



OECD Steering Group on Corporate Governance

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Corporate Governance in OECD Member Countries: Recent
Developments and Trends¹

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Room document 1

For discussion under item 4 of the agenda

1. This report relies extensively on specialised and general press reports and literature. Member countries may comment and offer corrections/clarifications to the information included.

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The objective of this report is to account for the corporate governance changes that have occurred in 2000 and until mid-March 2001. It attempts to provide the delegates of the Steering Group with an overview of corporate governance trends in the OECD area and serve as a background for discussion and exchange of information. This report has been drafted under the responsibility of the Secretariat. It relies primarily on press reports and does not claim to be comprehensive or exhaustive.

The report comprises two sections, devoted respectively to recent developments in selected OECD Member countries and to comparative trends taking place across national borders. The country section describes regulatory measures, private sector developments and events that took place in 2000 and early 2001. The second section highlights some key trends, which have emerged or were reinforced through this period of time: *(i)* the rise of pension fund activism for socially responsible investment; *(ii)* the continuously increasing utilisation of technology for corporate governance; *(iii)* the continuing harmonisation of disclosure practices and reporting standards; *(iv)* the emergence of free-float indexes. In this section, the report follows the trends identified in DAFFE/CA/CG (2000) 1, which was presented to the group at its previous meeting.

RECENT DEVELOPMENTS IN SELECTED OECD MEMBER COUNTRIES

This section highlights the key corporate governance developments in selected OECD Member countries since the beginning of 2000.

Australia: In 2000, Australian board practices and procedures came under close scrutiny. Following the collapse of corporate giants such as Bond Corporation, Quintex and Adelaide Streamship, Australian regulators in the early and mid-1990s encouraged a culture in which companies employed a majority of independent or non-executive directors. Australian corporate governance arrangements might have shifted too far in favour of independence. A study by the Australian consultancy company Corporate Governance International and the University of Melbourne's Centre for Corporate Law and Securities Regulation indicates that companies with a majority of independent board members have underperformed in the stock market. It is argued that directors who are too far removed from the operation of the company can be misled or at least can be ill informed about its day-to-day affairs. Conversely, the study indicates a marked positive effect for shareholders when executives sit on the board. One of the main messages of the report is that independence in itself is not a substitute for quality on a board and there is a clear need for balance between independent and executive directors. Another lesson from the Australian experience is that independent directors should not be selected purely on the basis of their independence, but also with a close view to their background and the fact that they can contribute to the business.

Another set of results of the above study shows that the number of votes cast in annual meetings on director elections represent 35 per cent of total votes, compared to 83 in the USA, 71-80 per cent in Japan, 60 per cent in France, 50-55 per cent in Germany and 50 per cent in Great Britain². Figures suggest that Australian institutions most often back management even where controversies invite scrutiny or opposition. The government has drawn attention to the need for fund managers to improve their record. It can also be expected that trade union funds will step up pressure on fund managers to vote.

2. These results are based on a survey of 59 blue chips holding AGMs in 1999.

Canada: In 2000, the Canadian government has re-introduced a bill in parliament to amend the main federal statute regulating corporations, the Canada Business Corporations Act, improving the legal framework for domestic companies and enhancing shareholder power. The main objectives of the proposed amendments are:

- to expand the rights of shareholders to participate in the major decisions of their corporation – for example, by allowing non-registered shareholders to submit proposals and by modifying the grounds for rejecting a shareholder proposal; by allowing increased communication between shareholders; by expanding the means for shareholders to solicit proxies; and by allowing electronic communication between a corporation and shareholders;
- to enhance global competitiveness – for example, by reducing the residency requirements for the board of directors and eliminating the residency requirement for committees of the board; and by establishing a due diligence defence for directors rather than the current "good faith reliance" defence;
- to clarify responsibility – for example, by establishing a regime of modified proportionate liability for those involved in the preparation of financial information required by the Act and by clarifying the rules regarding unanimous shareholder agreements.

In order to maintain its attractiveness to global capital and ensure continued competitiveness, Canada is planning to launch a second-generation recommendations on corporate governance. A new corporate governance panel led by the chair of the Canadian Broadcast Corporation succeeds to the 1994 Dey Committee.

