Original Article

General commentary on European Union corporate governance proposals

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ABSTRACT **The European Commission has put forward an interesting set of questions about how to improve corporate governance, within its 'Green Paper: The EU Corporate Governance Framework' (Green Paper, 2011). The following provides analysis and the responses by a working group of authors in Canada to these questions based on the experience and research of the group (academics and practitioners) and the relevant literature.**
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INTRODUCTION

The European Commission, in response to the governance failures that came to light in the credit crisis, is considering fundamental changes to European governance systems. As a step towards that goal, the EU has put forward a series of questions that examine essential aspects of governance, that is, what it involves, who it applies to and how it can be enforced. Whether these are the only or best questions that can be asked in this context is not the issue in this article, but rather, we see addressing them as an opportunity to bring to the reader the latest in governance research, as well as lessons from experience with the governance regimes in other regions, notably Canada, the United Kingdom and the United States.

This article is authored by a working group of academics and practitioners, with expertise in governance and various sub-governance domains. Members of the group have advised and worked with boards, regulators and companies that have become recognized for their leading governance practices. It is these experiences and the literature upon which we also draw.

Twenty-three of the 25 questions have been addressed below. Each question appears, followed by our group's response. Two of the questions (questions 13 and 16) were not addressed owing to the time constraints of the submission (which was due on 22 July 2011) and the group felt that it did not possess all of the requisite expertise.

At the outset, the European Commission should be congratulated for establishing a high-level governance forum for discussions and debates and for the exchange of experiences. The need for a clear road map through the shifting and confusing terrain of corporate governance is very compelling. In a global marketplace, the solutions and recommendations championed in Europe will have a profound effect on governance standards in Canada and elsewhere.

In this article, the authors address in detail the need for improved governance in the areas articulated by the EU. First we consider the need for similar or different standards for Small

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and Medium-sized Enterprises (SMEs) and unlisted companies. Then we focus on board recruitment, diversity and ways to improve the effectiveness of individual directors and boards. The critical area of governance over remuneration is then subject to our analysis, and we then assess ways to improve the board's role in the governance of risk, of asset managers and of proxy advisors. Ensuring adequate shareholder engagement is next addressed, as well as minority shareholder interests. Lastly, we make recommendations for improvements in the implementation and monitoring of governance codes.

Background: Canadian corporate governance practices

We believe that Canada is a leader in corporate governance practices and, given that our group members are primarily Canadian, we draw on many of the initiatives here to frame our response to the EU deliberations. We also draw on global developments, including those in the United Kingdom and United States.

Canada has adopted the Anglo-American, unitary model of corporate governance. Our companies, however, operate within different ownership structures, legal and linguistic dualities, geographic diversity, and a decentralized regulatory regime of 13 provinces and territories. We have companies that are state-owned, family, significant shareholder, small and medium-sized listed, as well as widely held, not dissimilar to the diverse plurality and tapestry within the European Union.

Canada has had formal corporate governance guidelines in place since 1994 (Dey *et al*, 'Where were the Directors?') within a flexible 'comply or explain' approach. There has been time to digest and assess a continuously evolving corporate governance landscape, as companies and boards adopt guidelines and practices to suit the foregoing diverse circumstances, in a flexible manner.

The Canadian corporate governance guidelines, most recently revised in 2005 (Canadian Securities Administrators, 2005), have been adopted and adapted by companies within the listed sector, and through osmosis and other best practices, within private, governmental and not-for-profit sectors as well. It is upon this experience that we also draw for our responses.

The EU questions now proceed sequentially.

THE GOVERNANCE OF SMEs AND UNLISTED COMPANIES

Instituting a corporate governance regime for SMEs

1. Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.

Inevitably, good governance will look somewhat different depending on a company's size and complexity. But, a diminutive corporate size, we maintain, is not a suitable reason to relax or diminish the principles of good governance. There is a compelling business case to be made for smaller companies to adopt good governance principles and to adhere to – or aspire to – lofty governance standards as a goal.[1] The need to create standards and behaviours that add value by adopting good governance principles is as important for SMEs, we argue, as for larger enterprises.

For the purposes of this discussion, we use the definition of SME adopted in 2008 by the Department of Business, Innovation and Skills (BIS), in the United Kingdom. BIS defines a small business as one employing fewer than 50 people and a medium-sized company as one that employs between 51 and 250 employees. Within these two brackets, there is considerable diversity – from small owner-manager company, to small, dynamic technology companies with significant growth potential, to family-owned and family-operated businesses, to relatively mature companies that are approaching in various dimensions the larger listed-company model.

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For one thing, SMEs, although overshadowed in the business press and in the public consciousness by larger market-cap companies, are in many ways the lifeblood of most economies and markets in Europe, in North America and elsewhere. To state the obvious, SMEs are, in many cases, the next generation of large market-cap enterprises. Eventually, as larger enterprises, many of these companies and their governance practices will increasingly come under the microscope and be subjected to heightened scrutiny by shareholder activists. If SMEs have (or 'are') not begun with a proper corporate governance culture, it becomes more difficult to acquire this as they grow.

Second, all SMEs operate within much the same legal and regulatory framework as larger listed or unlisted companies. The characteristics of this framework include the following:

(a) Separate legal status independent from its shareholders.
(b) A constitution comprising (among other things) by-laws.
(c) A code of directors' duties including a requirement to promote the success of the company for the benefit of its members as a whole.
(d) Legal and common law provisions relating to health and safety, the environment, employment and tax.
(e) Maintaining proper records, including books of account and financial statements.
(f) Filing annual returns with company regulators.

Corporate theorists – at least the modern ones – will dissect a corporate enterprise, regardless of size, into a varied assemblage of stakeholders including, among others, employees, creditors, suppliers, community groups and so on. Given the similar legal and regulatory frameworks, SMEs should, in our view, be subjected to the same governance standards as those for larger companies.

Third, SMEs are more likely to suffer from a lack of governance assessment and compliance, a lack of financial sophistication, and an absence of independent board members.[2] Investors in SMEs cannot rely on the institutional activists such as Institutional Shareholder Services Inc. (ISS) – who police rigorously the marketplace of larger enterprises to ensure proper disclosure, adequate financial controls, and anti-fraud and anti-corruption protections – to be vigilant and to monitor the periodic filings of SMEs. Maintaining strong governance requirements remains, therefore, part of the essential investor protection for investors in SMEs.

The Securities and Exchange Commission (SEC) has facilitated the offering process for large market-cap offerors – referred to as WKSIs or well-known seasoned issuers – by issuing Rule 405 under the *Securities Act of 1933* for companies with a market cap generally in excess of US$700 million. Interestingly, the governance provisions of the *Sarbanes-Oxley Act of 2002* or the *Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010* have not been relaxed by the SEC in favour of WKSIs or any other high-quality issuers. In fact, the internal controls over financial reporting set out in Rule 404 of the *Sarbanes-Oxley Act* and the requirement of preparing and filing attestation reports have proven to be expensive and burdensome for issuers of all sizes to comply with – although, declining recently relative to revenues – and have driven a significant number of New York Stock Exchange registrants – large and small – to de-register from the Exchange.[3]

Faced with questionable investment opportunities such as Sino-Forest Corporation (a commercial forest plantation operator in China), investors, in our view, need the support and protection offered by tough governance provisions.[4] Core governance principles are essential to the integrity of and public confidence in the capital markets; so much so that they must, in our view, be applied uniformly to all listed companies – including SMEs.

One countervailing argument in favour of a differentiated corporate governance regime is the disproportionate financial burden faced by smaller companies on designing and implementing

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suitable governance practices. The issue is one of fairness. Crippling costs associated with the design and implementation of governance measures will swiftly snuff out the entrepreneurial spirit among the officers and boards of many small companies. While not advocating a return to a regulatory 'Wild West', adherents to this argument do want to encourage and nurture a healthy entrepreneurial environment. Such proponents view the imposition of burdensome governance standards on all companies as an impediment to SMEs seeking listings as a capital markets option.

Alternative Investment Market (AIM) companies

The United Kingdom is a jurisdiction with a two-tier system of governance principles and standards with the AIM frequently described as 'lightly' regulated by the London Stock Exchange as compared with the more 'tightly' regulated main market (Mellor, 2008, p. 29). Recent governance surveys by PricewaterhouseCoopers and others have concluded that the record of AIM companies on governance issues is 'patchy' (Mellor, 2008, p. 38). In our view, this is unacceptable. Like Cadbury, Hampel and Higgs, our starting point is that 'high standards of corporate governance are as important for smaller listed companies as for listed ones. All public companies, irrespective of size, have obligations to their owners' (Higgs, 2003, p. 71).

Quoted Companies Alliance (QCA) Code

In 2010, the Quoted Companies Alliance (QCA) promulgated a set of Corporate Governance Guidelines for Smaller Quoted Companies (QCA Code, 2010). The key underpinnings of the QCA Code include transparency and trust between boards and shareholders, constructive and active engagement between shareholders and company boards, and high quality communications by boards. The QCA Code also acknowledges that each company has its own set of circumstances – robust corporate governance processes need to be tailored accordingly.

Our response

We do not accept the suggestion for the EU corporate governance code to have a differentiated or multi-tier structure with selected governance provisions only applying to companies above a specified size threshold. We do not believe that corporate governance provisions can be prioritized, with some governance provisions falling into the universal bucket of corporate governance measures applicable to all listed companies and other provisions being relaxed or eliminated for SMEs. We do not agree that the difficulties or challenges in applying corporate provisions across the range of structures, sectors, characteristics and sizes of companies are insurmountable. And, we do suggest that a line-drawing exercise between SMEs and larger enterprises for corporate governance reasons is so perilous and fraught with complexities and second-guessing that it should be avoided at all cost.

Bottom line, the need for a uniform architecture of governance provisions is paramount. Investors and other stakeholders must be able to expect basic governance provisions in all listed companies including SMEs.

For smaller listed enterprises, they should be provided limited flexibility through a 'comply or explain' governance model. In our view, companies – including SMEs – should be able to explain and justify non-compliance with any aspect of the governance code that is uncomfortably burdensome or non-compatible with the company's prevailing circumstances.

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Instituting a corporate governance regime for unlisted companies

2. Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?

Whether one uses the terminology 'close corporation', or 'private corporation' or 'unlisted corporation' or 'non-listed corporation', governance of the closely held enterprise will differ significantly from governance of other corporate

entities. In all cases, the unlisted company will exhibit one or more of the following characteristics: (i) share ownership is evidenced only by certificated securities held by no more than a specified number of holders or record; (ii) all of the company stock is subject to some restriction on transfer; and (iii) no public offering of company shares is permitted.

