas:

- Board composition, diversity and refreshment.
- Shareholder decision-making rights.
- Compensation-related issues.
- Audit-related issues.
- The board's role in risk oversight and management.
- Enhanced disclosure and "comply or explain" systems.
- Corporate social responsibility.

US boards and their advisors should follow these discussions, as they may offer useful insights on where the governance debate in the US may be headed.

BOARD COMPOSITION, DIVERSITY AND REFRESHMENT

Board composition is a "hot button" issue in many countries. When the OECD Principles were first issued, the primary concern about board composition related to the need to include some directors who lacked material relationships to the company, its management and in some jurisdictions, controlling shareholders.

In the last several years, concern has shifted to diversity, in particular, gender diversity. Women make up a growing proportion of business executives and professionals, but these increases are not yet reflected in proportionate numbers on boards in many countries. Several countries have adopted or are considering adopting quotas and disclosure requirements relating to board diversity and pressure for regulation is growing.

On November 20, 2013, the European Parliament approved a proposal that would require boards in EU member states to be comprised of 40% women by 2020. Companies that do not meet the target will be banned from bidding on public contracts. EU member states will need to ratify the law for it to become effective.

Interest in gender diversity on boards is not restricted to legislative and regulatory bodies. A group of Canadian directors has asked that the Ontario Securities Commission require companies listed on the Toronto Stock Exchange to develop measurable objectives for improving board gender diversity within a specified timeframe and provide annual reports on progress. Voluntary efforts at improving gender diversity on boards in the UK and US are also gaining traction.

Search Board Composition, Diversity and Refreshment for more on the challenges that boards face when making board composition decisions.

More attention is also being focused on the long tenure of many directors and the need for mechanisms to encourage board turnover. The advantages of encouraging board turnover can include:

- Allowing the board to change as business needs change.
- Accommodating more diversity.
- Addressing concerns that long-tenured directors may lack independence.

While age limits, and to a lesser degree term limits, are used by many boards, growing emphasis is being placed on rigorous evaluation of board needs and director performance on an annual basis. This is to assure that director re-nomination decisions are based on an active assessment of director performance and fit.

These issues are important to a wide range of companies, including controlled companies and state-owned enterprises where the progress toward greater board professionalism has been slow. Those companies should consider similar board evaluation exercises to assure that they have the diversity, experience and skillsets needed to guide them through changing times.

SHAREHOLDER DECISION-MAKING RIGHTS

Shareholders continue to push for greater decision-making rights and have had considerable success in achieving a voice on compensation policy. Shareholders in many countries now have an opportunity to vote on executive and/or director compensation on an advisory basis. Various countries are in the process of implementing or have a form of binding say on pay vote.

As of October 2013, the UK joined Brazil, Denmark, the Netherlands, Norway, Sweden and Switzerland in requiring that certain companies hold a binding shareholder vote on executive compensation plans and policies. Companies with a registered office in England, Wales, Scotland or Northern Ireland that have equity share capital included on the Financial Services Authority's official list now must:

- Obtain shareholder approval for executive compensation plans.
- Publish simplified information about how much executive officers have been paid.

Shareholders will continue to vote on an advisory basis on the actual pay awarded to directors (including senior executive officers), but that pay must be in accordance with the compensation plans approved by shareholders in the binding vote.

A binding say on pay vote is also under consideration in Spain, as part of a package of reforms being recommended by a committee of experts charged with reviewing the Corporate Enterprises Act and the Commercial Code.

COMPENSATION-RELATED ISSUES

Around the globe, growing concerns about wage disparity are likely to focus discussion on additional compensation disclosures as a means of pressing boards to limit executive compensation. Expect international interest in the SEC's proposed pay ratio disclosure rules and the directive contained in the Dodd-Frank Act that the SEC adopt these rules.

