an Institute of Directors publication

the HANDBOOK of INTERNATIONAL CORPORATE GOVERNANCE

A definitive guide

2ND EDITION

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IoD

KOGAN PAGE

London and Philadelphia

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Information in this book is correct at the time of writing, September–October 2008.

First published in Great Britain and the United States in 2004 by Kogan Page Limited and the Institute of Directors
Second edition 2009

120 Pentonville Road
London N1 9JN
United Kingdom
www.koganpage.com

525 South 4th Street, #241
Philadelphia PA 19147
USA

ISBN 978 0 7494 5508 8

British Library Cataloguing-in-Publication Data

A CIP record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

The handbook of international corporate governance : a definitive guide / the Institute of Directors. — 2nd ed.
p. cm.
ISBN 978-0-7494-5508-8
1. Corporate governance—Handbooks, manuals, etc. 2. Corporate governance—Law and legislation—Handbooks, manuals, etc. 3. Comparative management. I. Institute of Directors.
HD2741.H26 2009
330.03--dc22
2009008444

Typeset by Saxon Graphics Ltd, Derby
Printed and bound in Great Britain by MPG Books Ltd, Bodmin, Cornwall

Contents

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Foreword

Conflict about the direction of companies has been happening for at least the last 400 years. Merchants and captains, just the same as owners and executives, were prone to falling out over what course to steer. At what speed should they proceed? What risks could be taken? How were the rewards to be divided?

It is only in the last decade, however, that a concerted effort has been made internationally to draw up any guidelines for resolving this natural tension between those who invest in an enterprise and those who run it.

By the late 1990s, the stakes were too high and the risks of a spectacular wreck were too great. Capital was flowing freely into markets and companies over which investors could exercise little or no control. Abuses were bound to occur.

Because of their size, it was becoming unrealistic for some investors to exercise the traditional sanction of selling up a shareholding without undermining confidence in the market as a whole. The only alternative, if they wanted to realise value in their investments, was to start exercising their ownership rights to influence the direction of companies.

In parallel, the risk of over-mighty executives was becoming apparent in a series of corporate failures, where the board was exposed as nodding through highly risky or even fraudulent business models.

A system of checks and balances had to be put in place. Essentially, these followed two courses (as Professor Jaap Winter explains in Chapter 1.3). In the United States, the response to corporate failure is sharp and narrow. Strict standards for financial reporting and internal control are written in law. Any deviations will bring you in front of the regulator or land you in court.

In Europe, the regime is softer and broader. Companies either comply with a local code of practice or they explain why they have chosen to deviate. Investors can then act or vote accordingly.

Around the world, these two models of corporate governance are being adapted and interpreted in different ways. Often, it is easier to adopt a hard and fast set of rules, before allowing a more sophisticated investment culture to develop.

Legal cultures and ownership structures vary significantly, so governance still retains a series of distinctly local features. Directors and investors will find that they are expected to behave differently depending on where they are.

At the core of this book is a series of profiles of how governance is developing in leading economies, which we have organized in order of GDP as measured by Purchasing Power Parity. Written by an authority on each country, such as one of the IoD's sister organizations or by a business school, the chapters explore how the relationship between directors, investors, owners and regulators is taking shape both on paper and in practice. We then follow with a series of regional profiles where the main trends in governance are explored in Asia, Europe, the Middle East and North Africa, Latin America and the Commonwealth.

As you will see, the challenges in governance manifest themselves in different ways. In the Anglo-Saxon countries, where the capital structure is widely dispersed, conflicts tend to arise between companies and their shareholders, often revolving round the issues of accountability, notably executive pay. In Europe and the developing world, where ownership is often concentrated in a dominant stake held by an individual or the state, tension occurs more often between majority and minority shareholders.

To put all these variations into context, we start the book by running a series of chapters on particular aspects of governance written both by leading experts, as well as by directors and investors to whom governance is an integral part of their working lives.

In light of the credit crunch, this portrait presents a less than perfect picture. Serious questions have to be asked about the scrutiny to which corporate strategy has been subjected and about how, in particular, incentives could be put in place to encourage short-term gains that jeopardized not only the future of individual companies but the financial system as a whole.

So improvements will continue to be made, but no-one is seriously casting doubt on the direction that governance is taking. It is on the way to becoming, as the World Bank predicted it would, 'one of the pillars of the post-Cold War economic architecture'.

Almost everywhere, a framework of controls is now in place. The challenge is for directors and investors to learn how to use them.

In particular, boards have to exercise their independence and appreciate that their task is to govern, while leaving executives to manage. Equally, investors have to find their long-term voice and find a way of playing an active role in this system of corporate checks and balances.

This book is designed to give all these readers details of how governance is set up country by country, as well as explaining who is creating and enforcing these new regulatory and voluntary frameworks. It can be a technical area, of course, but we have deliberately endeavoured to produce a clear and easy-to-follow text.

The IoD is extremely grateful to all those who have so freely contributed their knowledge and expertise to this title. They have produced an authoritative account of how governance is becoming far more than just a question of compliance. It is at the core of how directors and investors will exercise their duties in the world after the credit crunch.

Miles Templeman
Director General, IoD

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Part 1

Models and Codes

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1.1

Global Corporate Governance Challenges for Public Companies and Their Shareholders in the 21st Century

Beyond Berle and Means

Stilpon Nestor, Nestor Advisors and former head of the OECD Corporate Affairs Division

In 1932, Adolf Berle and Gardiner Means published *The Modern Corporation and Private Property*, their seminal critique of the managerial corporation, as the Great Depression was unfolding, kick-started by the stock market crisis of 1929. Large US companies were by that time controlled by professional managers and owned by a vastly dispersed multitude of small shareholders who had no way of holding the former accountable because of vast information asymmetries and the impossibly high cost of collective action. To ensure a modicum of managerial accountability in large listed companies characterized by the divergence between ownership and control, one would have to look not to corporate governance mechanisms supplied by company law (or contract) but to the market for corporate control. An underperforming company would see its equity priced lower and lower until it reached the point at which another management team could buy control, oust the previous team and reap the gains of increasing return on existing assets. For this to occur, all that would be needed would be adequate, timely and reliable information, and a liquid market.

Berle and Means' paradigm of the modern corporation became a philosophical underpinning of the 'mother of all governance reforms', the federal securities laws adopted by the US Congress in 1933–34. The two Acts rested on the common understanding that weak or misleading corporate disclosure and widespread market manipulation were the main culprits for the crash.

The 2002 Sarbanes–Oxley Act, passed in record time in the wake of the Enron, WorldCom and Adelphia collapses, was a direct descendant of the 1930s' Acts in that it also tried to address, on the basis of the same philosophical precepts, a huge loss of confidence in the market. While its focus is more on internal control than financial reporting, its main philosophical assumption is that shareholders cannot really do much as principals of corporations. All they can do is buy and sell stocks, and therefore management and boards need to be legally coerced to structure internal control. In addition, the amended listing requirements of the biggest US exchanges (the New York Stock Exchange and NASDAQ, the National Association of Securities Dealers Automated Quotations) imposed a strict governance regime on domestic listed companies, requiring a majority of independent (ie non-management-related) directors on company boards to populate remuneration, nomination and audit committees. These committees, in turn, discharge the main oversight duties of the board.

In perceiving and treating shareholders as a vast multitude of unsophisticated individuals, the US regulatory (federal and state) system encouraged US companies to completely disenfranchise their owners of the right to appoint and control their fiduciaries, the boards of directors. Short of a very expensive proxy contest, most US boards effectively appoint themselves without any possibility for shareholders to prevent their appointment or recall underperforming directors. US shareholders do have significant *ex post* remedies against boards' abuse of their power, but since these remedies all go through the judicial system, it is lawyers and judges, not owners, who set the limits of board authority.

In the rest of the world, public company governance has emerged as an important issue only recently. It was during the last two decades of the 20th century that privatization and technological change fuelled the development of equity markets around the world to a level at which they are now prominent parts of their home economies. According to the Organisation for Economic Co-operation and Development (OECD), UK equity market capitalization jumped from 87 per cent of GDP in 1990 to 161 per cent in 2003. The respective figures in the EU-15 (minus the United Kingdom) were 30 per cent and 75 per cent, while in the United States they were 57 per cent and 137 per cent. In the context of these developments, institutional investors have become by far the dominant owners of securities in the largest equity markets in the world, including the United States. According to calculations by Nestor Advisors, at the turn of the current century large institutional investors such as pension funds and insurance companies owned more than 80 per cent of the total UK equity market capitalization. The respective figure in the United States – traditionally a much more retail-oriented market – was over 60 per cent.

As institutional investors came to dominate the ownership of world equity markets, the regulatory assumptions of the 1930s about the profile of listed company shareholders no longer seem valid. Rather than being dispersed retail investors, the key owners of an average listed company are nowadays far fewer than they used to be. As the chairman of a large US company recently noted in private, 'The critical mass of our shareholders is nowadays 15 phone calls away.' They are both larger and richer, and sophisticated enough to be able to shoulder the costs of being true owners, developing corporate governance guidelines for their investee companies and breeding in-house teams to enforce these guidelines by voting their shares and communicating with companies on corporate governance matters. Regulatory requirements generate, by and large, enough information for them to be able to do so. Moreover, many institutions have limited exit opportunities. A large proportion of their holdings are indexed, meaning that they must own certain stocks in order to maintain a risk profile that mirrors that of the market; or their positions on specific stocks are so large that they cannot significantly modify them without incurring substantial losses. The 'Wall Street walk' is not an option under these circumstances, and long-term stewardship is a necessity.

In addition to becoming an increasingly dominant force in their domestic equity markets, institutional investors are also becoming more international. Until recently, institutional portfolios were surprisingly local. The percentage of foreign equities in the portfolios of institutional investors is now considerable, having more than doubled over the past decade to more than 25 per cent in the United Kingdom and more than 15 per cent in the United States. At the end of 2005, foreign investors owned 33 per cent of listed shares on European exchanges.[1] Portfolio internationalization suggests that corporate governance requirements that were developed in Anglo-American markets (where institutions are more prominent) are being enforced in European and Asian markets where local institutional presence is not that strong. The adoption of global principles of corporate governance (see the box at the end of this chapter) by the OECD in 1998, which (following their 2003 review) are now widely accepted in most capital markets as a policy benchmark, is ample testimony to 'globalization' in governance norms.

This new reality of growing global institutional dominance conditioned the response to governance crises in the United Kingdom and Europe, in contrast to the adoption of Sarbanes–Oxley in the United States. Following the Maxwell scandal in the late 1980s, the United Kingdom developed a new approach to corporate governance regulation, based on the 'comply or explain' principle.

By the end of the 1990s this new approach was incorporated into the regulatory framework as part of the listing requirements for UK public companies. After the Parmalat scandal in Italy and minor crises of confidence in a number of other EU markets, the European Union gave new impetus to its effort to harmonize company law, an effort that had already created a foundation of common rules for reporting and capital protection in the 1970s and 1980s. The European Commission went through some soul-searching in deliberating whether to choose the US model of direct regulation, which would result in the further uniformization of EU company governance; or the UK model of 'comply or explain' market-driven transparency applied in a decentralized way by the adoption of governance codes in each member country in a manner that reflected each market's unique characteristics. Recognizing the capacity of shareholders to fend for themselves and make their own value judgements as regards the governance of the companies in which they invest, the European Union opted in the end to adopt the UK model.

This late-20th-century trend of (re)concentrated ownership and (re)convergence of ownership and control after almost a century of divergence was further strengthened during the first decade of the new century by a new breed of equity investor: activist hedge funds, private equity and sovereign wealth funds (SWFs) are playing an increasingly important role in the governance of public companies. Hedge funds are becoming bolder by the day in pushing their agenda on to listed companies. They sit on boards, take the lead in alliances with other shareholders and pressure companies to change their capital structure and strategy. SWFs are much less prone to shareholder activism, but the capital position they are assuming and their professed long-term shareowner perspective *de facto* make them important as principals that boards and management need to engage with in developing the long-term business strategy of their companies.

The 21st-century challenge to public policy is thus to shift the protective thrust of regulation from a regime of airtight protection of retail investors and across the board for fair treatment of all shareholders towards one that facilitates accountability to shareholders, especially those that have the capacity to act as real owners and corporate stewards. But it is not only regulators that face big challenges. Boards and investors have their own set of challenges to address in this new ownership and control environment.

Boards need to learn to communicate governance and strategy in a systematic and open fashion, not simply on road shows or at investor relations events. In most of the world outside the United Kingdom, boards and chairmen (who are not also the CEOs) are still hesitant to talk to shareholders directly for fear of undermining management. However, increased proximity to key shareholders should not compel boards to rule by referendum and abdicate their strategic leadership mandate. For example, the board chairman of a UK takeover target recently complained about a quandary he faced. As the takeover challenge materialized, the original institutional shareholders sold at a profit to very vocal hedge funds whose only, agenda was in the short term to sell at the highest possible price. His question: ‘Should we as a board agree to sell to the highest bidder even if the board and I really think that, in the long term, the company will be more valuable if it remains independent and follows the current strategy?’ In this very real conflict between accountability and leadership, I believe that leadership considerations should prevail at board level. The board’s role should not be to arbitrate between or represent the average of different shareholder interests. Rather, it should be to lead the company. However, if the short-term shareholders come to dominate the capital, they may then fire a board that does not represent their view.

The investor community also faces a set of acute challenges. Institutional investors are increasingly taking the role of the principal in corporate affairs but, in contrast to the capitalists of yore and modern-day entrepreneurs, they are themselves fiduciaries. As such, they face significant conflicts when exercising stewardship in investee companies. For example, investment management teams in asset management houses have fairly short-term horizons defined by their remuneration arrangements. They are therefore misaligned in practice with the long-term shareholder value objective that many of their institutions profess to be their guiding principle.

In conclusion, while the long-term 20th-century trend of separation between ownership and control is being reversed, the polemic of how principals can, in practice, exert control over agents and the corporation, has by no means gone away. Our 21st-century challenge is to identify its new parameters and question much of the received corporate governance wisdom of the past.

The current crisis is a wake-up call. Not only has it exposed important flaws along the governance chain, it also has precipitated further ownership concentration in key sectors. For example, large banks, heretofore among the companies with the most diffused ownership structure, are witnessing a surge in blockholder stakes (including those held by governments).

Regulators, boards and investors themselves need to get out of the cosy Berle and Means box and face the new governance imperatives: increase corporate governance transparency, facilitate direct accountability to shareholders, allow boards to lead by limiting box-ticking requirements as well as disproportionate *ex post* judicial remedies, and ensure that institutional investors take their fiduciary responsibilities seriously and not only 'talk the talk' of long-term shareholder value.

OECD Principles

OECD Principles of Corporate Governance was issued in 1999 as a direct response to the Asian crisis. The principles were revised in 2003. They have become the international benchmark for corporate governance, forming the basis for a number of corporate governance codes and reform initiatives in both member countries and non-member countries of the OECD. They have also been used by all major international financial institutions such as the World Bank/International Finance Corporation and the Asian Development Bank, and also by many international institutional investors. As they are non-prescriptive and, as the name suggests, principles based, they are relevant to different legal, economic and social contexts.

In contracts to guidance addressed to companies, such as corporate governance codes, the *OECD Principles* provide direction to policy makers who aim to improve the corporate governance framework of a country. They cover six key areas of corporate governance:

- the structure of an effective corporate governance framework;
- the rights of shareholders and key ownership functions;
- the equitable treatment of shareholders;
- the role of stakeholders in corporate governance;
- disclosure and transparency;
- the responsibilities of the board.

The Sarbanes–Oxley Act of 2002

The Sarbanes–Oxley Act was passed by the US Congress as a reaction to a series of corporate scandals in 2001–02. The Act amended existing securities regulation in order to enhance investor protection in listed companies. It provides for:

- new levels of auditor independence;
- personal accountability for CEOs and CFOs for financial disclosures;
- additional accountability for corporate boards for financial reporting via independence requirements for their audit committees;

- increased criminal and civil penalties for securities violations;
- certification of internal control over financial reporting by external auditors.

The Act has been criticized for being inflexible and onerous to implement.

Note

1. Data compiled by NeAd on the basis of reports by the Federation of European Stock Exchanges, the IMF and various other sources.

Stilpon Nestor is the Managing Director of Nestor Advisors Ltd. Nestor Advisors is a London-based consultancy specializing in corporate governance. Its clients include some of the largest European and Middle Eastern banks, and corporations in the oil and gas, mining, telecoms, real estate development and construction sectors. From 1997 to 2002, Stilpon was the head of the OECD Corporate Affairs Division, which developed the global benchmark, the *OECD Principles of Corporate Governance*. He has a corporate law background with an LLM from Harvard Law School.

1.2

The Governance Premium

New Evidence from Recent Academic Research

Alex Berg and Inessa Love, World Bank

The movement to reform corporate governance in emerging markets is about to reach its teenage years. In 1998, following the Asian financial crisis and the Russian debt default, the leaders of the G7 nations announced a new focus on corporate behaviour and incentives. By mid-1999 the Organisation for Economic Co-operation and Development (OECD) had adopted a set of basic principles. Since 2000 the World Bank has focused on improved governance practices as one of the keys to improving prosperity and the number of jobs by strengthening corporations' ability to compete for global capital, and has assessed country compliance with the OECD principles through the corporate governance Report on the Observance of Standards and Codes (ROSC) programme. In response, many countries have initiated legal, regulatory and institutional corporate governance reforms.

Corporate governance is different from other international financial standards because of the impetus it has received from academic research. Most important was the early finding that the laws that protect investors differ significantly across countries, in part because of differences in legal origins (see La Porta *et al*, 1998). That research and other related work showed that cross-country differences in laws and their enforcement affect ownership structure, dividend payout, availability and cost of external finance, and market valuations (La Porta *et al*, 1999, 2000, 2002). The research agenda has also been pushed by the development of an industry of commercial proxy research firms that have developed their own corporate governance research tools.

This chapter surveys the increasingly complex recent research on corporate governance and attempts to summarize and interpret answers to four interrelated questions:

- Does corporate governance affect *company performance*?
- Which specific corporate governance good-practice provisions are most important?
- What is the interplay between the *country-level corporate governance framework* and *specific company factors*?
- What are the caveats regarding this research?

In general, research continues to confirm early conclusions that improvements to corporate governance have a variety of positive impacts, especially higher valuations. However, the magnitude of this impact – the *governance premium* – appears to vary in different countries. More recent research suggests that to some extent the differences in the governance premium can be explained by differences at the country level. Specifically, preliminary evidence supports the hypothesis that company-level governance has more impact on valuation in countries with weaker legal protection.

1.2.1 Does Corporate Governance Affect Company Performance?

'Classic' corporate governance focuses on the protection of minority shareholders. Share prices are determined by the marginal shareholder, who is likely to be a minority shareholder and rely heavily on minority shareholder protection. Thus, share prices (and overall market capitalization) should directly reflect the legal and regulatory provisions that protect minority shareholder rights. Better governance works to reduce the incidence of tunnelling, asset stripping, related party transactions and other ways of diverting firm assets or cash flows from equity holders. The market value of the firm should thus be directly impacted. Firms with higher cash flows and profits will attract more investors, who will be willing to pay higher stock prices. Many studies test this supposition by studying the relationship between corporate governance and Tobin's *Q* – a measure of firm valuation that represents the ratio of market value of assets to book value of assets.

Good corporate governance should also translate into higher cash flows and thus work to improve a company's financial performance:

- With better oversight, managers are more likely to invest in value-maximizing projects and be more efficient in their operations.
- Fewer resources will be wasted on non-productive activities (perquisites consumption by the management, empire building, shirking).
- If investors are better protected and run less risk of losing their assets, they may be willing to accept a lower return on their investment. This will translate into a lower cost of capital for the firm and hence higher income.
- The availability of external finance may also be improved, allowing firms to undertake more of the profitable growth opportunities available.

Recent academic literature generally finds a positive association between governance and a variety of performance measures. The association appears to be the strongest for valuation and less strong for operating performance and market returns. However, some studies do not find this positive relationship.

One of the earliest studies of the relationship of governance and performance is that of Black (2001), who studied 21 large Russian firms. Despite the small sample, he found a surprisingly strong correlation between firms' valuation and the quality of their corporate governance. Many researchers have followed this line of work, trying to verify and further investigate this relationship.

Chong and Lopez-de-Silanes (2007) report results from individual studies in six Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico and Venezuela. They find a positive association between governance and valuation (the impact of one standard deviation change in governance on Tobin's Q is in the range of 10 per cent to 35 per cent).[1] Positive relationships between governance and valuation have also been found in Malaysia (Wahab, How and Verhoeven, 2007; Haniffa and Hudaib, 2006), Greece (Toudas and Karathanassis, 2007), Poland (Gruszczynski, 2006; Kowalewski *et al*, 2007), Tunisia (El Mehdi, 2007), Russia (Black, Love and Rachinsky, 2006), Korea (Black *et al*, 2006; Black and Kim, 2008), Ukraine (Zheka, 2006), Africa (Kyereboah-Coleman, 2007), New Zealand (Reddy *et al*, 2008), China (Bai *et al*, 2003) and other countries.

The relationship between governance and company operating performance appears to be somewhat weaker and more unstable than the relationship with market valuation. For example, Black, Jang and Kim (2006) find a strong effect of governance on market values, but do not find that it has a strong effect on operating performance or dividends payments. Chong and Lopez-de-Silanes (2007) find a positive effect of governance on operating performance but one that is smaller in magnitude than the effect on valuation. Bauer, Guenster and Otten (2003) find that in their European sample, governance is positively related to stock returns and market valuation, but negatively related to operating performance. Epps and Cereola (2008) do not find any relationship between governance and operating performance measures.

One explanation for the weak link between governance and operating performance is offered by Cornett *et al* (2006). They argue that strong governance mechanisms effectively constrain discretion in earnings management. As a result, they find that the estimated impact of corporate governance variables on firm operating performance more than doubles when discretionary accruals are eliminated from measured profitability. Dedman (2002) also found some evidence that compliance with the Cadbury recommendations in the United Kingdom enhances board oversight with respect to the manipulation of accounting numbers and the discipline of the top executives.

1.2.2 Which Specific Provisions Are Most Important?

Most research develops or uses a broad index to measure corporate governance. This use of an overall index is necessary to demonstrate impacts on performance. However, the disadvantage of this approach is that researchers cannot separate the impacts of specific corporate governance practices in order to determine which governance provisions are most important (and prioritize reforms).

In general, there is a lack of consensus on which provisions are most important. This is even truer outside of the United States, the United Kingdom and other major markets, where the availability of data is less.

Several aspects of good governance have been investigated. Many studies find that having independent directors on the board has significant positive effects (Black, Jang and Kim, 2006; Bruno and Claessens, 2007; Aggarwal *et al*, 2007). However, other studies find the opposite: Yermack (1996) and Klein (1998) report a negative relationship between the proportion of independent directors and Tobin's *Q*, and Gatti and Caselli (2007) find that having independent directors does not improve the return on private equity investments.

Bruno and Claessens (2007) find that the existence and independence of board committees is important for performance. Aggarwal *et al* (2007) also find that having an annually elected board and an annually ratified audit committee, as well as audit committee independence, are important for performance.

The influential paper of Gompers, Ishii and Metrick (2003) focused on anti-takeover governance provisions. Bebchuk, Cohen and Ferrell (2006) narrowed down the anti-takeover index to isolate the sub-index reflecting the degree of entrenchment (measured as staggered boards, super-majority requirements, poison pills and golden parachutes). They claim that the entrenchment is what matters most for valuation, while the rest of the components in the index of Gompers, Ishii and Metrick (2003) are not significant. However, Bruno and Claessens (2007) find that the entrenchment index is not robust in all specifications in their cross-country setting.

One difficulty in distilling the key provisions out of a wide range of possibilities lies in the differences among governance measures across studies. Different studies use different aspects and different subsets of governance while searching for the strongest ingredients. In other words, what one study may find to be the strongest ingredient may no longer be such when other components are added to the index.

1.2.3 What Is the Interplay between the Country-level Corporate Governance Framework and Specific Company Factors?

Why do some studies find a weak relationship between governance and performance? The answer may lie in the interplay between country and company performance.

Corporate governance is driven by both country-level and company-level mechanisms. The country-level mechanisms include laws on the books and the institutions that enforce those laws, plus the culture, norms and various formal and informal monitors of the companies (see Aggarwal *et al*, 2007). Company-level mechanisms are choices that companies make within the constraints of their legal systems. These choices are reflected in by-laws, charter provisions and policies, and in the day-to-day implementation of these policies.

A number of researchers have reviewed the impact of country-level governance on the relationship of firm-level governance to performance (technically known as the 'interaction effect'). To put the question simply: are relatively better governed firms valued more or less in countries with better country-level governance?

There are two alternative hypotheses. First, governance might matter less in countries with weak legal systems. In countries with weak governance laws and poor law enforcement, the adoption of firm-specific governance-related provisions could be less effective, because the provisions are not enforceable and additional mechanisms such as independent boards of directors or audit committees will be powerless to discipline insiders.

On the other hand, investors in countries with weak legal systems could place a higher value on companies with good corporate governance. Even a little bit of improvement relative to other firms should make a big difference for investors – which will improve market valuation and decrease the cost of capital (and subsequently improve operating performance). Doidge, Karolyi and Stulz (2004) suggest that controlling shareholders have more incentives to expropriate from minority shareholders in countries with less investor protection. In other words, the benefits of control are greater in countries with weaker rule of law, as shown by Nenova (2003). By establishing good governance mechanisms the controlling shareholders give up this high level of benefits of control, but in exchange get large improvements in the firm's performance and market valuation.

Preliminary evidence supports the second hypothesis: company-level governance does indeed have more impact on valuation in countries with weaker legal protection (Klapper and Love, 2004; Durnev and Kim, 2005; Bruno and Claessens, 2007).[2] The basic relationship is presented in Figure 1.2.1. The research is difficult to interpret because researchers tend to approach the problem from different perspectives, asking slightly different questions and using different datasets and models.

Doidge, Karolyi and Stulz (2007) put forward a corollary to this conclusion, explaining why companies in jurisdictions with weak legal systems do not immediately work to improve their governance practices. In countries with poor institutions it may be more costly to adopt good governance practices. Companies in countries with poor institutions will need to adopt numerous 'non-standard' provisions in their charters and by-laws to ensure good governance, and these provisions will then be harder for shareholders and judges to understand and enforce. In other words, in countries with weak institutions there is no easy way for firms to commit themselves to good governance. For the same reason, many have argued that American depositary receipt (ADR) listings are beneficial for firms from emerging markets because they allow firms to 'bond' to

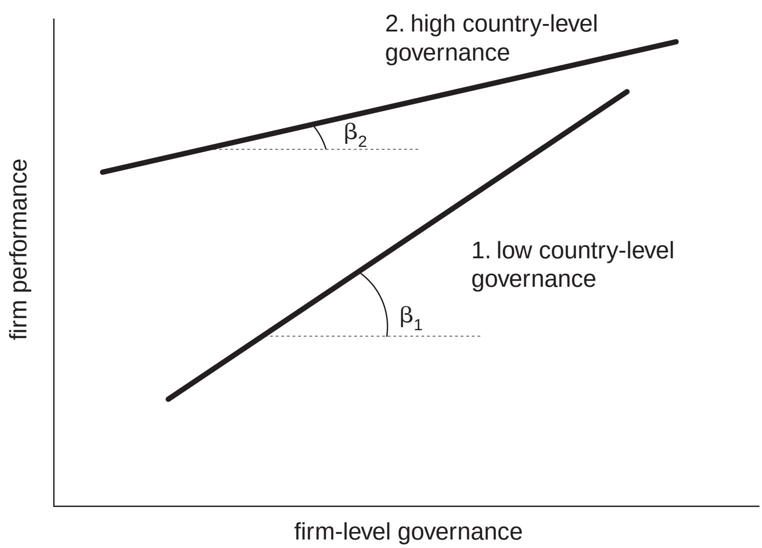

Figure 1.2.1 *Interaction between country-level governance and firm governance*

US securities laws (Doidge, Karolyi and Stulz, 2007). Another cost of better governance is borne by controlling shareholders, who have to give up their private benefits of control, and these costs are larger in countries with less institutional development (Nenova, 2003). In other words, the theory suggests that establishing good governance is more difficult and costly in countries with a weak institutional environment.

Chhaochharia and Laeven (2007) do not find any significant interaction effect between firm-level and country-level governance. However, their firm-level governance index is adjusted for minimum country-level norms, which means that the country-level index enters non-linearly and thus cannot be interpreted in the same way as earlier studies, in which country-level governance enters linearly. Contrary to previous evidence, Durnev and Fauver (2007) find that the positive relationship between governance and performance is weaker in countries where governments pursue predatory policies.

The evidence to date also suggests that average level of corporate governance is better in countries with better country-level governance protection, while there is wide variation both across countries and within countries (Klapper and Love, 2004; Durnev and Kim, 2005; Durnev and Fauver, 2007). Doidge, Karolyi and Stulz (2007) argue that what matters most is whether a country is developed or less developed, not the actual variation in country-level indicators within these groups of countries.

1.2.4 Some Important Caveats

There are several important caveats to this research. First, there is the difficulty of developing a single measure of corporate governance. It is difficult to collect data at the company and country level, and, as we have noted already, there is little systematic evidence that can be used to develop a weighting scheme that can be used to develop an index of good corporate governance.

Second, many researchers raise the question of causality; that is, does good governance lead to better performance, or does better performance result in better governance? The issue of causality is of great importance to researchers, investors and policy makers alike. There are several reasons to suspect that the causality may actually run from valuation to governance (for example, companies with weak performance may choose to adopt more anti-takeover provisions, which are associated with worse governance). At a technical level the evidence has been hampered by the lack of a solid econometric approach to addressing the causality issue.

Third, there is always a danger that the same governance standards may not be applicable, or even desirable, in different institutional environments. The 'tick-box' index approach may not even capture the best governance for each firm in each institutional environment (Arcot and Bruno, 2007). This caveat leads to doubts around the conclusion that governance is actually worse in countries with weaker institutional environments, or that the differences in a 'box-ticking' governance index actually capture the deviations from the optimal governance (Chidambaran, Palia and Zheng, 2006).

More research is needed to identify which provisions are the best for which firms in which environments. The future research needs to take into account the emerging understanding that not all corporate governance provisions should be equally important for all firms. The World Bank is building better datasets (including detailed country-level data based on the corporate governance ROSC programme) that will be useful to future research.

Notes

1. They also find a positive association between governance and dividend payout ratios; it appears that better governance helps outside investors to force dividend payments.
2. An alternative interpretation is that country-level governance is less important for firms with strong firm-level governance (Bruno and Claessens, 2007). There is no conflict between these interpretations, as both suggest that firm-level and country-level governance are substitutes when it comes to firm valuation.

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This chapter is based on a larger World Bank study (*Corporate Governance and Performance around the World: What we know and what we don't*, World Bank Working Paper (forthcoming), Inessa Love, Development Research Group). Please visit www.worldbank.org to find out more about the Corporate Governance ROSC programme.

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1.3

Models of Governance

Jaap Winter, Debrauw Blackstone Westbroek and the University of Amsterdam

The story of corporate governance starts as far back as 1612, when the world's first listed company was founded. The Dutch East Indies Company experienced many of the same problems as we still have today. A lack of transparency meant that shareholders had no idea what managers were doing. In fact, it turned out that many of them were using company funds to run their own private businesses buying spices and selling them privately. The result was the first ideas on how to exercise more control through additional disclosure and the appointment of supervisory directors, who had better access to the detail of what the company was actually doing and who could stop transactions going forward.

1.3.1 Conflict of Interest

Essentially, these agency problems still represent the most straightforward starting point in corporate governance. Managers, who have control but no economic interest, are opposed to shareholders, who have an economic interest but not control. There is bound to be a conflict of interest between the two. Managers typically want to grow the business and keep cash in hand to use at their discretion. Shareholders are more conscious of risks: they will take them as long as the rewards are good, but they do not want the company to grow regardless of performance. Any *non-performing* parts should be sold and the money returned to shareholders.

We see these conflicts in listed companies everywhere. Many of the mechanisms for corporate governance are designed to deal with them either by shedding more light on what managers are actually doing or by enhancing the rights of shareholders to appoint directors and have a say in major decisions. Corporate law is often designed to grant back to shareholders some control over what managers are doing on their behalf.

1.3.2 The Rediscovery of Governance

All these problems came sharply back into focus in the 1990s, after we had seen a huge increase in institutional share ownership. Investors discovered that holding such large amounts of equity made it hard to dissolve their position by selling their holdings. If they did, they could shoot themselves in the foot by bringing down the share price. As a result, they became more interested in how their investments were governed. What was the level of control that they could exercise? Did they indeed have any control at all?

Typically, they focused on companies' governance structure, rather than becoming activists in trying to force the companies' strategy in a different direction. Some investors more recently, however, have been more forceful in demanding a sale of assets and a return of the proceeds.

In parallel, we have seen governance scandals resulting in corporate collapses in a number of countries, which has led to a series of regulatory interventions. The Sarbanes–Oxley Act in the United States was probably the most aggressive and intensive of these. In Europe the response has been milder, but broader in scope.

Sarbanes–Oxley concerns only the processes for financial reporting and internal control, putting them more closely under the control of non-executives. In Europe the mechanisms have typically been applied more gently by way of codes. Enforcement is through 'comply or explain', rather than law.

Most European Union member states have evolved their own code to cover financial reporting and internal control, as well as the whole relationship between boards and shareholders, including the role of independent directors. It is an approach that allows for more flexibility.

Many of these broader aspects are not covered by any kind of regulation in the United States. Beyond the focus on financial reporting and internal control in Sarbanes–Oxley, the New York Stock Exchange requires non-executive directors to sit on the audit, nomination and remuneration committees. But nowhere is there any direction as to how the relationship between executives and non-executives should work. There is a lot of flexibility in how boards should be set up and what procedures are to be adopted. In particular, there is no rule against the roles of chairman and chief executive being combined.

In Europe, except in France, codes of governance assume that the same person should not be in charge of both the board and the company. Everywhere else it is accepted that such a concentration of power is unhealthy.

1.3.3 Actions and Voting

Where there is supervision in the United States, it is tough, as in the rules applied to financial reporting by the Securities and Exchange Commission (SEC). If companies get it wrong, they soon face securities litigation and class action, which is a fundamental difference with Europe.

In Europe the whole idea behind 'comply or explain' was that shareholders would be able to express their lack of satisfaction with how a company's board is set up. However, it is not at all easy for shareholders to use those rights. There is a problem of cross-border voting: shareholders in one member state find it hard to exercise their rights in another.

The position thus represents an interesting paradox. The United States has made it easy to vote in any shareholders' meeting anywhere in the United States by a system of proxy voting, although there is little to vote on. In Europe there is much to vote on, but Europeans have so far refused to build a system that allows them to vote efficiently.

1.3.4 Controlling Shareholders

Another complication on the European mainland is the number of companies with controlling shareholders. If certain shareholders control the board, then they can design a governance structure to suit themselves, whether or not it follows the country code. It does not really matter, because they are the majority shareholder. Basically, they are explaining to themselves what they would like. Minority shareholders lose their influence.

'Comply or explain' was basically developed in the United Kingdom, where ownership is widely dispersed and generally speaking there are no controlling shareholders, as a mechanism by which institutional shareholders are able to have some control over the type of governance that the board of the company would like to see. Where there is a controlling shareholder, this system has much less efficacy. It leaves small shareholders without any power at all.

The discussion so far leaves open the question of whether governance in these countries is improving or not. The European Corporate Governance Forum has asked the European Commission to produce a study on how these codes are actually applied in the member states. Is there any form of structured monitoring of the extent to which companies comply with the codes? What are the mechanisms by which shareholders can exercise their influence? We have a lot to learn on how governance really works in Europe.

1.3.5 Code Masters

In terms of subject matter, the codes are basically the same across each of the EU member states. Some sections might be much more detailed in one country than in another, meaning that companies have to explain more. But the fundamental differences are in how these codes function and in how they are enforced in each member state.

In some countries it is the stock exchange that issues the codes. In others, such as Germany and the Netherlands, it is an independent group with backing from the government. The key difference lies in whether the codes form part of securities regulation or come under corporate law.

If they are part of securities regulation, then the regulator or the exchange has some say over companies' compliance. If they are part of corporate law, investors will have to go to civil law courts to challenge what the board is doing. The question is then whether they can bring a civil law case against the board for not following the code. The position varies from country to country. Furthermore, in some countries, corporate governance remains entirely voluntary. The assumption is that listed companies will have to explain what they are doing, but there is no means of legally forcing them to do so.

In countries where the basis is in corporate law, such as the Netherlands and Germany, these codes apply to companies incorporated in that jurisdiction, no matter where they have a stock exchange listing. In the United Kingdom the combined code applies only to companies listed in London. So, if you are smart you incorporate in London, then list in Germany. You can then escape both codes. Air Belin plc is doing precisely that.

1.3.6 Scope for Convergence

Europe has more or less incorporated Sarbanes–Oxley, although in a much lighter way than the United States. The European Union has amended the Company Law Directive on auditing and included many elements of US regulation. One element it left out was the need for external certification for companies' reporting process, which is burdensome because companies have so much to document.

In fact, the SEC is reducing the requirements for smaller companies, as well as international ones. So, there is some convergence towards a more moderate way of dealing with internal control and risk management.

However, we do not see the United States moving towards treating corporate governance in a broader sense. There is little movement in the United States regarding the role of non-executive directors and the relationship between companies and shareholders. Shareholders can still do relatively little about the positions of directors on boards.

The general tendency in the United States is to steer clear of intervening in this area at all. Traditionally, it is the responsibility of each state, rather than the federal government, to make and enforce its own corporate law. The federal government intervenes only every now and then after a crisis.

Following the credit crunch, the federal government could intervene again, but probably only in respect of financial institutions, rather than listed companies in general. There is unlikely to be a huge wave of governance in general.

1.3.7 Trends Elsewhere

In other parts of the world there is some competition between the two models. The US approach is clear-cut and easy to sell. There are some strict and mandatory rules. Where there is no regulation, companies are completely free. As a way to get rules in place fast, this approach is much easier than the European one.

If a country wants to have an efficient system based on 'comply or explain', it has to have fairly sophisticated companies and investors who understand the nuances and who are willing to engage in a debate without jumping to conclusions. In developing countries, such a sophisticated relationship does not necessarily come first. It is easier to impose strict rules first, then see what happens. So, there is a tendency to give preference to the US model of strict regulation, then over time evolve a more flexible, more sophisticated and gentler system.

1.3.8 Pluses and Minuses

In the past decade there has been an enormous step-up in the efforts made by non-executive directors. It is now clearly understood that they have a real job to do, one that takes time and commitment. They need to have a much deeper level of understanding of the company than formerly. Managers are now being challenged sooner and in more detail.

The most disappointing area is executive remuneration. The intended alignment of interests between shareholders and managers through a system of variable pay, stock options and share grants is a complete failure. The mechanisms that have been developed are too easily exploited and manipulated, particularly when payment can only go up, irrespective of how people are performing. We know now that in financial institutions, people have been driven to put whole banks at risk because their incentive was to increase turnover with products that nobody understood. The problem might be specific to financial services, but it does show how quickly governance can go badly wrong.

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This article is written on the basis of an interview with Professor Winter on 7 October 2008.

1.4

Managing Governance

David Jackson, Company Secretary, BP

It is easy to fall into the trap of believing that governance is just about compliance. A Board spends 10 minutes on it, then move on to real business. In fact, governance is what the board does.

Just following a code is too narrow; all that the code gives you is the framework. You have to put in place the governance system and the behaviours that support it. Too often boards do not think enough about how they actually operate.

Their task is to govern, the executives manage. The Board has to resolve questions that cannot be delegated to executive management. These will present themselves under a variety of headings, such as strategy, setting the tone from the top, having a view on risk, hiring and firing the chief executive, and exercising proper oversight of the individual and collective performance of executives in implementing the strategy.

Codes might give you a system for reporting to shareholders on a comply-or-explain basis, but it is down to companies to decide how they want to govern themselves.

1.4.1 The Principles

BP put its own governance structure into place in 1996.

It's a clear system, defining the separate roles of the chairman and the chief executive as well as the relationship between the board and executives, setting out how delegation works.

Any temptation for the board to become too involved in management has to be resisted. Its focus must remain on governing in the widest sense. As company secretary, I almost act as the chairman's chief of staff to support directors in that task. My team and I are the only people in the organization who do not work for the chief executive.

In many companies the general counsel acts as the company secretary – which does raise the question of whether you can serve two masters. At BP we have more clarity about who does what.

The board's right to initiate discussion is also strongly protected. Executive management clearly needs to have a significant say on what should be covered, but items from the chairman and independent directors should not be allowed to fall off the agenda.

This framework of governance continues to serve us well, although some details have changed. In particular, a 10-page statement on the principles that guide the board in discharge of its obligations to BP's shareholders is now posted on the website.

We operate under our home jurisdiction of comply-and-explain in the United Kingdom. Clearly, we have a substantial part of our business in the United States, where governance is more about compliance. So in 2007 when we reviewed our governance principles we expressly recognized the need for the way in which the company was governed which could be understood on both sides of the Atlantic. We changed the use of 'monitoring' to describe the board's activities to 'oversight'.

1.4.2 The Mechanics

We regularly review the board plan against the skills of our directors. Over time, we need to try to match their skills with the challenges that the board is going to face. We are currently trying to recruit a new chairman, so we are going through the same exercise.

The board currently has 4 executives and 11 non-executives. It meets nine times a year. At least two or three times, the meeting will take place internationally, close to a BP location that non-executive directors can visit.

Its composition is under active review. When the Combined Code was introduced in the United Kingdom, it raised questions about the independence of two of our directors, who had been in post for over 10 years.

Instead of putting just them up for annual re-election, we decided to put each director up for re-election every year. We said that we are a long-term business and we want our directors here for the long term. We think it is better practice. Directors can stay on the board as long as the shareholders want, because every year shareholders have the right to object to them.

Some say our board is on the large side, but it is necessary to make a trade-off. The optimum should allow board members to have a decent conversation about strategy, while manning all the board's committees, which are taking more and more time.

The ideal is to leave the board as free as possible to look at strategy and risk as well as reputation. Oversight of other areas, such as audit, remuneration, safety, ethics and environmental issues, is best conducted by committee.

Corporate and social responsibility is often seen as a separate sphere of activity. BP's view is that it is woven into the governance framework. To maximize long-term shareholder value, you need to be responsive to a broad church of people who are touched by your operations. You can only be responsible to your shareholders, but you need to think about other interests when you are operating the business. So, acting responsibly is what a board should be doing in any event. It is going to be in the long-term interest of the shareholders.

1.4.3 Shareholder Engagement

The board should never forget that it is there as an agent of the shareholders. It has no God-given right to exist as an entity in itself.

Communication happens at a number of different levels. There is no one way of doing it. You have to be out there. Shareholders can talk to the chairman, or you can put on extra presentations from executive management. Dialogue is key.

We have an investor relations team who deal with the ebb and flow of discussions on performance with analysts and investors. As company secretary, I get involved with issues involving the board, governance and strategy. The chairman will meet annually with some of the larger shareholders.

We want to know who our shareholders are, and we have a ready dialogue. They know that they can pick up the phone. It is a major part of my role.

About 65 per cent of shareholders now vote regularly, a figure that has risen from 40 per cent in the past five years. We would like it to be more. Our top 20 shareholders all vote, and we monitor their vote. If they oppose a resolution, we can find out why.

It is important to have these resources in place, because the profile of shareholders is changing. Alongside traditional institutions, there are now sovereign wealth funds and hedge funds. For companies, these changes are raising the question of how they support their boards. It is necessary to make sure that directors discharge their role properly, making the best use of their limited time.

For the past six years, David Jackson has been Company Secretary at BP plc, one of the world's biggest energy companies. He had previously been Company Secretary and General Counsel at Powergen for 12 years. For details of BP's governance principles, see www.bp.com.

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Part 2

Shareholder Rights

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2.1

Active Shareholders

Colin Melvin, Chief Executive, Hermes Equity Ownership Services

At the root of the credit crunch lies a genuine crisis in ownership in the form of accountability and investor responsibility. The lack of dialogue between long-term shareholders and companies has meant that directors have been hearing only a lot of short-term noise from the financial markets. The priority has been next quarter's earnings, not longer-term strategy and risk management.

Financial centres such as the City of London excel at short-term trading, often for their own benefit. Company governance is generally treated as a matter of compliance. The effect, however, is an absence of active ownership.

If the banks were not having conversations with long-term shareholders, but were under pressure to perform in the short term, what were they going to do? Innovate and take risks in the short term, particularly if that behaviour was reinforced by compensation packages.

But short-term bonuses exceeded any long-term gains. The alignment of interest between shareholders and innovators had broken down, which then triggered a vicious circle. Long-term investors were putting their funds into products that ultimately undermined the health of the whole financial system.

Who was talking to the banks about the strategy and risks that lie behind such transactions? Too few investors by far. Sadly, trustees in pension funds allowed themselves to have the wool pulled over their eyes.

2.1.1 Universal Investors

Most large pension funds are in effect universal investors. They invest in every company in the index. In practice, the discipline of walking away or selling out does not exist.

By virtue of their size and their investment horizon, they tend not to be active traders of shares, at least not as regards the bulk of their holdings. A large fund will have a core holding of a blue chip as long as it is in the index. There may be some trading at the margin, going overweight or underweight relative to the index, but the substance of their investment tends to be in passive equity exposures. By buying and holding the index, you do not add value through the trading of shares; rather, you add value by being a responsible owner.

At the very least, sensible governance will help to prevent the destruction of value in the long term. It should also reduce the premium on equity risk. In 2002 a report from McKinsey found that investors will pay a premium of 12 per cent for shares in well-governed companies in the United Kingdom and 14 per cent in the United States. In markets where the regulatory backdrop is less certain, the figure can be as high as 40 per cent. These gains tend to be made once there is a clear expectation that governance is going to start to improve within a particular company.

2.1.2 Governance in Practice

Sadly, many investors are content to tick boxes relative to a code or guidelines. But governance is about more than routine checks. Investors should look to support companies in putting in place the structures that will support long-term growth.

Broadly defined, governance covers the relationship between the company and its shareholders, and the quality of the direction and management of the company. Fundamentally, it is about those structures that facilitate the accountability of a company to the owner. That is why independent directors are necessary. That is why compensation or remuneration schemes need to be aligned to the interests of investors.

At Hermes we have no single template; companies have to be considered in context. Each country will decide on its own code. One would not expect the same of a company in France as of one in the United States. To prosper, companies will have to structure themselves in different ways. On behalf of investors, we are happy to support local best practice – or listen to any variations.

2.1.3 The Vote

Shareholders' main formal lever is the vote, although the quality of shareholder rights varies from market to market. One of the poorest environments for active shareholding is the United States. We are expecting improvements there, but for now it is not straightforward to elect or dismiss a director. Shareholder elections do not exist in the same way as they do in the rest of the world. Instead, a slate is put forward, which you cannot vote against. The result is a lack of proper oversight of the board by shareholders in the same way as anywhere else. It is certainly not possible for shareholders to put forward their own candidate.

In most parts of the world, boardroom agendas are broadly similar, although there are variations on how votes on remuneration and compensation practices in particular take place. In the United States this issue is now part of the debate on what should be presented to shareholders.

2.1.4 Dialogue

Your other main tool as a large investor is face-to-face meetings with board directors. These give you the chance to review the link between strategy and financial progress.

Avoid letting these conversations becoming adversarial or tabling too many complaints. It never gets you too far and it is easy to relapse into ticking boxes. Instead, be constructive. You want directors to trust you this time and at the next meeting. The idea is to give them a sounding board.

Engagements cover a wide spectrum. Some relate to strategy. Others cover risk management, board membership, elections, nominations, audits and executive pay. Environmental and ethical issues are generally raised to the extent that they are financially material.

Many of these conversations are challenging. If you think the mix of assets might be managed better elsewhere, then you will want to discuss the question of a best parent for a particular activity. The goal is for companies to focus on what they are best at and where they can deliver value.

2.1.5 Going Forward

The main challenge for governance relates to the financial crisis. After some short-term actions to stabilize the market, the danger is that public money is seeding the next boom. Knee-jerk regulations will not put in place the conditions needed to ensure stable, steady growth in future. If long-term shareholders fail to engage in dialogue, we could see another boom and bust cycle, which would be in no one's interest.

The solution already exists. The trustees of our pension funds have a duty of trust to look after the beneficiaries, but they have been asleep, allowing themselves to become complicit in the short-term dance. They have had a wake-up call and now need to take up the cudgels.

Companies will benefit from a more constructive, longer-term dialogue. It is entirely wrong for governance to be mediated through a group of traders who are interested only in the short term.

Of course these short-term trading activities should continue. Markets need them. But if the only voice you are hearing on a board of directors is a hedge fund, then you are in trouble.

Colin Melvin, Chief Executive of Hermes Equity Ownership Services, has been in the investment industry for over 15 years, involved mainly in corporate governance and responsible investment. He joined Hermes six years ago, turning a corporate governance department into a service for pension funds, Equity Ownership Service, which now has £50 billion worth of assets under advice.

Hermes Fund Managers is an institutional fund manager, managing money for nearly 200 pension funds. It is 100 per cent owned by the BT pension fund, the United Kingdom's largest scheme.

To download a Hermes review on the impact of governance on value, 'Corporate governance and performance: the missing link', see http://www.hermes.co.uk/pdf/corporate_governance/Corporate_Governance_and_Performance_2007_web.pdf.

2.2

Shareholders, Blockholders and Stakeholders

Roger Barker, Head of Corporate Governance, Institute of Directors

For a British or American observer of corporate governance, continental Europe presents an unfamiliar landscape. Whereas Anglo-Saxon corporate governance debates revolve around the relationship between shareholders and management – reflecting the agency issues arising from dispersed company ownership – continental European corporate governance has centred on the uneasy coexistence between controlling and minority shareholders. This focus stems from the traditionally high levels of ownership concentration of European companies (see Table 2.2.1). In such a blockholder-dominated environment, minority shareholders – including foreign investors – have struggled to exert influence over publicly listed corporations, with significant implications for corporate behaviour.

The European model of corporate governance may be defined in terms of modern finance theory, which has identified two distinct models of corporate governance: the blockholder model and the shareholder model (see Table 2.2.2). According to the blockholder

Table 2.2.1 *Ownership concentration (%), mid-1990s*

United States	15.0
Netherlands	20.0
United Kingdom	23.6
Denmark	37.5
Norway	38.6
Sweden	46.9
Switzerland	48.1
Finland	48.8
Belgium	51.5
Austria	52.8
Spain	55.8
Italy	59.6
Portugal	60.3
Germany	64.6
France	64.8
Greece	75.0

Sources: La Porta, Lopez-de-Silanes and Schleifer (1999) for data relating to the United States, Denmark, the Netherlands and Greece; Faccio and Lang (2002) for other European countries. Data relate to the mid-1990s.

Note: Ownership concentration is the percentage of listed firms with individual owners holding stakes in excess of 20 per cent of total market capitalization.

model, owners of capital minimize agency costs by retaining direct control over individual public companies, normally through ownership of a large proportion of the equity capital. Through such an ownership strategy, blockholders seek to benefit from the advantages of both public and private corporate forms: access to the financing opportunities associated with a public listing, and retention of the control rights enjoyed by the owners of private companies. This is the ownership approach that has characterized most public companies in post-war continental Europe (although there are notable exceptions, eg Dutch companies).

In contrast, the shareholder model is preferred by investors with diversified equity participations in individual companies, and is typical of the liberal market economies (eg the United States, the United Kingdom, Ireland, Australia and Canada). The great business historian Alfred Chandler (1977) has depicted the shift from a blockholder to a shareholder model of corporate governance – which occurred in the United States in the early 20th century – as the transfer of control from the 'visible hand' of company insiders (blockholders) to the 'invisible hand' of company outsiders; that is, minority shareholders and the discipline of the capital market.

Table 2.2.2 *Shareholder and blockholder models of corporate governance*

	Shareholder Model	**Blockholder Model**
Geographical Coverage	liberal market economies	most other countries, including continental Europe
Ownership and Control	diversified ownership	controlling owner
Types of Owner	professional money managers	families, non-financial corporations, banks, the state
Minority Shareholder Protection	strong	weak
Board	often close to management	close to controlling owner
Management Power	strong, autonomous	weak, close to controlling owner
Management Incentives	determined by market signals in capital markets	directly supervized by controlling owner
Management Behaviour	shareholder value maximization	dependent on preferences of controlling owner
Bank Relations	arm's length, diversified, no ownership	close, concentrated, possible ownership
Capital Structure	lower ratio of debt to equity	higher ratio of debt to equity
Market for Corporate Control	hostile bids important	hostile bids rare
Political Power of Owners	weak, indirect	strong, direct

The distinction between blockholder and shareholder models of corporate governance can also be observed in terms of the type of institution involved in share ownership. Blockholding in continental Europe has often been employed by pyramidal business groups. In such a structure, an apex shareholder (often a wealthy family) directly controls a single company (which may or may not be publicly listed), which in turn controls large blockholdings in other companies. A complex web of cross-shareholdings may exist across the corporate sector, although control may ultimately reside with an opaque group of élite actors. Blockholding has also been pursued in many post-war European economies by industrial corporations (through cross-shareholdings in other corporations), universal banks (particularly in Germany), family networks (such as the Wallenberg family empire in Sweden, or the Agnelli family in Italy) and the state (for example, via nationalization or public investment in 'strategic' industries). In contrast, the shareholder model is characteristic of institutional investors such as pension funds, insurance companies, mutual funds and hedge funds, which dominate the ownership structure of the Anglo-American economies.

Blockholding creates potential difficulties for minority shareholders as, in the absence of regulatory or legal safeguards, blockholders may seek to exploit their position of control to override minority interests. They may do so by directing management to pursue a business strategy based on personal or political objectives such as growth, empire building, philanthropy or employment protection, rather than profit or value maximization. Or they could instruct management to retain profits within the company – despite a lack of attractive investment opportunities – rather than returning cash to shareholders through higher dividend payments or share buybacks.

In extreme cases, control rights may facilitate the blockholder's ability to undertake outright theft of the company's assets, or to indulge in insider trading. The most egregious example of expropriation by a European blockholder in recent years was the case of Parmalat, an Italian food and dairy products enterprise that collapsed in December 2003. The firm was listed on the Milan stock exchange and controlled by the Tanzi family via a pyramidal ownership structure. During the 13 years leading up to the collapse, the Tanzis exploited their privileged position of control to illegally extract an estimated 13 billion euros from the company by hiding losses, overstating assets, recording non-existent assets, understating debt and forging bank documents.

As well as the distinction between the blockholder and shareholder models, the concept of the stakeholder corporation has also been used to describe European corporate governance. Whereas a firm within a shareholder system maximizes profits in the interests of private shareholders,[1] the firm in a 'stakeholder' system is motivated by broader obligations to a wider range of stakeholders (eg employees, suppliers, customers, creditors, the state and local community). Reflecting this philosophy, European companies have often been viewed as playing a social role in their domestic economies, for example by cushioning employment levels during a downturn, supporting vocational training programmes or working with government to rescue companies in crisis.

However, there is a sense in which blockholder and stakeholder models are equivalent concepts. In order for a stakeholder approach to corporate governance to be pursued, blockholding is likely to be a necessary prerequisite. A controlling shareholder is at liberty to operate a firm in a manner that involves the fulfilment of broader social responsibilities rather than profit maximization. In contrast, managers of firms operating within the shareholder model have less scope for behavioural flexibility, owing to their external constraints. A corporate strategy that is deleterious to the interests of shareholders will be punished through the disapproval of capital markets, for example by a lower share price, an increased risk of takeover, higher cost of capital and, ultimately, the removal of management. Consequently, the stakeholder approach, rather than representing a separate category of corporate governance, is likely to be symbiotic with the continued survival of the blockholder model of corporate governance.

Note

1. Such corporations follow the advice of Milton Friedman, 'There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits', given in an article entitled 'The social responsibility of business is to increase its profits' published in the *New York Times* magazine, 13 September 1970, pp 32–33.

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2.3

Shareholder Voting

Alan MacDougall, PIRC

One of the most fundamental ways in which shareholders can exercise ownership in respect of the companies in which they invest, and seek to promote good governance, is through using the votes their shares entitle them to. Over the years, investors have used their voting rights strategically on numerous occasions to bring about changes in investee companies' policies, governance structures and behaviour. Shareholder voting remains one of the best tools that investors have for influencing company management.

As with previous episodes of market turmoil, the ongoing credit crisis is revealing some significant governance failures that may have been overlooked by investors when times were good. Therefore, we should expect to see a greater level of investor activism, including the use of shareholder voting, as a force to reform governance in various markets in the future.

2.3.1 European Developments

Although there is something of a trend towards some common governance principles across Europe, a trend encouraged by the European Commission, there remain many national differences. Research carried out by the European Corporate Governance Service in 2006 into the arrangements for 289 companies across 15 countries found significant differences in approach. For example, 42 per cent of companies require the approval of the remuneration report and/or policy by shareholders. This is an indication of the fact that some countries have made such a vote mandatory, while others have not. In addition, 25 per cent of European companies make use of differential voting rights, a practice frowned upon in many markets.

The impossibility of trying to apply a 'one size fits all' policy can be seen in the European Commission's difficulties in developing a continent-wide approach to shareholder rights. In October 2007 the Commission had to abandon plans for a 'one share one vote' policy in the face both of fierce resistance to the idea from some countries, and of mixed empirical evidence in support of the value of such a framework.

Shareholder voting levels also vary, from about two-thirds in the United Kingdom and Spain to around 50 per cent in Italy and about 45 per cent in Switzerland. However, within individual European countries, shareholders continue to push for both governance reforms and extensions to their rights. A few specific cases follow.

2.3.2 France

As in other markets, executive pay is a hot issue in France. The government has recently threatened to impose new limits on compensation at poorly performing companies, with French minister Christine Lagarde describing pay in the CAC40 as 'scandalous'. The government also signalled its intention in the summer of 2008 to use its turn as president of the European Union to push for European Union-wide rules on remuneration. The French government has already placed limits on 'golden parachutes', requiring companies to tie severance packages to performance criteria.

2.3.3 Switzerland

The value and power of shareholder voting was demonstrated forcefully to the Swiss market in 2008. Shareholder activist body Ethos put forward a request for the special audit of banking giant UBS in respect of its losses stemming from the sub-prime market. At an EGM held in February, 45 per cent of UBS shareholders backed the Ethos request, and UBS subsequently produced a full and frank report detailing risk management failings. Notably, the report also included a section highlighting the role remuneration within UBS had played in incentivizing inappropriate behaviour.

More recently, Ethos has also announced its intention to file 'say on pay' resolutions at the AGMs of ABB, Credit Suisse Group, Nestlé, Novartis and UBS in 2009. Among the main stock markets, Switzerland is the only country in which legislation does not provide shareholders with the right to review directors' remuneration.

2.3.4 The Netherlands

The highest opposition votes in the Dutch market are typically cast against resolutions relating to the restriction of pre-emptive rights for the authority to issue new shares and/or resolutions relating to the issue of preference B shares. The latter are used by many Dutch companies as an anti-takeover defence.

It is standard practice in the Dutch market for two types of share issue proposals to be made on the same proxy card: one resolution asking for the authority to issue 10 per cent of shares plus an additional authority to issue 10 per cent in the case of a merger or acquisition, and another resolution asking to limit or exclude the pre-emption rights when issuing shares pursuant to the first resolution. This so-called '10 + 10 rule' is Dutch market practice and has so far been accepted by Dutch institutional investors; foreign investors often consider these thresholds to be too high.

Other resolutions that have received relatively high opposition votes are those relating to new remuneration policies for executives.

2.3.5 Italy

The Italian market is characterized by relative ownership concentration. This is due to the fact that, on average, a particularly high proportion of shares represented at the AGM are held by strategic shareholders, compared to the proportion in other European countries. Strategic shareholders usually control companies through shareholders' agreements or simply by having a majority shareholding. Although the Italian legal framework is not a material obstacle to voting, minority shareholders' representative power is still low.