Czech Republic: Significant legal changes are planned for 2001. According to press reports, the Czech commercial code is being extensively redrafted. Proposals will include detailed take-over regulations with mandatory bid requirements.

Denmark: Among the initiatives announced by the Ministry of Trade and Industry in 2000 is the creation of an advisory panel of public officials, executives, fund managers, labour leaders and others to examine the Danish corporate governance landscape. The group will commission a survey of common board practices in the country and decide later on whether to draft a voluntary code.

France: The French government was quite active last year in discussing and implementing legal and institutional initiatives aiming to enhance corporate governance. French legislators are currently planning to streamline market regulation through the merger of two regulators, namely the *Commission des Opérations de Bourse* (COB) and the *Conseil des Marchés Financiers* (CMF) into a new *Autorité des Marchés Financiers* (AMF) responsible for the supervision of financial markets.

At the same time, secrecy over top executives' remuneration is about to end, following legal moves in the National Assembly and Senate. However, the bill requiring listed companies to reveal pay packages for each of the 10 top executives was not adopted by the upper chamber or parliament. The latter adopted a different bill requiring disclosure of pay of the top 2 to 4 executives, referred to as *mandataires sociaux*. The government will follow up with a proposal for reconciliation of the two versions. In 2000, the business federation *MEDEF* has accepted the principles of disclosure of the remuneration of top executives. They are considered particularly important in order to respond to pressure by foreign investors, currently holding approximately 50 per cent of equity ownership in large public companies in France. This legislation, if adopted by the Senate, would also separate the unitary post of *président directeur général* (equivalent of the chairman and CEO positions) into two posts, unless shareholders explicitly approve a unitary position.

According to existing 34-year old legislation, intermediaries such as custodians of fund managers do not have the right to sign ballot instructions on behalf of ultimate beneficial owners. This limitation has been

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routinely ignored for foreign voting. However, some large companies have started using this legislation to limit foreign voting. At the end of 2000, in order to remedy the situation, draft legislation authorising custodians to sign ballots on behalf of client-investors was debated. The draft also gives companies new powers to extract information on ultimate owners.

Recent research has shown that the increasing emphasis on corporate governance in France has led to tangible results. According to a report by the US-based recruitment company Kern/Ferry some French companies, including Air Liquide, Alcatel, Avenits, CCF and Crédit Lyonnais, are among the European front-runners on corporate governance. However, some companies seem to have backtracked in their practices. One example is Vivendi, who last year decided to put a cap on the ability of shareholders to vote the number of shares they had. In addition, the number of independent directors appointed to French companies was decreasing in 2000, whereas the number of non-French directors appointed in the same period was close to zero, even though France is among the most open capital markets in the world.

Germany: Germany is among the most active OECD countries in terms of corporate governance changes. Important developments are taking place in different areas, such as company law reform and development of corporate governance codes.

A key tax reform measure, approved by parliament in July 2000, is paving the way for further adjustments in ownership structures and corporate governance. According to the new legislation, the current 50 per cent capital gain tax imposed on corporate sales of shares in other companies will be abolished by 2002. It is expected that large German corporations and financial institutions will take advantage of the tax break to unwind vast blocks of cross-held shares and will become more competitive by eliminating protections against take-overs. Such developments could also lead to an increase of mergers and acquisitions activity and shareholder activism.

A voluntary German Code of Corporate Governance was released in 2000 by an Initiative Group of ten top executives and academics. It is referred to as the Berlin code and is the second such effort by the German private sector. It sets an 11-point agenda of board governance recommendations and advocates a more limited role for the supervisory board in overseeing management. Another corporate governance code was adopted in January 2000 by a Panel on Corporate Governance, led by the former managing director of DWS, the powerful mutual fund arm of Deutsche Bank, Christian Strenger. This code recommends a *sufficient* number of independent directors on the supervisory board and that boards should have as many as six board committees. In terms of disclosure, the code stipulates that companies should disclose information on performance targets for incentive compensation and that all company information, including full AGM agendas and voting results should be posted on the internet in German and English. The Strenger code is now followed by 25 of the DAX 30 and several smaller companies.

At the same time, a government-led Corporate Governance Commission has been nominated to explore the potential for legislative changes and prepare recommendations by June 2001. The Commission will not address the issue of *codetermination* according to which half of the seats in large company supervisory boards go to employees. It is expected that work will focus on issues, such as remuneration disclosure, independent auditors and take-over legislation.

