

SPEECH TO ICGN ANNUAL CONFERENCE

VERONIQUE INGRAM – CHAIR, OECD STEERING GROUP on CORPORATE GOVERNANCE

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MAKING THE NEW OECD PRINCIPLES WORK

After an intense period of steering the revision of the OECD Principles of Corporate Governance, it is now my great pleasure to discuss the results at this annual meeting of the ICGN. The ICGN and its members have always played an important role in the OECD's corporate governance work. The ICGN was actually among the very first non-governmental organisations to endorse the OECD Principles when they were first issued in 1999.

Since then, the ICGN and its members have actively disseminated and used the OECD Principles. You have also participated in a number of OECD consultations where you have provided significant input. And, I dare say that your hard work has had a direct and quite substantial impact on the content of the new OECD Principles. In particular, the ICGN's very positive proposals in relation to the need to enhance shareholder rights and participation, and the desirability of having more rigorous provisions relating to disclosure and the role of the board, have played a real part in shaping the design of the Principles.

The title for my address is 'Making the New OECD Principles Work'. The pertinent words here are 'new' and 'work'. This is because the revised Principles are probably now much more challenging for policy-makers to implement than the original ones. While the original Principles essentially catalogued governance practices existing at the time the Principles were first developed, the new set of Principles go much further. What they do is call for change to the status quo by stating what should be good practice, with the emphasis on 'should'. Every country will therefore need to reassess their corporate governance structures to see if they measure up against the Principles.

In this regard, I don't think any country could say that the revised Principles do not affect them. However, making the OECD Principles work is a shared responsibility where the private sector plays a critical role together with governments and the OECD.

BACKGROUND TO DEVELOPMENT OF CORPORATE GOVERNANCE PRINCIPLES

Before I outline to you the key results of the review of the Corporate Governance Principles, and the implications for practitioners at the coal face, it might be helpful if I gave you a brief history of the development of the Principles from when they were first issued by the OECD in 1999.

The original 1999 text of the OECD Principles was developed against the backdrop of the Asian financial crisis. However, the corporate governance climate at that time, at least from OECD member country perspectives, was relatively benign. In particular, there was no sense that the essentially western corporate governance system was flawed or tainted in any way. In fact, by 1999, the world's major capital markets were on a bull run and investor confidence was at a high level.

For this reason, the original text of the OECD Principles basically evolved to be a statement of existing good corporate governance practices in OECD countries. It served to provide a non-binding statement of the key elements essential for good corporate governance – the basic necessities if you will. The Principles were designed to assist policy advisers in evaluating and improving the legal, regulatory and institutional framework underpinning corporate governance. As such, the Principles have served as a guide to governments, regulators, stock exchanges, directors, investors and other market participants regarding good practice. The Principles are not prescriptive but are rather outcomes focussed.

Since 1999, the OECD Corporate Governance Principles have become the globally recognised benchmark in the area. They have been used as a basis for development of regulatory frameworks in many countries. They have also been endorsed by the Financial Stability Forum as one of twelve key standards considered essential for financial stability. In addition, the IMF and World Bank have been using the Principles as a benchmark in their country Reports on the Observance of Standards and Codes.

But equally importantly they are used as the reference point by the private sector. I believe that today there are hardly any initiatives that do not use the OECD Principles as the reference point or benchmark. This is the attraction of the Principles. They provide a common language and a shared aspiration that everyone can understand and relate to. Exactly how to reach that aspiration in terms of legislation, regulations or voluntary standards is left to individual countries. A wealth of experience is now being built up. As I said, rather than being prescriptive, the OECD's main role will be to facilitate the sharing of these experiences – to help answer the question of what does and doesn't work in practice.

The OECD's leadership in this field is very natural since good governance is at the heart of the effective operation of financial markets and financial markets are the life blood of our economies. Good governance clearly contributes to economic growth and development which is, after all, what the OECD is about. (Gone are the days, I hope, when one needs to argue about the links between governance and economic outcomes!)

Of course, OECD countries do not have all the answers when it comes to corporate governance. The Steering Group was therefore very keen to ensure that the review of the Principles was fully informed by the experiences of the private sector and emerging market economies. Many of the ICGN members who participated in our consultations are here today so let me take the opportunity to thank you once again for your contributions.

Also, experiences from the Regional Corporate Governance Roundtables, including one in Latin America, played a very important role in influencing the shape of the

revised Principles. As a result, the Principles now have a truly global reach and serve to influence outcomes in areas beyond the core subject of corporate governance such as the quality and independence of the judiciary.

