On Line Public Consultation on Corporate Governance and the Financial Crisis

Proposal for discussion

Preamble
1. Following the Corporate Governance Steering Group’s Roundtable discussion on corporate governance and the financial crisis on 18 March, the OECD secretariat has invited further on line comments in determining its next steps. The Issues for Consultation are set out in an OECD document downloaded from the OECD web site.¹

2. The matters set out below address two of the four headings - Board Practices and the Exercise of Shareholder Rights. The two remaining Issues for Consultation focus on Board Remuneration and Risk Management. These are matters of key importance but cannot be addressed until the other two main issues identified are fundamentally investigated.² The proposals are submitted as independent evidence to the Steering Group together with a list of strategic study objectives.

Board Practices
3. During the Roundtable difficulties may have arisen from the use of the same term with subtly different meanings in languages different to English. Discussants spoke about “boards” and “board practices” as if all board structures are more or less the same everywhere, when they are not, and relate to shareholders in much the same sort of way, when they don’t. This may conceal significant misunderstandings. These matters need to be systematically explored and clarified.

4. Misunderstandings may also have arisen where different types of board structures, (unitary and dual executive-supervisory) were being discussed, and the different ways in which they operate. These differences have, possibly, a critical bearing on access to ex ante information, and the effective exercise of shareholder rights. Nobody knows for certain the scale and importance of these differences, except that they are significant.

5. The term “information” was frequently used “generically” and without particular qualification. This too may have resulted in misunderstandings. The difference between ex ante and ex post information is of crucial importance. Within Anglo American unitary board arrangements, shareholders depend mostly on ex post information or fairly loose forecasts about what might be the case, in the future.³ Supervisory board structures in other jurisdictions appear to obtain, as a matter of course, vital ex ante information upon which effective supervision critically depends. Nobody knows for certain the scale and importance of these differences, except that they exist.

¹ http://www.oecd.org/document/18/0,3343,en_2469_32813_42229906_1_1_1_1,0.html 13/04/2009
² Governance Remuneration and the Implementation of Risk Management are matters clearly related closely to the proper functioning of the board and the exercise of shareholder supervision. They cannot realistically be addressed outside an examination of first order matters of concern.
³ As foreseen in the now defunct British OFR (Operating and Financial Review) and under the Sarbanes Oxley Act 2002 in the US.
The Exerciser of Shareholder Rights

6. This goes to the heart of current difficulties in Anglo American jurisdictions. It has most recently been brought to centre-stage as a result of the British government taking a very large equity stake in Lloyds/HBOS and discovering that, as shareholders, they have no clear mechanism for calling the board to account, ex ante, for its actions.4

7. Current arrangements supporting shareholder rights are embedded in “soft” comply or explain rules, and statute and common law in Anglo American jurisdictions. The directors of publicly held corporations (bank and non bank) often do not (and cannot easily5) share ex ante information with shareholders. More to the point the shareholders have no powers to insist upon this. They also have no standing in law to sue for perceived wrongs against the company committed, for example, by directors,6 who do not owe them a duty of care. The duty is owed to the company, a separate legal entity).7 Hence where serious disputes with directors are concerned, over negligence for example, (including the duty of care and skill), shareholders are obliged to rely on a derivative action where the corporation8 (as the lawful plaintiff), sues the directors a process which is complicated, risky and costly to initiate.

8. Though it is common practice in Anglo American jurisdictions to speak colloquially about shareholders being the “owners” of the corporation, and thereby being entitled, as such, to be “informed” about its affairs, this is not straightforwardly the case. The shareholders are not, strictly speaking, the owners of the corporation.9 The corporation, in the post limited liability world, is a separate legal entity which owns its own assets.10 Shareholders own shares, but shares, as landmark common law judgments support, do not represent a claim on the company’s assets.11 The implications of these findings are frequently misunderstood.

9. The use of the word “shareholder” is also a cause of confusion. Founder “shareholders” (who invest original equity into the company) are, for example, very different to “shareholders” who are simply investors in shares, as in the case of

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4 This has generated a good deal of debate in the UK. The essences of the argument are set out in a letter How Sir Victor put state ownership in its place published in the FT on 5 November 2008. The issues raised remain unresolved. Similar difficulties are being experienced by the US authorities.

5 Regulations concerning shadow directors are an impediment to information sharing with particular institutional investors; insider trading rules also pose a potential danger to institutional investors who may accidentally become aware of price sensitive information about other companies in which they hold investments.

6 As foreseen in Foss v Harbottle 1843, except in cases of fraud on a minority or other related offences.

7 The legal “fiction” of provisions under section 14 of the British Companies Act of 1985 portrays the shareholders as enjoined in a contract with the corporation. The reality is that neither party is a signatory. Section 14 resolves none of these long dated underlying legal problems.