How are governance standards and principles different for a non-listed company as compared with standards and principles for listed companies? We offer some examples.

First, under the Delaware corporate statute (2011), stockholders of a close corporation holding a majority of the stock of the company can, in certain circumstances, agree in writing to restrict the discretion or power of the board of directors to manage the business and affairs of the enterprise – and such an agreement is not invalid simply because it restricts directorial discretion. In these circumstances, the directors are relieved of liability 'for managerial acts or omissions … to the extent and so long as the discretion or powers of the board in its management of corporate affairs is controlled by such agreement'.

Similarly, the Delaware corporate statute permits the charter document of a close corporation to provide that the 'business of the corporation shall be managed by the stockholders … rather than by a board of directors'. This language effectively supplants the role of the board in corporate management. In this case, the stockholders are deemed to be directors and assume the directorial liabilities accordingly.

Thus, Delaware corporate statute law allows owners of a close corporation to vary the ordinary role of directors in corporate governance.

What corporate governance measures should be introduced for unlisted companies? What should be the governance priorities for unlisted companies that want to improve operational and financial performance through better governance?

The diversity of unlisted companies ensures that there will be no 'one size fits all' governance solution or approach for unlisted companies.

ecoDa governance principles

A set of governance guidelines has recently been promulgated by the European Confederation of Directors' Associations (ecoDa). Under the title *Corporate Governance Guidance and Principles for Unlisted Companies in Europe*, ecoDa stresses that good corporate guidance for unlisted companies is not primarily focused on the relationship between boards and external shareholders as is the case with listed companies. Nor is it focused on box-ticking and regulatory compliance with rules and regulations. Rather, good governance for unlisted companies is centred on building a framework of company processes and attitudes that add value to the business, as well as building reputation and profile and ensuring long-term sustainability and success.

Shareholders of unlisted companies have a limited ability to sell their ownership stakes. An absence of liquidity dictates that shareholders are committed in most instances to remaining an investor in the company for the medium to long term. Investors' dependence on good governance in unlisted companies is, thus, heightened.

Our response

Our view is that the governance issues faced by unlisted companies have been relatively neglected to date by governance commentators and experts. This neglect should be remedied immediately by adopting the 14 governance principles promulgated by ecoDa. Above all, though, the essence of the closely held enterprise – its vision, its mission and its values – is what matters. The detailed governance framework for unlisted companies, in our view, should be firm and transparent without being stifling or burdensome. Indeed, the ecoDa governance principles and the related guidance stress that a firm's governance framework should be implemented in a way that is both proportionate and realistic. And it should evolve over the company's business and operational life cycle (Bain and Barker, 2010, p. 155).

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BOARD RECRUITMENT: LEADERSHIP, SKILLS AND DIVERSITY

Division of function and duties of the board chair and CEO

3. Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?

The EU should take reasonable steps to ensure that the functions and duties of the chair of the board of directors and the CEO are clearly divided. The rationale for this division of duties is the conflict of interest if a CEO is accountable to a board led by him- or herself.

The division of the functions and duties of a 'non-executive' chair (Green Paper, p. 5) from those of a CEO, however, is inadequate to ensure the *independence* of this chair (Leblanc and Pick, 2011). The chair should be independent from management of the company, of any 'dominant or controlling shareholder' of the company (Green Paper, p. 11), and of any other relationship or association that could be reasonably perceived to compromise this independence. The basis of this independence of the chair should be affirmatively determined, published, and readily accessible by investors and other key stakeholders.

The identities, functions and duties of the chair of the board of directors, of the chair of each principal committee of the board, and of the CEO and the most senior financial officer (CFO) should be published and accessible in the form of clear position descriptions. These position descriptions should delineate roles, responsibilities, accountabilities and competencies required for each role, together with competencies and other attributes possessed by the incumbents to the positions. The EU should consider providing guidance or descriptors to ensure that these position descriptions are sufficiently detailed and complete and not boilerplate in nature.

These position descriptions should form the basis of the appointment, performance assessment and succession planning. Position descriptions for the board and committee chairs and the CEO are quite common in Canada, since publication of National Policy 58-201 (2005, section 3.5), and good examples can be found at the Canadian Imperial Bank of Commerce (2010) and Cameco Corporation (2011) (bank and natural resource company, respectively).[5]

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Director recruitment, with a view to ensuring the right skills and diversity

4. Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance, that is at national, EU or international level?

Recruitment policies should be more specific about the profile of directors, including the chair, to ensure that boards have the right skills and are suitably diverse. This objective can be achieved by the following response:

- The skills, knowledge, experience and attributes possessed by individual directors should be published and accessible in the form of a 'competency' or 'skills' matrix, wherein the competencies that the board as a whole should possess are listed, defined, revised as necessary, and the number of directors possessing varying degrees of various competencies are affirmatively determined and validated (Leblanc, 2009).

A definition for competency: 'synthesized from the suggestions of several hundred HR experts at a Johannesburg conference, is "a cluster of related knowledge, skills and attitudes that affect a major part of one's job (a role or responsibility), that correlates with performance on the job, that can be measured against well-accepted standards, and that can be improved via training and development"' (Parry, 1998).

Two examples of a director competency matrix include those of Nexen Inc. (2011)

and BHP Billiton (2010).[6] The results of a competency matrix assessment are intended to result in a gap analysis and a profile for the nomination of prospective directors; inform the committee rotation and retirement of incumbent directors; and be utilized in identifying prospective directors for membership on the board.

Director profile

In becoming more specific about the profile of directors, best practice is that the background for each director should be published and accessible (including on the company website), including independence and the basis of determination, age, tenure, domicile, meeting attendance, compensation (all forms, including cash, shareholdings and stock-related instruments), committee chairship and membership (as applicable), educational activities, other directorships, and individual areas of expertise. This disclosure should be clear, complete, current, accurate, understandable, and use updated website technology and design.

Desired attributes possessed by directors should also be published. These attributes may include accountability, independent-mindedness, business judgement, communication skills, teamwork, commitment and analytical abilities.[7] A position description for individual directors should also be developed, published and regularly revised.

Canadian National Policy 58-201 (2005, section 3.12 (B)) is explicit with regard to the importance of qualities of directors and determination of the board dynamic: 'Attention should also be paid to the personality and other qualities of each director, as these may ultimately determine the boardroom dynamic'. See also Leblanc and Gillies (2005, chapter 8) regarding director behaviour.

Board chair profile

For the board chair, two important competencies would include leadership skills and industry knowledge (Walker *et al*, 2009, p. 60; UK Code, 2010, pp. 9–11). Others would include independence, integrity, holding others to account, and coaching and development.

Ensuring board diversity

The foregoing responses, in respect of director (and chair) profile and competencies, may be implemented at the national, EU or international levels of governance. These responses may *not*, however, necessarily ensure that a board is suitably diverse, depending on how 'competency' and 'diversity' are defined, treated and made transparent by the board to stakeholders. Diversity is introduced and addressed in this section, given the definition and positioning of diversity within a director competency matrix and an overall director profile; however, a more fulsome response to a question on diversity follows in the next question.

The strong desire for executive experience – and in particular, CEO and C-suite operating experience – as part of a board makeup, could have the undesired effect of systemically discriminating against women and minorities.

Therefore, some boards have chosen to accord primacy to diversity considerations explicitly, in the form of designated groupings for individuals (for example, women, visible/racial minorities, Aboriginal Peoples and persons with disabilities, as a Canadian example) within a competency matrix.

In addition, some boards have exercised care in defining competencies (such as different forms of leadership, market knowledge, board experience and functional capabilities) with a view to being inclusive and not unintentionally disadvantaging prospective directors, but still draw on the best-qualified directors to lead the company.[8]

Some forms of diversity – for example professional diversity and gender diversity, as identified in the Green Paper – may transcend nation state boundaries (for example, financial acumen and women, as examples from the Green Paper). There are, however, nuances – such as industries that have been, and still are, male-dominant (mining or heavy industry, for

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instance); whereas other industries have made somewhat greater progress towards achieving (but certainly far from reaching) desired gender parity (for example, financial services or consumer products industries) at board and senior management levels. Companies may operate in certain languages, milieus and jurisdictions, and doing so may affect the need for international diversity (the third type of diversity identified in the Green Paper). Therefore the talent pools (or the supply of directors) and the needs (or the demand for directors) may not be equal or generalizable across industries and jurisdictions. Therefore diversity considerations (in all of its forms[9]) should address this reality.

BOARD DIVERSITY

Disclosure of diversity policies, including objectives and progress reporting

5. Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?

In the aftermath of the global financial crisis, board diversity has been at the forefront of societal debates, as it is recognized that there are systemic barriers preventing equal opportunity and a belief that diverse boards may produce more effective decision-making and mitigate groupthink within boardrooms.

Arguments for greater diversity in boardroom representation have been explored following two approaches – economic and moral. The first is based on economic arguments and considers that firms who fail to select the most able candidates damage their financial performance. For example, excessive compensation has also been tied to the absence of cultural diversity in the boardroom (Malsch *et al*, 2011). Benefits to gender-diverse boards that some studies have identified include higher attendance, enhanced monitoring roles and a greater propensity to replace poorly performing CEOs (Leblanc, 2011a, p. 8). Diversity policies for board members have also been suggested as one way of tackling problems and rejecting the groupthink that may have contributed to the challenges we face (Ernst and Young, 2009). Overall, the empirical literature regarding the business case for gender diversity on boards is mixed, including findings that 'the ability of women directors to influence profitability and shareholder value is contingent on the specific circumstances of each company' (Simpson *et al*, 2010, p. 1); that there exists no significant relationship between gender or ethnic diversity of directors and financial performance (Carter *et al*, 2010, p. 396); and the opposite, namely that there are 'significant positive relationships between the fraction of women or minorities on the board and firm value' (Carter *et al*, 2003, p. 33).

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The second argument for greater board diversity rests upon a moral viewpoint, arguing that it is wrong for women, for example, to be excluded from corporate boards on the grounds of gender. Although research cannot clearly prove or disclaim the financial benefits of greater diversity for all firms, the moral case has gained attention and is seen as sufficient to drive change. Such being the case, we suggest that companies be legally required to ensure a better gender balance on boards.