The German Ministry of Justice is in the process of reviewing company law. It is currently debating the introduction of electronic share registers and electronic signatures for proxies, paving the way for a broad introduction of electronic share voting. Most importantly, a special commission has been created to explore possible improvements to the rules governing shareholder protection. This initiative comes also in response to increasing national and foreign shareholder activism.

The German stock market operator, *Deutsche Borse*, has also been quite active in promoting corporate governance. The series of measures it undertook recently include: (i) tightening of the rules of the *Neuer Markt* to require company managers to make public any share transactions they have engaged in; (ii) publication of quarterly reports by all DAX-listed companies, as a precondition for the companies to remain in the index; (iii) adjustment of the DAX-30 and the second-tier index M-DAX-70, as of June 2002, to reflect only the capitalisation of one class of shares, which are in free-float.

Greece: Following the adoption in 1999 of Corporate Governance Principles, closely modelled on the OECD Principles, the stock market regulator is seeking ways to implement them through mandatory means. This follows the realisation that corporate governance is still far from adequate in the Greek stock market. Corporate governance failures have been identified as one of the key reasons of the market's severe underperformance in 2000.

Italy: An equity culture has developed in Italy during the past decade, as a result of a large scale privatisation and significant reforms of securities laws and market regulations. In addition, minority shareholder protection has been strengthened and the stock market regulator, the *Consob*, has stepped up its role of overseeing the market. For example, the Consob played an important role in the recent merger between the agro-industrial and energy group Montedison and the family controlled steel and energy company Flack. The deal was blocked to protect minority shareholders including Italian banks and unit trusts, which did not agree with the share exchange ratio, which was too much in favour of the Flack family. Italian institutional investors played a decisive role in this important corporate transaction.

In February 2001, *Borsa Italiana*, the Italian stock exchange unveiled STAR, a new market segment designed to emulate French and German efforts to increase liquidity and investor interest in small and medium-sized companies. The exchange is expected to launch STAR in the first half of the year, with 20 companies, all of which are existing listings. STAR corporate governance requirements are often more stringent than for the broader market. Companies making IPOs must float at least 35 per cent of common stock, compared with 25 per cent on the broader market; must print information in English; and must have independent directors. To be regarded as independent, a non-executive director may not have a direct or indirect controlling stake or be part of a voting pact that does. An additional corporate governance requirement is that a significant part of the pay of directors and senior executives must be performance-related.

Japan: In April 2000, the Japanese government launched a two-year programme to revamp and modernise company law. The issues, which are examined by the government committees, include boards, voting, quorums and the role of auditors. There will also be an attempt to codify for the first time responsibilities of outside directors, even though they are almost non-existent on corporate boards.

Japanese corporations are facing increasing pressure from courts and shareholders to end secrecy surrounding director compensation. Japanese companies release only aggregate figures on director remuneration. In response to a dissident resolution at its June 2000 AGM, Sumitomo Bank became the first financial institution in Japan to reveal the compensation packages of their executives.

Japanese shareholders are becoming increasingly active in monitoring boards. Shareholder lawsuits have multiplied since 1993, when the government made it easier for investors to sue by adopting a flat filing fee of about US\$ 70, rather than forcing investors to pay a percentage up-front of the total amount claimed. Thus, the number of court cases pending has risen from 31 in 1992 to more than 280 in 1999. Shareholder lawsuits can only be brought against executives, and any payout is from those executives to the company, whereas plaintiffs receive nothing. In a sign that the suits are starting to have a real impact, the Japanese employers' organisation Keidanren, is very much in favour of a bill to curtail "frivolous" suits.

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Korea: Corporate restructuring of large *chaebols*, which started in the wake of the 1998 crisis, is still taking place in Korea, with the insolvency of DAEWOO and some financial affiliates in the Hyundai group. However, changes in control are slow to occur, as government controlled banks are still taking a soft line to the troubled groups.

In March 2000, the Ministry of Finance and Economy announced measures to prevent conglomerates from making key policy decisions, such as management control transfers, without approval by the board of directors and shareholders of the individual companies involved.