8 An inanimate legal fiction in law whose actions can only be given expression by its directors.

9 They cannot be, because of limited liability, which separates in law the company from the shareholders and confers limited liability on the shareholders.

10 There may be case for removing limited liability from the largest publicly held corporations given the “too big to fail” mantra popular in recent policy decisions. This would have the effect of forcing institutional shareholders to establish credible mechanism of control over executive management.

11 Except in the case of liquidation though not necessarily in acquisition as evidenced in Short versus Treasury Commissioners (1948), which makes clear this vital point in law.
in institutional investors who buy and sell shares in third party transactions. Yet it is commonplace for people to speak of them as if they were broadly the same when they are not. This leads to misunderstandings. European shareholding which, broadly speaking, is patient, long term and often “founding” in nature, is quite different to shareholding in Anglo American jurisdictions which is institutional and short term, where shares are bought and sold in third party transactions. This results in very different forms of behaviour – the most important of which is that, generally, European shareholders take a longer term view on shareholder value, when compared with Anglo American institutional shareholders who are, inevitably, shorter term in perspective.12

**Board Structures**

10. The behaviour of shareholders and boards, alike, cannot be separated from board structures. Sweden provides an example where unitary board structures exist for certain types of company in which independent directors, alone, sit. In the Swedish model the unitary board is independent from the executive directors whose actions they are there to supervise.13 This sort of “countervailing influence” does not exit within the Anglo American unitary framework. The absence of this imperils accountability and from recent past experience confirms the serious threat that it poses to shareholder value.

11. Concerns about these matters, following the Enron scandal in the US, prompted the British Government to initiate a thoroughgoing review of the role of NEDs (non executive directors) in 200214 The resulting Higgs Report placed great importance on a very significant expansion of NEDs on the boards of publicly held companies, with the independent chairman being responsible for organising the NEDs. Unfortunately there is little evidence that these aspects of Higgs have been taken, seriously, into account. Anglo American boards remain strongly “executive” in orientation, with NEDs generally regarded as an unavoidable Combined Code15 requirement.16

12. Most recently the British Financial Services Minister, Lord Myners17, in the face of mounting criticism of the failure of NEDs, and institutional investors to ensure better and more effective disclosure in the context of the global financial crisis, has proposed a further strengthening of the role of NEDs.18 He has specifically suggested that NEDs should be funded by the corporation, if necessary, to support independent research into

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12 The research by Peter Marsh in the 1980s on short-termism in Anglo American capital markets helps to provide an English-speaking take on this, though it provides no insight into European habits and practices.
13 A glance at the website of Tomorrows Company, a British research outfit reveals some interesting insights into the importance of independent supervision and the need for the board to be independent of the company.
15 The British comply or explain code of good corporate governance.
16 The shocking revelations in the serious British press about NEDs being intimidated in the case of RBS Bank may very well, as the facts are revealed, confirm the asymmetry of power in British and American board structures which undermines independent scrutiny.
17 As a former fund manager one supposes that Lord Myners speaks with an insider’s understanding of how institutional investors, in practice, operate.
18 See The FT 6 April 2009 “Myners urges radical shake-up of boards” in which the Financial Services Minister urges a number of fundamental changes which can only be realised if equally far reaching changes are made to board structures.
the affairs of the corporation on whose board they sit, as NEDs. This can only be taken as recognition that existing arrangements do not provide an adequate countervailing power over the actions of executive directors.\textsuperscript{19}

Conclusions

13. A significant though little quoted contribution to the theory of corporate finance appeared in the Journal of the Wharton Business School, in 2002. The article argues that too little is known or understood about the differences between different board control models and the role of the shareholders and their rights in protecting shareholder value in different OECD countries.\textsuperscript{20} The research supports the conclusions that models in jurisdictions other than Anglo American achieve better performance ratings in terms of a number of key performance measures used as proxies for shareholder value.

14. The reasons which might explain these matters need, urgently, to be explored and the results of the research published in full. Only in this way will trust in the capacity of the corporation to generate and protect shareholder wealth, and report credibly on its actions to society, be restored. Some of the key objectives of the research are set out below:

- What limitations exist in Anglo American board structures which prevent institutional shareholders from obtaining relevant \textit{ex ante} information vital to the exercise of effective supervision?

- What legal changes would be required to enable institutional shareholders from obtaining \textit{ex ante} information vital to the exercise of effective supervision?

- Can countervailing influence be achieved within board structures that are executive in composition, culture and orientation?

- Should all boards be organised as supervisory entities separate from the executive functions of managing the corporation?

- What evidence is there that supervisory board structures are better at protecting shareholder value than unitary executive-oriented board structures?

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\textsuperscript{19} Some see this as a further step towards the creation of supervisory boards independent of executive boards representing shareholder and other stakeholder interests.

\textsuperscript{20} See Allen and Gale \textit{A Comparative Theory of Corporate Governance}, Wharton Business School 2002