Some participants in the debate view disclosure as an insufficient control on executive compensation and may assert that pay caps are necessary. Notably, Swiss voters were recently asked to approve an amendment to the Swiss Constitution to include a "fair wage" provision. On November 24, 2013, voters rejected the proposed amendment that would have limited executive pay to 12 times the pay of the lowest paid employee of the company.

While it would be unusual for the OECD Principles to include highly prescriptive provisions on these issues, this area will likely garner heated discussion.

Search SEC Proposes Dodd-Frank Pay Ratio Disclosure Rules for more on the SEC's proposed pay ratio disclosure rules.

AUDIT-RELATED ISSUES

There continues to be significant interest in how to improve audit committee disclosure and oversight, as well as the issue of auditor independence.

Recent developments include:

- In the US, a coalition organized by the Center for Audit Quality issued a Call to Action in November 2013 with respect to audit committee disclosures, with a goal of encouraging additional voluntary disclosures about committee activities.
- In the UK, the Competition Commission issued a report, *Statutory Audit Services for Large Companies Market Investigation*, which announced rules requiring:
  - FTSE 350 companies to rotate auditors at least every ten years (as originally proposed, the rules would have called for rotation every five years);
  - an "audit quality review" in FTSE 350 companies every five years, along with an audit committee report to shareholders on the outcome; and
  - an annual shareholder advisory vote on whether audit committee reports in company annual reports are satisfactory.

BOARD ROLE IN RISK OVERSIGHT, MANAGEMENT AND COMPLIANCE

The recent financial crisis has focused global attention on the need to strengthen oversight of risk management systems and the role of the board, and this is likely to be a core area of exploration by the OECD.

While primary responsibility for identifying and managing risk lies with management, the board has three key roles related to risk:

- Understanding the risks related to corporate strategy, including testing management assumptions related to strategic risks.
- Overseeing management's efforts to identify and manage risk, including management's implementation of systems and controls related to enterprise risk management.
- Managing certain risks that only the board can manage, including risks related to CEO hiring, succession planning and compensation, as well as governance and audit-related risks.

Investment in compliance systems and related controls and procedures is a closely related issue. This is an area where boards face increased responsibilities under new or tightened laws combined with more vigorous enforcement by regulators in many countries. There has been an increased focus worldwide on compliance and ethics, including anticorruption efforts designed to prevent bribery of officials.

Companies should take a fresh look at the effectiveness of their compliance programs in light of local requirements and emerging international best practices. In addition, boards should be aware that behavior that falls within the letter of the law may nevertheless be closely scrutinized and lead to allegations of unethical conduct.

The OECD is likely to discuss the need for boards to ensure that management has implemented strong compliance systems and controls, that include:

- Information systems.
- Complaint reporting mechanisms.
- Codes of conduct and education programs that explain expected and prohibited behaviors.
- Tailored compliance policies regarding, for example:
  - insider trading;
  - related person transactions; and
  - prohibitions on bribery.

ENHANCED DISCLOSURE AND "COMPLY OR EXPLAIN" SYSTEMS

The imposition of additional disclosure requirements has been a key regulatory tool to encourage, but not require, companies to adopt certain governance practices. Over the past 15 years, disclosure obligations have expanded significantly. In the US, concerns have been raised that the sheer amount of information that companies must disclose may be beyond the capacity of many investors to absorb. Indeed, many sophisticated institutional investors rely on third-party advisors to help them digest the information in annual reports, proxy statements and other corporate filings.

Boards and management teams are responding by trying to improve disclosures, for example by using executive summaries, charts and graphs in their annual reports and proxy statements.

Additional disclosure obligations have recently been imposed on UK-listed companies, including:

- An explanation of corporate strategy and business model in a "strategic report," together with disclosure of the key corporate risks, challenges and opportunities.
- Disclosure regarding greenhouse gas emissions.
- Disclosure of human rights issues that could affect the business.
- Disclosure of gender ratios for the board, senior management and the company.