However, there have been changes. In 2005, newly introduced legislation made it mandatory for public companies to reserve some board seats for lists not tied to the controlling shareholder, a move that ought to serve to protect minority shareholders. According to one Italian board member detailing his personal experience in the *Financial Times* in 2008, this has, as we would hope, brought a fresh perspective to discussion over issues such as remuneration and related party transactions.

2.3.6 The United Kingdom

In the United Kingdom, remuneration still tends to dominate voting at AGMs, and this tendency might be expected to intensify in the coming years as pay at financial institutions in particular has been highlighted by some as a contributory factor in the credit crisis. Shareholder opposition to pay-related resolutions is higher, averaging around 4 per cent in the FTSE 350, than opposition on other issues.

Whether shareholder voting on pay has actually brought about change is a subject of some discussion in the United Kingdom's corporate governance world. It is now five years since the government introduced a shareholder advisory vote on remuneration reports, leading some to reflect on what impact it has had. Certainly, communication and engagement between investors and companies over pay is now more common and more sophisticated. Investors have achieved real change in areas such as directors' contracts, and a greater element of pay is now performance related. However, the issue of quantum continues to vex investors.

In addition, the differential between executive and average employee pay has continued to increase. In an effort to encourage greater shareholder engagement in respect of this issue, the government introduced the following minor amendment to the recently passed Companies Act requiring companies to report on how pay and conditions of employees are taken into account when determining directors' remuneration. It is a small step forward.

In terms of extensions to shareholder voting rights, there has been some discussion among investors of the idea of an approval vote on audit committee reports. This is something supported by, for example, the Association of British Insurers. However, to date there does not seem to have been much enthusiasm on the part of regulators to enact such a power.

2.3.7 Across the Atlantic

There will be a significant push for reform of the US financial sector in the future, although the shape this will take is unclear at the moment. Some shareholders have already gone on the offensive, with union-controlled pension funds in particular targeting companies in the financial sector. A number of 'withhold vote' campaigns were run against investment banks and other financial companies. In some cases these were successful in bringing about board changes.

It is worth noting too that some of the companies that have failed have been those with poorest governance. In PIRC's own analysis, both Bear Stearns and Lehman Brothers ranked well below average on issues such as board independence and compensation arrangements.

Meanwhile, there is continuing pressure for the granting of greater shareholder rights. Two of the key demands of shareholders are 'proxy access' – effectively, the right of shareholders to nominate directors – and 'say on pay', the introduction of a shareholder advisory vote on executive compensation. Both proposals are being vigorously resisted by business lobbyists, but with both presidential candidates in the 2008 election looking to make political advantage from the crisis, corporates may be fighting a losing battle. Both John McCain and Barack Obama signalled their support for 'say on pay', for example.

Perhaps the most telling sign of the way things are likely to develop is the fact that some boards are accepting the need for greater accountability to shareholders. A number of companies, such as Aflac and H&R Block, have voluntarily introduced advisory votes on pay – a move that has gone down well with their shareholders.

2.3.8 Japan

Governance arrangements at Japanese companies often serve to frustrate overseas investors. In the summer of 2008 the Asian Corporate Governance Association (ACGA) claimed that the governance of Japan's listed companies was not working in the interests of either shareholders or other stakeholders. The ACGA said that managements of Japanese companies too often appeared to act as if they, rather than shareholders, were the owners of the business and that such attitudes were damaging to investor sentiment and could have economic ramifications. Issues in the Japanese market are similar to those that can trouble minority shareholders in other markets: anti-takeover devices, strategic cross-holdings and so on. Yet despite pressure from shareholders, attitudes in the Japanese political class sometimes betray a very different perspective. Early in 2008, Takao Kitabata, vice minister at the Ministry of Economy, Trade and Industry, even suggested that companies should be able to choose their own shareholders.

2.3.9 Conclusion

At the time of writing, the impact of the credit crunch on various corporate governance regimes remains to be seen. Already in some markets we have seen the unexpected re-emergence of the state as part-owner. In addition, in the United States and United Kingdom the taxpayers' money being provided to bail out financial institutions comes with strings attached. In particular, reforms in remuneration are being sought.

More broadly, there is an emerging view that one element of the crisis has been the failure of ownership. Shareholders have failed to understand or effectively steward financial institutions in which they often had substantial investments. If the public company is going to continue to work effectively as a form of economic organization, shareholders must play a more active ownership role than they have in the past. Therefore, if we can make one prediction about investors' reactions to the crisis, it is that governance issues are going to assume an even greater importance in their thinking in future.

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2.4

US Shareholder Litigation and European Investors

Darren J Check and Naumon Amjed, Barroway Topaz Kessler Meltzer & Check LLP

European institutional investors are increasingly using litigation in the United States as a means to recover losses from instances of corporate fraud and/or to implement corporate governance reforms within corporations. In fact, some European institutional investors have called on the investor community to take a more active role in corporate litigation filed in the United States as a means to protect the institutions' assets. According to a study published by the accounting firm of PricewaterhouseCoopers (the 2007 Securities Litigation Study):

> In March 2007, the UK's National Association of Pension Funds Ltd. (NAPF)… issued a paper outlining the potential benefits of investors taking part in securities class actions. NAPF stated that UK pension funds are becoming more active in joining US class actions, and posed the question of whether trustees had a fiduciary duty to join such suits.

According to the NAPF paper,

> it seems self-evident that trustees have a duty to protect the assets in their scheme and that they should therefore at the very least not neglect opportunities to recoup losses, where the cost and effort are commensurate with the expected return.

The increasing role of foreign investors in US lawsuits has sparked a debate regarding the reach of US securities laws (Buxbaum, 2007). In cases where fraud is committed within the United States and where the US fraud causes foreign investors to suffer losses or where US investors are injured by fraud caused by a foreign corporation, US courts generally allow such claims to proceed in the United States.[1] The debate regarding the reach of US securities laws grows thorny when it comes to the question of 'triple foreign' plaintiffs – foreign investors that purchased shares of a foreign company on a foreign exchange – and whether such plaintiffs can bring claims in the United States. Over the past few years, the number of triple foreign plaintiffs accessing US courts has increased steadily (Buxbaum, 2007). Although a full analysis of the jurisdictional limits of the federal securities laws is beyond the scope of this chapter, we highlight the issue because it is a developing area of the law and must be considered when evaluating any of the avenues of litigation discussed herein. Generally, the purpose of this chapter is to provide an overview of the three most common litigation tactics employed by shareholders in US courts to recover losses or force corporate reforms.

2.4.1 Class Action Lawsuits

The class action lawsuit is a vehicle in US law that allows victims of a similar wrong to pool together and file one lawsuit on behalf of all the victims against common defendants. The aggregated group of individuals is called a 'class'. There are two primary motivations behind allowing a class action: 1) to allow victims who may have suffered an insignificant loss (on an individual basis but which may be significant in the aggregate) to file a lawsuit; and 2) to allow the efficient prosecution of similar claims (see generally Schwarzer, 1996). The class is represented by a court-appointed representative called a 'lead plaintiff'.

In the United States the Private Securities Litigation Reform Act of 1995 (the PSLRA), a federal law, dominates the area of securities class actions and provides an orderly method for selecting a lead plaintiff. The PSLRA also dictates what must be pleaded by a plaintiff to state a claim for relief, as well as imposing other procedural and substantive requirements. Under the PSLRA, within 60 days of the filing of the suit any investor suffering a loss (irrespective of whether that investor filed a complaint) can petition the court to serve as the lead plaintiff. The court selects the movants with the 'largest financial interest' in the lawsuit – often calculated as the largest loss – to serve as the lead plaintiff. Groups of investors are allowed to petition the court in one application and move for appointment together, although some courts require a pre-existing relationship among members in a group. The rationale behind appointing the investor who lost the most money is that such an investor will be motivated to increase the total amount recovered for the class and thereby increase his or her pro rata share of the proceeds. The lead plaintiff is charged with litigating the case, directing counsel, participating in settlement discussions and deciding whether and, if so, when to settle an action.

European investors are increasingly being appointed as lead plaintiffs in some of the most significant cases in the United States, including class actions involving UBS, General Motors, Merck and Delphi, and have successfully settled lawsuits for hundreds of millions of dollars. For example, a lead plaintiff group consisting of, among others, Raiffeisen Kapitalanlage GmbH (an Austrian-based mutual fund manager) and Stichting Pensioenfonds ABP (the pension fund for public employees in the governmental and educational sectors in the Netherlands) settled claims involving fraud at Delphi for more than $300 million. Recently, Deka Investment GmbH and Deka International settled class claims against General Motors for a similar amount.

In addition to recovering money damages, class action lawsuits allow investors to protect the value of any investments in a corporation by allowing the class an opportunity to include corporate reforms as part of any settlement. For example, in July 2008 the California Public Employees' Retirement System (CalPERS) announced a proposed $895 million settlement of a class-action lawsuit brought against UnitedHealth Group over its stock-option grant practices. CalPERS' settlement included corporate governance changes, including a process for election of a shareowner-nominated director, enhanced standards for director independence, a mandated holding period for option shares acquired by executives, shareowner approval of any stock option repricing and that incentive compensation take into consideration UnitedHealth's performance as compared to that of its peer group.

Overcoming procedural attacks against a plaintiff's ability to state a claim is necessary, however, before any resolution of a claim can be entertained. The increasing role of triple foreign plaintiffs will, until the issues are resolved by the Supreme Court or Congress, face attack from defendants claiming that US courts do not have jurisdiction to hear triple foreign plaintiffs' claims. Such attacks are made early in litigation (although technically they can be raised at any time) and if granted end the case. Recently, in a lawsuit involving AstraZeneca, a UK pharmaceutical company with offices in the United States, the court hearing the action ruled that triple foreign plaintiffs could not assert claims in the United States. The court reasoned that although many of the misrepresentations emanated from the United States, the defendants' US-based conduct could not be said to have *caused* foreign investors' losses.[2] *AstraZeneca* is on appeal.

Other courts have reached the opposite conclusion from *AstraZeneca*. For example, in *Alstom*, Alstom Transportation Inc (ATI), US subsidiary (located in New York) of the French company, underreported costs on railcars.[3] The underreported costs were transmitted from the United States to France, where the numbers were included in Alstom's consolidated financial figures. In June 2003 ATI announced that it was the subject of an investigation from two government agencies and that it would place its CFO and CEO on leave. Subsequently, a class-action lawsuit was filed by a group of institutional plaintiffs asserting claims on behalf of all investors in Alstom's stock. As is customary in class-action lawsuits, the defendants moved to dismiss the case on several grounds. In response to the defendants' jurisdictional arguments, the court stated, '[US-based] conduct certainly served as an essential link in the causal chain leading to the losses suffered by foreign purchasers abroad.' According to the *Alstom* court, ATI's

> creation of the false financial data was concocted and executed in America. The false documents may have been sent to Alstom headquarters in France and incorporated into the Company's financial

> reports, but… the mailing of the fraudulent documents for publication outside of the United States does not render the conduct in the United States any less of a cause of plaintiffs' losses.

Alstom, unlike *AstraZeneca*, allowed all investors (US and foreign) to assert claims based on ATI's fraudulent conduct.

The law concerning the reach of the federal securities laws is evolving and will shape the role of foreign investors in class-action lawsuits going forward.

2.4.2 Individual/'Opt-out' Actions

When an investor's losses are significant, the investor can seek to recover losses by filing an individual action. Individual actions allow investors greater choices in the types of claims that can be asserted and provide the investor with complete control over the direction of the lawsuit. Where there is a class action pending, investors may 'opt out' of (exit) the class by filing an individual action. Opt-out suits are often coordinated with the class action in order to avoid having the defendants produce multiple sets of the same documents or sit for multiple depositions on the same topic but are separated once the information-gathering phase of the case (also called 'discovery') is completed.

Recent empirical data suggest that institutional investors who opt out of a class action recover significant premiums over passive class members (Coffee, 2008). For example, by opting out of the class action involving America Online (AOL), institutional investors were able to recover significant premiums: the State of Alaska settled its $60 million claim for $50 million, CalPERS recovered 90 per cent of its claimed losses while the University of California estimated that it did '16 to 24 times' better than it would have done under the class settlement with the AOL class (Coffee, 2008, p 16). ABP also filed an individual action in AOL. ABP settled its claims for $20 million.

The premiums received by filing an individual action require opt-out plaintiffs to actively litigate the case and fully participate in the discovery process. The merits of a case, the level of losses suffered, the burdens of discovery and the potential maximum recovery are all factors to consider when deciding whether to remain a passive member of a class or to opt-out and file an individual action. Opt-out actions generally cannot be used to institute corporate reforms and are limited to providing plaintiffs with monetary compensation.

2.4.3 Derivative Actions

Finally, when a corporation is harmed, investors are allowed to bring a 'derivative action' in the name of the company against the company's officers and/or directors. Derivative actions differ from class and opt-out actions in several respects.

First, derivative actions cannot be used to compensate shareholders for direct injuries as they can only be used to compensate derivative injuries suffered by the company. For example, if a director steals a business opportunity within the scope of his or her company's business, the injury flows to the corporation, and thus a derivative action can be asserted. Other examples include failure to properly oversee the business of a corporation, wasting corporate assets by overpaying executives, instituting defensive measures to prevent the sale of a company and failing to properly consider a business opportunity, among others.

Second, since the right to protect a corporation rests with its board, a procedural requirement to bringing a derivative suit is making a demand on the board to bring the suit. Derivative actions can be used to implement corporate reforms and recover assets for a company.

Class actions, opt-out actions and derivative actions are the most common litigation methods employed by investors to recover losses or force corporate change in the United States. We anticipate that European investors will increasingly avail themselves of these strategies as they identify areas of recovery within their portfolios.

Notes

1. See *In re Alstom SA*, 406 F Supp 2d 346 (SDNY 2005).
2. *In re AstraZeneca Securities Litigation*, 559 F Supp 2d 453 (SDNY 2008).
3. *Alstom SA*, 406 F Supp 2d at 396.

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Part 3

Board Effectiveness

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3.1

The Role of Boards

Patrick Dunne, 3i

In this chapter I shall discuss the core processes that I expect to see on a board. Many years ago I was asked to sort out a portfolio of underperforming minority investments. It quickly became apparent that to make any progress it was absolutely critical that the role of the board was not only clear but well understood by all of its members, especially the company chairman. In the intervening years there has been much written on the subject, from the joy of the Combined Code for listed companies to numerous books ranging from the deeply philosophical to the good, old-fashioned rant.

Whether working with dysfunctional boards or with high performers there are two simple models that I find tremendously helpful. They seem to work around the world and across a range of sectors and sizes of companies.

The first is the board model.

You can generally group most issues a board has under the headings shown in Figure 3.1.1, namely 'People', 'Purpose', 'Process'. Rarely can you create a high-performing board or transform a weak one without addressing each of these three aspects.

In the most difficult situations there is seldom time for a lengthy philosophical discussion on purpose. In these situations the mantra 'Right strategy, right resources and keep out of jail' turns out to be a pretty useful shorthand description of what the board should be focused on. In more positive circumstances, and especially during

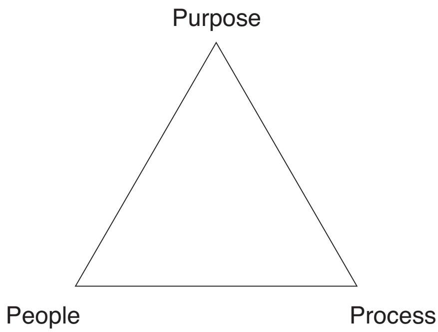

Figure 3.1.1 *Board model*

the creation of a board for a new situation, this model can also prove a very effective starting point in the discussion to determine the characteristics required for potential board members. Clarity of purpose also makes the pitch clearer to high-quality candidates.

Figure 3.1.2 is a very simple model for articulating what a board really does in practice. Clearly, the phase of the development and the company's own particular circumstances will determine the balance of activity.

'Right strategy' means that there is the right strategy in place for the ownership as well as for the business, that it is being implemented and monitored, and that there is a good process for formulating and adapting it. In the private equity world our investments have very detailed value creation plans. In addition to including in-depth plans for improving the performance of the business, these will also contain a plan for developing the strategic position of the business, and its value from the perspective of potential purchasers or the capital markets.

'Right resources' is all about ensuring that the organization has the right resources in place to meet the agreed strategy for the business and the ownership. The most important resources relate to people and money. The board must make sure not only that it has the right quantity of each, but also that they are organized in the most effective way.

'Keep out of jail' is simply shorthand for 'right governance'. Entrepreneurs and chief executives may tend to glaze over at the mere mention of the words 'corporate' and 'governance' when coupled together. However, I have found that they connect very quickly with the idea that getting the right governance architecture and processes in place leads to a less stressful life and frees up time

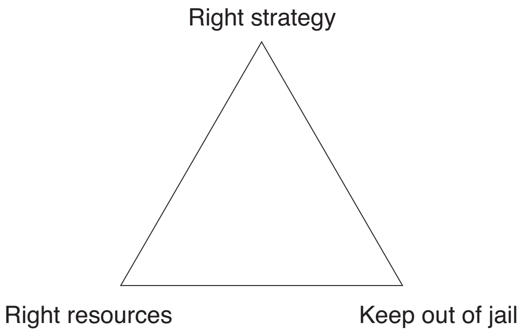

Figure 3.1.2 *Board purpose*

to do what they really enjoy doing. Having the right finance director and, if relevant, company secretary is crucial to achieving this and I've yet to hear of a chair or CEO complain that the finance director (FD) was too good.

A game I remember playing with groups of chairmen across Europe a few years ago was a *Twenty Questions*-style 'How do you know a good FD when you see one?' It is highly instructive to force yourself to focus in on the 20 most critical questions you could ask an incumbent FD before you join a board, or a new potential FD where you are already on the board.

One aspect of the board's role and the governance debate in general that has moved on considerably over the past few decades is the issue of 'shareholder primacy'. Long before the Enron or WorldCom crises or the words 'corporate responsibility' became mainstream, Professor Jay Lorsch from Harvard Business School wrote an excellent book called *Pawns or Potentates* (Lorsch with MacIver, 1989). In it he addressed the challenges that some 'traditionalist' directors would face if they continued to believe only in the primacy of shareholders and continued to refuse to believe that conflicts might exist between their traditional legal perspective and other constituencies.

Jay commended others whom he described as the 'Rationalizers' for being able to see conflicts and feel the growing tensions inherent in their responsibilities in an increasingly complex world. However, he then challenged them for rationalizing these conflicts away by presuming that what is good for the shareholders must be good for everyone else.

At the time, Jay felt that an emerging group whom he labelled the 'Broad Constructionalists' would become more common and would also adapt best to changing circumstances. These people openly recognized that their responsibilities encompass more than shareholders and that conflicts needed to be recognized and dealt with in a constructive way.

He was right, and the acceleration of globalization and concerns about the environment and climate change have reinforced this point of view. However, I think the game has moved on again. These days, failing to take into account the legitimate interests of others is not just about the risk of losing your licence to operate, but can also mean missing a commercial opportunity to differentiate your business, gain greater buy-in from staff and attract a wider pool of investors. In the private equity world we find it much easier to 'sell' companies that are strong on corporate responsibility issues and that have highly motivated and engaged workforces, and suppliers that have demonstrably sustainable earnings.

However, as with most other things in life, the words 'balance' and 'judgement' are important. Sometimes those who express an interest or make demands on a company do not really have a legitimate interest, and agreeing to do what they want you to do for the sake of an easy life, or just because your peers are complying, is not always the right thing to do.

Board process may be another topic that has a soporific feel to it, but good, simple, clear and unbureaucratic process underpins a successful board. Asking the question: 'Are our core board processes effective?' is a good one for a new director. Responses usually range from the well articulated and considered to the 'What do you mean?'

Good process for setting agendas and informing board members with relevant and timely information, and board subcommittees that assume responsibility and have appropriate delegated authority, add a lot to the effectiveness of the board. When it comes to reviewing board effectiveness, achieving the right degree of formality is critical. Too little and the process can lack authenticity. Too much and board meetings become sterile exercises with no one saying what they really think.

So, board structure and process are critical to success, but clearly not sufficient. Outstanding boards tend to have an outstanding chairman and cohesive and highly engaged boardroom teams of executives and non-executives. There are some universal characteristics of good directors whether they are executive or non-executive, and these relate to judgement, to the quality of interpersonal skills and to the power of a director's antennae. In my experience the best directors possess very good judgement of people and commercial situations. Their superb interpersonal skills and antennae also mean not only that their judgements are well informed but they can bring them to bear.

A chairman, as the leader of the boardroom team, will need some additional qualities. Chairmen need to ensure that there is the right pressure on the board. Too light and they risk the danger of entering the 'fat cat' zone. Here they risk not just failing to maximize shareholder value, but losing the strategic plot altogether. Too heavy and they risk ending up at the opposite end of the spectrum in the land of the 'headless chickens'. The best chairs always seem to be able to strike the right balance and avoid either end of this spectrum. They engender a spirit of constructive debate, ensuring that there is no prospect of any silent seethers in the boardroom, and create a feeling of high energy and calm at the same time.

The best chairmen also have the ability to make sure that meetings are managed well and agendas are well balanced, with the right focus on strategic issues. Many now devote a decent amount of time each year for the board to decide what the most important five or six issues are for it to discuss in the year ahead so as to allow time to conduct the right amount of preparation work beforehand. In doing so, the board will also need to allow time for the one or two unforeseen issues that inevitably will arise.

All chairmen need to be able to recognize conflict and deal with it. Spotting divergent interests or personality clashes early on and heading them off at the pass before they build in terms of destructive force is important. Knowing when to compete, collaborate, compromise, accommodate or avoid is central to their success.

In my experience, conflicts of interest are easier than personal conflicts. If personal conflicts are allowed to develop, they frequently end up with one of the parties having to go. Sometimes such conflict emerges because individual roles and expectations are not aligned or not clear. The classic CEO who becomes chair and cannot break the habit of years and stop being CEO is a perennial problem. By setting expectations at the outset and giving all members of the board clear roles and objectives, a lot of stress can be taken out of the situation.

Finally, it is my firm belief that being on a board should be an enjoyable experience. Business is fantastic fun and hugely challenging. The best boards do not necessarily do all that is expected of them by everyone but they do build significant shareholder value in a responsible way and enjoy doing it.

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Patrick Dunne has written several books on boardroom issues including *Directors' Dilemmas: Tales from the front line* and *The Non-executive Directors' Handbook* (co-authored by Glynis Morris). He is Group Communications Director for 3i Group plc, a member of the General Council of Warwick University, Chairman of the charity Leap – Confronting conflict, and a Visiting Professor at Cranfield School of Management.

3.2

Board Composition

Neville Bain, Chairman, Institute of Directors

There is sometimes reluctance on the part of boards of directors to focus on themselves and how they can improve. It is so easy to be immersed in the routine and important decision making that there is insufficient time to sit back and reflect. The Combined Code encourages boards to review their performance in a structured way. There is evidence that the governance structures in place today may be focusing boards on routine matters and causing them to develop a box-ticking mentality. If this is the case, then the boards are acting sub-optimally.

Many corporations are failing to obtain full value from their boards, say Thomas, Kidd and Fernández-Aráoz (2007). This lost opportunity applies not only to dysfunctional boards but also to successful companies. The authors say that their research highlights five key problems:

- *Inadequate competencies*. While most directors are capable, they lack the competence to deal with difficult, sensitive issues. Only 60 per cent of the directors in the research sample believe that all board members understand the key operating issues or the main sources of risk. (This is borne out by our own experience, and is a compelling argument for making risk assessment and control a key issue for directors.)

The MIT Sloan research also finds that 70 per cent of directors believe that their colleagues are inadequately prepared for meetings, and just 60 per cent feel that all directors participate effectively.

- *Lack of diversity*. Appointments tend to follow a common mould, so that richness of debate is lost. It is important to get the right balance on the board, as we shall see.
- *'Underutilization' of skills*. Only 60 per cent of directors believed that the company was getting the best from them. It should be possible to engage non-executive directors more without having them encroach on management territory.
- *Dereliction of duties*. Only 45 per cent of the sample felt that the company was seizing strategic opportunities, and in many cases directors felt that insufficient attention was being paid to strategic debate. The effort spent on short-term issues was seen as disproportionate.
- *Poor selection and assessment*. Fewer than 60 per cent of the sample felt that there was an appropriate system for board selection, and many criticized assessment methods. This is a powerful reason to focus on selecting the right people for the right roles and to ensure the process of reviewing the board and appraising individual directors is robust.

3.2.1 Board Composition

In the United Kingdom the company's Articles of Association will prescribe the way directors are to be appointed, and often a minimum and maximum number of directors. For companies with a full listing on the London Stock Exchange there will be further requirements under the Combined Code on Corporate Governance. (Note that the Code does not apply to Alternative Investment Market (AIM)-listed companies and includes some concessions for smaller companies.)

Key to a successful, productive board is a good balance. There should be a mix of independent non-executive directors and executive directors and, importantly, of skills and experience.

The Combined Code says that at least 50 per cent of board members should be independent directors and that the roles of chairman and chief executive should be separated. Further, it says that the chairman should not be a former chief executive. When companies believe they have good reason to go against these recommendations, they need to state their case in their annual reports. (The Code's regime is one of 'comply or explain'.)

The board will work best if non-executives have a variety of experiences, skills and backgrounds: diversity will add the most value to debate and decisions. When the board looks into the future as a part of the annual strategic review of the organization, its members will think of the resource needed in the years ahead to deliver the agreed strategy in times that will certainly have changed. So, then, the structure of the board should be mindful of this, and where there is a shortage of skills or experience for the new realities of the future, then those skills should be identified and filled as a part of the succession planning of the board.

Non-executive directors are appointed through the nomination committee after a rigorous process that starts with a definition of the role and a description of the competencies and experience sought. The nomination committee recommends to the board, which will make the final decision on new appointments.

Typically, board composition and effectiveness are examined by the chairman annually. This is a valuable exercise that will give good feedback on how the board can operate more efficiently and add greater value to the organization. The process by which the board evaluation is carried out can be kept simple and direct without the need for substantial time or resource. In addition, the chairman will have individual annual discussions with directors on their contribution to the board and identify any training or development needs. The senior non-executive director will also talk to the other directors on the chairman's performance in order to give feedback to him or her. The non-executive directors play an important part in assisting the chairman to fulfil his or her role by regularly and rigorously assessing the effectiveness of the board's processes and activities. Given their outside perspective, they are sometimes best placed to ensure that the board focuses its energies effectively on meeting the demands described earlier. A longer-term view of the board is taken as part of the succession planning process.

Action List for Deciding Board Composition

- Consider the ratio of non-executive to executive directors. Think of the future needs of the business; consider the energy, experience, knowledge, skills and personal attributes of current and prospective directors; ensure that there is a proper process for appointing directors.
- Consider the cohesion of the board and the chemistry between the directors when making new appointments.
- Make succession plans for members of the board and senior executives, and update them regularly.
- Agree the procedures for appointing the chairman and the chief executive.
- Appoint a nomination committee whose terms of reference ensure that: the range of potential candidates is wide; and recommendations are made to the board only after a rigorous selection process.
- Assess the contribution of each director in an annual review. (The chairman should lead the review and arrange individual development programmes where necessary or, in cases of persistent unsatisfactory performance, ask the director to leave the company.)
- Provide new members with a comprehensive induction programme.

Four Key Tasks of the Board

In the Institute of Directors' publication *Standards for the Board*, four key tasks of the board are identified. They can be summarized as follows:

A. Develop and maintain vision, mission and values

- Determine and maintain the company's vision and mission to guide and set the pace for its current operations.

- Determine and maintain the values to be promoted throughout the company.
- Determine and maintain, and review, company goals.
- Determine and maintain company policies.

B. Develop strategy and structure

- Review and evaluate present and future opportunities, threats and risks in the external environment, and current and future strengths, weaknesses and risks relating to the company.
- Determine strategic options, select those to be pursued and decide the means to implement and support them.
- Determine the business strategies and plans that underpin the corporate strategy.
- Ensure that the company's organizational structure and capabilities are appropriate for implementing the chosen strategies.

C. Delegate to and monitor management

- Delegate authority to and monitor management, and evaluate the implementation of policies, strategies and business plans.
- Determine the monitoring criteria to be used by the board.
- Ensure that the internal controls are effective.
- Communicate with senior management.

D. Fulfil responsibilities to shareholders and stakeholders

- Ensure that communications both to and from shareholders and stakeholders are effective.
- Understand and take into account the interests of shareholders and stakeholders.
- Monitor relations with shareholders and stakeholders by the gathering and evaluation of appropriate information.

- Promote the goodwill and support of shareholders and stakeholders.

The terms of the first task (A above) need defining:

- *Vision* is a view of the future state of the company. The best visions give a picture of the potential of the company and therefore inspire people; a leader uses a 'vision' to describe to colleagues what the company can be and to urge them to achieve.
- *Mission* is a statement of what needs to be done in order to achieve the envisaged state.
- *Values* are a set of principles, standards of conduct and deeply held beliefs – a leadership style that drives the decision-making of the company.

It is important to remember that to carry out the key tasks of the board (see the box immediately above) effectively, the boardroom processes have to be right. The board needs to be clear about those items that are reserved for its decision making and how this fits into the overall hierarchy of responsibilities.

Where the managing director is also the chairman, it is important that these two distinct roles are properly separated and that sufficient attention is given to carrying out the chairman's role effectively. The board should not be just an executive committee meeting.

The chairman's primary role is to ensure that the board is effective in its tasks of setting and implementing the company's direction and strategy. The chairman is appointed by the board and the position may be full-time or part-time. In smaller companies the role is often combined with that of managing director or chief executive. However, the joint role is considered to be less appropriate for public companies listed on the Stock Exchange.

3.2.2 The Role of Chairman

The main features of the role of chairman are as follows:

- He or she is expected to act as the company's leading representative, which will involve the presentation of the company's aims and policies to the outside world.
- The chairman takes the chair at general meetings and at board meetings. With regard to the latter, this will involve determining the order of the agenda, ensuring that the board receives proper information, and keeping track of the contribution of individual directors and ensuring that they are all involved in discussions and decision making. At all meetings the chairman should direct discussions towards the emergence of a consensus view and sum up discussions so that everyone understands what has been agreed.
- He or she takes a leading role in determining the composition and structure of the board. This will involve regular reviews of the overall size of the board, the balance between executive and non-executive directors, and the balance of age, experience and personality of the directors.
- He or she acts as a mentor and sounding board to the chief executive and senior directors, and provides input early on in key processes such as strategy, management development and succession planning.

Chairmen can also add real value by:

- ensuring that the board gives the entrepreneurial leadership the company needs;
- ensuring that there is clarity about the roles of the chairman and chief executive and where they divide;
- ensuring that terms of reference for the key committees are clear and the matters reserved for the committees are well expressed and understood;
- ensuring that the board has a good working chemistry to be challenging to, yet empathetic with, the executive;
- showing a strong interest in and commitment to key processes such as management development and succession planning, risk assessment and control, and the strategic planning and implementation;

- finding appropriate opportunities for the senior management to come to the board to present on areas of key interest to the board;
- being a living example of applying the values of the organization in the actions and decisions taken.

3.2.3 The Context for the Non-executive Director

Each board of directors is faced with unique problems and circumstances that must be addressed in order for the company to be truly successful. There are some universal challenges that are faced by all boards and a number of strategic tasks that any board must perform if its central purpose is to be achieved.

Legally speaking, there is no distinction between an executive and non-executive director. UK company law does not see the roles as distinct and therefore does not distinguish between their responsibilities. Yet there is inescapably a sense in which the non-executive director's role can be seen as balancing that of the executive director in ensuring that the board as a whole functions effectively.

Whereas the executive director will have an intimate knowledge of the company, the non-executive director may be expected to have a wider perspective on the world at large. Where the executive director may be better equipped to provide an entrepreneurial spur to the company, the non-executive director may have more to say about ensuring prudent control.

Ultimately, however, it is important to be clear that the challenges and tasks discussed in this chapter are those of the board, not of individual directors. While each individual may have a distinct contribution to make, it is the collective responsibility of the board to ensure the company's successful operation.

3.2.4 Matters Reserved to the Board

One of the board's earliest jobs is to decide the way it will work and to identify and agree the things that cannot be delegated. Following on from that, and cascading through the organization, will be a delegation of powers – to the executive committee, the subsidiary boards where applicable, and the senior management.

Matters reserved to the board should be reviewed annually to ensure their currency and relevance. They will include not only those powers that no board should surrender but also items that relate to the particular needs of the organization.

Example of Statement of Reserved Matters

1. Statutory obligations

1.1 Approval of:

- the interim report and dividend;
- the annual report and accounts;
- the final dividend;
- circulars to shareholders, including those convening meetings.

1.2 Consideration of returns to overseas stock exchanges where applicable.

1.3 Recommending to shareholders:

- changes to the Memorandum and Articles of Association;
- proposals relating to the appointment and removal of auditors and the approval of their fee (although this is often delegated to the audit committee).

2. Strategic and financial matters

2.1 Consideration of:

- the company vision, mission and values, and any changes to them;
- the strategy and the annual review of it;
- budgets, and regular review of progress against them, and the delivery of strategic milestones.

2.2 Approval of:

- treasury, risk management and capital policies, including funding and the issue of new shares of any class and of loan capital in excess of a prescribed value;

- capital expenditure in excess of agreed levels, acquisitions, joint ventures and disposals;
- significant changes in accounting policy. (These would usually be first approved by the audit committee and noted by the board.)

3. Human resource matters

3.1 Approval of:

- the appointment or removal of the managing director, other executive directors or the company secretary;
- the appointment or removal of other directors recommended by the nomination committee.

3.2 The roles and duties of the chairman and managing director and their discretionary powers.

3.3 The arrangement of directors' and officers' liability insurance.

4. Other matters

4.1 Approval of:

- any matter that would have a material impact on the company's financial position, liabilities, future strategy or reputation;
- significant contracts not in the ordinary course of the business;
- health and safety policy (this should be reviewed across the business to reflect changes such as new risks and new regulations);
- values statements and systems to monitor how the organization's values apply in practice.

4.2 Delegation of the board's powers and authority to subcommittees that will regularly report to the board and make minutes of their meetings available to the board.

3.2.5 Committees of the Board

The board delegates powers to its main committees and lays out formal terms and conditions for them, which it reviews annually. The Combined Code on Corporate Governance and the Stock Exchange Listing Rules oblige a company to have three committees of the board: the audit, remuneration and nomination committees.

3.2.5.1 Role of the Audit Committee

The audit committee is intended to provide a link between auditor and board independent of the company's executives, since the latter are responsible for the company's accounting rules and procedures that are the subject of the audit. The committee may thus help the board discharge its responsibility with regard to the validity of published statements. The Combined Code recommends that all members of the audit committee should be independent non-executive directors.

In a number of (usually) larger companies, risk assessment and control are examined by a separate committee. However, more often than not this important process is a key part of the audit committee's responsibility. This is a central first step in monitoring and improving the control environment. The audit committee needs to satisfy itself that a proper risk assessment and control process is in place and embedded in the organization. It also needs to be satisfied that there has evolved a list of high-level risks that are regularly monitored by the management. The process in arriving at the high-level risks is one that must be undertaken by the management team. It is not a financial exercise alone but a very real tool in managing the risks that have been identified from the strategy. Top management from all dimensions of the business will be involved in a risk workshop to think through the risks attendant in the chosen strategy and the actions in place to manage these risks to acceptable levels. This is now a well-defined procedure whereby risks are evaluated for impact and probability, and ranked accordingly.

3.2.5.2 Role of the Nomination Committee

One of the board's most crucial functions is to decide on new appointments to the board and to other senior positions in the company. Again, in some cases this is done within a committee composed of executive and non-executive directors whose task it is to ensure that appointments are made according to agreed specifications. Where implemented, the appraisal of directors is often tied directly into the selection and nomination process.

As a matter of good practice, the selection process of directors should be carried out by the nomination committee, which then makes recommendations to the full board. Non-executive directors should make up a majority on this committee.

3.2.5.3 Role of the Remuneration Committee

Most organizations will want to have a remuneration policy that is competitive and motivational yet affordable. The incentive payments will be designed to support the behaviours required in driving forward the business strategy and within the values of the organization. It is now considered best practice to include in the senior executives' contracts the basis of separation in the event of the company dismissing such a person. Payments 'for failure' are highly disliked and the cause of bad publicity. Contracts should in normal circumstances require not more than 12 months' notice from the employer.

Devising the appropriate remuneration packages for the executive directors can be one of the most contentious issues a board faces – not least because of the publicity executive pay has attracted in recent years. It is vital that decisions on executive remuneration, benefits and bonuses are seen to be taken by those who do not stand to benefit directly from them. In listed companies and some larger private companies, therefore, policy on executive remuneration is usually decided by a committee of non-executive directors. In deciding the total package for individuals the remuneration committee will typically seek advice from a remuneration consultant to check competitive levels, and it will have regard to the organization's ability to pay.

As a matter of good practice, executive directors should not be responsible for determining their own remuneration. The Combined Code on Corporate Governance recommends that this should be the remit of a remuneration committee made up wholly or mainly of non-executive directors.

In smaller companies the duties and responsibilities of the nomination and the remuneration committee may be combined.

3.2.5.4 Other Committees

Depending on the size and nature of the organization, other committees may be necessary.

In businesses with significant borrowings in multiple currencies there may be a case for a *treasury committee*. This is chaired by a non-executive director and consists of the finance director and a specialist group of non-executive directors who together review treasury policy, taking into account the company's exposure to fluctuations in foreign exchange rates and interest rates and its need to protect overseas assets. Where there are banking covenants or agency credit assessments to rate the company debt, the treasury committee will monitor these at quarterly meetings. The committee will recommend to the board changes in policy, having diligently reviewed proposals and alternatives. The board will take a good deal of comfort from the fact that this complex area is receiving the detailed scrutiny of non-executives with experience in accountancy and finance.

In some companies there will be a separate *health and safety committee*. Obvious examples include airlines, railways and petrochemical businesses, for which the health and safety risks and hazards are potentially high. The committee will monitor compliance with health and safety guidelines throughout the business and put right any discovered breaches.

As was mentioned earlier in this chapter, *risk assessment and control* is sometimes taken away from the audit committee, which many observers feel is overloaded, and given to a separate group. My preference is not to do this: audit and risk are too mutually dependent to be best dealt with by separate committees.

3.2.6 Improving the Board's Performance

The board is always capable of improving its performance. No board has reached a state of perfection – and states of near-perfection can never be taken for granted. The board constantly needs to fine-tune its performance if it is to be sure of being able to respond quickly and appropriately to changes in the wider environment.

The Combined Code recommends that board effectiveness be reviewed annually, and that the senior non-executive, after discussion with other directors, assesses the chairman's performance annually. This has been discussed in more detail earlier in the chapter.

Some boards ask an independent third party such as the Institute of Directors to carry out the appraisal. This can be a way of maximizing objectivity and credibility. However, boards that have the necessary emotional maturity can do the exercise equally well in-house. The in-house approach often takes the form of a questionnaire, with the results collated by a trusted person such as the company secretary. Some companies use the questionnaire as the basis for discussion and then have the company secretary and the head of internal audit conduct interviews and compile the report.

Whatever the approach, the performance review, if sufficiently robust, can be an enlightening and value-adding exercise.

Sir Christopher Hogg, former chief executive of Courtaulds and non-executive chairman of GlaxoSmithKline, has observed that there are three main questions to ask when judging a board's effectiveness:

- Is the entire board fully engaged in and contributing to the strategy?
- Does the board review its own performance effectively?
- Does it give sufficient time to succession planning?

3.2.7 Final Message

No matter how well balanced the board and how well it believes that it performs, there is scope for continuous improvement. In part this can be found by careful self-examination of its own performance and by ensuring that the agendas for discussion allow sufficient time for the big-ticket items. Focus on areas such as the generation and implementation of strategy, and on the development of talent and succession planning on both an emergency and a scheduled basis. Monitor the delivery of the business plan and the health of the business through good, timely information, perhaps on the basis of a balanced scorecard. Ensure that there is sufficient time to understand, discuss and monitor the big transformational projects. The best boards will spend time ensuring that risk assessment and controls are a fundamental part of the control environment and embedded in the decision making of the organization. Finally, carefully crafted value statements are fine things in their own right but pretty useless if they are not universally practised in the organization. The board will need to find an appropriate way to give assurance that the values are practised in all areas.

3.2.8 International Board Structures

The unitary board of directors is the form of board structure characterized by one single board comprising both executive directors (full-time, salaried company executives) and part-time non-executive directors.

The two-tier board (or dual board) consists of a supervisory board and an executive board of management, with a clear separation between the functions of supervision and management. A supervisory board is composed of representatives of shareholders, employees, etc, and it appoints a management board to deal with the detailed management of the company.

The board structures to be found in various countries are summarized in Table 3.2.1.

Table 3.2.1 *International board structures*

Region	Country	Board Structure: Unitary or Two-Tier
Europe	Albania	two-tier
	Armenia	two-tier
	Austria	two-tier
	Belarus	two-tier
	Belgium	unitary
	Bosnia-Herzegovina	two-tier
	Bulgaria	unitary or two-tier
	Croatia	two-tier
	Cyprus	unitary
	Czech Republic	two-tier
	Denmark	two-tier
	Estonia	two-tier
	Finland	unitary or two-tier
	France	unitary or two-tier
	Georgia	two-tier
	Germany	two-tier
	Greece	unitary
	Hungary	unitary or two-tier
	Iceland	unitary

Table 3.2.1 *continued*

Region	Country	Board Structure: Unitary or Two-Tier
	Ireland	unitary
	Italy	unitary or two-tier
	Latvia	two-tier
	Lithuania	unitary or two-tier
	Luxembourg	unitary
	Malta	unitary
	Moldova	two-tier
	Montenegro	unitary
	Netherlands	two-tier
	Norway	two-tier
	Poland	two-tier
	Portugal	unitary
	Romania	unitary or two-tier
	Russia	two-tier
	Serbia	two-tier
	Slovakia	two-tier
	Slovenia	unitary or two-tier
	Spain	unitary
	Sweden	unitary
	Switzerland	two-tier
	Turkey	unitary
	Ukraine	two-tier
	United Kingdom	unitary
The Americas	Argentina	two-tier
	Brazil	two-tier
	Canada	unitary
	Jamaica	unitary
	United States	unitary
Asia	Azerbaijan	unitary or two-tier
	Bangladesh	unitary
	China	two-tier
	Hong Kong	unitary
	India	unitary
	Indonesia	two-tier
	Japan	unitary
	Kazakhstan	two-tier
	Malaysia	unitary
	Mongolia	two-tier
	Pakistan	unitary
	Philippines	unitary
	Singapore	unitary
	South Korea	unitary

Table 3.2.1 *continued*

Region	Country	Board Structure: Unitary or Two-Tier
	Sri Lanka	unitary
	Tajikistan	two-tier
	Thailand	unitary
	Uzbekistan	two-tier
	Vietnam	unitary
Africa and the Middle East	Kenya	unitary
	Lebanon	unitary
	Nigeria	unitary
	South Africa	unitary
Australasia	Australia	unitary
	New Zealand	unitary

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Between 1997 and 2007 he was a non-executive director at Scottish & Newcastle, where he also chaired the audit committee. He has also been non-executive Chairman of Royal Mail, the SHL Group and Hogg Robinson. He currently sits on the board of Biocon, a Indian biotechnology company, and Provexis, a UK functional food company, and is chairman of the Scottish & Newcastle pension fund and the Hogg Robinson pension fund.

A qualified chartered accountant, he has a double bachelor's degree in accounting and economics, a master of commerce degree with honours and a doctorate from Otago University. He is the author of four books, including *The Effective Director: Building individual and board success*, a guide to best boardroom practice published by the Institute of Directors in 2008.

3.3

Board Evaluations

Anthony Carey, Mazars

Board evaluations can probably claim their place in history as the first major corporate governance innovation of the 21st century, certainly in the United Kingdom. They were first introduced in 2003 into the Combined Code for Corporate Governance, which is applicable to fully listed companies incorporated in the United Kingdom, when it was revised following the report by the late Sir Derek Higgs in the wake of the collapse of Enron. The code indicates that every board should undertake a 'formal and rigorous' annual evaluation of its own performance and that of its committees and individual directors.

If board evaluations are to secure their potential benefits (see the list below), they must be seen as primarily about enhancing board effectiveness rather than merely as an exercise in compliance with a governance code. Moreover, it is not only listed companies that can benefit from a thorough self-appraisal within a structured framework. Any leadership team in an organization, whether in the private or the public sector, should find the exercise of holding a mirror up to its performance very valuable so long as it is willing to take an honest look at its strengths and areas of development and follow through on what it sees. This chapter discusses practical issues to be considered when undertaking an evaluation, critical success factors and pitfalls to avoid.

The following are potential benefits of an effective evaluation:

- It sets the right tone at the top.
- It enables a structured boardroom look at people, processes and performance.
- It facilitates continual improvement and innovation.
- It is a mechanism by which to address difficult issues early.
- It helps identify any gaps in skills or experience.

3.3.1 Methodology

In essence, the methodology for evaluations is fairly straightforward. Most evaluations primarily consist of questionnaires, interviews or a combination of the two supplemented by group discussions involving the whole board or a selected group of board members. If there is external facilitation, another key variable, there may also be observation of the board in action at a meeting. The personal qualities and experience of the facilitator, whether internal or external are, however, at least as important as the methodology adopted since an effective evaluation involves considering both 'hard' and 'soft' issues. Board performance needs to be considered against strategic objectives and in terms of financial performance but it also involves understanding how people work together in a complex environment involving two interlocking groups, an executive management team and the board as a whole, which in addition to executive directors includes independent non-executive directors.

Questionnaires have the merit of enabling a comprehensive range of questions to be asked around each of the key areas of the board's responsibilities, and it is also possible to look at how successful the board is in conducting its business. The questionnaire results will help identify useful issues for further exploration in the interviews. When analysing the responses to the questionnaires, it is often best to focus on those areas where there is broad agreement that improvement is needed or where views on the board's performance are divided, especially if there is a difference of view between executive and independent board members.

Interviews of board members are normally held on a one-on-one basis with either the chairman or the facilitator of the evaluation.

Interviews allow a more in-depth discussion of the key issues arising from the questionnaires along with providing the opportunity to directors to flag up any other important issues they wish to raise. Interviews can be used to discuss the areas in which individual directors perceive there to be gaps between current and potential boardroom performance and can also assist in prioritizing areas for improvement .

3.3.2 A Strategic Orientation

Boards need to be strategic in orientation, hence the evaluation should explore whether the board has set out its strategy so as to make clear its positioning in its key markets and to provide a cohesive focus to the different parts of the business. It should also be robust in different external environments or able to be flexed to respond as circumstances change. A strategy that was, for example, based on acquisitive growth may have been viable when the cost of borrowing was relatively inexpensive and funds were plentiful but would be more challenging in a recession in which bankers are restricting borrowings. Strategies do not exist in a vacuum, and the evaluation should consider whether the board has ensured it has the people capabilities and financial resources to implement it successfully as well as whether the key risks and performance indicators are directly derived from the strategy and, in the latter case, extend beyond financial indicators to cover long-term drivers of value.

3.3.3 How the Board Conducts Its Business

In considering how the board conducts its business, a thorough evaluation will look at directors' views on how the chairman leads the board and encourages the appropriate blend of challenge and support for the executive team. The way in which the meetings are chaired will also determine whether there is open discussion of major initiatives before a decision to go ahead is taken or whether the board runs the risk of being a 'rubber stamp' for proposals coming before it. Having too many meetings a year is likely to lead to the board drifting towards becoming too operationally focused, but having too few will not allow it to keep properly up to date with developments. An away day can help the board take stock on progress being made towards the achievement of long-term goals.

The quality and timelines of board papers will also merit exploration. Do they, for example, provide a proper analysis of the risks associated with key acquisitions or capital expenditure projects and provide feasible alternatives to the preferred course of action where appropriate?

3.3.4 Critical Success Factors

The board as a whole must feel a sense of ownership of the evaluation, under the chairman's leadership, and needs to have confidence that it is an open process that encourages board members to contribute their views honestly even if it means uncomfortable issues being raised. There must not be any 'no go' areas or 'elephants in the sitting room'; that is, problems that all or most board members are aware of but which are not being tackled. There should be a thorough approach to undertaking the evaluation with regard to the use of questionnaires and interviews, and the process also needs to encompass reporting back to the board to ensure that all significant issues arising are addressed in a structured fashion.

After the board discussion, an action plan with deadlines for implementing improvements should be developed and the board's success in making agreed changes tracked. While it can be helpful to consider key issues or transactions that faced the board in the year under review in order to provide a common frame of reference for discussion with different board members, the overall orientation of the evaluation must be forward-looking, learning from the past but not dwelling in it. This is an integral part of developing a learning culture in the boardroom and in the organization as a whole, with the board setting the tone from the top through its commitment to fostering excellence, innovation and continual improvement in its own deliberations every bit as much as in other parts of the business.

The following are critical success factors in board evaluations:

- Ownership by the board as a whole is necessary.
- The evaluation must be an open process.
- The approach must be thorough.
- A forward-looking orientation is needed.

- There needs to be effective follow-up.
- A learning culture in the boardroom is needed.
- There must be a commitment to excellence.

3.3.5 Pitfalls to Avoid

The board evaluation should not be allowed to become a 'political' (with a small 'p') issue, which may be a risk if there is a difficult relationship between the chairman and CEO or if one of these key players is very dominant in the organization. While it may involve difficult conversations, in such circumstances the independent directors have a key role to play in making sure that all views in the boardroom are properly heard when the evaluation is undertaken.

There is also a danger where the benefits of a thorough evaluation are not recognized by the board, just 'going through the motions' and avoiding searching questions or using a very informal approach not designed to identify areas for improvement. An associated problem occurs when evaluations become too routine. Adopting a similar approach over a number of years and asking similar questions may have the merit of providing trend data over time but may also lead to board members adopting a 'tick-box' approach without much serious thought being given to the questions they are answering.

This problem can be avoided by varying the methodology periodically or adopting a cyclical approach where an external facilitator is used say once every two or three years. A particular focus may also be given to different committees or different board issues over the course of the cycle. As discussed, the evaluation must be forward-looking, and it must not become a blame allocation exercise for things that may have gone less well than hoped in the period. Moreover, it is always a great pity when the potential of an evaluation fails to be realized because there is ineffective follow-up, with a plan for changes not developed or its implementation left to chance.

3.3.6 Conclusion

Getting the right board in place and ensuring it works well are the cornerstones of an effective board and good governance. A thorough board evaluation is likely to provide a great return for a modest investment of time and money by the board and can make a substantial contribution to ensuring it achieves its full potential. Fortune favours the brave! Those boards willing to risk asking the most searching questions are likely to identify the best opportunities for development. Even a very successful board can learn from a self-appraisal of its performance and is likely to be among the most keen to do so.

Anthony Carey is a partner at Mazars LLP, where he focuses on board effectiveness, corporate reporting and public interest issues related to the profession. Anthony was project director of the original Turnbull Report on risk management and internal control, and serves on the corporate governance committees of The Institute of Chartered Accountants in England and Wales and the Quoted Companies Alliance. Anthony is also a member of the Financial Reporting Review Panel and sits on the governing bodies of two higher education institutions.

Copies of 'Unlocking your board's full potential', the board evaluation questionnaire developed by Mazars in association with Chartered Directors at the Institute of Directors and the Quoted Companies Alliance, can be downloaded from www.mazars.co.uk.

Part 4

Control and Disclosure

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4.1

Business Risk Reporting

Jaap van Manen and Jos de Groot, PricewaterhouseCoopers

Today the spotlight is on disclosures of business risks in companies' annual reports, and a description of the way these risks are managed. Because of the current credit crunch and economic turmoil, shareholders and other stakeholders will increasingly challenge directors on their strategy, their risk appetite and the way they respond to the rapidly changing strategic, operational, financial and compliance risks facing the company. Recent major internal control breakdowns at, for instance, Groupe Caisse d'Épargne and Société Général have also contributed to growing scepticism among stakeholders towards the effectiveness of risk management systems. Everyone has become aware that business risks are not static at all: new business risks can pop up out of nowhere, the likelihood and/or the impact of risks may change dramatically all of a sudden, and risk responses can become ineffective overnight.

In this rapidly changing and dynamic environment it is a challenge for directors to respond to the increasing demand for transparency on business risks and to ensure they take appropriate action given their reporting, managerial and oversight responsibilities regarding risk management within their company. The stakes are high: in the event of (perceived) failure or non-transparency, not only will the company face highly volatile, emotion-driven financial market conditions, but directors may be held personally liable for the way they have managed and disclosed business risks.

In this chapter we discuss, from an international perspective, certain emerging trends in business risk reporting and especially directors' responsibilities in this area. We also introduce a comprehensive framework for directors to assess the transparency of their risk disclosures in their company's annual report. Furthermore, we call for a new international set of generally accepted risk management accounting principles (GARMAP), which will lead to more convergence and consistency across the globe.

4.1.1 Directors Responsible for Transparent Risk Disclosures

Company law across Europe states that directors are responsible for providing true and fair financial statements and annual reports, including the risk profile. The risk profile outlines the principal strategic, operational, financial, compliance and financial reporting risks and uncertainties the company faces. In corporate governance codes across the globe it is common for the non-executive directors and the audit committee to have a key oversight role in discussing and assessing the strategy of the organization and its accompanying principal risks, as well as reviewing the executive directors' assessment of the effectiveness of the risk management systems within the company.

In Europe, over the past few years the implementation of the fourth, seventh and eighth EU Directives has clarified directors' responsibilities for risk disclosure and risk management in all EU countries. The EU Transparency Directive requires that the half-year financial reports should also include disclosures of the principal risks and uncertainties.

Directors have to assess the adequacy of the risk disclosures. In our view the guidance provided in 'Building a better MD&A [management discussion and analysis]: risk disclosure' (2008) issued by the Canadian Institute of Chartered Accountants (CICA) is a good practical checklist that directors can use to assess the adequacy of the risk disclosures in the annual report:

1. Are the risk disclosures consistent with the information that management has previously presented and reviewed with us in the course of our normal directorship duties?
2. Do the risk disclosures comply with regulatory disclosure requirements?
3. Are there adequate information systems and controls to support reliable and timely risk and risk management disclosures?
4. Are we satisfied with management's explanation of how it has determined what risk disclosures to provide in the annual report and do the resulting disclosures address principal business risks, their potential impact, and mitigation strategies?
5. Is there any risk information that management has omitted from the annual report due to competitive or other concerns and if so, are we satisfied with omitting this information?
6. What feedback, if any, has been received from institutional or other significant investors or their proxies about the adequacy of the company's risk disclosures?
7. Has the company received any comments from regulators on the adequacy of its risk disclosures?
8. What comments have legal counsel provided regarding risk disclosures and how have these comments been addressed?
9. What comments, if any, do the external auditors have about the risk disclosures?
10. Have the risk disclosures been written in clear, plain language?

4.1.2 Criticism Concerning Risk Disclosures

The quality of risk disclosures in the annual report is being criticized. In its review report of the narrative reporting in the annual reports over 2006, the British Financial Reporting Council (FRC) concluded that companies need to assess carefully what their principal risks and uncertainties are and report on them, as well as outlining their approach to managing and mitigating those risks, rather than simply providing a list of all the risks and uncertainties they face. The number of risks and uncertainties reported by companies in the FRC sample ranged from 4 to 33. The FRC questions whether a company can really have 33 principal risks and uncertainties. Eumedion, a Dutch organization that represents over 60 internationally operating institutional investors, claims in a survey of the 2007 annual reports of Dutch listed companies that only 1 in 10 companies really provide insight into the principal risks they face.

Linsley and Shrive (2006) state in their UK research that: 'overall the dominance of statements of general risk management policy and a lack of coherence in the risk narratives implies that a risk information gap exists and consequently stakeholders are unable to adequately assess the risk profile of a company.

From a review of annual reports of large UK listed companies, Linsley and Lawrence (2007) concluded that the level of readability of the risk disclosures is difficult or very difficult. Nor does the report of the Institute of International Finance (IIF) (2008) on the financial services industry's response to the market turmoil in 2007 and 2008 help to enhance the level of confidence in the current status of risk reporting. The IIF concludes that failures in risk management policies, procedures and techniques were evident for a number of firms. In particular, the lack of a comprehensive approach to firm-wide risk management often meant that key risks were not identified or effectively managed.

We expect that the credit crunch and current economic turbulence will keep risk profiles in the spotlight.

4.1.3 Guidance on Risk Disclosures

What does this criticism all mean in real terms for directors, given their responsibilities? What risks should the company disclose? What accounting rules, principles and guidance are available and helpful? What are stakeholders' expectations and how can they be met? Moreover, what are the legal consequences of a decision to disclose or not to disclose a certain risk?

In our view, directors have no option but to respond to the criticisms of risk disclosure. Risk accounting principles and guidance should help directors in carrying out their responsibility in this respect. However, after taking a close look at the rules, regulations and guidance available across different countries, we conclude that there is consensus on the overriding generic principle regarding risk disclosures: principal risks should be disclosed, so as to help readers understand and evaluate the risks faced by the company, and its decisions regarding the management of those risks. However, that is about it: if we go any more deeply into the matter, it is quite hard to find consensus on additional practical guidance on what (and what not) to do, and what disclosures on business risks should be included in the annual report. There is no consistent global set of generally accepted risk management accounting principles and additional guidance available for risk disclosures in the annual report, except for the IFRS-7 disclosures regarding financial instruments in the financial statements. For instance, in Germany there is a specific accounting standard (GAS 5) that states that risk reporting should allow users to reach an appropriate understanding of the risks affecting the future developments of the group. In other countries, listing rules define the requirements for risk disclosures, such as including them in the management discussion and analysis (MD&A), which is applicable in the United States and Canada. In the United Kingdom, risk disclosures are an element of the Operating and Financial Review (OFR, paragraphs 53–56), and the disclosures on the risk management systems are covered in the Turnbull guidance. In the Netherlands the Monitoring Commission Corporate Governance Code issued some high-level guidance on risk disclosure.

We call for the development of a set of generally accepted risk management accounting principles (GARMAP) to enhance transparency and consistency in reporting on business risk in our global economy. This is not an isolated issue, but is part of the discussion on the quality of narrative reporting in the annual report. The Internal Accounting Standards Board (IASB) launched a project in 2005 to develop guidance concerning a type of narrative report referred to as '*management commentary*'. As part of this project the IASB will develop the principles and essential content elements necessary to make management commentary reporting useful to investors. The end product will be issued as a non-mandatory guidance document. According to the IASB website, a draft guidance document will be issued in the fourth quarter of 2008.

4.1.4 Twelve Practical Tips for Making Transparent Risk Disclosures

Notwithstanding the need for GARMAP, below we introduce a practical list of potential elements (focus points) concerning the content of risk profile in the annual report. The list is based on a mixture of elements we have identified in the literature as well as our own practice on advising clients on risk reporting. Note that this list is not necessarily comprehensive:

1. *Present a balanced image*. Cover the full spectrum of strategic, operational, compliance and financial risks, and provide a balanced insight into each risk category. Include both external and internal risks.
2. *Be specific instead of generic*. Be company and industry specific, and take into account specific regulations that apply.
3. *Less is more*. Focus on the principal risks faced by the company instead of simply making a long list of all possible risks.
4. *No risk, no fun* (risk appetite). Articulate the risk appetite of the company, as this sets the tone as regards risks taken and response(s) selected.
5. *Strategy drives risks*. Link the risks faced by the business to its strategic and operational objectives.
6. *Cause and effect always come together*. Describe for each risk its potential impact on results and / or reputation and / or liquidity and / or strategic and other objectives.
7. *Numbers count*. Quantify the impact of specific risks if such quantification is common practice in your industry.
8. *Articulate the risk response*. Describe for each risk the response: how the risk is accepted, mitigated, transferred or managed.
9. *More is needed than just the risk profile*. Seek alignment with the IFRS-7 disclosures in the financial statements. Try to integrate the risk profile with, or clearly refer to, the other elements of the risk reporting, the description of the risk management systems and, if applicable, the in-control statement.
10. *Be up to date*. Ensure that you present an up-to-date risk profile given the current rapid changes in social, economic and

environmental conditions. Also, ensure that the risk profile in the annual report is fully aligned with the risk profile used for internal purposes.

