

# Corporate Governance Handbook of the SCGOP

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Since the end of the 1980s, when investing in shares started to become more popular, attention has focused increasingly on how publicly traded companies are managed.

It started in the United Kingdom and United States and spread from there.

In the Netherlands, interest in Corporate Governance was kindled by the publication on June 25<sup>th</sup> 1997 of 40 recommendations for “sound management, effective supervision and accountability” by the Corporate Governance Commission chaired by Mr. Peters.

This handbook is a publication of the Foundation for Corporate Governance Research for Pension Funds aimed at giving a concise account of what corporate governance means in practice and why it has become a major issue for pension funds.

The Foundation for Corporate Governance Research for Pension Funds, which goes by the Dutch acronym SCGOP, was established in 1998 to enable pension funds to work towards improving the corporate governance of companies in which they invest. The Peters Commission report was the first step in this line of action.

The founders of the SCGOP consist of four industry sector pension funds and four company pension funds. Membership of the SCGOP has, meanwhile, grown to include 25 pension funds which together manage over 80% of the total assets invested by Dutch pension funds.

“Everyone has his own role”

#### P. 8 What is corporate governance?

Corporate governance concerns the way companies are managed and how management is supervised. The various parties involved play their own specific role.

Those roles are governed only for a small part by law. In the Netherlands, legislators have given companies ample freedom to determine their own management set-up. Broadly speaking, the management responsibilities of the larger stock exchange-listed companies are apportioned as follows:

- The management – or executive - board is responsible for management of the company
- The supervisory – or non-executive - board regulates the management board
- The works council can advise management
- Unless the law or articles of association determine otherwise, it is the task of shareholders to appoint the members of the supervisory board, management board and auditors.

Needless to say, a shareholder who wants to protect his financial interests will not limit his involvement to this minimum.

This handbook focuses on the role of pension funds as shareholders in publicly traded companies. Pension funds must continually make decisions about which companies to invest the funds put in their good care. That is why corporate governance is an important issue. As shareholders concerned with long-term returns, pension funds want to be sure always that the management board structure of those companies meets their demands. That is the essence of corporate governance policy to be determined by each pension fund.

#### P. 9 Basic principles of corporate governance

There are great differences of opinion on what form of corporate governance is best for a company. In the last few years, however, the importance of good corporate governance has been widely recognized. The trigger has varied from country to country. In the United States it was a by-product of the big wave of mergers and acquisitions of the 1980s. In the UK it became an issue when a number of big scandals shocked the financial markets. In France it came about when privatized state companies began learning how to deal with (foreign) institutional investors. The Far East woke up to the importance of good corporate governance after 1997, when the Asian crisis revealed the dangers of rapid growth without responsible management.

The way in which publicly listed companies are managed varies from country to country. The cause of this diversity can be traced to differences in history and culture, in national laws and regulation, in the pattern of share ownership and in the related prevailing structure of national capital markets.

In literature on corporate governance there is a distinction made between the Rhineland and Anglo-Saxon model. The latter is defined as focusing only on shareholders' interests, while the former is seen as also taking into consideration the interests of other "stakeholders".

Within continental Europe, too, where the Rhineland model prevails, there are big differences between countries. Even the British and American practices differ despite the fact that they both bear the Anglo-Saxon label.

From a practical perspective it is useful to look at the distinction between market-oriented and control-oriented systems. The first type applies to countries with a broad shareholder base, while the second refers to a system in which larger shareholders have the power to control and discipline the executive board. In this situation the main governance focus is on protecting the interests of minority shareholders.

For the Netherlands, the difference between the so-called one- and two-tier systems is important. "Two-tier" means that a separate organ – the supervisory board – supervises the management or executive board. A "one-tier" system consists of just one "board".

The Netherlands has a "two-tier" system. In the Netherlands, investors are forced to put their trust first and foremost in the supervisory board to keep good watch over the management board of a company. In countries with a "one tier" system, the equity market regulator is the party whom investors have to trust.

