NBIM DISCUSSION NOTE

#14 - 2012

Corporate governance

19/11/2012

In this discussion note, NBIM's expectations on corporate governance are presented. Expectations directed at boards are discussed, as is the rationale for focusing on board accountability and equal treatment of shareholders. In the discussion, the academic literature underpinning NBIM's approach to corporate governance and opinions offered by leading industry practitioners are presented. Two sets of expectations are included as appendices that conclude the note.

Summary

NBIM publishes herewith two sets of expectations on different aspects of corporate governance. In formulating these expectations, NBIM has considered the challenges of protecting its interests as a globally diversified minority shareholder in light of empirical and theoretical evidence. The literature review identifies evidence of correlation of certain governance factors with measures of company performance. As a shareholder, NBIM must apply these findings carefully, together with professional experience, in defining corporate-governance expectations.

Greater corporate-governance consensus is found in international codes of corporate governance such as OECD principles, the ICGN Principles of Corporate Governance and national codes of best practice. We question the basis for the near-consensus in such codes given the lack of academic evidence and conclude that principles should be seen as best practices and that considered deviation must be expected and welcomed. We address the practical challenges of effective ownership within an investment culture.

NBIM's expectations have been formulated with this investment objective in mind. Our intention is not to provide another code of corporate governance for companies to comply with or report against. Rather, the ambition is to set out priorities for corporate governance as a means to foster dialogue and mutual understanding. NBIM welcomes comments from all stakeholders on the expectations at the end of this discussion note.

NBIM Discussion Notes are written by NBIM staff members. Norges Bank may use these notes as specialist references in letters on the Government Pension Fund Global. All views and conclusions expressed in the discussion notes are not necessarily held by Norges Bank.

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1 Introduction

1.1 Protection of shareholder interests

The Government Pension Fund Global is invested 60 percent in listed equities. The equity portfolio is invested globally with minority equity positions in publicly listed companies. The Fund cannot directly control management of these companies; there is a risk that management interests may at times not fully align with the interests of minority shareholders. This calls upon investors to seek protection of interests by means other than control rights.

From a long-term portfolio perspective, NBIM's ownership activities aim at promoting factors that support competitiveness, innovation and profitability at the companies in which the Fund has invested. Sometimes, profit-maximising major shareholders ensure effective monitoring of management, or top management are major shareholders themselves. Monitoring is, however, often left to dispersed minority shareholders. NBIM's primary corporate-governance focus will consequently be on mechanisms shareholders can use directly and indirectly to influence companies towards sustained business success. This challenge is addressed in the section on board accountability.

The Fund is dependent on companies' sustained profitability and a reasonable share of this being distributed to shareholders. Minority shareholders may be vulnerable to return leaks favouring participants closer to decision-makers. Examples of this problem could be the discriminatory distribution of benefits to controlling shareholders, or unfair related-party transactions. These issues are addressed in the section on the equal treatment of shareholders.

While guiding and monitoring companies and their management is an important ownership challenge, shareholders are exposed to a free-rider problem. In many cases, the costs of active ownership are borne by the active owner, while the benefits are also enjoyed by passive owners. Only when the investment is substantial can the costs of active ownership be justified by individual shareholders. This could imply a need for minority shareholders to coordinate and share efforts to monitor companies through effective corporate governance.

Diversified investment by institutional investors is frequently reflected in dispersed ownership of individual companies. Often there are no dominant shareholders who can be trusted to effectively monitor on behalf of all shareholders. Dispersed ownership and investors' free-rider problem may leave an ownership vacuum where companies struggle to obtain balanced information on shareholders' expectations. This presents an opportunity for large, long-term shareholders who are willing and able to engage.

To meet these challenges, NBIM operates a corporate-governance programme. Setting out generic expectations for good corporate governance is one of several steps in this programme and the topic of this discussion note.

1.2 Fund characteristics and the challenge of ownership

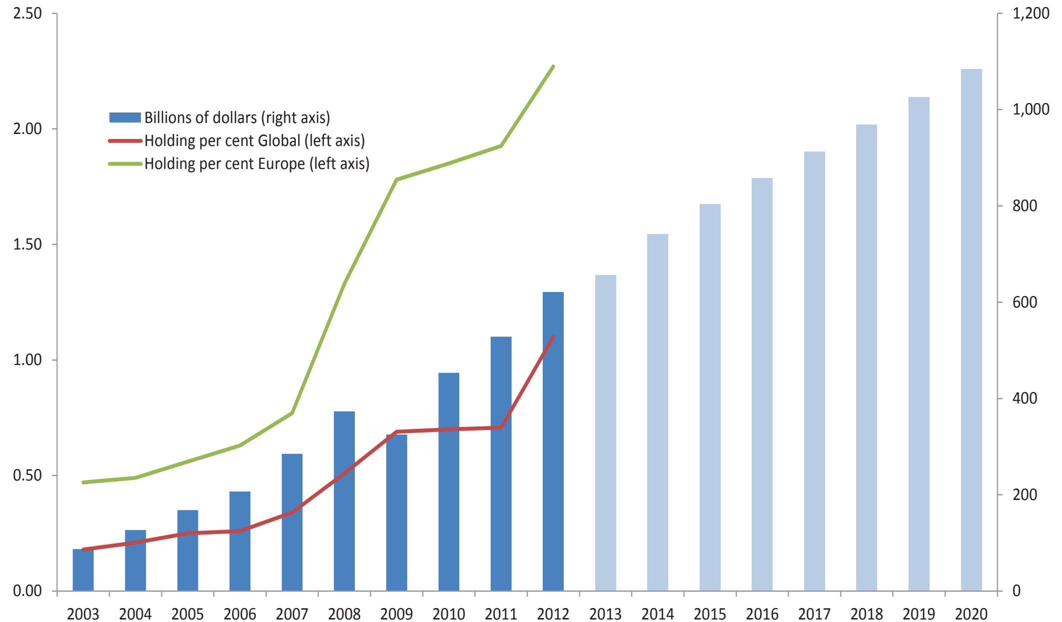
Norges Bank Investment Management (NBIM) was set up by Norges Bank in January 1998 to manage the Norwegian Petroleum Fund, now known as the Government Pension Fund Global (GPFG), alongside Norges Bank's long-term foreign exchange reserves. NBIM seeks to achieve the highest possible return given the mandate from the Ministry of Finance and the Executive Board of Norges Bank.

The size and diversification of the Fund bring opportunities and challenges to NBIM's ownership activities. The 600 billion US dollar fund is projected to almost double by 2020[1] based on net government petroleum revenue and fund return.

1 Ministry of Finance, National Budget 2013

Current asset allocation provides for 60 percent of the Fund to be invested in equity. The 380 billion US dollar equity portfolio is among the world's largest, and NBIM is consequently a major investor in most stock markets. Figure 1 summarises projected fund size.

Figure 1: Projected fund size and holdings in equity



Sources: *Ministry of Finance National Budget 2013, FTSE, NBIM data*

Despite diversification of investments across approximately 8,000 listed companies, NBIM is a major shareholder in a great number of individual companies. The equity portfolio has an average holding of 1.1 percent in listed companies within the investment universe and an average holding of 2.25 percent in listed companies in Europe.

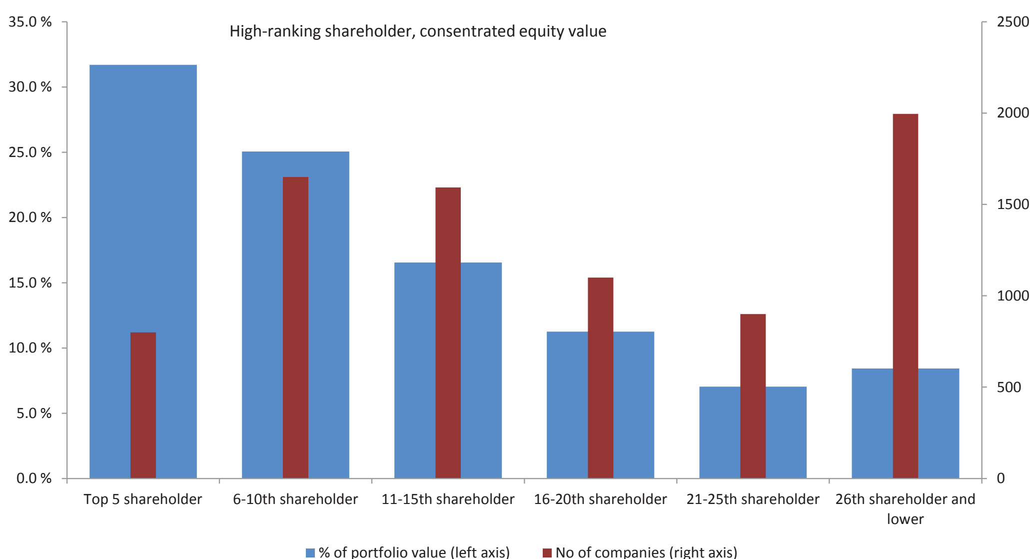
The ability of a shareholder to contribute meaningfully to the governance of a company may be related to holding size as well as rank on the share register. The percentage of votes held is of importance at the annual general meeting of shareholders. The rank on the share register is important as a proxy for access to corporate decision-makers, primarily the board of directors in the context of corporate governance.

There is no complete or consistent source for share registers globally, but using available third-party sources and NBIM holdings data, we can estimate the holding rank of NBIM in the companies the Fund invests in.