There are different approaches to increase the representation of women on boards: coercive measures via government intervention as initiated by Norway in 2002, or a more liberal approach that relies on voluntary corporate commitment, such as is seen in North America. An interesting alternative 'report or explain' model was recently put in place (2011) by the Australian Securities Exchange's Corporate Governance Council urging companies to disclose:

(a) the measurable gender diversity objectives set;
(b) the progress towards achieving them; and
(c) the proportion of women within the board and senior management.

Companies are not required to commit to these diversity measures, but they are required

to explain their decision in their annual report. While it is too early to assess the full impact of the Australian model, since the changes were announced, women have gone from 5 per cent of new board appointments to 27 per cent (Department for Business Innovation and Skills, 2011).

The main objective of a diversity policy is, first and foremost, to compel directors and senior officers (at the very least) to reflect on their position with regards to diversity of board and senior management membership, and then to inform stakeholders on their chosen objectives and their progression.

In our opinion, the European Commission should go beyond the US model adopted in late 2009 by the Securities and Exchange Commission, whereby companies are required to disclose: (i) whether, and if so how, a nominating committee considers diversity in identifying nominees for director; (ii) whether a company has a policy with regard to the consideration of diversity, in identifying director nominees; and (iii) how this policy is implemented and its effectiveness is assessed. While it is too early to evaluate the impact of this US directive, in our view, there is too much ambiguity in the interpretation and the possible application of this directive (Aguilar, 2010).[10]

The advantage of the Australian model lies in its clarity and measurability. Australia defines diversity to mean include 'gender, age, ethnicity and cultural background' (ASX, 2010, p. 24). However, failure to comply in both the United States and Australia does not appear to result in regulatory penalties or delisting.[11] It seems reliance on resulting bad press and investor and other stakeholder scrutiny following failure to report was deemed sufficient. On this point, we feel the European Commission should incorporate penalties/sanctions to give diversity disclosure regulation traction and in the hopes of avoiding the more extreme solution of gender quotas, which have the advantage of quickly transforming gender in boardrooms, as has been the case in Norway; however, this most extreme option is often greeted with much opposition.

Ensuring better gender balance on boards of directors

6. Should listed companies be required to ensure a better gender balance on boards? If so, how?

Legislators, advocates and academics have long followed board composition, including the slow advancement of women onto corporate boards despite four decades of equal opportunity policies (Terjesen *et al*, 2009). At the current rate, it is estimated that it will take more than 70 years to achieve gender balanced boardrooms in Canada, for example.

Regulatory approaches to board diversity range from rules requiring disclosure of diversity plans by boards, with 'diversity' itself sometimes undefined by the regulator (as in the United States, established in 2010), to hard gender quotas. Such quotas range from 20 per cent to 40 per cent (in jurisdictions such as: Norway, France, Spain, Belgium and Iceland).

The recent Canadian experience, which includes the defeat of Senate Bill-206 mandating a 50 per cent quota on boards, illustrates the highly controversial nature of quotas. However, the voluntary corporate commitment measures adopted in the United States are not likely to yield significant results. Therefore, we suggest a middle approach based on the Australian regulation, which defines diversity and requires that measureable targets be set in order to assess objectives and evaluate progress. The hope is that 'what gets measured gets done'.

However, women have concerns about the need for appointments to be seen to be made on merit. Therefore a 30–40 per cent target strikes a sensible balance to achieve better representation without tokenism (McKinsey & Company, 2008). Our response is that these targets include a timeline and that they be accompanied by greater transparency in recruitment processes that could range from public posting of board positions to a detailed description of

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the mix of skills each board member brings to the table.

INDIVIDUAL DIRECTOR AND BOARD EFFECTIVENESS

Limiting the number of external directorships that directors may hold

7. Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?

Duty of care

To state the blindingly obvious, a cornerstone principle undergirding all governance codes is that directors must dedicate sufficient time to fulfil their duties as board members. This basic duty is referred to as the 'duty of care' (or the 'duty of attention').

As the name implies, the 'duty of care' involves the concern, attention, skill, devotion, involvement, commitment and diligence that directors are expected to exercise in discharging their duties. The duty of care is a common law doctrine – that is, one created by judges and judicial decisions or opinions – although many jurisdictions have codified the essential elements of the duty.

Various commentators have pointed out that 'care' has a somewhat specialized meaning in this governance context. It must not be confused with 'caution'. After all, taking measured or reasonable risks is an essential part of doing business.

But 'care' clearly *does* entail on the part of directors a commitment, dedication and ability to contribute necessary time, preparation, study and reflection. (NACD, 2005a, pp. 32–34).

Two astute and experienced commentators on governance matters, Martin Lipton of Wachtell, Lipton, Rosen & Katz of New York and Jay Lorsch of the Harvard Business School, have concluded that: 'Based on our experience, the most widely shared problems directors have is a lack of time to carry out their duties' (Lipton and Lorsch, 1992, p. 64). That is, directors' responsibility to oversee management is undermined by the fact that many directors are unable to devote sufficient time or resources to the task. This observation obviously has considerable bearing on whether directors should be limited or restrained in accepting additional governance mandates (Monks and Minow, 2008, p. 261).

Lipton and Lorsch continue by stating that, for a director to do his or her job properly, he/she needs to devote at least 100 hours annually to the role. More recent analyses suggest that directors must be able to devote at least 250 hours a year to each board position *where the company has no specific problems*. When there is a crisis, that marker can quickly escalate to full time. Because so many directors serve on more than one board, in addition to having a full-time career, they may not be able to contribute or dedicate the appropriate amount of directorial time.

Interestingly, the countervailing argument in favour of individuals filling a large number of governance roles concurrently has numerous adherents. Anecdotally, one can point to many leaders, giants and stalwarts in the governance field who have served successfully on many corporate and non-profit boards simultaneously (Dimma, 2006, p. 183). Directors, it is argued, improve their judgement and decision-making abilities by expanding their portfolio of experiences. We agree with this perspective – but only up to a point. Diminishing returns set in at some point for all individuals. Indisputably, all directors, as pointed out by Lipton and Lorsch, eventually become ineffective in fulfilling their governance responsibilities because of time deficits.

Solutions to overboarding

What is the solution to what we refer to as 'overboarding' or excessive board positions held by individual directors?

Our experience suggests that simple solutions do not work in complex environments. Therefore, a simple formulaic cap on numbers

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of board positions, for the following reasons, is not a feasible answer:

First, different corporate boards require differing levels of involvement and time commitment by individual directors. Imposing a maximum number of board positions on individual directors assumes a somewhat similar set of expectations of board members by all companies in all sectors. This assumption is clearly flawed. The varying complexity of issues considered at the board level; the significant issues imposed by insolvency situations; the challenges and time pressures associated with material mergers, acquisitions, restructurings and financings; the evolving regulatory environment and its impact on companies; the ongoing operating dynamic between boards and management teams; the reliance on board committees to analyse, investigate and resolve important issues; and the operating challenges encountered by various companies – all these realities generate differing levels of monitoring and decision-making by boards. These factors, among others, have a significant bearing on the amount of director time required to fulfil directorial and other governance responsibilities.

Second, there are many weighty distractions experienced by directors that influence whether a director is able to dedicate sufficient time to fulfil his/her governance duties. Other board positions, health issues and complications, travel obligations, family commitments, extracurricular interests, and career and related work responsibilities are just a few. Because these distractions are experienced in varying degrees by individual directors, it is inappropriate – perhaps impossible – to generalize about directors' abilities to absorb or take on additional responsibilities and tasks.

Third, individual directors have varying capacities to cope with the responsibilities associated with multiple director positions. Cries of 'unfair' and 'inequitable' would greet any attempt to standardize limits or thresholds on numbers of director positions assumed concurrently by individual directors. Those directors who have a compelling understanding of important governance issues or who are prepared to dedicate extraordinary time to deal with, and understand, and analyse, and reflect upon important governance issues should have the ability to assume multiple board positions as long as these directors adequately fulfil all of their governance responsibilities. Penalizing individuals who demonstrate an unwavering dedication and commitment to become 'professional directors' would be wrong.

Finally, any regulatory or legislative initiative to limit board positions by individual directors may have a negative impact on the availability of sufficient suitable directors to fill vacant board positions and future vacancies. Experienced directors might be denied the opportunity to take on additional directorships. Also, a limit on concurrent board positions may (but not necessarily as the pool would be bigger) have a more pronounced impact on the ability of small private enterprises to recruit effective and experienced directors because if an individual corporate director is limited to a maximum number of directorial positions, he or she will likely opt for the better-paying and higher profile large enterprises.

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What, then, are the effective solutions to overboarding?

Moral suasion – or encouraging a reasonableness standard on maximum board positions for individual directors – has been tried by some companies. Without setting a numerical cap on board memberships, some public boards stipulate that all board members should have 'significant time available to devote to board activities, to enhance their knowledge of the relevant industry and related industries, and to attend annually some meaningful per cent (say, 90 per cent) of the scheduled board and board committee meetings'. Each board member is encouraged to limit the number of other public company boards on which he or she serves so that such other directorships and commitments do not interfere materially with his or her services as an effective member of the company's board.

The Higgs Review of 2003 – under the leadership of Derek Higgs and which built

upon the governance building blocks created by Sir Adrian Cadbury and Sir Ronnie Hampel and Sir Richard Greenbury – offers a very useful sample retainer letter for non-executive directors. The letter states in part:

> Overall we anticipate a time commitment of [number] days per month after the induction phase. This will include attendance at [monthly] board meetings, the AGM, [one] annual board away day, and [at least one] site visit per year. In addition, you will be expected to devote appropriate preparation time ahead of each meeting.
>
> By accepting this appointment, you have confirmed that you are able to allocate sufficient time to meet the expectations of your role. The agreement of the chairman should be sought before accepting additional commitments that might impact on the time you are able to devote to your role as a non-executive director of the company. (Higgs, 2003, p. 107)

Other companies have created a numerical threshold, which prevents directors from exceeding a formulaic cap in terms of other professional activities and offices held in associations. Appointments as an executive director or as a non-executive director are assigned weightings, which, in the aggregate, cannot exceed a specified arithmetic threshold. The weightings are further adjusted depending on whether the position is with a listed or unlisted company and whether the work commitment (measured in days per month) is significant or not. Further, the board may, under certain circumstances, grant exceptions to the formulaic rule.

Other companies have imposed numerical limits on the number of 'administration and control offices' that can be held concurrently with executive director and non-executive director positions. The limits vary considerably. As a non-executive director, the range of maximum additional offices held concurrently is between three and six whereas for an executive director the range is between zero and three (NACD, 2005b).