THE REVIEW OF THE OECD PRINCIPLES

The up-dated text of the Principles approved by the OECD last April very much reflects developments since 1999. It is fair to say that the review of the Principles was undertaken in quite a different climate from when the Principles were first promulgated. Clearly, there has been a loss of trust and confidence by investors in financial markets more recently. Much of this loss of confidence must be attributed to poor governance practices that flourished during the bull run and contributed to the several high profile corporate collapses that have occurred in many of our countries.

I don't think any market has really been immune from the effects of this loss of confidence. The sheer magnitude of initiatives over the past eighteen months in the corporate governance area, whether it be through legislation, or codes of conduct, is testimony to the fact that many governments have seen the need for reform or updating of their regulatory frameworks.

This has made the review of the Principles very timely. As I said at the beginning, rather than cataloguing existing practices, the revised Principles can now act as a beacon for reform efforts. The onus is thus on OECD countries to take up the challenge of implementation in the same way that many developing countries have already been doing for some time.

Though the consultation process extended over a relatively short period, roughly 15 months, it was extremely intensive and wide-ranging. I understand that it was also rather unprecedented for the OECD. This is especially so in respect of the extensive involvement of non-member countries as I mentioned before. However, without the involvement of the users of the Principles in the review process, the credibility and relevance of the Principles going forward would be seriously diminished.

The overwhelming feedback from our consultation process during the review was that the Principles are not defective - they are in fact very sound. Nevertheless, there was a recognition that some gaps needed to be plugged and that the text could benefit from further elaboration or guidance in some areas.

Most importantly, there was strong support for retention of the objectives and outcomes focus of the Principles. That is, there was support for the Principles remaining as Principles and avoiding prescriptive requirements with detailed rules. This has the key advantage of preserving the flexibility of the Principles and allows them to be easily adapted to many different legal, economic and social environments. The outcomes focus also allows innovative but effective practices to develop, thereby avoiding a single and static model of good governance. We certainly want to foster competition with respect to best practice, rather than promoting passive box ticking approaches.

The objectives focus of the Principles means that it is up to policy makers to determine the appropriate balance to be struck between regulation and self-regulation in terms of implementation of the Principles. Depending on the legislative and regulatory infrastructure existing in a country, and the credibility of the relevant professional groups, it may be that the objectives of the Principles can be achieved through minimal prescription.

The OECD is certainly not about advocating new and onerous regulatory requirements of business. Nor does it want to be responsible for causing overly risk averse behaviour on the part of directors so that they potentially lose sight of their goals. Nobody benefits if companies lose their entrepreneurial spirit and cease to grow.

It may be that as a result of pressure from retail investors some governments have been inclined to over-react to large scale corporate failures by mandating detailed requirements and imposing severe sanctions on directors and auditors. This can mean that any benefits from increased regulation may be obtained at too great a cost. Also, in some cases, it could be doubtful as to whether the benefits or objectives will even be achieved. Added to this is the risk of complacency on the part of directors, auditors and investors if they think that everything has been fixed and tied up by the system through black letter regulation. After all, corporate governance should be about best practices and outcomes, not processes.

OUTCOMES OF THE REVIEW

The original text of the Principles has been revised in 6 key areas:

- A stronger, more active and informed, role for shareholders is promoted in the text;
- The role of the board is strengthened, including with respect to the relationship of board members with related companies. Conflicts of interest and self-dealing in respect of board members are also explicitly dealt with;
- Executive and director remuneration is more explicitly dealt with and there is greater emphasis on showing the link to performance;
- Greater transparency is promoted;
- A number of principles focus on bolstering financial market integrity, especially with respect to the role of financial intermediaries or other corporate service providers; and
- Finally, effective enforcement measures are advocated to facilitate better market discipline.

I will go into a bit more detail regarding the changes I have just described, but before I do that I would like to just explain some of the key drivers for these changes to the Principles that influenced the OECD Steering Group in its decision making.

First of all, there was a general consensus amongst the Steering Group members, as well as feedback from the Financial Stability Forum, that many players in the system, whether they be directors, auditors, analysts or brokers, seemed to lack independence or be tainted by inherent conflicts of interest. Allied to this was the issue as to whether boards have been able to exercise sufficient independent judgment regarding oversight of management.

Secondly, unsound disclosure practices were becoming increasingly prevalent. In particular, the use of off-balance sheet transactions and poor revenue recognition practices have tended to cloud transparency.

Thirdly, and related to this, incentive structures in the system were not always working effectively. For example, in relation to dot.com or hi-tech companies, it seems that some directors were motivated to inflate earnings because they were heavily influenced by their share option incentive schemes. Also, institutional investors, who have the market power to influence board behaviour, were often passive.