The data indicate that NBIM is among the 10 largest shareholders in approximately 2,400 companies[2] and among the five largest shareholders in about 800 companies. These 800 companies alone represent almost 32 percent of the value of the equity portfolio. The 2,400 companies in which the Fund is a top 10 shareholder represent 57 percent of the portfolio's value.

2 FactSet/LionShare and NBIM data.

Figure 2: NBIM shareholder rank tranches: number of companies and share of portfolio value (as at end July 2012).



The top 500 holdings in the portfolio represent 65 percent of the value of the equity portfolio; NBIM's average holding here is 1.6 percent. Within these 500 holdings, NBIM is a top five shareholder in about 140 companies, which represent 27 percent of the equity portfolio. The average holding in these 140 companies is 2.6 percent. 64 of the companies have no individual shareholder with more than 10 percent ownership. Less than half of these 140 investments represent significant overweight positions compared to the benchmark. This means that NBIM has a considerable and concentrated ownership responsibility by virtue of the investment strategy and the size of the Fund.

The data above indicate that NBIM is well-positioned to act as an active owner for a significant portion of the equity portfolio. NBIM needs to address its ownership opportunity adequately, irrespective of whether positions are actively or passively held.

Due to the size of the Fund and NBIM's ownership strategy, not only does NBIM have a strong interest in securing effective governance, but the Fund is also subject to greater scrutiny and expectations as to how it manages ownership. Since good corporate governance is dependent on the involvement of shareholders in communication with the companies and in the considered exercise of shareholder rights, the onus is increasingly on NBIM to consider our ambition and activity. In this note, we present arguments for how this supports NBIM's mandate to seek to achieve the highest possible return on the Fund.

1.3 NBIM's focus areas

In recognition of the size of the Fund and the broad topics that fall within the "responsible investment" objective, the Executive Board of Norges Bank has identified six focus areas for ownership activity. Two areas deal with corporate governance: "board accountability" and "equal treatment of shareholders"; one deals with market structure and functional ability: "well-functioning markets"; and three deal with environmental and social effects: "climate change", "water management" and "children's rights". This discussion note covers corporate governance only.

1.4 Ownership tools

NBIM has actively used a number of strategies and tools to advance its ownership activities. There are eight distinct tools, all of which are relevant to the corporate-governance focus areas:

- setting principles and expectations
- voting
- company interaction
- standard-setting, including public policy and peer-group initiatives as well as industry programmes
- shareholder proposals
- legal action
- reflecting corporate-governance characteristics in portfolio composition
- research

NBIM may express views publicly on individual companies only when this can improve and emphasise the principle-based stance, but will generally work on a confidential basis. Legal action will be evaluated on a case-by-case basis when necessary to safeguard the Fund's interests.

1.5 Expectations documents

NBIM regards the setting of expectations as central to the task of ownership. It provides an unambiguous foundation of thought and consideration for our work, and should provide guidance to companies on how to understand NBIM's priorities.

NBIM has issued expectations for the focus areas defined for our ownership activities. This discussion note deals with two expectations documents which have not been published previously:

- NBIM Expectations: Board Accountability
- NBIM Expectations: Equal Treatment of Shareholders

These documents are set out at the end of this discussion note as separate appendices.

2 Rationale for corporate governance expectations

The Government Pension Fund Global is a long-term, globally diversified shareholder with minority equity positions in publicly listed companies. The Fund therefore seeks protection of its financial interests through sound corporate-governance standards and practices as well as by other means. There has been a growing realisation among long-term institutional investors that they need to pursue better market standards and practices in order to promote behaviour which enhances returns and reduces risk in the companies they invest in.

This discussion note presents the rationale for why NBIM has emphasised corporate governance. A growing body of academic research underpinning investor efforts is reviewed. The discussion note also presents how NBIM seeks to promote good corporate governance through the expression of specific expectations.

2.1 Remit to safeguard the financial interests of the Fund

Above, we discussed the need to protect the Fund's interests via the means that corporate governance can offer.

In line with this need for protection, Norges Bank is mandated[3] by the Ministry of Finance as follows: "*The Bank's primary goal in its active ownership is to safeguard GPFG's financial interests.*" The Ministry also states that "*the Bank shall give priority to a long-term horizon for investments and the investments being broadly placed in the markets included in the investment universe.*"

We regard this remit as a guide to the application of all ownership tools, being either the exercise of our formal shareholder voting rights, or the wider influencing powers stemming from our significant ownership positions, investment capacity, company knowledge, ability to operate in investor networks, and the effect NBIM's actions may have on market standards and practices.

Through the mandate, the ministry asserts its belief that exerting influence as a shareholder and major investor has merit as a strategy to protect the value of the Fund. The mandate requires NBIM to take a broad and systematic approach to the ownership task. NBIM must direct its ownership influence towards the activities most important to protect the financial interests of the Fund. Finally, ownership activities should be framed along internationally accepted lines, as evidenced by the mandate's reference to UN and OECD guidelines.

2.2 Focus areas and their selection criteria

In the selection of corporate-governance focus areas, NBIM considered the following criteria:

1. Focus areas should capture the topics most important to protect the financial interests of the Fund

2. Focus areas should reflect the role of shareholders in the governance of the companies

3. Focus areas should be rooted in principles with broad support among investors

4. Focus areas should enable a relevant ownership programme at NBIM

3 Full mandate available on the Ministry of Finance's website.

NBIM has concluded that the focus areas for ownership activity within corporate governance should be:

- Board accountability
- Equal treatment of shareholders
- Well-functioning markets[4]

Each focus area has a rationale that matches the above selection criteria, as discussed below.

2.3 Rationale for board accountability

The Fund is broadly invested across the investment universe. In the long term, the Fund's equity portfolio will share key characteristics with global equity markets. From a portfolio perspective, ownership activities should aim at promoting factors that support competitiveness, innovation and corporate profitability within markets with the greatest concentration. NBIM's corporate-governance focus must be on mechanisms shareholders can use to influence companies towards sustained profitability.

NBIM believes shareholders in publicly listed companies are best served by delegating managerial issues to the company. Attempts by single shareholders to micromanage a dispersed-ownership company are likely to frustrate and undermine management, disturb strategy processes and blur lines of responsibility.

The better option for shareholders is to retreat from detailed involvement in corporate decision-making and hold the board accountable for its actions and outcomes. This model is the principled basis for corporate law in most markets and has support among shareholders.

However, market practices are often insufficiently tuned into actually holding boards accountable. This is partly due to inadequate mechanisms whereby boards may insulate or entrench themselves, and partly to a lack of initiative from shareholders to involve themselves in overseeing the boards. Being a constructive and firm owner overseeing boards and holding them to account remains an available option for NBIM.

Due to this, NBIM has identified board accountability as a focus area that meets the selection criteria of financial relevance, role consistency, shareholder backing and workability. We discuss briefly the formulation of concrete expectations on board accountability below.

2.3.1 Dissection of the expectations on board accountability

NBIM has chosen to break its "board accountability" focus area down into five headline expectations:

A. The board has a thorough comprehension of its role

B. The board fulfils its duties through high-quality work

C. Shareholders have the freedom to elect, and change, the board

D. The board sets out its strategies, processes and results in a transparent manner

E. The board assumes accountability for outcomes

This set of expectations forms a holistic argument regarding board accountability, and the roles of, and division of responsibility between, the board and shareholders. NBIM emphasises the high-quality advice that the board should contribute to the company. NBIM expects the board to ensure the

4 Full consideration given in a separate NBIM Discussion Note.

company reports comprehensively and truthfully to shareholders, and that it takes responsibility for the outcomes delivered. As a shareholder, NBIM will determine when a board needs to change.

This set of expectations distinguishes itself from other observed investor statements on corporate governance in four respects:

- It takes a high-level approach as opposed to giving detailed prescriptions
- It focuses on outcomes for the shareholder rather than technical compliance by the company
- It expresses support for the board and protects against shareholder intrusion into the remits of the board and management
- It calls on shareholders themselves to take action to hold boards accountable whenever needed

The expectations document on board accountability is presented in full in appendix 1.

2.4 Rationale for equal treatment of shareholders

The Fund is dependent on sustained profitability in the companies it invests in, and on their returning a reasonable and proportionate share of this to each shareholder. Since the distribution to shareholders is a residual claim, minority shareholders are vulnerable to agency costs and return leaks to players sitting closer to decision-makers.

While there are many sources of agency costs and return leaks, unequal treatment of shareholders is a weakness against which the law does not always offer shareholders sufficient protection. Benefits that risk being distributed unequally among shareholders include control rights, transaction design preferences, asset sales privileges and other preferential business advantages. Other return leaks may be excessive staff advantages and preferential business treatment of non-shareholder interests etc.; these are not addressed in this discussion note.

Even shareholder discrimination that is explicitly regulated, such as differentiation between share classes, often introduces conflicting interests and may be associated with additional agency costs.

Failure to ensure equal treatment of shareholders has potential remedies both in regulation and in market practices, as well as in behaviour by individual boards and management teams. At company level, the board has responsibilities that may affect the treatment of shareholders, such as managing the claims on the company of different stakeholders, choosing transaction designs, and initiating changes to the articles of association. All of these duties should be fulfilled to the satisfaction of the principle of treating shareholders equally. When unequal treatment exists, a periodic testing of its justification remains an available option for the board.