ISS, an influential proxy voting organization, is a leading provider of corporate governance solutions to the global financial community. Institutional investors rely on ISS to help them make informed investment decisions on behalf of the owners of companies. ISS has recommended proxy voting guidelines relating to, among other things, overboarding. As a general rule, the ISS cap is set at five board appointments. And there are reduced additional-appointment levels recommended for executive directors and chairs.

Our response

Instead of limiting the number of board mandates held concurrently by a director, we advocate full disclosure of all executive and non-executive positions held by individual directors. We also respond by suggesting transparency in terms of committee work, projects, task forces and other significant commitments and obligations by individual directors for all organizations. Finally, the reporting of individual director evaluation outcomes, particularly when they identify time commitment and other possible shortcomings by individual directors. On the basis that sunlight is the best disinfectant (Brandeis), we believe that full disclosure of governance responsibilities assumed by individual directors will gradually drive overboarding offenders to relinquish excessive governance positions.

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Regular external board evaluation of board effectiveness

8. Should listed companies be encouraged to conduct an external evaluation regularly (for example every 3 years)? If so, how could this be done?

It is becoming a recognized best practice for boards to evaluate their performance as a basis for identifying opportunities for improving their effectiveness as a board. However, there is an inherent conflict of interest in any body assessing its own performance. If or when a board of directors lacks the time or resources to carry out the evaluation, and the evaluation is conducted

internally to the company, management may design an evaluation questionnaire and administer the results. This could also be a conflict of interest (that is, the reasonable perception of self-interest on the part of management in participating in an evaluation that includes oversight of themselves) that could affect board evaluation design, anonymity, candour, results and reporting. In addition, if a board chair carries out or oversees the evaluation (or even impedes or unduly influences it), and if there exist concerns with the chair's performance, this factor may also compromise the effectiveness of the evaluation and hence of the board.

There is merit, therefore, in encouraging boards of directors to have an external evaluation (including evaluation of board committees and individual directors) conducted regularly (for example, every 3 years), for independence, rigour, objectivity and assurance purposes. This approach has been adopted in the United Kingdom (UK Code, 2010, B.6.2, p. 17), where FTSE 350 companies are required to have an externally facilitated board assessment at least every 3 years. However, there has been inadequate guidance offered within the UK Code on how external evaluations should occur, which is the area upon which the Green Paper requested commentary. We offered the following response, in some detail, based on experience undertaking independent external evaluations of boards of directors.

Role of the governance committee

The governance committee of the board should possess explicit authority within its charter to appoint, compensate, oversee and retain an external board evaluation provider – similar to authorities for audit and remuneration committees to retain auditors, remuneration consultants, legal counsel and other advisors, respectively, subject to shareholder approval as necessary. Management, the board chair or a significant shareholder should not unduly influence the selection of, the relationship with, the reporting by, or the findings of, the board evaluation provider. The board evaluation provider should consider the governance committee to be the client, and should be accountable to that committee rather than to management. The governance committee, in its discretion and within its charter, should be empowered to conduct an executive or in-camera session with the board evaluation provider (or the full board in the judgement of the governance committee), at any stage in the evaluation (inception and interim or final reporting).

External board evaluation provider

The external board evaluation provider retained by the governance committee should be independent, qualified and restricted from providing non-board evaluation-related services (for example, consulting, head-hunting or any other services that would give rise to a conflict of interest). The board evaluation provider's remit should include facilitating the evaluation of the board (including the board chair), the standing committees of the board (including committee chairs) and the individual directors.

Information should be collected and analysed by the board evaluation provider for report preparation purposes from a questionnaire(s) of directors at a minimum (and, ideally, certain members of management if considered appropriate in the view of the governance committee and anonymity is protected); from interviews between the board evaluation provider and directors (as interviews often yield additional information and context), and certain members of management (if considered appropriate in the view of the governance committee); and from observation of the board and/or committee(s) in session (in the view of the governance committee) (Leblanc, 2006, p. 7). Each director should affirm that the responses provided to the board evaluation provider (questionnaires, and interviews if applicable) represent an accurate and independent representation of his/her views.

Board evaluation report

The external board evaluation provider should submit a written board evaluation report based on the foregoing sources of information

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(questionnaire, interviews and observation), the analysis and the judgement employed by the board evaluation provider, to the governance committee. The board evaluation report should be made available to other directors (and, in its entirety or a portion thereof, to certain members of management if considered appropriate in the view of the governance committee).

The board evaluation report should report on the effectiveness and contribution of the board, the board chair, each standing committee and each committee chair, on an unattributable director basis (that is, director remarks or constructive suggestions for improving effectiveness and contribution are anonymous) and should be consistent with the country's or region's relevant corporate governance code or guidelines.

With regard to the effectiveness and contribution of individual directors, unless directors have agreed otherwise, individual reports should be submitted by the board evaluation provider to each director on a director-by-director (also unattributable) basis, with copies to the board and governance committee chairs for interview and developmental purposes.

Internal discussion and reporting

The board chair should conduct an individual in-person session with each director based on the results of each director's evaluation, and take follow-up action as necessary. The chair of the governance committee should conduct an individual in-person session with the board chair based on the results of the board chair's evaluation, and recommend follow-up action as necessary. Each committee chair should have an in-camera session with each respective committee, and report in writing to the governance committee chair on each committee's evaluation and follow-up action taken, or to be taken, as necessary.

The governance committee chair should report to the board of directors in writing (with all or part of his or her report provided to certain members of management if considered appropriate in the view of the governance committee) on the results of the board, committee and director evaluations (the latter in aggregate), and recommend follow-up action as necessary, in the form of a governance committee board evaluation statement. The board chair should report to the board of directors in writing on the results of director interviews in the form of a director evaluation statement. The governance committee chair should report to the board of directors in writing on the results of the board chair evaluation, and the board chair should leave the room for discussion purposes at this time. The results of board, committee and individual director evaluations (board and committee chairs, and other directors) should greatly assist board and committee leadership, appointments, membership and achieving optimal effectiveness in these roles.

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External board evaluation statement

Shareholders and other stakeholders should have assurance that the foregoing reporting and recommended courses of action, follow-up and remediation have taken place, as necessary. The governance committee on behalf of the board should report to shareholders and other key stakeholders on the process, outcomes and actions taken in respect of the board, committee and individual director evaluations, via a one- or two-page board evaluation statement, authored by the chair of the governance committee and attested to by the external board evaluation provider (Canadian Securities Administrators, 2008).[12] The attestation should affirm that the board evaluation statement is consistent with the process and outcomes of the board evaluation report. The name, independence, qualifications and remuneration of the external board evaluation provider should be published.[13]

THE GOVERNANCE OF REMUNERATION

Mandatory disclosure of remuneration policy, the annual remuneration report and individual director remuneration

9. Should disclosure of remuneration policy, the annual remuneration report (a report on

how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?

Disclosure should be mandatory for all three elements pertaining to executive and non-executive director remuneration: the policy, the report (how the policy was implemented), and individual remuneration of executive and non-executive directors.

One key responsibility of a director's fiduciary duty is to ensure sound oversight of the business strategy. Having a robust approach to executive remuneration policy, reports and implementation is a demonstration of sound fiduciary oversight. Sound work in this area helps executive retention and alignment with shareholders.

Establishing mandatory disclosure is appropriate because it:

(a) sets an equal playing field for all listed organizations;
(b) mitigates the first mover disadvantage of organizations adopting better governance practices (for example, visibility, heightened scrutiny, reluctance to be 'ahead of the pack'); and
(c) allows shareholders the opportunity to compare key executive remuneration practices between companies and make better-informed investment decisions.

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Executive and non-executive director compensation is a critical component to ensure that appropriate executive behaviours are aligned to the organization's risk appetite and strategy. Mandatory disclosure of the remuneration policy, annual remuneration report and individual remuneration of the executive and non-executive directors provides shareholders with a necessary level of transparency to evaluate the effectiveness of the board's decision-making process relative to the remuneration platform.

Disclosing the organization's remuneration policy provides shareholders with a description of the intention of the remuneration plan. The remuneration policy should disclose to shareholders a description of the executive remuneration principles and objectives, as well as capture the spirit of the business strategy, compensation elements, peer group and target pay positioning. The policy should establish a foundation by which the shareholder may assess the desired executive behaviours that the board wishes to reward and how well the remuneration outcomes align to the organization's business strategy.

The annual remuneration report should be mandatory as it enables the organization to describe how the outcomes of the executive remuneration platform aligned and supported the remuneration policy. This report should discuss the purpose of each element of compensation and illustrate how it links remuneration to organization performance. The report provides the opportunity to discuss the definitions of performance (that is, financial, operational, sustainability and so on) and how and why remuneration choices and decisions were made for the CEO and other senior management. The detail should reinforce to shareholders how the board arrived at the remuneration outcomes and justify the appropriateness and competitiveness of the executive remuneration. Finally, the report enables organizations to describe how pay as well as pay policies align to longer-term risk.

The mandatory disclosure of executive and non-executive remuneration for directors will help organizations communicate to shareholders the results of the remuneration policy and programme. Disclosing individual remuneration informs shareholders that the compensation plans align executive behaviours to the business strategies in which shareholders are investing. Disclosure reinforces to shareholders that pay is aligned to performance, and emphasizes the quality of the board's decision-making and that they are meeting their fiduciary duty.

There are few negative impacts that can be imagined from making disclosure mandatory. A well designed and disclosed pay for performance executive remuneration platform will reinforce to shareholders that the board of

directors has in fact achieved its fiduciary duty to implement properly an executive remuneration programme that aligns pay to performance and shareholder expectations.

Mandatory advisory shareholder vote on the remuneration policy and report

10. Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

It should be mandatory to put the annual remuneration report to a vote by shareholders. Many organizations in countries like Canada and the United States originally opposed this practice. More recently, many companies recognize the potential value of such votes and although it may be imperfect they seem accepting of the practice. This 'say on pay' practice has provided investors and shareholders with a voice on an important governance matter.

'Say on pay' is an attempt by regulators to put the shareholder's voice in the boardroom. Establishing a mandatory vote is appropriate because it:

(a) sets an equal playing field for all listed organizations;
(b) frequently stimulates a proactive dialogue between the organization and shareholders, which helps strengthen the board's relationship with shareholders;
(c) allows shareholders the opportunity to indicate their support for or against the executive remuneration; and
(d) mitigates 'influencer' good governance and shareholder activist organizations from creating a market disequilibrium. More specifically, when these influencer good governance groups add a new policy to an agenda, history shows that large market cap organizations tend to be targeted first for adopting a new policy, which tends to create a cascading effect of mid-and small cap organizations adopting the policy over a multi-year period thereafter throughout an exchange.