All these differences make it difficult to design an international code of conduct for good corporate governance. In early 1999 the Organization for Economic Cooperation and Development (OECD) made an attempt to do so. It published a document called "Principals of Corporate Governance" to develop a general international concept of the elements of a good corporate governance regime. The OECD plans periodically to review and adjust its principles to new developments.

The guidelines of the OECD were intended to accompany conditions attached by the IMF to granting financial support to several Asian nations that could not be termed "developing" but which were nevertheless obliged to request the support of the international community on account of the lack of sufficient corporate governance at their larger companies.

Investors represented in the International Corporate Governance Network (ICGN) have put together the "ICGN Statement on Global Corporate Governance Principles (1999)" on the basis of these OECD guidelines.

Many countries also have their own codes. An overview of these codes can be found on the website of the SCGOP ([www.scgop.nl](http://www.scgop.nl)). The SCGOP asked the Catholic University Brabant to make a comparative study of all these codes, which can also be found on the SCGOP website. Several key points can be distilled from this wealth of source material. They fall into the following four categories:

1. Shareholder rights

Shareholders must be given timely access to all relevant financial information in order to judge whether a company's actions are in line with its stated goals. Important matters must be put to the approval of shareholders. Shareholders must be allowed to vote at shareholders' meetings and the voting process must be simple.

2. Anti-takeover defenses

Anti-takeover defenses can be useful for guaranteeing the continuity of a company in exceptional situations. Anti-takeover defenses must however not be used to give management the opportunity to go against the advice of the majority of shareholders for long periods of time.

3. Management structure

Under the Dutch system, supervisory board directors are expected to be independent. That means that they must not be allied to any particular shareholder, to the management board or to other interested parties. The management structure must also be transparent.

4. Transparency

The company must clearly disclose its strategy, the decision-making process within the company and the level of remuneration of the executive and non-executive directors.

In each system, no matter how much it might differ from country to country, these four issues must be adequately dealt with. It's not a question of which system is best. It's a question of whether the structure meets the basic principles. It's then up to investors to make sure that the basic principles are adequately met. This means that corporate directors and their supervisory directors must take adequate responsibility for policy and surveillance. A corporation is accountable in different ways to the various interested parties. Corporate governance controls the way in which this responsibility is accounted for to the ultimate providers of risk-bearing capital: the shareholders.

#### P.12 Pension funds and corporate governance

Pension funds are shareholders. In the last few years they have increased considerably their share investments. They have the legal obligation to invest prudently in order to continue to meet payment commitments.

Pension funds therefore want to have their own opinion on the companies they invest in as well as on the key decisions taken by the directors. This does not mean that pension funds want to sit in the director's chair. It is the task of the company director to take decisions carefully. Pension funds play no role in the decision making process. But they can and will judge the decisions taken by the director, to evaluate whether they fit in with their investment policy criteria.

Pension funds have always played this role. In the past, however, the range of steps that could be taken was limited. When share investments represented a relatively small part of the total portfolio, pension funds limited their corporate governance policy to "voting with their feet". In other words, they held the shares of companies in which they had confidence and sold the shares of companies that no longer fit in their portfolio.

They could still act in this way, but this policy when applied now is often too late. Moreover, given the increasing importance of shares as an asset class, pension funds see greater possibilities. The exercise of voting rights attached to shares can also improve the risk/reward profile of investments. In the United States the saying goes "sell or care". There many pension funds are obliged to use their voting rights. Their active voting policy has already demonstrated clearly the positive effects attainable.

The optimization of the risk/reward relationship is a primary aim of pension fund investment policy. For that reason corporate governance is not a matter that pension funds can cast aside at will.

Management of share voting rights is an important element of investment policy and on a par with the management of financial rights linked to share ownership.

Even pension funds that outsource management of their portfolio can be rightly asked about their policy towards voting rights. It is important in the case of benchmarked portfolios in particular for the pension fund to be sure that the companies in the benchmark index fulfill the requirements of good management, and to lobby those that do not comply. That's because the criteria of size and liquidity that determine inclusion in an index are not enough to ensure that a company constitutes a responsible investment.