The "equal treatment of shareholders" focus area meets the criterion of being consistent with the principled view that shareholders should relate to the board as the body to look after their interests. Prevention of discriminatory distribution of benefits among shareholders is believed to be material in a global portfolio. Long-term investors tend to share concerns about discrimination against minority non-insider shareholders. A number of adequate tools are available to the investor, ranging from evidenced research, communication of expectations, influencing of market standards and regulations, and action targeting individual companies, to factoring shareholder protection factors into portfolio construction. Consequently, the four selection criteria for focus areas are met in the case of the equal treatment of shareholders.

2.4.1 Dissection of the expectations on the equal treatment of shareholders

The "equal treatment of shareholders" focus area has been broken down into three expectations:

A. The board will act in the interests of all shareholders

B. Board decisions should treat shareholders equitably

C. The board will consider steps towards equality

This set of expectations seeks a principled yet practicable approach to achieving and maintaining equality, acknowledging the global variety in law, tradition and practices. Against this background, we seek to move from principled debate on the merits of shareholder discrimination to an agreed roadmap towards equality and investor protection.

NBIM's expectations reflect its global approach, while most institutional investors take their domestic market as the point of reference. This provides for some approaches not usually seen in investor statements on corporate governance:

- While advocating equal treatment and rights among shareholders, NBIM accepts differentiation if the benefits can be evidenced to the satisfaction of different shareholder groups
- The board is expected to regularly test presumptions justifying unequal treatment
- The board must set out what the differences are, how they are justified historically and going forward, and their likely effects

The expectations document on equal treatment of shareholders is presented in full in appendix 2.

2.5 Role of expectations documents

NBIM's investor expectations are formulated in expectations documents, outlining expectations and requirements. The expectations documents are intended to support practical ownership. They are the foundation on which NBIM's ownership tools depend and core positions are founded.

NBIM analyses and interacts with companies as part of the investment process. NBIM interacts in order to gather information and deepen our understanding. However, NBIM also interacts in order to influence companies, by applying knowledge, investment capacity and shareholder rights. NBIM does this with the purpose of positively affecting long-term investment returns for the Fund.

The expectations documents specify the values and the practical expectations that NBIM will express when we interact with companies, as well as when we communicate via, for instance, NBIM's website. The documents provide guidance for all NBIM representatives on company interaction. Acting consistently lays the best long-term foundations for building suitable market expectations on investor priorities.

Specific expectations and suggestions will be formulated in each company engagement case as required, building a business case for the individual company underpinned by global expectations. The expectations documents will be available to boards of all portfolio companies and can be presented by NBIM representatives to all board members who interact with NBIM.

The documents provide the policy underpinning NBIM's wider strategy for ownership activities, including board dialogue and board appointments. Keywords in the strategy are "trust" and "accountability". Shareholders have entrusted the board with the stewardship of capital, and NBIM's relationship with the board therefore needs to be marked by accountability. Equally, NBIM expects that the board seeks the equal treatment of all shareholders.

The bottom line of the expectations is that NBIM will extend trust in the board as long as the information from the company to the market is of high quality, business implementation is in line with strategy, and outcomes are satisfactory. Any differences in shareholder treatment must be persuasively justified or removed. If these expectations are not satisfied and exceptions not convincingly explained, we may demand board change.

2.6 Relevance to board appointment strategy

As discussed above, the "NBIM Expectations: Board Accountability" document seeks to re-emphasise the board-shareholder axis as a key element in the governance of corporations. As part of this, we need to look at the role shareholders play in the process of appointing board members.

Shareholders have the responsibility to approve the board through board elections at shareholder meetings. This approval marks the end of the board appointment process.

The board appointment process, however, starts at a much earlier point in time with what NBIM labels the nomination process. The nomination process, in one form or another, starts with board member evaluation and the determination of criteria for candidate selection. The nomination process concludes with the production of a candidate list that is recommended to shareholders by the nominating body, this body usually being the incumbent board (the exception being in Sweden, where it is a shareholder-led nomination committee).

As shown, the board appointment process has two phases: the nomination process leading up to a recommended board slate for the coming term, and the formal election whereby shareholders are invited to approve the nominated slate. Since board elections are usually uncontested, the nomination process is the phase in which outcomes are most likely decided. While shareholders inevitably play a role in the board election at the shareholder meeting, they are largely absent in the usually more decisive nomination phase.

"NBIM Expectations: Board Accountability" states a requirement that shareholders are meaningfully involved in the nomination phase of the board appointment process. This is partly for the purpose of ensuring that shareholder interests determine the outcome of the process.

Shareholder involvement is also relevant for behavioural reasons. Board members will seek recognition for their contribution to the success of the company. The absence of shareholders in the nomination process will lead to weaker ties between board members and shareholders, and those ties may be supplanted by board member ties to those actually driving the nomination process.

Increased involvement of shareholders, if effective, will reinforce shareholders as a preeminent stakeholder group for board members. This is consistent with the function of the board in its duty to look after the interests of dispersed owners. Reforms of market practices for board nomination are, on this basis, a key element of a strategy for board accountability. The board accountability expectations lay a foundation for NBIM's activities in this area.

3 Theoretical and empirical foundations for NBIM's expectations

The process to establish the appropriate expectations should include an assessment of notable academic research. An understanding of the key institutional best practice conventions is also necessary. This chapter is not a comprehensive review of academic literature supporting NBIM's expectations. The subject is too broad to permit full coverage in the context of this discussion note. Consequently, there are known and doubtless unknown gaps in this review that may compromise the intended context and arguments of the authors reviewed.

3.1 Research universe

The literature on corporate governance has expanded over the past decade, and the exponential growth in output shows no sign of slowing. The Social Science Research Network (SSRN) database has more than 8,000 academic papers referencing "governance" published just in the past three years. This is a consequence of increased interest in the wake of corporate scandals and the ongoing credit crisis, but also reflects growing demand from practitioners for empirical evidence on the interplay between governance and corporate performance. It is also a consequence of greater supply from academic institutions with specialist centres and expertise in corporate-governance research. Inevitably, there is a trade-off between quality and quantity in all published research. We have elected to focus on what NBIM believes are the most prominent papers and research from faculties and authors considered to be at the forefront of corporate-governance research.

NBIM's goal is aligned with a commonly accepted definition of corporate governance, namely the way in which suppliers of finance assure themselves a return on their investment (Shleifer and Vishny 1997). A broader definition is provided by Goergen, Manjon and Renneboog (2004): "the amalgam of mechanisms which ensure that the agent (the management of a corporation) runs the firm for the benefit of one or multiple principals (shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business)." This references the wider universe of stakeholders affected by governance decisions, not all of whom have staked invested capital.

3.2 Governance and performance

A central theory underpinning much corporate-governance literature addresses the "agency conflict". The agency theory argues that managers and corporate insiders will have different objectives to those of outside investors and will act in their own best interests whenever they have the opportunity, usually at the expense of the outside investors (Jensen and Meckling 1976). O'Donnell et al. (2005) establish that the diagnosis of this corporate-governance problem goes back at least as far as Adam Smith (1776) who observed that directors in a joint stock company could not be expected to be as vigilant and careful with other people's money as with their own. This hypothesis is now grounded in research discussed in the following.

The opportunities for agency conflict are more likely to arise in companies with poor governance, characterised by weak or absent monitoring and disciplining mechanisms. By applying good governance practices, companies can reduce the agency conflicts and so improve company performance. On the basis of agency theory, therefore, there should be a positive relationship between company performance and corporate-governance practices.

Empirical analysis typically uses indexes on sets of observable governance indicators, or third-party corporate-governance ratings, as proxies for immeasurable or hard-to-measure governance practices. The findings of prior empirical studies investigating the relationship between corporate-governance ratings and firm value or performance are mixed.

There are a number of alternative routes to reviewing the body of research concerning governance and performance. A logical approach would be to review a range of generally accepted governance factors (for example, the 24 governance rules selected by Gompers, Ishii and Metrick in their 2003 study). From a global investor's perspective, however, the factor approach is hobbled by the lack of global data sets. Almost all studies are carried out on national pools of data. While clearly a compromise, we review the evidence on the basis of broad regional boundaries from which we draw some common conclusions.

3.2.1 US evidence

Gompers et al. (2003) document a strong correlation between anti-takeover measures and performance in the US. Using 24 governance rules, a governance index was constructed to proxy for the level of shareholder rights at about 1,500 large firms during the 1990s. An investment strategy that bought firms in the lowest decile of the index (strongest rights) and sold firms in the highest decile of the index (weakest rights) would have earned abnormal returns of 8.5 percent per year during the sample period. The study found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth and lower capital expenditure, and made fewer corporate acquisitions.

Bebchuk et al. (2004) advanced and refined Gompers' governance index on the hypothesis that there was no presumed reason to expect all 24 provisions to contribute to the documented correlation between index, performance and stock returns. Some provisions might have little relevance, while some provisions might have disproportionate correlation with firm value. The study concluded that just six provisions were uniquely correlated with reductions in firm valuation as well as large negative abnormal returns during the period 1990-2003: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. The same research is used later in the note to support the equal treatment of shareholders through the removal of such contractual impediments.

The Gompers and Bebchuk studies are counterbalanced by Larcker, Richardson and Tuna (2007) who find only weak evidence of a relationship between corporate-governance ratings and market value. Bhagat and Bolton (2007) find a positive link between a number of corporate-governance measures and operating performance, but no evidence of a relationship with stock performance or market value.