Although adopting 'say on pay' should be mandatory, it is important to note that the vote should be a non-binding vote, so that the board continues to oversee the overall fiduciary responsibility for the company. For the exchanges to remain competitive globally from a compliance and cost perspective, two policies that might exempt some organizations from the mandatory vote should be considered:

(a) granting a grace period to adopt the shareholder vote for new-IPO organizations; and
(b) establishing a threshold market cap.

In markets that have adopted 'say on pay' as a non-binding advisory vote, the policy has improved organizational transparency and disclosure. The policy has helped improve investor relations by improving communication and dialogue between directors and shareholders. Academic research has found that the effect on 'say on pay' in the United Kingdom has been greater penalties for poor performance, and specifically the removal of controversial pay practices and the *ex ante* removal (for example, advance scrutiny by the board or compensation committee advising their removal) of poor practices before the 'say on pay' vote, for those firms experiencing low dissent. Regression tests have documented an increase in pay-for-performance sensitivity, including firms experiencing high dissent and excess CEO pay before the 'say on pay' legislation was introduced (Ferri and Maber, 2011).

In addition, for those organizations that have adopted 'say on pay', the policy has further shaped the work of boards (see parenthesis in immediately preceding paragraph for example). Specifically, the remuneration committee's activities have often become more rigorous in analysing the executive remuneration design. Boards that have adopted 'say on pay' tend to focus more on the pay for performance analysis on both a relative and absolute basis. As a result, executive pay designs have tended to further integrate performance results into

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actual executive remuneration payouts, therefore better aligning pay with shareholder interests. Boards also tend to focus more on both the level and time horizon of risk associated with remuneration outcomes, and if the plan designs incentivize excessive risky behaviour outside of the organization's 'say on pay' risk appetite.

Lastly, 'say on pay' tends to establish a market threshold on executive remuneration policies, such as excessive severance, perquisites, pensions and income tax payments. For example, in the United Kingdom and USA normalized parameters around severance have now surfaced regardless of the industry or size of the organization.

While 'say on pay' is a blunt instrument (a no vote does not provide the level of detail to the board on what specifically shareholders disapprove of), it has not tended to slow down the rate of change or scale back executive remuneration levels. An unintended consequence of adopting a shareholder vote on executive remuneration is that boards of directors may choose to not change a plan design once a yes vote is achieved, despite a potential change in business strategy. Another shortcoming of adopting the shareholder vote is that regardless of the increased transparency, disclosure and shareholder communications surrounding executive remuneration, shareholders will never have the level of detail on the business strategy and competitive landscape that the board has; therefore, the shareholder will continue to vote with incomplete information.

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THE GOVERNANCE OF RISK

Board approval and taking of responsibility for the company's 'risk appetite' and reporting of it meaningfully to shareholders

11. Do you agree that the board should approve and take responsibility for the company's 'risk appetite' and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?

Background: The term 'risk appetite' has much confusion surrounding it.[14] So much so that the 22 countries who agreed to adopt ISO 31000 risk management guidelines[15] in 2009 decided not to use it anymore. It would be better to ask: 'Do you agree that the board should review and approve the company's risk criteria[16] as developed and used by management?'

The second part of the first question is a bit more problematic, that is: 'report it meaningfully to shareholders?'

The use of the term 'it' perpetuates the idea that an organization can have a single 'risk appetite', which is just not correct, because it would depend on the objective being evaluated and on the expected rate of return.

'Meaningfully' implies a level of detail that would be helpful to readers. Such detail (assuming now we are using 'risk criteria'), while helping some readers, may disclose more than is good for the organization because of disclosing competitive information. 'Risk criteria' is very helpful to management, and the board should be aligned and agree to such measures, but there comes a point at which time disclosure could lead to loss of revenue, lawsuits for failed initiatives and a distraction to readers. There are many other key aspects of managing the business (for example, approval limits, technical specifications, credit scoring models, trade secrets) that are not disclosed and that is why shareholders should appoint qualified directors to provide the necessary board oversight.

In summary: The wording should be changed to avoid using the contentious term 'risk appetite' and should not be disclosed to shareholders. Instead the strategic objectives and initiatives of the corporation should be provided to shareholders so that there is a clear understanding of what is being envisioned and what is being done to achieve such goals.

Disclosure arrangements to include key societal risks?

Whether or not the foregoing disclosure arrangements should include key societal risks is problematic. The term 'societal risks' is not well understood. It appears to be a new term

promulgated by The World Bank (Holzmann, Sherburne-Benz & Tesliuc, 2003) to bring focus on social issues. Although this is valid and laudable, it is a social and government construct rather than one for corporations *per se*.

As is pointed out in the Green Paper (at page 10), 'activities that might potentially generate such risks are subject to specific sectoral legislation and to monitoring by competent authorities'. It is the responsibility of governments and social agencies to focus on 'societal risks' and where appropriate provide laws and regulations and other guidelines and motivations for the betterment of society. This is not part of a public corporation's mandate, while they may well choose to address some societal issues either for altruistic reasons or for better brand image and reputation. It is the accountability of corporations and of their boards to ensure compliance with laws and regulations and to protect and enhance the brand and reputation. The latter may well be a strategy that is assisted by advancing societal risk management.

There can be much debate on exactly what are 'societal risks' from the viewpoint of a corporation. One can surmise that the term includes environmental damage, which is a bad thing and harms the environment. Hopefully, there are laws that address this and must be observed. However, it is unlikely, for example, that food processing companies would define their processed food products as societal risks, even though the medical profession considers their products to be a major cause of obesity, diabetes and heart problems. This example is provided to illustrate that defining and getting agreement on what are 'societal risks' will require much effort and will not be easy to implement in the short term.

In conclusion, we do not think that this idea is practical and instead 'societal risks' need to be addressed through normal risk management that would disclose risks to regulatory compliance and reputation. Of course, all major risks, both financial and non-financial, that would impact the stakeholders' views of the company should be disclosed to achieve regulatory compliance and to protect against future lawsuits from investors in all regulatory filings, such as prospectuses and so on.

Board ensuring that company's risk management arrangements are effective and commensurate with risk appetite

12. Do you agree that the board should ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

One of the key priorities of a board is to ensure that risk management arrangements are effective.[17] This is often referred to as oversight of risk management.[18] Therefore the statement 'Do you agree that the board should ensure that the company's risk management arrangements are effective' is correct and should probably stay at that, but see below for the subsequent proposed phrase.

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The phrase 'commensurate with the company's risk profile' is laden with potential confusion and misinterpretation owing to the term 'risk profile'. A corporate risk profile is a periodic documentation of the key risks to an organization to achieving its stated business objectives over a specified future time period (Fraser and Simkins, 2010, p. 171). Risk profiles[19] are like balance sheets, that is, the status of a company's risk exposure after taking into account its strategic objectives, its context and its treatment of risks.

As risk profiles, by definition, are where a company is at, then the risk management arrangements will always be commensurate with the profile, that is, its derivative. A more meaningful question might be 'Do you agree that the board should ensure that the company's risk management's arrangements are commensurate with the company's strategy and risks'. The phrase 'and commensurate with the company's risk profile' is therefore redundant as 'ensuring the risk management arrangements are effective' covers the intention of this last statement.

13. Please point to any existing EU legal rules which, in your view, may contribute to

inappropriate short termism among investors and suggest how these rules could be changed to prevent such behaviour.

This question was not answered by our group within the time constraints of the call for comments and given the expertise of the group.

THE GOVERNANCE OF ASSET MANAGERS

Incentive structures and performance evaluation of asset managers managing long-term institutional investors' portfolios

14. Are there measures to be taken, and if so, which ones, as regards the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

Commentary is phrased in terms of institutional investors, although it is equally relevant, and perhaps more so, in relation to individual investors.

Institutional investors have both the resources and the power to negotiate asset management contracts that protect their interests. For this reason, securities legislation has traditionally focused on the protection of individual investors, who lack the requisite resources and clout. That the European Commission should feel compelled to ask this question seems to indicate that it is uneasy with how institutional investors are discharging their responsibilities.

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In the quest for solutions, the Green Paper focuses on how to improve the relationship between institutional investors and asset managers. In our view, a more fundamental approach would involve questioning the governance of institutional investors, such as pension funds. The Green Paper does not seem to address this vital issue. Indeed, the issue is sufficiently important to warrant its own consultation paper.

The Green Paper asks the question whether additional measures could be introduced to ensure congruence between the interests of institutional investors and those of asset managers. We believe that it would be more productive to recognize that there are inherent conflicts of interest between investors, both institutional and individual, and asset managers. The implication is that, rather than pursue the illusory objective of ensuring alignment of interests, the EU should focus its efforts on ensuring that conflicts of interest in the management of client portfolios are resolved in favour of the client.

The Green Paper is correct in its assessment that relative performance evaluations can encourage herd behaviour and a short-term focus. We would add that it could also encourage excessive risk taking. Suppose the performance measurement period is nearing its close and an asset manager is badly lagging its benchmark. The rational course of action for this manager would be to redeploy the client's portfolio into the most volatile stocks available. If the gamble works and the stocks shoot up, the manager may actually end up outperforming the benchmark. If the gamble fails and the stocks plummet, the manager will be no worse off because it was badly lagging the benchmark to begin with. While rational for the manager, this course of action is unconscionable because it exposes the client to more risk than bargained for.

Short termism is also encouraged by some practices, which are the norm in the asset management industry. There is considerable evidence that stock prices are unpredictable in the short term. If so, short-term performance has more to do with luck than with skill. Yet, institutional investors typically meet with asset managers on a quarterly basis to review the previous quarter's results. The tyranny of the quarterly meeting has much to answer for.

We suggest that investors, asset managers and indeed the market as whole would gain from refocusing industry practices, including the evaluation of asset managers, on the long term, by which we mean up to 10 years or more. This raises the question how best to

achieve this result. We believe that the answer involves consideration of the standard of conduct that should apply to institutional investors, their accountability to their constituents and ultimately their mode of governance.

Effective monitoring of asset managers by institutional investors

15. Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?

The Green Paper refers to asset managers as 'stewards' of the investee companies. Stewardship, a concept going back to the Middle Ages if not earlier, indeed hits the nail right on the head, although we tend to think of asset managers as being stewards for their clients, that is, institutional and individual investors, rather than for the investees. Indeed, the investee companies, in turn, are stewards for the asset manager, rather than the other way round.