#### p. 14 Corporate governance and performance

Pension funds strive to achieve optimal returns within pre-set risk parameters. Each corporate governance policy must satisfy this primary goal. Since the execution of a corporate governance policy entails costs, clearly it must also generate adequate compensatory income.

Practice shows an active use of shareholder rights can deliver higher investment returns. That is not news. The ancient Greeks used to say that the eye of the master fattens the horse. Company directors who know their investors are following their every move will make greater efforts than companies that ignore the discipline of corporate governance all together.

In the U.S., studies conducted on behalf of the California Public Employees Retirement System (CalPers) - one of the world's largest pension funds - have shown that an active shareholder approach leads to higher investment returns. Research by McKinsey and Co. too has demonstrated that investors elsewhere in the

world are prepared to pay a premium for companies that have a completely independent supervisory system within their governance structure.

Scientific research in the Netherlands has likewise shown a positive correlation between good corporate governance and performance. Being an active shareholder in particular played an important role. On the other hand, the suppression of shareholder rights has been shown to have a negative influence on performance. (An overview of these studies can be found on the website of the SCGOP.)

Apart from return, pension funds also look at risks. Insufficient supervision, inadequate reporting, opaque structures and a management not subject to market discipline – all these aspects have a negative impact on the risk profile of a share investment.

In fact investors are increasingly using the corporate governance structure of a company as one of the criteria for stock picking. The creation of international standards for corporate governance plays a useful role in this process.

‘Good governance adds value’

Yardsticks for corporate governance in the Netherlands

Legislators, the stock exchange and the financial market regulators are responsible for determining the framework for corporate governance. Within this framework, the details must be added as best as possible.

To this end, in 1999 the SCGOP drew up a number of yardsticks that participants can use in executing their own corporate governance policy within Dutch companies.

These yardsticks are derived from the recommendations of the Corporate Governance Commission published in 1997.

To make for easier comparison, these yardsticks are in line with international rating standards and divided over the four categories mentioned earlier:

Shareholder rights

1. Companies should state which recommendations of the Corporate Governance Commission they are not adopting and why.
2. To improve the role of annual shareholders meetings as a forum for discussion between the board and capital providers, the right to submit agenda topics should be enjoyed by shareholders and certificate-holders and not just management.

For the sake of maintaining orderly annual general meetings, this right should only be extended to those holders of shares and certificates who, depending on the company size, collectively own between EUR 5 and 50 million on the meeting or registration day.

The period for submitting agenda topics should be a maximum of two months before the meeting allowing the agenda to be published one month before the meeting date according to usual practice.

3. Companies should introduce a “record date” system so that the period of share deposition does not prevent shareholders from exercising their voting rights.
4. A practical system of proxy voting should be introduced to allow institutional investors to vote at the shareholders’ meetings of all the companies in which they have shares.
5. Major decisions should be approved at the annual general meeting of shareholders. This demonstrates how the interest of shareholders is weighted in relation to other interests, and also in relation to the interests of any majority shareholders.

Anti-takeover defenses

6. Certification

- (a) It’s in a company’s interest to guarantee continuity and balance in the decision-making process at the annual shareholders’ meeting. If the meeting suffers from absenteeism, to the extent that the attendees present cannot be seen to adequately represent the shareholders and financiers of the company as a whole, the company might want to certify its shares. For this reason, the trust office of the company should be independent. When it comes to voting, its management must act in the interests of holders of certificates, or depository receipts. The trust office should in principle cooperate when asked to convert certificates.