11. *Accept that some things do go wrong*. No matter how well designed an internal control system may be, breakdowns will occur, so be transparent about the material/significant internal control issues and the actions taken by management to address these issues.
12. *Use plain, crisp language* that readers can easily understand.

Whether one likes it or not, it is a fact that financial reports are becoming legal documents to a greater and greater extent. That being the case, obtaining legal advice is a prerequisite, but the balance between the document being fully legally sound and the information being of value to the users should be right as well. Too much risk-averse behaviour in the disclosure of risks will lead to disclosures that do not meet shareholder expectations.

4.1.5 Conclusion

The credit crunch and economic turmoil will accelerate the trend for stakeholders to seek more, and more transparent, risk disclosures in the annual report. They are looking to obtain a clear insight into the principal business risks, given the strategy, the risk appetite and the risk responses in relation to strategic, operational, compliance and financial risk. Recent research is critical of the current quality of risk disclosures. Directors will be challenged regarding the adequacy of companies' risk profile, not just at the annual shareholders' meeting and investor relations meetings, but also in court.

But what is the benchmark for transparent risk disclosures? Although there is a high-level principle to discuss all the principal risks, there is no generally accepted framework covering how accounting for risk and risk management should be presented in company annual reports. In this chapter, however, we have introduced a practical checklist for drafting a risk profile in the annual report.

A new set of global, generally accepted risk management accounting principles (GARMAP) might fill the current gap in practical principles and guidance for drafting the risk paragraph in the annual report. Moreover, it would lead to more globally consistent reporting of the risks facing companies. We advocate that the convergence initiative for financial accounting (alignment of the US GAAP and IFRS) should be extended to risk reporting and narrative reporting in general. We hope that the draft IASB management commentary guidance paper, due in the fourth quarter of 2008, will stimulate this trend and provide some practical guidance for all those who use, or prepare, risk paragraphs in annual reports.

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4.2

Corporate Governance and Its Relevance to Audit Quality

Gerald Russell, Vice-President, ICAEW

Corporate governance is described variously and at different lengths virtually every time one picks up an article on the subject. But however it is described, it essentially boils down to being concerned with:

- board structure and effectiveness;
- control and efficiency of operations;
- reliability of financial reporting;
- compliance with laws and regulations;
- safeguarding of assets.

Given that an audit is of itself a strong governance process, and addresses certainly the last four of these points, it behoves those charged with corporate governance (that is, basically the whole board but especially the independent directors) to ensure that the audit process, being itself part of the governance arrangements, works well and is carried out to a high standard.

Easily said, but not in my experience easily done. And while I consider that a duty has always been there for the board to evaluate audit, and it has been enshrined in the corporate governance code in the United Kingdom, this will now be a requirement throughout Europe as a result of article 41 of the European Directive.

It is clear that an audit means different things to different people. It is important to understand that an audit is essentially an independent opinion on a set of financial statements for a period and at a point in time. Such opinion extends extensively to narrative information and other statutory and International Financial Reporting Standards-type disclosures, which go beyond the concept of truth and fairness of the accounts taken as a whole and often into extensive minutiae.

Furthermore, certain audit procedures have been extended to cover some of companies' risk management and control processes, for example the work required by the Sarbanes–Oxley legislation in the United States. But, overall, the purpose of an audit is to confirm that the financial statements taken as a whole are not materially misleading or false. Leaving aside any discussion on the concept of materiality, which again means different things to different people, it is the quality of the work supporting such an opinion that needs to be assessed by the company as part of its governance procedures, and the task here falls quite firmly to the audit committee.

A useful definition of audit quality can be found in the submission to the Financial Reporting Council on this topic by the Institute of Chartered Accountants in England and Wales (ICAEW):

> Audit Quality depends on the robustness and competence of the work performed and the integrity of judgements formed by appropriately qualified, skilled and experienced teams in order to deliver a reliable and independent opinion that the financial statements taken as a whole are not materially misstated.

Such a definition immediately provides a number of pointers concerning areas that will need to be probed, and conclusions reached, by those reviewing the quality of the audit to ensure that the opinion given is robust. For example, detailed discussion around the experience of the partner and team on the assignment would be a priority. While this in itself is no guarantee of a robust audit, it is highly unlikely that a sound opinion could be formed by inadequately trained and inexperienced people. Similarly, assessing 'the integrity of judgements' made is undeniably a difficult task.

Reviewing the effectiveness of the audit has, as I have said earlier, been a requirement in the United Kingdom for some time. Of course, an 'effective audit' means different things to different people. Effectiveness will be seen differently by the company, and possibly even more so among the executive and the audit committee, the shareholders to whom the report is addressed, regulators who independently assess audit firms, the general public (who generally have an uninformed view of what an audit is all about anyway) and not least by the audit firm that carries out the work.

In terms of evaluating audit quality, the Smith Guidance to audit committees suggests that the areas to probe are around qualification, expertise and resources, effectiveness, and independence. There is no further official guidance. In the United Kingdom, both the ICAEW and the Institute of Chartered Accountants of Scotland (ICAS) have issued booklets that, although in different styles, essentially provide a checklist of matters to consider.

The trouble with a checklist approach is that effectiveness *per se* is extraordinarily difficult to get to the bottom of. The checklists can provide much information around process, monitoring and reporting but at the end of the day this helps only partially. From management's point of view, an effective audit might well be one that was delivered on time at a 'sensible fee' by skilled people with a minimum of disruption. It is therefore being assessed largely around hygiene factors rather than technical quality. From audit committees' point of view, and indeed that of independent regulators, it is technical quality that is more important. Following all the auditing standards in the world and ticking all the boxes is no guarantee of such quality. At the end of the day it comes down to the quality of judgements made in the light of information available at the time. So, in the main, audit committees are left with a considerable part of their assessment needing to be based around trust, feel and a common-sense view. For example, when discussing difficult accounting areas, is there an appropriate robustness and degree of challenge such that the audit committee members can feel comfortable that a sensible approach to the issue and audit thereof has been adopted?

Consideration of the overall approach to an audit is important. Not all audit committees have members who are experienced in auditing, and therefore judging the appropriateness of the approach can be tricky. What auditors do, and the whys and hows, will increasingly be relevant, not least from the requirements of the recent European audit directive.

The trouble is that an ineffective audit can only really be noted if its ineffectiveness subsequently comes to light – hardly helpful. Quality of auditing will ultimately depend on both the quality of the audit firm and, most particularly, the quality of the audit team actually undertaking the work. These two factors do not guarantee quality but are significant building blocks. And these cannot really be assessed purely by process-type checks, whether by the company, audit committee, regulators or, still less, investors. At the end of the day it just comes down to the professionalism with which the audit is being or has been approached. It is that which will support the conclusion stated in the financial statements underpinning any further Code requirements.

The process of assessment is becoming more important as audit committees increasingly have to disclose their reasons for retaining or changing the auditor. This need to declare reasons results from pressure from investors, who, in the absence of having a direct say in the audit appointment, do wish to feel satisfied that decisions relating to the auditor are appropriate. This pressure is likely to be exercised by direct questions of audit committee chairmen, and also through enhanced disclosures relating from a current update to the Code.

Gerald Russell is Vice President of the Institute of Chartered Accountants in England and Wales (ICAEW) and chaired its Audit Quality Forum, which brings together companies, investors, the profession and regulators to formulate policy suggestions. He was previously at Ernst & Young, where he was a senior audit partner and chaired its Independent Director programme. For further details, see www.icaew.com.

4.3

Unlocking Value through Sustainability Reporting

Ernst Ligteringen, Global Reporting Initiative

Sustainability reporting is becoming an increasingly mainstream business activity. Many companies, large and small – including the majority of companies listed on major indices such as the FTSE 100 and Standard & Poor's (S&P) 500 – now issue such reports.

Reporting on environmental, economic and social performance has come on in leaps and bounds from the days when companies would use their sustainability report or corporate social responsibility report to tell a story about their philanthropic activities interspersed with pictures of smiling children. These days a sustainability report is a vehicle through which a company discloses its performance on a range of economic, environmental and social issues relevant to the company's operations. Reporting on these issues can provide companies with the opportunity to show how, in their thinking and actions, they are taking leadership on the critical sustainability issues of the day.

4.3.1 Developing a Common Language

The Global Reporting Initiative, although merely 10 years old, has made great progress in developing a common language to enable businesses to speak both to each other and to their diverse groups of stakeholders on issues of common concern. Today, the GRI's latest version of the Sustainability Reporting Guidelines – G3 – is the world's most widely used framework for sustainability reporting. The Guidelines are made freely available as a public good for companies and other organizations globally, irrespective of size, sector or country.

In order to develop a language that is universally understood, the GRI convenes a unique multi-stakeholder global network of businesses, academics, NGOs, labour organizations, investors, accountants and others. Over 30,000 people had input into the development of the G3 Guidelines.

The GRI G3 Guidelines contain principles and guidance as well as standard disclosures – including organization profile and performance indicators – to outline a disclosure framework that organizations can voluntarily, flexibly and incrementally adopt as they learn a new universal language at their own pace.

But languages do not stay still, fixed at one point in time. They evolve. Languages borrow from other languages, just as they themselves lend phrases back to others. They develop new words for new concepts and new thinking. The common language for sustainability reporting provided by GRI is no exception to this rule.

In order to ensure that the Sustainability Reporting Framework continues to represent the best current thinking on sustainability, GRI continues to engage a wide range of stakeholders in continuously developing the framework. Following stakeholder consultation, current priorities include the development of specific supplemental guidance for companies within specific sectors as well as a renewed focus on key sustainability indicators including human rights, community relations and greenhouse gas emissions.

4.3.2 Eager Listeners

During this time of unprecedented global challenge, disclosure of a company's economic, environmental and social performance can thus provide that company with the opportunity to engage with investors, consumers, employees and other stakeholders.

Investment analysts have long understood that the net asset value of a firm is not enough to base investment decisions on. The information disclosed in a sustainability report provides another piece of the puzzle. In their quest to assemble the complete jigsaw, more and more investment analysts are expanding their business language to include so-called non-financial information. For example, signatories to the United Nations Principles for Responsible Investment commit themselves to analysing the 'environmental, social and governance' aspects of companies in their investment universe. The signatories represent over $1 trillion of assets under management. These investors are stakeholders of growing importance.

And it is not just investors who want to know how companies are rising to the challenge of sustainability. The rise of the informed consumer is well documented; a company perceived to be out of step with the evolving consensus on respect for people and planet, as well as profit, is punished at the checkout. Many recent surveys also suggest that, increasingly, employees seek out companies showing leadership on the pressing economic, environmental and social issues of today. In these value-driven times, if a company wants the best employees, it is no longer enough just to offer the best pay.

4.3.3 Saying the Right Thing

Openness in disclosing economic, environmental and social impacts can therefore give companies a competitive edge, but the consumers of this information have a sophisticated palate. When they search the net for information about a company's environmental or social performance they have specific questions in mind and they will be looking for meaningful data that address their concerns.

In 2008 the Global Reporting Initiative (GRI) commissioned KPMG and SustainAbility of the United Kingdom to undertake a global survey of sustainability report readers. Unsurprisingly, the report finds that 90 per cent of respondents agree that their views of a company have been influenced by its sustainability disclosures. Of these, 85 per cent reported a more positive perception of the company after reading its sustainability report. However, although respondents welcomed sustainability disclosure, they were averse to 'greenwash'.

Respondents viewed adherence to sustainability reporting standards and telling a balanced story – reporting on the good news and openness about challenges – as vital to building trust and credibility. Consumers, employees, investors and other stakeholders know that companies often have difficult choices to make – for example, how to improve production conditions in a supply chain while keeping low-paid workers' need for employment in mind, or how to pick the right mix of energy sources to ensure security in supply and lower emissions while balancing the short-term need to keep costs low in difficult economic circumstances.

People want to know how companies balance these issues and what their long-term thinking is – how well placed a company is to evolve to meet the challenges of tomorrow. Thus, companies that do not provide the information that this informed and important subset of stakeholders seek are missing the opportunity to engage with them as investors, potential employees, suppliers, buyers or consumers. As Dan Boss, senior director of corporate citizenship at Microsoft Corporation puts it, 'We think these measures help us improve our performance, demonstrate leadership, and build trust essential for our success as a business.'

4.3.4 Measure to Manage, Manage to Change

At the GRI we hear from many companies from all over the world who have found that the real value in sustainability reporting is the process companies go through in preparing to report. What you can measure, you can manage; what you can manage, you can change. The sustainability reporting process helps a company better understand itself and its relationship with the wider world. This is often where the real value of the process is unlocked. It is unlocked not just though increased cost savings associated with sustainability or being more attractive to external stakeholders, but through the better definition of corporate strategy and the identification of new markets. As Orwell demonstrated in *1984*, to limit language limits thought. In expanding the means through which we can communicate, we achieve greater cognitive power. This, above all, is the value unlocked in sustainability reporting.

4.3.5 Steps to Take in Issuing a Sustainability Report

GRI Sustainability Reporting: How valuable is the journey? (available at www.globalreporting.org/learning) lists five steps your company can take in issuing a sustainability report:

1. *Prepare*. This step aims to promote internal discussion, especially at management level, to identify the most obvious positive and negative economic, environmental and social impacts.
2. *Connect*. This is a vital part of the process and involves seeking shareholder input on what aspects should be included in the final report.
3. *Define*. The stakeholder impact in step 2 will confirm whether the positive and negative aspects identified by the management team in step 1 are the ones that really matter. This will define the focus of the report, and the reasons for the choices should be clear.
4. *Monitor*. This is the gathering of the data that will go into the final report. GRI indicators were developed to help organizations know what to monitor. The GRI multi-stakeholder approach also developed 'reporting principles' to help organizations check their monitoring processes and obtain high-quality information. This, in turn, will help organizations to better manage and report.
5. *Communicate*. The data collected in step 4 go into the final report; but the process does not stop there. The final step involves not only the preparation and writing of the final report, but also important decisions about the best ways to communicate the results of the report. And, of course, the next cycle starts right here.

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Part 5

Directors

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5.1

Selection and Nomination of Directors

Jennifer Stafford, Australian Institute of Company Directors

Directors are required by law to act in the best interests of the company as a whole. Directors have a shared and equal responsibility for a company. While independent views are encouraged, a board must act as a team to govern effectively.

An effective board has a well-balanced combination of capable board members who are well suited to the circumstances and needs of the company. This is the rationale for boards proposing new directors for election by shareholders. Boards look for people who will add to their collective skills set and will be able to contribute in the board environment.

New directors are usually nominated by the board after a careful selection process and are elected formally by shareholders at the next annual general meeting. Their independence is safeguarded by the fact that they cannot be removed except by the shareholders at another general meeting.

It is the usual practice for new board members to be appointed to casual vacancies by the board during the year, with the formal election being confirmed by shareholders. The board may not endorse a director for re-election if there are concerns about his or her performance or suitability. Generally a director will not seek re-election without the support of the board and may choose to resign sooner if the support of board colleagues is lost.

A common misunderstanding perceives the board as needing to be expert in the field in the same way as management. The board aims to challenge management in its decision making but not to second-guess it. To be effective, its members must work as a team, both within the boardroom and in combination with management. The best decisions are made where there is total candour and trust in the boardroom.

Boards are not parliamentary in style, with partisan views advocated and decisions made by a majority. Boards make decisions by consensus, a point seemingly not always appreciated by observers. Thus, voting is rare in well-managed boards. The evolution of nomination committees has been an important development in establishing a formal process for succession planning and renewal of the board and management. The nominations committee can recommend adjustments to board membership to achieve an appropriate mix of skills and a balance between members who are independent and those with experience. The advice of executive search firms is often used to assist the nomination committee's work.

Compatibility is an important consideration for the harmony of the team. Commercial savvy and financial literacy are essential qualities for all directors of listed companies. Company needs are dynamic, and board composition must reflect changing needs. The board's task is broader than in the past; the pressures on companies are more complex, owing to globalization.

Well-managed boards are mindful of the need for refreshment and renewal of board skill sets, while at the same time balancing the need to retain adequate knowledge of their company. People with executive and director experience are well regarded by boards faced with increasing obligations for risk management. It is essential to have directors with knowledge of the industry in which the company operates. Strategic skills are also important in determining the right direction for the business and thereby adding to shareholder wealth.

Boards seek specialist skills, such as legal and accounting skills, in response to regulation and technology. They are also looking for younger members, with appropriate experience, who may have more affinity with the younger demographic in their market. Experience in human resources is a valued skill on today's board, reflecting the complexity of a multi-generational workforce and the recognition that human capital is a critical asset.

A recent source of new recruits to boardrooms has been younger executives who depart corporate life in search of alternative and more flexible careers in directorship. This trend includes executives who retire early from highly paid careers, and others whose careers have been disrupted by takeovers and corporate change. Women, in particular, may seek board appointments at a younger age as they seek more flexible career paths. New board recruits must demonstrate good business judgement if they are to be recruited.

Board composition and selection processes are evolving in response to global markets and increased competition. This evolution will continue as the needs of companies change. These selection processes are a planned and considered approach to identifying the skills and qualities needed for effective board leadership. Companies vary in the sophistication of their approach to board selection. An Australian study released in September 2007 by the UTS Centre for Corporate Governance identified board evaluation as a significant positive trend in corporate governance, noting that the outcomes were applied to succession planning and identifying the skills needed on a board.

There is growing interest among shareholder groups in the composition and selection of board members. Some shareholders are expressing interest in appointing directors who will be sympathetic to their views. Most often the debate is focused on the appointment of individual directors when the major task before the board is in choosing the best team.

Boards are not composed of shareholder representatives from different constituencies. Directors may not represent special interests or advocate the preferences of external parties if they are to carry out their fiduciary responsibilities as a director. Directors who are appointed with the support of a major shareholder must 'leave their interests at the door' or risk serious conflicts of interest. Directors are required to act on behalf of all shareholders and exercise discretion and independent judgement in the best interests of the company.

Some public-sector boards have been perceived as less effective than their private counterparts, owing to the fact that compulsory external appointments are made. These appointments may create disharmony through being perceived to represent special interests rather than the interests of the organization as a whole.

The size of the board is another consideration. Large boards can be unworkable, with too many directors wanting to speak and influence the outcomes. Different companies have different needs but a maximum of around 10–12 board members is a popular convention. The BHP Billiton board has 10 members, for example. This is contrasted, for instance, with the much larger governing boards for some academic institutions, which experience well-publicized disharmony and factional activity from time to time.

Australian Institute of Company Directors (AICD) Guidelines

- AICD respects the rights of shareholders to nominate, elect and remove directors and does not seek to diminish those rights in any respect.
- The present practice whereby shareholders vote on the board composition works well to ensure that the board functions as a team with appropriate skills and experience.
- It would be a good practice for nomination committees to publish their methodologies for selecting and appointing directors on company websites for the benefit of shareholders.
- AICD suggests the use of executive search firms as one way to ensure that the selection process is professional and to expand the pool of potential recruits to boardrooms.
- Shareholders, including institutional investors, should be able to make suggestions about the skills and experience that they see as being needed for appointments to specified boards, and for boards in general.
- Board evaluation is an important element of communicating with shareholders about board performance, including considerations of tenure, board composition,

workload and whether individuals are able to commit the time required.

- The confidence of shareholders in a board's composition is enhanced by disclosure of the process for evaluating the performance of the board and individual directors.

It is a challenge for boards to find suitable candidates in whom qualities of independence and experience are clearly displayed to the satisfaction of shareholders.

Many shareholders have called from the floor of annual general meetings for a director to speak in support of his or her election or re-election. Such speeches inevitably take on a political quality, and not all shareholders are represented at the meeting, with the majority of votes having been cast by proxy in advance.

Attempts to define independence have been controversial. If taken to the extreme, the 'independence from association' approach, which is used in the Australian Stock Exchange Corporate Governance Council Principles, could result in the board being made up of people with no experience with the industry in which the company operates.

The capacity for independent thinking is highly valued by institutional investors. A director's independence reflects personal qualities, such as integrity, that cannot be prescribed. The demonstration of independence is indicated by a director's behaviour and performance in the boardroom, and this is capable of being observed only by other board members.

Independence is not the only desirable quality in the boardroom, and institutional investors recognize the value of industry experience and a good track record of performance. The main considerations for board composition cover membership renewal and the need for directors who are open to fresh ideas and capable of independent thinking, all of which need to be balanced with relevant experience. The market for directors of large listed companies is competitive and favours proven performers with a sound track record in directorship. This reflects increasing risk and regulatory exposure for company directors. It is reasonable to expect companies to provide detailed information on proposed candidates for election. This information could demonstrate both the candidate's experience and background, and how his or her involvement will complement the skills of existing directors. A statement in the annual report covering what the directors have done to develop their knowledge of directorship and their business experience would also assist shareholders in understanding the skills of board members.

Prior consultations between nomination committee chairmen and institutional investors and shareholder associations could identify where more information is required to support the election process for directors. Although there are practical advantages in gauging the views of major shareholders, boards must nevertheless act in the interests of all shareholders, both large and small.

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AICD is a member institute for directors dedicated to making a positive impact on the economy and society by promoting professional directorship and good governance. AICD delivers education, information and advocacy to enrich the capabilities of directors, influence the corporate governance environment in Australia and promote understanding of and respect for the role of directors. With offices in each state and more than 24,000 members, AICD represents a diverse range of corporations, from the top 200 publicly listed companies to not-for-profits, public-sector entities and smaller private family concerns. Further details are available from www.companydirectors.com.au.

5.2

Non-executive Directors

Peter Waine, Hanson Green

Non-executive directors in their present guise are a recent phenomenon. Previously, they were largely recruited for their specific technical expertise and for their status. It is very different now. The United Kingdom and continental Europe operate under evolving yet effective regimes. The United Kingdom has opted for a Code of Practice with teeth, the rest of Europe for a more legalistic framework.

Furthermore, the current corporate governance scene encourages executives to become non-executive directors (NEDs) and for those not in a current executive position to go plural. In turn, the main board in the United Kingdom has become smaller, with an imbalance in favour of NEDs. Consequently, the board relies less on functional representation, becoming instead a vehicle for generalist debate and a more streamlined strategic think-tank. The change allows the executive committee to deliberate more clearly on day-to-day matters.

The situation on the Continent appears, at first glance, to be markedly different, with larger boards and a system lacking the simplicity of the United Kingdom's unitary system. Yet the similarities are there and the trend in corporate governance has been to merge the two approaches, with an increasing emphasis on the UK model.

For the NED there are a number of benefits, which in turn also benefit his or her board. The executive goes to teach and comes away learning; he or she contributes but also learns in the process from colleagues on the board, and recognizes in turn that no business problem is unique and that the other person's grass is no greener. The executive brings back to his or her own board skills learned from fellow NEDs who themselves may well be executive directors on other boards with other NEDs.

5.2.1 Prepare Early

How does an NED career develop? However successful you might be in your corporate career, most executives aged under about 45 lack sufficient gravitas and general experience to make a rounded and effective NED. It is wise to be patient rather than apply prematurely. Certain steps can be taken, though, in order to enhance one's prospects. Ideal candidates have experience of more than one company and therefore more than one corporate culture. They have the right attitude: an effective combination of curiosity and courage combined with an appropriate corporate culture, supplemented with the right chemistry.

Most move regularly in their executive careers, but if you have not moved, and for good reason, it is essential to acquire some experience outside the one corporate culture. Almost without exception this should be with a main board, but a good second best is via a not-for-profit organization, or on a subsidiary board, or even on the board of a joint venture. Even if your own company has changed considerably over time, and your role within it, you are still basically working within a variation on the same culture.

Plan ahead and seek your first NED role at least five years prior to your scheduled retirement date. Later there can be a seamless transition into a plural career post-retirement. Possibly your existing NED position will become the first chairmanship around which you subsequently attach other NED roles. A plural career without a chairmanship can be fussy and strangely unfulfilling.

Make sure that the board you join is where the ultimate decision making takes place, meaning either the main board in the case of the UK unitary system or the supervisory board in respect of continental Europe. The key is to find the level where budgetary decisions are taken and where major policy is developed.

While most boards seek to fill their positions with other main board directors, those below the main or supervisory board should, on occasion, also be considered. Their appointment merely necessitates additional thought, careful preparation and a degree of flexibility. Such leapfrogging will help women in particular, who are currently woefully under-represented at main board or supervisory board levels.

It is wise not to be too choosy when considering your first NED position, while never compromising on standards or denying your instinct. Candidates can help themselves to get that first NED position. Consider approaching former customers; they will need prompting but may be grateful for the consideration. Remember that the first NED position is the crucial one, the initial rung on the ladder. But remember too, if you are financially illiterate, forget an NED career.

In the meantime, the receiving board needs to have the relevant corporate culture and not misuse its NEDs. The NEDs are not there to rectify a technical imbalance or because of the network they can bring; corporate networks do not work in practice, they merely frustrate and cash in goodwill.

The ideal NED will provide an outsider view and challenge introverted thinking, will control the chairman or CEO, will provide an international perspective, will improve board processes, will help maintain an ethical climate and will act as a confidant(e) to board colleagues. Where appropriate, the NED will help steer a company through difficult or sensitive times and offer continuity if the executive directors come and go (and reflect the changing needs of a company more easily than by changing the executive directors). There are other inputs, but these are among the most pertinent and in themselves justify the careful selection of NEDs.

5.2.2 The Pitfalls

On no account should the NED become a 'police officer'. The NED should encourage the CEO to dream dreams, albeit not too many, and only realistic ones, and should urge appropriate risk but only after due diligence has been taken at main board level. In the case of the entrepreneur the NED will have an additional function, namely to channel the entrepreneurialism without stifling it. In the case of a family firm, caution is essential to ensure that the NED, who may be a non-family member, is kept sufficiently abreast of developments in order to be able to operate effectively.

Sometimes an NED will find a whole raft of new issues that will prove exciting and informative. The NED can put such events into perspective and with conviction.

However, the downside of being an NED can be considerable for the unlucky or the careless, though the real consequences are often greatly exaggerated. This does not mean that there is a shortage of good candidates; indeed, the supply is better than ever! The single biggest reason is the willingness of chairmen to allow their executive colleagues to have one non-executive directorship each. The responsibilities of the NED are increasing, the remuneration gap between executives and NEDs widening, and no directors' and officers' liability insurance can mitigate loss of reputation – or, often, even the basic costs of litigation.

In addition, membership of the committees of the board – audit, remuneration and nominations – can be demanding. Until recently the audit committee was recognized as the principal committee, but the remuneration committee is now often regarded as the most demanding and its chairmanship the most lonely. External data can help, but internal interpretation is essential. It is not an easy task to stand up at an AGM and defend what appears to be an illogically generous remuneration package for a CEO – when the company's shares have been on the slide and profits likewise. Nor is it easy when a CEO or other executive director bullies and threatens to leave. Even membership of the nominations committee, when the organization is recruiting for senior staff, can be time-consuming. Yet there is still no shortage of appropriate candidates!

5.2.3 Getting It Right

However, if the chemistry is right and the company understands corporate governance, the relationship should be mutually beneficial, and especially so if a few basic criteria are followed. In addition to not being appointed in order to rectify a technical imbalance on the board, or for the network of contacts he or she brings, the NED should also not be appointed because he or she is one of the great and the good.

The best way to convey a message in respect of the appointment is via the quality of the individual who has been attracted to that board. Appointing somebody recently retired who therefore has more time is rather pointless. While main board skills are evergreen and transferable, an NED begins to lose some of his or her effectiveness when once away from the executive period of a career unless the NED has plural directorships and is pursuing a portfolio career. But even a portfolio can be a disadvantage if more than one company demands the NED's services simultaneously.

The NED will not operate effectively if he or she takes up the position either for status or for money. In those circumstances the individual will not be sufficiently courageous to be truly independent. Also, it can be a failed appointment if a former company adviser is made an NED to the same company; there could be confusion of roles and it is often much better to bring in somebody totally different. Failure can also follow if the candidate is known personally prior to the appointment or if the pool by definition is kept very restrictive – or if the NED is overpaid, or the contract of engagement is too inflexible. Anything, therefore, that curtails the independence of the independent director is counter-productive.

Furthermore, becoming chairman immediately on appointment rather than via a NED role within the company can imply a failure of succession planning and may indicate that the company is in trouble. An NED should not necessarily join a sector where he or she is sufficiently unfamiliar; executive directors can dominate and control boards, which includes bypassing the NEDs.

There are still too many NEDs who underperform, and that is usually because of the inadequacy of the induction programme. Inductions should be spread over at least 12 months and should cover a multitude of issues, including current debtors, principal customers and experience in different parts of the world. The NED can also contribute better if the chairman encourages discussion rather than mere presentation and if the NED has consulted the company secretary on past issues discussed at board level. The company secretary is the eyes and ears of a board and will know the status of various items on the agenda.

Before joining, the new NED should ensure that the balance between executive and non-executive directors is appropriate as per the Combined Code and ascertain how long the other NEDs have been there and how they were appointed. Do they have a contract and, if so, what are the terms and conditions? Does the company make a profit or merely generate cash? How does the company manage risk? What is the whistle-blowing mechanism? How well briefed are non-executive directors? Do the chairman and chief executive get on well?

5.2.4 Diversity

Finally, sometimes there is a need for greater diversity at main board level. Undoubtedly women are under-represented, but the pool to draw from is relatively small despite the best efforts of many, and the many years of equal numbers of men and women graduating. Those from a non-commercial background such as the military, academia and to a lesser extent certain professions also find it difficult to get on to the NED ladder – because of a combination of laziness on the part of the company and the inappropriate experience of the candidate. However, there is a need for diversity where a board has already made the conventional appointments; a board can often benefit from a trained, curious mind that may view matters differently and thereby help advance the thinking of the board. Achieving that important additional ingredient is often more a question of the manner of the individual's approach than of his or her sector background.

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5.3

Rising Liabilities Worldwide for Directors

Andre Basile, AIG

Directors need to be aware of their rising liabilities in territories around the world, as increased regulator enforcement, shareholder activism, use of collective actions and even the threat of jail terms become ever more significant. The prosecution by the Office of Fair Trading (OFT) of four British Airways executives accused of price fixing – and the fact that they could have faced extradition to the United States had they not been charged in the United Kingdom – has once again brought into the spotlight the risks faced by directors, as well as highlighting the risk of prosecution both at home and abroad.

In fact, we are seeing a number of key themes emerging in terms of the changes that governments and judiciaries are encouraging, including growing regulatory intervention, new ways to fund and settle litigation, more collective action, and rising accountability in foreign territories.

5.3.1 Investigations Increase

Regulatory investigations are a serious cause for concern, and particularly in the United Kingdom, where the OFT, the Financial

Services Authority and the Serious Fraud Office are increasingly active. They are cracking down on anti-competitive behaviour, unfair business practices and fraudulent activities. The creation of the cartel offence under the Enterprise Act, carrying with it a possible five-year jail sentence, underlines this trend. And significantly, as these bodies get more active they are pursuing individuals, rather than just their companies, with the possibility of fines and even imprisonment.

In the culmination of the first case of its type, three British businessmen were each jailed for between two and a half and three years in June 2008 in a case brought by the OFT over price fixing of marine hoses. At the time, OFT chief executive John Fingleton said:

> This first criminal prosecution sends a clear message to individuals and companies about the seriousness with which UK law views cartel behaviour. The OFT will continue to investigate and prosecute cartels vigorously, with the aim of ensuring strong competition within the UK economy.

This trend for increasing OFT investigations and prosecutions looks set to continue. In its annual plan for 2008–09 the OFT says that in addition to its criminal powers in relation to cartels, it is to gain new criminal prosecution powers in other areas under its remit.

5.3.2 Lowering Costs of Litigation

The proliferation of lawsuits against directors and officers worldwide is partly due to the fact that the costs of bringing an action can now be shared or subsidized – as we are seeing with litigation funding firms in Australia. These firms will fund litigation on behalf of investors and take a proportion of any settlement. Big wins are rare, so they tend to back a range of cases that they believe they are likely to win in order to spread their risk.

In a recent example of a litigation funding firm in action, Aristocrat Leisure has been ordered to pay more than $144 million to litigation funder IMF and around 4,000 shareholders – the largest class action settlement in Australia so far. Aristocrat had twice misstated earnings and issued a profit forecast that was unattainable, resulting in a share price drop and losses for its shareholders when the true state of the company was revealed.

Although litigation funding already exists in the United Kingdom, it looks likely to follow further in the footsteps of that in

Australia. The OFT has recently said that third-party funding for class actions is an 'important potential source of funding… and should be encouraged', which could herald change in the UK system.

Germany has also taken important steps toward lowering barriers to entry, bringing in new legislation that means that shareholders can now share the costs for bringing an action. The Capital Markets Model Proceeding Act provides a mechanism by which, if a shareholder sues a German company and other shareholders feel similarly aggrieved, they can join the proceedings and share the costs. This effectively reduces the cost of entry, streamlines the process and enables those who would not normally bring a lawsuit to have the option of doing so. Deutsche Telekom is one of the first companies to feel the effects. It is part-way through a landmark lawsuit brought by 16,000 shareholders who are suing for up to 80 million euros because they believe the company inflated the value of its assets and thus misled them.

5.3.3 Calls to Action

Efforts to increase the speed of claims settlements, as well as collective actions being initiated by associations of shareholders, are also encouraging claimants to bring mass actions against companies and directors. For example, the Dutch Class Action Financial Settlement Act has been brought in to facilitate the effective and efficient settlement of mass damages claims. For claimants this offers the opportunity to obtain a settlement relatively quickly rather than facing years of legal proceedings, making the prospect of litigation less daunting. For companies and directors that may be targeted by such claims, the Act means that they may face just one mass proceeding rather than multiple cases and associated defence costs.

In a high-profile example, Royal Dutch Shell in 2007 made a settlement relating to the company's recategorizations of its 'proved' oil and gas reserves with non-US investors. Shell was ordered to pay $352.6 million plus administrative costs to the non-US shareholders, in a relatively short timeframe. This proved that the Act could really deliver when it came to streamlining and speeding up the claims process, especially as the non-US portion was settled before the US claim – unusual for such a case.

In another recent example of collective action, the Dutch Investors' Association (VEB) threatened to sue the Belgian–Dutch financial services group Fortis in June 2008 if it did not respond to its questions. The questions related to why Fortis and its management had said repeatedly over the preceding months that Fortis's financial position was solid and there would be no issue of new shares or change of dividend policy. It then went on to sell 1.5 billion euros' worth of new stock and some assets, and cancelled its interim dividend – all of which wiped almost 20 per cent off the company's share price. VEB's campaigning added to growing pressure on Fortis, which culminated in the resignation of chief executive Jean-Paul Votron in July 2008.

5.3.4 Accountability Abroad

The United States continues to lead the way in terms of rising liabilities and vulnerability to shareholder actions for directors, so it may hold important clues about how trends around the world will develop.

Crucially, suits against directors of non-US companies in the United States are a growing concern. Even 10 years ago the chances of litigation being brought against a European company or its directors in a US court were relatively slim. However, the increasing globalization of finance, a US plaintiffs' bar actively looking for markets that offer greater volatility, and stronger cooperation between regulatory bodies worldwide make it increasingly likely that more corporate officers will face a lawsuit at some point in their career. In fact, in 2007 alone, class actions were brought against 25 international companies – up from just six in 1997.

In a high-profile example the Department of Justice campaigned for the extradition to the United States of Ian Norris, former chief executive at Morgan Crucible, on charges for price fixing for carbon components, as well as obstructing the investigation. The extradition request has now been approved, subject to appeal, after five years of legal wrangling.

Lawsuits that allege violations of US securities laws are typically brought in the United States against a foreign issuer or its directors and officers, and companies that have fallen foul of this already include Credit Suisse, Deutsche Bank, GlaxoSmithKline, Royal Bank of Canada and Société Générale. As part of this general tendency there is a growing trend for jail terms to be handed down if a cartel is found to have affected US customers or competitors. In the beginning, individuals were imprisoned for relatively short periods and in many cases only one director was imprisoned per leading cartelist. However, there has now been a shift towards several executives being jailed, and for longer periods of time.

US companies and directors are also at risk of being held accountable abroad. Canada is a good example of a country that is tightening up its legislation, making its rules increasingly thorough and specific. It is taking an ever tougher stance on issues that include timely disclosure, avoiding generic disclosures, and civil liability cases – all of which are covered in Bill 198. This means that there is now greater potential for companies and their directors to fall foul of regulations if they are not as diligent as they could be, and, notably, US companies that engage in cross-border trading with Canada are now at risk of prosecution if they break the law.

5.3.5 Looking Ahead

Because of liabilities increasing for directors virtually across the board, companies must revisit their corporate development strategies in the light of the litigation risk and, where possible, tighten up or amend procedures. Effective compliance has never been more necessary – and it is not just a question of pieces of paper that people sign and file, but rather encompasses everything from proper training to auditing and review, and has to be built into a company's enterprise risk management system. The real value lies in execution; companies need to be able to demonstrate that their processes actually work and, most of all, compliance needs to become embedded in a company's culture.

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5.4

Criminalization of the Business World

Nick Benwell, Simmons & Simmons

Business is about risk. While undergoing a spell behind bars is a risk that most directors would rather not take, it is a risk that is increasingly hitting the news: directors of British Airways face charges in the United Kingdom, directors of Siemens face charges in Germany, Ian Norris of Morgan Crucible faces extradition to the United States. Some of this news is generated by tougher enforcement of existing laws, but there are also new factors in play. Governments (with some exceptions[1]) are realizing that they are tarnished by large corporate and banking failures and that there is no better way to deter undesirable corporate activity than to criminalize that undesirable activity. The prospect of a term of imprisonment, or just the prospect of a criminal conviction with the associated stigma that it carries, is bringing a new focus to boardroom discussions about compliance.

The criminal law was something that directors could generally ignore in the 1990s. Since then, a raft of new criminal laws has been introduced, which has fundamentally altered the corporate governance landscape.

Criminalization in the United Kingdom

Since 2000 a range of criminal laws have been passed:

- The Enterprise Act 2002 has introduced a criminal cartel offence.
- The Anti-terrorism, Crime and Security Act 2001 has specifically criminalized the payment of bribes overseas.
- The Financial Services and Markets Act 2000 has introduced offences in relation to misleading statements and practices.
- The Proceeds of Crime Act 2002 has created very wide money-laundering offences, and a requirement for regulated entities to report suspicions of money laundering.
- The Fraud Act 2006 has introduced new offences of fraud.
- The Serious Crime Act 2007 has created the concept of the Serious Crime Prevention Order, which enables the criminal authorities to seek court orders restricting companies in the way they do business.
- The Corporate Manslaughter and Corporate Homicide Act 2007 has created a new offence of corporate manslaughter.

The trend is in many ways US-influenced. For example, the United Kingdom's criminal cartel regime takes its inspiration from the US offence, with its associated leniency regime providing very significant incentives to blow the whistle on fellow cartel members. Thirty-seven countries have also now signed up to the OECD's Convention on Combating Bribery of Foreign Public Officials,[2] which itself came into being following US pressure resulting from the concern of US business that it was operating at a disadvantage internationally following the passage of the US Foreign Corrupt Practices Act 1977.

While new laws create news coverage when they are introduced, they quickly fall into disrepute unless enforced. For many international businesses the steady stream of stories of directors being extradited to the United States, or being arrested at US airports, is a significant deterrent to doing business in the United States. Yet US corporate crime laws are generally no tougher than those elsewhere, and are in several cases less tough.[3] The difference is in the enforcement regime. The United States sees itself as a global prosecutor of corporate misdeeds and has demonstrated that it is willing to take on cases with only the most tenuous of links to the United States – for example, because funds have passed through the United States, or because the activity is said to have an anti-competitive effect on US markets. The US legal system also provides real benefits for self-reporting in ways that simply do not exist elsewhere. The well-trodden paths of plea bargaining and deferred prosecution provide real incentives for companies to go to the criminal authorities if they find they have committed an offence, and a degree of certainty as to the likely outcome. The same cannot be said of most other jurisdictions.[4]

5.4.1 The International Angle

The risk that a director can be based in one country but commit an offence in another without ever having set foot there is exacerbated by the increased levels of cooperation between governments, resulting from a range of legislation and agreements relating to extradition and mutual legal assistance. Cases such as those of the NatWest Three, Norris and the computer hacker Gary McKinnon have put the United Kingdom's extradition relationship with the United States under considerable scrutiny. Questions have been asked about the ease with which extradition can be achieved, with US authorities not having to establish even a prima facie case for the charges they are bringing, while others have drawn attention to a lack of balance in the reciprocity of the US–UK arrangements.

The arrangements are, however, far from unique, with many countries enjoying a similar freedom from the need to establish any kind of case at the extradition hearing. Within the European Union the process is virtually automatic.[5] Outside the European Union there are a host of countries that fall into the same category as the United States, including Russia, Azerbaijan and Serbia. And unlike many countries, the United Kingdom is prepared to (and does) extradite its own nationals.

The starting point for extradition is that the activity of which the individual is accused must be a criminal offence. So, a side effect of the increasing number of criminal laws in the business arena is that this leads inevitably to an increasing list of grounds for the extradition of directors to stand trial in a country away from their home.

5.4.2 The Outsourcing of Policing

A large proportion of enforcement activity in the United States is triggered by self-reporting. The United Kingdom, along with many other countries, has adopted a different strategy, and reliance is now placed, at least in part, on an outsourcing of the policing function. Money-laundering legislation often imposes an obligation on regulated entities, such as banks and auditors, to report suspicions of money laundering.[6] In the event that auditors suspect, for example, that their audit client has made a corrupt payment overseas, they are often obliged to report their suspicion to the criminal authorities. Failure to do so is an offence, as is tipping off the client that they have made such a report. This reporting regime is leading to a substantial amount of intelligence for the criminal authorities.

5.4.3 Is It All Too Risky?

It is of course important to keep all of this in proportion. As with all risks, the question is how they can be managed down to an acceptable level. The good news is that the risk of criminal liability on the part of directors can largely be mitigated by ensuring that the company has a strong compliance culture, with good compliance systems and controls. These should include:

- a code of ethics;
- a compliance training programme;
- dawn raid and crisis management procedures;
- a whistle-blowing hotline;
- directors' and officers' (D&O) liability cover (although this will not protect a director against criminal fines).

While business may be about risk taking, the risk of a spell in prison is not one that any director needs to run.

Notes

1. President Nicolas Sarkozy of France has launched an initiative looking to decriminalize French company law and business life. His theme, *la dépénalisation de la vie des affaires*, is based on the premise that reducing the threat of criminal liability will help companies work more efficiently. In August 2008, South Korea announced the pardon of a large number of convicted executives on the grounds that they were needed to help revive a troubled economy.
2. The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions 1997.
3. For example, UK overseas anti-corruption laws apply to payments in both the public and the private sectors, whereas the US Foreign Corrupt Practices Act (FCPA) applies only to payments to foreign public officials, and the UK law contains no exemption for 'facilitation payments', unlike the FCPA.
4. The UK government is looking at introducing a concept of 'plea negotiation' in fraud cases; see 'The introduction of a plea negotiation framework for fraud cases in England and Wales: a consultation', the Attorney General's Office, 3 April 2008. The UK Serious Fraud Office is also using its civil forfeiture powers under the Proceeds of Crime Act 2002 to achieve a similar effect (see the SFO's £2.25 million settlement with Balfour Beatty on 6 October 2008).
5. While there are certain statutory bars, they are very limited in scope, for example the defendant being too old or ill, or on grounds of national security.
6. See, for example, the United Kingdom's Proceeds of Crime Act 2002.

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5.5

Director Development

George Bartlett, Institute of Directors

Many individuals believe that their existing skills, knowledge and experience will equip them to be an effective director. Nothing could be further from the truth. The transition from being a manager to becoming a director, or from being a director to becoming chairman of the board, is more than a change in responsibility; it requires a major change in behaviour and a broader range of skills, knowledge and experience.

Managers are usually responsible for a particular function within a company, whereas directors are responsible individually and collectively for the success of the whole company. To be successful in this wider role, company directors need a combination of intangible skills and functional skills, knowledge and experience. Intangible skills include leadership skills, the ability to cope with stress and take risks and decisions, financial and business acumen, the ability to listen and communicate concepts and facts succinctly and empathetically, strength of character, courage, tenacity and integrity. In addition to these intangible skills, directors should possess a broad range of functional skills including knowledge of corporate governance, strategy, finance and marketing, the ability to manage people and the ability to lead strategic change.

At the time of first appointment to the board, most directors have a good grasp of one or more of these functional skills, but rarely all of them, and most directors do not understand the principles of corporate governance. Many directors fail to understand that a company is a legal entity separate from its owners to which the directors owe a fiduciary duty – a duty to act in good faith in the best interests of the company – and that while directors can delegate power and authority to others to carry out the company's functions, they cannot delegate responsibility, and in both respects therefore have significant potential liabilities.

Corporate governance, which is the system of law and best practice by which companies are directed and controlled, came to the fore in the early 1980s and developed rapidly in different parts of the world via codes of best practice or legislation. This best practice spread from the private sector into the public and third sectors, and during the past decade there has been considerable convergence of best practice in these three sectors. In many developed nations, increased activism from shareholders or by pressure groups has meant that directors have had to ensure that their companies or organizations adopt a more enlightened shareholder approach, with increased accountability, probity and transparency.

Training and development of individual directors aims to make directors more aware of intangible skills, to broaden their functional skills and to increase their awareness of developments in corporate governance.

5.5.1 Board Development

In addition to directors' individual roles, most directors need training in the role of the board. An effective board is the key driver of the development of the business. The board's role is to provide entrepreneurial leadership of the company within a framework of prudent controls that enables risk to be assessed and managed; to set the strategic aims of the company and ensure that the necessary resources are in place for the company to meet its objectives; to set the company's values and standards and ensure that the company's obligations to its shareholders and other stakeholders are understood and met; and to review management's performance.

In the same way that many individuals fail to understand that a broader set of functional skills is required in order to be an effective director, so too it is common for boards of directors to fail to appreciate the benefits that flow from an annual review of the effectiveness of the board, its committees and individual directors. Enlightened boards of directors, or the equivalent governing body in organizations in the public and third sectors, are now conducting such evaluations. Over a period of time a board may become badly structured; the information that it is receiving may be inadequate; major decisions may be being taken without challenge or adequate debate; or the board may have become dominated by an individual or a small group, resulting in a loss of efficiency.

Assessing the performance and general effectiveness of both the directors and the board is a complex and challenging process. Boards that have carried out such evaluations have discovered there is no board or governing body in the world that, if the members think about it, cannot improve its effectiveness. In succeeding years the board is usually more willing to embrace the objectives of a board performance evaluation; that is, to explore the board's structure, style and processes in the light of the company's changing needs, to highlight issues, to identify the training needs of the board and individual directors, and to provide a basis for improving effectiveness.

Training and development of boards of directors aim to make directors more aware of best practice in corporate governance and the role of the board – particularly the need to focus on strategic rather than operational matters – and how the board's effectiveness can be improved via a regular review of its performance, its committees and individual directors.

The Institute of Directors

As the world's most experienced and long-standing organization advocating director professionalism, the Institute of Directors (IoD) in the United Kingdom has received numerous requests over the years to assist and support the start-up of affiliate institutes, which have benefited from the kudos, reputation and extensive experience of the IoD while maintaining an independent stance. This international interest has led to the formation of IoD International, the Institute's global network of IoD branches and affiliates.

The IoD's training courses for directors last from one to three days. Designed from the director's viewpoint, they are led by business experts with outstanding experience of training. They are also ideal forums for meeting other directors and expanding your personal network and can form part of a tailored training package for you and your organization.

In addition, the IoD runs a number of study programmes that can lead to the award of a professionally recognized Certificate and Diploma in Company Direction, two of the major steps towards becoming a Chartered Director – the professional qualification for company directors.

George Bartlett, FCIS has been a company director for over 20 years. For more than a decade he was also Group Company Secretary of a UK-listed company that had manufacturing operations in six European countries, serving on the board of its main subsidiary company. In this role he was responsible for the group's legal affairs, public relations, investor relations, property portfolio, risk management function, insurance programme and pension arrangements.

He was UK President and International President of the Institute of Chartered Secretaries and Administrators in 1997 and 2000 respectively.

Since 2002 he has been a self-employed consultant delivering training courses for directors and boards, conducting board performance evaluations and offering executive coaching.

He is the lead tutor for the IoD in courses covering 'The role of the company director and the board' and the IoD's Diploma in Company Direction.

He is also a non-executive director of two companies in the financial services sector.

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Part 6

Profiles of Corporate Governance in Leading Countries

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6.1

The United States of America

Roger W Raber and Alexandra R Lajoux,
National Association of Corporate Directors

6.1.1 Legal Framework: Laws, Models and Codes

6.1.1.1 Legal Standards

In the United States, boards of directors operate in a complex environment. A multiplicity of professional organizations regularly recommend best governance practices for boards, while multiple government authorities periodically legislate or promulgate governance mandates.

Standards for *voluntary practices* come from literally dozens of groups. Heading the list for board practices is our own organization, the National Association of Corporate Directors (NACD; http:www.nacdonline.org), a not-for-profit educational organization for directors of public and private companies. Founded in 1977, the NACD has been developing authoritative practices for more than three decades. To date, the NACD has issued 14 Blue Ribbon Commission reports as well as a set of principles. The sum and substance of these reports and principles amount to a complete set of guidelines that boards can choose to adopt or amend as needed.

Other sources of guidance include the American Bar Association (ABA; http://aba.org), for practising attorneys, both internal and external; the Association of Corporate Council (ACC; acc.com), for internal counsel; the Business Roundtable (BRT; http:www.businessroundtable.org), for CEOs of the largest public companies; the Council of Institutional Investors (CII; http:www.cii.org), for institutions investing in public companies; the Institute of Internal Auditors (IIA; http:www.theiia.org), for internal auditors; and the Society of Corporate Secretaries and Governance Professionals (http:www.governanceprofessionals.org), for various professionals serving boards. These different sources tend to agree on the main principles of governance and vary only on points of application and interpretations.

The voluntary best practices set out by the NACD and other organizations have had a notable impact over time on *mandated practices*. These required standards come primarily from federal and state governments (emanating from the legislative, executive, and judicial branches of the US government and the government of each state).

The most significant example of a mandated governance practice in the United States is the Sarbanes–Oxley Act, passed by the US Congress in 2002, and the implementing regulations passed by the Securities and Exchange Commission. For public companies the mandatory standards also come from stock markets.

Typically in the United States, the private sector develops voluntary standards for business conduct. When problems occur and poor standards are blamed, then some standards that have been voluntary become mandatory. Many of the legal and listing standards (described below) that followed the various corporate bankruptcies and scandals of 2001 and early 2002 (Enron, WorldCom, and others) had been developed originally in the private sector as voluntary standards.

6.1.1.2 The Role of the Board under US Corporation Law

Corporations need boards. Under state law in the United States, expressed with various nuances, certain powers of the corporation are reserved to the board. Only the board has these powers. These include the power to sell the corporation or substantial assets, to declare dividends, to declare bankruptcy, and so forth. In addition, there are certain functions normally expected of the board under state law, such as overseeing management of the corporation, reviewing strategic plans, and so forth.

The current governance system in the United States is still based largely on the laws of incorporation enacted in each of the 50 states. These state corporation laws resemble each other closely – thanks in part to the so-called Model Business Corporation Act (MBCA), published and regularly updated by the ABA. State laws (and the influential MBCA) set forth the fundamentals of corporations and the fiduciary duties of directors, namely the 'duty of care' and the 'duty of loyalty', sometimes modified with due.

These duties are complex and undergo changing interpretation. Indeed, one major publisher has issued a two-volume, 2,000-page tome that has as its sole focus the duty of care, as interpreted through the so-called business judgement rule. (The business judgement rule is a judicial standard that says that directors who exercise due care and loyalty will not be second-guessed even if their decisions lead to very negative results.)

Suffice it to say here that the duty of care is a duty to act in good faith with the amount of care that directors would exercise in a similar situation. This means making decisions after obtaining all reasonably available information required to make an intelligent decision. The duty of loyalty means making decisions in the interests of the corporation and its owners, rather than in one's own personal interest. It also means making decisions without conflicts of interest, withdrawing from votes where such conflicts are present, and disclosing all known potential conflicts whenever they arise.

6.1.1.3 New Trends

Courts are constantly giving new shades of meaning to the duties of due care and loyalty, and as such these duties are always worth director attention. Today, however, directors of the more than 15,000 public companies in the United States are focusing on two other sources of mandated practices: the law known as Sarbanes–Oxley and the related stock market listing rules for each of the self-regulating organizations (SROs).

6.1.1.4 Sarbanes–Oxley

On 2 July 2002, President George W Bush signed into law the Public Accounting Reform and Investor Protection Act of 2002, known as Sarbanes–Oxley after its sponsors Paul Sarbanes (Democrat, Maryland) and Michael Oxley (Republican, Ohio). The law, which applies primarily to public companies has been hailed as a landmark comparable to the securities laws that created the Securities and Exchange Commission (SEC) in the 1930s.

With nearly a dozen sections and more than 80 subsections, the law covers many topics – from analyst conflicts of interests to document shredding. Among other goals, the law has created a publicly funded oversight board, the Public Company Accounting Oversight Board (PCAOB; http://www.pcaobus.org), to monitor auditors; strengthened auditor independence; increased CEO accountability for financial statements; made CEOs and CFOs sign off on financials; eased private securities litigation; and given the SEC more resources and authority to enforce securities laws. It has also increased criminal penalties for fraud, providing for the disbarring of directors and officers found guilty of fraud, specifying longer prison sentences for certain types of white-collar crime, and enforcing the disgorgement of ill-gotten gains to benefit defrauded shareholders.

Perhaps most notably for boards, Sarbanes–Oxley has *strengthened the role of the audit committee*. The law defines the audit committee as the:

> committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer [or] if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

The audit committee's new strength comes from several aspects of the new law. Sarbanes–Oxley set *new standards for auditor independence*, banning nine types of consulting services that auditors had been able to provide in the past: bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; legal services; and other expert services unrelated to the audit. Some tax consulting is still permissible.

Section 404 of Sarbanes–Oxley

In section 404 the law also *requires a new section of the annual report on internal controls*, describing the responsibility of management for this function and assessing its effectiveness. Among other things, the internal control report must include not only management's own assessment of the effectiveness of the company's internal control over financial reporting, but also a statement that the company's auditor has issued an attestation report on management's assessment of the controls – in other words, two reports about internal controls: one from management, and one from the auditor.

In a rule implementing section 404, the SEC defines internal controls as:

> A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.[1]

Looking back over the past five years of corporate life after Sarbanes–Oxley, it is clear that the section 404 requirements for a management and an auditor report on internal control have been the most expensive and burdensome to companies. For the first two years following Sarbanes–Oxley, compliance was particularly difficult because the PCAOB put out a standard for public company auditors (Standard 2) that did not allow auditors to take management's word for anything and required heavy documentation of relatively trivial processes. To its great credit, the PCAOB, along with the SEC, held roundtables for the airing of complaints. The final standard, Standard 5, allows auditors to rely on management statements in some areas, and encourages auditors to take a more risk-based approach.

In addition, under Sarbanes–Oxley, auditors must give reports to the audit committee on all critical accounting policies and practices to be used, as well as reports on the auditors' discussions with management about accounting policies and any material matters. Furthermore, Sarbanes–Oxley requires that audit committees of companies listed on stock exchanges disclose the presence or absence of at least one member who is 'an audit committee financial expert'. In its final rule implementing this provision of the law, the SEC provided a detailed definition consistent with the one in the law. A 'financial expert' for the purposes of audit committee service is a person with understanding of generally accepted accounting principles and financial statements; experience in the preparation or auditing of financial statements of generally comparable issuers, and the application of such principles in connection with the accounting for estimates, accruals and reserves; experience with internal accounting controls; and an understanding of audit committee functions.

Audit committees of public companies now, conforming to Sarbanes–Oxley, must:

- assume responsibility for the appointment, compensation and oversight of the auditor;
- meet strict new independence requirements (having no affiliations and accepting no fees);
- establish procedures for the 'receipt retention and treatment of complaints received by the issuer regarding accounting internal accounting controls or auditing matters' and the 'confidential,

anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters';

- have authority to engage 'independent counsel and other advisers, as it determines necessary to carry out its duties';
- receive any necessary funding from the company, 'as determined by the audit committee in its capacity as a committee of the board of directors', for payment of compensation to the auditor or any advisors to the committee.

Furthermore, the SEC prohibits the listing of any company, after giving it a chance to 'cure defects', that does not comply with these standards.

The SEC has issued a number of rules implementing the major governance provisions of Sarbanes–Oxley. Of note are the following:

- *Standards relating to listed company audit committees*. This rule addresses the independence of audit committee members, the audit committee's responsibility to select and oversee the company's independent accountant, procedures for handling complaints regarding the issuer's accounting practices, the authority of the audit committee to engage advisers, and funding for the independent auditor and any outside advisers engaged by the audit committee (http://www.sec.gov/rules/final/33–8220.htm).
- *Implementation of standards of professional conduct for attorneys*. This rule sets more stringent reporting obligations for attorneys who suspect legal violations. If a lawyer (whether internal counsel or outside counsel) sees wrongdoing, he or she must warn the company about it. If the company fails to respond, the auditor must report the wrongdoing and make a 'noisy withdrawal' by stating that he or she is resigning for 'professional considerations' (http://www.sec.gov/rules/final/33–8185.htm).
- *Strengthening the commission's requirements regarding auditor independence*. This rules sets out detailed restrictions on non-audit services provided by auditors (http://www.sec.gov/rules/final/33–8183.htm).

- *Disclosure required by sections 406 and 407 of the Sarbanes-Oxley Act of 2002*. This rule sets standards for ethics codes and the audit committee financial expert (http://www.sec.gov/rules/final/33–8177.htm).

6.1.1.5 The Self-regulating Organizations (SROs)

As mentioned, in addition to living with Sarbanes–Oxley, directors in the United States need to heed listing rules from their relevant stock exchanges, including the three largest equity exchanges in the United States: the New York Stock Exchange (NYSE), the NASDAQ and the American Stock Exchange (Amex).

In recent years there has been convergence in the activities of these exchanges. The NASDAQ and the New York Stock Exchange (now part of a larger organization called NYSE Euronext) continue to compete for listings, but they trade each other's securities. In other words, a company with shares listed on the NYSE can also trade on the NASDAQ, and vice versa. Meanwhile, the Amex – long rumoured to be considering a merger with one or the other of these larger exchanges – is currently considering a definitive offer for a merger with NYSE Euronext (see the box).

US Exchanges Expanding, Converging

The NASDAQ stock market, the largest US electronic stock market, lists approximately 3,200 companies, including 335 non-US companies from 35 countries representing all industry sectors. It is an automated information network that provides brokers and dealers with price quotations on securities traded over the counter. The NASDAQ is the leading marketplace for NASDAQ-listed securities. It also trades securities that are listed on the NYSE, including the securities of companies listed on NYSE Euronext. NASDAQ is an acronym for National Association of Securities Dealers Automated Quotations.

The New York Stock Exchange is part of NYSE Euronext, Inc (NYSE/New York and Euronext/Paris: NYX), bringing together six equities exchanges in five countries and six derivatives exchanges. As of 31 December 2007, NYSE Euronext claims 4,000 listed companies, including nearly 3,000 based in the United States. NYSE Euronext also trades stocks that are listed on the NASDAQ stock market.

Amex is an independent mutual organization owned by its members (as of June 2008). Amex's core business has moved over the years from stocks to options and exchange-traded funds, but it continues to trade small to mid-size stock. Currently, it lists the securities of nearly 900 companies. Currently Amex is considering a merger with NYSE Euronext.