3.2.2 European evidence

With regard to European evidence, Drobetz, Schillhofer and Zimmermann (2004) document a positive impact from corporate-governance ratings on the market value of German companies, while Bauer, Gunster and Otten (2003) establish no significant relationship between corporate-governance ratings and either market or accounting performance measures.

However, any sample for empirical testing must control for the variation in legal and regulatory requirements from country to country within Europe, as well as the fact that many European companies are characterised by concentrated ownership structures (Becht and Roell 1999; Faccio and Lang 2002). Additionally, and unlike the US, European governance regimes are largely voluntary (Wymeersch 2005 and 2006) and legal investor protection is weaker than in the US (La Porta, Lopez-de-silanes, Shleifer and Vishny 1998). Finally, an active takeover market is largely absent in Europe (Mikkelson and Partch 1997) with the exception of the UK. NBIM's expectations are global in nature and must sit above these regional complications.

An explanation for why prior European studies failed to unequivocally establish a positive relationship between corporate-governance ratings and company performance is given by Gaeremynck et al. (2010). This paper models the relationship more carefully than earlier studies by controlling for selection bias, omitted variables and autocorrelations. It finds a significant positive relationship between corporate-governance ratings and performance. Notably, the paper finds that improvements in corporate-governance ratings over time result in decreasing marginal benefits in terms of performance.

3.2.3 Emerging-markets evidence

There is greater evidence to show that corporate-governance ratings have a significant positive impact on market value in emerging markets (Black 2001; Black, Jang and Kim 2006; Balasubramanian, Bala, Black and Khanna 2010).

3.3 The OECD, UN and ICGN institutional foundations for NBIM's expectations

Ownership activities are based on the UN Global Compact and the OECD's Principles of Corporate Governance and Guidelines for Multinational Enterprises. The NBIM expectations documents on board accountability and equal treatment of shareholders find primary relevance in the OECD principles and the International Corporate Governance Network (ICGN) Global Corporate Governance Principles. We have framed our reference analysis within the subject boundaries set by the OECD and ICGN principles. There are six OECD principles:

1. Ensuring the basis for an effective corporate governance framework
2. The rights of shareholders and key ownership functions
3. The equitable treatment of shareholders
4. The role of stakeholders in corporate governance
5. Disclosure and transparency
6. The responsibilities of the board

They reflect a global consensus regarding the critical importance of good corporate governance in contributing to the economic vitality and stability of economies by underpinning market confidence, financial market integrity and economic efficiency.

The expectations document on board accountability takes reference from three OECD principles:

- The responsibilities of the board
- Disclosure and transparency
- The rights of shareholders and key ownership functions

The expectations document on the equal treatment of shareholders takes primary reference from one OECD principle:

- The equitable treatment of shareholders

The OECD principle "Ensuring the basis for an effective corporate governance framework" is dealt with in the NBIM expectations document on well-functioning markets.

3.4. Academic foundations for specific expectations on board accountability

In the following discussion, we will take the OECD principles as a framework.

3.4.1 OECD Principle of Corporate Governance: The responsibilities of the board

- *The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.*

The board is found worldwide and is the overwhelmingly preferred organisational body for everything from the smallest, informal enterprise through partnerships, private and public equity corporations and NGOs to the largest governmental organisations. Its universality should lend it to a single theory of best practice. However, every board is a construct under national law rather than a natural phenomenon. Every board is, therefore, unique. Even if a global rule demanded all boards to be composed of an equal number of members with perfectly matching gender, age, qualifications etc., every board would still be unique as a consequence of individual and collective behaviours. The board is, therefore, a value-creating (or value-destroying) entity. This fact makes it necessary for investors to analyse the contribution of each board to business outcomes.

Adams, Hermalin and Weisbach (2009) recognise that the board differences that we would most like to capture are differences in behaviour. Unfortunately, outside of detailed field work (such as company meetings), it is difficult to observe differences in behaviour and harder still to quantify them in a way useful for statistical study. We do, however, call upon the literature survey by Adams and Ferreira (2010) as the basis for an understanding of recent work on the role of the board and its measurable impact on company performance.

Given this unavoidable fact, our starting point is to set expectations for what boards can do rather than a list of what they have done or what they must do. This approach is supported by a prior study (Carver 2010) and correctly acknowledges that a single governance framework – or the much sought-after single governance theory – needs to be sufficiently broad to encompass all governing boards, yet flexible enough to embrace every possible variation by jurisdiction, industry, culture and individual company circumstances.

3.4.1.1 Board behaviour

NBIM's expectations hypothesises that good governance is associated with a highly qualified, well-functioning and confident board. Every board member can act with integrity; therefore, it is quite reasonable that NBIM should expect board members to demonstrate behaviour, motivation and character worthy of trust.

While no code of corporate governance can demand compliance with a particular threshold of integrity, there is a solid academic footing for setting it at the heart of NBIM's expectations. Michael Jensen (2009 and 2010) defines integrity as honouring one's word. Integrity will provide unambiguous and actionable access to the opportunity for superior performance and competitive advantage at the individual, organisational and social levels. He further argues that integrity empowers the three virtue phenomena of morality, ethics and legality.

> [*Integrity*] *has nothing to do with good vs. bad, right vs. wrong behaviour. Like the law of gravity the law of integrity just is, and if you violate the law of integrity as we define it you get hurt just as if you try to violate the law of gravity with no safety device.* (Jensen 2009)

There is no "integrity measure" for measurement or comparative ranking purposes. Nevertheless, that must not prevent NBIM from establishing the clear expectation that accountability starts with an individual's behaviour and motivations. But a board is not just a collection of individuals. Ibrahim (2007) explores the individual/collective nature of boards and establishes a justification for regarding the board itself as a responsible entity. Montier (2005) extends this suggestion. He reviews the overwhelming

physiological evidence which suggests that if "good" people are put into bad situations they usually turn "bad". Taken together, investors require more than just good people on boards.

The NBIM expectations on board accountability set out a further four fundamental controls to act as monitors for the occurrence of Montier's "bad apples and bad barrels": transparency, independence, board process and an exemplary chairman.

3.4.2 Board actions and duties

In the absence of direct monitoring by shareholders (as can exist in a private equity model, for example), governance monitoring via the board of directors elected by shareholders is the necessary compromise.

Adams, Hermalin and Weisbach (2009) provide one of the most recent and comprehensive surveys of the literature on boards of directors. They find the two questions most asked about boards are: 1) What determines their makeup? and 2) What determines their actions? The questions are intertwined, which, they conclude, complicates the study of boards. The outcome of these questions is not answers but a third question: How can boards work better?

The core fiduciary duties of outside directors are set out by Black (2001). We have refrained from using the term "fiduciary duty" in the expectations document as it has a particular common-law connotation that is not appropriate for all jurisdictions. NBIM believes that every director will recognise the three key obligations:

- the duty of loyalty
- the duty of care
- the duty of disclosure

Black introduces a fourth, the duty of special care when a company is a takeover target, which we do not see the need to separate from the general duty of care in the document. Black sets out the case for each duty and concludes that they are "generally not waivable".

3.4.2.1 Board composition and independence

Much of the research on board composition focuses on the executive/non-executive split and then further into the independent/non-independent director division among the non-executives. One increasingly applied suggestion is to have independent boards. Gordon (2007) finds that, in the US, between 1950 and 2005, the composition of large public-company boards shifted dramatically towards independent directors, from approximately 20 percent independents to 75 percent independents. The analysis finds that the overriding effect of more independent directors is to commit the firm to a shareholder-wealth-maximising strategy. In this environment, independent directors are more valuable than insiders.

Initial empirical studies to measure the effects of director independence failed to find a link between board independence and higher firm value (Bhagat and Black 1999 and 2002). However, more recent studies (e.g. Chhaochharia et al. 2006) find that reforms requiring firms to increase their use of independent directors were associated with increases in the value of such firms.

However, there is now a body of research indicating that director independence is associated with improved decisions with respect to some specific types of topics such as CEO turnover (Weisbach 1988), executive compensation (Chhaochharia and Grinstein 2008), the incidence of fraud (Beasley, Carcello, Hermanson and Lapides 2000) and the incidence of opportunistic timing of stock-option grants (e.g. Bebchuk, Grinstein and Peyer 2009). We can conclude that the single dimension of independence brings service to the oversight function expected of the board.

3.4.2.2 The role of chairman

The vital role of chairmanship is best and most powerfully set out by Adrian Cadbury (2002). He is the founding father of the codified approach to corporate governance in the UK – the Code of Best Practice, or "Cadbury Code", was first published in 1992. Its novel "comply or explain" regime has become the blueprint for many national and international codes around the world. Cadbury sets out

a number of arguments for separating the roles of chairman and chief executive. First, that different mixes of ability and experience are required for the two posts. Second, that it is up to the chairman to build the board team, a task that takes time and commitment. Third, that putting the two positions together concentrates a great deal of power in the hands of one person. Finally, the combination makes it more difficult for the board to carry out its supervisory function.

The merits of separating the CEO and chairman roles have attracted a vast body of research (e.g. Donaldson 1991, Baliga 1996, Brickley 1997, Dahya 2000 and Faleye 2007), much of which is focused on the US market where the combined model has been relatively common – though less prevalent now. The studies only concern those markets where a single-board model applies and allows for the combination of roles. The empirical research finds no conclusive relationship between role separation and performance. Nor does the research find evidence that combining the roles creates value for shareholders. Despite such mixed conclusions, we find convincing merit in the original arguments set out by Cadbury and advocate a separation of roles.