Getting incentive structures in the system right is terribly important. When they are functioning optimally, incentive structures are usually more effective in preventing abuse and are more efficient than surveillance by the regulator or the imposition of sanctions after the fact.

When I refer to incentives I am not just talking about the role of institutional investors or formal governance structures. An example of what I mean is the benefits that can be obtained from a free, active and informed financial press. Astute and professional journalists can often keep directors much more honest than any amount of regulation. They can certainly promote transparency and facilitate a healthy dialogue about ethical standards. In my country, Australia, I believe the press has played a very real and positive role in lifting standards of governance, though some would say that the press is sometimes too negative and sensational!

Finally, (in relation to the key drivers for change,) it seems that the relevant regulators in some key markets were not exercising adequate supervision – they were leaving it to the market to sort out best practice without the proper incentive structures in place. This left a large gap in terms of investor expectations and actual performance by market participants.

Having regard to the failings I have just mentioned, many of the enhancements to the Principles introduced by the Steering Group seek to address these systemic weaknesses and bolster incentive structures within the market.

I should say that there was a remarkable degree of consensus in the deliberations of the Steering Group on these issues. However, you may be interested to know that there were some areas of contention regarding how far the Principles should go in addressing the concerns I have identified.

Examples of some of these areas of contention include how far the Principles should go in addressing the responsibilities of institutional investors and whether they should be required to disclose not only their voting policies but also how they voted on particular matters.

In relation to the rights of shareholders, there was a question as to how much shareholders should be involved in specific management decisions of the company such as voting on the remuneration packages of key executives.

While there was complete agreement regarding the need for directors to be objective and act in the interests of all shareholders, there was quite a deal of discussion about how the Principles could be expressed so as to emphasise the state of mind required of directors without becoming overly prescriptive. On the one hand the Principles could state what are the key attributes of independence or they could focus on the outcome to be achieved.

The role of stakeholders received a fair degree of attention. Trade unions maintained that the Principles should effectively mandate workers' involvement on company boards while business groups advocated that flexibility should be retained on this question.

Another area of some debate was in relation to how far the Principles should stray into areas such as the rights of creditors upon insolvency of a company and the role of financial intermediaries in corporate governance. Should brokers, analysts and rating agencies have specific requirements imposed upon them since they now carry so much influence in the market?

Some of these issues may go beyond what is considered to be corporate governance per se but the Steering Group was mindful of how insolvency laws, market disclosure requirements and the behaviour of financial intermediaries can impact on governance practices. Clearly, corporate governance can no longer be considered a stand alone science.

I am sure that you are by now awaiting with great interest the outcome of the Steering Group's deliberations. So, I will now explain in more detail the key additions to the Principles approved by the OECD last April.

1. The strengthened role of shareholders

The Principles now place an even greater emphasis on effective shareholder participation in key decisions of a company. These include the nomination, election and removal of board members, proposing resolutions and asking questions of the board.

With respect to institutional investors – and this is an area that I am sure interests this audience – the new Principles represent somewhat of a sea change. All that was really stated in the original 1999 text was a brief note that investors should consider the costs and benefits of voting their shares. This time around, in the new Principles, we

have first of all changed the title of the Chapter from the Rights of Shareholders to The Rights of Shareholders and Key Ownership Functions. Second, a number of principles have been added, including a general statement on the need to facilitate the exercise of ownership rights.

In essence, I think that these changes represent a sentiment that institutional investors need to pick up the ball. It doesn't really matter how many rights you give shareholders if they don't make proper and informed use of them. Institutional investors have a special responsibility in this respect. The market economy and the corporate governance system operate on an assumption that shareholders have the incentives and clout to act. If they don't, the system will fall apart regardless of what rights shareholders formally have.

The Principles further facilitate shareholder activism by stating that shareholders should be able to consult with each other concerning their rights.

But with rights come responsibilities. That is why the new Principles also call upon disclosure of voting policies by institutional investors, how they manage conflicts of interest and the procedures that they have in place for deciding how to vote their shares. Importantly, the new Principles also recognise that when institutional investors have disclosed a corporate governance policy (which more and more institutions are tending to do), effective implementation requires that they also set aside the resources to pursue that policy in a way that is expected from their beneficiaries and portfolio companies. Otherwise we risk having mere window dressing statements. That would be the worst outcome and very misleading for the market.

Another addition to the Principles that is of special interest to institutional investors is the requirement for impediments to cross-border voting to be eliminated as far as possible. This specifically recognises the increasing international integration of markets.