In late 2003 the Securities and Exchange Commission approved new rules pertaining to listed company governance for all three exchanges. See:

- NASDAQ: http://www.NASDAQ.com/about/CorpGovSummary.pdf;
- NYSE: http://www.nyse.com/pdfs/finalcorpgovrules.pdf;
- AMEX: http://wallstreet.cch.com/AMEXtools/PlatformViewer.asp?SelectedNode=chp_1_1_8&manual=/AMEX/CompanyGuide/amex-company-guide/.

The new rules aim to increase the independence of boards and board committees, and to require certain governance board and committee functions. For example, the New York Stock Exchange requires that boards of listed companies have entirely independent committees for audit, compensation and governance, and that they publish detailed charters for the work of each committee. The NYSE sets forth a template for the charters that in essence tell the committees what they must do, at a minimum.

6.1.1.6 Private Company Regulation in the Aftermath of Sarbanes–Oxley

Private companies do not sell shares to the general public in the United States, so they are not listed on any stock market and are not covered by most provisions of Sarbanes–Oxley. But private companies are hardly immune from the changes sweeping governance. These changes are arriving via *state corporation laws*. A number of states have passed laws that are similar to Sarbanes–Oxley and in some cases even more stringent. Also, accounting practices of private companies are affected by the opinions expressed by *certified public accountant (CPA) organizations* such as the National Association of State Boards of Accountancy (NASBA; http://www.nasba.org) and the American Institute of Certified Public Accountants (AICPA; aicpa.org).

6.1.2 Board Structure and Roles

The United States has more than 15,000 public companies (including the smallest 'shells') and another 15 million or so unlisted private companies, including sole proprietorships and 'mom and pop' stores. Under state law, all corporations must have boards.

In the case of public companies the boards are functional, having, for example, an audit committee that performs certain functions (in order to be listed on a stock exchange). In the case of private companies the boards may be in name only. However, many private companies do have working boards. Many NACD members serve on or head such boards.

Boards of US companies are unitary in structure. That is, most companies have only one board, rather than having a board of owners and a board of managers or employees, as companies in some nations do. To say 'unitary' is somewhat simplistic, however. In the case of holding companies there is a central board, with additional boards for subsidiaries. And in mutual funds – technically known as investment companies – fund families may have a single board (overseeing all funds) or multiple boards (one per fund or fund subgroup).

Since 1992 the NACD has been collecting data on boards via a survey. In recent years we have drawn additional data from Risk

Metrics Group of Rockville, Maryland (http://www.riskmetrics.com), based on information disclosed by public companies in their annual proxy statements sent to shareholders. By combining the proxy data with the answers to survey questions (about matters not disclosed in proxies) we obtain a deep and wide view of trends.

6.1.2.1 Key Trends

Board size has remained relatively constant over the past three years, at about 8 members on average. Small companies will average 6 or 7 directors, while large companies will average 9 or 10.

Most public companies have independent audit, compensation and governance committees. The New York Stock Exchange requires that listed companies have three entirely independent committees, for audit, compensation and nominating respectively. The NASDAQ requires an entirely independent audit committee, and sets a similar standard for compensation and nominating (but says that in exceptional circumstances, the committees could have one non-independent member). In the case of the nominating committee function, this function can be performed by the directors working as a group, rather than by a formal committee.

One topic of continuing interest is board leadership. The following summarizes the *Report of the NACD Blue Ribbon Commission on Board Leadership*, with statistics provided by the NACD's 2008 Public Company Governance Survey.

The leader of the board of directors is the chairman, also called the board chair. The board chair may be:

- an independent chair;
- combined with the CEO role;
- an executive chair (former CEO).

Separate roles are extremely common in private and not-for-profit organizations (approximately three out of four boards have them), while public companies remain split in their approach, with slight gains and slight declines in one model or the other over time. Here are the trends according to the NACD's *2008 Public Company Governance Survey*, including proxy data from Risk Metrics Group as well as from other NACD surveys:

- combined role: 48.6 per cent (most common in large public firms);
- separate roles: 51.3 per cent (most common in small public firms, up from 46.7 per cent in 2007 and 44.8 per cent in 2006.

On roughly half of all boards with separate roles, the chair is entirely independent. In the remainder, the chair is an insider or an affiliated director.

When the CEO and chair role are combined, a board usually uses a lead director. A lead director is a board member, usually elected by the independent members of the board, who performs certain duties on behalf of the board. This director often chairs of the nominating committee of the board.

One can define a lead director in two ways: official/*de jure* versus unofficial/*de facto*. An official/*de jure* lead director is a director formally voted to serve in the capacity of lead director and carries this title. An unofficial/*de facto* lead director is a director who by virtue of a key governance position in fact leads the board. Key positions would include chairman of the governance committee, and/or the 'presiding director', named to preside over the executive sessions of the board (held without members of management present). Current NYSE listing guidelines require boards to hold executive sessions and require companies to disclose the name of the person presiding at these executive sessions. This presiding director need not be the same person for every session (although NACD reports recommend continuity).

6.1.3 Shareholder Rights

The governance of corporations centres on the role of a fiduciary or representative on behalf of securities owners, whether they own equity (shareholders) or own debt (bondholders). Hence, communications with securities holders, including shareholders, are very important. In 2008 the NACD selected board–shareholder communications as the subject of its 14th Blue Ribbon Commission report. The following discussion is based closely on that report (which is still in draft form as we go to press with this chapter).

6.1.3.1 Board–Shareholder Communications

Investors in corporations own securities. Holders of equity securities elect fiduciaries to represent their interests. The rights of owners of securities, and responsibilities of those who represent them, are governed by securities laws. The laws are both federal (the Securities Act of 1933 and the Securities Exchange Act of 1934) and state, as well as 'judge made'. Duties of care, loyalty and good faith are set out not only in state law but also through judicial precedent.

Shareholders of corporations have annual meetings where they can put forward resolutions for a vote, and elect directors. Although some shareholders have complained that boards fail to communicate often enough or substantially enough, in fact there are many mechanisms for communication enshrined in federal securities law – notably the extensive November 2003 rules in this regard, as well as the stock exchange listing standards approved by the SEC that same month.[2]

6.1.3.2 The Varied Interests of Shareholders

To establish effective communications with shareholders, directors can benefit from knowing their shareholders' interests. Shareholders have diverse investment objectives or strategies and directors need to understand these.

Within the institutional investor community, there are several key players:

- *Pension funds*. These hold the largest percentage of equity outstanding – 28%. All pension funds have long investment horizons. In order of prevalence, pension fund holders comprise:
  - *Corporate pension funds*, governed by the Employee Retirement Income Security Act of 1977 (ERISA). These funds have traditionally voted with management but have become more active in voting their shares.
  - *Public employee pension funds*, governed by state laws administered by pension review boards. While they have developed a legitimate interest in governance, and instituted many valuable reforms, some critics have claimed that their issues and votes can be politically motivated.[3]

– *Labour union pension funds*, governed by the Taft–Hartley Act of 1947, which among other things imposed standards that unions and employers must meet in order to offer and operate pensions to unionized employees. Labour union funds are, in effect, multi-employer pools of retirement savings. Some of these shareholders propose resolutions on topics that arguably pertain more to the goals of their unions than to the building of long-term shareholder value on behalf of all shareholders.

- *Investment companies* (including mutual funds). This group holds another 23 per cent of the total equity market. Some of these funds (notably actively managed equity funds) have short-time horizons and churn their holdings regularly.
- *Hedge funds*. A type of private investment vehicle, hedge funds can have extremely short time horizons. Until recently there were few regulatory curbs on their conduct other than anti-fraud and tender–offer rules. Often the managers of hedge funds are uninterested in long-term performance. Indeed, some make money for the funds by predicting bad futures for the companies by engaging in short-selling.
- *Sovereign wealth funds*. According to the US Department of the Treasury, a sovereign wealth fund is a 'government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities'.[4] These government-owned investment funds can be used to advance a political as well as an economic agenda, ranging from destabilization of financial markets to expropriation of technology. Companies with shares owned by these funds should exercise caution in their relations with these investors.
- *Other institutional investors* include banks, insurers, foundations, university endowment funds and various smaller funds formed for the purpose of activist investing.

6.1.3.3 Directors' Obligations to Other Stakeholders

Shareholders are not the only constituency that US directors serve. More than 30 states explicitly permit directors to prioritize 'other constituencies, and the number could increase. Non-shareholder constituencies include holders of debt securities (bondholders), lenders and other creditors, employees, customers, and local communities.

6.1.3.4 Director Nominations and Elections

Directors of public companies are nominated on the proxy form and then voted in by shareholders.

Director Nominations: Access to the Proxy

Ever since the early 1940s the SEC has considered granting shareholders the right to include their candidates' names on the proxy card – a right called 'shareholder access'. In October 2003 the SEC solicited comments on a proposed proxy access rule, which is still pending as we go to press. This rule has received more than 20,000 comment letters.[5]

Director Elections: Plurality versus Majority

Another trend of note is the changing nature of director elections. Some shareholders have complained that plurality voting (see below) tends to favour the status quo, leaving shareholders without a meaningful voice in the election process. In response, more than half of all Fortune 500 firms have adopted policies requiring directors to submit a letter of resignation in the event that they receive more withhold votes than affirmative votes for their election. These and other public company boards have changed their by-laws or governance to require such 'majority voting', a change advocated by an increasing number of shareholder activists.

- *Plurality voting*, the default rule under most state corporate laws, allows individuals to win elections even if they do not receive a majority of votes cast. They merely need to receive a stated 'plurality' of votes, as the standards may define, which could mean election with just a single affirmative vote.
- *Majority voting*, by contrast, requires directors to receive a majority of votes in order to win a seat on the board. Recent amendments to both the Model Business Corporation Act and Delaware corporate law now allow corporations to adopt the majority standard. However, plurality voting will continue to be used in contested elections. The American Bar Association has issued a report condoning this approach, subject to review by individual boards.

6.1.3.5 Other Issues Pertaining to Director Elections

In other developments, the SEC has been re-examining rules for broker discretionary voting in director elections as well as rules for broker votes on behalf of beneficial owners 'objecting' to disclosure of their identity as owners. The SEC held roundtables on these and related subjects in May 2007.[6]

- *Broker discretionary voting for director elections*. Under Rule 452, NYSE members (brokers and banks) can vote shares on behalf of the beneficial owners on routine proposals. In June 2006 a NYSE Working Group – noting that 'shareholder voting for directors is a critical component of good corporate governance' – recommended that Rule 452 be amended to ban discretionary broker voting for director elections. The NYSE has proposed such an amendment, except in the case of mutual funds.[7]
- *NOBO–OBO rules*. Current rules permit stockholders who buy stock through a broker to remain anonymous to the companies they buy. An owner can identify him- or herself as an 'objecting beneficial owner' (OBO) or 'non-objecting beneficial owner' (NOBO). Currently, the default choice is OBO, which shields the purchaser's identity. This makes direct communication with the purchaser more difficult and costly for the company in director elections and other matters.[8] The NACD has joined with the Business Roundtable and other groups to remove this impediment to transparent communications between companies and their owners.[9]

6.1.4 Disclosure and Transparency

The United States business model is built primarily on the notion that as long as companies disclose to shareholders what they are doing, then shareholders will make their own decisions.

The requirements for public company financial reporting are set out in the securities laws cited earlier (the Securities Act of 1933 and the Securities and Exchange Act of 1934). In addition, each of these laws has generated hundreds of rules. For example, one very important rule is Regulation Fair Disclosure, which aims to prevent selective disclosure of material information. The rule, passed in 2000, is generally applied in the context of conversations with analysts and investors. If a company tells analysts and investors anything new that might be important to other investors (material information), it should promptly release the information to the public.

6.1.5 Responsibility

Ethical conduct, social responsibility and environmental sustainability are deeply embedded in the social mores of many American corporate executives, and reflected in the voluntary practices as well as laws and rules guiding corporate life in America. In addition to the securities laws outlined above, the United States already has a fully developed system of laws for such areas as protection of competitiveness (antitrust laws) and intellectual property (copyright and trademark law).

On the social side, the United States also has extensive regulation in consumer protection, civil rights, the environment, and health, safety and labour. Furthermore, under Sarbanes–Oxley section 406, mentioned earlier, public companies must disclose their codes of ethics.

As a result, many in business believe that current laws and regulations are already sufficient for a just and safe society, and that companies should be allowed to operate within the boundaries of the law as they see fit.

Under Rule 14a8, companies can ask the SEC for permission to reject any shareholder proposals that pertain to the ordinary business of the company. Traditionally, proposals relating to social issues were considered ordinary business and were therefore excludable, but in recent years the SEC has begun rejecting requests to exclude social proposals, so more of these have appeared on proxies. In 2008 at least 280 social proposals were voted on.

6.1.6 Directors

As was mentioned in the opening section of this chapter, the directors of US companies work within a complex system of laws at the federal and state levels. The NACD has advocated and provided director education about laws and other topics for more than 30 years. In recent years, director education has become an expectation of stock listing organizations and shareholders as well.

The New York Stock Exchange requires that listed companies adopt and disclose corporate governance guidelines that address:

- responsibilities of directors;
- director access to management and, as necessary, independent advisers;
- compensation of directors;
- continuing education and orientation of directors;
- management succession;
- an annual performance evaluation of the board.

The requirement for guidelines on continuing education and orientation has created a demand for reliable sources of education. Risk Metrics, the leading proxy advisory firm for institutional shareholders, has recognized more than 60 providers of director education in the United States. To be recognized by Risk Metrics a programme must include directors in its faculty, and meet certain other criteria. Risk Metrics considers director education to be important in the valuation of corporate securities for the purpose of institutional investment. It has a Corporate Governance Quotient (CGQ) score for companies, and director education can get companies a higher CGQ score.

The NACD offers a variety of educational programmes that have been recognized by Risk Metrics. The cornerstone programme is the Director Professionalism Program, which earns directors a Certificate of Director Education. Directors attend a one-day eight-hour programme that goes through several basic modules, such as director liability and responsibilities of key committees (audit, compensation and governance). To keep the certificate current, directors must continue to receive at least eight hours of education per year. Directors can attend any programme accredited by Risk Metrics, including of course NACD programmes.

6.1.7 Executive Pay and Performance

Executive pay has been a concern within corporate governance for some time now. The very first Blue Ribbon Commission the NACD ever convened (in 1993) was on this topic. Among other recommendations, that original commission urged boards to link executive pay to company performance. Companies did so through stock options that sometimes created very large windfalls for company executives, particularly when combined with generous several packages. In 2003, 10 years after the original commission, the NACD convened a new commission to re-examine the problem.

The commission identified a set of core principles that can apply almost universally when examining compensation matters:

Principle 1: Independence

Make independence a bedrock of compensation committee philosophy. Ensure that committee membership, processes and approach are entirely independent from the CEO and management.

Principle 2: Fairness

Fairness is not readily defined or measured. Different companies may define fair pay in different ways. Nonetheless, each compensation committee should try to create pay packages that will pass the test of scrutiny for fairness both internally and externally.

Principle 3: Link to Performance

Importantly, in selecting performance measures, committees should link pay to desired outcomes that the individual can affect rather than to stock price alone. Few things erode confidence or disrupt a pay system more than exceptions.

Principle 4: Long-term Value for Shareholders

Compensation committees should design pay packages that encourage long-term commitment to the organization's well-being. Tying bonuses, stock grants or other compensation to an increase in the company's long-term value can help align a CEO's personal financial interests with those of shareholders. While executives do need to meet short-term targets and should be rewarded for doing so, compensation committees should focus primarily on awards for achieving key metrics over an extended period of time. A commitment to long-term stock ownership by management is the best way to align executives' interest with that of the owners of the business.

Principle 5: Transparency

Compensation committees should embrace a philosophy of transparency – meaning full and clear disclosure. Compensation committee members need to learn the important facts about compensation arrangements and then let shareholders know these facts in a timely matter. In this way a philosophy of transparency can both inspire and enable the highest degree of care in approving packages.

Slowly but surely, these principles, as well as others, are taking hold in the United States on a voluntary basis, and with some help from regulators and shareholders. In 2003 the SEC approved NYSE rules requiring shareholder approval of pay packages that include equity. And in 2006 the SEC increased the requirements for disclosure of executive pay. Currently there is a movement towards 'say on pay', with more than 100 proposals filed on compensation matters in 2008. In the November 2008 elections it was clear that both candidates planned to take a tough line against excessive executive compensation. The principles listed above are likely to become watchwords for any reforms under President Barack Obama.

Notes

1. Securities and Exchange Commission, Final Rule: Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports. Release nos. 33–8238; 34–47986; IC-26068; File nos. S7–40–02; S7–06–03. Effective 14 August 2003.
2. SEC rules are found at http://www.sec.gov/rules/final/33–8340. Stock exchanges' rules are posted on their websites.
3. For a 138-page critique of the current system, 'The Gathering Pension Storm', June 2005, see http://www.reason.org/ps335.pdf. This paper notes that '[w]hen political appointees rather than individuals, manage [or oversee] investments, [the] serving the interests of the beneficiaries and the maximum health of the pension system take a back seat to pursuing political goals'. It gives examples of alleged conflicts of interest in the public employee pension arena.

4. US Department of the Treasury, *Semiannual Report on International Economic and Exchange Rate Policies*, June 2007, at www.treas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_FXReport.pdf (3 March 2008).
5. For the 2003 rule, including an extensive history of SEC consideration of shareholder access, see http://www.sec.gov/rules/proposed/34–48626.htm# P65_7845. For comment letters, see http://www.sec.gov/rules/proposed/ s71903.shtml. The NACD letters can be found at http://www.sec.gov/rules/ proposed/s71903/nacd032604.pdf, http:// www.sec.gov/rules/proposed/s71903/nacd030904.htm and http:// www.sec.gov/rules/proposed/s71903.shtml.
6. For a transcript of the 2007 roundtables, see http://sec.gov/news/openmeetings/2007/openmtg_trans052407.pdf.
7. Specifically, the Working Group recommended that the New York Stock Exchange amend Rule 452 to make the uncontested election of directors a 'non-routine' matter. The NYSE has voted to require all votes for directors to come from 'beneficial' owners rather than from the brokers who hold their stock. In May 2007 the NYSE exempted investment companies (mutual funds) from this proposed rule. The rule is still pending as we go to press. See http://www.nyse.com/pdfs/ PWG_REPORT.pdf.
8. Since beneficial owners are more likely than brokers to vote for dissident directors, this change, if enacted, has the potential to trigger more turnover in the boardroom. The impact of this rule will be felt by larger companies that have adopted majority voting, a perhaps unanticipated consequence of the enactment of two seemingly disparate reforms. If both are enacted, the effect of each will be magnified by the other. If beneficial holders are voting their shares under unknown (OBO) identities, this could affect the work of the governance committee as well. For an example of a policy for responding to shareholder resolutions, see http://www.ibm.com/annualreport/2006/proxy_faq2.shtml.
9. The Business Roundtable, the National Investor Relations Institute, the Society for Corporate Secretaries and Governance Professionals, the NACD and others have asked the SEC to study its existing rule permitting shareholders to remain anonymous when buying shares through brokers. This is part of a broader proxy reform agenda. See shareholder.com.
10. For Key Agreed Principles to strengthen corporate governance see http://www.nacdonline.org/pdf/KeyAgreedPrinciples.pdf.

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The National Association of Corporate Directors (NACD) is a not-for-profit educational organization for directors of public and private companies, currently headed by Kenneth Daly.

Founded in 1977, the NACD has been developing authoritative practices for more than three decades. To date the NACD has issued 13 Blue Ribbon Commission reports on various governance topics. For more resources, visit nacdonline.org.

6.2

China

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Corporate governance in China has undergone significant change during the past three decades as the Chinese economy has liberalized and developed. Prior to the historic reforms initiated in 1978 the economy had been structured as a state-owned, centrally planned economy; practically all enterprises were government or commune owned. Today, many companies are partially or wholly privately owned, and that historic change has brought a sea change in Chinese corporate governance, with securities policies well in place and governing boards well established.

The first significant changes in company ownership came in the 1980s as small state-owned enterprises and collectively owned enterprises in rural areas began issuing shares to the public. As the reforms spread to larger enterprises, the rapid increase in company-issued securities led the Chinese government to swiftly create a capital market from scratch. In 1990 it authorized the cities of Shanghai and Shenzhen to establish national stock exchanges.

The stock exchanges were tiny at the start: just 14 companies were listed at the outset, and in the early years state agencies and the listing companies kept some two-thirds of the shares out of the market. Company listing and trading volume rapidly increased in line with China's extraordinary economic growth, however, and the government created the China Securities Regulatory Commission (CSRC) in 1993 to provide regulatory oversight of the burgeoning listings and the fast-expanding capital market. China subsequently instituted the 'Company Law' in 1994, which prohibited self-dealing by executives and directors and delegated merger approval to shareholders, and the 'Securities Law' of 1998, which strengthened the CSRC's supervision of the equity market and its power to penalize improper behaviour. China opened its equity market to foreign institutional investors in 2003, and in 2005 it initiated a programme to convert untraded state and company-held shares into tradable securities.

With China's market reforms and accelerating growth, the stock exchanges have come into their own over the past decade. By mid-2008 the Shenzhen Stock Exchange listed 540 companies with a total market value of RMB 1 trillion, and the Shanghai exchange listed 1,172 companies with a collective value of RMB 15 trillion. The combined 1,712 companies with a capitalization of RMB 16 trillion (£1.3 trillion) remained modest by comparison with the New York Stock Exchange's 2,800 companies and £11.4 trillion ($20 trillion) capitalization, and the London Stock Exchange's 3,000 companies and £3.5 trillion capitalization. The Chinese exchanges were expanding rapidly, however, and the basic institutions of an actively traded public equity market had been put in place.

In just two decades, China had created a capital market that measured up reasonably well by Western standards. Virtually all – 98 per cent – of the state- and company-held shares, for instance, had become tradable, eliminating the privileged ownership rights that had initially been reserved for state and company shareholders. The World Bank and the International Monetary Fund gave high marks to China's many reforms, and a study conducted in 2006 by Canada's Centre for International Governance Innovation (CIGI) concluded that China rated first among 10 Asian nations in adopting a set of governance principles put forward by the Organisation for Economic Co-operation and Development. Much remained still to be done, however, with company compliance and public enforcement of the reforms far from complete. The same CIGI study rated China's actual governance practices ninth among the 10 Asian countries.

6.2.1 Distinctive Features of Chinese Corporate Governance

Corporate governance practices in many countries have displayed some convergence towards Western standards in recent years (often emulating Britain's 1992 Cadbury Code and the United States' 2003 Sarbanes–Oxley Act), but countries generally retain a set of distinct practices. In building its own system, China has been no exception. Four distinctive features of Chinese corporate governance in the late 2000s are particularly notable: 1) highly concentrated ownership; 2) strong state ownership; 3) pyramid ownership structures; 4) weak markets for corporate control.

6.2.1.1 Highly Concentrated Ownership

Company ownership is generally diffuse in the United Kingdom, the United States and other Western economies, with relatively few shareholders controlling more than a few per cent of the shares of any given firm. By contrast, ownership in China's listed firms is highly concentrated. Of the 1,602 companies listed on the Shanghai and Shenzhen stock exchanges in August 2008, the single largest owner held 36 per cent of an average company's shares, the top three owned 49 per cent and the biggest five controlled 52 per cent. The high degree of concentrated ownership has remained relatively stable since the founding of the exchanges. As a result, owners tend to exercise more control over Chinese companies than is common among their Western counterparts.

6.2.1.2 Strong State Ownership

Despite a long-running process of privatization of state-owned enterprises, government agencies have maintained a high level of ownership and thus strong influence over many of the country's publicly listed firms. State-owned or state-controlled enterprises were responsible for 31 per cent of China's GDP in 2007, but the Shanghai Stock Exchange reported that the government held 51 per cent of its listed shares. Government officials overseeing the state's ownership stakes are not immune to political considerations; members of the Communist Party are often appointed to company boards, and Chinese regulations require that publicly listed companies provide 'necessary support' for the functioning of the Communist Party within their firms.

6.2.1.3 Pyramid Ownership Structures

Most major British and US publicly traded companies are owned and operated as stand-alone entities that work independently of one another to optimize investor returns. Many listed Chinese firms, by contrast, are owned or controlled by an unlisted parent company, and many of the listed firms in turn control other listed companies. The resulting pyramid ownership structure has opened the way for the malfeasance of tunnelling, in which a controlling firm extracts resources from other firms in its pyramid whose minority owners would disapprove if the transfer came to light. A 2006 study by the Shanghai Stock Exchange revealed that such practices had become widespread: of the 1,377 firms studied, 35 per cent had misappropriated to their parent companies funds totalling RMB 48 billion. As a sign of the breadth of the problem, in 2006 China added pyramid misappropriations to its criminal code.

6.2.1.4 Weak Markets for Corporate Control

Because two-thirds of a typical firm's shares were held by the state and the companies themselves, and were untradable before 2005, the market for corporate control in which companies and investors compete for control of other firms has been virtually non-existent. With the formal movement of untraded shares on to the open market completed by 2007, active contests for control became more feasible.

Yet even then, large blocks of a company's shares – often a third, half or even more – remained in the hands of public agencies. Unlike private investors, state organizations are concerned with a host of factors in addition to optimizing shareholder value, and few of the newly 'tradable' shares were actually traded in any case. A CSRC study in 2008 found that among the 10 largest market-cap companies on the exchanges, 8 of them had fewer than 10 per cent of their shares in active trading, and the other 2 had less than a third actively traded. As a result, most mergers and acquisitions were achieved through negotiation, and most required state approval as well. A hostile takeover bid for a financially underperforming company – the most prominent weapon in the Western arsenal for corporate control – could rarely attract the shares required or win government approval. More entrenched management at poorly performing companies has been one result.

6.2.2 The Chinese Governing Board

As the Chinese public equity market matured, the organization, composition and practices of boards of directors of some publicly listed companies in China came to acquire some features similar to those of Anglo-American firms. The personal computer maker Lenovo, for instance, brought several independent directors on to its boards after it acquired the IBM personal computer division in 2005. Chinese governing boards have nonetheless followed a distinctive path in the areas of 1) board structure, 2) shareholder rights, 3) disclosure and transparency, 4) corporate social responsibility, 5) the role of directors, and 6) executive compensation.

6.2.2.1 Board Structure

China has adopted a two-tier board structure similar to the German convention of having a supervisory board overseeing a board of directors. Chinese supervisory boards are required to have at least three members, and a third of the members must be employee representatives. In principle the supervisory board monitors the directors and management, but in practice virtually all supervisory board members are from inside the firm, and the supervisory board largely rubber-stamps the decisions of directors and management.

The board of directors in the Anglo-American system sits at the hub of company governance, while in China the annual shareholders' meeting has emerged more to the front and centre. Chinese company law endows the shareholders' meeting with powers normally reserved for the board in the United Kingdom and United States. The board of directors in China, for instance, is required to 'develop and formulate' the company's annual budget and investment plan, but not approve the budget and plan, as is common in the Anglo-American world. Still, given that those attending the annual shareholders' meeting cannot effectively exercise discretionary authority in that venue, most of the real decision-making power remains in the hands of the directors and management.

Chinese regulations require a firm to designate one individual as the 'legal person representative' to act on behalf of the firm. This position is normally assumed by the chairman of the board, and this rule has had the effect of investing greater power in the board chair than is common among British or American companies when the chair and CEO roles are separated.

6.2.2.2 Shareholder Rights

China's Company Law, revised in 2006, requires greater disclosure of information to stockholders than is common in the West. Shareholders elect directors and vote at shareholder meetings, but they also have access to company charters, shareholder lists and the minutes of meetings of both the supervisory board and the board of directors.

To protect minority shareholders at companies where ownership is concentrated and pyramids prevail, companies are required to follow formal procedures for entering into related-party financial transactions. It is now mandatory, for instance, that shareholders approve a company's transactions with a controlling company, and the controlling company cannot vote its shares on such transactions. Minority shareholders have the right to introduce motions at, and to convene or even preside over, shareholders' meetings, and they can adopt a cumulative voting system for electing directors and supervisors.

6.2.2.3 Disclosure and Transparency

Compared to those in OECD countries, China's disclosure requirements have been vague and enforcement has been weak. A 2003 study by the Shanghai Stock Exchange reported that 'distortion of accounting information is quite common', and a 2007 CSRC report concluded that 'there are still many cases of management entrenchment or "insider control" in capital markets', and that 'fraud, price manipulation and insider trading by securities professionals' are still evident.

China has made many efforts in recent years to increase transparency and strengthen enforcement in the public equity market through four avenues. The National People's Congress has established the legal framework through such provisions as the Company Law, the State Council has created the regulatory framework though the Security Trading Management Regulation and related rules, the China Securities Regulatory Commission has offered even more specific guidelines though its Listed Company Disclosure Requirement Implementation Rules, and the Shanghai and Shenzhen stock exchanges have added their own specific listing requirements.

The People's Congress strengthened the penalties for market manipulation, and in 2006 explicitly prohibited the practice in many companies of maintaining two sets of accounting records. The Ministry of Finance imposed a set of accounting standards in 2005 that are largely in line with international accounting reporting principles. In 2007 the CSRC imposed stricter requirements on the disclosure of company information. Disclosure of material information now must be made simultaneously to all parties, and companies are now required to have an internal process in place to ensure that the CSRC disclosure standard is met.

6.2.2.4 Corporate Responsibility

China has placed formal emphasis on corporate social responsibility, more so than is common in many Western economies. The Company Law of 2006, for instance, has required that a company 'observe social norms and business ethics standards, operate honestly, accept monitoring by government and the general public, and assume its social responsibility'.

The exchanges have gone even further. Shenzhen demands of its listed companies that in the process of maximizing shareholder value, they must also 'consider' the interests of their creditors, must not sacrifice creditors' interests for the sake of shareholder value and must provide creditors with access to financial and operational data. Shenzhen companies must also 'commit themselves to social welfare services like environmental protection and community development in order to achieve social harmony'.

Despite such formal efforts, companies have often fallen short of properly combining company ownership and social responsibilities. The Shanghai Stock Exchange, for example, identified several especially problematic areas in 2007. Formerly state-owned enterprises were still sometimes shouldering social responsibilities that should have been shifted to public agencies. Company executives were still failing to faithfully fulfil their financial obligations to their owners. And because of pressures for rapid growth, many companies were failing to protect the environment properly, ensure safe working conditions, assure product quality and prevent fraud.

6.2.2.5 The Role of Directors

Prior to 2001, no law or regulation required that any directors be independent of management. The CSRC now requires that a third of the seats on a publicly listed company board be held by independent directors, and many companies have reached that threshold. A 2004 study by the Shanghai Stock Exchange found that independent directors constituted nearly a third of the board members, and on occasion have exercised a very independent role. In one widely publicized incident, for example, an independent director challenged related-party transaction by the board chair of a prominent food maker, and upon CSRC investigation the company ousted its chairman.

The 2006 Company Law strengthened the obligations of directors to include both 'duty of loyalty' and 'duty of care', though neither is defined very clearly. It did state that the loyalty obligations included forbidding the use of company funds for personal use, the making of loans to others without authorization, the disclosure of proprietary information, self-dealing and bribes. It also held directors personally liable if director decisions violated state regulations or the company charter.

6.2.2.6 Executive Compensation

Executive compensation in China has been substantially lower than that in the West, though it has been rising rapidly. A survey conducted by the Shanghai Stock Exchange reported that the average compensation of the highest-paid executive of listed firms in 2003 was close to RMB 200,000 (£16,800), but just two years later the average had jumped to RMB 300,000 (£25,200). The highest-paid executive in 2005 received compensation of RMB 6 million (£500,000), but three years later the largest executive pay cheque had soared to RMB 66 million (£5.5 million). Not surprisingly, executive compensation in state-owned enterprises remained far below that in privately held corporations.

Even with the rapid rise of executive compensation, most pay remained fixed, rather than varying with performance. In many US and British listed firms the great majority of top executive compensation is variable, while in Chinese listed firms, according to a study in 2006, fully 97 per cent was still paid in the form of a fixed salary. Only a tenth of the firms used stock options at all. In 2006 the CSRC gave its blessing for more, though it declared that no more than 1 per cent of a company's shares can be used as options for the top executive, and no more than 10 per cent for all of the executives combined.

6.2.3 Chinese Governance

China has created one of the largest markets for publicly listed companies in the world. The total market capitalization of the two

Chinese stock exchanges ranked below only those of the United States, Japan, Europe and the United Kingdom in 2008, up from no market capitalization at all less than three decades earlier.

China's regulatory regime has come to include everything from prohibitions against self-dealing and tunnelling to prescriptions for independent directors and contingent compensation. Though some features of Chinese corporate governance are akin to those found in most Western economies, several features remain distinctive, including highly concentrated ownership, much of it by the state, and a relatively weak market for corporate control.

Similarly, though certain aspects of the governing boards of Chinese publicly traded companies are similar to those elsewhere, distinct features are evident here too, including less influential boards, weaker disclosure enforcement, greater social responsibility and less contingent compensation. Whether Chinese corporate governance will converge with the Anglo-American model or retain its distinct features in the years ahead remains to be seen.

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The research assistance of Ms Shu Lin, a PhD candidate at the China Center for Economic Research of Peking University, is gratefully acknowledged.

6.3

Japan

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6.3.1 Background

Over the past 10 years, discussions about who corporations belong to have been extremely lively in Japan. Clearly, the law states that a corporation belongs to its shareholders, its governing body is its shareholders and the essential purpose of corporate governance is to maintain and increase corporate value. I do not think that there is a director in Japan who does not understand this fact. But sometimes people's feelings do not always correspond with the reality.

Following the Second World War, Japan achieved rapid economic growth that was dubbed the 'Asian miracle'. As part of that successful experience, shareholders were relegated to a position outside the field of vision of directors. The Japanese did not see corporations as entities to be bought and sold. Rather, they understood them to be concerns that continued to exist as joint undertakings of labour and management and that continued to provide value to customers. Even now, such ideas as 'Companies belong to the shareholders (owners) but not only to the shareholders' and 'Shareholders may be the owners of the capital, but they are not the owners of the company' are perfectly acceptable to most Japanese.

Such ideas may have been fine in the days when Japanese corporations could achieve the growth, and guarantee their stakeholders the returns, that made them the envy of the world. However, times have changed. The Japanese economy peaked in 1989. After that, business results worsened. Moreover, following reforms of the financial system implemented by the government, many companies switched from obtaining indirect financing from banks to obtaining direct financing from the market. As a result, the influence of foreign investors and pension funds increased and, concomitantly, directors found themselves faced with the responsibility of providing explanations to world investors – something of which they had little previous experience. In addition, corporations were mainly run by directors who rose from within their ranks, as a result of which a lack of clarity arose with regard to such matters as moral hazard and managerial responsibility.

The population of Japan is 130 million; it has increased by 50 million since the Second World War. The directors in many industries (food, everyday articles, etc) that rely primarily on domestic demand have found it possible to survive nicely within the confines of the country. However, the Japanese population peaked in 2000 and then began decreasing at a pace unparalleled in the rest of the world. As a result, many directors found themselves forced to place the pivot of their growth strategies in foreign markets. According to statistics from 2008, the percentage of Japanese manufacturing industry's overseas sales has reached a historical high of 45 per cent.

In the past 10 years the rules of the game have completely changed for the directors of Japanese companies. They are now fighting on a global stage, and they must now continue to produce results while fulfilling the responsibility of providing explanations to shareholders and other stakeholders. For both people and businesses, what is a strength at one time can become a weakness at another – and vice versa. This has certainly been the case with many of the 'strengths' for which Japanese management was praised by the world in the 1980s: *keiretsu* (interlocking ownership of companies), lifetime employment, bureaucratic control. What is required of Japanese directors is a strategic approach, and an ability to act, by which they can resolutely overcome their 'dilemma of innovation'.

6.3.2 The Development of Laws, Models and Codes

The 2005 revision of the Companies Act was the first truly radical revision of that legislation in 100 years, since the creation of the Commercial Code. For Japanese companies it was also a monumental event. It involved a wide-ranging relaxation of the Act's regulations, and also broadened the range of the optional systems that can be selected according to a corporation's actual condition. On the other hand, it encourages self-responsibility on the part of corporations, and strongly demands corporate governance and compliance with the law. The 'current situation with corporate governance' was newly established as a section required in securities reports and elsewhere, and disclosure of the following was made obligatory:

- the situation regarding the establishment of an internal controls system;
- the situation with regard to the establishment of a risk management system;
- details about the compensation of directors and officers;
- details about the compensation of auditors.

6.3.3 Board Structures

Since the start of the 1990s, many Japanese corporations, in order to ensure the effectiveness of their governance, have improved their information disclosure and auditing functions by bringing in outside directors and outside auditors; separated their decision-making mechanisms from their mechanisms for conducting business operations, by introducing a system of operating officers; and carried out other reforms as well. As of 2008, 33.0 per cent of corporations have introduced a system of operating officers. This is an increase of 20 per cent as compared with the situation three years earlier. For large corporations (capital of at least 30 billion yen) the figure is over 50 per cent.

With the revision of the Companies Act, moreover, it became possible to establish 'committee-establishing companies' that establish a nominating committee, an audit committee and a compensation committee. Such companies have a corporate governance system different from that of ordinary joint-stock companies: on their board of directors they establish a committee the majority of whose members are outside directors, and the board of directors supervises management; on the other hand, the company's business operations are conducted by operating officers. The aim of this arrangement is to rationalize and optimize management.

6.3.4 Shareholder Rights

Previously, the requirements that small shareholders had to meet in order to exercise their rights were all predicated on the right to vote. In the revision of the Companies Act, however, standards regarding the number of shares owned were added to those requirements. These standards were established in order to deal with shareholder needs arising from the diversification of stock types (classified stock, etc). Compared to what they were in the past, the rights of small shareholders have been strengthened. When one shareholder owns 10 per cent or more of all issued shares, that shareholder can exercise the right to demand that the company be dissolved. It has thus become impossible to ignore small shareholders with little voting power.

6.3.5 Disclosure and Transparency

Appropriate disclosure is also becoming increasingly necessary in order to guarantee the principle of self-responsibility of investors. Establishing internal controls related to financial reporting is thus indispensable. The Japanese version of the Sarbanes–Oxley Act (the Financial Instruments and Exchange Law) was enacted to ensure that the information disclosed in securities markets is reliable. Accordingly, it especially focuses on internal controls related to financial reporting. In particular, it requires the following:

- To ensure the appropriateness of the information entered in financial reports, directors must establish and operate an effective system of internal controls inside their companies.
- Companies must evaluate the effectiveness of their internal controls related to financial reporting and disclose this information to investors in the form of 'internal control reports'.
- Companies must be audited to ensure that their evaluation methods and results are appropriate.

6.3.6 Responsibility

In the old Companies Act there was, in principle, absolute liability: liability regardless of whether there was negligence. Under the new law, by contrast, there is, in principle, liability only in the case of negligence, so that directors are not held liable if they are not negligent. This change was made basically because absolute liability was considered too severe. However, according to the new law, should a director cause harm to a company through any of a number of actions, such as illegal disbursements, illegal pay-offs, conflict-of-interest transactions and violations of law or the articles of incorporation, the director will bear liability for the damages jointly with the other directors, etc. This arrangement was established to ensure the dynamics of management and to protect shareholders.

6.3.7 Directors

Since a company's directors bear responsibility for its management, there is concern that they could inflict great harm on the company if they pursued their own interests or committed some grievous error. Thus, for directors the Companies Act establishes general obligations (the obligation to exercise the diligence of a good director, the obligation to act faithfully) and restrictions on certain transactions (transactions with competitors, conflict-of-interest transactions). In order to accomplish these, it is necessary for directors to be professionals. The Japan Management Association (JMA), in cooperation with the Institute of Directors (IoD), offers a training programme for directors, the Company Direction Programme. A total of 2,850 people have participated in this programme to date, and 95 have been awarded a JMA–IoD Diploma/Certificate. Expectations for directors, as well as the need for training directors, are increasing year by year.

6.3.8 Executive Pay and Performance

According to precedent, if the number of directors is small, it is enough to disclose the total amount of executive pay rather than the amount of each director's pay. In the case of companies that have low levels of dividends, however, many have criticized this practice as unacceptable and voiced the opinion that the amount of each director's pay should be disclosed in order to promote transparency in the company's management.

6.3.9 Conclusion

No single global model for good corporate governance exists. Since companies are social entities, it is necessary to understand the society in which a company is situated in order to understand the company. Respecting the diversity of ways in which corporations are organized is also linked to respecting the history and culture of the countries to which the corporations belong. Humankind has repeatedly experienced tragedy when countries have ceased to respect one another. On the other hand, Japanese directors must extricate themselves from a culture of 'sensibility' that understands on the basis of context, and learn and implement more effective methods of communicating with stockholders, employees and other stakeholders. And what is most important is that they seek the methods of corporate governance that they think will best realize the purposes of corporate governance, and that they improve their business results and truly increase their effectiveness.

6.3.10 Useful Contacts

- Nippon Keidanren, the consensus opinion of the Japanese business community:
  http://www.keidanren.or.jp/ index.html
- Information on Japanese companies, finance, law:
  http:// www.japancompany.info/JAPANCOMPANYINDEX.html
- Authors' opinions on Japan:
  http://www.glocom.org/

Yasunobu Yokota is Director, Top Management Development of the Japan Management Association. The Japan Management Association (JMA) is a non-profit membership organization promoting innovation in management. For further details, see www.jma.or.jp.

6.4

India

David Gardner, Director of Public Policy, KPMG and Graham Ward, PricewaterhouseCoopers and Vice Chair of the UK–India Business Council

6.4.1 Legal Framework and Codes

India's post-liberalization-era economic reform programme has ushered in a new business environment. High economic growth levels are making it more attractive for large-scale domestic and foreign investment. Local and global stakeholders expect companies to align their corporate governance practices with global norms.

Statutory underpinning for corporate governance is provided by the 1956 Companies Act, which addresses various governance aspects, including shareholder rights, directorships and disclosures.

A codified system for corporate governance in India started in 1998, when the Confederation of Indian Industry (CII) published *Desirable Corporate Governance: A code*. Since then, corporate governance has been driven by the Securities and Exchange Board of India (SEBI), which issued and enforces Clause 49 of the Listing Agreement ('Clause 49') in 2001 with an updated code in 2004.

These laid down the fundamentals of corporate governance, which operates on a 'comply or explain' basis.

Clause 49 covers certain aspects from leading governance codes such as the OECD Principles and the Turnbull guidance in the United Kingdom. Clause 49 is required to be complied with by listed companies with a paid-up capital of 3 crore rupees (about £370,000) or net worth greater than 25 crore rupees (£3.5 million). Companies are required to submit a quarterly compliance report to the stock exchanges within 15 days of the close of each quarter. The report needs to be signed by either the company's compliance officer or the CEO.

Table 6.4.1 sets out the main regulations included in Clause 49 and is split between those that are mandatory and those that are merely recommendations.

Table 6.4.2 illustrates some of the differences in corporate governance practices before and after the introduction of the new Clause 49 in 2001.

6.4.2 Board Structure and Roles

Clause 49 makes the following provisions in respect of the board of directors:

- The board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than 50 per cent of the board of directors comprising non-executive directors.
- Where the chairman of the board is a non-executive director, at least one-third of the board should comprise independent directors. If he or she is an executive director, at least half of the board should comprise independent directors.
- Where the non-executive chairman is a promoter or is related to promoters or persons occupying management positions at the board level or at one level below the board, at least half the board of the company should consist of independent directors.
- The board shall meet at least four times a year, with a maximum time gap of four months between any two meetings.
- The gap between the resignation or removal of an independent director and the appointment of another independent director in his or her place shall not exceed 180 days.

Table 6.4.1 *Mandatory and recommended regulations set out in Clause 49*

Mandatory	Recommended
Board of Directors Board composition, non-executive directors' compensation and disclosure, frequency of board meetings, minimum information to be placed before the board, director membership on other committees, code of conduct for the board, a minimum age for independent directors, a gap between resignation or removal and the appointment of an independent director.	Occupation of chairman's office by a non-executive chairman Tenure in respect of independent directors Qualification and experience of independent directors Operation of a remuneration committee
Audit Committee Qualification and independence of audit committee, frequency of meetings, powers, role, review of information.	A half-yearly declaration of financial performance including a summary of the significant events Transition towards a zero-qualified financial statements regime
Subsidiary Companies Independent director of a holding company to be a director on the subsidiary board, audit committee oversight over subsidiary.	Training of board members A mechanism for evaluating non-executive board members
Disclosures Basis of related party transactions, disclosure of accounting treatment, risk management, proceeds from public issues, rights issues, preferential issues etc., remuneration of directors, management discussion and analysis report, other shareholder related disclosures.	Operating a whistle-blower policy
CEO/CFO certification Defines the responsibilities of the CEO/CFO for the purpose of controls over financial reporting.	
Report on Corporate Governance Requires a separate section on compliance report on corporate governance as a part of the annual report. Non-compliance of any mandatory requirement with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted.	
Annual compliance certificate from auditors or practising company secretary Stipulates certificate on compliance of conditions of corporate governance.	

Table 6.4.2 *Changes introduced in Clause 49*

Practice before Clause 49	Practice after Clause 49
The board had freedom to decide whether a materially significant relationship between the director and company affected his or her independence.	The new clause takes this discretionary power away from the board.
The original clause had stipulated that the audit committee must meet at least three times a year and at least once every six months.	The new clause makes it mandatory for the audit committee to meet a minimum of four times a year with a maximum gap of four months between meetings.
The original clause was silent on the qualifications of audit committee members.	The new clause states that all members should be financially literate and at least one should have accounting or related financial management expertise.

Source: www.clause49.com/clause49.htm

- The minimum age for independent directors shall be 21 years.
- A director shall not be a member of more than 10 committees or act as chairman of more than 5 committees across all companies of which he or she is a director. Furthermore, it should be a mandatory annual requirement for every director to inform the company about the committee positions he or she occupies in other companies and notify changes as and when they take place.
- The board shall lay down a code of conduct for all board members and senior management of the company. The code of conduct shall be posted on the website of the company.
- All board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed by the CEO.

Clause 49 does not stipulate specific regulations in respect of the roles of top executives or separation of the roles of chairman and chief executive, and is silent as to the clear role of independent directors. However, the key expectations from independent directors from various stakeholders are to bring about a transformation in the attitude and working of the board, bring brand credibility and better governance, contribute to effective board functioning and lead the governance committee effectively.

In addition, certain committees are required by Clause 49 or relevant SEBI guidelines (see Table 6.4.3).

6.4.3 Shareholder Rights

The Companies Act 1956 specified various shareholder rights. Some of the key rights are:

- to elect directors and thus to participate in the management through them;
- to vote on resolutions at company meetings;
- to enjoy the profits of the company in the shape of dividends;

Table 6.4.3 *Committees prescribed or recommended by Clause 49*

Mandatory Committees	**Objective**
Audit Committee	Exercise 13 key roles such as oversight of financial reporting process and disclosure, oversight over statutory auditors, review of internal control systems and review of the functioning of the whistle-blower mechanism.
Shareholders'/Investors' Grievance Committee	Redressing shareholder and investor complaints, eg share transfers, non-receipt of balance sheet and non-receipt of declared dividends.
Compensation Committee	Administration and superintendence of ESOPs. Mandatory only if company offers ESOPs, as per the Employee Stock Option Scheme and Employee Stock Purchase Scheme Guidelines, 1999.
Recommended Committees	**Objective**
Remuneration Committee	Determine on behalf of the board and shareholders, with agreed terms of reference, the company's policy on specific remuneration packages for executive directors, including pension rights and any compensation payment.

- to apply to the court in the case of oppression or for relief in the case of mismanagement;
- to inspect documents and registers to be kept by the company under the said Act and ask for extracts therefrom.

Clause 49 gives various additional rights to shareholders, including the following:

- Information should be sent to shareholders, including details concerning the appointment or reappointment of a director.
- Quarterly results and presentations made by the company to analysts should be made publicly available.
- A board committee under the chairmanship of a non-executive director shall be formed to look specifically into the redressing of shareholder and investor complaints.
- Company boards shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once a fortnight.

A half-yearly declaration of financial performance, including a summary of the significant events of the past six months, may be sent to each household of shareholders. This is recommended but not mandatory.

6.4.4 Disclosure and Transparency

The Companies Act 1956 wields the most significant laws in respect of financial reporting and accounting practices for Indian corporates. Every company's annual balance sheet, profit and loss account, report by the board and the report by the auditors thereon is required to be adopted by the shareholders at the annual general meeting. The Act has specific provisions with respect to disclosures, formats, depreciation rates and other related disclosure schedules.

The Institute of Chartered Accountants of India (ICAI) has specified 30 mandatory accounting standards (as of June 2008). ICAI is further transitioning towards an International Financial Reporting Standards (IFRS) regime, and IFRS is expected to roll out in India by 2011.

In addition, Clause 49 requires the following in respect of risk controls:

- The company is required to lay down procedures to inform board members about the risk assessment and minimization procedures. These are periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.
- The section on management's discussion and analysis is required to include discussion on risks and concerns.
- The CEO/CFO must accept responsibility for establishing and maintaining internal controls. An evaluation of the effectiveness of internal controls, including an evaluation of their deficiencies, as well as any changes in internal controls have to be disclosed to auditors and the audit committee.

6.4.5 Responsibility

As per Clause 49, the board of directors is required to lay down a code of conduct for all board members and senior management of the company which shall be posted on the company website. All board members and senior management are required to affirm compliance with the code annually. The annual report should contain a declaration to such effect signed by the CEO.

It is recommended that the company establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud, or violation of the company's code of conduct or ethics policy. This mechanism could provide for adequate safeguards against victimization for employees who avail themselves of the mechanism, and also provide for direct access to the chair of the audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization.

Disclosures in respect of corporate social responsibility (CSR) and environmental sustainability are not mandatory requirements as part of the corporate governance mandates. However, larger companies have initiated a trend of voluntary disclosure on CSR. Typically, they highlight considerations relating to health, safety and the environment, along with social responsibility and community development initiatives taken during the year.

6.4.6 Directors

Directors are considered agents of the company in transactions they enter into on behalf of the company, though they are not agents for individual shareholders or members. Directors' liability arises because of their position as agents or officers of the company, and also because they are in the position of trustees or have a fiduciary relationship with the company or its shareholders. Some of these liabilities are in contract, some are in tort, some are under the criminal law and others are statutory; that is, they are stipulated by the Companies Act 1956 and other laws. In deciding the liability of directors, the courts have taken into consideration a director's position as a whole.

A company may train its board members in the business model as well as the risk profile of the company's business parameters, their responsibilities as directors and the best ways to discharge them.

Companies may ensure that an independent director has the requisite qualifications and experience on appointment that would be of use to the company and would in their opinion enable him or her to contribute effectively.

6.4.7 Executive Pay and Performance

The Companies Act 1956 provides overall remuneration limits, calculation methodologies and requirements for shareholder approval in respect of managerial remuneration. Clause 49 requires disclosures to be made in respect of executive pay and performance, including all pecuniary relationships or transactions of non-executive directors, and all elements of the remuneration packages of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options and pension.

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The UK–India Business Council (UKIBC) is the lead organization supporting the British government in the promotion of bilateral trade, business and investment between the two countries. UKIBC seeks to play an influential role in creating and sustaining an environment in which free trade and investment flourish. A key objective in this regard is the highlighting, and dismantling, of bureaucratic and regulatory barriers to entry. Through the facilitation of partnerships, and with the support of an extensive network of influential corporate and associate members, UKIBC provides the resource, knowledge and infrastructure support vital for UK companies to make the most of emerging opportunities in India. For further information, please go to www.ukibc.com, or e-mail us on enquiries@ukibc.com, or telephone 020 7592 3040.

6.5

Overview and Current Issues in Germany

Christian Strenger, DWS Investment

6.5.1 Framework of the German Corporate Governance Code

6.5.1.1 Development of the German Corporate Governance Code

Particularly after the Holzmann insolvency crisis in late 1999, the German government realized the practical importance of better governance for German companies in the competitive international context. In July 2000 the German chancellor convened the first 'Government Commission on Corporate Governance' to develop official standards for German governance and to draft recommendations for future company law developments.

In September 2001 a second Government Commission was mandated to develop the official 'German Corporate Governance Code' (GCGC). Its mission was to develop a code that would be broadly accepted and supported by all relevant interest groups. The members of the commission were recruited from listed companies representing different industries, institutional and private investors, audit firms, academic experts on law and finance, and union representatives. For select issues the commission consulted experts, for example from executive search or law firms. After five months of intensive work with a draft for public comment, the code was published in February 2002.

The Code is reviewed at least annually by the Government Commission, which acts as a standing commission. The most recent update took place in June 2008.

6.5.1.2 The Underlying Corporate Governance Model

Following the 'comply or explain' principle, as determined in the Stock Corporation Act (article 161 of the AktG – see below), German companies have to declare annually how they comply with the Code and must explain any deviations from the Code's 'Shall Recommendations'. The Code comprises three layers of governance issues:

- The legal stipulations relating to key governance points.
- 'Shall Recommendations', which reflect key international governance standards. Companies that do not comply with these recommendations have to say so in their annual report and on their website as well as explain the resons for the non-compliance.
- 'Should Suggestions', which represent additional important elements of good governance. These 'suggestions' do not expressly require disclosure in case of non-compliance but it is a good-practice suggestion, and one that is increasingly followed.

6.5.1.3 Legal Framework

The key laws relating to corporate direction and control are as follows:

- Aktiengesetz (AktG) – the Stock Corporation Act;
- Bürgerliches Gesetzbuch (BGB) – the Civil Code;

- GmbH-Gesetz (GmbHG) – the Limited Liability Corporation Act;
- Handelsgesetzbuch (HGB) – the Commercial Code;
- Mitbestimmungsgesetz (MitbestG) – the Co-determination Act;
- SE-Ausführungsgesetz (SEAG) – the European Stock Corporation Act;
- Wertpapierhandelsgesetz (WpHG) – the Securities Trading Act;
- Wertpapiererwerbs- und Übernahmegesetz (WpÜG) – the Securities Acquisition and Takeover Act.

6.5.2 Board Structures and Roles

6.5.2.1 Two-tier Board Structure of the Stock Company (Aktiengesellschaft, AG)

All German stock corporations (*Aktiengesellschaften*) have a two-tier board structure comprising a supervisory board (*Aufsichtsrat*) and a management board (*Vorstand*).

Structure and Role of the Supervisory Board

The supervisory board appoints, supervises and advises the members of the management board and has to approve decisions of fundamental importance to the enterprise.

Composition and Size of the Supervisory Board

The representatives of the shareholders are elected to the supervisory board by the general meeting. As specified by the Co-determination Act, in companies with 500–2,000 employees one-third of the members of the supervisory board must be employee representatives. In companies with more than 2,000 employees, the representatives elected by the shareholders and those of the employees must be equal in number, leading to supervisory boards with up to 20 members. (See page 200 on co-determination for details.)

Key Stipulations of the German Corporate Governance Code

Key recommendations regarding the supervisory board in the German Corporate Governance Code are as follows:

1. Essential requirements for supervisory board members are sufficient knowledge and industry experience (Art. 5.4.1 GCGC).
2. There is an age limit (Art. 5.4.1 GCGC).
3. They shall have sufficient independence (Art. 5.4.2 GCGC).
4. Election by the general meeting shall be on an individual basis (Art. 5.4.3 GCGC).
5. As a rule, a former CEO shall not become chairman of the supervisory board (Art. 5.4.4 GCGC).
6. Compensation must be appropriate (Art. 5.4.6 GCGC).
7. Efficient and regular cooperation between the management board and supervisory board shall take place (Art. 3.4 GCGC).
8. Resolution and review of an adequate management compensation system, including the main contract elements, shall take place. Appropriateness of management compensation shall be based on performance assessment (Art. 4.2.2 and 4.2.3 GCGC).
9. Conflicts of interest shall be dealt with properly (Art. 5.5.2 and 5.5.3 GCGC).
10. Committees shall be established (Art. 5.3 GCGC), in particular:
    - The audit committee (*Prüfungsausschuss*), which deals with issues relating to accounting, risk management and compliance, the necessary independence required of the auditor, the issuing of the audit mandate to the auditor, the determination of key audit points and the fee agreement (Art. 5.3.2 GCGC).
    - The nomination committee (*Nominierungsauschuss*), which proposes qualified shareholder representatives to the supervisory board for its recommendation to the general meeting. It is composed exclusively of shareholder representatives (Art. 5.3.3 GCGC).
11. The efficiency of the supervisory board shall be evaluated regularly (Art. 5.6 GCGC).

Structure and Role of the Management Board

The management board is responsible for managing the business affairs of the enterprise.

Composition and Size of the Management Board

Management boards of large publicly listed companies (*Aktiengesellschaften*) are typically composed of three to eight members. In co-determined corporations with more than 2,000 employees the board must have a member responsible for all employee matters (*Arbeitsdirektor*).

Key Stipulations in the German Corporate Governance Code

Key stipulations regarding the management board in the German Corporate Governance Code cover:

- efficient and regular cooperation between management board and supervisory board (Art. 3.4 GCGC);
- individual disclosure of the remuneration of executives (including termination payments) (Art. 4.2.4 GCGC);
- appropriateness of all compensation components, both individually and in total (Art. 4.2.2 GCGC);
- a severance payment cap of two years' compensation in the case of a 'good leaver' contract termination (Art. 4.2.3 GCGC);
- proper dealing with conflicts of interest (Art. 4.3.4 GCGC);
- proper dealing with third-party transactions (Art. 4.3.2 GCGC).

6.5.2.2 Alternative to the Traditional German Board Structure: Societas Europeae (SE)

While the Societas Europeae (SE) gives enterprises the possibility of choosing between a one- and a two-tier board structure, to date all medium-sized or large German companies have adopted a two-tier SE structure. The SE allows – regardless of the number of employees – a reduction in the number of supervisory board members to 12, thus making the board more efficient. Since the representatives of the employees must reflect the company's international operations, it also increases the international representation of the workforce.

6.5.3 Issues Relating to Shareholder Rights

6.5.3.1 Classes of Shares

There are two types of shares in Germany are ordinary shares or preferred shares:

- *Ordinary shares with voting rights* (the vast majority of all shares issued). Voting right restrictions for ordinary shares were legally banned in 1998. A one share, one vote therefore applies to all ordinary shares.
- *Preferred shares without voting rights*. In recent years the number of preferred shares with no voting power has declined substantially. Many of the outstanding preferred shares have been phased out since then (including SAP). Important and relevant examples that remain include BMW, Metro and Volkswagen.

6.5.3.2 Current Issues concerning Shareholder Rights

Lack of Shareholder Consent for Significant Measures

The lack of necessary shareholder consent for substantial takeovers or similar significant strategic moves remains a governance issue for Germany. A recent example: in a takeover of a major pharmaceutical company the acquiring company paid two-thirds of its own market capitalization for a major strategic diversification without the consent of its shareholders.

Shareholder Activism: Acting in Concert

The German 'Risk Limitation Act' was recently passed by the federal legislature. According to the new law, cooperation among shareholders constitutes acting in concert if only 'the shareholders enter binding agreements on the exercise of voting rights or cooperate in other ways to influence a company's strategic orientation in a permanent and significant manner'. The interpretation of the latter point is left to the jurisdiction.

Issues that do not constitute acting in concert are:

- agreements on single general meeting (GM) issues;
- continuing cooperation on the same non-strategic issues over several GMs;

- parallel, coordinated acquisition of shareholdings without further objectives concerning the issuer or target company;
- standstill agreements, reciprocal rights of first refusal and options;
- acting in concert to preserve the issuer's status quo.