Beyond separation of the CEO and chairman roles lies full independence for the chairman. The clearest call for independence has been made in a report published by the influential Millstein Center for Corporate Governance and Performance at Yale School of Management (2009). It argues that independent chairmanship of a public company is now an increasingly successful model of corporate board leadership in the US and Canada. Global experience has shown that the model is a tested instrument of governance. Having an independent chairman is a means to ensure that the CEO is accountable for managing the company in close alignment with the interests of shareholders, while recognising that managing the board is a separate and time-consuming responsibility. There has been less research on the nature of chairmanship, which may be a fertile area for study.

3.4.2.3 The CEO

There is considerable research into the role, duties, competencies, performance and remuneration incentives of the CEO. It is reviewed in detail by Adams, Hermalin and Weisbach (2009), so it is not necessary to review it again in this discussion note. Also, the NBIM expectations document does not have a particular focus on the CEO beyond the need for a relationship of mutual respect and trust with the chairman and board. The Adams et al. (2009) paper does review and comment on an area of interesting research pertinent to our focus. Baker and Gompers (2003), Boone et al. (2007) and Ryan and Wiggins (2004) each find evidence consistent with the idea that successful CEOs are able to bargain for less independent boards. When the CEO has bargaining power – specifically when he has demonstrated that he is a "rare commodity" by performing well – the board's independence declines. This outcome has been suggested as having been the case at the Royal Bank of Scotland (Financial Services Authority Board Report 2010) and is therefore a real and present danger to the goal of safeguarding value through good governance.

The board's dual role as advisor and monitor of management places the CEO in a conflict of interests. Adams and Ferreira (2007) present the trade-off a board member CEO faces when deciding what information is disclosed to the board: if he reveals all material information, he, as CEO, should receive better advice; however, an informed board will also be in a position to monitor management more intensively. Since an independent board is a tougher monitor, the CEO may be reluctant to share information with it. Thus, management-friendly boards can be optimal for the CEO but suboptimal for investors.

3.4.3 OECD Principle of Corporate Governance: Disclosure and transparency

- *The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.*

For a stock market to work efficiently and fairly, two principles must apply: companies need to release relevant information, and all those who want to deal in shares should have access to the same information at the same time. Stock exchanges and applicable company laws will codify these principles in slightly different ways. For example, the UK Listing Rules require that "a listed company must communicate information to holders and potential holders of its listed equity securities in such a way as to avoid the creation or continuation of a false market." This rule cannot be narrowly confined to the disclosure of price-sensitive information. It encompasses all communication by the company.

3.4.3.1 Disclosure

There are many ways in which the effects of information asymmetry have been measured in the academic literature. An interesting recent example is Ravina and Sapienza's 2008 study (there are a series of papers between 2006 and 2010 introducing, repeating and updating the study) which analyses the magnitude of informational advantage by comparing the trading performance of independent directors and other officers of the firm. It finds that independent directors earn positive and substantial abnormal returns when they purchase their company stock. Executive officers and independent directors both earn higher returns in firms with the weakest governance. In addition, independent directors who sit on the audit committee earn higher returns than other independent directors at the same firm. Independent directors earn significantly higher returns than the market when they sell the company stock in a window before bad news and around earnings restatements.

This is indication of information asymmetry. It is an obvious breach of the principle that ensures that timely and accurate disclosure is made on all material matters regarding the corporation. It provides the empirical foundation for our expectations on transparency and disclosure.

3.4.4 OECD Principle of Corporate Governance: The rights of shareholders and key ownership functions

- *The corporate governance framework should protect and facilitate the exercise of shareholders' rights.*

The most important contractual right that shareholders have is the right to vote on important corporate matters (Easterbrook and Fischel 1983), while director elections are at the core of corporate governance (Ventoruzzo 2010). Together, the right to vote and elect the directors constitutes a fundamental corporate-governance principle. Ventoruzzo (2010) argues that the extensive powers that directors enjoy as fiduciaries of the shareholders can only be justified if shareholders, acting as principals, retain control of the selection and removal of their agents. This expectation is clearly set out in our board-accountability document. Hermalin and Weisbach (1998) present a model in which directors imposed on the firm by regulations are likely to be less effective than those picked through the shareholder and board-selection process that occurs in the absence of regulation. The primacy of shareholders in the director-election process is established.

3.4.4.1 The right to elect

The right to vote and to elect may be fundamental, but the impediments to exercising this right are covered extensively in the academic literature. Bebchuk's 2007 paper "The Myth of the Shareholder Franchise" sets out the known obstacles to the power of shareholders to replace the board. He focuses on costs, information deficits on alternative candidates, board-adopted bylaws, staggered boards and plurality voting systems. NBIM's expectations do not (and should not need to) present an exhaustive list of reasons for the inability to elect directors. Rather, they simply set out the need to achieve this outcome at all companies in which the Fund invests.

3.4.4.2 Shareholders' right to seek remedy

Shareholder engagement as a necessary control mechanism and an obligation is well-documented in the academic literature. Nell Minnow said: "Boards of directors are like sub-atomic particles. They behave differently when they are observed." The behaviour of directors and the outcomes of boards can change when shareholders are active. The literature on the effectiveness of activism is extensive. Well-known studies include Becht et al.'s 2008 and 2009 papers on the returns to public and private activism in Europe and the returns to shareholder activism from a clinical study of the Hermes UK Focus Fund. Similar studies have been carried on CalPERS' Focus List engagements. The 2009 paper on the Hermes Focus Fund finds excess abnormal annual returns net of fees of 4.9 percent between 1989 and 2004. The authors estimated that around 90 percent of the abnormal fund returns was due to the activism programme. Other studies have found results less persuasive on the value of activism. However, Black (1998) observed that [the then] currently available evidence, taken as a whole, points to institutions achieving negligible effects on firm performance, but only as a consequence of the level of effort invested – "namely, not much".

3.5 Academic foundations for specific expectations on the equal treatment of shareholders

3.5.1 OECD Principle of Corporate Governance: The equitable treatment of shareholders

- *The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.*

3.5.1.1 Equal versus equitable

There is an immediate challenge to address with the NBIM expectations document on the equal treatment of shareholders. The OECD principle that frames the expectations sets out from a position of seeking equitable treatment of shareholders rather than equal treatment. There is an obvious gulf between equal and equitable treatment that is little addressed in the academic literature. We address this potential contradiction in the expectations document. There is no developed academic foundation – or apparent expectation – for all shareholders of every share class to be treated equally at all times.

3.5.1.2 Blockholder versus dispersed ownership

The literature acknowledges the artificial constructs that immediately arrive with different concentrations of ownership. As with boards of directors, share registers will never be uniform. They will reflect the origin, longevity, rule of law etc. of the company and its listing jurisdiction. La Porta et al. (1998) present data on ownership structures of large corporations in 27 developed markets and identify the ultimate controlling shareholders of these firms. Their findings reveal that, except in economies with very good shareholder protection, relatively few firms are widely held among sufficiently dispersed shareholders to prevent any one holder having superior influence or bargaining power over another. La Porta recognises that this reality of ownership is in contrast to the Berle and Means (1932) "classic" image of ownership dispersed between a multitude of small shareholders (giving rise to control concentrated in the hands of managers).

A premise for our expectations for equal treatment is the reality that the most typical modern (post-1932, non-US) corporation has ownership controlled by families, blockholders or the state. The UK model with dispersed shareholders is not typical. In controlled firms, there is a further inconvenient truth that the controlling shareholders typically have power over firms significantly in excess of their cash flow rights, primarily through the use of pyramids, preferential rights or participation in management.

Another unavoidable conflict with equal treatment of all shareholders is the impact of share-owning managers on the outcome of a corporation. As an example, Jensen (1988) usefully summarises a series of papers published in the *Journal of Financial Economics* and originally presented at a conference on the distribution of power among corporate managers, shareholders and directors. One of the major findings was that patterns of stock ownership by insiders and outsiders can influence managerial behaviour, corporate performance and shareholder voting in election contests.

So, having set the scene for the impracticality of equal treatment of all shareholders, it is relevant to consider the literature on two alternative fronts: 1) Equal treatment of shareholders in the same share class, and 2) Fair treatment of all shareholders by the appointed board. This is again done within the OECD framework.

3.5.1.3 Behavioural and structural causes of inequitable treatment of shareholders

The equal/equitable treatment of shareholders can be divided into behavioural and structural (contractual) causes. The behavioural aspects of equal treatment – such as those requiring the board to demonstrate that it has considered the interests of all shareholders in its decision-making and actions – are addressed in the board-accountability literature review. This is quite simply due to equal and equitable treatment of shareholders being a measurable outcome of board action and behaviour.

The literature review for equal treatment of shareholders will concentrate on the empirical analysis of structural impediments to equal treatment. These include anti-takeover defences such as supermajority amendments, staggered boards and poison pills, in addition to contractual impediments such as multiple share classes, differential voting rights, blockholders, voting caps and golden shares.