In our view, the stewardship quality of an asset manager is far more important than the factors mentioned in the question – strategies, costs, trading and engagement with investees. The question, then, is how to assess stewardship quality.

The volume of research effort on the stewardship quality of asset managers and its determinants is not commensurate with the importance of the subject. The EU should encourage more research in this area.

Morningstar, an independent provider of investment fund research, assigns stewardship grades on the basis of five main factors:

(a) The corporate culture of the asset manager – this is assigned the heaviest weight.
(b) The quality of the fund's governing body, for example its board of directors.
(c) The fees and expenses charged by the asset manager to the fund.
(d) The motivation of the individuals managing the portfolio, with particular reference to the size of their personal investment in the fund and the structure of their remuneration, including the manner in which their bonus is determined.
(e) The regulatory requirements of the asset manager.

Independent research has suggested that high stewardship grades are correlated with superior fund performance (Wellman and Zhou, 2008).

The evaluation of an asset manager's stewardship quality is hampered by the lack of information. For example, in most jurisdictions, the disclosure of the information in (d) above is not mandatory.

As an initial step towards improving the stewardship quality of asset managers, the disclosure of the relevant factors, such as those listed above, should be made mandatory.

In the longer term, the EU should consider requiring asset managers to obtain a stewardship grade as a precondition to offering their services. For now, we leave open the question as to who should assign the stewardship grades and how.

Independence of asset managers' governing body, and disclosure and management of conflicts of interest

16. Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

As we suggested earlier, the relationship between asset managers and investors is inherently conflictual in many respects. High priority should be given to dealing with this issue. In the first instance, asset managers should be subject to a standard of conduct that makes it clear that, in managing client portfolios, they owe their primary loyalty to their clients, in whose best interests they should always act. EU rules should include severe penalties for transgression of the standard of conduct.

Organizational controls would also be helpful in ensuring that conflicts of interest are

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always resolved in favour of the client. The asset manager should be required to take all conflicts of interest to an independent party, which would be charged with ensuring that the issue is resolved in the client's favour. That independent body could, for example, be

(a) the governing body of the asset manager, provided it includes a majority of independent directors and an independent chair;
(b) if the client is an investment fund, the governing body of the fund, provided it is independent; or
(c) an independent body dedicated to the resolution of conflicts of interest.

Canada has opted for solution (c). All publicly distributed investment funds in Canada are now required to have an Independent Review Committee, whose role is to examine conflicts of interest referred to it by the asset manager and to provide a decision to the latter (Fok Kam, 2009). In some cases, the Committee's decision is binding. In other cases, the Committee only has the authority to make a recommendation. It would be helpful to the EU to monitor the progress of Independent Review Committees in Canada and determine if the model might apply in the EU.

17. What would be the best way for the EU to facilitate shareholder cooperation?

This question was not answered by our group within the time constraints of the call for comments and given the expertise of the group.

THE GOVERNANCE OF PROXY ADVISORS

Achieving enhanced transparency (for example, of analytical methods, conflicts of interest) of proxy advisors

(18) Should EU law require proxy advisors to be more transparent, for example about their analytical methods, conflicts of interest and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?

Unless proxy advisory firms are prepared to self-regulate by adopting an industry-wide code of conduct, EU law should require proxy advisors to be more transparent (Millstein Centre, 2008). There are two main reasons for enhanced transparency:

Influence

Although it has yet to be ascertained what percentage of votes proxy advisors can influence on either a routine or non-routine matter, taking into account just the number of institutional shareholders who disclose that they subscribe to a proxy advisor, it cannot be denied that the proxy advisory industry has the potential to influence a significant block of votes. In addition to the potential to influence voting outcomes, there is consensus that proxy advisors are no longer merely 'independent' experts evaluating corporate governance, but are in fact furtively shaping behaviour of market participants through their views on corporate governance best practices (Hill, 2008, p. 822).

Inaccuracies

There is convergence in the existing literature on the proxy advisory industry on the limited predictive power in the models of the proxy advisory industry and on the frequency of inaccuracies underpinning the proxy advisory firms' recommendations (Center on Executive Compensation, 2011). The problem with this lack of transparency at the proxy advisory firm level is that it does not provide scholars, issuers and investors with an opportunity to question the quality of the data, analyse voting recommendations and potentially point out inaccuracies in proxy advisors' analyses.

Our response

We believe that any conflict of interest should be disclosed. Whether self-regulated or legislated, proxy advisors should disclose, review, manage and mitigate all potential conflicts (for example, consulting services, financial stakes,

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record-keeping services and voting platforms). The disclosure of potential conflicts of interests would not only address conflicts of interests with the provision of a multiplicity of functions to issuers, but it would also address potential conflicts of interest between affiliates and subsidiaries of the proxy advisory firms. The idea is that if institutional investors were made aware of the concerns surrounding the quality and creditability of the voting recommendations and conflicts of interests, they would demand that proxy advisory firms be more transparent or switch to a firm that is. Alternatively, institutional investors will rely more on their own discretion when reviewing a proxy advisor's recommendations.

We believe that the sources of research should be disclosed. When providing a recommendation, proxy advisors should be required to list the name and contact details of the lead analyst and key team members.

In addition, all sources consulted to produce a report should be listed (for example, public information, private information, media reports). As part of this sourcing requirement, a proxy advisory firm should be required to disclose whether an issuer's management or board were consulted.

We believe that there should be a method of challenging the adequacy of research/erroneous data, incomplete facts or inaccurate data analysis; for example:

- Issuers being assessed ought to have a mechanism to challenge the recommendations made by proxy advisory firms.
- On request, an issuer should be able to receive a copy of a proxy advisory firm's report.
- A public agency (for example securities commission) ought to be able to request, audit and challenge any voting recommendation.

Restrictions on the ability of proxy advisors to provide consulting services to investee companies, or other measures

19. Do you believe that other (legislative) measures are necessary, for example restrictions on the ability of proxy advisors to provide consulting services to investee companies?

While restrictions on the ability of proxy advisors to provide consulting services to investee companies are not necessary, there are other legislative measures that might be useful.

It is not known whether the investment objectives of a proxy advisory firm's affiliate(s) may interfere or override a proxy advisory firm's voting recommendations. Among other measures to minimize conflicts of interest, many proxy advisory firms have erected firewalls among consulting and other businesses by floating subsidiaries for non-rating services. Without evidence that proxy advisory firms are acting on conflicts of interest, it is not necessary to restrict the ability of a proxy advisory firm to provide consulting services. This does not, however, mean that proxy advisory firms need not be much more forthcoming in disclosing their conflicts of interest and how they manage their conflicts of interest.

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Institutional investor regulation

Institutional investors, as the only customers of the proxy advisory firms, arguably have the necessary clout to demand better governance of the proxy advisory firms. Accordingly, along with disclosing their proxy voting record on a functional website[20] and keeping it up-to-date, institutional investors ought to disclose how they use proxy advisory firm(s) (Hansell and Murphy, 2011). Some institutional shareholders rely on proxy advisors to analyse, vote and organize all its proxy votes. Other institutional shareholders do not seem to use proxy advisory firms at all. How and to what extent institutional investors rely upon proxy advisory firms should be disclosed with specificity (for example, is there an internal team; does it have a customized voting guideline with the proxy advisory firm; what services supplied by the proxy advisory firm does it rely upon?). It would further be advisable to have institutional investors disclose what internal controls they have in place

to ensure that these services are being carried out in a timely and accurate way.

Increased competition

The proxy advisory industry is marked by the absence of competition, which naturally raises apprehension about proxy advisory firms misusing their market power. Legislative action might be needed to encourage more competition between existing proxy advisory firms and new entrants to the market. Reforms aimed at increasing competition are, however, complicated by the fact that size and market recognition may be higher barriers to entry than regulatory status (Rose, 2010, p. 62).

SHAREHOLDER ENGAGEMENT

Shareholder identification, dialogue and cooperation

20. Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (for example objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

A mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues

While we acknowledge the importance of the ability of issuers to communicate with shareholders, 'identifying' shareholders is critical as a matter of public policy because doing so improves the integrity of *voting* procedures. One of the central motives for identifying voters seems to be the prevention of over-voting and 'empty' voting.[21] The present Green Paper, in focusing on the importance of 'communication' between issuers and their shareholders, seems essentially to ignore the question of corporate democracy, relegating it to footnotes.

The ability to communicate effectively with shareholders, and for shareholders to coordinate among themselves, enables meaningful dialogue and engagement with and among them, in particular, in elements of corporate governance. However, more needs to be done to understand the problems of, for example, over-voting, and the extent to which shareholder identification is a suitable remedy to those problems.

Shareholder identification and communication is a serious issue. Given high annual rates of shareholder turnover, and given the roles of various intermediaries (including especially banks and brokerages), the technical challenges inherent in identifying and communicating with shareholders before an issuer's Annual Meeting are substantial. Some EU member states (for example, Spain) have made significant progress in this direction. We have no specific suggestions in this regard, but we urged the Commission to focus on the question of establishing mechanisms aimed specifically at providing issuers with information necessary to improving the integrity of voting procedures, in addition to focusing on the more general question of shareholder communication.

A mechanism to benefit cooperation between investors

Whether a mechanism benefits cooperation between investors depends very much on the particular mechanism chosen. In principle, a mechanism adopted to facilitate communication between issuers and shareholders in the interest of more rigorous voting procedures might well benefit cooperation between investors, and that might well be a good thing.

Objective of the shareholder mechanism

The key objective should be to improve the integrity of shareholder votes, by clarifying share ownership. The goal here should be to reduce the prevalence of over-voting, 'empty' voting and other attempts to 'game' the system of shareholder democracy.

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PROTECTING THE INTERESTS OF MINORITY SHAREHOLDERS

Additional rights to represent minority shareholders in companies with controlling/ dominant shareholders

21. Do you think that minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

We agree that minority shareholders should have board representation, given the difficulties identified with 'comply or explain' in this instance; the difficulty of (or inability) of engaging minority shareholders; and the approval of related party transactions. A 'significant' (or 'dominant' or 'controlling', however defined) shareholder may be defined as a shareholder with the ability (either *de facto* or *de jure*) to exercise a majority of the votes for the election of the board of directors. A significant shareholder could be an individual, a group of individuals (for example, a family, a voting trust and so on) or a corporation.