Applicable disclosure rules are as follows:

1. After reaching or passing the threshold of 10 per cent, detailed disclosure is obligatory within 20 trading days on the source of funds for the share purchases and the objectives of these purchases. (However, shareholders who reach or pass 10 per cent are not obliged to reveal whether they aim to gain control over the issuer.)
2. Any change in the then stated objectives has to be disclosed within 20 trading days.
3. Companies are allowed to waive (opt out of) these obligations by a change of their corporate statutes (with consent by a GM).
4. Such disclosures as well as failures to report are to be fully published by the issuer.
5. Disclosure is also mandatory on voting rights emanating from financial instruments if they reach or pass a threshold of 5 per cent.
6. The sanctions for violations of disclosure obligations are a six-month suspension of voting rights (but this applies only to intentional violations).
7. All new disclosure obligations will only apply to future cases of acting in concert, or of passing reporting thresholds. The obligation to disclose holdings of financial instruments (derivatives etc) applies only from 1 March 2009 onwards.

Building of Controlling Stakes without Full Transparency

Given recent cases of the building of controlling stakes (Porsche / Volkswagen, Schaeffler / Continental) with substantial unpublished purchases in excess of the 3 resp. 5 per cent threshold, many companies and investors are now calling for the reporting requirements to be extended to avoid creeping substantial stake building without adequate transparency.

6.5.4 Disclosure and Transparency

6.5.4.1 Key Transparency Stipulations

Key governance-related transparency stipulations are as follows:

1. Companies shall annually publish a corporate governance report.
2. All shareholders shall be informed equally ('fair disclosure') (Art. 6.3, 6.4, 6.8 GCGC).
3. Regular investor and stakeholder meetings to be held.
4. Companies shall publish regularly a detailed analysis of deviations from major previously published performance and strategy targets.
5. Companies that disclose information outside Germany must also disclose this information within Germany (Art. 6.5 GCGC).
6. Actual shareholdings (including options and derivatives) by management and supervisory board members and any changes thereto shall be published without delay on an individual basis and separately in the annual report or corporate governance report (Art. 6.6 GCGC).

6.5.4.2 Governance-related Stipulations for Financial and Business Reporting and Accounting Practices

Key stipulations relating to financial and business reporting as well as accounting practices are as follows:

1. Reports are to be prepared according to International Standards on Auditing (IAS) (Art. 7.1.1 GCGC).
2. Special accounting standards and measures must always be made transparent.
3. Consolidated financial statements are to contain information on stock option programmes and similar incentive systems (Art. 7.1.3 GCGC), as well as information on their valuation and accounting treatment.

4. Sufficient independence is to be an important criterion in the selection of the auditors (Art. 7.2.1 GCGC).
5. The supervisory board must set an appropriate level for the auditing fee.
6. Companies' business reporting is to be based on non-financial key performance indicators.

6.5.5 Responsibility

Social responsibility issues have gained considerable momentum in the capital market. However, there is a strong need to find a uniform basis of application and for measurement through key performance indicators. Such key performance indicators should provide information about management systems, corporate governance, long-term viability, potential reputational risks and liability issues.

6.5.6 Current Governance Issues Relating to Non-executive Directors

Some important supervisory board quality issues are as follows:

- insufficient independence on the part of directors, including in committees;
- the impact of co-determination;
- the lack of diversity, such as international and gender representation;
- too many past CEOs have become supervisory board chairmen.

6.5.6.1 Insufficient Independence

Independent non-executive directors comprise only 28 per cent of German company boards compared to the European average of 54 per cent. Just 27 per cent of major companies have an independent chairman. The proportion of independent members of audit and remuneration committees in Germany is only 26 per cent and 23 per cent respectively. However, the Eighth EU Directive (auditor directive), implemented in 2008, could lead to a change of this proportion since it requires the audit committee to have an independent chairman.

Improvement in board independence could also come from the recent recommendation of the German Governance Code for a 'nomination committee' solely composed of shareholder representatives.

6.5.6.2 Co-determination: The Special German Problem

The conceptually good solution of 'checks and balances' between the executive and the supervision of the German 'two-tier board' system is seriously affected by the German co-determination issue on board size, independence and international composition. With 20 board members for large companies, it is difficult to hold an engaging and serious discussion of complex issues. The employee representatives are by nature dependent.

6.5.6.3 Insufficient International Representation

Only 7 per cent of German supervisory boards are international board members compared to with 31 per cent in the United Kingdom and 45 per cent in Switzerland. Given that the big German companies generate a major part of their income internationally, efforts to increase the international representation on the board do appear necessary. Again, this could change with increased usage of the European SE.

6.5.6.4 CEO Succession to Supervisory Board Chairman

A practice still prevalent in large German companies is the practice of former CEOs to become supervisory board chairman: at present, more than half of the chairmen of the supervisory boards of the 30 DAX (Deutsche Aktien IndeX 30) companies are former members of the management board (mostly a former CEO). Conceptually, this requires that a CEO has the ability to change from a dynamic CEO to a balancing and controlling non executive chairman with a truly independent mind. A good solution could be to make a previously successful CEO a normal supervisory board member without too much influence over decisions relating to his or her tenure as CEO.

6.5.7 Executive Pay and Performance

According to the German Corporate Governance Code, appropriate compensation structures should take into account the following essential issues in order to avoid 'pay for failure':

1. Compensation shall be linked to long-term profitability and to individual success.
2. Share-based compensation shall depend on the longer-term share price and profit development, and be a substantial part of the compensation package.
3. An appropriate length for employment contracts should also be established:

   A five-year term, still the norm in Germany, carries the risk of excessive pay-offs in the case of early termination. The German Code has included since June 2008 a 'Shall Recommendation' for a cap of two years (with an additional 50 per cent addition in 'change of control' cases).
4. Recently the German Government Commission on Corporate Governance emphasized the appropriateness and long-term performance requirements (related stipulation: 4.2.3 GCGC). Executive compensation shall be linked to a manager's and company's long-term performance as well as external parameters such as the results of the company's peer group. A bonus/malus system shall be implemented and executives should be obliged to invest their own moneys as a precondition for participating in share based incentive schemes.

6.5.8 Further Information

- The German Code Commission on Corporate Governance, Regierungskommission Deutscher Corporate Governance Kodex, www.corporate-governance-code.de
- The Society of Investment Professionals in Germany, Deutsche Vereinigung für Finanzanalyse und Asset Management (DVFA), www.dvfa.de
- The German Stock Exchange, Deutsche Börse, www.deutsche-boerse.de

- The Federal Ministry of Finance, Bundesfinanzministerium, www.bundesfinanzministerium.de
- The Federal Ministry of Justice, Bundesministerium der Justiz, www.bmj.bund.de
- The National Agency for Supervision of Financial Institutions, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), www.bafin.de

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6.6

The United Kingdom

Anna Burmajster, Institute of Directors

Since the first edition of the *Handbook* there have been substantial changes to the business landscape and economic climate in the United Kingdom; the country is experiencing an economic downturn in response to the subprime mortgage crisis in the United States, rocketing oil prices and turmoil in the financial sector. This chapter has been written in the midst of a rapidly changing environment, which could lead to changes in the described framework. Under those conditions, adhering to good corporate governance standards is more important than ever. Good corporate governance promotes trust and confidence in business, encourages investment and provides the basis for sound commercial decision making.

The United Kingdom has always encouraged free trade, innovation and wealth creation. Historically, the country embraced a *laissez-faire* approach to business regulation – one based on principles rather than legislative rules. This approach encourages business practice instead of stifling it through detailed regulations, thus reducing compliance costs for UK and global businesses. As a result, the United Kingdom is consistently ahead of other countries in terms of corporate governance standards, while having lower compliance costs than countries with a more legislative approach (notably the United States). Justifiably, London remains the world's largest and most diverse international marketplace.

Although there is a strong basis of company legislation and regulation, at the heart of the United Kingdom's approach to corporate governance is self-regulation backed by codes and guidelines. Good corporate governance is seen as essential to the effective operation of a free market. It has become shorthand for the way an organization is run, with particular emphasis on its accountability, integrity and risk management. The stronger its presence in daily business practices, the less the need for the government to intervene in and legislate for the corporate sector.

The key aspects of corporate governance in the United Kingdom are based around the Combined Code on Corporate Governance, operating under the motto 'comply or explain'. In short, it promotes a unitary (or single) board with a collective responsibility for the company's success. It advocates the separation of the roles of chief executive and chairman and the importance of a balance between executive and independent non-executive directors; it recommends independent and transparent audit, remuneration and nomination committees and an annual evaluation by the board of its performance. Finally, it promotes effective rights for shareholders.

The 'comply or explain' regime allows companies to apply governance practices in a way that suits their particular circumstances, which can vary enormously from company to company depending on their size, ownership structure and the complexity of the business model.

A number of professional bodies make recommendations on best corporate governance practice. The leading authority on directors' and boards' roles and responsibilities is the Institute of Directors (IoD), the world's most experienced and long-standing not-for-profit organization advocating director professionalism. For a fuller account of its activities, see page 225–26.

6.6.1 Corporate Structure and Ownership

A company is a separate legal entity from those who manage it and those who have put up the capital. The key parties are the shareholders, the creditors and the directors. The directors must act in the best interests of the company at all times and not represent any special group of shareholders.

The United Kingdom has a plethora of company structures, including:

- companies limited by shares:
  - private companies;
  - public limited companies;
- companies limited by guarantee;
- unlimited companies.

Economically, the most important are the two types of company limited by shares, and for the purposes of this chapter all references to a company are either to a private company limited by shares ('private company') or to a public limited company ('plc').

There are over 2.7 million active companies in the United Kingdom. Of these, 11,209 are public limited companies and some 2,100 are listed on the London Stock Exchange. This includes around 1,174 companies listed on the Alternative Investment Market (AIM), which is intended for new companies not eligible for the Official List. Given the numbers of registered companies, it is no surprise that a large majority of them are very small businesses. Their corporate structures are and will remain very different from those of the listed company.

There are different governance requirements for each type of company, with more stringent requirements for public limited companies. While the major principles of good corporate governance are of relevance to all companies, it would be a mistake to believe that every aspect of the detail of what is promulgated for large listed companies is relevant across the corporate spectrum. To achieve acceptance and, eventually, enthusiasm for corporate governance, the principles must be relevant to the size, structure and nature of the business entity.

Ownership patterns have changed radically over the past few decades. Direct shareholder involvement in the management of larger companies has diminished to a point where there is almost entire separation of the two. According to the National Statistics 2006 Share Ownership Survey, whereas 54 per cent of shares were owned by individuals in 1963, the figure had fallen to 12.8 per cent by the end of 2006. Overseas ownership has grown over the same period from 7 per cent to 40 per cent. This increase partly reflects international mergers where new companies are listed in the United

Kingdom, flotation of UK subsidiaries of foreign companies, in which the parent has retained a significant stake, and companies moving their domicile to the United Kingdom.

Alongside this, the growing importance of share ownership in the hands of institutional investors has had a very real effect. Institutional shareholders accounted for 41.1 per cent of UK ordinary shares as of 31 December 2006, with a combined value of £762.8 billion. Of these, the largest holders were insurance companies (£272.8 billion) and pension funds (£235.8 billion). In recent times, institutional investors have increasingly turned to using their votes at annual general meetings. There are a number of reasons for this; one factor is probably the current state of the stock market, where many investors are holding stocks at a very large loss. Increasingly, it is seen as a role of corporate governance to attempt to align the interests of shareholders and boards. That said, it is noticeable that the average duration of institutional holding in the United Kingdom is no longer than two years. Companies find it hard to regard this as shareholders taking a long-term interest in the company.

6.6.2 Legal Framework

Two main areas are fundamental to the relationship between the director, the company, the shareholders and others: *the duty of care and skill*, and *the director's fiduciary duties*. For over 250 years these two areas were governed by a common law system, which is the foundation of the legal framework of the United Kingdom.

The legal provisions relating to companies and their governance derive from a number of sources:

- statute and subsidiary legislation;
- directly applicable European Union law;
- regulation including accounting standards;
- listing rules applicable to quoted companies;
- takeover rules;
- specific legislation applying to companies operating in specific sectors (eg banking and insurance);

- decisions of the courts;
- extra-legislative codes.

The current basis of company legislation is the Companies Act 1985, the Companies Act 1989, the Companies Act 2006, the Company Directors Disqualification Act 1986, the Insolvency Act 1986, the Financial Services Act 1986, the Financial Services and Markets Act 2000 and the Corporate Manslaughter and Corporate Homicide Act 2007.

6.6.2.1 Company Law

European Union (EU) law has been the main source of amendment to UK company law since accession in 1973 and is expected to continue to be a significant factor. Because the EU Directives address specific subject areas and each has to be incorporated into the national law, there was, for a long period, no time for overall review and reform of company law to shape or even reflect modern corporate reality.

In 1997 the Company Law Review Steering Group was set up under the instructions of the Secretary of State for Trade and Industry with four key objectives:

- to enhance shareholder engagement and a long-term investment culture;
- to ensure better regulation and a 'think small first' approach;
- to make it easier to set up and run a company;
- to provide flexibility for the future.

After extensive consultation and investigations, the Steering Group issued its final report in 2001. In 2002 the government published a White Paper, *Modernizing Company Law*, suggesting some radical changes to the governance of UK companies. In 2005 there was a second White Paper, which included drafting for a number of provisions. The Company Law Reform Bill was introduced into the House of Lords later that year and finally received royal assent in November 2006.

The Companies Act 2006 is reputedly the longest piece of legislation ever to have been passed by the Westminster Parliament, or indeed any parliament anywhere in the world. However, it is better drafted and better organized than its predecessors. Its main provisions are as follows:

- The premise is that, unlike previously, the legislation was drafted from the viewpoint of the smallest companies, with additional requirements for larger companies. The new approach recognizes the realities of the structure of companies.
- Probably the most radical changes are in the area of directors' duties. In the United Kingdom the law on directors' duties (both the duty of care and fiduciary duties) had previously been entirely based on common law. Now, for the first time in UK legal history, many of these duties are codified. While there are no new duties or responsibilities as such, the Act confirms and replaces in a single statement what has previously evolved in case law. The fundamentals of the current common law duties are retained; hence, the unitary board is recognized, with all directors being subject to the same general duties. Equally, the shareholder model is retained (that is, directors must act in a way that promotes the success of the company for the benefit of the members as a whole). In doing so, they need to have regard as necessary to long-term factors, the interests of other stakeholders such as employees, the community and the company's reputation.
- There will no longer be a statutory requirement for private companies to hold annual general meetings (AGMs). However, businesses can still hold AGMs if they wish.
- Shareholder meetings for private companies can now all be on a 14-day notice period, unless the company's articles specify different arrangements.
- Decisions by written resolution of a company's shareholders will be much easier to make. Written resolutions now need a signature from a majority of shareholders, not all of them, and special resolutions need a majority of 75 per cent.
- There will be a clearer way for shareholders to make a derivative claim to sue directors on behalf of the company – for instance, for fraud.
- Unless a company files small-company accounts, its Directors' Report must contain a Business Review in its accounts.

Many of these changes do not apply to limited liability partnerships.

Seven General Duties of Directors

- to act within the powers of the company;
- to promote the success of the company for the benefit of its members as a whole, paying due regard in decision making to:
  - likely long-term consequences;
  - employees' interests;
  - the need to foster relationships with suppliers, customers and others;
  - the impact of operations on the community and the environment;
  - the need to maintain high standards of business conduct and to act fairly between members of the company;
- the need to exercise independent judgement;
- the need to exercise reasonable care, skill and diligence;
- the need to avoid conflicts of interest;
- the need not to accepts benefits from third parties;
- the need to declare, where applicable, any interest in a transaction or arrangement with the company.

6.6.2.2 Corporate Manslaughter

At its worst, a breach of health and safety rules can result in death. The liability of a company and its directors for fatalities has been much in the news in the past 15 or so years, with tragedies such as the capsizing of the *Herald of Free Enterprise*, the fire at King's Cross underground station in London and various rail crashes raising the issue of corporate manslaughter and the related responsibility of both the company and individual directors.

In the past, employers whose negligence led to a death could be convicted only where there was enough evidence to prove that individual senior managers were guilty. From April 2008, with the introduction of a new Corporate Manslaughter and Corporate Homicide Act 2007, a limited company as a whole, or a group of its directors, or an individual director can be prosecuted for a gross failing throughout the organization in the management of health and safety resulting in workplace deaths.

The Act does not create any new offence for directors but, in the event of a company being found guilty of the offence and fined, the company's value and reputation will be affected. In such a situation the company may turn on the directors who were responsible.

The long-standing common-law offence of manslaughter on the grounds of gross negligence remains in place and is a criminal offence that a director can personally be accused of in the courts. When considering whether to prosecute a company for corporate manslaughter, the authorities can be expected to focus on whether also to prosecute an individual director for gross negligence, manslaughter or for another criminal offence under health and safety legislation.

Companies found guilty of corporate manslaughter will face an unlimited fine, as well as a remedial order requiring them to address the cause of the fatality. Companies that already comply with existing health and safety legislation have nothing to fear.

The Institute of Directors' stance has been firmly based on the foundation that helping create and maintain high standards of health and safety performance – and having that approach led by the board of directors – is an extremely desirable aspiration in its own right:

- Identify potential areas for risk and address them as a matter of utmost importance.
- Ensure that your health and safety policies are up to date and are regularly reviewed.
- Train your all senior managers in health and safety and make sure that they are aware of the new laws and regulations and their implications.

In conjunction with the Health and Safety Executive, the IoD published official guidance for directors or board members on what they should be doing and what their responsibilities are under health and safety legislation: *Leading Health and Safety at Work*, www.iod.com/hsguide. The guidance sets out good practice for directors and boards on how to provide leadership in health and safety so that their organizations meet their legal obligations as employers under the Health and Safety at Work Act 1974 and gain the business benefits arising from effective, sensible health and safety management.

6.6.2.3 Competition Law

Companies can face civil penalties of up to 10 per cent of global turnover if they infringe competition law. Since 2003 it has also been possible for directors in the United Kingdom to be held personally liable for serious breaches of EU and UK competition law.

An individual who participates in a cartel can be found guilty of a criminal offence, and a director of a company that commits any breach of competition law can also be disqualified from acting as a director for up to 15 years.

6.6.2.4 Disqualification

A defaulting director not only may expect personal or criminal liabilities as a consequence of a breach of duty but also may receive a court order disqualifying him or her from acting as a director for up to 15 years. A person can be disqualified from acting as a director on a number of grounds, including persistent breach of company law legislation and conviction for fraud under the Company Directors Disqualification Act 1986.

6.6.2.5 The European Union

The European Union (EU) also significantly influences corporate governance in the United Kingdom. The European Union is very active in company law, and in 2001 appointed a High Level Group of Company Law Experts to make recommendations for a modern regulatory framework for company law in the European Union. Among the topics considered was corporate governance. In 2002 this Group published its final report (the Experts' Report) and in 2003 the EU Commission issued a communication to the EU Council and the European Parliament, *Modernizing Company Law and Enhancing Corporate Governance in the European Union: A plan to move forward* (the Corporate Governance and Company Law Action Plan), proposing a mix of legislative and regulatory measures that will affect all member states.

Among the various EU member states there have been some 40 corporate governance codes over the past decade (with the United Kingdom acting as pioneer in this respect). A European Union-wide corporate governance code was not proposed; however, the report stated that 'some specific rules and principles need to be agreed at EU level'.

The Plan targets for a legislative approach:

- disclosure requirements;
- exercise of voting rights;
- cross-border voting;
- enhanced disclosure by institutional investors;
- enhancing the responsibilities of board members.

Alongside the Company Law Action Plan sits the Financial Services Action Plan. A number of measures with corporate governance implications fall within its remit. These include the draft Transparency Directive, which, among other provisions on disclosure requirements, introduces quarterly financial reporting.

The EU Commission has moved to improve compliance across Europe with the 2003 Market Abuse Directive. This has led to the introduction of a new market regime abuse in the United Kingdom, which took effect in 2005. It encompasses both insider dealing and market manipulation, and classes seven types of behaviour as market abuse. Both insider dealing and market manipulation remain criminal offences.

6.6.2.6 The Sarbanes–Oxley Act

Examination of corporate governance in the United Kingdom would be incomplete without any reference to the US Sarbanes–Oxley Act of 2002 (SOX). Passed in the aftermath of the Enron, Tyco and other corporate scandals, the Act affects some UK companies and their directors. SOX applies to all companies, whether incorporated in the United States or elsewhere, that publicly issue securities in the United States and file reports with the US Securities and Exchange Commission (SEC), for example such UK companies as Cadbury Schweppes and British Airways, which trade on the New York Stock Exchange.

It has no direct application to other companies. US and non-US subsidiaries outside the terms of the Act may, however, be indirectly affected if their parents have to comply. For example, SEC rules require management to include a report on their internal controls and procedures for financial reporting in their annual reports filed with the SEC. Management must evaluate the effectiveness of those controls and procedures, and the company's auditors must issue a report on the assessment. These requirements are likely to have a knock-on effect on directors and managers in UK subsidiary companies, who may be asked to provide similar certificates and confirmations in respect of their own financial reporting and internal controls.

6.6.3 Codes, Standards and Good Practice Guidelines

Although there is a strong basis of legislation and regulation, at the heart of the United Kingdom's approach to corporate governance is self-regulation backed by codes and guidelines. Widespread interest in the subject really took off in the early 1990s. There was increasing concern about the standards of corporate reporting and the accountability of boards in the wake of corporate scandals, including the Robert Maxwell pension funds scandal, the collapse of the BCCI bank, Coloroll and the collapse of Polly Peck, which all involved published accounts that did not give a true indication of the state of company finances. It was recognized that if published information could not be trusted, there would be serious consequences for the reputation of the United Kingdom as a business and financial centre. The UK business community recognized the need to put its house in order.

6.6.3.1 The Cadbury Report (1992)

Thus, in May 1991 the Financial Aspects of Corporate Governance Committee was set up and sponsored by the London Stock Exchange, the Financial Reporting Council and the accountancy profession, under the chairmanship of Sir Adrian Cadbury. The resulting report, widely known as the Cadbury Report, was issued in December 1992 and included a Code of Best Practice, which was the first corporate governance code in the United Kingdom. Its recommendations were incorporated into the London Stock Exchange Listing Rules.

Key recommendations included the separation of the roles of chief executive and chairman, balanced composition of the board and selection processes for non-executive directors.

6.6.3.2 The Greenbury Report (1995)

In 1995, following concerns about directors' pay and share options, the Confederation of British Industry set up a group under the chairmanship of Sir Richard Greenbury to examine the remuneration of directors, particularly compensation packages, large pay increases and share options. The Greenbury Report put forward a code of best practice and established the remuneration committee composed of non-executive directors, which became responsible for executive director remuneration. Again the majority of the recommendations were endorsed by the Listing Rules.

6.6.3.3 The Hampel Report and Original Combined Code (1998)

Not long after the Greenbury Report had been published, a number of institutions (the London Stock Exchange, the Confederation of British Industry, the Institute of Directors, the Consultative Committee of Accountancy Bodies, the National Association of Pension Funds and the Association of British Insurers) decided that the time was right to review the extent to which Cadbury and Greenbury had been implemented and whether their purposes were being achieved.

The Hampel Report of the Committee on Corporate Governance was published in 1998, together with a summary of conclusions and recommendations. These, following further consultation by the London Stock Exchange, became the Combined Code on Corporate Governance (the Original Combined Code), which applied to all listed companies from 31 December 1998 until it was superseded by the revised Code in 2003.

An important aspect of the Original Combined Code was the provisions relating to internal control. These were translated into the Listing Rules, which required listed companies to include a narrative statement in their annual report of how the internal control provisions had been applied or, if they had not been, to explain why not.

However, there was little guidance in the Combined Code as to how these provisions should be applied by companies.

6.6.3.4 The Turnbull Report (1999)

This led to the establishment of a working group under the auspices of the Institute of Chartered Accountants in England and Wales, chaired by Nigel Turnbull. The resulting report, *Internal Control: Guidance for directors on the Combined Code*, was issued in September 1999 and endorsed by the London Stock Exchange as consistent with the Original Combined Code.

6.6.3.5 The Myners Review (2001)

Paul Myners' review of institutional investment was commissioned by the government as a result of the investigation of possible distortions in institutional investment decision making and concern over the reluctance of institutional investors to tackle corporate underperformance in companies in which they invest.

It included suggestions for the improvement of communication between investors and companies, and encouraged institutional investors to consider their responsibilities as owners and how they should exercise their rights on behalf of beneficiaries.

6.6.3.6 The Directors' Remuneration Report Regulations (2002)

In 2002 the Directors' Remuneration Report Regulations were introduced to strengthen further the powers of shareholders in relation to directors' pay. The regulations increase the amount of information shareholders are given on directors' remuneration and certain disclosures, as well as performance graphs. Shareholders may vote in an advisory capacity to approve the directors' remuneration report.

6.6.3.7 The Higgs Report (2003)

In July 2002, following a review of company law, the Department of Trade and Industry (DTI) and the Treasury commenced a review of the Combined Code, which was conducted by Derek Higgs. The Higgs Report, *The Role and Effectiveness of Non-executive Directors*, was published in 2003.

It raised the agenda of boardroom effectiveness and made a number of recommendations to give a more active role to independent directors. It gave a definition of 'independence' and stressed the importance of having the right proportion of independent non-executive directors on the board and its committees. The role of the senior independent director was to provide an alternative channel to shareholders and to lead evaluations of the chairman's performance. One of the recommendations highlighted the importance of the nomination process to the board and emphasized a transparent and rigorous process and evaluation of the performance of the board, its committees and individual directors.

6.6.3.8 The Smith Report (2003)

Some two months into Derek Higgs' review, the Financial Reporting Council set up a group under the chairmanship of Sir Robert Smith to develop guidance on audit committees in the Combined Code. The ensuing Smith Report was published in January 2003.

6.6.3.9 The Tyson Report (2003)

Following the publication of the Higgs and Smith Reports, the DTI commissioned the Tyson task force under the chairmanship of Professor Laura D'Andrea Tyson, dean of London Business School, which published *The Tyson Report on the Recruitment and Development of Non-executive Directors* in 2003.

6.6.3.10 The Revised Combined Code (2003)

The recommendations made in these three reports (Higgs, Smith and Tyson) instigated changes to the Combined Code. The Financial Reporting Council (FRC), a body established by the government and comprising members from industry, commerce and the professions, issued the Revised Combined Code in July 1993. The FRC was appointed the guardian of the Combined Code and established a committee to keep it under review. The most recent update was issued in June 2008.

6.6.3.11 The Turnbull Review (2004)

In 2004 the FRC established the Turnbull Review Group to consider the impact of its original guidance for directors on internal control and to determine whether it needed to be updated. In 2005, *Internal Control: Revised guidance for directors on the Combined Code* was published, reiterating the board of directors' responsibility for the company's system of internal control and risk management.

6.6.3.12 The Operating and Financial Review (OFR) and Business Review

In 1998 the UK government instigated a company law review and produced a White Paper in 2002, which put forward a number of proposals relating to company reporting. A significant development was the requirement for companies to produce a mandatory operating and financial review (OFR) to provide information on the company's current and prospective performance and strategy. This came into effect on 1 April 2005.

However, on 28 November 2005, after reconsidering the matter, the government announced its intention to remove the statutory requirement for quoted companies to publish an OFR. Instead, all companies, public and private, with the exception of those private companies that fall under the definition of 'small companies', need to produce a business review as part of their directors' report. The Companies Act 2006 requires UK-quoted companies to follow the enhanced business review reporting.

6.6.3.13 The Revised Combined Code (2008)

The latest version of the Revised Combined Code was issued by the FRC in June 2008, following subsequent consultation on possible amendments to the Code. This Code supersedes and replaces the versions of the Combined Code issued in 2003 and 2006. The full text of the Code can be found on the FRC website, www.frc.org.uk.

The FRC may be the custodian of the Code but compliance is a matter for the Listing Rules. Produced by the Financial Services Authority, these Rules regulate companies with a full listing on the London Stock Exchange.

For a quoted company, reporting on its application of the Code is one of its continuing obligations under the Listing Rules published by the UK Listing Authority (UKLA). The Code does not form part of the UKLA Listing Rules, but is appended to them. It is a voluntary code, but since a statement of compliance with it is required by the Listing Rules to be included in each annual report, there is an element of compulsion.

The Code does not apply to companies whose shares are traded on the Alternative Investment Market (AIM) or other markets not covered by the Listing Rules, although companies listed on AIM are recommended to have regard to its provisions. Nor does the Code apply to listed companies incorporated outside the United Kingdom, though such companies do have a lesser reporting obligation. There is, though, nothing to stop such companies complying with the Code if they choose to do so. Shareholder pressure, or simply a wish to conform to 'best practice', may lead many 'exempt' companies to follow some or all of the Code's recommendations.

Most of the Code's principles, if not all the detailed provisions, provide a sound basis for the governance of many companies, and indeed it has had a noticeable wider impact on the governance of non-quoted companies. It has been the impetus for the development of a more formalized approach to governance among charities and other not-for-profit organizations and in the public sector. Universities have produced their own governance code; public-sector bodies have guidance from the Independent Commission on Good Governance in Public Services. And mutual life companies are expected to follow guidelines on governance produced in the wake of the Equitable Life inquiry.

All the UK reports and codes, including the latest revised 2008 version, have taken the 'comply or explain' approach.

The Code is divided into main principles, supporting principles and provisions. The main principles are general statements of corporate life. Supporting principles expand on the main principles and give more guidance. But it is the Code's provisions that state the detailed requirements necessary for upholding the principles.

For both main principles and supporting principles a company has to state how it applies those principles. There is deliberately no prescribed form, the intention being to allow companies a free hand to explain their governance policies. In relation to the Code provisions a company has to state whether it complies with the provisions or give an explanation where it does not. It is the Code provisions that contain the detail on matters such as separation of the roles of chairman and chief executive, the ratio of non-executive directors and the composition of the main board committees.

The 'comply or explain' basis of the Combined Code offers a degree of flexibility, but must be treated with care by both companies and investors. The expression has now become common parlance, but companies should not use it as an excuse to ignore the provisions. If they do this or provide unconvincing explanations, they rightly run the risk of investors attacking their standards of governance. On the other hand, analysts and investors must get away from a 'box-ticking' approach and take seriously any proper explanations of 'non-compliance'.

The first principle of the Code states that 'Every company should have an effective board.' The board's effectiveness is widely regarded as a prerequisite for sustained corporate success. The quality and effectiveness of directors determine the quality and effectiveness of the board. Formal processes for appointment, induction and development should be adopted. Effectiveness of the board and its individual members has to be assessed. The Code states that no one individual should have unfettered powers of decision making. It sets out how this can be avoided by splitting the roles of chairman and chief executive, and specifies what the role of the beginning chairman should be. The Code offers valuable guidance on the ratio of non-executive to executive directors and definitions of independence.

For the provisions, companies must either confirm that they have complied with them or, where they have not, provide an explanation.

Main Principles of the Revised Combined Code (2008)

A. Directors

The Board (A.1)

Every company should be headed by an effective board, which is collectively responsible for the success of the company.

Chairman and chief executive (A.2)

There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.

Board balance and independence (A.3)

The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.

Appointments to the board (A.4)

There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.

Information and professional development (A.5)

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

Performance evaluation (A.6)

The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

Re-election (A.7)

All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.

B. Remuneration

The level and make-up of remuneration (B.1)

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of directors' remuneration should be structured so as to link rewards to corporate and individual performance.

Procedure (B.2)

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

C. Accountability and Audit

Financial reporting (C.1)

The board should present a balanced and understandable assessment of the company's position and prospects.

Internal control (C.2)

The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

Audit committee and auditors (C.3)

The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

D. Relations with Shareholders

Dialogue with institutional shareholders (D.1)

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.

Constructive use of the AGM (D.2)

The board should use the AGM to communicate with investors and to encourage their participation.

E. Institutional Shareholders

This section, the second, is not subject to any sanction, but it does stress the need for institutional shareholders to consider carefully explanations for departure from the Combined Code and make a reasoned judgement in each case.

Dialogue with companies (E.1)

Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of the objectives.

Evaluation of governance disclosures (E.2)

When evaluating a company's governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.

Shareholder voting (E.3)

Institutional shareholders have a responsibility to make considered use of their votes.

Schedule A: Provisions on the design of performance related remuneration
Schedule B: Guidance on liability of non-executive directors: care, skill and diligence
Schedule C: Disclosure of corporate governance arrangements

6.6.4 Legal, Regulatory and Institutional Bodies

Much of the United Kingdom's corporate governance structure is determined by a series of regulatory bodies. Between them they cover a whole range of duties, from setting accounting standards and policing their compliance to the listing of company securities.

6.6.4.1 The Financial Services Authority (FSA)/UK Listing Authority (UKLA)

The FSA is an independent non-governmental body given statutory powers by the Financial Services and Markets Act 2000 (FSMA). It is a company limited by guarantee and financed by the financial services industry. Under the FSMA the FSA board is appointed by the Treasury.

Much UK financial services regulation originates in the European Union. Indeed, around 70 per cent of the FSA's policy-making effort is driven by EU initiatives, including the Financial Services Action Plan (FSAP).

Under various EU Directives each member state had to identify a single competent authority for listing. The United Kingdom named the FSA, which, when acting as the competent authority, is referred to as the UK Listing Authority (UKLA). The UKLA has taken over the listing function from the Stock Exchange and has published the Listing Rules as part of its *FSA Handbook of Rules and Guidance*, formerly known as *The UKLA Sourcebook*. In this capacity the FSA is responsible for the listing requirements relating to the Combined Code.

The *FSA Handbook of Rules and Guidance* also includes the Disclosure and Transparency Rules, bringing into UK law provisions from the European Union's Transparency Directive, and designed to ensure greater transparency as to the ownership and control of corporate entities.

According to the 2006 Oxera Report, commissioned by the FSA, the latter is planning to switch to principles-based regulation where it can, to minimize compliance costs incurred by financial services firms, and ultimately by the users of the financial services: private individuals and companies.

Further information is available on www.fsa.org.uk.

6.6.4.2 The Financial Reporting Council (FRC)

The FRC is the United Kingdom's independent regulator responsible for promoting confidence in corporate financial reporting and governance. It was established by the government and it comprises members from industry, commerce and the professions.

The FRC's functions are exercised principally by its operating bodies: the Accounting Standards Board, the Auditing Practices Board, the Board for Actuarial Standards, the Professional Oversight Board, the Financial Reporting Review Panel and the Accountancy Investigation and Discipline Board. The Committee on Corporate Governance, whose members are drawn from the board, assists it in its work on corporate governance.

The FRC has played a key role in corporate governance and is the body charged with oversight of the Combined Code; in this capacity it took forward the recommendations of the Higgs Review and the Smith Report and issued the revised Combined Code in 2003; further revisions were made in 2006 and in 2008.

Further information is available on www.frc.org.uk.

6.6.4.3 The London Stock Exchange (LSE)

The LSE provides a regulated primary and secondary market for securities. As of June 2008 the official List included 1,216 UK listed companies, plus an additional 337 international listed companies. The Alternative Investment Market (AIM) had 1,657 companies listed.

The distinction between a full listing and an AIM listing is important, since the Combined Code (and its predecessors) applies only to companies with a full listing. As the AIM market is made up of younger, smaller companies, they are not yet eligible for the Official List.

Further information is available on www.londonstockexchange.com.

6.6.4.4 The National Association of Pension Funds (NAPF)

The NAPF is the principal UK body representing the interests of workplace pensions. Among its 1,300 members are both large and small companies, local authority and public-sector bodies. The member organizations provide pensions for over 10 million employees and 5 million people in retirement, with combined assets in excess of £800 billion. They account for 75 per cent of occupational scheme assets in the United Kingdom and control 20 per cent of the shares of the London Stock Market.

The NAPF supported the Myners Report on institutional investment in the United Kingdom, together with a set of voluntary principles for occupational pension schemes, which was published in 2001. At present the NAPF is reviewing the Myners principles on behalf of the Treasury.

Further information is available on www.napf.co.uk.

6.6.4.5 The Confederation of British Industry (CBI)

Founded in 1965, the CBI is a non-profit-making, non-party-political organization funded by the subscriptions paid by its corporate members. The CBI's objective is to help create and sustain conditions in which business in the United Kingdom can compete and prosper. It exists to ensure that the government of the day, the European Commission and the wider community understand both the needs of British business and the contribution it makes to the well-being of UK society.

Further information is available on www.cbi.org.uk.

6.6.4.6 The Institute of Chartered Accountants of England and Wales (ICAEW)

As a world-leading professional accountancy body, the Institute of Chartered Accountants in England and Wales (ICAEW) provides leadership and practical support to over 130,000 members in more than 160 countries, working with government, regulators and industry in order to maintain the highest standards among the accountancy profession.

Since the establishment of the Cadbury Committee in 1991, the ICAEW has played a significant role in the development of corporate governance in the United Kingdom. The *Turnbull Guidance on Internal Control* was published by the ICAEW in 1999 and was approved by the US Securities and Exchange Commission as a framework for compliance with section 404 of the Sarbanes–Oxley Act.

In 2005 the ICAEW provided staff support to the Financial Reporting Council in producing the *Revised Guidance for Directors on the Combined Code* in relation to internal control.

Further information is available on www.icaew.co.uk.

6.6.4.7 The Institute of Chartered Secretaries and Administrators (ICSA)

The ICSA is the professional body for chartered secretaries, with 44,000 members in the United Kingdom and 28,000 students in over 70 countries. It is committed to raising company secretaries' professional standards, and provides a number of professional courses for its students in company law, accounting, corporate governance, administration, company secretarial practice and management.

Further information is available on www.icsa.org.uk.

6.6.4.8 The Institute of Directors (IoD)

The IoD is a politically independent membership organization for over 53,000 individual directors. It was established in 1903 and granted a Royal Charter in 1906. The Institute's motto is 'enterprise and integrity'.

The IoD is the world's most experienced and long-standing organization advocating director professionalism and boardroom excellence. Within its remit to develop director professionalism, the Institute's main activities are:

- to educate, and enhance the professionalism of, directors and boards through development programmes, certification and evaluation;
- to develop, set and monitor standards of director professionalism;
- to represent and advocate the interests of its members to government and civil society;
- to research, publish and formulate policy on issues of relevance to directors;
- to support directors through the provision of information and advice relevant to the strategic direction of companies.

The IoD produces a wide range of publications on the subject of directors' duties and boardroom practice, including such flagship titles as *The Director's Handbook: Your duties, responsibilities and liabilities*, *The Effective Director: Building individual and board success* and *The IoD Handbook of International Corporate Governance*. With over 100 years' experience in supporting business leaders and representing their views, the UK IoD plays a significant role in the international business environment through its global network of affiliates and branches, IoD International.

As a founding member of the Global Director Development Circle (GDDC), the IoD continues to broaden its international influence. The GDDC is made up of the leading professional membership organizations for directors across six continents and aims to foster close cooperation between member organizations, sharing knowledge and good practice on national, regional and global levels.

In addition, the IoD continues to develop its influence across continental Europe, where it has an expanding network of proactive members and IoD branches. Along with strengthening the range of membership benefits available in continental Europe, the IoD represents the views of its members at EU level as one of the founding members of the new European Confederation of Directors' Associations (ECODA), an influential voice for directors.

Further information is available on www.iod.com and www.ecoda.org.

6.6.5 The Role and Structure of a Board of Directors

6.6.5.1 Composition

The first directors of a company are appointed at the time of its registration. Subsequent appointments are governed by the company's articles of association, which will prescribe the way directors are to be appointed and, often, a minimum and maximum number of directors. Typically the articles will provide for the board of directors to fill any casual vacancies or to appoint additional directors up to the maximum number specified by the articles.

For companies with a full listing on the London Stock Exchange, there will be further requirements under the Combined Code on Corporate Governance. (Note that the Code does not apply to AIM-listed companies and includes some concessions for smaller companies.)

Key to a successful, productive board is a good balance. There should be a mix of independent non-executive directors and executive directors and, importantly, a mix of skills and experience.

The Combined Code states that at least 50 per cent of the members of the board should be independent directors and that the roles of chairman and chief executive should be separated. Further, it says that the chairman should not be a former chief executive. When companies believe they have a good reason to go against these recommendations, they need to state their case in their annual reports.

In the United Kingdom all directors have the same basic duties and liabilities whether they are executive (full-time employed) or non-executive. The existence of non-executive directors and the split of the roles of chief executive and chairman depend, to a certain extent, on the size and type of company.

The importance of non-executive directors in improving both accountability and company performance has long been recognized. The past five years have seen more than a 10 per cent increase in the number of non-executive positions on boards in FTSE 350 companies and a 20 per cent reduction in the number of executive directors. In many companies the role of the chairman will have changed from executive to non-executive.

As shown in Table 6.6.1, the average FTSE 350 board has 10 members – 6 non-executive directors (including the chairman) and

4 executive directors – which has been the case for the past three years. It is unlikely that we will see further significant increases in the number of non-executive directors in FTSE 350 companies.

The question of the independence of non-executive directors has been of increasing concern in the United Kingdom in recent years and is essentially considered an attitude of mind and a matter of personality. Different measures have been adopted by different organizations, institutions and associations to measure independence. This has been a problem for companies in two main ways. First, they have had to deal with sometimes conflicting criteria; and second, a 'tick-box mentality' has arisen, with standardized checklists being used by analysts and commentators.

In relation to composition, there is concern that the limited range of appointees to boards, particularly non-executive directors and chief executives, has resulted in the boards of UK companies being less effective than they could be. While there is little support for notions of diversity for its own sake, there is strong recognition that traditional methods of recruitment of directors through personal contacts have tended to act as a barrier to expanding the diversity of boards. Since the publication of the Original Combined Code in 1998, one of the principles has been that companies should have a 'formal and transparent procedure for the appointment of new directors to the board'. They must, unless 'the board is small', establish a nomination committee.

The stereotypical white, male, middle-class board remains the norm. According to a Deloitte & Touche 2007 research finding, the typical age of an executive director is between 45 and 55 with an average of 50 years. For women directors the average age is 47. Non-executive directors are generally older, typically between 53

Table 6.6.1 *Average number of executive and non-executive directors*

Type of company	Chairman	Executive directors	Non-executive directors	Total
Largest 100 companies (FTSE 100)	1	4	7	12
Largest 101–350 companies listed on the stock exchange (FTSE 350)	1	4	5	10

Source: Deloitte & Touche LLP, September 2007 and 63 with an average of 58. Around 5 per cent of executive directors are under the age of 40.

In September 2007 only 4 per cent of executive directors in FTSE 350 companies were women. Only nine FTSE 350 companies were headed by a woman chief executive. This figure is in stark contrast to the 30 per cent of women managers. The percentage of women directors increases with the size of company. Women non-executive directors constitute 21 per cent in FTSE 350 companies (13 per cent in FTSE 100 companies and 8 per cent in FTSE 250 companies). There are only two women non-executive chairmen and three women deputy chairmen in the top 350 companies, which is fewer than in the previous year.

The ethnic composition of boards shows even less diversity. Only 7 per cent of directors are not British, with just 1 per cent from ethnic minority groups.

Board Composition

- Determine and regularly review board composition and identify any need for changes in board membership (including the chairman) and the timing thereof.
- Identify any gaps or (undesirable) overlap between individual directors' roles and responsibilities; plan and execute corrective action required.
- Select, appoint, induct, develop or remove board members or company secretary.
- Ensure regular and rigorous appraisal of the competence of all board members.
- Identify and select external advisers when in-house expertise is insufficient.
- Consider the ratio and number of executive and non-executive directors.
- Consider the energy, experience, knowledge, skills and personal attributes of current and prospective directors in relation to the future needs of the board as a whole, and develop specifications and processes for new appointments, as necessary.

- Consider the cohesion, dynamic tension and diversity of the board and its leadership by the chairman.
- Make and review succession plans for directors and the company secretary.
- Where necessary, remove incompetent or unsuitable directors or the company secretary, taking relevant legal, contractual, ethical, and commercial matters into account.
- Agree proper procedures for electing a chairman and appointing the managing director and other directors.
- Identify potential candidates for the board, make the selection and agree terms of appointment and remuneration.
- New appointments should be agreed by every board member.
- Provide new board members with a comprehensive induction to board processes and policies, inclusion to the company and their new role.
- Monitor and appraise each individual's performance, behaviour, knowledge, effectiveness and values rigorously and regularly.
- Identify development needs and training opportunities for existing and potential directors and the company secretary.

6.6.5.2 Matters Reserved to the Board

One of the board's earliest jobs is to decide the way it will work and to identify and agree the things that cannot be delegated. Following on from that, and cascading through the organization, will be a delegation of powers – to the executive committee, the subsidiary boards where applicable, and the senior management.

In its guide to best boardroom practice, *The Effective Director*, the IoD identifies the following key tasks of the board:

- to establish and maintain vision, mission and values;
- to decide the strategy and the structure;

- to delegate authority to management and monitor and evaluate the implementation of policies, strategies and business plans;
- to account to shareholders and be responsible to stakeholders.

6.6.5.3 The Role of a Chairman

The chairman's primary role is to ensure that the board is effective in its tasks of setting and implementing the company's direction and strategy.

The chairman is appointed by the board and has the same legal duties as other directors. The position may be full or part time. The role is often combined with that of managing director / chief executive in smaller companies. However, the joint role is considered inappropriate for public companies listed on the Stock Exchange.

The main features of the role of chairman are as follows:

- providing leadership for the board;
- taking responsibility for the board's composition and development;
- ensuring that the board receives proper information;
- planning and conducting board meetings effectively;
- getting all directors involved in the board's work;
- ensuring that the board focuses on its key tasks;
- engaging the board in assessing and improving its performance;
- overseeing the induction and development of directors;
- supporting the chief executive / managing director.

6.6.5.4 The Role of a Managing Director/Chief Executive

The managing director or chief executive is the most senior full-time executive of the company (except when there is an executive chairman). The role of managing director (MD) and chief executive (CEO) are virtually the same. (The latter title originally comes from the United States.)

An MD is responsible for the performance of the company, as dictated by the board's overall strategy. He or she reports to the chairman or board of directors. The MD's responsibilities include:

- formulating and successfully implementing company policy;
- directing strategy towards the profitable growth and operation of the company;
- developing strategic operating plans that reflect the longer-term objectives and priorities established by the board;
- maintaining an ongoing dialogue with the chairman of the board;
- putting in place adequate operational planning and financial control systems;
- ensuring that the operating objectives and standards of performance are not only understood but owned by the management and other employees;
- closely monitoring the operating and financial results against plans and budgets;
- taking remedial action where necessary and informing the board of significant changes maintaining the operational performance of the company;
- monitoring the actions of the functional board directors;
- assuming full accountability to the board for all company operations;
- representing the company to major customers and professional associations;
- building and maintaining an effective executive team.

6.6.5.5 Separation of the Roles of Chairman and Managing Director

The chairman is the person who leads and runs the board, whereas the MD leads and runs the company.

The recommendation that the roles of chairman and MD should be separated first came to prominence in the code of best practice set out in the Cadbury Report. This has been a contentious issue; however, the figures show that although there are still joint role-holders there is in general a high level of compliance, particularly among larger listed companies. According to Deloitte & Touche 2007 research findings, only three FTSE 100 companies and eight FTSE 250 companies had a combined role.

6.6.5.6 *The Role of a Non-executive Director*

Essentially the non-executive directors' role is to provide a creative contribution to the board by providing objective criticism.

The 1992 Cadbury Report initiated a debate about the main functions and responsibilities of non-executive directors. Today, it is widely accepted that non-executive directors have an important contribution to make to the proper running of companies and, therefore, more widely to the economy at large. As the Cadbury Report said, they 'should bring an independent judgement to bear on issues of strategy, performance and resources including key appointments and standards of conduct'.

There is no legal distinction between executive and non-executive directors. As a consequence, in the UK unitary board structure non-executive directors have the same legal duties, responsibilities and potential liabilities as in the growing number of private companies, including executive counterparts. Clearly, it is appreciated that non-executive directors cannot give the same continuous attention to the business of the company. However, it is important that they show the same commitment to its success as their executive colleagues.

All directors should be capable of seeing company and business issues in a broad perspective. Nonetheless, non-executive directors are usually chosen because they have a breadth of experience, are of an appropriate calibre and have particular personal qualities. Additionally, they may have some specialist expertise or, perhaps, key contacts in related industries or the City.

Not all non-executive directors are the same. There is a difference between the non-executive director and the independent non-executive director. 'Independent' directors are defined in the Cadbury Report as persons who 'apart from directors' fees and shareholdings [are] independent of the management and free from any business or other relationships which could materially interfere with the exercise of the independent judgement'. The Cadbury, Hampel and Higgs reports, some of whose recommendations are included in the revised Combined Code, stress that the board should include independent non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's deliberations.

The Combined Code, which effectively codifies the main features of the Cadbury, Hampel and Higgs reports for listed companies, advises that the balance of executive and non-executive directors should be such that no individual or small group of individuals can dominate the board's decision taking. Non-executive directors should comprise not less than half the board.

While much of the comment and discussion on non-executive directors tends to focus on listed companies, it is important to note that they can also make a valuable, albeit somewhat different, contribution to private companies. Indeed, there are a growing number of private companies, including relatively small ones, that are now actively searching for the 'right' non-executive director.

Non-executive directors are expected to focus on board matters and not stray into 'executive direction', thus providing an independent view of the company that is removed from its day-to-day running. Chairmen and chief executives should use their non-executive directors to provide general counsel – and a different perspective – on matters of concern. They should also seek their guidance on particular issues before they are raised at board meetings. Indeed, some of the main specialist roles of a non-executive director will be carried out in a board subcommittee, especially in listed companies.

Key Responsibilities of Non-executive Directors (NEDs)

- *Strategic direction*. As an 'outsider', the NED may have a clearer or wider view of external factors affecting the company and its business environment than the executive directors. The normal role of the NED in strategy formation is therefore to provide a creative and informed contribution and to act as a constructive critic in looking at the objectives and plans devised by the MD and his or her executive team.
- *Monitoring*. NEDs should take responsibility for monitoring the performance of executive management, especially with regard to the progress made towards achieving the determined company strategy and objectives.
- *Communication*. The company's and board's effectiveness can benefit from outside contacts and opinions. An important function for NEDs, therefore, can be to help connect the business and board with networks of potentially

useful people and organizations. In some cases the NED will be called upon to represent the company externally.

- *Audit*. It is the duty of the whole board to ensure that the company accounts properly to its shareholders by presenting a true and fair reflection of its actions and financial performance and that the necessary internal control systems are put into place and monitored regularly and rigorously. NEDs have an important part to play in fulfilling this responsibility, whether or not a formal audit committee (composed of NEDs) of the board has been constituted.

6.6.5.7 Committees

The board delegates powers to its main committees and lays out formal terms and conditions for them, which it reviews annually. The Combined Code and the Stock Exchange Listing Rules oblige a company to have three committees on board – the audit, remuneration and nomination committees – or explain why not.

Of the three committees the remuneration committee is the most universally adopted, followed closely by the audit committee, with the nomination committee lagging some way behind. According to Deloitte & Touche 2007 research findings, all but one FTSE 350 companies have established remuneration and audit committees.

The Remuneration Committee

The remuneration committee plays a pivotal role in ensuring that the executive remuneration strategy is aligned with the company's strategy and that pay is linked to performance. It is vital that decisions on executive remuneration, benefits and bonuses are seen to be taken by those who do not stand to benefit directly from them. As a matter of good practice, executive directors should not be responsible for determining their own remuneration. The Combined Code recommends that this should be the remit of a remuneration committee made up wholly or mainly of NEDs. In listed companies and some larger private companies, therefore, policy on executive remuneration is usually decided by a committee of NEDs.

The board retains ultimate responsibility for the setting of directors' pay and rewards and, in line with the Higgs guidance, the performance of members of the remuneration committee should be reviewed annually.

Shareholders now have the right to an advisory vote on the remuneration report.

The Audit Committee

The audit committee is intended to provide a link between auditor and board independent of the company's executives, since the latter are responsible for the company's accounting rules and procedures that are the subject of the audit. The committee may thus help the board discharge its responsibility with regard to the validity of published statements. The Combined Code recommends that all members of the audit committee should be independent NEDs.

The audit committee frequently encompasses risk within its remit. Where it does not, companies tend to have a separate risk committee.

The Nomination Committee

One of the board's most crucial functions is to decide on new appointments to the board and to other senior positions in the company. As a matter of good practice the selection process of directors should be carried out by the nomination committee, which then makes recommendations to the full board. The committee should be composed of executive and non-executive directors (the latter should be in a majority), whose task it is to ensure that appointments are made according to agreed specifications. Where implemented, the appraisal of directors is often tied directly into the selection and nomination process.

Other Committees

Depending on their size and nature, individual companies may also have other committees, either standing or *ad hoc*. In businesses with significant borrowings in multiple currencies there may be a case for a *treasury committee*. In some companies where health and safety risks and hazards are potentially high, such as airlines, railways and petrochemical businesses, there will be a separate *health and safety committee*.

6.6.5.8 *Appraisal and Review*

The Combined Code requires chairmen of all listed companies to meet with the NEDs separately each year, and the senior independent director to meet with the NEDs to appraise the chairman's performance each year.

All directors will want to see that the board operates well, and the tool that most boards use to establish theirs is an annual board effectiveness review. The review is often 'outsourced' to a consultant or a professional body such as the Institute of Directors.

Board Effectiveness Review: The Key Elements

Corporate Strategy

- The corporate strategy is clearly understood by the board, shareholders and employees.
- Corporate strategy is regularly reviewed and updated to ensure its continued appropriateness, support and effectiveness.
- Directors have collectively and individually brought their knowledge and experience to bear in the testing and development of group strategy.
- Strategic options are effectively and systematically evaluated.
- There is an effective and productive process for the review and updating of group strategy.

Business Principles

Business principles:

- are owned and championed by the board;
- are underpinned by a set of clear and comprehensive group policies, approved by the board;
- are reviewed annually by the board and updated to ensure their continued appropriateness, support and effectiveness;

- are explicit, unambiguous and practicable;
- are championed by the executive management group;
- provide appropriate guidance and motivation to all staff;
- are effectively communicated to shareholders and other stakeholders.

Internal Controls and Risk Management

- There is a clear and comprehensive framework of risk-based internal controls to implement the group policies adopted by the board and thereby manage significant risks.
- Significant risks are effectively identified and evaluated.
- The board effectively assesses and monitors the system of internal controls and the effectiveness with which risk is being managed.

Shareholders and Stakeholders

- The group strategy is effectively communicated to shareholders and other stakeholders.
- The board receives sufficient information about the views of shareholders and other stakeholders from relevant external sources.

Communications

- The timing, coverage and quality of shareholder and stakeholder communications are appropriate.
- The board communicates effectively with the executive management group.
- The organization has the resources, skills and experience to manage the key risks and deliver the business plan.

Organization and Culture

- The group culture encourages continuous improvement.
- Performance reporting is adequate and timely, and ensures prompt capture of adverse trends.
- Variances from budget are clearly identified and corrective actions are detailed.
- Management performance is regularly and thoroughly reviewed, and rewards or sanctions are executed promptly.

Succession, Development and Reward

- There is an appropriate succession management plan for all board and executive management group positions.
- Training and development are encouraged and are focused on the delivery of the business plan.
- The range of rewards is suited to recruiting and retaining qualified, capable and high-quality staff.
- Rewards are structured to focus on short-, medium- and long-term performance.

Board Composition

- The present board membership and composition are optimal for the company, given its current needs.
- The range of skills, knowledge and experience is appropriate.
- The process for identifying and recruiting new board members is transparent and appropriate.

Board Induction and Training

- There is a comprehensive programme to provide new non-executive directors with an induction to the group.

- Directors are kept up to date with the latest developments in the regulatory and legal environment and how these affect their responsibilities.
- There is a comprehensive training programme for directors to refresh their knowledge and skills.

Delegation and Accountabilities

- The matters reserved for the board are appropriate.
- The present range of committees is capable of addressing all areas that should be reviewed on behalf of the board.
- The committee chairs report appropriate and timely information on their activities to the whole board.
- The board delegates appropriate authority to senior management.

Board Meetings

- The agenda includes only what is important.
- Agenda items and presentations are relevant and timely.
- The agenda allows the appropriate amount of time for the discussion of each item.
- The time allowed for each item is appropriately allocated to ensure proper consideration of key issues.
- The schedule of meetings, lunch and dinner allows adequate time for discussion, participation and reflection.
- Meetings are of high quality and are productive, with a full and open discussion of issues.
- Board visits to overseas assets are useful and effective.

Secretarial Service

- Board papers are received in sufficient time.
- Board papers are sufficiently clear and concise.
- The minutes accurately reflect the substance of the discussions.

- Minutes are distributed in a timely manner.
- Action points from the meetings are properly followed through.
- The board receives appropriate information on the activities of all its committees and subcommittees.
- The board receives timely and comprehensive advice on matters of governance relevant to items on discussion.
- The AGM venue and arrangements are appropriate.

Other

- In which area(s) do you believe the board operates most effectively?
- In which area(s) do you believe the board operates least effectively?

6.6.6 Disclosure and Transparency

6.6.6.1 Remuneration

Factors That Have Influenced Boardroom Pay over the Past Quarter-century

- Changes to the tax regime during the Thatcher years saw a move towards lucrative share option plans.
- In the past 12 years, executive pay has come under the scrutiny of five separate corporate governance committees.
- Institutional shareholder bodies are taking a progressively more prescriptive approach.
- The government has intervened to promote transparency and increase shareholder power.

Directors' pay has long been an emotive and ongoing issue in UK boardrooms.

In the ten years up to 1979, successive periods of statutory and voluntary pay controls compressed differentials between executives and other employees. High marginal tax rates had reduced the incentive effect of cash remuneration increases. Under the first Thatcher administration, marginal tax rates were lowered and new, 'approved' executive share option plans were given favourable tax treatment.

The late 1980s saw an escalation in executive pay packages, fuelled by lower inflation, a bullish stock market and improving company performance. Base salaries rose; annual bonus plans and share option plans offered the prospect of significant wealth creation for executives in public limited companies.

The early 1990s saw the privatization of utility companies, when many directors were awarded large pay increases and made large amounts of money from share options. These were sometimes coincident with staff reductions, pay restraint for staff and price increases. They led in some cases to shareholder revolts. At the same time, there was public concern about payments to departing directors. Increasing executive remuneration levels and wider pay differentials have led the media to concentrate its attention on so-called fat cats and executive greed. It was these issues that led to the establishment of the committee under the chairmanship of Sir Richard Greenbury, which produced the Greenbury Report on directors' remuneration in 1995.

The lasting legacy of the Greenbury Report was the establishment of the remuneration committee. Other related aspects of the report included:

- the approval by shareholders of new long-term incentive schemes (including option schemes);
- notice periods being reduced to one year or less;
- terms of directors' contracts avoiding rewarding failure.

In essence, these provisions form the basis for the Combined Code, which has built on them and strengthened them, but not radically altered them.

In contrast to the 1960s and 1970s, when governments intervened through pay policy to control executive pay, the government's emphasis over the past 20 years has been on the taxation environment and wider governance issues. Despite concerns about the role executive remuneration played in the high-technology boom and bust, and the linking of executive remuneration practices to accounting and company scandals in the United States, the response of the UK government has largely been to put further onus on shareholders to deal with the issues.

The most recent significant government intervention was the adoption of the Directors' Remuneration Report Regulations (2002). These regulations applied to quoted companies and were designed to provide a framework of greater openness and further increase shareholder powers. Under the regulations:

- Quoted companies must publish a detailed report on directors' pay as part of their annual reporting cycle. Disclosure requirements both about facts and policies have increased. The report must be approved by the board of directors.
- A graph of the company's total shareholder returns over five years, against a broad equity index, must be published in the directors' remuneration report.
- The names of any advisers to the remuneration committee and the fees paid for their services must be disclosed, along with whether they were appointed independently.
- Companies must hold a shareholder vote on the directors' remuneration report at each annual general meeting.

The aspect that has received most publicity has been the introduction of a vote by shareholders to approve the directors' remuneration report. Individual directors' entitlement to remuneration is not affected by the vote, so it is an advisory vote. However, the first 'reporting season' since the introduction of the regulations in 2003 saw significant shareholder activity, which included a vote against the directors' remuneration report of GlaxoSmithKline plc. Marconi, Prudential and Sainsbury's are all examples of companies where institutional investors have launched concerted attacks on remuneration policy.