As you can see, these changes are really all about encouraging shareholder activism to keep company boards focussed on the main game, driving shareholder value.

2. Board responsibilities – conflicts of interest, self dealing & related party transactions

The Principles have been strengthened in the area of board responsibilities by requiring boards to apply high ethical standards and seek to embed these standards into the corporate culture. There is a clear statement that the duties of board members are fiduciary in nature and are owed to the company and shareholders (but not necessarily to a company group).

Under the Principles, boards have responsibility for oversight of the internal controls and risk management systems of companies and to provide confidential access to whistleblowers. Board members must also be prepared to commit themselves effectively to the job, meaning that they should not be overburdened with multiple directorships and should devote sufficient time and energy to the performance of their duties.

The Principles now also contain more robust criteria for board independence and objectivity. Directors are required to avoid conflicts of interest and the Principles specifically cover situations characterised by block and controlling shareholders. Moreover, boards must review related party transactions using independent directors.

Significantly, there is an express call for minority shareholders to be protected from abusive actions by controlling shareholders. They should also have effective means of redress.

3. Executive and director remuneration

There is now an explicit statement that boards should align key executive and board remuneration with the longer term interests of the company and shareholders. The board should also establish a remuneration policy.

Annotations to the Principles commend the establishment of a dedicated remuneration committee with independent directors as best practice.

Disclosure of the board's remuneration policy is now mandated under the Principles and shareholders are given the capacity to make their views known on the policy. Shareholders may also approve the equity components of compensation schemes for board members and employees.

4. Transparency

I guess you could say that disclosure provides the oil to the wheel of market integrity. Without it, the market cannot function efficiently. The Principles covering disclosure have thus been strengthened across the board. They have been especially strengthened in relation to conflicts of interest and related party transactions.

A key addition to the principles is a clear statement that the external auditor of a company is accountable to shareholders and has a duty to the company to exercise due professional care in the conduct of the audit. This is designed to overcome the tendency for some auditors to treat the company directors or executives as their client thereby being influenced by their views, sometimes at the expense of the company.

The Principles also pay greater attention to issues of auditor independence. This should enhance the integrity of the financial reports.

A new principle has been included to the effect that the mandate, working procedures and composition of board committees should be disclosed.

5. Financial market integrity

It is fair to say that all the Principles are more or less designed to enhance market integrity and investor confidence. Although a large number of the Principles are directed at boards and auditors, it is important that directors and auditors do not bear all the responsibility for ensuring good governance.

In this regard as I mentioned earlier, financial intermediaries, such as brokers, analysts and ratings agencies can provide significant incentives for good governance of companies. It is for this reason that a new principle, which I view as extremely

important, specifically calls on these market players to avoid conflicts of interest that could compromise their advice. The Annotations to the Principles note that the preferred approach adopted by some countries in regulating conflicts of interest is to mandate their full disclosure and how they are managed.

6. Effective enforcement

In relation to implementation and enforcement of the Principles, a comprehensive new chapter has been included that specifies the objectives governments should follow in developing the regulatory framework underpinning effective corporate governance.

Broad principles have been included covering useful implementation and enforcement mechanisms that governments and regulators can use to enable investors to protect their interests.

WHERE TO FROM HERE

It is appropriate that I should finish with a discussion of enforcement mechanisms and implementation strategies. Implementation and enforcement go to the heart of the effectiveness and usefulness of the Principles.

Obviously, the Principles are of no value, and will make no impact on governance practices, if they are not used and implemented by market participants. The onus is therefore not only on governments to review their legislative and regulatory infrastructure but also on each player in the system, from company directors to the financial press, to fulfil their role as envisaged by the Principles. The Principles, as I said at the outset, are not about prescriptive rules, but about good outcomes - for that, we all need to take responsibility.

For its part, the OECD will continue its active work in the area of corporate governance. We will focus on developing and disseminating effective implementation strategies that can be shared with everyone. This will assist to ensure that the Principles remain a useful and relevant tool in the promotion of market efficiency and integrity.

In this work, the OECD Ministerial meeting in May was very clear that our close co-operation with the private sector and other stakeholders should continue. The ICGN, and its members from all over the world, will be an important part of this continuing dialogue. So, as I said at the beginning, it is appropriate that one of my first international presentations of the new OECD Principles is to this very group which I hope to see a lot of in the years to come.

For the OECD, the completion of the review does not represent the finish line. It represents the start of a new and exciting work-program that we should perhaps name after the theme of this session; Making the New OECD Principles Work – A Joint Effort.

Many thanks.