3.5.1.4 Contractual anti-takeover defences

The research appears to settle upon two alternative hypotheses regarding the effects of takeover defences. The first alternative suggests that managers adopt takeover defences to preserve their jobs at the expense of shareholders (DeAngelo and Rice 1983). The second alternative argues that takeover defences increase shareholder wealth because they enhance management's ability to either extract higher premiums from legitimate acquirers or to fend off inadequate offers (Linn and McConnell (1983) set out a review). This is the shareholder interest hypothesis. The extensive research does not settle on a clear conclusion. This is despite, as the authors acknowledge, the studies often using similar methodologies and sample periods. Bebchuk and Cohen (2004) find that staggered boards are associated with an economically significant reduction in firm value (as measured by Tobin's Q). They also find evidence consistent with staggered boards bringing about, and not merely reflecting, a lower firm value.

Ray (2004) provides another useful summary of each side. He finds the defences are seen by many to be against shareholders' interests and to be put in place by managers of companies with weak corporate-governance structures (Gilson 1981; Easterbrook and Fischel 1981). Others find them to be an important weapon enabling the target firm to extract better terms from a raider (Baron 1983; Macey and McChesney 1985; Shleifer and Vishny 1986; Hirshleifer and Titman 1990; Hirshleifer and Thakor 1994; Hirshleifer 1995). From the perspective of a minority shareholder, who cannot always be sure of effective monitoring of management, it is natural to emphasise the disciplinary effect on management of an open market for corporate control. As a shareholder of the acquiring company in a takeover situation, close scrutiny of the claimed benefits of the transaction is necessary.

3.5.1.5 Majority or minority controlling shareholders

Turning to the role of shareholder blocks and their impact on equal treatment, Bebchuk and Weisbach (2009) set out in great detail the corporate-governance implications of controlling shareholders (controlling can be economic control, voting control or minority control by veto). They acknowledge that, with a controlling shareholder, the fundamental governance problem is not opportunism by executives and directors at the expense of public shareholders at large but rather opportunism by the controlling shareholder at the expense of the minority shareholders. As, by mandate, NBIM is a perpetual minority shareholder, it is NBIM that will suffer value expropriation.

The opportunity for financial tunnelling – the legal but self-serving reallocation of assets or cash flow by major shareholders or the management of a publicly traded company – is addressed in the literature. Kirchmaier et al. (2009) and Johnson (2000) set out the value disadvantage to minority shareholders in circumstances of tunnelling. It is important to note that these studies concern US and European universes.

3.5.1.6 Multiple share classes and differential voting rights

The literature on multiple share classes is deep and broad. There is a long history of decoupling of economic and voting ownership for studies to tap, and there are many jurisdictions in which it is permitted. Together, they produce a rich stream of data. Hu and Black (2007) set out the multitude of mechanisms by which voting and capital rights can be separated. Rightly, NBIM's expectations do not discriminate between methods. Gompers, Ishii and Metrick (2003) report evidence that US firms with strong takeover defences have lower share prices than firms with weak defences. Cremer and Nair (2005) report positive abnormal returns to firms with weak takeover defences. Both papers suggest that insider entrenchment through asymmetric vote entitlement could reduce firm value. The conclusion opens up another enormous thread of research that addresses the efficiency of family control. Zingales (2004) and Mork (2000) provide a respected door to enter this topic. We can conclude that, from a minority investor's perspective, it is questionable whether the disadvantages of multiple share classes with differential voting rights outweigh any liquidity or ownership advantages.

3.6 Next steps

The preceding section is a very brief survey of the body of academic literature relating to the broad subject of governance. It is not a robust test of the foundations of good corporate governance and cannot fully ensure the long-term integrity of NBIM's accepted principles. Separate surveys and/or discussion notes can be produced on a number of topics directly referenced by our expectations – for

example, separation of chairman and CEO, board independence and the provision of pre-emption rights. Alternatively, there are topics that are tangential to individual expectations but central themes of governance and investment. Take, for instance, asset tunnelling. Asset (or financial) tunnelling is the possible outcome of weak board accountability *and* inequitable treatment of shareholders. The corporate-governance term refers to the expropriation (hence, tunnelling) of minority shareholders' wealth to other parties. Typically, those parties are management or other shareholders with superior rights. These rights may be control, information, board or voting. As a minority investor, NBIM is subject to the risk of asset tunnelling and its impact on our task to safeguard the financial interests of the Fund.

A second topic integral to NBIM's mandate is the evidenced relationship between corporate-governance practices and financial performance. Deeper study and research will serve the purpose of supporting the argument of holding the board accountable for corporate outcomes.

4 Considerations when applying global expectations to individual companies

4.1 Investor-led global guidelines and codes of governance

We acknowledge the influential role played by global guidelines and international codes of governance in framing the debate on corporate-governance best practice. The previous chapter sets out the theoretical analysis that provides some foundation for best-practice standards and codes. We have made reference to the OECD Principles of Corporate Governance. Other sets of global guidelines are the Principles for Responsible Investment (PRI) and the International Corporate Governance Network (ICGN) Global Corporate Governance Principles. The ICGN principles are intended to be of general application around the world, irrespective of legislative background or listing rules. They assert standards of corporate governance to which global investors believe all companies should aspire. In addition to these global principles are national laws, governance codes and listing rules, industry standards and voting guidelines set by major investors and by a number of proxy advisors.

Such a plethora of standards poses a challenge for companies, as the aggregate matrix of all such informal guidelines must be accommodated within formal statutory laws and listing requirements. This is all before a company's own specific governance requirements are addressed.

4.2 Translation of guidelines into formal rules

There is a conflict between advancing detailed universal principles and the need to take legitimate company-specific factors into proper consideration. We observe that this conflict is largely addressed by investors through rigid application of voting rules with the consequence of subduing considered, applied governance. The outcome is largely unhelpful to companies. This problem is to a great extent created by institutional investors rule-basing or outsourcing their exercise of shareholder rights with minimum investment in company-specific research.

4.2.1 The first chapter of corporate governance: code development

The original 1992 UK code of good governance (by informal tradition referred to as the "Cadbury Code"), on which many subsequent national and international codes have been based, was not intended to lay down the law on how companies should be governed. It was, explicitly by design, a statement of recommended good governance practices. It was then for boards to implement in ways which made sense to them and to their shareholders. Corporate governance would then be correctly positioned as a contract between a company and its investors.

In the intervening twenty years, these well-founded best-practice recommendations have been somewhat corrupted – first into principles and then into hard and fast rules. This has largely occurred for reasons of expediency and convenience. It is also an outcome of international portfolio diversification and a tradition of global standards and benchmarks in other important areas of investment: accounting, financial reporting, financial ratio analysis etc. A separate corporate-governance lexicon has been created which is now technical and perhaps largely impenetrable to the generalist investor.

The 1992-2012 period can be considered as the first chapter for broad acceptance of corporate governance where the concept became legitimised as integral to good stock-picking and risk analysis.

4.2.2 The next chapter of corporate governance: applied ownership

As institutional investors have gradually recognised the potential importance of corporate governance to long-term returns, the tendency has been to organise specialist functions that are often not fully integrated in investment processes. The NBIM expectations documents are intended to lead into a next chapter that de-emphasises corporate governance as an independent function and integrates it as a discipline within a balanced and long-term investment-decision-making process. NBIM cannot

lean on established market practices in this shift to applied fundamental ownership. However, it can be a model for other funds to follow. It will be welcomed by companies if implemented effectively.

4.3 NBIM expectations in support of active ownership

When applied to the tool of company interaction, the NBIM expectations seek to avoid being another layer of rules. The documents set out their intended purpose as:

> *"a reference tool in board corporate-governance discussions and planning. Our intention is not to provide another code of corporate governance for companies to comply with or report against."*

The expectations can be considered effective if they are recognised as a catalyst for deeper communication and consideration of corporate governance at company level. Underlying the expectations is the idea that market practices should conform to high-level universal principles rather than to detailed prescriptive rules. To this end, a key component of the process to determine the expectations has been early input and testing by a number of practitioner and stakeholder groups. We address our expectation preparation and testing with company directors in the next section of the discussion note.

5 Findings of practitioner contributions

Subsequent to internal deliberations on the expectations documents at NBIM and Norges Bank, we have consulted selected external practitioners to obtain independent feedback.

A first round of consultations in the summer of 2011 included key governance stakeholders – investor, company, academia, regulator, proxy advisor, executive search, standard-setter and emerging-market investor advocacy.

A second round in late 2011 and early 2012 focused on 20 selected corporate board chairmen/women and other individuals of recognised corporate influence to "road-test" the NBIM expectations on board accountability.

The samples were not intended to be entirely representative. The process merely focused on obtaining qualitative feedback and ideas and to "road-test" the expectations in discussions with the intended audience and other stakeholders.

The consultations, while not altering the overall approach, were valuable in clarifying and nuancing the documents.

5.1 Main conclusions from chairman meetings

The chairman meetings inspired and renewed our optimism in the possibility that lies within every company and its board of directors. Consequently, the expectations set the stage for vaulting ambition among directors individually and the board collectively. The tone of the document became clearer and less cautious. In particular, the following clarifications were made:

- There should be unambiguous expectations on the integrity, behaviour, motivation and character of directors who accept the invitation to join a board
- The duty to build value over the long term should not be frustrated by short-term distractions
- The primacy of the role of the chairman and a particular skill set for chairmanship should be expressed directly
- Delineation of duties between the board and the executive should be clarified

We continue to focus on the role of the board and its accountability to shareholders. The complex dependencies that exist between the board and the executive are addressed but, consciously, cannot be the focus of the document.

5.2 Other input from chairman and leading board expert consultations

We present a brief summary of the points most frequently raised by chairmen/women and other leading board members in the consultations on the investor expectations on corporate governance.