Shareholder activism is gaining momentum in Korea. PSPD, a shareholder-activist group provoked board changes in the large telecom concern Dacom in the spring of 2000. The adopted measures include the nomination of a non-executive as a chairman of the board and at least 50 per cent independent directors. A fully independent audit committee will monitor related party transactions to ensure they are done at arm's length.

The Netherlands: At the end of 2000, the Ministry of Finance announced that the government was finalising legislation to mandate disclosure of individual executive remuneration in listed companies. Under the current version, disclosure is expected to encompass salary, bonuses, options and other remuneration for each member of the executive and supervisory boards.

Following the endorsement of the OECD Corporate Governance Principles, the government charged the advisory Social and Economy Council to find ways to enfranchise shareholders. Under current rules dating back to 1970, corporations following the so called *structuurregime* system grant the supervisory board virtually all key powers, including the effective power to appoint its own members. However, the current proposal grants employees rather than shareholders formal power to recommend one third of the candidates for board members. Another provision further reduces the role of shareholders, by requiring a 75 per cent majority to reject nominees.

New Zealand: In a move to attract foreign investors, the government approved more stringent rules on shareholder protection, which are expected to become effective as of 1 July 2001. Under the new Take-over Code, an investor buying more than 20 per cent of a company will, in most cases, have to make a bid for at least 50 per cent and offer the same price to all equity owners.

A 2000 study by ANZ Investment Bank examined corporate governance practices in 500 companies in New Zealand. According to the study, in 1998 the cost of weak governance is estimated at 7 per cent of GDP. The study recommends that pension fund managers be mandated to report on the governance standards of the companies they invest in, and on their own policies to improve such standards.

Poland: In partly privatised large corporations where a strategic investor holds a minority stake, and the treasury remains the majority but passive owner, any disagreement over strategic matters risks a deadlock. In 2000 this happened with the national insurance giant PZU, where parties disagreed on key management appointments, business policies and investment decisions. This compromised the completion of PZU privatisation, which was expected to generate ZL 5 billion in 2001. In the initial privatisation agreements of PZU, the bloc investors had agreed to pay a higher price (reportedly embodying control premia over the company) to purchase a 30 per cent stake, in exchange for "more than proportional" board representation: a nine-person board was expected to comprise four investor and four treasury representatives, under the chairmanship of a "respected independent industry expert". However, this arrangement proved unworkable. The case is now pending before the court.

A more fundamental problem lies in the fact that the stock market does not yet play a real role in raising capital for the corporate sector. Most of the listed stocks originate from Treasury IPOs in consecutive

privatisations, and share redemptions by employees of privatised companies. Genuine equity issues are scarce. For most companies, only a minority of shares (less than 30 per cent on average) are floated; controlling stakes remaining with the strategic investors (or with the state). This ownership pattern explains the limited number of mergers and acquisitions taking place in the market. Efforts to strengthen the role of the stock exchange and the quality of corporate governance include a new commercial code, which will be finalised in 2001. It bans multiple voting (with the exception of the Treasury, which is compensated for the loss of its “golden share” rights, with ordinary shares bearing multiple voting rights). The powers of the supervisory boards and of the annual shareholder meetings in monitoring and disciplining management are increased. Take-over regulations are also strengthened with mandatory bid provisions.

Portugal: The market regulator *Comissão de Mercado de Valores Mobiliários* (CMVM) has recently issued detailed recommendations aimed at stimulating postal voting. The latter has been sanctioned by the Portuguese Securities Code in 1999. The recommendations are deemed as a tool to enhance the use of voting rights. They are also perceived as complementary to the CMVM 1999 corporate governance best practice code.

United Kingdom: In March 2000, the Department of Trade and Industry, in the context of its Report on Company Law Reform, recommended that boards foster “inclusive” relationships with employees, customers, suppliers and the community. The working group, preparing the review (Company Law Review Steering Group) included participants from all sectors of the market. As a result of vivid debate on whether or not a more stakeholder-focused model should be adopted, the group has recommended that a “shareholder-oriented, but inclusively framed, duty of loyalty” is most likely “to lead to optimal conditions for companies to contribute to the overall health and competitiveness of the economy. The report recommends measures aiming to: (i) create monitoring obligations for non-executive directors; (ii) increase the proportion of non-executive directors on boards; (iii) change the non-executive directors’ appointment method to minimise the role which executive directors play in appointing non-executive directors; (iv) tighten the definition of director independence; (v) strengthen the independence of the chairman.