- (b) The trust office should in principle issue voting rights to certificate holders upon request. In the case where no voting rights are issued, the trust must accept voting instructions. If the trust office has issued no voting rights and received no voting instructions for shares in its jurisdiction, the trust office must decide how to vote following its own judgment.
  - (c) The management of the trust office should report to certificate holders on its actions. If the trust office makes use of voting rights linked to shares, it must explain at the shareholders' meeting how this action is in the interests of certificate-holders.
  - (d) If in addition to the trust office there are other shareholders, and if the trust office wishes to vote differently from the majority of those other shareholders, the trust office must justify its standpoint. The trust office therefore must not exercise its voting right before other shareholders have done so.
7. Anti-takeover defenses can only be used in the event of a takeover to override the right of say of the providers of capital. This is in order to grant the executive board a pre-set period of time in which to weigh carefully the arguments for and against. The use of more than one anti-takeover device should be avoided.
  8. The introduction of a practical and efficient proxy voting system and proxy solicitation will enable the practice of limiting voting rights to be abolished.
  9. The board of a company should not issue (certificates of) preference shares without having first justified the planned issue and related financial advantages at the shareholders' meeting. The board should take pains to prevent an unbalanced relationship arising between the capital providers and voting right influence as a result of the issuance of preference shares. Preference shares that cannot be freely traded must be seen as anti-takeover preference shares.
  10. A company should only accept a so-called "structure regime" by choice if this decision has been put to (annual) approval of shareholders at the annual meeting.
  11. To prevent an issue of ordinary shares from being used as an anti-takeover device, companies should limit the period during which the authority to issue shares is granted to 18 months. In addition, the number of non-preference shares issued should not exceed 10 per cent of existing outstanding shares.
  12. Companies should not issue options on ordinary or anti-takeover preference shares that have a life longer than the period for which the authority to issue these shares has been granted.

#### Management structure

13. The supervisory board is the body that, in keeping with the interests of shareholders, must watch over the actions of the executive board and general developments at the company and its holding company.
  - a) The supervisory board is expected to provide independent expertise in carrying out its responsibility. The annual report must state whether each supervisory board member is independent from management and any majority shareholders.
  - b) The remuneration of supervisory board members should not be linked to the company's profits. Supervisory board members must therefore not receive options.
  - c) The tenure of supervisory board members should generally be limited to two terms of four years.
  - d) Former members of the executive board should not be automatically appointed as members of the supervisory board. Should a former executive board member be appointed to the supervisory board, he should not act as chairman.
  - e) The supervisory board director's performance should be evaluated at the end of the term of appointment. This evaluation should be taken into account in deciding whether the supervisory board member should be considered for a second consecutive term.

#### Transparency

14. Shareholders at the general meeting must approve option scheme plans in advance. This is to create a clear relationship between achieving strategic goals and rewards in the form of options.
15. Dilution of earnings per share must be avoided as much as possible in the design of options plans. If this cannot be avoided, the company should strive to be as transparent as possible in explaining dilution aspects.

16. Options plans should be reported on in the annual accounts. Should options positions represent an off-balance sheet risk to the company, this risk should be quantified in the annual accounts.
17. Profiles of the supervisory board and its rules and regulations should be made available to shareholders.
18. Companies whose shares are listed also on stock exchanges outside the Netherlands should make available on their websites any documents they are obliged to make public in those countries.

Members of the SCGOP will judge the corporate governance practices of companies based on these yardsticks.

p. 21 the principles in practice

The annual general meeting of shareholders (AGM) is the formal forum for discussion between the managing board of a company and its shareholders.

To be an active shareholder, however, it is necessary to follow the companies in which investments are made on a continual basis. For that reason SCGOP has asked an independent bureau to follow developments at the largest Dutch companies and to report to the SCGOP on any developments that affect shareholder interests.

When this occurs, the SCGOP warns member pension funds and discusses with them – either collectively or separately – the steps to be taken.

SCGOP also organizes the AGM visits of individual pension funds. And it commissions third-party research to analyze important issues. In the last few years, members of SCGOP have urged Dutch companies at shareholders meetings to implement the recommendations of the Peters Commission and the yardsticks drawn up by the SCGOP.