If a corporation has a significant shareholder, an appropriate percentage of board seats should be reserved for minority shareholder representation. These directors selected by minority shareholders: (i) should be reasonably perceived to be independent of management *and* the significant shareholder; (ii) should pass all categorical tests of independence in the relative jurisdiction; and (iii) should not have any relationship or association with the corporation that would give rise to independence concerns (from a reasonable person – that is, objective – perspective, as opposed to the subjective judgement of those directors who are neither independent from the significant shareholder nor from management).

As to what percentage of board positions that are allocated to minority shareholders representation should be, this percentage should fairly reflect the investment in the corporation by shareholders other than the significant shareholder.

If the mandate of the board, any principal committee of the board, or any board or company leadership role (for example, the chair of the board, the CEO or a chair of any principal committee) is limited in any way by the significant shareholder, full, true and plain disclosure should be made. In companies with a significant shareholder, disclosure should be made of the powers, rights and responsibilities of the significant shareholder, in a similar manner.

Additional protection of minority shareholders against related party transactions

22. Do you think that minority shareholders need more protection against related party transactions? If so, what measures could be taken?

A related party transaction is a conflict of interest between the related party (for example, a control person, a significant shareholder, an officer or a director of the corporation) and the corporation itself. If the board of directors does not take all appropriate action in light of the conflict, or shareholders (all shareholders, including minority) do not have full and complete knowledge of, or the opportunity to approve, *ex ante*, the transaction, the result could be self-dealing and appropriation of monies or opportunities by the related party at the expense of the corporation and/or minority shareholders.

Specific and precise guidance should therefore be offered by independent directors and advisors to companies in respect of related party transactions, based on principles of transparency, clarity, independence of decision-making, independence of advice and approval by all shareholders of the corporation.

The rights of minority shareholders to board representation has been addressed in the question above. So far as the treatment of the related party transactions by the board, our response is the following steps:

(a) A disclosed means to define, identify and manage the conflict of interest, at the board level.

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(b) The establishment of a committee of directors who are deemed independent of all related parties, with disclosure of this committee's remit.
(c) The retention of independent expert opinion on the nature and effect of the transaction on minority shareholders (Green Paper, at page 18).
(d) The retention of records and documentation of decision-making.
(e) A mechanism for minority shareholder coordination and engagement of the committee in (b).
(f) A recommendation to shareholders by the committee in (b), with supporting rationale.
(g) The opportunity to approve the related party transactions by shareholders at a General Meeting (Green Paper, at page 18).

To assist the Commission, the Canadian Securities Administrators, in December 2008, shortly after the height of the Global Financial Crisis, proposed Principle 6 – Recognize and manage conflicts of interest.[22]

Share ownership by employees

23. Are there measures to be taken, and if so, which ones, to promote at EU level employee share ownership?

In short, no. The desirability of employee ownership ought not to be prejudged by regulators. The question of motivating employees is a fundamental challenge faced by all companies, and various companies will arrive at different solutions. There is far too little consensus regarding the best combination of salary, bonuses, equity and non-financial rewards such as status or public recognition. Nor is it likely that there is one right solution that is best for all organizations. Further, there is insufficient evidence of social benefit from employee share ownership to make such ownership a policy objective. Finally, there is a risk that any move taken to promote employee share ownership will inadvertently result in overinvestment in single firms by employees who ought, instead, to be encouraged to hold diversified investment portfolios. At most, the Commission should encourage issuers to take a thoughtful approach to the issue, such as neither to discourage nor over-encourage employee share ownership.

The Green Paper (at page 18) notes that employees' involvement in the affairs of the company may take the form of participation in the board, as well as share ownership. Although employee participation on the board was not addressed in question 23, we offer some views.

There is merit in having employee representation on boards of directors, in the form of information, diversity and consultation. In the United Kingdom and Germany, employee representation occurs (in the form of executive and worker representatives). In Canada, large institutional shareholders,[23] credit unions, cooperatives[24] and not-for-profit organizations[25] have board positions allocated, in varying degrees, to employee or member representation. We are not aware of any scholarship that boards of directors with employee representation are less effective or fail to meet their obligations. Providing that employee members act with a view to the best interests of the corporation, the benefits to employee membership on boards may include diversity,[26] information flow and worker commitment.

GOVERNANCE CODE IMPLEMENTATION AND MONITORING

Companies departing from corporate governance codes to provide detailed explanations and alternative solutions

24. Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

The 'comply or explain' model is generally an admirable regulatory framework due to its flexibility; however, it is thought to be problematic in respect of controlled companies

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and minority shareholders (Green Paper, at page 17). In addition, more broadly, there could be greater guidance offered to all companies on improving the information quality of reporting within the 'comply or explain' regime (Risk Metrics Group *et al*, 2009, p. 14; Canadian Securities Administrators, 2010, p. 3; and EU Green Paper, 2011, p. 19).[27]

Our response

(a) That a robust and rigorous framework of 'comply or explain' disclosure and assurance – including general, free-form and provision-by-provision responses – be developed that would assist companies, boards of directors and investors in providing, pressing for and comparing responses.

There are opportunities for greater attention to, and development of, the *explain* plank of the 'comply or explain' regime. At present, inadequate guidance could encourage: uncertainty and low disclosure quality, defensiveness on the part of legal counsel, reluctance by boards of directors to press for increased disclosure and informative content, lack of consistency and quality in responses, and the inability to compare ambiguous or inadequate responses efficiently and effectively.

(b) That, where departures are permissible in the first place, companies departing from the recommendations of corporate governance codes be required to explain themselves fully, via detailed, specific, clear, accessible and concrete reasons for the departure.

Insofar as departures from recommended code practices are concerned, departures reflect the sensible view that there should be a presumption in favour of recommended practice, without the assumption that no deviation could ever be justified. The Swedish model in particular (requiring disclosure of departure, disclosure of the reasons for departure and disclosure of the alternative adopted) is very good (as identified in the Green Paper at page 19). Shareholders and potential investors deserve to know why a company has deviated from recommended practice. The requirement is also minimally burdensome, and allows companies to seek out tailored governance solutions.

(c) That certain provisions within the 'comply or explain' regime require compliance.

That being said, we do believe that a general preference for the 'comply and explain' model is consistent with the view that, on some matters, compliance should simply be required. These matters where compliance is required should be identified within the enhanced disclosure 'comply or explain' framework of our response in item (a).

The 'comply or explain' model has the further benefit of helping to disseminate innovative governance practices. As individual companies are expected to highlight and justify deviations from codes, this effectively puts the innovation into the public sphere, both for critique and for other companies to adopt and modify.

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Assessment of information quality and explanations by monitoring bodies

25. Do you agree that monitoring bodies should be authorized to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?

We also address the monitoring role and responsibilities of institutional investors in our commentary.

Our response

(a) That 'principles of stewardship' within a 'comply or explain' regime – addressing communication, engagement, monitoring and enforcement – be developed and implemented for institutional investors.[28]

We note that the monitoring responsibility of shareholders is still largely unregulated. We believe

that reluctance to commit time and resources on the part of investors (as identified in the supporting Green Paper study)[29] and free-rider issues may be addressed by strengthened disclosure rather than regulation. All institutional investors should be required to disclose voting policies and records, monitoring activities, enforcement practices, and the implementation of their corporate governance policy, via a 'comply or explain' framework (similar to listed companies).

(b) That monitoring bodies (for example, securities regulators, stock exchanges) be authorized to check the informative quality of the explanations of corporate governance statements and require companies to complete the explanations where necessary.

The role of monitoring bodies should be as follows:

(a) to act at all times in the public interest; to foster fair and efficient capital markets and confidence in their integrity; and to foster investor confidence;
(b) to develop, and revise on a regular basis, the 'comply or explain' disclosure framework recommended in Question 24 (at (a));
(c) to foster complete and trustworthy corporate governance disclosure by companies;[30]
(d) to provide independent[31] and appropriately resourced[32] oversight of the quality and completeness of the information provided by companies, not the decisional content itself;
(e) to provide analysis and disclosure, based on (d), on a company as well as on an aggregate basis (Risk Metrics Group *et al*, 2009, p. 16) to companies, to investors and to other stakeholders;
(f) to liaise with monitoring bodies within other Member States;[33] and
(g) to have the authority to sanction companies in serious cases of non-compliance.[34]

There is an opportunity for significant improvement for both institutional investors and monitoring bodies in respect of monitoring the 'informative quality' (wording used in Green Paper) of the explanations in the corporate governance statements The role and importance of monitoring bodies, however, is more important as they represent the wider public interest.

CONCLUSION

The above responses, modified to suit this journal publication, were submitted in response to the public consultation and invitation for comments on the Green Paper on proposed corporate governance enhancements in Europe.

The spirit of the EU proposed corporate governance reforms, which seek to build trust in the single market and contribute to the competitiveness of European business, is supported. The authors believe that the implementation of the above responses would greatly strengthen this objective.

It is hoped that this article was beneficial and informative to journal readers.

NOTES

1 King III, for example, applies to 'all entities regardless of the manner and form of incorporation or establishment and whether in the public, private sectors or non-profit sectors. We have drafted principles so that every entity can apply them and, in doing so, achieve good governance'. See page 16 of 'King Code of Governance Principles for South Africa 2009' (Institute of Directors Southern Africa, effective March 2010). The King III Code and Report have comprehensive principles and cascading practices that companies can choose to adopt, to achieve the objectives of the principles, based on a 'comply or explain' approach. The key to comprehensiveness and providing choice and flexibility for companies is in the drafting of principles and, in particular, the recommended practices. The UK Code (2010) also does a good job of this (through cascading main principles, supporting principles and code provisions), although the drafting of King III, in respect of its flexibility to small and mid-cap and private companies, is exemplary, in our view.