Ever since the UK first adopted the Cadbury Code on a "comply or explain" basis in the 1990s (subsequently replaced by the Combined Code), countries around the world have been interested in adopting the disclosure-based approach to encouraging specific governance practices. These types of codes are fairly prevalent in Europe and have been the subject of an EU Directive. Japan is also currently considering adopting a similar code.

The OECD is likely to discuss the value of having an official comply or explain code against which corporate governance

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practices are disclosed. From time to time there have been calls in the US for an official code that could be imposed on a comply or explain basis. To date, however, the initiative has not gained traction, likely due to the significant disclosure of governance structures and practices already imposed through listing and SEC rules.

Continuing pressure to expand disclosures, including in relation to social and foreign policy objectives, can be expected. The US Congress and the SEC have imposed disclosure rules relating to conflict minerals and relations with Iran. Non-governmental organizations and special interest groups continue to push individual companies for increased disclosure in the areas of sustainability, human rights and political contributions.

Search Conflict Minerals Disclosure Requirements Checklist for information on the requirements concerning conflict minerals.

Search Iran Sanctions Disclosure in SEC Periodic Reports for information on the annual and quarterly disclosure requirements regarding relations with Iran.

CORPORATE SOCIAL RESPONSIBILITY

Public concern about corporate responsibility is likely to drive some focus in the OECD's review of the OECD Principles. As the ability of government to address social and environmental concerns lessens, the expectation that companies will help solve these issues increases. Failure to meet these expectations and maintain the public's trust has potentially significant implications for the economy, open markets and free enterprise.

Countering more regulation in this area will require a restoration of trust in business. By design, the company is intended to be a social good, and public trust is the company's "license to do business." Trust in companies and their leaders, however, has fallen.

Boards need to appreciate the broader context when evaluating a course of action and understand that shareholders and other key constituents are interested in social and environmental issues. This requires more effort in communicating and also in engaging with shareholders and other constituents. Boards should also consider whether they have the information and expertise they need to address these often complex issues.

REMAINING FOCUSED ON CORPORATE STRATEGY AND PERFORMANCE

The key challenge for corporate governance, particularly for boards, is to meet expanding expectations and balance conflicting pressures while remaining focused on corporate strategy and performance. In reviewing the OECD Principles, the following points should guide the OECD's consideration of any revisions:

- **Preserve distinct corporate roles.** Shareholders, boards and executive officers each have important though distinct roles to play. Regulatory efforts need to respect those roles and the limits of those roles to ensure appropriate checks and balances in the governance system. Ultimately it is for the board to provide the corporate oversight and decision-making that is critical to the company's capacity to serve as an engine of economic growth, job creation and innovation.
- **Avoid undue interference with board functions.** Regulators should avoid "piling on" board responsibilities and interfering with the board's fundamental mandate to direct the affairs of the company in a manner that maximizes performance over the long term.
- **Recognize the limits of board power.** Even the best governance system and the most effective board cannot prevent all bad things from happening. Not every fraud, scandal or failure is a corporate governance problem. Rogue actors will skirt rules, systems will fail and business judgments that were rational at the time will be unwise with the benefit of hindsight.
- **Recognize the limits of regulation.** Regulation is necessary in setting the framework for corporate governance, but it has its limits. While the regulatory framework and board structure, composition and processes all matter, it is the culture of the board and the behavior of individual directors on which the effectiveness of the board and (for the most part) corporate governance rests. The regulatory framework can at best establish outer limits on behavior, mandate basic structures and processes and require disclosure. Anything more will no doubt result in a host of unintended consequences.
- **Weigh the potential impact of reforms against their effect on the global economy.** Reform proposals should be assessed in light of their likely impact on companies' ability to raise and deploy capital to sustain growth and create wealth. The goal of any reform effort should be to ensure that companies are positioned to continue their successful role in the economy, which ultimately benefits society at large.

The views stated above are solely attributable to Ms. Gregory and do not reflect the views of Weil, Gotshal & Manges LLP or its clients.