Thanks in part to the actions of SCGOP participants, a number of stock exchange-listed companies have made improvements to their corporate governance structure. ABM AMRO Holding reduced the excessive control linked to its preference shares in 1999 for “normal situations”. CSM granted greater say to its certificate holders at the end of 1999. In 2000, Vast Ned shareholders put a stop to a merger between Vast Net and Uni-Invest by protesting what they saw as Vast Ned’s excessively generous “golden parachute”. In 2001, several participants of SCGOP lobbied United Pan European Communications (UPC) to appoint independent supervisory board directors.

In 2001, the visits to annual general meetings of shareholders focussed particularly on the following yardsticks:

- The independence of non-executive directors
- The rights of certificate holders
- The introduction of proxy voting

In addition we plan to visit the shareholders’ meetings of those companies whose corporate governance performance has already been criticized by institutional investors, to ensure that real progress is being made.

p. 23 Proxy Voting

Given the large number of companies in which pension funds invest, it is not feasible for them to visit all shareholders’ meetings to exercise their voting rights. If only routine items are being covered, however, it will not be always necessary to attend the meeting. Pension funds that take part in the Alert Voting Service through the SCGOP are informed of any items requiring their specific attention at shareholders’ meetings. They also receive well argued voting advice.

In addition, it is possible at a number of companies to vote by proxy. In 1998, 11 Dutch stock exchange-listed companies set up the Shareholder Communication Channel Foundation. Its

aim is to make contacts between companies and their shareholders, as well as among shareholders themselves, more direct and simple.

This channel works firstly as a distribution system for information such as annual reports and AGM agendas. But it is also possible to vote at shareholders' meetings through this channel without having to attend the meeting or to send an authorized representative.

Due to a change in the law, everyone who owns shares on the so-called date of registration - often seven days before the planned meeting - has the right to vote. Investors who want to vote therefore no longer have to block their shares for a few days, which was the case in the past.

A limitation is that only investors who hold a securities account at a financial institution in the Netherlands are able to participate in the Communication Channel. Pension funds using a foreign custodian will have to come to separate arrangements. SCGOP is involved in Shareholder Communication Channel Foundation decisions through the Investor Platform to which the Foundation belongs.

#### *Proxy Solicitation*

Shareholders who own at least 1% of issued share capital are able to use the Communication Channel to send information to other shareholders, for example to solicit votes for items on the agenda of forthcoming shareholders' meetings.

#### p. 25 Pension Fund Governance

The increasing importance to society of good management and accountability means that companies are paying more attention to corporate governance. But it's not just companies that are asked questions about management, transparency and accountability. Pension funds too are affected and in their case are being asked about pension fund governance. Pension funds that have already determined their corporate governance policy will have already prepared for this. The very act of pension funds pressing for transparent corporate governance structures and adequate accountability at the companies in which they invest raises the question of how they themselves are governed.

It's not only the pension funds with an active corporate governance policy that will be confronted with questions about pension fund governance. The call for greater transparency and accountability is a growing social trend.

Article 5, paragraph 4 of the pensions and savings fund law states that the persons who determine the policy of a pension or savings fund should focus on the interests of the fund's participants, former participants and other interested parties. Attention is focusing more and more on the way in which the board and management of pension funds report to participants on their management of the fund.

Corporate governance and pension fund governance coincide when pension funds account for their investment policy. Increasingly, boards of pension funds are being asked to draw up a code of conduct as a basis for their investment policy. A corporate governance policy is a component of that code.

The formulation and execution of a proprietary governance policy can thus be seen as a component of good pension fund management. Hence corporate governance and pension fund governance are closely related.

SCGOP can assist participants in developing their own pension fund code of governance.

#### p. 27 Socially responsible investments

Corporate governance and socially responsible investing are subjects that are not directly linked. But since both concepts are often intertwined, it's important to point out the differences clearly. The corporate governance policy of pension funds is focused on improving the risk/reward relationship of share investments. The term socially responsible investing is applied to investments that follow criteria other than just financial return.