The most visible sign of the new shareholder activism has been the shortening of service contracts. At one time, 3- or even 5-year periods were normal, but now everybody is striving to bring them down to 12 months.

When the Higgs Report was published in 2003, it contained recommendations on the role and operation of the remuneration committee, which have been since incorporated into the Combined Code on Corporate Governance, annexed to the Listing Rules of the UKLA.

The inquiry committees have focused primarily on the corporate governance issues associated with directors' remuneration; they have (with the notable exception of the Higgs Report) been more cautious as to what defines best practice in terms of the make-up of the executive remuneration package. By contrast, the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF) and other institutional investors have taken an increasingly more prescriptive approach to executive remuneration policy and practice. Their interest in executive remuneration started with the growth of executive and all-employee share and share option plans in the 1970s and 1980s, and the need to protect shareholders from equity dilution. From 1995 onwards their guidance on executive remuneration expanded significantly to include aspects of contracts, severance arrangements, pay–performance linkage, long-term incentive design, grant levels, grant patterns of all long-term incentive arrangements and market–pay comparisons.

In 2002 the ABI and NAPF published *Guidelines on Executive Remuneration*, including best practice on contracts and severance. As the representatives of the large UK shareholders, the ABI and NAPF do not guarantee their members' support or rejection of companies' executive remuneration proposals, but their review committees and guidelines are a useful input into remuneration committee deliberations. The fact that the guidelines have expanded in content, and increased in specificity, indicates clearer direct interest by shareholders in setting directors' remuneration.

Another major trigger for change has been International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS), which became 'official' on 1 January 2005, according to which share options must now be shown as expenses in the profit and loss account.

The fact that executive reward has, over the past 12 years, been the subject of no fewer than five inquiries by eminent committees, and more than a dozen sets of regulations and guidelines from the government, the Stock Exchange and investor institutions, shows how difficult it has become to reach a conclusion that satisfies all interested parties. Excessive executive pay is now generating more headlines than ever. However, the 'fat cat' label so beloved by the press is very misleading for most directors. The recent 2007–08 Institute of Directors and Croner Reward survey of executive pay showed that the basic pay for an MD of a small company with a turnover of up to £5 million (and most UK companies are small) is £65,000, and pay for other directors averages £52,500. This is around the same as a head teacher's pay and less than a local GP's.

Cadbury, Greenbury, Hampel, Turnbull and Higgs Recommendations in Respect of Directors' Remuneration

The Cadbury Committee (1992)

- All companies should have a remuneration committee made up of a majority of non-executive directors.
- The remit of the committee should cover directors' remuneration and the use of plans involving share dilution.
- There should be detailed disclosure of the pay of executive directors in annual reports.

The Greenbury Committee (1995)

- The remuneration committee should be composed exclusively of independent directors and make decisions on executive remuneration on behalf of the board.
- There should be a remuneration committee report in the annual company report disclosing contract, compensation and benefits details for all executive directors. A format for reporting directors' remuneration was established.
- Employment contracts for directors should not exceed one year in length.
- There should be a set of executive remuneration guidelines in the Stock Exchange listing particulars.

The Hampel Committee (1998)

- The broad framework and cost of executive remuneration must be a matter for the board, acting with the advice of the remuneration committee.
- Stock Exchange guidelines should be revised and extended.
- Companies should not be obliged to seek shareholder approval of remuneration reports and directors' remuneration. (The argument was that it would be 'inappropriate' to single out one aspect of company policy for approval in this way.)

The Turnbull Working Party (1999)

- Boards should consider 'whether human resource policies and performance reward systems support the business objectives and risk management and control system'.

The Higgs Review (2003)

- Greater transparency and accountability in the boardroom are needed.
- There should be formal performance appraisal for directors.
- Closer relationships between non-executive directors and shareholders are needed.
- All boards should put in place a significantly more rigorous appointments process.

6.6.6.2 Reporting

Governance is an increasingly important criterion in investment decisions. Thus, companies are trying to find a meaningful way of presenting in their annual reports the state of corporate governance in the company for the benefit of key shareholders, fund managers and analysts.

Cadbury Schweppes was one of the earliest companies to provide information on governance and the values that inform the business. (Its former chairman, Sir Adrian Cadbury, led the first inquiry into corporate governance in the early 1990s and his subsequent report formed the basis of the current Combined Code.)

In 1998 the UK government instigated a Company Law Review and produced a White Paper in 2002, which contained a number of proposals relating to company reporting. A significant development was the requirement for companies to produce a mandatory operating and financial review (OFR) to provide information on the company's current and prospective performance and strategy. This came into effect on 1 April 2005. However, on 28 November 2005, following reconsideration, the government withdrew this requirement. Instead, under the Companies Act 2006 all companies, public and private, with the exception of those private companies that fall under the definition of 'small companies', need to produce an enhanced business review (EBR) in the directors' report, which was introduced as a result of the EU Accounts Modernization Directive for reporting periods commencing on or after 1 April 2005, and which replaced the short-lived OFR.

The Companies Act gives the EBR a new focus: it is to inform shareholders and help them to assess how the directors have performed their duty to promote the success of the company. To that end, the Business Review must contain:

- a fair review of the company's businesses;
- a description of the principal risks and uncertainties facing the company;
- a balanced and comprehensive analysis of the development and performance of the business during the year, and its position at the end of the year;
- to the extent necessary to understand the business, an analysis using financial key performance indicators (KPIs) and other KPIs, particularly those on environmental and employee matters.

UK listed companies (excluding those listed on AIM or PLUS) need to make additional disclosures in their business review to cover:

- the main trends and factors likely to affect future development and performance;
- information about the impact of the business on the environment, plus information on employees and 'social and community' issues;
- information about people with whom the company has contractual or other arrangements that are 'essential' to the business.

The EBR is not subject to an audit, although directors will commit a criminal offence if they fail to comply with these requirements.

There can be great similarity between published governance statements. Most of the FTSE 100 statements included in annual reports have the same structure and headings.

Principal Content of the Corporate Governance Statement in FTSE 100 Companies' Annual Reports and Accounts

- The extent to which the company has followed the Combined Code – and the reasons for any non-compliance.
- The role of the board and how it is governed; changes in board membership during the year; matters reserved for the board and its main committees; the name and duties of the senior independent director.
- The way the chairman and chief executive operate; their main responsibilities.
- The work of the board during the year; a list of board meetings and subcommittee meetings and the attendance of directors at each.
- Induction for new directors; training and development for all directors.
- How the company communicates with its shareholders; how companies can use the senior independent director if the occasion demands; procedures for informing shareholders of annual meetings or of extraordinary meetings.

- Notifiable interests of shareholdings in excess of 3 per cent.
- A statement about performance evaluations of the board, its committees, the chairman and each director.
- Individual reports from the chairs of the main committees.
- Directors' interests, if any.
- Internal control and audit; an outline of the responsibilities of the board; the process of identifying and managing significant risks.
- A statement on internal audit: how the internal audit function operates and the assurance it gives the board.
- A statement of 'going concern': a declaration that the directors believe that there are sufficient cash resources or facilities to allow the company to operate for the foreseeable future.

In the summer of 2007 the government undertook a consultation on implementation of the Fourth and Seventh EU Accounting Directives. The proposals seek to enhance confidence in financial statements and annual reports published by European companies. One of the key requirements is for publicly traded companies to include a corporate governance statement in their annual reports. Although the requirements broadly replicate those that already exist under the Combined Code, implementation of the Directive will change the nature of those elements of the Code from 'comply or explain' to mandatory. In particular, the Directive imposes a mandatory requirement on all companies traded on a regulated market, which includes AIM, to include a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process. The Directive also includes requirements relating to the composition of the board and its committees.

In light of the responses to the consultation and with the agreement of the FSA, the government proposes to implement the requirements via the FSA rules.

6.6.6.3 Audit and Risk Management

An organization should have a robust system of internal control. One of the main principles of the Combined Code states that 'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets' (C.2). This is particularly pertinent in today's tough economic climate.

Risk-taking entrepreneurship is an essential part of any business, and therefore it is necessary to have a system in place that manages risk rather than trying to eliminate it. Directors are all aware in broad terms that their business faces risks of one sort or another all the time, be they financial (cash flow, interest rates, foreign exchange and credit), strategic (research and development, mergers and acquisitions, competition, intellectual capital, industry developments and changes in customer base and trends, not to mention existing board composition, succession plans for board members or reputation risks), operational (accounting and IT systems, recruitment, supply chain, contracts and regulatory changes) or, last but not least, hazards (to employees, properties, public access, products and services caused by human-caused and/or natural disasters).

Shareholders, employees, contractors and the authorities are increasingly keen to hold directors personally responsible for how they run a business. Directors can be held personally liable for the failings of their firms, risking disqualification, fines and imprisonment. Although the rules and regulations for directors have become more complex and onerous, there is no expectation of perfection or infallibility; all that the law requires is for the director to act honestly and competently. It is, therefore, important for directors to have a clear understanding of their roles, duties and liabilities and it is equally important for them to implement a robust system of internal controls.

Directors have a duty to constantly monitor the risks they are running. Since risks change as the company's business and the commercial environment in which it operates change, they must be reviewed and assessed regularly. The Combined Code recommends that the board (or the audit or the risk committee) annually reviews the system of internal controls, and reports to shareholders that it has done so. The review, it says, should cover 'all material controls, including financial, operational and compliance controls and risk management systems'. The Turnbull guidance on internal control suggests ways of applying that part of the Combined Code.

Some risks have traditionally been given more attention than others. Apart from complying with a raft of health and safety legislation, directors usually put in place various insurance policies, including commercial directors' and officers' insurance, which is a wise option – indeed, the Code recommends it – but not a panacea.

However, there are other issues, such as overly generous credit terms for customers, lax internal accounting controls or a slight change in the market that has gone unnoticed, that also need close attention, for they may contain the seeds of a company's downfall. Many more businesses fail because of cash-flow problems or bad debts than because their factory burns down.

The practice of providing assurance in regards to financial control differs from organization to organization. At the most basic level a company will have an accountant draw up the annual accounts for filing with Companies House. At the more sophisticated levels there will be an audit – an inspection of accounts and accounting procedures, and a discussion on the controls.

Some larger companies will have an internal audit function, where accounting procedures and the risk environment are then reviewed by an external auditor. These companies will also have a competent audit committee that will, on behalf of the board, review and form an opinion about the control environment and the high-level risks.

It is important to stress that risk assessment and control cannot be 'outsourced': it remains the responsibility of the board, and it demands regular attention from both directors and managers. It is important, too, to remember that the system for internal control should be comprehensive. The Turnbull guidance emphasized the need to think not only of 'narrow financial risks' but also risks relating to business reputation and the environment.

In the summer of 2007 the government carried out a consultation in relation to the EU Eighth Directive on statutory audit of annual and consolidated accounts, which is intended to establish a set of basic principles for the conduct and oversight of statutory audits conducted in the European Union. It mainly affects auditors, but one key change is the requirement for public interest entities to have an audit committee. A public interest entity is defined as an entity that has securities admitted to trading on a regulated EU market, credit institutions and insurance undertakings. The Combined Code provisions with regards to audit committees are more extensive than those required under the Directive, but currently they are under a 'comply or explain' regime rather than being a mandatory requirement. The UK government's proposal is to implement those requirements under the FSA rules.

6.6.7 Shareholder Rights and Stakeholder Relations

Directors are fiduciaries, acting on behalf of shareholders, and a company's purpose is to continue to perform satisfactorily and provide adequate returns for shareholders.

Shareholder activism is an expression that sometimes has negative connotations: single-issue pressure groups, class actions and the like. On the other hand, companies frequently complain that shareholders, particularly many institutional shareholders, do not play an active role, and are interested only in short-term performance. The average institutional holding in the United Kingdom is for no longer than two years. This is not surprising, as the majority of investors are traders, who perceive shares as a commodity to make money from, through taking profits at the optimum time. This has an effect on company attitudes. There is a tendency for short-term market pressures either to take precedence over longer-term strategy or, at the least, to influence strategy. Linked with this is the pressure then put on individual directors to perform over comparatively short periods, with consequences not only for remuneration packages but also for the duration of executive directors in post. In the United Kingdom the average life-cycle of a chief executive is less than four years.

Short-termism is the subject of much discussion and debate between companies and investors, and it was highlighted as being of concern in the preamble to the Combined Code. It is not a simple matter to resolve.

Some institutional investors have taken a particular interest in corporate governance. Prominent among these is Hermes, whose Hermes Principles were published in 2002. The five headings under which the Hermes Principles are grouped are:

- economic communication;
- financial;
- strategic and social;

- ethical;
- environmental.

6.6.8 Corporate Social Responsibility

It is clear that a company is an economic entity, and a major contributor to the wealth of the countries in which it operates. But it is also clear that it is a social entity, and this means that there are non-economic factors that need to be taken into account. The interests of shareholders are increasingly seen as linked to those of stakeholders: customers, suppliers, labour, government and the community at large.

Corporate social responsibility (CSR) has over recent years been as ubiquitous a subject for debate in the United Kingdom as directors' remuneration. Although no part of the Combined Code is specifically concerned with CSR, there is some recognition that a company's duties extend beyond its shareholders. There has been a trend for many pressure groups and some investors to try to introduce the 'stakeholder' model into the United Kingdom.

The UK Companies Act 2006, supported by case law, makes it clear that directors are to run the company in its best interests and for the benefit of shareholders as a whole, not for that of any other group or groups. Therefore, even if a particular investor or a group of investors has particular social interests, the directors would be in breach of their duty to promote these unless they coincided with the interests of the shareholders as a whole. But the Act also requires directors to have regard to community and environment issues when considering their duty to promote the success of their company and by the disclosures to be included in the business review, enshrining, for the first time, the concepts of stakeholder and 'enlightened shareholder value' in UK law.

The Association of British Insurers (ABI), whose members own more than 20 per cent of the companies on the London Stock Exchange, publishes guidance on CSR-related issues for both companies and investors. Its 2007 'Socially Responsible Investment Guidelines' ask that the annual report highlight a company's environmental, social and governance (ESG) risks.

Recently the government introduced a new corporate vehicle called the Community Interest Company (CIC) (Enterprise for Communities). CICs are a new type of limited company created by the Companies (Audit, Investigations and Community Enterprise) Act 2004 and the Community Interest Company Regulations 2005. CICs aim to meet the needs of organizations that trade with a social purpose ('social enterprises') or carry out other activities that benefit the community, rather than their members, but are not able, or do not wish, to become charities. CICs enjoy the benefits of limited company status and have greater flexibility than a charity in terms of their activities. CICs do not have trustees, and their directors can receive reasonable remuneration. Regulation is light-touch. However, there is a greater transparency of operation, as a CIC has to deliver an annual community interest company report about its activities for the public record.

6.6.9 Director Development in the United Kingdom

There are two professional bodies focusing on developing board competency and effectiveness: the Institute of Directors (IoD) and the Institute of Chartered Secretaries and Administrators (ICSA).

6.6.9.1 The Institute of Directors (IoD)

The IoD has been championing professionalism in the boardroom since its establishment in 1903. It is the only UK organization to focus solely on directors' development needs in both the public and the private sectors. IoD Professional Development provides a unique offering of products and services designed specifically by directors for directors to address all needs at senior level ranging from prospective, newly appointed and experienced directors from all sizes of business to board development services. It includes:

- *Short courses*: one- to three-day practical courses using the latest case-study material and covering all subject areas essential to the success of each and every director.
- *The Certificate and Diploma in Company Direction*: these concentrate on helping directors of companies of all sizes and business sectors to fulfil their role more confidently and help them lead their companies effectively and successfully in today's rapidly changing business environment. The IoD Diploma in Company Direction is one of the main criteria for Chartered Director status.

- *The Chartered Director*: the professional qualification for directors. In 1999 a milestone was achieved in the United Kingdom when the Privy Council agreed to the creation of the qualification. Since its launch, hundreds of directors have achieved this status, following a comprehensive training programme, examinations and professional reviews. In addition, Chartered Directors must subscribe to the Code of Professional Conduct and undertake continuing professional development.
- *Bespoke consultancy services*: offering tailored services to main, subsidiary and business unit boards from all types of organizations and helping boards to improve their structure, procedures and performance for enhanced corporate success – expertly delivered in the context of the organization's own industry and culture, and addressing its key issues. These services also offer accreditations for the board as a whole.
- *Executive coaching*: a tailored service driven by the needs of the client, offering individual directors a unique resource to provide guidance on every aspect of their career progression.

Both members and non-members of the IoD can benefit from the IoD Professional Development offering, although members receive a significant discount on all fees.

Further information is available at www.iod.com/development.

6.6.9.2 The Institute of Chartered Secretaries and Administrators (ICSA)

The ICSA is the professional body for Chartered Secretaries. A Chartered Secretary is qualified in company law, accounting, corporate governance, administration, company secretarial practice and management.

The ICSA is committed to raising company secretaries' professional standards by encouraging company secretaries to attain high levels of expertise and effectiveness and by providing a number of professional courses, certificates and diplomas on a wide range of subjects, such as:

- company secretarial practice;
- corporate finance and taxation;
- corporate financial management;

- management practice;
- professional administration;
- administration of corporate affairs.

Further information is available at www.icsa.org.uk.

6.6.10 Useful Contacts

- Association of British Insurers (ABI), www.abi.org.uk
- Accounting Standards Board, www.frc.org.uk/asb
- Association of Chartered Certified Accountants, www.acca.co.uk
- Bank of England, www.bankofengland.co.uk
- British Bankers Association, www.bba.org.uk
- Companies House, www.companieshouse.gov.uk
- Confederation of British Industry (CBI), www.cbi.org.uk
- Department for Business, Enterprise and Regulatory Reform (BERR), www.berr.gov.uk
- Financial Reporting Council (FRC), www.frc.org.uk
- Financial Services Authority (FSA)/UK Listing Authority (UKLA), www.fsa.gov.uk
- Institute of Chartered Accountants of England and Wales (ICAEW), www.icaew.co.uk
- Institute of Chartered Secretaries and Administrators (ICSA), www.icsa.org.uk
- Institute of Directors (IoD), www.iod.com
- London Stock Exchange (LSE), www.londonstockexchange.com
- National Association of Pension Funds (NAPF), www.napf.co.uk

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6.7

France

Pierre-Yves Gomez, Director, the French Corporate Governance Institute and Caroline Weber, Director, MiddleNext

6.7.1 Corporate Governance in France: Beyond Commonplaces

French capitalism has been through some profound changes since the mid-1980s, as have all Western countries, shifting from an international, managerial, Fordist form to a global, financial, shareholder-driven form. This change has been particularly fast-moving since the 1985 Law on Financial Deregulation, leading to a very high level of exposure to international financing and to an exceptionally high proportion of foreign investment: half of the capital of the companies in the SBF 250, and 40 per cent of that of the top 40, is now held by funds representing foreign investors (against 25 per cent in Germany and 22 per cent in the United Kingdom). This financing is due to the absence of pension funds in France.

At the same time, financial deregulation and highly conducive fiscal policies have brought about a large-scale shift of household saving towards investments in companies: while shares represented only 0.7 per cent of the assets of French households in 1974, they now represent 20 per cent, and as much as 60 per cent if indirect investment products are taken into account. France ranks third in the world for investment fund management.

Lastly, the withdrawal of the state as a shareholder since the early 1990s has been considerable. While the state controlled 2,300 firms in 1996, it had majority holdings in just 845 companies in 2006. Just 6 of these, mainly in the energy sector (EDF, GDF, CEA), represent 75 per cent of the jobs in these corporations. Generally speaking, the past 15 years have seen a clear withdrawal of the public sector from all fields of economic activity, and a rise of company financing by individual investors at home and abroad. These ground shifts have transformed French capitalism, which is all too often interpreted, even today, in terms of commonplaces dating back to the 1970s (omnipresence of the state, poor minority shareholder protection etc).

But the expansion and internationalization of financing have also considerably increased the differences between companies in terms of size and shareholding structure. In all Western countries, recent developments have not concerned all companies to the same extent. The more open they are to international capital, the more they are affected by the consequences of shareholder power and financialization. Conversely, the more they remain under the control of dominant shareholder groups, the more they have specific expectations, while still being affected by the consequences of general governance reforms. In a modest-sized country like France (and all European countries), no more than 100 or so corporations are genuinely confronted with the new rules of global shareholder capitalism: very diluted capital, short-term stock price sensitivity, international governance standards etc. The great majority of companies, because they have at least one reference shareholder (family, founder, etc), do not obey this logic, although they are subject to the regulatory or legal requirements of the 'new governance standards'. In a study of more than 280,000 companies, carried out in 2000, the Banque de France showed that 72 per cent of these companies had a majority shareholder (either an individual or another company). Only 4 per cent of them had diluted shareholdings, meaning in this case that the biggest shareholder represented no more than 10 per cent of the capital. These figures have been confirmed by less extensive studies since then. In short, French capitalism is very much concentrated in the hands of entrepreneur shareholders, except for a small number of companies with a large number of shareholders.

A number of circles can be defined according to: 1) the varying levels of capital concentration; 2) the key role of an owner in corporate management; 3) the size of the company.

In the first circle can be found some 100 companies, which are among the largest in France. The CAC 40, which is to say the 40 biggest market capitalizations on the Paris market, form a central core. Even among these companies, very few are diluted to any great extent: half of them have a single reference shareholder exceeding 30 per cent of their capital. Their float is sufficiently large, however, for these companies to be subject to global governance rules.

The second circle contains the next 800 companies listed on the Paris market. For these 'Midcaps', the proportion of their float does not generally exceed 20 per cent. They have a market capitalization of less than 1 billion euros, and represent only 4 per cent of the overall capitalization of the Paris market and less than 2 per cent of transactions. So, even for listed companies the significance of their listing varies widely depending on their size.

The third circle comprises 27,600 unlisted small and medium-sized companies with over 50 employees, which essentially have one or several owners.

Finally, in the fourth circle we find the 2,600,000 small companies (with from 0 to 50 employees) that make up the bulk of French firms in number.

In the first two categories we are seeing faster concentration of companies than in the other groups, and the creation of micro-groups. These have increased in number from 600 in 1980 to 5,300 in 1995 and to 32,000 in 2005. This restructuring of capitalism around small companies has been little studied, although it does have obvious implications for corporate governance.

So, when we are talking about corporate governance, we must bear this capital structure in mind, not only to understand expectations in terms of governance, which are not identical between different companies, but also to understand the tensions created by applying general rules without taking account of the specifics of companies.

6.7.2 Key Corporate Governance Trends

6.7.2.1 The Legal Framework: Laws, Models and Codes

For large listed companies, changes in corporate governance have come mainly from two sources: codes of conduct and the law. As in all Western countries, these reforms have come in the wake of scandals that have forced either corporate leaders or the public authorities to step in to reform practices. Three codes have been decisive in defining good market conduct, exclusively for listed companies: the Viénot I Report (1995), the Viénot II Report (1999) and the Bouton Report (2002). These reports were written under the supervision of the successive presidents of a bank (the Société Générale) by a commission composed exclusively of directors of large corporations. They adopted approaches very close to those of the OECD or of other reports of this type in Europe: inclusion of independent directors on company boards (at least 30 per cent), discussion of the separation of the powers of the CEO and the chairman, the importance of oversight by specialized committees, the independence of directors. To this effect, an independent director is one who 'has no relationship of any kind with the company or its group that might prevent them exercising their freedom of judgement' (Bouton Report, page 9). These are only proposals and are in no way binding, although the vast majority of CAC 40 companies do refer to them, thereby creating a 'market culture'. For example, 92 per cent announce in their annual reports that they apply or draw inspiration from the Bouton Report, notably as regards the number of independent directors (one-third of board members). These texts are sufficiently general and flexible to be accepted by all, and there is no obligation to sign up to them or to take up a position on compliance in the official corporate documents.

In fact, they have been added to and discussed in a number of initiatives taken by associations or institutes seeking to improve governance practice in more specific ways: APIA, MiddleNext, AFGE, AFG, IFGE, IOD France, IFA etc. The VIGEO rating agency, set up by Nicole Notat, formerly the leader of one of the largest trade unions, takes account of 'good governance' standards in its ratings, thereby contributing to bringing about changes in practice. These multiple sources of thinking favour debate and an objective appraisal of 'good practice' by bringing a variety of points of view into play.

Another far from negligible form of indirect influence on governance is provided by the AMF (Autorité des Marchés Financiers, the financial regulator), which enforces standards on disclosure of information to the public, among other things. For listed companies, as well as issuing an activity report, it requires the publication by the chairman of a report on internal control within the corporation, to ensure that all the provisions are applied to reduce exposure of companies to risk to the greatest extent possible. This report is obligatory for all listed companies according to the terms of the

European 'Prospectus' Directive. It has given rise to ongoing debates, however, owing to the weight and cost of these procedures for smaller companies.

As far as public regulations are concerned, the laws of 2001 and 2003 tended to confirm the proposals of the Viénot and Bouton reports. These laws essentially provide a clearer distinction between internal and external directors, and qualify the independence of directors. On the whole, French law has sought to keep track with broader changes, rather than causing them. Under pressure from public opinion the law of 2002 required listed companies to publish an annual report on their social and environmental policy (article 116). The law of 2003 mainly provided a framework for transparency on directors' pay, rendering disclosure in the annual report obligatory. The law has in fact been ahead of certain recent changes, however. For example, since 1967, French corporations have had the possibility of opting to separate the supervisory board from the board of directors, as in Germany, or to remain with a single board. Neither the reports nor the law require just one form, leaving the choice open to companies so that they can choose the one that is best suited to their culture or economic situation. In 2007, 26 per cent of the companies in the CAC 40 and 27 per cent of Midcaps had chosen this 'dual' form.

To summarize, reforms of practice have been largely due to the self-organization of companies, with the backing of public intervention. They have been characterized by a very pragmatic approach and flexibility to adapt the rules to the different situations of listed companies. It is important to take this into account when we look at the French situation. Contrary to what people often think, the laws leave a lot of room for negotiation. In this respect, mention should be made, for non-listed companies, of the law of 1999 creating a new form of company, the SAS (*société anonyme simplifiée*), the main feature of which is to leave companies free to establish the governance institutions to suit their needs. By 2008, over half of non-listed companies of more than 10 employees had chosen this form. Most have kept a single board of directors as the reference body.

6.7.2.2 Board Structure and Roles

France has seen the same changes as other Western countries, with a shift from somewhat inactive boards to institutional control by directors. Media coverage of certain scandals (Crédit Lyonnais in

1991, Vinci in 2006) has contributed much to transforming this role and increasing the responsibility of directors and the pressure on them. The role of the board still remains blurred, however. Article L 225–35 of the French *Code Civil* states that the board represents the interests both of the company and of the shareholder. In these times, when shareholding is diluted and global, the expectations of shareholders may vary, and getting their interests to coincide can be difficult. The codes have tried to limit this gap. Generally speaking, in the French tradition they give preference to the general interest of the company over that of the shareholders, considered as being an important stakeholder although not decisive. For example, the Viénot Report defines the board as follows: 'whatever the composition and organization of the board, it is and must remain a collegiate body representing all the shareholders collectively, and with the obligation of acting in all circumstances in the interests of the company' (page 2).

The legal term of office for directors is six years. In 2006 the average size of the boards of CAC 40 companies was 15 members, of whom 8.5 on average are independent. For Midcaps the figure was 8 in total, 3 of them independents. The reports recommend creating three types of committees to help the board: a compensation committee, an appointments committee (with 50 per cent of independent directors) and an audit committee (with 66 per cent of independent directors). For the CAC 40, most companies have chosen to combine the audit and compensation committees. Eighty per cent apply the recommendations of the Bouton Report. More rarely, there are boards that set up a strategic committee or an ethics committee. For Midcaps the proportion is smaller: 43 per cent have an appointments committee, 40 per cent an audit committee, but just 20 per cent a strategic committee and 10 per cent a compensation committee.

Generally speaking, corporate boards have evolved to become more open. The 2003 law limited to five the number of board positions per director, thereby preventing directors from holding too many seats. Although this has not reduced the networking effect between directors, it has extended their networks and the interlocking between corporate boards. This is due essentially to the structure of capitalism, referred to earlier. While directors of large corporations are to be found in smaller companies, it does not work the other way round. The result of this is that the 'directors' market' is structured by company size, thereby necessarily limiting the number of directors and increasing interlock within each of the 'circles' of companies that make up French capitalism.

6.7.2.3 Shareholder Rights

Minority shareholders are represented by associations and activists (ADAM, Deminor) or proxy consulting firms (Proxinvest), which benefit from a relatively high media profile and regularly take part in debates. In France there are no class actions allowing certain shareholders to take legal action on behalf of all shareholders. Their approach generally involves ensuring media coverage before shareholders' meetings and then speaking in those meetings, in most cases on the subject of stock valuations in takeover bids. One particular case attracted much media attention in 2004, when shareholders in Eurotunnel joined forces to overthrow the management in place and impose a new one. This spectacular action remains the exception, however. In general, small shareholders are not very active and seem little interested in becoming so.

The law of 2003 requires that investment funds give a reason for not taking part in shareholders' meetings. This has led to greater participation by these funds, which tend, on the whole, to vote in favour of management proposals.

Since the 1980s, the practice of issuing shares without voting rights (and shares with double or multiple voting rights) has developed. The use of non-voting preference shares, as allowed by Art. L. 225–126 of the French *Code de Commerce*, was extended in 2005 by the creation of preference shares, which enable companies to associate all sorts of rights with their shares in their by-laws, according to the expectations and interests of the owners and whether they wish to play a role in management or not.

Multiple voting shares are still widespread, especially in listed family companies such as Legrand or SEB. The law (Art. L. 225–123) authorizes double or multiple voting rights to be associated with certain shares if the shareholder had had their shares for at least two years – and as much as 10 years for Pernod Ricard, the spirits market leader. This practice is criticized by some, in the name of the 'one share, one vote' principle, and also because of the fact that it becomes obsolete as the capital becomes more diluted, as is the case for Danone or Total. But it is defended by others, who consider it normal to encourage shareholders' loyalty and their greater involvement in company management the longer they hold their shares.

In fact, if this type of share has been retained, it is due to the fact that French capitalism opened up suddenly and extensively to international financial markets in the mid-1980s. In a country where, as we have said, almost half the capital of large corporations belongs to foreign funds, the question is not merely one of ideology:

multiple voting shares are a way for certain companies to ensure stability of their capital, especially in periods of intense speculation on markets. In many cases the founders of, or heirs to, companies have agreed to list their companies on stock markets only on condition that they could retain a certain amount of control over the strategy of companies in which they are investing over the very long term. If double or multiple voting shares were to be brought into question, this would probably lead some companies dominated by families or entrepreneurs to go private. However, debate on the subject in France has been far from intense, and has tended to lean in favour of the advocates of 'shareholder loyalty', notably during periods of stock market instability.

Finally, employee stock ownership has grown under the effect of a series of laws encouraging employee participation. Although it represents only 1 per cent of share ownership of all companies taken as a whole, it is very much concentrated in listed companies. It represents 2.5 per cent of the stock market capitalization of listed companies. There are 38 firms in the SBF 250 in which employees hold over 3 per cent of the capital and the number of employees concerned is over 25 per cent of their total staff. Among CAC 40 companies, employee stock ownership exceeds 3 per cent of the capital in three of them, and 5 per cent in eight of them. As we can see, the further up we move into the large companies with diluted capital that are therefore the most closely concerned by new governance rules, the greater the employee stock ownership we find.

The Fédération des Actionnaires Salariés (FAS), which comprises 30 employee shareholders' associations, has launched an index to show the relative performances of companies with more extensive employee shareholding. Questions have also emerged as to the rules on employee participation in corporate governance. The Giraud Law of 1994 on employee stock ownership required the presence of directors elected by the employees in privatized companies. The number of elected employee representatives on the board cannot exceed four and must remain lower than the number of shareholder representatives. Basing themselves on this, employee stockholders have sought admission to corporate boards, and have obtained it in 14 of the CAC 40 giants. By promoting more loyal (notably through the use of multiple voting shares), stable employee shareholding in capital that is otherwise increasingly diluted, on the one hand, and by enforcing rules of transparency and also of employee involvement in the economic life of corporations, this is much more likely to bring about profound changes in French corporate governance than might be achieved by changes in rules or laws.

On the whole, French corporate governance has evolved towards greater transparency and openness, in line with the general trend in the Western world. This shift towards global standards is also one of great pragmatism. The task now under way is to apply these changes to companies whose capital has not been diluted. In this respect, it would be absurd to apply the same costly transparency and control rules if their economic efficiency is not clear. Rather than demanding that the 'good conduct' rules of large listed corporations be generalized, what are now needed are governance rules that are compatible not only with the new financial situation, but also with the working of Midcaps and entrepreneurial companies.

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6.8

Italy

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Italian corporate governance is characterized by advanced regulations (equalling or exceeding the continental European average) but a low degree of enforcement. The ownership structure of listed companies is highly concentrated, and public companies with dispersed ownership are rare. Most of the time, a majority shareholder (a family, a company or the government) controls a relevant stake of voting rights and exercises full control of the company. Legal devices such as pyramidal groups, non-voting shares and voting agreements are relatively widespread and allow separation of ownership from control, especially in family groups. It follows that the typical agency conflict is not between managers and shareholders, as in the United States or the United Kingdom, but between majority and minority shareholders.

6.8.1 Regulatory Framework

Corporate governance regulations of Italian stock companies is mainly set out in the Italian Civil Code of 1942, as amended by a comprehensive corporate law that took effect on 1 January 2004 and supplemented by a few significant reforms enacted during the past decade. Unlike the US framework, the Italian fully regulates rights and duties of companies'main corporate bodies. These provisions are generally compelling and, except for some cases (detailed below), they cannot be derogated by companies' by-laws. In the past 10 years, several law reforms have substantially modified the Italian corporate governance system (for thorough discussion of the topic, see Bianchi and Enriques, 2005; Ferrarini, Giudici and Stella Richter, 2005; Ferrarini, 2005) (Figure 6.8.1). We shall provide a general overview of the major changes that are still in force, stressing their effect on shareholder protection and market transparency.

The year 1998 represents a crucial stage in the Italian corporate governance reform process. The Consolidated Law on Financial Intermediation (Testo Unico della Finanza, TUF), also known as 'Draghi's law',[1] came into effect on 1 July of that year and strengthened minority shareholders' rights. In a nutshell, the interventions were in three key directions.

First, the Act increased minority shareholders' protection and 'voice', lowering the percentages of voting capital required to exercise some minority rights, such as the right to call an ordinary shareholders' meeting and the right to sue directors (from 20 per cent to 10 per cent, and from 10 per cent to 5 per cent, respectively). On the same lines, the statutory auditors' powers and responsibilities were enhanced, and stricter regulation of insider trading was established.

Second, the reform was intended to improve market transparency through a wider set of disclosure requirements for listed

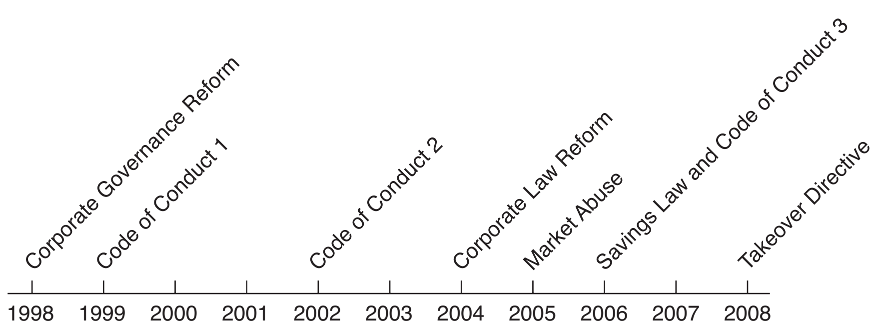

Figure 6.8.1 *Events in the reform of Italian corporate governance*

firms: quarterly reports, a lower threshold (2 per cent) above which equity holdings have to be disclosed to the Italian market authority (the Commissione Nazionale per le Società e la Borsa, CONSOB) and full publicity regarding shareholders' agreements or voting pacts.

Third, a stricter discipline concerning takeovers was introduced, imposing equal treatment of shareholders (through a mandatory total tender offer on 100 per cent of the shares) when control is acquired by buying more than 30 per cent of voting shares of a listed firm (the so-called coat-tail provision). If evaluated on the basis of the index of La Porta *et al* (1998), Draghi's law significantly improved the protection environment for Italian shareholders, increasing the Italian score for the index from 1 to 5 (out of 6) (Dyck and Zingales, 2004; Aganin and Volpin, 2005).

Another crucial step towards Italian corporate governance development is represented by 'Vietti's law', entitled 'Structural reform of corporations and cooperatives',[2] which took effect at the beginning of 2004. The innovations brought about by the reform greatly increased the degree of autonomy and flexibility achievable through companies' by-laws. The reform also introduced two new possible corporate governance structures: the 'dual' governance model, inspired by the German two-tier board structure, and a 'unitary' governance model in the classical Anglo-Saxon mould. These models will be discussed in more detail later in the chapter. Along with wider autonomy for the company charter provisions, minority shareholders' protection was increased through a wider application of the right to withdrawal. Finally, as a further element of flexibility the possibility of issuing financial instruments has been extended: a wide range of special classes of shares can now be created, including limited-voting shares, as can shares with economic rights tracked to a particular firm's business.

After some major financial scandals (such as Cirio, Parmalat and BPL-Antonveneta) the Italian government further toughened corporate regulation. Along the lines of the US Sarbanes–Oxley Act (SOX), the Italian Parliament approved the so-called Law on Savings (Legge sul Risparmio),[3] which came into force on 12 January 2006. This new reform introduced a number of legislative changes aimed at protecting public savings and preventing corporate frauds. SOX certainly inspired some of the new provisions, such as the supervision of external auditing companies, the increased responsibility for companies' CFO and the increased transparency requirements for offshore companies and stock option plans, which must now be approved by the shareholders' meeting, disclosed and filed to the market regulator.

The Law on Savings also amended the 1998 TUF with regard to the appointment and composition of the board of directors of listed companies and potential actions against them. In particular, at least one director must be reserved for the minority shareholders' list that collected the greatest number of votes. Since the threshold for presenting a list varies from only 0.5 per cent to 2.5 per cent of the voting capital (depending on the company's size), the new provision attracted some activist funds (eg Hermes and Algebris), which bought small stakes in some Italian listed companies and tried to gain a seat on their board. However, ownership of 2.5 per cent of the shares is now sufficient to sue directors, as against the previous required level of 5 per cent.

Although a little later than required by the EU Commission, in 2005 the Italian Parliament transplanted the 'market abuse directive',[4] which amended and partly replaced the 1998 TUF provisions on insider trading and other market abuses. Among the main interventions, this law carefully defines the notion of 'inside information' and the way in which price-sensitive news must be disclosed to the CONSOB and the public.

Recently, a law that came into effect at the end of December 2007[5] transplanted the EU 'Takeover Directive' 2004/25, aiming at harmonizing member states' takeover regulations. The new Italian takeover law confirmed the existing 'passivity rule' and 'breakthrough rule', already in force since the 1998 TUF. As far as the 'squeeze-out'/'sell-out' provision is concerned, minorities are obligated or allowed to sell their shares once the bidder owns more than 95 per cent of total voting rights.

To conclude, we ought to mention that in the past few years the pressure towards better shareholder protection has by no means come exclusively at a mandatory level. In particular, on October 1999 a corporate governance committee appointed by the Italian Stock Exchange approved a code of conduct with the aim of consolidating best-practice principles and improving investors' confidence in the domestic financial market. Although compliance is on a voluntary basis, listed companies are required to disclose their level of adoption of the code and to justify why they are not fully compliant (the 'comply or explain' principle). After two thorough revisions (in 2002 and 2006), the third version of the code is now in place. It mainly regulates the role, composition, appointment and remuneration of the board of directors and the board of auditors, price-sensitive information and related party transactions.

6.8.2 Shareholders' Meetings

Regardless of the specific corporate governance model chosen by the company, the general discipline of shareholders' meetings is largely the same. In Italy, two different types of shareholders' meetings exist: the ordinary meeting (or annual general meeting) and the extraordinary meeting. In traditional corporate governance, the ordinary meeting takes the major decisions concerning the 'typical' activity of the company (such as the approval of the financial statements and the appointment of the other bodies), while an extraordinary meeting is convened to approve modifications of the company's charter or by-laws (resolutions concerning mergers, equity issue, etc).

Depending on whether the meeting is ordinary or extraordinary, some specific rules governing its validity are in place. In fact, in order for the meeting to be valid, there is a minimum establishment quorum to be met. In the event that the required capital is not present at the first scheduled meeting, a second meeting has to be called. For ordinary meetings the quorum for the first call is set at 50 per cent of the voting capital, whereas no quorum is required for the second call. In both calls, resolutions are then adopted on the basis of a majority of the represented votes. For extraordinary meetings of unlisted firms, resolutions in the first call can be taken only if the votes of one-half of the voting capital (which is also the implicit minimum establishment quorum) are in favour, while in the second call one-third of the capital must be present and resolutions are taken with a majority of two-thirds of the voting capital (the votes in favour must in any case exceed one-third of the capital for a given set of decisions). As far as listed firms are concerned, an extraordinary meeting needs an establishment quorum equal to one-half, one-third and one-fifth of the voting capital in the first, second and third call respectively, while resolutions always have to be approved by a two-thirds majority of the voting capital represented at the meeting. For both unlisted and listed firms the company's charter is allowed to set higher establishment and deliberative quorums.

6.8.3 The Board of Directors

As we mentioned in the previous section, the 'traditional' Italian corporate governance system provides a board of directors (*consiglio di amministrazione*) and a separate board of statutory auditors (*collegio sindacale*) with supervisory functions. As required by Italian law, an external auditor is in charge of auditing the financial statements of a listed company. The shareholders' meeting is the sovereign body, the expression of the will of the firm's owners. As a consequence, in the traditional system all the members of the board of directors and board of statutory auditors, as well as the external auditors, are appointed by the general shareholders' meeting.

However, the 2004 corporate law reform introduced two additional alternative structures of corporate governance: the two-tier system and the one-tier system. In line with the German governance model, in the two-tier (dualistic) system the shareholders' meeting appoints the members of the supervisory board (*consiglio di sorveglianza*), and this latter, in addition to its oversight and supervisory functions, has the power to appoint the management board (*consiglio di gestione*). As in the traditional model, the shareholders' meeting also nominates an external auditor. The second alternative model, reflecting the Anglo-Saxon practice, is 'unitary', or one-tier. Its main difference with respect to the traditional system regards the lack of a separate supervisory board. In fact, in the one-tier model the shareholders' meeting appoints the board of directors while a management control committee (*comitato per il controllo sulla gestione*), composed only of independent directors, is endowed with the monitoring function. Despite some major banks having adopted the two-tier model, the most common corporate governance structure still remains the traditional one.

6.8.4 The Ownership Structure of Listed Companies and Its Evolution

The Italian financial system can be seen as the archetypal one where publicly listed firms are characterized by the presence of 'a controlling ultimate shareholder' (often a family), whose limited capital exercises control on a wide amount of assets thanks to pyramidal structures, non-voting shares and voting agreements. In this setting, controlling shareholders may extract a considerable amount of private benefits, as shown by the huge gap between the value of voting and non-voting shares and the high premium for control paid in controlling block transactions.

As previously discussed, Italy has recently brought in relevant legal reforms, but these have not discouraged the ultimate owner from retaining full control of listed firms. However, the typical controlling block has gradually changed since 1998. In fact, the 1998 reform raised the quorum needed to deliberate in the shareholders' extraordinary meeting to two-thirds of the voting rights represented in the meeting. As a consequence, a block of 33.34 per cent of voting shares is now sufficient to prevent any hostile takeovers, as it can block any decision taken at an extraordinary shareholders' meeting. Moreover, since 1998 the takeover discipline has required that a bidder willing to take over a listed firm has to make a public offer to all minority shareholders once the bidder controls 30 per cent of the votes. The combined effect of such provisions is that many controlling stakes now comprise between 30 per cent and 40 per cent of voting rights (Mengoli, Pazzaglia and Sapienza, 2009).

6.8.5 Pyramiding, Dual-class Shares and the Value of Voting Rights

Families typically use pyramidal groups, dual-class shares, voting agreements and cross-holdings in order to control large amounts of assets with limited capital. Recent studies (Mengoli, Pazzaglia and Sapienza, 2009) have shown that the percentage of firms that exhibit a pyramidal structure declined from 31 per cent in 1995 to 14 per cent in 2005 as a result of a change in corporate governance practices and disclosure regulation. Moreover, since 2008, 5 per cent of inter-corporate dividends are always double-taxed (they were completely tax-exempt till 2004 and 5 per cent were double-taxed in some circumstances after 2005).

About 44 per cent of listed firms had a dual-class equity structure in 1990 as against only about 10 per cent in 2008, thanks to many dual-class unifications made after 1998 (Bigelli, Mehrotra and Rau, 2007). The most common dual-class equity structure is made up of voting shares (carrying one vote) and non-voting shares (carrying no vote). Non-voting shares can be issued up to 50 per cent of equity capital and take precedence in the event of bankruptcy. They also have some dividend privileges, entitling their owner to a minimum dividend and to an extra dividend in respect of the voting share. Both dividend privileges are set by the company charter as percentages of the par value of the shares and are typically equal to 5 per cent and 2 per cent of par respectively.

Notwithstanding the dividend privileges, non-voting shares were traded at a deep discount in the 1980s. The price difference between voting and non-voting shares (an underestimate of the value of a voting right) averaged about 82 per cent in the 1980s (Zingales, 1994) but decreased to about 20 per cent in recent years (Caprio and Croci, 2008) thanks to stronger investor protection, the more international nature of investors, and expectations that in the future the dual classes will be unified.

Notes

1. Legislative Decree 58/1998.
2. Legislative Decree 6/2003.
3. Law 262/2005 and Legislative Decree 303/2006.
4. By way of Law 62/2005 implementing EU Directives 2003/6, 2003/124, 2003/125 and 2004/72.
5. Legislative Decree 229/2007.

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6.9

Trends in Russia

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6.9.1 Concentrated Ownership, State Control and Rapid Expansion of Mergers and Acquisitions

Outside the Anglo-Saxon countries, companies with controlling stockholders and blockholders prevail, while a widely dispersed stock capital structure is rare. Russia is also one of the countries with a highly concentrated ownership; in these conditions a dispersed stock capital structure and the absence of a powerful blockholder are still interpreted as an anomalous situation, unstable and a danger to the company's survival. The reason for this is the immaturity of public institutions that are intended to provide effective protection of property rights, notably the judicial and court systems, which can hardly be considered independent.

Still, great progress in corporate governance has been made in the past five years, in a market that has only 15 years' history from the start of the privatization process. Privatization made it possible to speak of corporations, shareholders, stocks and governance in Russia.

According to data from the Ministry of State Property of the Russian Federation, as of January 2002, 129,811 formerly state-owned companies had been privatized, which represents more than

66 per cent of the total number of enterprises that existed at the start of privatization in 1992. Currently the state has a 100 per cent stake in about 160 joint-stock companies, a controlling stake in 540 companies and a blocking stake in 1,200 companies. It also holds a minority stake in 1,750 other companies.[1] The vast majority of the joint-stock companies that were privatized are non-public, closely held companies. Only about 100 are traded on the main stock exchange markets, and up to a dozen may be called 'blue chips', including some in which the state holds a high stake: Gazprom, Rosneft, Vneshtorgbank (VTB), Sberbank, etc. Interestingly enough, on 1 July 2008 the Russian electrical giant RAO UES ceased to exist, being split into several dozen privately owned generating companies and a few united infrastructure services companies, controlled by the state.

A survey of 822 joint-stock companies demonstrated that in 2005 over 80 per cent of companies had a shareholder (or a consolidated group of shareholders) with a blocking interest and over 70 per cent of companies had a shareholder with a controlling stake of over 50 per cent. Among the companies with a controlling shareholder, only 30 per cent noted the existence of a second major shareholder (a 'counterweight') that could acquire a blocking interest. This is typical of companies of various sizes and in different sectors, and both publicly traded and private companies. In addition, having combined ownership and management is still a common practice. These functions have begun to separate only in recent years.

The growing influence of the federal government is the latest trend that has become apparent in the past four years. It is expressed both in the expansion of the state's share in the capital of major companies and in the establishment of holding companies with a controlling state interest (in aeronautics, shipbuilding, atomic machinery and arms manufacturing). This is accompanied by an increasing tendency to acquire blocks of shares in other companies on the part of large state-owned joint-stock companies and the newly formed so-called state corporations, which are being established in the form of non-commercial state-owned entities and are managed in a non-transparent way.

The driving forces behind improvements in corporate governance are as follows:

- initial public offerings (IPOs) and pressure from institutional investors, regulators and stock exchanges (23 IPOs in 2007, and 7 IPOs in the first quarter of 2008);

- mergers and acquisitions, private placements and/or attracting strategic investors; those involved should understand the decision-making process in the company and whether they are protected as shareholders from inadequate behaviour by major shareholders and from managerial fraud (see Table 6.9.1);
- division of the owner's and the managers' functions and responsibilities: the need to establish boards of directors with strategic responsibilities and control over management functions.

6.9.2 Concentration of Ownership

According to Standard & Poor's 2007 report *Transparency and Disclosure by Russian Companies*, there was a moderate decrease in ownership concentration of the largest Russian companies as compared with 2006 (see Table 6.9.2). In 2007 the share of controlling stakes in the aggregate market capitalization was 49 per cent as opposed to 55 per cent the previous year. A comparison of the 61 companies included in both surveys demonstrates even more vividly the reduction of aggregate share of controlling stakes: to 44 per cent of aggregate market capitalization from 55 per cent.

The share of blocking (>25 per cent) stakes in aggregated market capitalization of the 2007 sample increased by 3 percentage points in 2007 to 62 per cent, from 59 per cent in 2006. This is because most of the new companies we added to the sample have a concentrated ownership structure. However, if we look at the 61 companies included in both samples, the decreasing trend in ownership concentration becomes apparent, as the share of that group fell by 4 percentage points. By the same token, we see more widely held

Table 6.9.1 *Mergers and acquisitions in Russia, including cross-border mergers and acquisitions*

Year	Value ($ billion)	Increase as Compared with the Previous Year	Number	Increase as Compared with the Previous Year
2006	71	41% increase	~440	10% increase
2007	131.7	almost double	~590	33% increase

Source: Ernst & Young (CIS) data.

Table 6.9.2 *Concentration of ownership for the 80 largest Russian companies, 2007*

	No. of Companies	Companies in AMC (%)[a]	Stakes in AMC (%)[b]
Widely held companies (largest stake <25%)	6	6.2	2.8
Companies with at least one blockholder >25%)	74	93.8	61.7
Of which: majority owned companies (>50%)	57	76.0	49.2
Companies with direct government stake >25%	10	48.2	29.2
Companies with direct government stake >50%	6	46.7	28.8
Companies with large stakes (>25%) owned by government holdings	22	8.3	4.8
Companies controlled by government holdings (50%)	18	6.0	3.8
Overall companies controlled by the government	24	52.7	32.6
Companies with large (>25%) private stakes	54	41.6	27.6
Companies with private stakes >50%	33	23.3	16.6

Source: Standard & Poor's 2007 report on *Transparency and Disclosure by Russian Companies 2007*

Notes:

[a] Share of combined market capitalization of the relevant companies in aggregate market capitalization of the 80 largest companies.

[b] Share of the corresponding stakes in aggregate market capitalization of the 80 largest companies. AMC – Aggregate market capitalization of the 80 companies included in the survey.

companies in our current sample, partly owing to two newcomers: Integra Group and Cherkizovo.

The aggregated state stake in the overall sample has gone down by 3 percentage points year on year. There are two reasons. The first is the fact that the number of state-owned companies in the new sample is relatively lower. The second is the privatization process of

RAO UES. RAO UES has substantially diminished or sold completely its controlling stakes in TGC-5, WGC-3 and WGC-5.

The aggregate share of controlling packages in private companies also went down, to 17 per cent of total market capitalization from 19 per cent. The main drivers for this were IPOs by Severstal and MMK. In addition, the owners of WBD sold shares and now have less than a controlling stake. Another observation is that ownership distribution became more balanced through the increase in blocking (>25 per cent) private stakes. The 2007 sample includes more private companies, and in addition, in the RAO UES privatization process some of its shares changed hands from the state to private owners. Some electricity generating companies acquired new strategic shareholders, and existing investors increased their stakes in others. For example, Enel Investment Holding became the new blockholder of WGC-5, and Norilsk Nickel increased its shareholding in WGC-3.

There is not a single bank with the features of a widely held corporation among the 30 largest commercial banks of Russia. A blockholder can be identified in each case – individual or collective – and the concentration of property and control has lately been growing steadily. During the past three years, owners have not become more effective financial investors, delegating business decisions to a professional board of directors. The owners prefer to control the bank activity directly: the main shareholder of the bank is a member of the board of directors in 53 per cent of cases, the second most important bank owner is a member of the board of directors in 39 per cent of banks and the third most important shareholder is a member of board of directors in 36 per cent of banks.

6.9.3 Governing Bodies: Managing versus Governing

According to *Study of Corporate Governance Practices in the Russian Regions, 2005*, commissioned by the International Finance Corporation (IFC) and the Independent Directors Association (IDA), almost three-quarters of the 442 companies surveyed (74 per cent) reported that members of the supervisory and executive boards always act reasonably and in the interests of shareholders. Supervisory boards generally carry out functions related to strategic planning and management oversight. However, they frequently take on functions that would generally be the role of management. In most companies (80 per cent), executive directors make up no more than a quarter of the total membership of the supervisory board, as stipulated by law. Almost one-third of companies (30 per cent) reported that they have independent directors. The understanding of independence varies greatly among companies and rarely corresponds to the definition given in the Russian Corporate Governance Code. Competency is the most important criterion shareholders apply in electing directors. On the other hand, one-fifth of companies (19 per cent) cited loyalty to major shareholders as a key criterion. Companies' executive bodies do not always carry out functions related to the daily management of the company and the realization of strategy, frequently impinging on the role of the board of directors or the shareholders' annual general meeting (AGM).

In accordance with the Russian law on joint-stock companies, most companies have formed a Revision Commission, although its composition does not always adhere to good practice. Other control bodies have been created in a much smaller number of companies. Nonetheless, the share of companies that have an audit committee of the supervisory board grew significantly in comparison with 2002 from 2 per cent to 10 per cent. The external auditor's functions are fairly clearly outlined and are in accordance with legal requirements in the companies surveyed. However, the functions of other control bodies are weakly differentiated from one another and frequently duplicated.

Immaturity on the part of public institutions intended to provide effective protection of property rights, the weakness of corporate governance institutes and the prevalence of informal actions over formal rules causes Russian owners to take part directly in managing their companies. They take no pleasure in doing so in many cases.

The major stockholders of 13 per cent of Russian banks are board members. This does not mean that the chief stockholders of the remaining 87 per cent of banks only meet the board of directors, without taking administrative decisions but engaging purely in governance. The blockholder's presence in the board of directors does not automatically turn the board into a primary decision-making centre. In practice, the pattern of main interactions can be major stockholder–CEO, or major stockholder–a group of top managers.

6.9.4 Shareholder Rights

The separation of authority between the AGM and other governing bodies has improved as compared with what was found in the 2002 IFC and IDA survey. Nonetheless, some issues delegated by law to the AGM are not always resolved by the meeting. Thus, in a quarter of companies the external auditor is appointed not by the AGM, as stipulated by the law, but by other bodies. Almost all surveyed companies (94 per cent) properly inform their shareholders about the AGM; that is, in the form stipulated by law and within the timeframe set by the law: no less than 20 days before the meeting. Shareholder participation in setting the agenda of the AGM is low, with there being only slightly more than a quarter of companies (27 per cent) where shareholders propose issues for the agenda. In 13 per cent of companies the agenda of the AGM was amended during the course of the meeting, in violation of the law. In 91 per cent of companies, vote counting during the AGM is conducted by a counting commission or the external registrar. In the remaining companies, the violation of this practice can be explained by the small number of shareholders. In 10 per cent of companies, directors, executives or individual shareholders participate in vote counting, which runs counter to proper corporate governance practices. One-third of surveyed companies (144 companies) maintain their shareholder register themselves. Of these, 23 have more than 50 shareholders and thus maintain their register in violation of the law.

Oversight of extraordinary transactions and related party transactions has improved. Thus, the share of companies calling extraordinary general meetings of shareholders (EGMs) to approve extraordinary transactions has increased threefold compared to the 2002 survey. Half of the companies went through procedures to approve related party transactions. However, in a quarter of companies where related party transactions were concluded, approval was given by executive bodies, the members of which were often the interested parties. The situation regarding dividend payments has not improved compared to what was found in the 2002 survey: 70 per cent of companies did not declare and pay dividends in 2002–03. Almost half of those companies that did pay dividends paid them more than 60 days after the dividend decision had been taken, which is against good corporate governance practice and may even go against the law in the event that there is no such provision in the company's charter.

As a result of amendments to joint-stock law that came into effect in 2007, major shareholders with over 95 per cent of shares can now force the minority shareholders to sell them their shares so that they can acquire full control of the company. The problem lies in the lack of a mechanism for fairly valuing shares in companies that are not publicly traded, meaning that minority shareholders face underestimation of the value of the shares they are selling.

6.9.5 Information Disclosure and Transparency

Companies are relatively transparent in terms of the information they provide to their shareholders. In comparison with the previous survey, the number of companies informing shareholders about major shareholders grew from 93 per cent to 95 per cent. Information disclosure to the public, on the other hand, is noticeably worse. Thus, 34 per cent, 40 per cent and 46 per cent of companies do not disclose, respectively, their annual report, financial statements and list of affiliated parties. Not more than one-sixth of companies (8–14 per cent) provide information about various groups of shareholders, and extremely few (3–7 per cent) provide it on executive compensation and director remuneration. The larger a company in terms of sales and employment and the more shareholders it has, the more information it publicly discloses. Some 6 per cent of companies prepare their financial statements in accordance with International Financial Reporting Standards (IFRS). Companies that have shifted to or are planning to shift to IFRS disclose significantly more information. Information on ownership structure is less fully disclosed by those companies where the largest shareholder is a Russian company or the state.

The 2007 Standard & Poor's *Transparency and Disclosure* report demonstrates that the greatest net improvement is on weakly disclosed items related to shareholder rights. For instance, in 2006 only 33 per cent of the companies surveyed had a clear dividend policy and disclosed it. In 2007 almost half of the companies (45 per cent) did so. This improvement could indicate that the companies understand that their dividend policy is one of the important issues for the minority shareholders, and raises their attractiveness to investors. In the component describing the disclosure of operational information, there was also strong growth for the criterion on social reporting. In 2007, nine companies prepared these reports according to Global Reporting Initiative standards, up from only two the previous year. This is because a growing number of oil and power generation companies use the reports as a tool through which to have a dialogue with society.

6.9.6 Ownership Disclosure

The analysis of ownership transparency in the largest Russian corporations indicates a slowdown in the rate of improvement. The aggregate share of disclosed blocking stakes in the total market capitalization in 2007 is 52 per cent, only 1 per cent higher than in the previous year. In support of the same trend, there was only marginal improvement in the disclosure of the identity of at least one owner.

The private sector was the only area with an appreciable positive dynamic. The share of all disclosed large private stakes has increased by 4 percentage points since the previous year. The first reason for this trend is that out of 17 privately owned newcomers, only 2 do not disclose major beneficial owners. Another reason is the disclosure of real owners by two companies that did not publish this information previously: MMK (driven by its recent IPO), and Rambler Media (in November 2006 a new shareholder, Prof-Media, acquired 55 per cent of Rambler's shares).