5.2.1 On the communication between board and shareholders

- Informed shareholder engagement – to discuss high-level governance, board nomination and strategy issues – is legitimate and, in most cases, welcome, but even top shareholders in major companies are generally quite passive. The lack of relevant initiative on the part of shareholders is generally a bigger problem than any deviations from the official "rulebook" for governance.
- It is important for institutional investors to have a close dialogue at board level in order to understand whether the board is effective. The chairman has a pivotal role in framing the board dynamic and

overseeing management to ensure high performance. "Get to know your chairman!" one chairman said.

- Shareholders can demand deeper and more honest communication with the board and top management while respecting fair-disclosure guardrails as they apply in different jurisdictions. Management too often chooses to market the stock as a substitute to truthful and balanced information.

- External asset-manager incentives are generally not tuned into fostering proper corporate-governance dialogue. Even many of the largest institutional investors spend minimal time and resources caring about key governance processes.

5.2.2 On the responsibility of the board

- Shareholders are right in holding the board accountable for financial performance, transaction merits and shareholder return relative to the competition. But close examination of outcomes over reasonable time horizons is necessary.

- While codes of best practice for corporate governance are useful, due consideration should be given to the specific circumstances and challenges of the individual firm. Governance should not be oversimplified to the point where firms are scored on shallow compliance with codes. It has more to do with actual processes and behaviours that cannot be easily observed from public reporting.

- The term "board accountability" should be used carefully so as to indicate that the investor is not only focusing on the past. The most important issue is the future and whether the company has a good enough board in that respect.

5.2.3 On the relations with the executive

- "The way the company is governed is a proxy for the quality of management," one highly experienced board member and previous asset manager said.

- On corporate governance, the board and the chairman should be the focal point for shareholders, not the CEO.

- The processes for developing and implementing corporate strategy require a long-term view and commitment, and it is therefore desirable to shield management from an overly short-term quarter-to-quarter focus in the market. The board must be able to support management in this respect.

In conclusion, the feedback largely supports our strategy of taking a high-level approach, but at the same time emphasising company specifics and board dynamics in a programme of close contact with the boards of portfolio companies.

Appendix 1

NBIM Expectations: Board Accountability

Norges Bank Investment Management (NBIM) is responsible for investing the assets of the Norwegian Government Pension Fund Global. The goal of our ownership activities is to safeguard and build wealth for future generations.

Purpose

When applied to the ownership tool of company interaction, the purpose of the expectations on board accountability is to provide board members with a clear understanding of what NBIM expects of them individually and collectively.

The document serves as a transparent basis for constructive dialogue between NBIM and the companies in which we invest.

We encourage directors to use our expectations as a reference tool in board corporate-governance discussions and planning.

Our intention is not to provide another code of corporate governance for companies to comply with or report against.

Why is board accountability important for NBIM?

As a shareholder, we are one of many contributors of equity capital to the company. This high number of shareholders cannot manage the company without delegating most decision-making authority to the board of directors. For this delegation to function effectively, there needs to be a high degree of board accountability towards shareholders. We will not seek to micromanage the company. Rather, we will hold the board accountable and reserve the right to seek changes to the board when it deviates from our expectations.

We regard board accountability as essential to ensure that boards manage invested capital efficiently.

Expectations

Our expectations are laid out in five sections with accompanying requirements. These sections encapsulate what we regard to be the chronology of board accountability:

A: The proper perception of the role of the board is fundamental to its success. This first section is therefore titled: **'The board has a thorough comprehension of its role'**. By getting to a shared view of its role, the board has gone a long way towards confidence and accountability.

B: Once the role of the board is clear, it can have confidence to set itself high standards of contribution to the success of the company. This section is titled: **'The board fulfils its duties through high-quality work'**. Our investments are best safeguarded by an exemplary board of directors reflecting the specific and changing needs of the company.

C: The equity investors have the ultimate responsibility for ensuring that the stewardship of capital by the board is of sufficiently high quality. It is therefore essential for shareholders to be able to meaningfully use their director election rights. This section is titled: **'Shareholders have the freedom to elect, and change, the board'**. This provides the necessary rights of authorisation and sanction to ensure that a company is governed accountably.

D: For investors to carry out their role, the board must ensure the company makes all material information available. This section is titled: **'The board sets out its strategies, processes and results in a transparent manner'**. Through transparent communication, the board allows the corporate strategy and its inherent risks and rewards to be understood by shareholders.

E: The board must take responsibility for its decisions and outcomes. This section is titled: **'The board assumes accountability for outcomes'**. As shareholders, we have entrusted the board with the responsibility to manage capital on our behalf. Such delegation can only work if the board is accountable for the outcomes.

Within these five sections, we have divided our expectations into requirements for the board and, where appropriate, requirements for directors and the chairman.

A. The board has a thorough comprehension of its role

Shareholders receive a return on their equity only after the company has ensured the fulfilment of obligations to all other parties. Shareholders are therefore rightly given prerogatives to influence the company through the appointment of the board and the approval of certain decisions. They will use their rights in support of the goal of maximising the return on equity. This is the starting point for defining the role of the board.

Each board will find value in the thorough contemplation of its role. However, across jurisdictions, cultures and industries, five universal principles exist for the role of the board:

1. *The board must act as representatives of the owners of the equity capital.* Each board member shall promote the interests of all shareholders, without discrimination.

2. *The board shall appoint the chief executive and oversee the implementation of strategy by management.* The board shall monitor and guide management, set its remuneration, and change management when needed.

3. *The board shall approve overarching strategic decisions, without striding into the realm of management or being distracted from its monitoring role.* It shall check that implementation is in line with strategy. The board is ultimately responsible for managing conflicts of interests and relations with affected parties, as well as ethical dilemmas.

4. *The board is responsible for establishing a corporate-governance system that alleviates agency costs.* Wide delegation of powers to the board and subsequently to management is in the interests of shareholders. However, minority protection, shareholder approvals and the right to make changes to the board are necessary safety measures.

5. *The board must ensure adequate and honest information to the market and the shareholders.* Reporting must aim at building trust, and the board must accept responsibility for the entirety of the company's communication.

B. The board fulfils its duties through high-quality work

Good governance starts with a highly qualified, well-functioning and confident board. Our investments are best safeguarded by an exemplary board of directors led by a fully engaged and motivated chairman. NBIM expects every board to have a clear aspiration to create value. All directors are in a privileged position to contribute to the delivery of superior business performance that can be maintained over the long term.

To the board:

We expect directors to possess independent perspectives and competencies that meet the specific and changing needs of the company, so that the board has sufficient industry and financial knowledge to understand risks and to constructively challenge strategy. In order to enrich decisions and channel management, the board must have independent authority.

The board must implement a framework of clear governance that allows management to take a long-term perspective on business development. It is the board's responsibility to ensure that short-term influences cannot distract the company from this task.

Principles to delineate the responsibilities between the board, chairman and chief executive must be clearly established and anchored by the board. This framework should shield management from inappropriate intervention by the board in managerial decisions.

The board should seek shareholder approval for changes to bylaws/articles of association, share issues, dividends and other changes to equity and shareholder rights.

Shareholders should have the right to file proposals at general meetings of shareholders, including bylaw changes.

The board should not try to protect itself from shareholders through takeover defences or otherwise. It should not seek to circumvent or manage shareholder approvals or block proposals put forward by shareholders.

To the directors:

Directors should demonstrate behaviour, motivation and integrity worthy of trust.

Alternative views, as well as the constructive challenging of management's proposals, are necessary contributions to excellence in decision-making and should be encouraged by fellow board members.

Directors should be able to secure all necessary professional resources to support their work and to ensure that all directors can contribute to their fullest capacity.

Board members must ensure sufficient time to prioritise both planned processes and contingencies. Only board members with no executive employment should normally accept more than two outside board assignments. No-one should accept more than three to five board assignments depending on complexities.

Before a top executive accepts a board seat in an external company, the board of the company where the executive is employed should consider the trade-off between the corporate benefit of having executives on the specific external board against the usage of executive time in his/her primary job.

To the chairman:

We consider the role of chairman to be crucial to a well-functioning board. The chairman must ensure that the necessary culture and behavioural dynamics prevail on the board. All board members should be expected to contribute to the deliberations. Constructive debate and the

ability to disagree with management and the majority of the board must be promoted. We expect the chairman to act decisively if board dynamics are suboptimal.

It is the responsibility of the chairman to present management with firm conclusions after the deliberations of the board, or if necessary explain the further processes needed for the board to conclude.

An effective relationship between chairman and CEO is vital. It is the duty of the chairman to ensure such a relationship exists and to seek remedy when it does not.

The chairman role demands unconstrained attention and commitment. This will determine the time allocation to other obligations.

We expect no chairman of a complex company to be the serving CEO of another company.

The roles of chairman and CEO are fundamentally different and should not be held by the same person. This can best ensure effective monitoring of management, and a balance of power in the governance of the company. A separation provides a greater opportunity to devote the attention each role demands.

C. Shareholders have the freedom to elect, and change, the board

Shareholders should have the right to approve fundamental changes affecting the company. This will include the right to appoint and remove directors. Moreover, shareholders will benefit from a rigorous nomination process through the phases of board evaluation, criteria identification, candidate search and appraisal, and proposal and explanation.