There is a debate in the United Kingdom on whether boards need to pay greater attention to stakeholders. New legal requirements also compel pension funds to describe their policies on social issues in their Statement of Investment Principles. United Kingdom corporations face intensifying pressure for social and financial performance also on behalf of investors. A statement by Hermes Investment Management in its latest revision of corporate governance policies at the beginning of 2001 calls on companies to disclose annually the effect of social, environmental and ethical matters on their performance. The text was agreed by another eight investor institutions, PricewaterhouseCoopers and BP Amoco, which are expected to incorporate it into their own policies. Prompted by these developments, the Manifest voting agency is rating top United Kingdom companies on environmental risk. The corporate responsibility profiles/ratings of a number of companies evaluating their records on the environment, workplace practices, human rights and community relations are in the pipeline.

United Kingdom legislation is also paving the way for electronic voting. The Electronic Communications Bill, passed in May 2000, allows digital signatures on proxies. Providers are competing for investors’ confidence and are preparing to ensure that investors will be able to use electronic means to vote in most United Kingdom listed companies. On the other hand, in June 2000 the National Association of Pension Funds (NAPF) has published corporate governance standards to assist members in proxy voting. The NAPF guidelines go beyond the London Stock Exchange Combined Code by recommending: (i) the separation of the positions of chairman of the board and CEO; (ii) a ten part test to determine board member independence; (iii) avoiding re-pricing share options in situations of under-performance; (iv) an annual shareholder vote on the report of each company’s remuneration committee.

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In a revealing case as to uncertainties of corporate governance norms, BP Amoco triggered recently a major trans-Atlantic contest over fundamental shareholder rights by blocking four dissident resolutions from the company's annual meeting. Management declared that individual owners of American Depository Receipts have no power to endorse resolutions. This is a grey area of the law and BP's position is indeed alerting investors who own BP shares through ADRs that they have markedly fewer rights than those who own BP common stock.

In 2000 the government commissioned a report reviewing decision-making structures and practices of institutional investors. The pension and life insurance industry in the UK currently manage the savings of millions of people and own over £1500 billion of assets, representing more than half of the national equity market. In the light of the increasing importance of UK institutions and their critical role in the process of allocating capital within the economy, the report has focused on setting out a blueprint for reform, including suggestions for changes of the regulatory framework and the fiscal policy related to institutional investors. The report has also defined some basic principles of an effective approach to investment decision-making and proposed that they are promulgated by the government and either adopted voluntarily by the industry or enforced through legislation.

United States: The Securities and Exchange Commission (SEC) – building on the work of the Blue Ribbon Committee on Audit Committee Effectiveness -- issued rules that strengthen the audit committee's independence and give its members the tools to better fulfil their duty to the investing public. The rules enhance the independence of outside auditors, and improve communications, through greater disclosure among the board, through its audit committee, outside auditors and management. The rules establish clear guidelines on the types of non-audit services an auditor may provide to an audit client, as well as the meaningful involvement of the audit committee in considering consulting services that may impair independence. As a result, the board audit committee will have to alert investors annually to steps it has taken to ensure that the auditor's independence will not be undermined by other business. At the same time, each company will have to disclose how much it pays its auditing firm for non-audit consulting services. The Council of Institutional Investors, representing the largest US pension funds, has taken a more extreme stand: its members agreed that an accounting firm should not do consulting work for corporations they audit.

The SEC is also debating whether investment advisors, pension and mutual funds should face a mandate to disclose their voting policies. Such a policy would emulate the 1999 British "truth in voting" rule that would require U.K. pension funds to divulge their policies on how they exercise their voting rights. The SEC proposal, floated in April 2000, is backed by the Council of Institutional Investors who consider that investors need tools to hold mutual funds accountable for how they act as shareholders, especially as they wield so much equity power.

Another initiative of the Council of Institutional Investors advocates the suppression of broker voting at the New York Stock Exchange (NYSE). Under rules long approved by the SEC, NYSE officials weekly flag upcoming corporate AGM resolutions as either routine or non-routine. Brokers can then cast client ballots on "routine" items if they receive no voting instruction within 10 days of the meeting. They vote these, without exception, for management. However, what is routine to the Exchange is not necessarily considered as such by shareholders. For example, NYSE is reported to have classified contested director elections suitable for broker voting, which had triggered massive votes for incumbents.