Disclosure among government-owned enterprises historically has been strong. Despite this general trend, two companies do not disclose information about the state's stake, as was also the case in 2006. Rosobonexport, a state defence industry entity, owns about 66 per cent of the shares in VSMPO-AVISMA, but information on the state's stake is not available via any of AVISMA's public sources. In addition, Rosobonexport co-manages 66.5 per cent of AvtoVAZ, but there is no public reference to that fact.

Tables 6.9.3 and 6.9.4 give some data concerning transparency of ownership and comparative disclosure for Russian companies.

6.9.7 Specific Areas of Disclosure

Auditor rotation policy and the CEO's contract were the two worst-disclosed issues in 2006. In 2007 there was a slight improvement in the disclosure of these items. RosBusinessConsulting (RBC) is the only company to disclose its auditor rotation policy. The previous

Table 6.9.3 *Transparency of ownership, 80 Russian companies, 2007*

	No. of companies	Companies in AMC (%)[a]	Stakes in AMC (%)[b]
companies disclosing at least one owner	73	93.9	59.0
companies disclosing all large beneficial owners (>25%)	64	80.4	51.7
companies disclosing ALL stakes >25% directly or indirectly belonging to government	29	55.7	33.6
Companies disclosing ALL large (>25%) private owners (5)	41	27.2	18.2

Source: S&P's *Transparency and Disclosure by Russian Companies 2007* report.
Notes:
[a] Share of combined market capitalization of the relevant companies in aggregate market capitalization of the 80 largest companies.
[b] Share of the corresponding stakes in aggregate market capitalization of the 80 largest companies. AMC – Aggregate market capitalization of 80 companies included in the survey.

Table 6.9.4 *Comparative disclosure by components by the largest Russian companies, 2007–08*

	Components (%)					
	Ownership Structure	Shareholder Rights	Financial Information	Operational Information	Board and Management Information	Board and Management Remuneration
80 Russian companies, 2007	59	52	55	61	63	22
70 Russian companies, 2006	56	53	55	63	56	30
54 Russian companies, 2005	49	49	46	67	57	29

Source: S&P's *Transparency and Disclosure by Russian Companies 2007* report.

year, none of companies disclosed this at all. By adding CTC Media to our sample, we doubled the number of companies that disclose the details of their CEO contract. The other one is Golden Telecom. Both companies are listed on NASDAQ and thus are obliged to meet reporting requirements of the US Securities and Exchange Commission.

Early release of IFRS/US GAAP (Generally Accepted Accounting Principles) financials is also crucial, because timely financial information allows investors to make better-quality decisions. Analysis shows that 21 companies (26 per cent of the sample size) published IFRS/US GAAP accounts before the end of April 2007, compared with 16 the previous year (23 per cent). The share is still relatively low, which means that many companies are not conforming to international best practice. However, in an attempt to provide timely information to investors, four more companies have released unaudited results according to internationally accepted standards during the first four months following the year end. The release of IFRS financials within the six-month period after the year end is also more or less acceptable. This is because the majority of AGMs are held at the very end of June, which is the legal deadline for these meetings in Russia. If the statements are released within this period, the investors can analyse them before the AGM. In 2007, 54 companies (68 per cent of the current sample) released these statements by the end of June. In 2006, 42 companies (60 per cent of that sample) did so.

Unfortunately, disclosure regarding some opaque areas that are critical to investors has not improved. Indeed, the disclosure of some of them was worse in 2007 than in 2006. These include related-party transactions (eg an indication whether such transactions are carried out at market terms), auditor engagement (scope of non-audit services and remuneration for those services), ownership structures of affiliates and subsidiaries, and details of executive remuneration.

6.9.8 Boards of Directors

The separation of the functions of ownership and management has led to a growing role for boards of directors. The board is becoming a body that acts in the interest of major shareholders and controls the activities of management. The boards of the companies with separated functions have proportionally twice as many outside and independent directors. Based on an Independent Directors Association study completed on 2007, there are 256 independent directors in major 100 companies. Board committees are established in 85 per cent of the surveyed companies. The average board has 9 members, the range being from 4 to 16. The share of independent non-executive directors (INEDs) is about 28 per cent. Among independent directors in the larger companies there is a trend towards increased representation of foreigners among INEDs, from 40 per cent in 2006 to 52 per cent in 2007, which can be explained by IPOs recently held in foreign markets, mostly in London.

Experienced Western board practitioners who have worked with the top Russian executives and board members would observe the drive to improve governance in Russia. Forward-thinking companies are searching for ways of improving board effectiveness and further improving their reputation. Directors have looked to improve their skill sets and companies have sought to improve the way their boards operate so that they can add more value. While a number of these companies need to meet standards set in countries in which they propose to list, there is a growing trend for leading Russian companies to get better value from their board. They also understand that high levels of governance need to add value far beyond the box-ticking exercise that one sees with codes of governance such as Sarbanes–Oxley and the United Kingdom's Combined Code.[2]

Notes

1. Vedomosti, 22 December 2004.
2. Based on a conversation with Institute of Directors (IoD) chairman Neville Bain, who taught several coaching sessions for the top executives and board members of the leading Russian companies, and actively supported the launch of the IoD Chartered Director International Programme in Russia in May 2008.

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6.10

Spain

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6.10.1 Legal Framework, Laws and Codes

In Spain, increasing globalization and the convergence of capital markets across the world have led the country to evaluate its corporate governance regimes with the aim of instituting reform. Spanish corporate governance is characterized by the features shown in Table 6.10.1.

Regarding the general principles of law, it is worth mentioning the principles that directors must follow in performing their fiduciary duties: 1) with the diligence of a careful businessperson, and as loyal representatives; 2) with faithfulness; 3) with loyalty; and 4) in secrecy. These principles are set out in article 127 of the Public Companies Law. The duties of directors are as follows:

- The directors shall perform their functions with the diligence of an orderly businessman and a loyal representative.
- The directors shall perform the duties the law imposes on them with fidelity to the corporate interest.

Table 6.10.1 *Characteristics of Spanish corporate government*

General Principles of Law	Good Governance Recommendations
Spanish Commercial Code (**Código de Comercio**)	Olivencia Code (**Comisión de Olivencia**) in 1998
Public Companies Law (**Ley de Sociedades Anónimas**, **LSA**)	
Securities Market Law 24/1988 of 28 July (**Ley de Mercado de Valores**, **LMV**) and its implementing regulation; regulations of the Spanish Securities Market Commission (**Comisión Nacional de Mercado de Valores**, **CNMV**); and listing rules of the stock exchanges with disclosure requirements for listed companies	
Bankruptcy Law 22/2003 of 9 July (**Ley Concursal**)	
Transparency Law 26/2003 of 17 July (**Ley de Transparencia**)	Aldama Report (**Informe Aldama**) on January 2003
Reform Measures of the Financial System Law 44/2002 of 22 November (**Ley de Medidas de Reforma del Sistema Financiero**)	
Order ECO/3722/2003 of 26 December of the Ministry of Economy	
Order ECO/354/2004 of 17 February of the Ministry of Economy	
Order EHA/3050/2004 of 15 September of the Ministry of Economy	Unified Good Governance Code of Listed Companies or Conthe Code (**Código Unificado de Buen Gobierno de las Sociedades Cotizadas** or **Código Conthe**) on 19 May 2006
Circular 1/2004 of 17 March of the CNMV	
Circular 2/2005 of 21 April of the CNMV	
Circular 4/2007 of 27 December of the CNMV	

- Directors shall not use the name of the company to perform operations for their own benefit.
- Directors shall make known any conflict of interest with the interests of the company that may arise.
- Directors shall communicate their stake in the capital of a company with the same, an analogous or a complementary line of business as the business purpose, and offices or functions exercised therein, as well as the performance, for their own benefit or that of a third party, of an analogous or complementary line of business as the business purpose. That information shall be included in the annual report.
- Directors, even when they cease to fill that role, shall observe the secrecy of confidential information and shall undertake to keep confidential any information, data, reports or antecedents of which they are aware as a result of their position, without communicating it to third parties when this could jeopardize the corporate interest.

Aside from the provisions established in the Public Companies Law, the Securities Market Law and regulations of the Commission Nacional de Mercado de Valores (CNMV) require public companies to disclose, among other information, quarterly financial reports as well as all relevant events that may affect the market price of shares. Also, the Transparency Law has imposed additional disclosure requirements on Spanish companies, including the requirement that listed companies publish an annual report setting out their corporate governance practices and provide the report to the CNMV. By contrast, the Good Governance Codes are purely voluntary in nature.

The background to the Conthe Code is the previous Codes, the Olivencia Code in 1998, the Aldama Committee's Report (Aldama Report) in January 2003 and the ideas and recommendations included in the Instituto de Consejeros-Administradores (IC-A) Principles of Good Corporate Governance (June 2004) (Table 6.10.2). The IC-A Principles of Good Corporate Governance are summarized in the following box.

Table 6.10.2 *Principles and recommendations of the Olivencia Code and the Aldama Report*

Olivencia Code	Aldama Report
Principles:	*Principles:*
Based on the Anglo-American common law corporate governance systems under the principle of leaving execution of its recommendations to the market and to companies themselves, assuming that the market will reward those companies that choose to comply with the Code.	Based on experience of the Olivencia Code, applying the principle of freedom, understood in a double dimension: freedom of shareholders; and freedom of companies to regulate themselves. From this principle of freedom derive the principles of transparency and loyalty, duly balanced.
Recommendations:	*Recommendations:*
The Code Recommendations included issues with respect to: ■ the size, composition, and operating characteristics of the board of directors; ■ disclosure obligations; ■ directors' duties of care and loyalty; ■ the extension of the duty of loyalty to controlling shareholders.	The Code Recommendations included issues with respect to: ■ fiduciary duties of directors; ■ regulation of controlling shareholders; ■ judicial remedies available to shareholders.

IC-A Principles of Good Corporate Governance

Principles

- Based on wide acceptance, checks and balances, suitability, transparency and the principle of 'comply or explain'.
- Based on international corporate best practices, as well as Spanish codes, reports and laws. (More than 17 codes and reports were analysed for elaboration of the IC-A's Principles.)

Recommendations

The Principles include issues with respect to the board of directors, which is expected to be 'active, well informed and independent':

- Corporate interest.
- Board internal structure based on committees. Committees are internal board bodies that report to the board.
- The positions of chairman and managing director or CEO should be held by different persons. In the effective governance and management of the company, no individual should have unrestricted decision-making powers.
- In the event that the functions of chairman and managing director are performed by the same person, or, in the case of an executive chairman, a senior independent director/lead director, the board must be made up of internal/executive directors and external/non-executive directors. In the case of those companies in which there is no majority shareholder or a controlling group holding a majority interest, there must be a majority of independent directors among the external/non-executive directors.
- Board directors should show awareness and have the right professional and personal attributes, show responsibility and dedicate their time to the company. External advisers' help is a possibility in specified circumstances and directors' training and updating programmes should be available.
- Directors should be well informed: a director should 'not approve any matter which he does not understand or is not aware of, or with which he does not fully agree'.
- Independence criteria for independent directors should be strict, and verified annually.
- Board committees' composition and the succession plan for board members are covered in the Principles. At a minimum, a nomination committee, remuneration committee and audit committee should be established.
- The role of the board in setting company strategy is dealt with.
- The role of the different committees in situations where there is a change of control, or mergers or acquisitions occur, is covered.

- There are principles concerning transparency, and conflicts of interest concerning operations where directors or shareholders are involved.
- The board secretary should have qualities of independence, impartiality and fairness.
- There should be an annual evaluation by the board of its committees and directors.

Shareholders' Meeting: 'Key Forum of Information and Decision Taking, Promoting the Majority of Shareholders' Involvement'

- There are board responsibilities concerning shareholders' rights to information.
- There needs to be complete information on all agenda items.
- The agenda of the shareholders' meeting should include for approval items that could create conflicts:
  - individual directors' election and re-election or removal;
  - individual directors' remuneration;
  - by-laws and modifications to regulations.
- Shareholders should be given (conditional) access to items included on the agenda.
- Chairs of the board committees should be available during shareholders' meetings.
- Voting by institutional investors is to be encouraged. Institutional investors' voting records should be released when votes are cast against board proposals.

6.10.1.1 Recommendations of the Conthe Code

The Conthe Code originates in section 1f of the Order ECO/3722/2003 of 26 December issued by the Ministry of the Economy), which specifies that the CNMV must publish a single document combining existing recommendations regarding corporate governance and relevant international recommendations in order that listed companies can refer to this document when presenting their degree of compliance with corporate governance recommendations in their annual corporate governance reports (the Spanish abbreviation is IAGC), justifying any failure to comply, so that shareholders, investors and the markets in general can reach an informed judgement, as mandated by article 116 of the Securities Market Law (LMV). Therefore, this article and the Code suggest using the 'comply or explain' principle, meaning that listed companies can freely decide whether or not to comply with the recommendations, but their IAGC must explain any departures from the recommendations and respect the binding definitions established in the Code (eg on 'independent directors'). Pursuant to the provisions of article 116 of the Securities Market Law, the CNMV may order companies to make good any omissions or false or misleading data.

The Conthe Code reforms are not limited to rewriting the recommendations that existed prior to 2003 but also take into account recommendations made after that date by the Organisation for Economic Co-operation and Development (OECD) and the European Commission, as well as recommendations and ideas from the IC-A Principles of Good Corporate Governance. (The chair of the IC-A standards committee was one of the members of the group that elaborated the Conthe Code.)

6.10.2 Main Regulators and Supervisors

Details of the main regulators and supervisors are set out in Table 6.10.3.

Table 6.10.3 *The main regulators and supervisors*

Regulator/ Supervisor	Functions	Characteristics	Origin
Securities Market Commission (Spanish abbreviation CNMV)	Agency in charge of supervising and inspecting the Spanish stock markets and the activities of all the participants in those markets.The purpose of the CNMV is to ensure the transparency of the Spanish market and the correct formation of prices in them, and to protect investors. The Commission also exercises supervision over the secondary markets in securities and to investment services companies in order to ensure transaction security and the solvency of the system. These entities are the following:	The main beneficiaries of the CNMV's work are Spanish investors, to whom it must assure adequate protection, through audits and new disclosure requirements relating to remuneration schemes for directors and executives that are	It was created by the Law 37/1998, LMV, which established a regulatory framework that is fully in line with the requirements of the European Union and favours the development of European stock markets.

Table 6.10.3 *continued*

Regulator/ Supervisor	Functions	Characteristics	Origin
	■ Collective Investment Schemes, a category that includes: 1) investment companies (securities and real estate); 2) investment funds (securities and real estate) and their management companies; ■ broker-dealers and dealers, which are entities engaging primarily in the purchase and sale of securities; ■ portfolio management companies, ie entities focusing primarily on managing individual's assets (principally securities). The CNMV annually produces a report on all Annual Corporate Governance Reports of all listed companies with a lot of information and classification to provide a market view.	linked to the price of the shares of the company where they work. It detects and pursues illegal activities by unregistered intermediaries.	
Bank of Spain	Functions as a member of the European System of Central Banks (ESCB): ■ defining and implementing the euro system's monetary policy, with the principal aim of maintaining price stability across the euro area; ■ conducting currency exchange operations, and holding and managing the states' official currency reserves; ■ promoting the sound working of payment systems in the euro area; ■ issuing legal tender banknotes. As a national central bank it has the following functions: ■ the holding and management of currency and precious metal reserves not transferred to the European Central Bank; ■ the promotion of the sound working and stability of the financial system and, without prejudice to the functions of the ECB, of national payment systems; ■ the supervision of the solvency and compliance with specific rules of credit institutions, other entities and financial markets, for which it has been assigned supervisory responsibility, in accordance with the provisions in force; ■ the putting into circulation of coins and the performance, on behalf of the state, of all such other functions	The Banco de España, as a fully fledged member of the ESCB, is subject to the provisions of the Treaty on European Union and to the statute of the ESCB.	The start of Stage 3 of economic and monetary union (EMU) on 1 January 1999 and the institution of the European System of Central Banks (ESCB) and the European Central Bank (ECB) have meant that several of the functions traditionally performed by the national central banks of the euro-zone countries have had to be redefined.

Table 6.10.3 *continued*

Regulator/ Supervisor	Functions	Characteristics	Origin
	entrusted to it in this connection; ■ the preparation and publication of statistics relating to its functions, and assisting the ECB in the compilation of the necessary statistical information; ■ the provision of treasury services and financial agent for government debt. ■ advising the government, preparing the appropriate reports and studies.		
Directorate-General of Insurance and Pension Funds (Spanish abbreviation DGSFP)	■ To check the fulfilment of the specific requirements for the access and extension of private insurance and reinsurance activity, ordinary supervision of their exercise, the control of the necessary requirements to the company's directors and partners which carry out such activity and the rest of natural and legal entities subject to the regulation of the Legislative Royal Decree 6/2004 on 29 October, on regulation and supervision of private insurers. ■ To check the mergers, economic associations, portfolio assignments, transformations, splits and other transactions between insurances entities and the initiatives on measures and transactions involve an improvement in the sectoral structure or any of their activities, without of prejudice the assigned duties to the Spanish Competence Commission. ■ Resolution of claims and complaints submitted against the entities subject to the supervision of DGSFP. ■ Response to the issued consultants on private insures and reinsurances and pension funds.	Under the supervision of the Ministry for the Economy.	
Spanish Stocks and Markets (Bolsas y Mercados Españoles, BME)	Spanish Stocks and Markets (BME) encompasses the companies that direct and manage the securities markets and systems in Spain. It brings together, under a single activity, the decision-taking and coordination unit, the Spanish equity, fixed-income and derivatives markets and their clearing and settlement systems. The BME has a diversified structure that covers the entire chain of value in securities	The BME Group is formed by the Barcelona, Bilbao, Madrid and Valencia stock exchanges, MF Mercados Financieros and Iberclear.	BME emerges as the Spanish markets' response to the new international financial setting, where investors, intermediaries and firms demand an ever-expanding range of services and products within a

Table 6.10.3 *continued*

Regulator/ Supervisor	Functions	Characteristics	Origin
	markets from trading to settlement, including the provision of information and data-processing services.		framework of security, transparency, flexibility and competitiveness.
AIAF (AIAF Mercado de Renta Fija, SA (AIAF Fixed Income Market)	AIAF is the Rector Society of the Financial Market in which assets issued by industrial companies, banks and regional public administrations are traded in order to finance their activity. Through AIAF, issuers, in accordance with their funding strategies, offer investors a series of assets and products that cover a wide range of maturities and financial structures. Under the supervision of the CNMV, AIAF Market guarantees the transparency of trades and promotes liquidity of the listed securities.	AIAF is one of the few official and regulated European markets dedicated exclusively to these types of financial assets. AIAF is part of mF Group, which in turn has been integrated, along with the Spanish stock exchanges and the payment and settlement systems into the holding Bolsas y Mercados Españoles (BME).	Market authorized by Ministerial Order on 1 August 1991.
Spanish Futures and Options Market (Spanish acronym MEFF)	MEFF is the futures and options Spanish official market. MEFF clears and trades options and futures on bonds, interest rates, and the IBEX-35 index and futures and options on the leading Spanish stocks.	MEFF has been recognized by the Swiss and British supervisory authorities as an authorized exchange for trading with entities under their respective jurisdiction. Likewise, offering of bond and equity futures and options contracts in the United States has been authorized by the Commodity Futures Trading Commission, which has granted the 'Part 30 Exemption' to all exchange members.	It started its activities in November 1989 and belongs to the MEFF-AIAF-SENAF Holding de Mercados Financieros.

Table 6.10.3 *continued*

Regulator/ Supervisor	Functions	Characteristics	Origin
		MEFF is an official exchange and therefore is fully regulated, controlled and supervised by the Spanish authorities (CNMV and the Ministry for the Economy). Any resident or non-resident entity or natural person can be a client and trade at MEFF, buying or selling futures and options. The formal procedure for starting to trade at MEFF is as simple as opening a current account.	

6.10.3 Board Structure and Roles

The Conthe Code recommends that the board of directors should perform its duties with unity of purpose and independent judgement, according all shareholders the same treatment. It should be guided at all times by the company's best interests and hence should strive to maximize its value over time.

To this end, the Conthe Code emphasizes the need for the board to become a supervisory body that is sufficiently distinct from management to exercise its decisional capacity objectively, to ensure accountability and provide strategic guidance. The board directors are responsible for supervision as a general function, with:

- responsibility for strategy: the board of directors decides on and puts into operation the company's policies;
- responsibility for vigilance: the board of directors keeps track of the actions of the management;
- responsibility for communication: the board of directors is the link with the shareholders.

Article 123 of the Ley de Sociedades Anónimas (LSA) requires that the appointment of directors and the determination of their number shall be confirmed by a resolution of the general shareholders' meeting. When management is entrusted jointly to more than two persons, they shall constitute a board of directors.

In Spain, boards have a unitary structure, rather than the two-tier board structure found in some other EU member states that require certain types of corporations or corporations of a certain size to have a supervisory board and a distinct executive board of management. In the majority of EU member states the unitary board structure is predominant, although in several of them a board of directors and a separate general manager or managing director may be required. In addition, several member states have a unitary board of directors and a separate board of auditors.

6.10.3.1 Size

The Conthe Code recommends in the interest of maximum effectiveness and participation that the board of directors should ideally comprise no fewer than 5 and no more than 15 members. A study prepared by Spencer Stuart in 2007[1] analysed 90 listed companies, 45 of which are included in the IBEX 35 index, and found that the number of directors of the companies analysed ranged between 5 and 22, with the average being between 9 and 12.

- 27% of the companies had fewer than 10 directors;
- 56% of them had between 10 and 15 directors;
- 17% of them had more than 15 directors.

6.10.3.2 Composition

The Conthe Code recommends that external directors, both proprietary and independent, should occupy an ample majority of board places, while the number of executive directors should be the minimum practical, depending on the complexity of the corporate group and the ownership interests it controls.

Among external directors, the relation between proprietary members and independent directors should match the proportion between capital represented on the board by proprietary directors and the remainder of the company's capital. The independent directors should constitute at least one-third of all board members.

A basic distinction is made between internal or executive directors and external directors. There are two types of external directors: 'domanial' ('monetary') and 'independent' directors. The internal or executive directors are senior officers or employees of the company or its group. The board members who are senior officers or directors of the company's parent firm are to be classed as domanial directors.

The domanial external directors are:

- those who own an equity stake above or equal to the legally determined threshold for significant holdings, or are otherwise appointed as a result of their status as shareholders; or
- those representing the shareholders when:
  - the director has been appointed under a power of attorney;
  - he or she is a director, senior officer, employee or regular service supplier of the said shareholder, or of companies within the same group;
  - company records show that the shareholder acknowledges the director as his or her appointee or representative;
  - he or she is the spouse of, or maintains an analogous affective relationship with, or is a close relative of a significant shareholder.

Finally, the independent external directors are persons of acknowledged professional prestige who can contribute their experience to governing the company, satisfying the conditions of impartiality and objectivity.

The overall composition of boards in 2007, based on the study mentioned earlier, is as shown in Table 6.10.4.

Table 6.10.4 *Overall composition of company boards in Spain*

	Percentage	Average by Board of Directors
internal or executive directors	19%	2.2
external directors	81%	9.8
domanial	42%	5.1
independent	35%	4.2
others	4%	0.5

Internal or Executive Directors

The majority of companies (54 per cent) have one or two executive directors:

- 7% do not have any executive directors;
- 29% have one executive director;
- 25% have two executive directors;
- 39% have between three and eight executive directors.

External Directors

The external directors make up 81 per cent of the numerical total. Their number ranges between 4 and 18 and the average has been established at between 8 and 9.8 (Table 6.10.5).

Independent Directors

The number of independent directors is shown in Table 6.10.6.

Table 6.10.5 *Average number of external directors on Spanish company boards*

External Directors	Percentage
between 4 and 5	8%
between 6 and 10	51%
more than 10	41%

Table 6.10.6 *Average number of independent directors on Spanish company boards*

Independent Directors	Percentage
none	2%
between 1 and 3	41%
between 4 and 13	57%

6.10.4 The Roles of Chairman and Chief Executive

The Conthe Code makes no comment on the advisability or otherwise of separating the positions of chairman and chief executive, but some measures are proposed as a check on the over-concentration of power. It is proposed that when a company's chairman is also its chief executive, an independent director should be empowered to request the calling of board meetings or the inclusion of new business on the agenda; to coordinate and give voice to the concerns of external directors; and to lead the board's evaluation of the chairman.

In Spain, 72 per cent of the companies in the sample analysed have an executive chairman. The same study also shows that all companies with an executive chairman take measures to balance the chairman's power. For instance, 46 per cent of the companies have appointed a domanial or independent vice-president and 43 per cent adopt other measures such as reaching consensus decisions to try to avoid the executive chairman imposing his or her decision.

6.10.5 The Role of Independent Directors

For the board of directors to be able to exercise objective judgement on corporate affairs, their composition needs to include a proportion of independent directors. The Conthe Code recommends that one-third of the board should be made up of independent directors.

It is worth mentioning that the Conthe Code includes the definition of independent director as a binding definition and incorporates nine negative conditions that prevent someone from being an independent director. Recommendation 5 of the Conthe Code states that a director who is independent of the corporation's management should not:

1. have been an employee or an executive director of group companies during the previous three or five years, respectively;
2. have received significant payments or other form of compensation from the company or its group on top of their director's fee;
3. be, or have been during the previous three years, a partner in the external auditors or the firm responsible for the audit

report, during the said period, of the listed company or any other within the same group;

4. have been an executive director or senior officer of another company where an executive director or senior officer of the company is an external director;
5. have had material business dealings with the company or some other company in the same group or have had such dealings during the preceding year, either on their own account or as the significant shareholder, director or senior officer of a company that has or has had such business dealings;
6. have been a significant shareholder, executive director or senior officer of an entity that receives significant donations from the company or its group, or has done so during the previous three years;
7. have been the spouse, or partner maintaining an analogous affective relationship, or a close relative of one of the company's executive directors or senior officers;
8. have been proposed for appointment or renewal by the nomination committee;
9. have been in some of the situations listed in 1, 5, 6 or 7 above in relation to a significant shareholder or a shareholder with board representation.

A director with shares in the company may qualify as independent provided he or she meets all the conditions stated in Recommendation 5 of the Code and the holding in question is not significant (less than 3 per cent).

6.10.6 The Role of Advisers

A key issue is to ensure the protection of investors and shareholders – specifically, the liability and accuracy of audit reports and the objectivity of the recommendations and analyses made by financial analysts, investment banks and rating agencies. Consequently, the responsibility of advisers is based on the transparency and independence principles of their opinions and recommendations.

6.10.7 Directors' Conflicts of Interest

The regulation of conflicts of interest is included in the mandatory law. No specific definition of conflicts of interest is provided but the importance of avoiding director conflicts is acknowledged.

Some legal references on this issue are contained in:

- Article 115 of the LSA, which provides that resolutions of the general shareholders' meeting may be declared null if they are harmful to the company's interests and made for the benefit of one or more shareholders or third parties. Although this provision does not refer specifically to conflicts of interest of directors, it can be interpreted that directors would fall into the category of 'third parties' if resolutions of the general shareholders meeting were deemed to benefit directors.
- Article 127 of the LSA requires that directors: 1) refrain from entering into personal transactions using the name of the company; 2) refrain from taking personal advantage of corporate opportunities; 3) refrain from divulging confidential information; and 4) communicate all conflicts of interest to the company and do not vote on matters affected by a conflict of interest.

Corporate governance recommendations state that a meeting must be abandoned if a conflict of interest exists.

Thus, in Spain conflicts of interest are connected to the loyalty and transparency principles.

The Conthe Code reserves to the board of directors the knowledge and the authorization of transactions carried out by the company with:

- a significant shareholder;
- shareholders with board representation;
- those connected with the shareholders mentioned in the previous two points;
- inter-group transactions.

In Spain the main conflict of interests communicated to CNMV are:

- contracts for the supply of services with a director or connected person;

- transactions with a significant shareholder with representation on the board of directors.

6.10.8 Required Committees

We shall now outline the Conthe Code recommendations on committees.

The objective of committees is to exercise supervision in order to ensure control and a balance of powers in the board of directors. In addition to the audit committee, mandatory under the LMV and the Law on Measures to Reform the Financial System (Law 44/2002, dated 22 November), the Conthe Code recommends that the board of directors should form a committee, or two separate committees, on nomination and remuneration.

Committees should contain at least three external directors and should be chaired by an independent director. They may engage external advisers. The board of directors should appoint the members of such committees with regard to the knowledge and experience of the committee's individual directors, set the terms of reference of each committee, discuss its proposals and reports, and be responsible for overseeing and evaluating committees' work.

According to the Spencer Stuart Report (2007), mentioned earlier, the companies analysed had between one and seven committees:

- 54% of the companies had an executive committee;
- 100% of the companies had an audit committee (which is mandatory by law);
- 92% of the companies had a nomination/remuneration committee;
- 28% of the companies had other committees.

In the United Kingdom, 100 per cent of companies have three committees – the audit, nomination and remuneration committees – and 93 per cent of these committees are made up of independent directors. By contrast, in the United States the three committees mentioned are mandatory and 100 per cent of their members are independent directors.

6.10.8.1 The Audit Committee

All members of the audit committee, particularly its chairman, are to be appointed with regard to their knowledge of and experience in accounting and auditing matters. Listed companies will have an internal audit function, under the supervision of the audit committee, to ensure the proper operation of internal information and control systems.

Control and risk management policy must specify at least:

- the different types of risk (operational, technological, financial, legal, reputational etc) the company is exposed to, with the inclusion under financial or economic risks of contingent liabilities and other off-balance-sheet risks;
- the probability of risks occurring and the determination of the risk level the company see as acceptable;
- measures in place to mitigate the impact of risk events should they occur;
- the internal reporting and control systems to be used to control and manage the above risks, including contingent liabilities and off-balance-sheet risks.

The audit committee's role will be as follows. With respect to internal control and reporting systems:

- On the financial information prepared on the company, the audit committee will check for compliance with legal provisions and the correct application of accounting principles.
- The committee will review internal control and risk management systems on the main risks.
- The committee will oversee the independence and effectiveness of the internal audit function. It will propose the selection, appointment, reappointment or removal of the head of internal audit.
- The committee will establish and supervise a mechanism whereby staff can report, anonymously or confidentially, any irregularities they detect in the course of their work.

With respect to the external auditor:

- The committee will make recommendations to the board regarding the selection, appointment, reappointment and removal of the external auditor, and the terms and conditions of his or her engagement.
- The committee will receive regular information from the external auditor on the progress and findings of the audit programme, and check that senior management are acting on its recommendations.
- The committee will oversee the independence of the external auditor, to which end:
  - The company will notify any change of auditor to the CNMV as a significant event, stating the reasons for its decision.
  - The committee will ensure that the company and the auditor adhere to current regulations on the provision of non-audit services, the limits on the concentration of the auditor's business and, in general, other requirements designed to safeguard auditors' independence.
  - The committee will investigate the issues giving rise to the resignation of any external auditor.

The audit committee may meet with any company employee or manager, even ordering their appearance without any senior officer being present.

The audit committee will report on the following points before board decision making:

- the financial information that listed companies must periodically disclose;
- the creation or acquisition of shares in special-purpose vehicles or entities resident in countries or territories considered tax havens, and any other transactions or operations of a comparable nature whose complexity might impair the transparency of the group;
- related-party transactions.

The board of directors will present the annual accounts to the general shareholders' meeting without reservations or qualifications in the audit report.

6.10.8.2 The Nomination Committee

The nomination committee will have the following functions:

- It will evaluate the skills, knowledge and experience of the board, define the roles and abilities required of the candidates to fill each vacancy, and decide the time and dedication they will need to bring in order to perform their duties properly.
- It will examine or organize, in appropriate form, the succession of the chairman and chief executive, making the pertinent recommendations to the board so the handover proceeds in a planned and orderly manner.
- It will report on the senior officer appointments and removals that the chief executive proposes to the board.

The nomination committee will consult with the company's chairman and chief executive, especially with regard to executive director appointments.

6.10.8.3 The Remuneration Committee

The remuneration committee will have the following functions:

- It will make proposals to the board of directors regarding:
  - the remuneration policy for directors and senior officers;
  - the individual remuneration of directors and the forms of contract the company should conclude with each executive director;
  - hiring modalities for senior officers.
- It will oversee compliance with the remuneration policy set by the company.

The remuneration committee will consult with the chairman or chief executive, especially on issues involving executive directors and senior officers.

6.10.9 Shareholder Rights

The law recognizes the right of shareholders, regardless of the size of their holdings, to participate and vote in the general meeting of shareholders – although it is worth mentioning that a company's articles of association may alter this right.

The shareholders, through participation in the general shareholders' meeting, are entitled:

- to elect the board of directors;
- to amend the articles of association;
- to approve new share issues;
- to approve the selection of the external auditors, the annual accounts, the distribution of dividends, and extraordinary transactions such a mergers, acquisitions and takeovers. See Table 6.10.7.

Table 6.10.7 *Typical items reserved for shareholder action or approval*

Share Issues	Articles of Association	Election of Board of Directors	Annual Accounts	Auditors	Mergers	Dividends
×	×	×	×	×	×	×

Note: Under the regulatory framework or as otherwise usually provided in articles of association or incorporation.

The Transparency Law established new disclosure requirements to such end. The shareholders of listed companies have access to information about corporate performance through mandatory and voluntary reports; for instance, financial data must be disclosed on an annual, semi-annual or quarterly basis.

6.10.9.1 Equal Treatment of Shareholders

The LSA applicable to shareholder voting rights recognizes the principle of share voting proportionality: one share, one vote.

OECD Principle II sets out the general proposition that the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders.

The Conthe Code looks at how small shareholders can combine in defence of the corporate interest, ensuring that the shareholders use these coordination mechanisms in good faith to defend the corporate interest, and not for opportunistic purposes. Two of the coordination mechanisms contemplated are:

- creation of an electronic shareholders' forum so that individual shareholders and shareholder groups can seek others' backing or proxy for proposals to be put to the general shareholders' meeting;
- creation by the CNMV of a voluntary register of shareholder associations.

Some other mechanisms are as follows.

By-law Restrictions

The by-laws of listed companies may not limit the number of votes held by a single shareholder, or impose other restrictions on the company's takeover via the market acquisition of its shares.

The Code gives an incentive to favour the participation of minority shareholders by decreasing the limits on participation based on the number and the nominal value of shares.

Competencies of the Shareholders' Meeting

The boards of directors should submit the following decisions to the general shareholders' meeting for approval or ratification:

- the transformation of listed companies into holding companies through the process of subsidiarization;
- any disposal of key operating assets that would effectively alter the company's corporate purpose;
- operations that effectively add up to the company's liquidation;
- acquisitions of companies whose corporate purpose bears no relation to that of the buyer, when the investment amounts to more than 20% of the latter's consolidated balance sheet.

Separate Votes on General Meeting Items

In accordance with the Conthe Code, separate votes will be taken at the general meeting on materially separate items, so that shareholders can express their preferences in each case. This rule will apply particularly to the following items:

- appointment or ratification of directors, with separate voting on each candidate;
- changes to the by-laws, with votes taken on all articles or groups of articles that are materially different. In any event, articles must be voted on individually if a shareholder so requests.

Split Votes

Also in accordance with the Code, companies will allow split votes, so that financial intermediaries who are shareholders of record but acting on behalf of different clients can issue their votes according to instructions.

Transparency and Voting at the General Shareholders' Meeting

In accordance with the Code, the board will submit a consultative report on the directors' remuneration policy to the vote of the general shareholders' meeting, as a separate point on the agenda. This report will be provided to shareholders along with the annual accounts and directors' report. It will focus on the remuneration policy the board has approved for the current year, with reference to the policy planned for previous and future years.

Protection from Controlling Shareholders

The report includes a mechanism for protecting minority shareholders in situations where the majority or controlling shareholder's interest may not be the same as the interest of the company and/or the other shareholders. To such end, the controlling shareholders should abstain from voting on decisions in which they have a direct or indirect interest.

6.10.10 Disclosure and Transparency

As contemplated in this document, disclosure and transparency are issues that are highly regulated under the mandatory laws, specifically in the LMV and implementation regulations, the LSA, and the Transparency Law, with respect to:

- financial reports, as well as all relevant events that may affect the market price of shares;
- listed companies' corporate governance practices (to be reported to the CNMV);
- the composition of the board of directors;
- individual executive and director remuneration;
- shareholder structure;
- substantial changes in governance rules;
- relevant transactions (mergers, acquisitions etc).

An annual corporate governance report should be submitted to the Securities Market Commission, as specified by Order 3722/2003 of 26 December of the Ministry of the Economy. It should include:

- the structure of corporate ownership: significant shareholders, the percentage of their holdings and relations of a family, commercial or corporate nature that may exist; shareholdings of members of the board, shareholders' agreements specifying the identity of the parties; and the percentage of the company holding of its own shares during the last accounting period;
- the structure of corporate administration, composition, rules and functioning of the board and its committees, with the identification and remuneration of its members;
- affiliated operations of the company with its shareholders and its directors and managers.
- risk control systems;
- functioning of the general shareholders' meeting;
- the degree of follow-up of recommendations on corporate management or an explanation of the absence of follow-up.

Additionally, the Order establishes that listed companies shall have a web page giving at least the following information:

- the company's by-laws;
- general shareholders' meeting regulations;
- the board of directors' regulations;

- the company's annual report and internal regulation of conduct;
- a report on the company's corporate governance;
- documents relating to the general shareholders' meeting (ordinary or extraordinary);
- how the company and its shareholders communicate;
- how powers to be represented in the general shareholders' meeting are conferred;
- how distance voting and the forms required in order to vote electronically are arranged;
- other relevant facts required by the Order.

Moreover, the Order states that the company directors shall be responsible for keeping the web page updated and for coordinating its content.

6.10.11 Context of the Company's Social Responsibility

In accordance with the Conthe Code, a company in managing its business must consider the interests of society by taking responsibility for the impact of its activities on customers, suppliers, employees and shareholders, as well as the environment. Thus, the company must act in a balanced way to take into account economic, social and environmental aspects of the sectors and territories where it does business, upholding additional ethical or social obligations or commitments and any additional social responsibility principles it has subscribed to voluntarily.

6.10.12 Directors' Duties and Liabilities

The Conthe Code recommends in one of its annexes a revision of the current regime of the company director's liabilities. Some measures that might be considered in the future are:

- a clearer statement regarding loyalty and the procedures to be followed in the event of conflicts of interest;
- the extension of duties of loyalty, and the associated liability, to controlling shareholders, as well as to *de facto* and shadow directors;

- direct empowerment of shareholders to file a derivative suit for breach of trust, perhaps to be referred to as a 'minority right';
- establishment of a 'leave to proceed' filter so that a judge can reject any cases constituting abuse of process;
- the imposition of heavier penalties for unjust enrichment, to include at least the return of sums corresponding to those unjustly gained.

This Recommendation refers solely to breach of trust and not negligence or breach of care. Liability for breach of care or negligence is regulated in the LSA and LMV, and in implementation regulations. Some relevant articles are listed in Table 6.10.8.

6.10.13 Remuneration: Executive Pay and Performance

The Conthe Code recommends that the board submit a report on the directors' remuneration policy to the advisory vote of the general shareholders' meeting, as a separate point on the agenda. This report can be supplied to shareholders separately or in the manner each company sees fit.

The report will focus on the remuneration policy the board has approved for the current year, with reference, as the case may be, to the policy planned for future years. The Conthe Code also recommends that the notes to the annual accounts should list individual directors' remuneration for the year, including fixed payments, variable payments, bonuses, stock options, severance packages, pension plans and others. The Code contains some recommendations and guidelines on remuneration for directors.

All listed companies, as we mentioned earlier, should submit every year an annual corporate governance report in which directors' remuneration, including that of executive directors, is disclosed. Companies are requested to split the remuneration into different categories such as fixed amount, variable amount, severance package, pension plan etc, but only for groups of directors (executive directors, independent directors, etc).

According to the Spencer Stuart Report (2007), mentioned earlier, CEO performance is evaluated at 58 per cent of companies.

Table 6.10.8 *Some articles from the LSA and LMV relating to negligence*

LSA – Civil Responsibility Derived from a Breach of the Corporate Governance Rules	LMV – Administrative Responsibility Derived from a Breach of the Information Rules on Corporate Governance
Article 112 sets out directors' liability to meet the obligation to provide information requested by shareholders on the issues contemplated in the board of directors' agenda or on the public information provided by the CNMV.	**Article 35** Information obligation for listed companies: Each year, issuers of securities listed on any official secondary market shall submit their financial statements to audit.
Article 127 sets out directors' liability to perform their duties: (i) with the diligence of a careful businessperson, and as loyal representatives, (ii) with faithfulness, (iii) with loyalty and (iv) under secrecy.	**Article 112** relates to the disclosure of shareholder agreements and other pacts that affect a listed company. Shareholder agreements shall be understood to be those agreements that include regulating the exercise of voting rights in shareholders' meetings, or that restrict or condition the free transferability of listed companies' shares, or pacts that, with the same objective, refer to convertible or exchangeable bonds issued by a listed company. Shareholder agreements must be disclosed immediately to the company in question and to the CNMV. Once these disclosures have been made, the document containing the shareholder agreement must be recorded in the Mercantile Registry in which the company is registered. At the request of the interested parties, when disclosure may be seriously detrimental to the company the CNMV may decide not to disclose the shareholders' agreement of which it has been informed, or to disclose part of it, and to dispense with notice to the company itself of said agreement, with the deposit of the document on which it appears in the Mercantile Registry, or with its publication as a significant disclosure, determining the time for which it can be kept secret among the interested parties.

Table 6.10.8 *continued*

LSA – Civil Responsibility Derived from a Breach of the Corporate Governance Rules	LMV – Administrative Responsibility Derived from a Breach of the Information Rules on Corporate Governance
Article 133 The directors shall be responsible by the damages caused to the company, shareholders and creditors by acts against law or by-laws or breach of their obligations. The directors have personal responsibility. The joint and several liability shall apply to all board members, unless for those directors who can prove that: a. the relevant resolution was taken without their intervention; or b. they had expressed clear opposition to the resolution; or c. they were unaware of the resolution. Approval of the harmful resolution by the general shareholders' meeting will not relieve directors of their responsibility.	**Article 114** The directors shall not be entitled to adopt resolutions that are harmful to the company's interests or that represent a conflict of interest, or obtain profits by means of privileged information that they obtain by virtue of their functions. **Article 116.** Annual Report on Corporate Governance. Listed companies must publish a corporate governance report on a yearly basis. The annual report on corporate governance must be notified to the CNMV, accompanied by a copy of the report itself. The CNMV must forward a copy of said report to the respective supervisory authorities when the company in question is a listed company within the scope of its competencies. **Articles 99 and 100** recognize as serious infringements acts or omissions by individuals or legal entities that breach information obligations.

Note

1. All the data taken from this report refer to the status of boards of directors as at 31 January 2007.

Further Information

Web Pages

- www.iconsejeros.com (Instituto de Consejeros-Administradores)
- www.cnmv.es

- www.bolsamadrid.es
- www.iberclear.es
- www.meff.es
- www.aiaf.es
- www.europa.eu
- www.spenserstuart.com
- www.bde.es
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European Commission (2002) *Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States*, January

IC-A (2004) Principios de buen gobierno corporativo (Principles of Good Corporate Governance), June

IC-A (2005) Guía para la incorporación a un consejo de administración: consejero no ejecutivo/externo (Guide to Sitting on a Board of Directors: No Executive/External Director), July

IC-A (2005) Código de ética para empresas (Code of Ethics for Companies), September 2005

IC-A (2005) Principios de buen gobierno corporativo para empresas no cotizadas (Principles of Good Corporate Governance for Unlisted Companies), December

Olivencia Code (1998)

Study prepared by Spencer Stuart on board of directors (2007)

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The Instituto de Consejeros-Administradores (IC-A) is the Spanish association of board directors of companies and

enterprises. It is an independent, non-political, not-for-profit organization made up of individual directors.

Among its purposes are the promotion, diffusion and establishment of international models on corporate governance practices, the implementation of the highest standards of professional regulations, as well as training of directors in order to improve director professionalism. IC-A's Directors' Training Programme is highly appreciated and recognized in Spain as well as abroad.

Furthermore, it also issues opinions on rules, regulations and guidelines affecting corporate governance both before and after they have been enacted, and represents and defends directors' interests before public administrative bodies and in civil society.

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6.11

Canada

Aaron Emes, Torys

6.11.1 Introduction*

The start of the revolution in corporate governance in Canada is marked for many observers by the work of the Toronto Stock Exchange (TSX) Committee on Corporate Governance in Canada, chaired by Peter Dey, a well-known corporate governance advocate, beginning in 1993. The committee was set up after a number of high-profile corporate failures in Canada and the pressing question that arose about the role of directors in those cases.

The committee released its report, known as the Dey Report – but also, more provocatively, by its title, *Where Were the Directors?* – in 1994. The report established 14 best-practice guidelines for corporate boards. Among other things, the guidelines called for a majority of independent directors and for separating the roles of chairman and chief executive officer (CEO). The guidelines were voluntary, but companies listed on the TSX had to report annually, as a condition of being listed, on whether they were adhering to them, and if not, why not.

* Note: this Introduction is by Beverly Topping, CEO of the Institute of Corporate Directors.

There has been considerable progress since 1994 in strengthening corporate governance in Canada. From being a matter of interest to a few devoted advocates, it is now front and centre for many people involved in the capital markets. Membership in the Institute of Corporate Directors (ICD) has grown 10-fold to over 3,000 individuals. We have developed a formal director education programme that is delivered by leading business schools across the country. As of the fall of 2008 there are more than 1,500 graduates. We have also developed a formal certification process for graduates, the ICD.D; to date, more than 900 directors have achieved that distinction.

At the ICD we believe that director education can play an important role in developing better directors, better boards and, ultimately, better businesses. Research undertaken in 2007 by Professor Michael Hartmann while at the University of Toronto's Rotman School of Management showed that:

- participation in a director education programme has a positive impact on trainees' knowledge, skills and attitudes;
- a director education programme promotes transfer of learning from the classroom to the boardroom;
- a director education programme enhances appointment opportunities for groups traditionally under-represented on corporate boards.

The full research report is available on our website at www.icd.ca.

On the regulatory front there have been significant changes made to various governance requirements. However, there is a sense among many governance observers in Canada that rigorous criminal prosecution of white-collar crime is lagging behind that in some other jurisdictions. A report commissioned by the RCMP (Canada's national police force) and released in December 2007 was sharply critical of the efforts of the RCMP's enforcement. Part of the reason may lie in the lack of a single national securities regulator, with this responsibility being held by various provincial agencies across the country. There have been many efforts over the years to create a single regulator (or a passport system whereby approval in one jurisdiction would be recognized in another), without success so far.

Business is becoming ever more global in scope, as trade and investment barriers continue to fall. As a consequence, many directors need to keep abreast of corporate governance trends and regulatory requirements across multiple jurisdictions. The ICD is a member of the Global Director Development Circle together with our sister institutes in Australia, New Zealand, South Africa, the United Kingdom and the United States. Collectively we are working on sharing these trends, identifying best practices in corporate governance and providing information for director education programmes. The ICD, for instance, developed a set of 13 Key Competencies for Director Effectiveness (see Appendix A); these have received favourable feedback both within Canada and by our sister organizations internationally.

6.11.2 Legal Framework: Laws, Models and Codes

Corporate governance in Canada is evolving rapidly. Until recently, corporate governance was an area of law defined primarily by the statutes under which companies incorporate, with little in the way of active regulatory oversight. However, the past decade has seen securities regulators and institutional investors increasingly flex their muscles in terms of governance requirements and standards. There is a belief among these market watchdogs that more prescriptive governance requirements would have mitigated the damages suffered by investors in a number of failed publicly traded corporations.

6.11.2.1 Corporate Statutes

In Canada, companies incorporate under either provincial or federal corporate statutes. For the typical publicly traded corporation,[1] there is no significant difference in these statutes in terms of basic corporate governance requirements, with the two key governance duties of directors and officers being: 1) a *duty of care* – that is, a requirement of directors and officers, in fulfilling their roles, to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances; and 2) a *duty of loyalty* – that is, a duty to act honestly and in good faith, with a view to the best interests of the corporation.[2]

In satisfying the duty of care, courts in Canada have imported from the United States the concept of the business judgement rule; that is, as long as directors and officers have made an informed and reasonable decision, courts will not second-guess them by substituting their own business judgement, even if the decision is ultimately not the best one.

In satisfying the duty of loyalty, courts in Canada have made it clear that the duty is owed to the corporation itself, as opposed to any particular constituent of the corporation. For example, it would be improper for a director to take into account the interests of a shareholder responsible for electing that director at the expense of the corporation. A more difficult issue is whether, in the circumstances of a potential merger or acquisition of the corporation, the duty of loyalty requires the board of directors to seek to maximize shareholder value as its primary function. A recent Supreme Court of Canada decision examined this specific question and reiterated that at all times the duty of loyalty requires directors to act in the best interests of the corporation. However, in doing so, the Supreme Court provided directors with broad discretion to determine how to satisfy the duty of loyalty and treated the question as one of business judgment not to be overturned by courts unless the decision taken falls outside the range of reasonableness. The effect of the decision in that case was to uphold a value-maximizing strategy.

6.11.2.2 Securities Regulators

Canadian securities regulators[3] have waded into the governance arena, primarily through two measures: 1) a rule containing a number of mandatory requirements in respect of audit committees, including the composition of audit committees of senior issuers (being those listed on the Toronto Stock Exchange), the responsibility of audit committees to recommend the retainer of the corporation's auditor and the responsibility to oversee the work of the auditor in the preparation of financial statements; and 2) a policy statement outlining what Canadian securities regulators consider to be best corporate governance practices, with an associated disclosure rule requiring public companies to compare their approach against the recommended practices (a so-called comply or explain approach).

Table 6.11.1 sets out the key Canadian sources of governance requirements.

6.11.2.3 Institutional Shareholders

Institutional shareholders in Canada have also become increasingly vigilant in their approach to governance. Many significant institutions have developed proxy guidelines that set out governance

Table 6.11.1 *Key Canadian sources of governance requirements*

Federal and Provincial Incorporating Statutes	Rules and Policies of Canadian Securities Regulators
See, for example, the Canada Business Corporations Act: ■ Section 122 (duty of loyalty / duty of care) ■ Section 115(3) (restrictions on delegation by directors) ■ Section 105(3) (director residency) ■ Section 137(4) (nomination rights) ■ Section 143(1) (right to requisition a meeting)	■ National Instrument 51–102 – Continuous Disclosure Obligations ■ Multilateral Instrument 52–109 – Certification of Disclosure in Issuers' Annual and Interim Filings ■ National Instrument 52–110 – Audit Committees ■ National Instrument 58–101 – Disclosure of Corporate Governance Practices ■ National Policy 58–201 – Corporate Governance Guidelines ■ Multilateral Instrument 61–101 – Protection of Minority Security Holders in Special Transactions.

standards that the institutions will require to be met in order to vote in favour of corporation-nominated directors. Many institutions also retain proxy advisory services that develop their own sets of governance standards in order to advise the institutions on how they should vote.

The Canadian Coalition for Good Governance (CCGG) was established in 2003 to represent Canadian institutional shareholders in the promotion of corporate governance practices that best align the interests of boards and management with those of shareholders. Currently, there are 46 members, who in total manage approximately C$1.4 trillion of assets on behalf of Canadian investors. The CCGG has contributed to the national debate, advocated for certain governance changes and undertaken board governance ratings, to name some activities.

6.11.3 Board Structure and Roles

Under Canadian requirements and practice, the role of the directors is to oversee management's running of the day-to-day operations of the corporation, as opposed to being directly involved in those operations. Under corporate and securities laws, directors are required to approve certain key matters (that is, there are certain matters that cannot be delegated to management), including: 1) equity issuances; 2) matters that require shareholder approval; and 3) approval of financial statements. In practice, boards typically require approval over a broader set of areas, with specific financial or strategic markers setting out the extent of board involvement and what management may do without board approval or oversight.

The board composition recommended by securities regulators is a majority of independent directors, with a compensation committee and a nominating committee each composed entirely of independent directors. In addition, the audit committee rule requires senior issuers to have an audit committee composed entirely of independent, financially literate members, with a minimum total of three members. Independence is rigorously defined and precludes, among other restrictions, any family members of management, any employees of the corporation's auditor, those who receive compensation from the corporation other than for board work, and members of management of controlling shareholders (in the case of the audit committee). In cases of transactions involving management or significant shareholders, it is also typical for a special committee of independent directors to be formed to review and approve the transaction, with securities regulation mandating such an approach in certain circumstances.

In practice, most large publicly traded companies do in fact have a majority of independent directors, even in the case of family-controlled corporations, a common feature in Canadian public markets. To do otherwise runs the risk of institutional shareholders not supporting corporation-nominated directors, as this is an area of particular concern to them. Board size has also become smaller (with recommended sizes typically in the range of 5–20 members) as governance standards look negatively on larger boards, viewing them as unwieldy. Most Canadian corporate statutes also require a certain number of Canadian resident board members.

The CEO is typically a board member. However, it is much less common than it used to be for the CEO to also be the chairman of the corporation. Today, 84 per cent of boards in Canada have separate and independent chairs, a percentage that is much higher than in the United States, where 8–10 per cent of boards have independent and separate chairs. Indeed, it might be stated that in Canada the debate is over; the accepted best practice is separation.

In those circumstances where the CEO is the chairman, governance best practices dictate that there also be an independent lead director, a practice that is generally followed in Canada.

6.11.4 Shareholder Rights

The primary right of shareholders with respect to the operation of the corporation is to vote on the election of directors of the corporation, as mandated by corporate statutes. Shareholders holding in aggregate at least 5 per cent of the shares of the corporation may also require management to include nominees in the proxy materials circulated by the corporation. In addition, there are no restrictions on shareholders nominating candidates at the meeting of shareholders. In this regard, there are recent examples in Canada of activist investors holding significant shares making surprise nominations at meetings and voting out the corporation-nominated slate of directors. Shareholders holding 5 per cent or more of the corporation's shares may also requisition a meeting.

As noted above, institutions have become more vocal on mandating certain governance requirements to be met before they will vote in favour of the corporation-nominated slate of directors. Furthermore, there is a developing practice in Canada (but by no means a standard practice at this time) of majority voting policies – whereby the corporation has a policy of requiring directors who receive a majority of 'withhold votes' from shareholders in an uncontested election to resign.

Shareholders may also exercise rights derivatively on behalf of the corporation, including the right to cause the corporation to take action against directors and officers who have failed to perform their duties properly. Corporate statutes in Canada also provide shareholders with an oppression remedy whereby shareholders may apply to a court to seek remedies against the corporation or a director if the corporation or director acts in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of the shareholder. Oppression remedy cases are much more common in private company circumstances and tend to be examined through the scope of the reasonable expectations of the shareholder.

6.11.5 Disclosure and Transparency

Canadian public corporations are subject to extensive disclosure requirements. Canadian securities regulators consider it essential to a fair and equitable trading market that shareholders make investment decisions on a fully informed basis and on a level informational playing field. In this regard, public companies are required to provide quarterly and annual financial statements (audited in the case of annual statements) accompanied by a discussion by management of key financial changes. Public companies must also annually disclose an information form that provides a general overview of the corporation's business. In addition, the CEO and Chief Financial Officer (CFO) must personally certify the accuracy and completeness of such quarterly and annual disclosures. Senior issuers are also subject to requirements regarding establishing and reporting on internal financial and disclosure control procedures.

Canadian companies are subject to timely disclosure requirements under which they are required to disclose immediately any material change to the business, operations or capital of the corporation. Such timely disclosure requirements, combined with the periodic disclosure requirements described above, in theory provide investors with a clear snapshot of a corporation's state of well-being at any given time. In practice, however, the determination of when a material change has occurred can be a difficult one, particularly in the case of merger negotiations, where many different stages are involved (confidentiality agreement, non-binding letter of intent, binding purchase agreement, receipt of regulatory approvals, closing). In a recent case, Canadian securities regulators held in this context that the material change generally occurs when both parties have legally committed themselves to the completion of the merger, which is typically at the point of the binding purchase agreement.

6.11.6 Responsibility

Canadian corporations are not subject to general requirements with respect to ethical conduct and social responsibility. However, many industries have their own detailed regulatory requirements that govern various manners of how business is conducted, including extensive regulations in matters involving the environment, occupational health and safety and employment standards. It is also typical now (and a recommended governance practice of Canadian securities regulators) for corporations to have codes of conduct covering conflicts of interest; proper use of corporate assets and opportunities; confidentiality of corporate information; fair dealing with shareholders, customers, suppliers, employees and competitors; compliance with laws; and reporting of illegal or unethical behaviour.

6.11.7 Directors

As was mentioned earlier, the main duties of directors of Canadian public companies are the duty of care and the duty of loyalty. Breaches of those duties can potentially lead to personal liability pursuant to a derivative action by the corporation or pursuant to an oppression remedy claim by shareholders. In addition, directors in Canada face a myriad of potential statutory liabilities, including liabilities for unpaid wages, unpaid corporation taxes, liabilities for breaches of environmental and occupational health and safety requirements, and liabilities for failing to comply with obligations and standards under pension benefits legislation.

More recently, statutory civil liability for public disclosure violations (including misrepresentations in financial statements and failure to make timely disclosure of material changes) has been implemented, including personal liability for directors and officers for such violations. The legislation also facilitates class-action suits by shareholders for such violations. However, directors and officers are afforded a due diligence defence, and such a defence will succeed if it can be established that a reasonable process was implemented to avoid disclosure violations. This has led the vast majority of Canadian public companies to implement disclosure policies that provide detailed processes that must be followed prior to a document being issued to the public. In addition, many companies now have disclosure committees made up of senior members of management to consider disclosure questions that arise from time to time and report to the board in respect thereof.

It is a recommended best governance practice (of both Canadian securities regulators and institutional investors) that directors have a comprehensive understanding of, first, the roles and duties of directors generally, and second, the corporation's business. Many public company directors now take rigorous courses such as those offered by the Institute of Corporate Directors, both to orient themselves as to the proper role of a director and to stay current on best governance practices and legal developments in this area.

6.11.8 Executive Pay and Performance

There is little regulation around the topic of executive pay, leaving boards free generally to determine such matters as they see fit, subject to the duties of care and loyalty noted above. However, there are detailed compensation disclosure requirements requiring corporations to report annually on amounts (cash, stock or otherwise) paid to senior officers; and such disclosure requirements are in the process of being enhanced. In addition, there is a general trend towards using objective performance-based standards in order to establish executive pay and bonuses, with a particular focus on longer-term corporate success. In this regard it is not uncommon now for boards or compensation committees to retain outside consultants to advise on executive pay packages.

In 2007 the Institute of Corporate Directors released a Blue Ribbon Commission (BRC) Report on the Governance of Executive Compensation in Canada. The BRC Report noted that executive compensation packages play a key role in determining how executives will run the firm. Accordingly, the BRC Report championed a new standard for transparency about compensation decisions and provided a straightforward process that corporations of any size can follow to ensure that executive pay is tied to the actual performance of the corporation. The report also called for improved financial and human resources literacy among members of compensation committees, and an increase in independence of the committee and its advisers.

Notes

1. Under the corporate statutes, private companies may contractually restrict the roles, and therefore the duties, of directors and officers through unanimous shareholder arrangements and similar agreements. As corporate governance in Canada is primarily focused on public companies, the different circumstances that may apply to non-public companies are not examined in this profile.
2. Canada has a significant number of publicly traded unincorporated vehicles, including trusts and limited partnerships. These vehicles, in their organizational

documents, typically apply similar duties to trustees, directors, officers and similar persons; investment banks require such as a condition of underwriting them.

3. In Canada, securities laws are regulated at the provincial level. However, in the governance area the provincial regulators have generally harmonized their requirements.