To the board:

It is incumbent upon the board to ensure a process by which shareholder input into the director evaluation and nomination process has been established. The shareholder body must be close enough to the nomination and election process to determine its outcome.

The board or nominating body must demonstrate that it has considered the future needs of the company when recommending board candidates. The required future characteristics and capabilities of the board should be compared with the current composition.

The board should provide comprehensive information in a timely manner so that shareholders can make an informed voting decision in board elections.

The information to shareholders on the nominees should explain the main qualifications each individual brings to the board in light of the identified requirements of the company.

The information provided must include all contractual and non-contractual benefits offered to the director and associates, as well as all information that may have a bearing on an individual director's ability to act in an independent capacity.

A board must not establish a formal or informal process that aims to result in its self-perpetuation. We expect the board to establish a nomination process for prospective board directors that is transparent and accommodates alternative pools of candidates.

The right to elect directors is contingent upon three key requirements:

- All directors should stand for re-election at frequent intervals in line with the global trend towards shorter election terms.
- Each director must be approved by a majority of the shares voted.
- There should be a way for shareholders to put forward alternative candidates inexpensively and with reasonable ease.

To the chairman:

The chairman or, where relevant, the lead director must take particular responsibility for the planning of succession for the board member and chairman roles. He should facilitate input from shareholders and be open to discussing board development with them.

D. The board sets out its strategies, processes and results in a transparent manner

A company has a choice as to how transparently and consistently it informs shareholders. This choice is demonstrated by the content of financial statements and periodic reporting, including securities market communications, company policies, information on key board processes, ad-hoc statements and all private communication.

To the board:

The board is to be held responsible for all the information that is provided by the company and for how the company chooses to communicate with shareholders and the wider market.

We expect the board to ensure the company communicates the corporate strategy and its inherent risks and rewards in a manner that permits the strategy to be understood by shareholders.

The board must fully inform shareholders about its structure, activities and procedures so that shareholders have confidence in the outcome and integrity of these processes.

The board must not assess the information needs in light of legal requirements only, but rather seek the best possible understanding by shareholders with the likely benefit of higher trust and better evaluation. In doing so, the board should benchmark the information practices against the best practices seen in the global marketplace.

We recognise that cultural differences can affect the way businesses must operate to be successful. This should not prevent boards from being transparent and accountable.

To the directors:

Prior to election, and on a regular basis, each director is responsible for providing the necessary disclosures regarding conflicts of interests, independence and competencies, so that shareholders can determine the basis on which director duties will be fulfilled.

To the chairman:

The chairman must ensure the full understanding of the actual information practices of the company, including the investor relations process and private investor communication by management.

The chairman is expected to seek an understanding of the views and concerns of shareholders and to communicate these views to the board. It will then be possible for the board to take this information into consideration when it establishes strategy. However, the board cannot be distracted by special interests promoted by single shareholders.

The chairman must expect every board member to report whenever a director is at risk of becoming conflicted or his/her impartiality cannot immediately be trusted.

E. The board assumes accountability for outcomes

Shareholders should not seek to interfere with executive decision-making or with the board in the setting of strategy. Wide delegation to the board can only work if there is accountability for outcomes, both individually on the part of directors and collectively on the part of the board. The board must, in turn, ensure full accountability of executive management to the board.

To the board:

The board is responsible for the outcomes of its decisions. Among others, essential outcomes include:

- The sustainable profitability of the business
- The acceptable treatment of stakeholders
- The corporate-governance provisions
- The managed levels of financial, commercial and operational risks
- The adherence to stated strategies and risk levels
- The integrity of financial reporting
- The capability to honour dividend policy
- The long-term total return to shareholders

The board should recognise the long-term nature of value-creation processes and that profitability today is influenced by previous board decisions.

We expect the board to maximise long-term returns on shareholders' capital within the understood and communicated strategy and risk.

We expect the board to establish sound and rational incentives that provide for good business management. The board should seek cost-efficient ways to align management with shareholder interests, but also guard against the pursuit of private transactions or personal benefits.

The board should not shield itself or management from being accountable to shareholders by installing or maintaining control or defence mechanisms.

To the directors:

Individual directors must be prepared to step down from the board if they have material unresolved concerns or doubts over the outcomes or the processes and decisions of the board.

Appendix 2

NBIM Expectations: Equal Treatment of Shareholders

This section sets out the document 'NBIM Expectations: Equal Treatment of Shareholders' in its entirety and concludes the discussion note alongside the preceding expectations document on 'board accountability'.

Norges Bank Investment Management (NBIM) is responsible for investing the assets of the Norwegian Government Pension Fund Global. The goal of our ownership activities is to safeguard and build wealth for future generations. Our activities are based on the UN Global Compact and the OECD's Principles of Corporate Governance and Guidelines for Multinational Enterprises.

Purpose

When applied to the ownership tool of company interaction, the purpose of the expectations on equal treatment of shareholders is to provide board members with a clear understanding of what NBIM expects of them individually and collectively. The document sets out NBIM's ownership priorities for equal treatment of shareholders. It also serves as a transparent basis for constructive dialogue between NBIM and the companies in which we invest.

We encourage directors to use our expectations as a reference tool in board corporate-governance discussions and planning. Our intention is not to provide another code of corporate governance for companies to comply with or report against.

Why is equal treatment of shareholders important to NBIM?

NBIM is a diversified investor that, by mandate, holds minority stakes in listed companies. Consequently, the protection of minority shareholders' rights is a necessary requirement to protect and promote the Fund's long-term returns.

Every listed company has made a conscious choice to seek the economic benefits of external capital. By doing so, the board has implicitly accepted the obligations of public-market participation and must act in the interests of all shareholders. This necessitates recognition of the principle of equal treatment of shareholders.

Expectations

Our Expectations are laid out in three sections with accompanying requirements. We establish the requirement for transparency in structure and transactions, and the goal that all transactions benefit shareholders equitably, before concluding on routes to remove aspects of unequal rights.

A: **The board will act in the interests of all shareholders.** The board will always act with integrity and ensure equal access to comprehensive information for all shareholders.

B: **Board decisions should treat shareholders equitably.** It is the responsibility of the board to always seek solutions that fairly distribute the benefits among all shareholders.

C: **The board will consider steps towards equality.** Current inequality may be justified, but the board should consider the appropriateness of these structures at reasonably frequent intervals.

Within these three sections we have divided our expectations into requirements for the board and, where appropriate, requirements for directors.

A. The board will act in the interests of all shareholders

The board is always expected to create value with an eye to the equal benefit of all shareholders. We accept and support that a majority shareholder may seek to exert control via board representation, but not at the expense of other shareholders. Even a controlled company must ensure measures are in place to protect the interests of non-controlling shareholders.

To the board:

We expect the board to demonstrate that it has considered the interests of all shareholders in its decision-making and actions. NBIM expects shareholders to have equal access to all relevant information. The board should provide sufficient transparency of communication to enable all shareholders to make equally informed investment decisions.

The capital structure should be clearly set out. Shareholders should be provided with a description of all authorised share classes and the voting and cash flow rights associated with each class.

Any ownership and control structure known to the board that may influence the control of the company should be disclosed annually. This should include cross-holdings, interlocked board representation, pyramid structures and any informal control structure that may impact the governance of the company. We expect the board to describe all inequalities of shareholder rights and what purpose each serves.

We expect credible representation of independent directors on the board, and full, auditable transparency of decision-making.

To the directors:

- All directors must act in the interests of all shareholders. This will require the highest standards of director integrity and conduct.

B. Board decisions should treat shareholders equitably

The obligations of public-market participation for companies are framed by laws, formal listing rules and corporate-governance codes. However, the reasonable expectations on board decision-making extend beyond narrow, legal or regulatory compliance requirements. There are further duties resting with directors individually and the board collectively to secure the equitable treatment of shareholders.

To the board:

- The company must demonstrate that there is equal treatment of all shareholders within the same class of shares. NBIM expects the board to avoid board members becoming unnecessarily conflicted. The board should establish auditable systems and procedures to manage and regulate such conflicts. This should include a disclosed policy for the recusal of board members from participating in board discussions and voting when there is a potential disqualification.

- All related-party transactions should be declined, unless such transactions can be shown to be the best business opportunity and beneficial for all shareholders.

- The board should treat shareholders equally in the event of a takeover offer. Shareholders' pre-emption rights in capital issuances should be applied and respected. When the board seeks to waive current shareholders' pre-emption rights, including the issuance of convertible securities and other derivatives, it must ensure that the decision fairly benefits all shareholders.

C. The board will consider steps towards equality

In most circumstances, the equal rights of all shareholders, in proportion to their holding, will reduce the potential for conflicts of interests, mitigate agency costs and avoid unnecessary costs of capital.

To the board:

- We expect boards of companies with differential rights to consider the arguments in favour of moving to an equal-rights regime. The board should make such an assessment at regular intervals and upon restructuring and capital events. As an outcome of its assessment, we expect the board either to propose steps towards equalisation, or to demonstrate to the satisfaction of shareholders why discrimination is beneficial to all shareholders.

- We expect the board to demonstrate its commitment to removing differential rights when designing corporate actions, including share buy-backs and issuance.

- When removal of differentiated rights requires a conversion transaction, the terms must be fair and reasonable. We expect all share classes to approve the transaction.

- The board should ensure equal treatment of all shareholders when making changes to the corporate structure, and when designing and setting the terms of transactions.

- Ultimately, we expect the board to implement one share class with each share having one right to vote.

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