In early 2001, the Social Economic Council (SER) published advice on socially responsible business entitled “The profit of values”. In a paragraph on the investment policy of pension funds, the SER does not link socially responsible investing to corporate governance. The SER says it assumes that employers organisations and labor unions, “given their direct or indirect involvement in the policy of pension funds, are well placed to promote socially responsible investment policy at pension funds – of course all within the framework of the pension and savings fund law”. It has been agreed to discuss this matter in the context of the 'Stichting van de Arbeid', the forum where these representative organisations meet.

SCGOP does not consider socially responsible investing one of its subject areas either. Corporate governance policy is of course aimed at paying closer attention to the wishes of shareholders. If a majority of shareholders wanted companies to be more socially responsible, a company with a good corporate governance structure would be more receptive than one without.

In this way, the attention pension funds give to corporate governance will contribute to the creation of a climate in which the case for socially responsible investing – like that to be formulated by the 'Stichting van de Arbeid', has a greater chance of succeeding.

p. 28 SCGOP: goals and members

When shareholders, as a result of their efforts to maintain an active corporate governance policy, achieve an increase in the value of their investments, all shareholders benefit, even the “free-riders” who have made no effort whatsoever.

A majority shareholder wins the bulk of the fruits of his efforts. Pension funds, however, are always minority shareholders. Their investment policy requires them to diversify, limiting their interest in each company to less than 5%.

As minority shareholders, pension funds can choose to avoid the cost and efforts of maintaining a corporate governance policy in the hope that third parties will do the dirty work for them. This is only prudent if they can be sure others will indeed act in their interest. Without these assurances, inertia introduces a new risk element in the investment policy. This can be at odds with the responsibility of a fund manager to keep watch over his investments like a good father.

SCGOP believes that the exercise of voting rights linked to share ownership can make a positive contribution to the risk/reward profile of investments. For that reason good corporate governance is not a matter that pension fund managers can cast aside at will.

SCGOP was set up in 1998 to support pension funds in their corporate governance activities. The foundation was not established to develop corporate governance independently of its participants. The participants decide themselves how they wish to proceed. The SCGOP merely creates an infrastructure and provides assistance.

The SCGOP therefore performs research and provides information to participants. It also promotes an exchange of information among pension funds and between them and company directors regarding management, supervision and accountability. The SCGOP continually stresses and respects the freedom of choice and individual responsibility of each participant.

SCGOP members include:

- Company pension funds
- Sector pension funds
- Professional pension funds
- Management organizations associated with pension funds

SCGOP has founders, members and observers. The board of SCGOP is made up of representatives of each of the founders and one representative of the participants.

*Founders, participants and observers*

*Founders*

ABP Pension fund  
PGGM Pension fund  
KLM General Pension Fund  
KPN Company Pension Fund  
Philips Pension Fund  
Shell Pension Fund  
Railways Pension Fund  
Unilever Pension Fund “Progress”

*Participants*

Company Pension Fund for the Painting, Decorating and Glass-setting trades  
Company Pension Fund for Hotel and Catering companies  
Provision Fund for Physicians, Dentists and Chemists  
Pension Fund for Physiotherapists  
Sector Pension Funds for Media PNO  
Pension Fund for Housing Corporations  
Pension Fund Solvay Pharmaceuticals  
Pension Fund Royal Volker Wessels Stevin  
Ministers Pensions in the Netherlands Reformed Church  
Company Pension Fund for Industry  
Pension Fund HBG  
Relan Pension BV  
Pensioenfondsen Casinospelen  
SBA Doctors Pension Fund  
Akzo Novel Pension Fund  
Beon Pension and Asset Management  
Pension Fund of ABN AMRO Bank

*Observers*

Association of Sector Pension Funds  
Foundation for Company Pension Funds

*Additional information*

For more information about the SCGOP and its activities please look on the internet site [www.scgop.nl](http://www.scgop.nl) or get in touch with the foundation's secretariat at the following address: P.O. Box 2889, 6401 DJ Heerlen, The Netherlands. Tel: +31 45 579 1613. Fax: +31 45 579 2143. Email: [scgop@abp.nl](mailto:scgop@abp.nl)