A new provision was adopted in Delaware that would allow the replacement of physical annual meetings with all-electronic AGMs. Under the statute, a meeting could be held entirely through remote communication. The Council of Institutional Investors and the trade union federation AFL-CIO have disapproved the measure. According to them, meetings entirely relying on Internet eradicate face-to-face

dialogue that helps to hold directors and executives accountable; furthermore, such practices act against shareholders without access to the Internet.

One of the largest investing institutions in the world, CalPERS, has switched strategies when it voted in October to sell its tobacco stocks. This move was made on the basis of the perception that equity in corporations with poor social and ethical record looks increasingly risky, because such firms court boycotts, lawsuits or labour action. CalPERS board also decided to apply social criteria to investment decisions in emerging markets. More concretely, the fund will rely more on active management by switching US\$1.8 billion in emerging markets from an indexed portfolio to a managed one. There will also be updates on financial and economic criteria as to the markets in which CalPERS can invest, based on specific tests on transparency, political stability, rule of law, including on labour issues as well as effective prohibition of child and slave labour.

Another large fund, the State of Connecticut pension system, has also incorporated social concerns in its routine share voting policies around the world. The state legislation requires the Connecticut Retirement Plan and Trust Funds not only to protect the long-term benefits of members, but also to “consider the social, economic and environmental implications of all investments”. Detailed global proxy voting guidelines were adopted in May 2000 to put these requirements at the heart of Connecticut’s policy as it votes at AGMs around the world.

European Union: The European Commission has been exploring ways to act on corporate governance since December 1997. The Commission has recently commissioned a detailed study of codes of best practice in member states. The European Federation of Investment Funds commissioned an experts group to draw specific recommendations on how to improve shareholder activism in Europe. The Federation will also explore the possibilities for preparing corporate governance principles based on existing codes setting out investment managers’ expectations of EU companies. European companies could also soon face broader and more co-ordinated shareholder activism on their social responsibility records.

Easdaq, the Brussels based electronic market for high-tech companies, is relying on corporate governance standards to increase its investor base. Its founders, the European Association of Securities Dealers adopted voluntary principles for Easdaq listed companies. These principles expressly cite OECD principles as a key source. The Easdaq recommendations favour board accountability to shareholders, one share, one vote and discourage take-over defences. They are innovative in the sense that they call on fund managers to disclose their proxy voting policies.

In February 2001, the European Commission unveiled a regulation requiring European Union-registered companies to adopt International Accounting Standards (IAS) by 2005 at the latest. The proposed regulation, which must be approved by EU ministers and the European Parliament, is in line with a Commission policy first outlined last June, which aims to improve EU companies’ access to capital markets and increase transparency among investors. The Commission’s proposed Accounting Regulatory Committee will review rules created by the International Accounting Standards Committee (IASC), the London based body backed by the accounting profession. These rules will be checked for EU-compliance by a new private sector body, the European Financial Reporting Advisory Group. Critics fear that such a review initiative may slow down the process of accepting global rules and create rival sets of regional standards. In a groundbreaking agreement last year, the organisation of stock market regulators, IOSCO decided to back the use of IASC standards for cross-border offerings and listings.

MAIN CORPORATE GOVERNANCE TRENDS

This section attempts to identify corporate governance trends that have emerged or have gained additional impetus in OECD countries in 2000 and early 2001. The trends discussed below are: (i) the rise of pension fund activism especially as regards socially responsible investment; (ii) the increased use of technology for corporate governance; (iii) the continuing harmonisation of disclosure practices and reporting standards; (iv) the emergence of free-float indexes.

Given the growing importance of institutional investors in OECD countries, it is worth flagging the findings of a report commissioned by the UK government in 2000 (also referred to as "The Myner's report") to identify distortions in investment decisions and define an agenda for reforming the industry. The report underlines that key decision-makers do not always have the skills, expertise and information to carry out their responsibilities effectively. In addition, it stresses that the lack of clarity about decision-making structures and incentives causes a misalignment of the objectives of the ultimate investors – the consumers and pension fund members – and the agents investing on their behalf. It sets out some basic principles to an effective approach to investment decision-making. Clear, transparent objectives and responsibility structures, specialised expertise for decision-makers and greater competition in the market for advice are expected to improve the investment policies and lead to a greater diversity of asset allocation policies.