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2 PriceWaterhouseCoopers (2008).
3 See, for example, Bova *et al*, 'The Sarbanes-Oxley Act and Exit Strategies of Private Firms', available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1730242.
This article shows that post SOX, the propensity to do an IPO has reduced. In general, the literature, according to one author, documents that SOX has imposed unintended costs on US firms (not disputing the benefits). Other relevant papers: (i) Leuz *et al* (2008): documents the going dark phenomenon http://papers.ssrn.com/sol3/papers.cfm?abstract_id=592421; (ii) Doidge *et al*: other foreign exchange listings instead of the United States: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982193&rec=1&srcabs=956987; (iii) Leuz, 2007: costs of SOX: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=990016&rec=1&srcabs=592421; and (iv) Zingales, 2007: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1028701&rec=1&srcabs=982193.
4 See, for example, Leblanc (2011b).
5 See, for example, Mandate of the President and CEO, Chair of the Board and Committee Chair, available online at the Canadian Imperial Bank of Commerce: (www.cibc.com/ca/inside-cibc/governance/board-of-directors/mandates.html); and Chair's Role and CEO's Role, available online at Cameco Corp.: (www.cameco.com/responsibility/governance/chairs_role/) and (www.cameco.com/responsibility/governance/ceos_role/), respectively.
6 Available online at Nexen Inc.: (www.nexeninc.com/en/Governance/BoardofDirectors/AreasofExpertise.aspx); and at page 133 of 'Section 5 Corporate Governance Statement 2010', available online at BHP Billiton: www.bhpbilliton.com/home/aboutus/ourcompany/Pages/governance.aspx, respectively.
7 These attributes may be affirmed and published, for example, 'All of our board members have these …', which limits the utility of such a statement. Directors may possess these attributes to varying degrees, and such possession contributes to individual effectiveness and overall board dynamics. These attributes and director behaviours should therefore comprise part of a competency matrix, and be assessed for prospective and incumbent directors.
8 For example, 'Enterprise Leadership' as a competency could have sub-competencies of CEO/GM of large organization, CEO/GM of small organization, Other Experience with Small/Medium Organization, Active Professional, Volunteer/Community Organization, Leading/Managing Growth, and Experience 'Under Fire'.
9 We use the example above of women, visible/racial minorities, Aboriginal Peoples and persons with disabilities, as examples of designated diversity groupings. The Green Paper speaks to (in this order) professional diversity, international diversity and gender diversity. Diversity groupings may also include, in no particular order, age (explicitly identified in Australia), socio-economic diversity, sexual orientation and military service.
10 See, for example, Aguilar (2010):

> 'Unfortunately, while some companies provided useful information in the spirit of the SEC rule, many other companies provided only abstract disclosure – often times limiting their disclosure to a brief statement indicating diversity was something considered as part of an informal policy. Many companies did not include any discussion of any concrete steps taken to give real meaning to its efforts to create a diverse board. By leaving out the steps taken and how those efforts are evaluated, these companies fail to provide investors with useful information, and it deprives investors of information they have demanded. I have asked our staff to follow up with some of these companies and I expect this disclosure to improve' (emphasis added).

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11 In the United States, failure to disclose at all may result in a comment letter for which the company has 10 days to reply. See, for example, letter from the SEC to Republic Airways Holdings Inc., dated 24 September 2010, at page 1: 'Please confirm that in future filings you will disclose whether, and if so how, you consider diversity in identifying nominees for director. Refer to Item 407(c)(2)(vi) of Regulation S-K. …'. It is not known if a failure to respond, in respect of this diversity disclosure requirement, could ultimately result in de-listing.

12 Therefore we disagree with the EU that 'any evaluation statement to be disclosed should be limited to explaining the review process' (page 8 of Green Paper). See, for example, Institute of Chartered Secretaries and Administrators, 'Board Performance Evaluation: Review of 2008 Annual Reports of UK Listed Companies' (February 2009), wherein substantive outcomes of board evaluations are disclosed for numerous companies. See also the Ontario Securities Commission, 'Canadian Securities Regulators Seek Comments on Revised Corporate Governance and Audit Committee Regimes' (proposal, 19 December 2008, after which it was withdrawn shortly after the height of the Global Financial Crisis in September 2008), at Principle 4(a): 'Describe any practices the board uses … including (iii) the assessment process and outcomes …' (emphasis added). See also, as a third example, 'Annex 5: Illustrative statement on a BOFI's [Board of a Financial Institution's] evaluation process', within 'A review of corporate governance in UK banks and other financial industry entities' (Draft report), Walker *et al*, 16 July 2009, at page 114, wherein five ((a)–(e)) board evaluation outcome-oriented items are discussed.

13 Publicizing these items would increase transparency and may address professionalism of offerings and providers, including viewing external board evaluations as a viable business model by professional service firms and independent advisors.

14 Before the publication of COSO 2004, the terms 'risk appetite' and 'risk tolerance' were used interchangeably by risk managers and the attendant literature. However, COSO 2004 attempted to define these terms differently: the former as being a higher level single view of risk, with 'risk tolerances' being a lower level more specific definition of tolerable risks. Attempting to define a single statement for an organization for its 'risk appetite' has proven difficult or impossible, often leading organizations to define numerous sub definitions for each of the many types of risks.

15 ISO 31000 Risk management – Principles and guidelines were issued in 2009 by the International Organization for Standardization. This is the first true international standard for risk management and has been widely adopted. It encompasses much of the concepts and practical reality of the well accepted AS/NZ 4360 Risk Management Standard.

16 ISO 31000 describes 'risk criteria' (section 5.3.5), which represent the definitions and means by which an organization's management (and board) would evaluate how critical the various sources of risks are as part of their risk assessments and treatment processes.

17 An example of regulatory requirements for a board regarding risk oversight is the Ontario Securities Commission 'National Policy 58-201 Corporate Governance Guidelines', section 3.4, which requires: 'The boards should adopt a written mandate in which it explicitly acknowledges responsibility for the stewardship of the issuer, including responsibility for: …

(b) adopting a strategic planning process and approving, on at least an annual basis, a strategic plan that takes into account, among other things, the opportunities and risks of the business;
(c) the identification of the principal risks of the issuer's business, and ensuring the implementation of appropriate systems to manage these risks'.

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18 ‘The oversight of the enterprise risk management process employed by an organization is one of the most important and challenging functions of a corporation’s board’. See page 51 of Fraser and Simkins (2010). See also ‘Effective Enterprise Risk Oversight: The Role of the Board of Directors’ (2009) COSO.

19 Other definitions of a risk profile include: ISO defines a risk profile as ‘a description of any set of risks’ and risk as ‘effect of uncertainty on objectives’ (ISO 31000 2009). HM Treasury’s The Orange Book: Management of Risk Principles and Concepts (October 2004) defines a Risk Profile as ‘the documented and prioritized overall assessment of the range of specific risks faced by an organization’. The 2002 Risk Management Standard produced by the Institute of Risk Management (UK) and the Institute of Insurance and Risk Managers (UK) defines a Risk Profile thus in section 4.5: ‘The result of the risk analysis process can be used to produce a risk profile which gives a significance rating to each risk and provides a tool for prioritizing risk treatment efforts. This ranks each identified risk so as to give a view of the relative importance’.

20 The word ‘functional’ is deliberately chosen and stems from spending hours surfing various Canadian institutional investors’ websites and not being able to locate their voting records. First, not all institutional investors have websites. Almost all do, but not all. Second, it was found during the course of research that many institutional investors’ websites were not functional, for two reasons:

Links Not Working

Sometimes, the websites were simply not working. This was the case for example for an institutional investor whose website was powered by a proxy advisor. The company was contacted and the website is now working (that is, the links displaying the proxy voting records now work). The company was certainly not alone.

Not User Friendly

What was found throughout the course of research is that many websites were not well-designed. It was not easy for someone to try to find out how an institution voted on a given matter without getting lost or spending an inordinate amount of time. Where do you find the proxy record? Is it under an investor relations tab on the company’s website? Is it under a corporate governance link? If you do find the proxy voting record … . Do you search by issuer name? By date? By subsidiary of the institutional investor? Certain institutions may as well not have proxy voting records on their websites because the information is so poorly organized.

21 See KattenMuchinRosenman (2010), at page 1: ‘Both “over-voting” and “empty voting” refer to types of errors that can occur in the way that proxy votes are counted. Over-voting refers to a situation where a bank or broker communicates to the vote tabulator more votes than its clients are technically entitled to register. (The tabulator is hired by the issuer to make a final tally of the votes that are submitted.) Empty voting refers to a situation where a shareholder has voting rights in the shares to be voted, but lacks full economic interest in those shares.

Over-voting differs from empty voting in one important respect. While the former is a processing issue that is always – or virtually always – corrected before a final outcome, when the latter occurs, it could undermine the legitimacy of a final outcome’.

22 This proposal was later withdrawn, given the financial crisis 2 months earlier. See (www.osc.gov.on.ca/en/26274.htm).

23 In the Ontario Teachers Pension Plan board of directors, for example, four of nine directors are elected by the Ontario Teachers Federation (an association of employee/retiree teachers), with the chair of the board of directors jointly selected by the employee group and the provincial government. In the Ontario Municipal Employees Retirement System, another large pension fund, equal

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representation on the board of directors occurs between employer and employee/retiree members (seven members each).

24 Financial and non-financial cooperatives have well-developed democratic processes enabling members to participate, via election, on the board.

25 Medical staff, and faculty, staff and students often have board level representation within hospital and university boards of directors.

26 The above examples offer the opportunity to address board diversity (gender, ethnicity, age), as these types of boards (with employee member representation) are recognized for being diverse; and may bring skill sets such as human resources, community representation, industry knowledge and information technology, onto the board.

27 See, for example, Risk Metrics Group *et al* (2009) at page 14, where '[o]nly 39 per cent of all explanations on the reference corporate governance code are classified as sufficiently "informative"'. See also, 'Canadian Securities Administrators (2010), at page 3, where non-compliance with the disclosure requirements of the Corporate Governance Instrument was termed 'unacceptable'. See also the Green Paper, at page 19, where the overall quality of companies' corporate governance statements when departing from a code recommendation is 'unsatisfactory', according the study (ibid.).

28 (Ibid.), item one, 'Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States', at pages 17–18.

29 (Ibid, p. 13). UK Treasury Minister Lord Myners had described investors as 'absentee landlords' (21 April 2009, in a speech to the Association of Investment Companies).

30 (Ibid, p. 16).

31 Monitoring bodies should have arms-length relationships from listed companies, including personnel, and rigorous conflict of interest guidelines. This might mean a cooling off period for former listed company employees working for monitoring bodies.

32 Monitoring bodies should be staffed and compensated appropriately.

33 The Green Paper refers (at page 20) to there being 'great potential' for improving and extending the current exchange of best practices developed by monitoring bodies. We agree.

34 See, for example, Green Paper at page 20. The Commission might also consider that sanctions (monetary) in the most serious cases of non-compliance (as identified in the Green Paper as being done in Spain) be directed to funding of the monitoring body, rather than general revenue. Funding of monitoring activities could also be provided by listed companies, on an aggregate basis, providing strict conflict of interest guidelines were in place.

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