Pension fund activism towards socially responsible investment

Socially responsible investment (SRI) funds comprise a small proportion of the investment community, but they have been growing rapidly in OECD countries in recent years. One reason is an apparent shift in the consumer and employee opinion³, in the sense that companies should not only act within the law but also help enhance social well being. Another is the growing evidence that a company and its share price can suffer serious damage if it jeopardises its reputation with consumers by not acting in a socially responsible manner.

There have been numerous examples of dissident resolutions and rebel proposals encouraging progress in social and environmental issues in 2000 and 2001. Key United States funds – particularly CalPERS and the State of Connecticut pension system – have shifted to a more active policy on social issues. Furthermore, at the beginning of 2001, CalPERS announced a shift of its proxy voting policy bringing it into line with its strategy of social responsibility.

CalPERS efforts to bring stakeholder issues into the mainstream of investor activism parallel recent moves by institutions in Europe. Pension funds in the United Kingdom have come under a regulatory obligation to disclose their policies on social issues. Many have developed guidelines. This is a strong signal to companies that their record on these issues may affect access to capital. Pension funds activism, driven by

3 . A recent survey conducted by Environics International, the Toronto-based consultancy company and the Prince of Wales Business Leaders Forum, found that 6 out of 10 consumers form impressions of a company based on broader responsibilities such as labour practices, business ethics, responsibility to society at large and environmental effects.

the international trade union movement, is also channelling attention to social issues. It aims at the adoption of International Labour Organisation principles, calling for independent verification of compliance and reporting annually on results.

The increasing interest towards SRI has also led to attempts in defining socially responsible investment. The index provider FTSE is to establish a range of global indexes covering companies acting in a socially responsible way. The new indexes will assess companies on environmental performance, human rights, and social issues. They will join existing SRI Indexes, such as the Dow Jones Sustainability series.

Continuously increasing utilisation of technology for corporate governance

As noted in DAFPE/CA/CG(2000)1, recent advances in technology, and the advent of the Internet in particular, have opened new possibilities for promoting and improving corporate governance. The Internet is proving of great help to shareholder activists, who can overcome collective action problems by exchanging news and strategy online. Throughout 2000, a large number of websites have emerged, each aiming to keep international investors informed of corporate governance activities. Governance news and research, meanwhile, have become freely available on a number of sites, helping to further the governance reform effort.

Governments are reviewing company laws in order to allow greater reliance on new technology for better corporate governance. For example, most company acts contain detailed provisions on the minimum and maximum time between calling the AGM and the actual meeting. This is an important issue, in that it may reduce the risk of manipulation and it should enable especially foreign institutional investors to be informed and obtain documents on time. Therefore, some countries are planning to change to electronic publication of the notice. This is the case in the United Kingdom, where shareholders who have agreed on electronic communication can receive the notice by email, or may be contacted by email so that they can retrieve the notice and the agenda and all other documents from the company's web-site. This is also the case in France.

Electronic voting at the meeting, by those present, is not perceived as raising specific legal issues. However, the use of electronic casting of votes by absent shareholders is more difficult. Many jurisdictions deem that it is not possible under present company law rules. Some countries envisage to adapt their statutes to permit electronic voting: in France, an increasingly debated draft provision states that when electronic voting takes place, the respective shareholders will be included in the count for quorum and majority. The rule would be applicable in all companies, listed or not. Draft legislation in Germany would not allow electronic voting as such. However, the use of electronic communication techniques in the transmission of voting instructions between the shareholder and the bank with which the shares have been deposited would be possible. The United Kingdom proposed amendments to the Companies Act do not deal with voting. However, the Company Law Review proposes to further investigate certain issues related to electronic voting.

The market for commercial corporate governance services via the Internet is also expanding. JP Morgan investor services is currently launching an initiative for a common world-wide standard for transmission of shareholder meeting agenda notices and proxy voting forms and instructions. JP Morgan investor services is proposing that SWIFT, the Belgium-based operator of a secure messaging network for financial institutions, convene a summit of vendors, investors, custodians, companies and others to agree on a single transmission protocol. If successful, the initiative could pave the way for electronic voting of shares in all markets.

Furthermore, investors can benefit from increasing competition among providers of electronic access to worldwide proxies. For example, investors currently have a choice among companies supplying electronic access to proxies in approximately 50 countries. This is likely to boost foreign shareholder voting. However, important problems remain in the smooth operation of cross-border share voting systems.

Continued harmonisation of disclosure practices and reporting standards

The trend towards harmonisation of accounting/disclosure practices and reporting standards around the world was further reinforced in 2000. A Survey by the World Economic Forum /Deloitte Touche Tohmatsu on Corporate Performance highlights the strong support of CEOs for the current steps towards more global accounting and auditing standards. They also recognise the importance of efforts by the International Forum for Accountancy Development (IFAD)⁴ to create the partnership of public and private sector interests necessary to establish a global framework of financial responsibility.

There is also a growing recognition across Europe of the importance of a common business language for accounting and governance. A PriceWaterhouseCoopers survey published in 2000 aiming to explore the perceptions and current understanding of IAS among publicly listed companies reveals that 79 per cent of European CFOs support the European Commission requirements for listed companies to use IAS by 2005. Seventy five per cent of those questioned thought it would be useful to adopt IAS ahead of this deadline. The survey was related to companies in the EU and Switzerland and covered 717 companies. Asked whether IAS should be mandatory, 79 per cent were in agreement. The reasons given for using IAS were mainly for business strategy purposes (financing, acquisitions, etc.) and in order to bring clarity, credibility and international comparability to their financial reports.

There also seems to be a growing consensus on the valuable role, which audit committees can play in helping to ensure quality financial reporting and effective internal control. Investors in many OECD countries take a more active interest in audit committees and in the absence of audit committees, they ask management critical questions about governance arrangements. The independence of audit committees is another important issue. As indicated in the first section of this report, in late 2000 the United States SEC has adopted rules establishing clear guidelines on how to enhance the independence of audit committees, improve communication with the board and management, and most importantly on the involvement of audit committees in safeguarding the independence of outside auditors.

Emergence of free-float indexes

In the current market environment, where there has been a substantial increase in assets managed on an indexed basis, investors have become increasingly concerned with the ability of benchmarks to capture the equity market. There has been a growing concern about the existing system of calculating indexes directly on the basis of market capitalisation, with no regard to the liquidity of the stocks and the ensuing distortions in the market. In response, some of the international firms publishing equity market indexes have announced their intention to calculate them in future on the basis of the free-float, or the proportion of issued shares in each company that can actually be traded, as opposed to total market capitalisation.

4. In June 1999, the Big Five accounting firms, along with the international association of the accounting and auditing profession and international organisations, established IFAD in order to raise accounting standards worldwide to the levels of the IAS.

FTSE, one of the leaders in the creation and management of equity indexes, has introduced a free-float adjustment for new constituents in 2000. Weighting factors will be applied for existing constituents from June 2001. Morgan Stanley Capital International (MSCI) has announced its intention to proceed with free-float adjustment to the constituents of its widely tracked investment indexes in 2001. Furthermore, some stock exchanges in OECD countries are also planning to proceed with modifications to their indexes. For example, as mentioned earlier in this report, *Deutsche Borse* is debating the adjustment of the DAX-30 and the second-tier index M-DAX-70, as of June 2002, to reflect only the capitalisation of one class of shares, which are in free-float.

The introduction of weighting adjustments can be expected to impact on benchmarks and on the strategies of global fund managers. Passive investors may have to make portfolio adjustments re-balancing in order to track a modified benchmark, while active investors will have to consider their overweight and underweight stock and sector positions relative to a new benchmark. Therefore, the introduction of weighting factors by MSCI, FTSE and some stock exchanges could result in wide-ranging portfolio shifts.

Re-weightings could have implications for ownership and control in markets with a relatively high proportion of companies with state holdings or cross-shareholdings. Germany could serve as an interesting example for the changes, which could be brought about by the adjustment of indexes to free-float. As a result of the index change, German companies with a dual structure of shares -- common shares, which have voting rights and preferred shares, which do not -- might see their market weight fall significantly if they do not pool their stock. In response, two large DAX-30 companies -- SAP, the software group and Metro, the retailer -- have already begun converting preferred shares into common shares.

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