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Appendix: ICD Key Competencies for Director Effectiveness and Their Relationship to Specific Tasks

Competency Group: Knowledge Tasks

C1 *Knowledge of Specific Industry, Company and Its Executive Team*. Understands the competitive environment in which the company operates. Understands the company strategy and the respective roles of the executive team in operationalizing this strategy. Tasks T1, 2, 4, 5, 6 (see below for description of the tasks)

C2 *Knowledge of Board and Role*. Understands own responsibilities, accountabilities and liabilities as a director and board member. Is knowledgeable of best practice principles associated with board structure and board processes as set out by the Canadian Coalition for Good Governance. Tasks T1, 2, 4, 5, 6

Competency Group: Analytical and Technical Skills

C3 *Financial Acumen*. Can read and interpret financial reports. Task T1

C4 *Group Decision Making Orientation*. Can identify and diminish 'group think' tendencies and recognizes decision-making biases in board discussions. Tasks T1, 2

C5 *Process Orientation*. Makes decisions and seeks outcomes through the consistent application of a logical sequence of steps. Tasks T1, 3

Competency Group: Thinking

C6 *Independent Thinking Skills*. Maintains own convictions despite undue influence, opposition or threat. Tasks T1, 9

C7 *Open-mindedness/Information-seeking Skills*. Values the diverse opinions of others and builds innovation on the foundation of other people's views. Tasks T1, 3

Competency Group: Personal Style

C8 *Ambiguity Tolerance*. Based on limited information, retains a positive outlook when the group is unable to resolve an issue or reach a conclusion and is willing to make a risk-adjusted decision when the outcomes are uncertain. Seeks decisions that optimize the relationship between risk and reward. Tasks T1, 3, 4, 5, 6

C9 *Effective Judgement*. Applies common sense, measured reasoning, knowledge and experience to come to a conclusion. Tasks T1, 4, 5, 6, 7, 8

C10 *Integrity*. Trustworthy and conscientious and can be relied upon to act and speak with consistency and honesty. Tasks T1, 3

C11 *Self-awareness*. Accurately assesses strengths and weaknesses of self and of others and can manage them successfully. Task T9

Competency Group: Social Style

C12 *Orientation to Resolve Conflict*. Ensures conflict is resolved with justice and fairness in order to restore healthy relationships. Tasks T1, 3, 9

C13 *Effective Communication and Listening Skills*. Gives and receives information with clarity, attentiveness, understanding and perception. Task T9

Tasks

T1 *Understanding and evaluating strategic plans and reports presented by management*. In order to effectively understand and evaluate issues and risks, a director must have some level of knowledge of a firm's capabilities and its competitive environment. Individually, directors must also understand that their responsibility is to oversee the development of the firm's strategic plan and obtain management updates on developments affecting the strategy as opposed to being directly involved in the management process. Some basic level of financial acumen is needed to support this task. Directors must also be able to reach their own independent conclusions based on information provided by management to the board. This will require an ability to think objectively and with an open mind in order to see possible trends and patterns or relationships presented by the data which may not be readily apparent in any communication. Finally, directors must be able to communicate their feedback to management in a clear and logical manner.

T2 *Monitoring financial performance*. Effective monitoring of financial performance requires directors to have some degree of financial acumen, including the ability to read and interpret financial reports. Some industry/company knowledge is required to provide context for the financial data.

T3 *Recognizing and validating management's and fellow directors' underlying decision assumptions*. To be effective in recognizing and validating the decision-making assumptions of others, it is important to have the analytical skills needed to recognize 'group think' dynamics and breakdowns in decision-making logic. Individuals with this skill have a strong level of self-awareness and the ability to examine a situation with a completely objective and open mind in order to reach independent conclusions.

T4 *Selecting, hiring and evaluating top management*. An effective selection and hiring process requires directors to be knowledgeable about the company and its executive team and to make decisions by exercising their best judgement. To establish an effective evaluation process, directors must have the ability to draw conclusions through the impartial evaluation of other perspectives and views without prejudice or biases.

T5 *Setting and negotiating compensation for top management*. Setting and negotiating compensation requires directors to exercise effective judgement aided by their industry/company knowledge regarding reasonable compensation measures.

T6 *Developing effective succession plans for top management*. An effective succession planning process requires directors to be knowledgeable about the specific needs of the company and executive team and to make decisions using their best judgement.

T7 *Prioritizing relevant risks*. To prioritize risks effectively requires establishing a logical process for first identifying all relevant risks, based on an understanding of the industry/company, and then determining an acceptable relationship between risk and possible reward which should be used to guide a director's decision-making process.

T8 *Ensuring appropriate risk levels*. An effective board ensures that, once prioritized, relevant risks are continuously monitored for appropriateness.

T9 *Supporting an effective and efficient board meeting process*. An effective board meeting process is one that promotes effective and efficient decision making based on clear, consistent and honest communication, effective judgement and reasoned debate. This process strives for consensus but also supports initiative and accepts opposition. When conflict does arise, it is dealt with justice and fairness in order to restore healthy relationships.

6.12

The Development of Corporate Governance in Australia

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Australia has a robust economy that has sustained unparalleled growth among the advanced industrial countries for the past two decades, and has mature corporate governance and regulatory institutions. However, the country and economy also bear the legacy of the colonial past, the origins of industry in the vast resources of the country, and the dependence created by being a relatively small country in terms of population and market capitalization with a high proportion of overseas ownership of Australian assets.

Broadly speaking, Australian corporate governance firmly follows Anglo-American traditions, as a result of Australia's close economic relations with the United Kingdom and the United States. However, the model of dispersed ownership is less applicable to Australia, where there is a higher proportion of concentrated holdings, whether due to foreign ownership or entrenched family ownership. Historically, Australian market cycles and corporate governance enjoyed an Eldorado aspect (Sykes, 1996); however, standards of market regulation and corporate governance have risen considerably.

6.12.1 Development of Laws, Models and Codes

Much of Australian law originated from Great Britain during colonial times, but after independence and the establishment of the Constitution in 1901, Australian lawmaking followed its own peculiar path, because of the unique division of powers between federal and state governments. It was only very recently, in 2001, that the states reluctantly agreed to give up most of their powers in order to permit the creation of a national system of legislation set out in the Corporations Act 2001 (see Figure 6.12.1).

Henry Bosch (who, like Adrian Cadbury in the United Kingdom, produced one of the first reports on corporate governance in Australia) commented, 'Before the crash of 1987 the term corporate governance was rarely used in Australia and few people gave much thought to the concepts now covered by it' (2002, p 273). As this suggests, reform of Australian corporate law was a response to unethical behaviour and fear of economic downturn after several corporate scandals in the 1980s and 1990s. The hotchpotch of regulators at state level, all with different priorities and inadequate resources, was thought to have given free rein to Australia's corporate cowboys (Clarke, 2007, p 146).

Some would say the Corporations Act 2001 is not much better than what went before. John Farrar, a lawyer and author of one of the key textbooks on Australian corporate governance, describes it as 'a monument to complexity and confused thinking about modernisation' (2005, p 15). Nevertheless, it did create one lead regulator, the Australian Securities and Investment Commission (ASIC), empowered to enforce both the Corporations Act 2001 and the listing rules of the Australian Stock Exchange (ASX). Also, in recognition of the need for dynamic legislation, the Corporate Law Economic Reform Program (CLERP) was commenced, involving regular policy reviews and legislative amendments to the Corporations Act 2001.

Corporate governance, both in practice and in theory, comprises more than just legal regulation. The first set of Australian corporate governance standards were developed by a working group made up of leading business organizations. After the corporate collapses

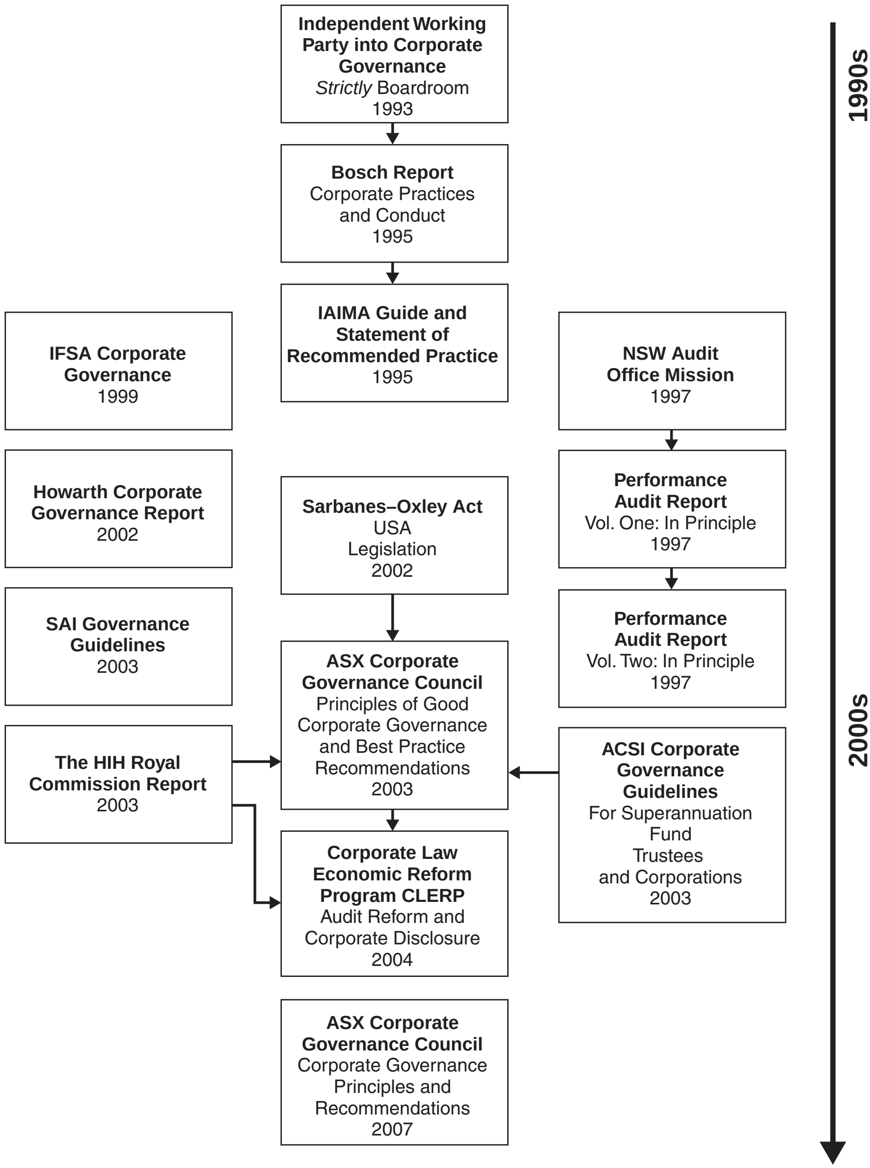

Figure 6.12.1 *Reform of corporate governance in Australia*

of the 1980s it became difficult for companies to raise capital and it was the Business Council, the Australian Institute of Company Directors, the ASX and professional accounting bodies that got together and published the document *Corporate Practices and Conduct* in 1991 (Bosch, 2002, p 274). Commonly known as the Bosch Report, this document was revised and updated in 1993 following publication of the United Kingdom's *Cadbury Report on the Financial Aspects of Corporate Governance* in 1992 (the Cadbury Report) and again in 1995.

This type of collaborative effort continues today. The current guiding light of governance standards is the ASX's *Corporate Governance Principles and Recommendations* (ASX Corporate Governance Council, 2007) (the *ASX Principles*). This is a revised edition of the *Principles of Good Corporate Governance and Best Practice Recommendations*, launched in March 2003. The *ASX Principles* were drafted by the ASX Corporate Governance Council (CGC), a body made up of representatives from 21 business organizations promoting the interests of a wide range of groups such as shareholders, directors, accountants and superannuation funds. The CGC reports to the ASX, which is a commercial entity licensed under the Corporations Act as a market operator.

The *ASX Principles* provide an extensive framework for good corporate governance by setting out eight broad principles together with more detailed recommendations for putting them into effect. They cover topics such as board composition, director independence, financial reporting, ethics, market disclosure, communication with shareholders, risk management and fair remuneration.

It is important to understand the regulatory context of the *ASX Principles*. First, they apply only to ASX listed companies; and second, they do not have direct legal effect. The legal force behind them comes primarily from the ASX listing rules.

Listing rule 4.10.3 requires companies to disclose the extent to which they have adopted the *ASX Principles* and to explain any decision not to adopt particular recommendations. The adoption of the 'comply or explain' principle means that it is not necessary for all listed companies to apply all of the ASX principles. It is possible to comply fully by giving an explanation of why each recommendation has not been followed. (The only exception to this is in relation to audit committees, where an ASX listing rule requires mandatory compliance for larger companies.)

In general, therefore, the *ASX Principles* do not uniformly mandate or prescribe good governance and they do not restrictively prescribe which practices amount to good governance. By forcing disclosure, the system allows investors to decide how much importance to place on a company's governance practices. The impetus is on the companies – to either follow the *ASX Principles* or explain why they have taken an alternative approach. In a strict legal sense, adoption of the *ASX Principles* is entirely voluntary. The pressure to demonstrate that a company has good governance comes not from legal sanctions but from market forces. In principle it is possible to comply by giving an explanation of why an ASX recommendation has not been followed, and the market can decide whether this is an acceptable explanation or not. Yet there is considerable evidence that the benchmarking surveys of corporate governance conducted by investment institutions exert a consistent pressure towards full compliance, reducing some of the flexibility that was intended for companies to develop models of corporate governance appropriate to their needs.

Australian law is not silent on corporate governance; quite the contrary. At around the same time as the first edition of the *ASX Principles* was being developed, the ninth policy paper in the legal reform programme mentioned earlier (CLERP 9) proposed various changes to the Corporations Act 2001, focusing upon governance. Like the corporate governance developments of the early 1990s, these changes followed a period of international corporate disasters in 2001–02. The impact of the spectacular downfall of US companies such as Enron and WorldCom was heightened by the collapse of local Australian companies such as HIH Insurance and OneTel from similar causes.

CLERP 9 made amendments to the Corporations Act in four key areas: executive remuneration, financial reporting, continuous disclosure and shareholder participation. These will be discussed in more detail later in the chapter; however, most of the amendments were based on a similar principle to the *ASX Principles* – requiring disclosure of practices rather than prescribing those practices.

Therefore, both the *ASX Principles* and CLERP 9 are designed to increase the amount of information provided by companies to their investors and the public at large. The CLERP 9 provisions do not permit explanations of non-compliance but generally do not prescribe in detail how companies must arrange their internal affairs. The Australian approach overall is one of flexible regulation designed to leave much of the enforcement to the market. This follows the United Kingdom's Combined Code approach rather than the more prescriptive nature of the Sarbanes–Oxley Act in the United States.

The corporate response to these reforms on the whole has been good. The level of adoption of the *ASX Principles* by listed companies has increased every year with disclosure in annual reports improving greatly in its clarity and coverage (ASX, 2008). The influence of the *ASX Principles* has extended to non-listed companies, with many large private entities and smaller start-ups choosing to adopt the recommendations.

6.12.2 Board Structure and Roles

The board of an Australian listed company typically consists of six to eight directors of whom one or two would be executives and the rest non-executives. Increasingly, the non-executive directors meet the exacting *ASX Principles'* definition of an independent director, although there has been some scepticism about the value of such independence. It is now unusual to find a CEO who also acts as chairman of the board. Nearly all listed companies will have an audit committee and most will also have a nomination and remuneration committee as recommended by the *ASX Principles*.

Ownership structure tends to be more concentrated in Australia than in the United Kingdom or United States, with many companies having one or two influential shareholders owning a large proportion of shares. In 1999 only 11 of the 20 largest publicly quoted companies were widely held (that is, did not have a shareholder with 10 per cent or more of the equity) (Clarke, 2007, p 144).

Nearly all listed companies now have a board charter in accordance with the *ASX Principles*, which defines and separates the roles of board and management. The role of advisers, particularly accountants, has also been more carefully defined in recent years. CLERP 9 requires formal statements from directors regarding the integrity of the accounts, as well as disclosure of certain information related to auditor independence. Instead of prohibiting appointment of the auditor for consulting services, it requires disclosure of the amounts paid for such services and an explanation of why this does not compromise auditor independence.

6.12.3 Shareholder Rights

Under the Corporations Act 2001 the most significant rights of shareholders are: 1) the right to information and accounts; 2) the right to vote; 3) the right to requisition general meetings and propose resolutions; and 4) the right to appoint and remove directors (Farrar, 2005 p 166).

A comply or explain system of corporate governance regulation relies on the market as arbiter of corporate behaviour, not the legislator. It is therefore vital that shareholders assess and act upon the information disclosed. Historically, however, shareholder activism in Australia has not been strong. For this reason, CLERP 9 introduced various provisions aimed at encouraging shareholder participation in corporate governance. For example, AGM notices must be clear and concise, and the auditor must be available at the AGM to answer questions. However, it seems likely that technical advances such as the internet are likely to be most effective in promoting activism. Information is readily available on company websites, and some companies are now producing webcasts of their AGM and e-mail updates of ASX announcements.

6.12.4 Disclosure and Transparency

Australia has a continuous disclosure regime that requires prompt disclosure of price-sensitive information. The test is whether a reasonable person would expect the information to have a 'material effect' on the value of the securities of the entity. CLERP 9 strengthened this regime in two ways: 1) by imposing personal liability on individuals responsible for a failure to disclose; and 2) by giving ASIC the power to issue infringement notices.

These enforcement powers were deemed necessary to improve compliance with the continuous disclosure regime. They demonstrate a more traditional, legal approach to regulation through deterrence and sanctions for breach. If ASIC has reasonable grounds for believing that a disclosing entity has contravened the continuous disclosure provisions (usually such belief will be based on a prior investigation), it can issue a notice requiring payment of a penalty of up to A$100,000. Companies can choose to comply, request withdrawal of the notice or not comply. If they do not comply, ASIC can commence civil proceedings. The provisions aim to provide a method of enforcing minor breaches where costly court action would not be warranted at first instance.

When the *ASX Principles* were first introduced, the principle regarding risk management was one of the more controversial issues. It recommended that companies establish policies on risk oversight and management and disclose a description of those policies. In addition, to back up their declaration on the integrity of financial statements, it was recommended that the CEO and CFO declare that such statement was founded on a sound system of risk management and internal controls.

Much of this was new to companies, and there was confusion over what was expected. Companies were unclear as to whether this additional sign-off was to extend to non-financial risks. The second edition of the *ASX Principles* (ASX Corporate Governance Council, 2007) made it clear that the sign-off was to cover only financial risks. However, a new recommendation suggests that the board request a management report that also covers material non-financial business risks.

6.12.5 Corporate Social Responsibility

There have been two recent inquiries into the issue of corporate social responsibility (CSR) in Australia. In March 2005 the Parliamentary Secretary to the Treasurer requested advice from the Corporations and Markets Advisory Committee (CAMAC) on 'the extent to which the duties of directors under the *Corporations Act 2001* should include corporate social responsibilities'. CAMAC released a discussion paper in November 2005 and then a final report in December 2006.

In addition, in June 2005 the Parliamentary Joint Committee on Corporations and Financial Services (PJC) initiated an inquiry into corporate responsibility. Its purpose was to examine 'the extent to which organisational decision-makers should have regard for the interests of stakeholders other than shareholders, and the broader community'. Like the CAMAC inquiry, this involved an examination of directors' duties and reporting requirements as well as broader policy issues. The PJC issued its final report in June 2006.

Neither report recommended any change to the law. Thus, there is still no explicit legal requirement for directors to include social or environmental concerns in their general decision making, nor is there any requirement to report on these issues. Nevertheless, both inquiry reports encouraged voluntary corporate reporting and suggested that there may be an implied duty on directors to take these factors into account on the basis that doing so is likely to be in the long-term interests of the company and its shareholders.

The second edition of the *ASX Principles* took into account some of the suggestions of these reports but declined to recommend specific reporting on CSR. This leaves Australia some way behind the United Kingdom, the rest of Europe and Japan in corporate reporting.

6.12.6 Directors

The basic duties of Australian company directors are to act in good faith in the best interests of the company and for a proper purpose. These exist as fiduciary duties under the common law as well as being codified in sections 180 and 181 of the Corporations Act 2001. There is relatively little case law expanding on the detailed meaning of these duties, although it is generally understood that 'the interests of the company' equate to the interests of its shareholders as a general group rather than the company as a firm (Farrar, 2005, p 109). As was discussed earlier, this principle of 'shareholder primacy' has been much debated in recent years in the context of whether companies and their directors should be more widely accountable, not only to shareholders but to local communities and the environment.

Certainly the job of a director has been said to have become more onerous in recent years. There is much more focus on the role of the board, the skills and experience of its directors as well as their independence or otherwise. The *ASX Principles* recommend that companies have processes for evaluating the performance of their directors, and annual board evaluations are becoming more commonplace.

6.12.7 Executive Pay and Performance

CLERP 9 requires companies to include within their annual directors' report a remuneration report setting out details of executive and director remuneration. When the amendments were introduced, the Regulatory Impact Statement explained that the legislation 'does not seek to intervene in the market by placing limits on the quantum of director or executive remuneration'. Rather, it is aimed at ensuring transparency such that shareholders can make informed decisions about the remuneration policies of companies. Again shareholder activism on this issue in Australia is some way behind that in the United Kingdom. For example, at the 2008 AGM of Telstra there was a majority shareholder vote against the remuneration report, which the Telstra board determined not to act upon.

6.12.8 The 2008 Financial Crisis

Though Australia has weathered the global financial turmoil originating in the sub-prime mortgage crisis on Wall Street better than most industrial countries, there have still been many casualties. Highly leveraged property trusts and financial companies witnessed their business models implode as asset prices fell, liquidity dried up and excessive debt levers were exposed. Not only were the companies highly leveraged, but executives and directors had often taken out large-margin loans to fund share purchases, and as these margin loans were called in, company share prices hurtled into a spiral of decline, often hastened by predatory short selling. Protracted and painful de-leveraging caused the failure of a string of companies including MFS, Centro, Alco Finance and Tricom, and severely damaged other companies including Babcock & Brown, Macquarie Bank and ABC Learning.

6.12.9 Conclusions

The IMF recently endorsed the high quality of regulation and corporate governance in Australia. A qualitative survey confirmed the view that Australian company boards across the ASX listed sector from ASX 100 to smaller companies have responded well to the challenge of reforming corporate governance policy and practice (UTS CCG, 2007). Yet an annual survey of adherence to governance standards completed by BDO Kendalls (2007) highlighted the lax standards of governance widespread in the burgeoning small-cap resources sector in Australia. This is a traditional problem of small-resources companies being established in highly speculative industries, which have focused on their operational and capital raising rather than their governance practices (often to the detriment of investors). It shows that even in well-regulated economies with high standards of corporate governance, problems can still occur.

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The Australian Institute of Company Directors (AICD) is a member institute for directors dedicated to making a positive impact on the economy and society by promoting professional directorship and good governance. The AICD delivers education, information and advocacy to enrich the capabilities of directors, influence the corporate governance environment in Australia and promote understanding of and respect for the role of directors. With offices in each state and more than 24,000 members, the AICD represents a diverse range of corporations, from the top 200 publicly listed companies to not-for-profits, public sector entities and smaller private family concerns. For further details, go to www.companydirectors.com.au.

6.13

South Africa

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6.13.1 Corporate Governance Codes

The corporate governance regime in South Africa is for the most part not legislated. South Africa was one of the first countries to adopt a code on corporate governance, in 1994. The King Report (King I) on corporate governance, named after the chair of the drafting committee, was issued in 1994 under the auspices of the Institute of Directors in Southern Africa (IoD).

A revised corporate governance report was soon considered necessary for a number of reasons, probably the most important of which was the political reform that had taken place in South Africa following the transition to democracy. Account also needed to be taken of international developments in corporate governance since the drafting of the first report.

The second King report (King II) provided comprehensive guidance on the conduct of boards and directors and also defined new parameters in the areas of risk management and assurance on internal control, as well as issues of corporate social responsibility. The triple bottom-line approach represented pioneering thinking that required companies to take cognizance of the social, environmental and health aspects of their activities in addition to the profitability objectives of the business.

The significance of the King II report was that while it remained focused on the private sector, the participants in the drafting process were drawn from nearly all relevant sectors of society, including government and regulators. Hence, it achieved extensive commitment from across the broad spectrum of South African business and society.

Six years have passed since the King II report was issued, and from a corporate governance point of view it has internationally been an eventful period that has seen among other changes the implementation of the controversial Sarbanes–Oxley legislation in the United States, changes to the UK Companies Act and changes to the Combined Code.

In South Africa there have also been significant legislative developments, the most important of which is the Corporate Law Reform process for companies. In response to these changes internationally and locally, the IoD convened the King Committee to commence the drafting process on the update of the King II report and it is anticipated that the South African Code of Corporate Governance (King III) will be issued early in 2010. This revised version of the Code will be a definite move away from process-oriented to substantive governance.

The key principles in the King III report include the following:

- The overarching philosophy of the Code involves Corporate Citizenship and ethics. Entities should be seen to be good corporate citizens, which implies that business has to be conducted in such a manner that the needs of the present are met without compromising the ability of future generations to meet their needs. It is important to understand how an entity has made its money, and not only how it has spent its money.
- One of the main principle of the Code is that strategy, governance and sustainability are inextricably intertwined and that one cannot be considered without also taking account of its impact on the others. Hence, strategy must be considered with a long-term view on the sustainability of the entity, and the governance must be implemented to drive this strategy. The consideration of these three elements should take place on a continuous basis.

- Emphasis will be placed on risk-based internal audit as a governance tool to be utilized in conjunction with external audit to provide combined assurance not only to the board, but also to investors and other stakeholders. Internal audit planning should be informed by the entity's strategy and it is vital that internal audit is a contributor to achieving the entity's strategy.
- An extension of the corporate citizenship theme is that an entity needs to form and manage relationships in order to remain relevant. This encompasses establishing constructive two-way communication with stakeholders in recognition of their legitimate expectations. Fostering and preserving relationships also entails finding alternative dispute resolution mechanisms for costly and time-consuming legal proceedings as a way of resolving disputes.
- It is recognized that whereas before, the valuation of a company was mostly about the value of its tangible assets, this has fundamentally changed and the true value of an entity now relates to the intangible assets such as brand and reputation. It should therefore be one of the aims of corporate governance to protect these assets through sustainable business practices, ethical decisions and transparent communication with stakeholders.
- Stakeholders have a legitimate expectation of transparent communication from the entity. This type of reporting is moving away from financial reporting to providing stakeholders with insight into the positive and negative effects the entity has had on the community's economic life. Stakeholders should be informed on how the entity enhances the positive and eradicates the negative impacts.

6.13.2 Relationship between the Codes and Regulation

The South African Codes of Corporate Governance (both King I and King II) were drafted with a view to being used as a guideline for voluntary and judicious compliance. The reason for this is that it was considered that a 'one size fits all' approach was not appropriate. Compliance in form only does not achieve the goal of the Code. The South African approach is that legislated governance will in all probability lead to governance in mere form, lacking substance.

The King III Code will be applicable to all entities, regardless of size, complexity or form of incorporation. The principles of the Code will be considered on an 'adopt or explain' basis. This implies that all entities must consider the principles, and those that are applicable should be adopted in the form and manner that are applicable to the entity. Certain governance principles (particularly relating to listed companies and state-owned enterprises) are legislated, and a 'comply or else' governance regime will be followed in those instances.

It is anticipated that this revised approach will promote making governance decisions on an intellectually honest basis and will guard against compliance in form without substance.

Once King III has been issued, it is the intention of the IoD to issue practice notes in order to facilitate implementation of the Code.

As we have observed, while self-regulation is encouraged through the corporate governance codes, regulators in South Africa have chosen to enforce compliance of a number of the recommendations through mandatory legislation and regulations.

- The JSE Ltd (JSE) comprehensively revised and updated its listing requirements in line with international standards in the late 1990s. The JSE listing rules were then again comprehensively updated (for the third time in seven years) to incorporate certain elements of King II as mandatory requirements for quoted companies. The JSE adopted the principles of King II on a comply or explain basis as part of its listing requirements, and JSE-listed companies were therefore required to disclose in their annual reports to what extent they were complying with the code. It is anticipated that the JSE will mandate compliance with the King III Code for listed companies.
- A number of important changes were made to the legislation concerning public entities and state-owned enterprises as a result of the recommendations contained in the King I report. Public-sector finance reporting and accountability were significantly strengthened in the Public Finance and Management Act and the Municipal Finance and Management Act, and a range of other legislation addressing social and labour priorities impacted on existing governance standards and practices.

- The Protocol for State-owned Enterprises on Corporate Governance was comprehensively updated in line with King II and adopted by Cabinet in 2003. It forms the basis of corporate governance standards for state owned entities. This supplements the already onerous requirements of the Public Finance Management Act and the National Treasury Regulations, which were updated to bring it into alignment with the principles contained in King II.
- The banking regulator introduced, arguably, extremely rigorous provisions around director accountability in amendments to the Banks Act that reflect a number of principles enshrined in King II. Greater powers have been conferred on the banking regulator to intervene on matters such as director and executive appointments.
- The Financial Services Board (FSB) continued to give attention to enhancing the financial markets legislation that falls under its supervision, embracing a number of the King II guidelines. In 1997 the King I Committee recommended that insider trading should be regulated under a separate statute outside the Companies Act 1973. As result of this the Insider Trading Act, 135 of 1998, came into operation on 17 January 1999. This Act replaced section 440F of the Companies Act. Under the new Act the Financial Services Board replaced the Securities Regulation Panel as the watchdog for insider trading. The Stock Exchanges Control Act 2001, also regulated by the FSB, was introduced to enable a stock exchange to regulate price-stabilizing mechanisms in its rules or listing requirements to give more integrated consistency to these provisions and with enhanced enforcement powers.

6.13.3 Legislative Framework for Corporate Governance: Recent Developments

The legal system in South Africa draws from both common-law and civil-law traditions. The common law represents the body of jurisprudence that was brought to the country by the Dutch and English colonialists, as well as African customary law and Muslim personal law.[1] Over time the common law developed through interpretation by courts, and aspects of it were amended or replaced by legislation. The Constitution that became effective in 1996 now forms the supreme law of the land. The Constitution states that law and conduct in the Republic that are inconsistent with the principles contained therein are invalid.[2]

The main legislation in place in respect of corporations in South Africa is the Companies Act, which was promulgated in 1973. It is broadly based on legislation that was established in mid-19th-century Britain. As is to be expected, during the intervening period of more than 30 years there have been significant developments in the corporate and the political environment in South Africa, sufficient to warrant a complete overhaul of this legislation.

The Department of Trade and Industry is therefore currently in the process of reforming the corporate law. The first phase of this development, namely the amendment of the Companies Act, was completed through the promulgation of the Corporate Laws Amendment Act (CLAA), effective from 14 December 2007. The purpose of this legislation was to facilitate the more urgent changes that were required to the Companies Act, amongst others those affecting auditors and audit committees. The Companies Act 1973 will be repealed in its entirety, with new legislation expected to be implemented in 2010.

The main guiding principles for the corporate law reform established by means of a policy established at the outset of the reform process were the following:[3]

- a simple, comprehensive and accessible legal framework;
- accountability and transparency;
- harmonization with international corporate legislation.

The following are some of the specific issues that were addressed in the new legislation:

- Company formation will be simplified, and flexibility provided in this regard. There will also be recognition of the fact that the legislation will apply to state-owned enterprises and non-profit companies, with modification.
- It will address transparency, accountability and the integrity of companies concerning retention and access to company records, the keeping of accounting records and the issuing of annual financial statements and reports.

- Capitalization of profit companies by means of share issues and securities will be dealt with in general and public offerings of company securities in a specific way. The capital maintenance regime will be modified and will provide for a 'solvency and liquidity test' to be applied.
- The corporate governance provisions will include shareholder and investment protection, directors' standard of conduct and liability, and the structure of the board. As part of corporate governance the law will also aim at encouraging maximum transparency by adequate and appropriate disclosure and reporting. It will, however, allow for private companies not to issue audited financial statements.
- Fundamental transactions, takeovers and offers will be dealt with in terms of the approval and regulation of these transactions.
- A business rescue regime will be introduced with a view to formally facilitating and establishing a climate for saving companies, similar to the Chapter 11 regulations in the United States.
- Administration, remedies and enforcement will also be provided for in the Bill.

The process of corporate reform has already had an impact on corporate governance, and through the CLAA a number of corporate governance principles have been legislated, including the requirement for boards of so-called widely held companies to appoint audit committees with prescribed composition and duties.

As was mentioned earlier, the public sector is regulated by some of the most advanced and onerous public finance legislation internationally in terms of the Public Finance Management Act. The National Treasury, falling under the Minister of Finance, and the Office of the Auditor-General, which is an independent constitutional oversight authority, administer this legislation.

An interesting legislative development is contained in the Consumer Protection Bill 2007. This Bill provides for consumer protection groups to be accredited by the National Consumer Protection Commission for the purpose of initiating legal action on behalf of customers. This is expected to establish in South Africa the equivalent of the class actions that exist in the United States. This makes available to the consumer, as an important stakeholder in South African businesses, a mechanism through which to make his or her voice heard. Extended standing to apply for remedies acting as a member of a class of person affected is also provided for in the Companies Bill.

Since King II, various other legislation that contains some elements relating to corporate governance has been introduced. Some of these Acts are:

- the Auditing Profession Act 2005, which provides for the education, training and professional development of registered auditors, accreditation of professional bodies, registration of auditors and the regulation of the conduct of registered auditors;
- the Electronic Communications and Transactions Act 2002, which facilitates and regulates electronic communications and transactions;
- the National Credit Act 2005, which seeks to protect against reckless lending.

Legislation that permeates all aspects of the business landscape, including corporate governance in South Africa, is the Broad Based Black Economic Empowerment Act (BBBEE), promulgated in 2003. The legislation emanated from the government's multifaceted strategy to address the injustices of the past created by the apartheid system, which resulted in black South Africans not having had the same opportunities as white South Africans. In terms of the legislation, codes of good practice that lay down the principles and facilitate the implementation of the Act are issued by the Minister of Trade and Industry. The BBBEE Codes provide for a scorecard in order that implementation can be measured.

A good BBBEE score makes entities eligible for government contracts, and its broad-based measurement, which reaches from black representation in ownership and management through to employees and supplier base, is reported on. As such, it has a considerable influence on the foundation of business in South Africa. Black economic empowerment considerations are considered to form an important part of governance, as it is generally accepted that there is a moral and social obligation on companies to participate in this effort.

6.13.4 Regulators in the Corporate Governance Environment

Regulators and oversight bodies that are involved in issues of corporate governance include the following.

6.13.4.1 The JSE Ltd (JSE)[4]

The JSE Ltd is licensed as an exchange under the Securities Services Act 2004 and is Africa's premier exchange. It has operated as a marketplace for the trading of financial products for nearly 120 years and listed in June 2006.

The JSE offers a securities exchange in five different markets, namely equities, equity derivatives, agricultural derivatives and interest rate instruments. Measured by market capitalization, the JSE is one of the top 20 exchanges in the world. Alternative Exchange, better known as AltX, was launched in October 2003 as a parallel market or alternative exchange for small to medium-sized and growing companies. AltX was formed as a result of partnership between the JSE and the government's Department of Trade and Industry.

The JSE uses an electronic settlement and depository system for dematerialized equities (STRATE).

6.13.4.2 The Financial Services Board (FSB)[5]

The FSB is an independent statutory body created in 1990. It is financed by levies and fees. The FSB regulates the non-banking financial industry, which includes the insurance and pension fund industries, the stock and bond exchanges, the central securities depositories and insider trading, but not issuers of securities. It has formal powers of investigation, with criminal conduct being referred to the National Directorate for Public Prosecution.

6.13.4.3 The South African Reserve Bank (SARB)[6]

SARB is the central bank of the Republic of South Africa. It regards its primary goal in the South African economic system as 'the achievement and maintenance of price stability'. Within SARB the Bank Supervision Department is intended to ensure that the legal framework in terms of which banking institutions and banking groups in South Africa are regulated and supervised remains relevant and current. The Department is also one of the key players in the risk-management process of banks.

6.13.4.4 The National Treasury[7]

The National Treasury was formerly called the Department of Finance. Its task is to ensure sound public finances and an efficient and equitable use of resources. It seeks to advance economic growth and job creation through appropriate macro-economic, fiscal and financial policies.

6.13.4.5 The Independent Regulatory Board for Auditors (IRBA)[8]

The duty of the Independent Regulatory Board for Auditors (formerly the Public Accountants and Auditors Board (PAAB)) is to promote the integrity of the auditing profession, including investigating alleged improper conduct, conducting disciplinary hearings, imposing sanctions for improper conduct and conducting practice reviews or inspections.

6.13.4.6 The Financial Reporting Standards Council

The Financial Reporting Standards Council was established by the CLAA to establish financial reporting standards that promote sound and consistent accounting practices. It will develop accounting standards in accordance with the International Financial Reporting Standards of the International Accounting Standards Board.

6.13.4.7 The National Credit Regulator (NCR)[9]

The NCR was established as the regulator under the National Credit Act 34 of 2005 and is responsible for the regulation of the South African credit industry. It is tasked with carrying out education, research, policy development, registration of industry participants, investigation of complaints and ensuring the enforcement of the Act.

6.13.4.8 The Competition Commission[10]

The Competition Commission is a statutory body constituted in terms of the Competition Act 89 of 1998 by the government. It is empowered to investigate, control and evaluate restrictive business practices, abuse of dominant positions and mergers in order to achieve equity and efficiency in the South African economy. The Competition Tribunal adjudicates competition matters in accordance with this Act and has jurisdiction throughout South Africa.

6.13.4.9 The Department of Trade and Industry (DTI)[11]

The DTI assists in the development of industries, the building and expansion of trade relations, the promotion of foreign trade and exports from South Africa and the maintenance of competitive conditions in the domestic market. Since April 1995 the DTI has promoted an institutional support framework for small, medium-sized and micro businesses, including the Chief Directorate for Small Business Promotion, the Ntsika Enterprise Promotion Agency, Khula Enterprise finance and local business service centres.

6.13.4.10 The Companies and Intellectual Property Commission[12]

The Companies and Intellectual Property Commission (the Commission) will succeed the Companies and Intellectual Property Registration Office (CIPRO), which currently fulfils a similar function to the one intended for the Commission under the Companies Act. In terms of the Companies Bill 2008 the Commission is to be 'established as a juristic person to function as an organ of state within the public administration but outside the public service'. The functions of the Commission will include the registration of companies, maintenance of information concerning companies and intellectual property rights, and promotion of compliance with the new Companies Act and other relevant legislation.

6.13.4.11 The Companies Tribunal

The Companies Bill requires the establishment of a Companies Tribunal to facilitate alternative dispute resolution and to review decisions of the Commission.

6.13.4.12 The Takeover Regulation Panel

According to the provisions of the Companies Bill, a Takeover Regulation Panel will be established as a juristic person, to function as an organ of state within the public administration, but as an institution outside the public service. The main function of the Takeover Regulation Panel will be to administer the requirements of the Companies Act.

6.13.5 Board Structure and Roles

South Africa has a unitary board structure. This was taken under reconsideration with the drafting of the new corporate legislation and it was decided to maintain the status quo. It was considered by the DTI that although a two-tier board provides the opportunity for stakeholder presentation, there was a view that the European experience has shown that this is not always effective. The cost of conversion from a one-tier to a two-tier system was another factor in making this decision.

The Corporate Laws Amendment Act (CLAA), referred to on page 351, prescribes specific duties for audit committees for widely held companies. These duties include:

- nominating for appointment the auditor of the company;
- determining the fees to be paid to the auditor;
- ensuring that the appointment of the auditor complies with the Act;
- determining the nature and extent of non-audit services to be provided;
- pre-approving any proposed contract with the auditor for the rendering of non-audit services;
- inserting in the financial statements a report describing how the audit committee carried out its functions and stating whether the audit committee is satisfied that the auditor was independent of the company;
- receiving and dealing with complaints relating to accounting practices, internal audit, the financial statement or any related matter.

Interestingly enough, there is no prescribed statutory duty for audit committees to consider the financial statements. The Companies Bill does, however, make reference to the audit committee being responsible for making submissions to the board on any matter concerning the company's accounting policies, financial control, records and reporting. Another addition in the Companies Bill to the statutory duties of the audit committee is for it to report in any way the committee considers appropriate in the annual financial statements, the accounting practices and the internal financial control of the company.

Considering the above, it is noteworthy that the nature of the stipulated duties, and especially the requirement to include a report in the financial statements, elevates the status of an audit committee to the level of the board in some respects.

In addition to the above, King II further recommends that in addition to an audit committee, entities should also have at least also a remuneration committee, risk committee and nominations committee. It stipulates that industry requirements will stipulate what other board committees are necessary.

6.13.6 Shareholder Rights

It is a firm principle of South African law that a company is an entity separate from its members and that a shareholder has no right to manage the company's business merely by virtue of its shareholding. If, for instance, directors breach their fiduciary duties so that a contract purportedly entered into by them on behalf of the company transpires to be void, then it is the company that has to extricate itself from it. The action to achieve this has to be initiated by the board or the shareholders at an annual general meeting (AGM).[13]

Basic shareholder rights are observed in South Africa, although share registration processes are inefficient. Holders of ordinary shares may attend and vote on proposed resolutions at the AGM but often are passive and do not. The rights of shareholders to participate in fundamental decisions are largely observed under the Companies Act. The Companies Act provides that shareholders may appoint proxies, and unless the articles provide for it, proxies cannot vote by a show of hands. Electronic voting is not currently permitted.

Changes by the CLAA aim to promote shareholder activism by requiring the external auditor of widely held companies to attend the AGM at which the financial statements will be discussed, and answer any question related to the audit to the best of his or her ability.

The Public Investment Corporation (PIC) has with its proactive approach with regard to shareholder participation made inroads in the traditional apathy in this area. The PIC[14] manages assets of over R700 billion of public-sector entities, most of which are pension, provident, social security or guardian funds. It is the largest single investor on the JSE. It is also the largest shareholder in many of the top 40 companies on the JSE.

The PIC has issued guidelines to all external PIC managers to guide their votes on behalf of those PIC investments that it manages.[15] Its sheer investment power means that the PIC holds a lot of sway when it comes to imposing these requirements, and it is more likely than not that there will be adherence to these.

The PIC actively participates at annual general meetings and it is by now well known that it asks pertinent questions of boards concerning black empowerment (and especially empowerment representation and role at board level), director independence and executive remuneration.

Another development concerning shareholders' activism and accountability to the ultimate investors, who are typically the beneficiaries of pension funds, is the efforts by some asset managers to become more transparent to the owners of the funds that they manage. They do this by posting information on their websites on which their shareholder activism is tracked, including how they voted at AGMs and why.

The principle that all shareholders should be treated equally is largely observed. Differentiated voting rights are prohibited for companies listed on the JSE. Nominees or custodians are used extensively and the dissemination of relevant documentation to clients is not always ensured. Insider trading is prohibited in South Africa under the Insider Trading Act. The enforcement of the law in the area of disclosure of interests of board members in transactions affecting the company, and in fact the imposing of all other requirements provided for in the Companies Act, is lax because the Registrar of Companies does not have the necessary resources. The Companies Bill moves away from criminal offences to civil liability, which may prove to be a more efficient enforcement mechanism.

Recent changes to shareholder rights include the greater protection afforded to minority shareholders in the face of takeovers by providing for a special resolution that is required to sanction the disposal. In the past an ordinary resolution sufficed.

An indication of the trend towards greater accountability to be expected towards shareholders' rights is the far-reaching judgment (albeit on specific facts) that was handed down a few years ago concerning the rights of a shareholder in a private company to gain access to information from the company under the Promotion of Access to Information Act.[16] The high court held that the rights afforded by the Companies Act to shareholders fell short of the constitutional right of access to information and the Promotion of Access of Information Act. The Companies Bill also provides for the rights of shareholders to company information.

6.13.7 Disclosure and Transparency

Accountability and transparency are recurring themes of the intended legislation as encompassed in the Companies Bill, and for some companies and under certain circumstances a higher standard of accountability and transparency is required.

The South African Statement of Generally Accepted Accounting Practice (GAAP) is fully harmonized with the International Financial Reporting Standards, and since 1 January 2005 the JSE listing requirements have specified compliance with IFRS for all listed companies, but lacked legal backing. As was pointed out earlier, the Financial Reporting Standards Council has been established in terms of the CLAA and once the standards have been issued by the Minister provides legal backing for IFRS or standards that are consistent with GAAP. A Financial Reporting Investigations Panel will, in terms of the legislation, investigate non-compliance and recommend appropriate measures for rectification or restitution.

With regard to external audit, there used to be no statutory definition of independence and the same auditor sometimes performed internal and external audit functions for the same company. This has changed through the introduction in the CLAA of a requirement for the audit committee to consider the independence of the auditor and to report on it in the annual financial statements. The CLAA further stipulates that the Independent Regulatory Board for

Auditors shall define and prohibit the provision of non-audit services by an auditor in circumstances in which these will be subject to the auditor's own auditing procedures.

There is now also a limitation of five consecutive years for which an individual auditor is allowed to act as the auditor of a widely held company. This restriction applies to individual audit partners responsible for signing the audit opinion, and not auditing firms.

The fair and timely dissemination of information is largely observed and the Companies Act has been amended to permit electronic distribution of full annual statements, where shareholders consent.

There are no specific listing requirements to disclose material foreseeable risk factors but King II recommends that boards undertake annual formal risk assessments.

The accuracy of ultimate beneficial ownership is difficult to verify.

Under the current Companies Act, each director must issue a declaration regarding conflict of interest every year, and King II has highlighted practices to make this more effective.

6.13.8 Corporate Responsibility

Corporate responsibility in South Africa, initiated in the King I report in 1994, initially focused mainly on philanthropy. Many entities supported various charitable organizations and charitable causes not necessarily aligned to the business or strategy of the entity. This type of philanthropy was difficult to measure and the intended impact and value were often not achieved.

The concept of corporate social investment (CSI) was introduced in King II, which later evolved into corporate social responsibility (CSR). This includes not only the utilization of money, but also investments in the form of time commitment and products or services in kind. Although the main objective of both CSI and CSR is to provide value to both the entity and the recipients of the initiatives, the fact that these are often not aligned to the strategy of the entity results in value that cannot be measured and quantified.

King III focuses on the concept that entities should consider sustainability as a business opportunity, where long-term sustainability is linked to the strategy to create business opportunities. In making these decisions, entities should be aware of the impact the entity has on the economic life of the community in which it operates, both positive and negative. Efforts should be made to enhance the positive impacts and eradicate or ameliorate the negative impacts.

6.13.9 Director Development and Training

King II states that:

> new directors appointed to the board should be made familiar with the company's operations, senior management and its business environment, be made aware of their fiduciary duties and responsibilities, and of the board's and chairman's expectations. Since their responsibility carries with it significant personal liability, new directors with no board experience should receive the relevant education and development.

A major response in all of this to the King II guidelines was a surge in director development and corporate governance training led by the IoD, private consultants, large auditing and accounting firms, and higher education institutions, including business schools. All the largest South African universities and major technical colleges have incorporated corporate governance education as part of their auditing and accounting, law, or higher business management degrees and diplomas, and some offer specialized corporate governance postgraduate qualifications. Interactive e-learning courses on corporate governance have also been developed in order to make specialized education on this topic accessible to many more people.

In order to address the skills required of top directors and to supplement the pool of non-executive directors, the IoD has embarked on an Accelerated Directorship Programme. It consists of a five-day interactive programme that provides delegates with practical tools to apply when acting as directors. Following in the footsteps of the United Kingdom, the IoDSA is also in the process of introducing a Professional Director qualification and an élite category of Chartered Directors. In order to attain the qualification, applicants will have to meet certain selection criteria and attend education programmes, including case-study work. There will also be an assessment and a peer review by other company directors.

The IoD also presents one-day programmes for directors that deal with various issues around corporate governance and directors' duties.

The IoD is in the process of establishing a Director Internship programme for companies within South Africa. The main aim of this programme will be to transfer the knowledge, skills and personal attributes of experienced board members to current and/or new board members. The Director Internship programme will allow the chairman of SA boards to facilitate the channelling of experience from experienced board members to new board members, and to build board capability in supporting the growth and development of SA business.

Specific experience and attributes required for effective board participation include (according to McKinsey) the following.

Skills

1. Bringing commercial and board experience.
2. Working to obtain sound understanding of the context of the business, the industry, company strategy and any pertinent statutes.
3. Keeping abreast of industry trends.
4. Preparing for board meetings in advance by factual analysis of board papers to identify issues, concerns and challenges.
5. Constructively challenging and steering management through effective board meeting interactions.
6. Making appropriate remuneration and succession decisions.

Knowledge

1. Bringing business technical knowledge and industry-specific knowledge to bear on a situation or problem, including within the board committee structure.
2. Understanding the statutory obligation of the board to shareholders and other stakeholders.

Personal Attributes

1. Having positive personal qualities such as mindset, character, values and beliefs that drive the way one behaves.

2. Living the role of a board member as distinct from the roles of management and the shareholders.
3. Challenging board and management in an articulate way and adding creativity to debates when appropriate.

6.13.10 Directors

In terms of the CLAA, audit committees need to have at least two members who are non-executive directors of the company and who must 'act independently'. Since 'non-executive director' had not been legally defined, the Act includes a definition stating that a non-executive director is a director who is not:

- involved in the day-to-day management of the business and has not in the past three financial years been in the full-time employ of the company or its group;
- a member of the immediate family of an individual mentioned in the above paragraph.

It is stated that a director acts independently if that director:

- expresses opinions, exercises judgement and makes decisions impartially;
- is not related to the company or to any shareholder, supplier, customer or other director of the company in a way that would lead a reasonable third party to conclude that the integrity, impartiality or objectivity of that director is compromised by that relationship.

The substance of what being a non-executive director and acting independently entails, as set out above, is still included in the Companies Bill, but is incorporated as a requirement for audit committee members without reference to that specific terminology.

The definitions of non-executive directors and 'acting independently' as they stand in the CLAA are narrower than the meaning given to similar terms in the King II report. This, together with the fact that South Africa is now moving towards legislating for certain aspects of corporate governance, is probably indicative of the higher prominence that this now enjoys.

Another indication of this happening is the incorporation in the Companies Bill of directors' standards and conduct, which are still for the main part determined in terms of the common law. The incorporation of these is an attempt to provide for more clarity and accessibility of the provisions and it is part of a greater endeavour towards decriminalizing South Africa's corporate legislation and instead replacing it with civil liability. In line with this, the Companies Bill also contains provisions for declaring directors delinquent or for placing them on probation.

An interesting development with regard to accountability of directors and the role of the auditor in this is contained in the Auditing Profession Act 2005. The legislation refers to reportable irregularities, which constitute any unlawful act or omission by any person responsible for the management of an entity that has caused material financial loss to the entity, its creditors, members or investors or that is fraudulent or amounts to theft or that represents a material breach of fiduciary duty. The legislation places a duty on the auditor of the entity to report such an irregularity to the Independent Regulatory Board for Auditors. The reportable irregularity may involve matters that do not affect the annual financial statements.

6.13.11 Executive Pay and Performance

The JSE first required listed companies to disclose executive pay in 2002, but criticism has been levied that the South African market has lagged its counterparts in the United States and United Kingdom. There are, however, a few developments concerning this in progress.

There has been a call from the IoD that incentive schemes should take into account triple bottom-line performance as opposed to mere financial performance.

Share options remain a contentious issue, with some people being in favour of them as they align directors' interests with those of shareholders. It is accepted that for this to be true, a longer vesting period for options is necessary. The opinion against the issuing of share options considers that this impairs directors' independence. There is also some debate regarding whether share options should be counted as part of normal compensation or whether they should be regarded as more in the nature of a loan and therefore be dealt with through the income and expenditure account.

The PIC has had occasion to request the board of one of the major companies that it invests in to attach to its annual report in future a summary of the remuneration committee's deliberations. The reason provided for the request was that the basis of the remuneration calculation should be made clear in order that this information could be considered when resolutions were voted on. It is expected that shareholder interest in executive remuneration will grow.

Notes

1. Kate O'Regan (Judge of the Constitutional Court), The best of both worlds? Some reflections on the interaction between the common law and the Bill of Rights in our new Constitution; paper delivered at the second Colloquium 'Constitution and Law' held at Potchefstroom on 30 October 1998.
2. Section 2 of the Constitution of the Republic of South Africa.
3. *South African Company Law for the 21st Century, Guidelines for Corporate Reform*, issued by the Department of Trade and Industry, May 2004.
4. http://www.jse.co.za.
5. http://www.fsb.co.za.
6. http://www.reservebank.co.za.
7. http://www.treasury.gov.za.
8. http://www.paab.co.za.
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10. http://www.compcom.co.za.
11. http://www.thedti.gov.za.
12. http://www.cipro.co.za.
13. *Letseng Diamonds Ltd* v *JCI Ltd*.
14. http://www.pic.gov.za.
15. Public Investment Corporation (2007) *Corporate Governance and Proxy Voting: Principles, policies and practical application*, PIC, Pretoria.
16. *Davis* v *Clutcho Pty Ltd*.

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Professional Practice of KPMG, focusing on Assurance and Corporate Governance.

Ansie Ramalho joined the Institute of Directors in June 2008 as the Head: Technical for the Institute's Centre for Corporate Governance. She heads a number of projects on behalf of the IoD, including the establishment of a corporate governance assessment instrument that is being developed to assist boards in fulfilling their corporate governance responsibility. She also represents the IoD on the Corporate Governance Network and the Public Sector Governance Forum, where she provides technical input for the position papers issued as practical guidelines for directors and other corporate governance stakeholders. Ansie is an Advocate of the High Court of South Africa and has a BIuris and an LLB degree as well as various postgraduate qualifications. Before joining the IoD she was with KPMG, where she held the position of Associate Director from 2002. Ansie cut her business teeth in the corporate restructuring and recovery environment with assignments that included the Saambou Bank receivership and the Kebble insolvency.

For further details, go to www.iodsa.co.za.

6.14

The Swedish Corporate Governance Model

Per Lekvall, Swedish Corporate Governance Board

Fundamentally, Swedish corporate governance resembles that of most of the industrialized world and is closely in line with key developments within the field during the past few decades. Still, because of specific circumstances regarding, for example, regulatory framework and ownership structure, it has some distinctive differences compared with governance practices in other countries, notably those with an Anglo-Saxon judicial tradition.

Rather than trying to convey a comprehensive picture of all aspects of Swedish corporate governance, the aim of this chapter is to highlight some distinctive features of the Swedish governance model.

6.14.1 Regulatory Framework

The regulatory framework for Swedish corporate governance is made up of legal requirements – primarily the Companies Act – as well as self-regulation, such as the Stock Exchange's rules and the Swedish Corporate Governance Code.

The Companies Act has been subject to a thorough review during the past 15 years, and a new Act came into effect on 1 January 2006. Sweden therefore has a modern Companies Act, and the review, besides implementing EU directives, focused on shareholders' rights and corporate governance issues. In fact, many aspects of modern corporate governance that in other jurisdictions are regulated through corporate governance codes are incorporated in the Swedish Companies Act. Examples include matters of board composition, division between the positions of CEO and chairman, approval of principles for the remuneration of management by the shareholders' meeting and transparency towards the shareholders and the general public.

Since the early 1990s, certain aspects of modern corporate governance have also been introduced into the rules of the main Swedish stock exchange, the privately owned OMX Nordic Exchange Stockholm, such as requirements on the composition of boards and the independence of board directors. Today these provisions have also been adopted by the second stock exchange in Sweden, Nordic Growth Market (NGM), which means that all companies listed on a regulated market in Sweden are contractually bound to comply with these rules.

There is a long tradition of self-regulation in the Swedish private business sector. The prime manifestation of this in the field of corporate governance is the Swedish Corporate Governance Code, introduced on 1 July 2005. This code, which is based on the principle of 'comply or explain', resembles the codes of other EU member states, although it differs on some points, owing to the specific Swedish circumstances mentioned earlier. During its first year of application the Code was mandatory only for about the 100 largest companies on the OMX Nordic Exchange Stockholm, although in practice it was applied in full or part by many smaller listed companies too. However, on 1 July 2008 a revised version of the Code became mandatory for all Swedish companies listed on a Swedish regulated market, at present amounting to about 300 companies. The Code is administered by the Swedish Corporate Governance Board, an independent body within the Swedish self-regulatory system.[1]

Other important aspects of the Swedish self-regulatory system in this field include the work of the Swedish Securities Council, which interprets and issues statements about the meaning of the concept of good practice on the securities market – which all listed companies are contractually bound to follow – as well as the ownership policies issued by many institutional investors.

6.14.2 A Different Corporate Governance Structure

From a structural point of view the Swedish corporate governance model offers a third alternative to the so-called one-tier or unitary model, prevalent in countries with a predominantly Anglo-Saxon judicial tradition, as well as the two-tier model used in Germany and several other continental European countries. See Figure 6.14.1.

The Swedish corporate governance model is based on a hierarchical governance structure in which each governance body has far-reaching powers to issue directives to subordinate bodies and to some extent even take over their decision-making authority. With few exceptions, where the board has exclusive decision power or veto right, the shareholders' meeting is sovereign to decide on any company matter, including – where appropriate – to issue express instructions to the board. In practice, however, such powers are rarely used in listed companies, where they would most likely trigger the immediate resignation of the board directors.

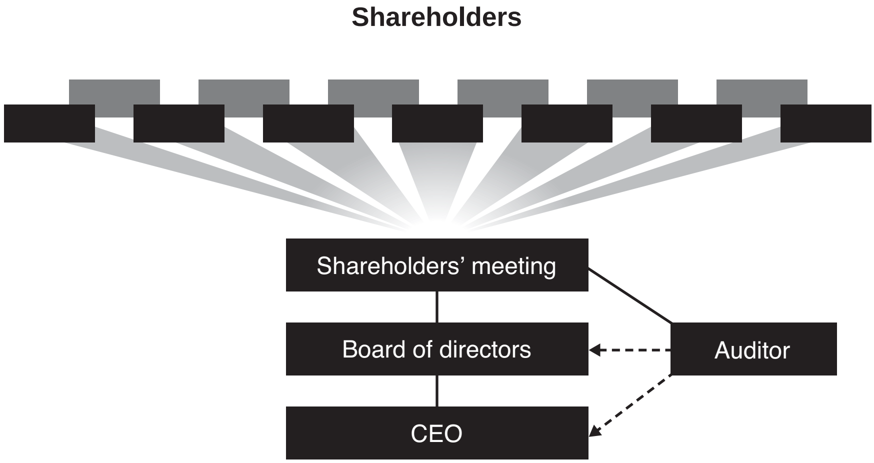

Figure 6.14.1 *The Swedish corporate governance model*

Source: Adapted from the Swedish Code of Corporate Governance, Stockholm, 2008 by permission

Subordinate to the shareholders' meeting there is a unitary board. However, in contrast to the predominant situation in US and UK boards, Swedish boards are entirely or predominantly non-executive. In listed companies no more than one person from the company management may sit on the board. This possibility is used in half of the listed companies, usually by appointing the CEO a member of the board.

Subordinate to the board there is a single-person CEO function, legally defined in the Companies Act to be responsible for the day-to-day management of the company. Also by law, the positions of chairman and CEO may not be held by the same individual. The board may at any time dismiss the CEO without stated cause.

6.14.3 Concentrated Ownership

An important institutional precondition for Swedish corporate governance is the relatively concentrated ownership structure on the capital market. Whereas the majority of listed companies on the US and UK stock markets have a highly dispersed ownership structure, the ownership of many Swedish listed companies is – like the situation in many continental European countries – dominated by one or a few major shareholders. Such controlling shareholders are generally expected to take a long-term responsibility for the company by holding on to their shareholding even in rough times, when owners with a more short-term perspective tend to 'vote with their feet', and to take an active role in the governance of the company. In fact, the notion of widely dispersed ownership structures, resulting in what are sometimes referred to as 'masterless companies', is regarded with considerable scepticism on the Swedish capital market.

6.14.4 Strong Ownership Powers

Through the far-reaching authority of the shareholders' meeting, as outlined above, the Swedish corporate governance model provides the groundwork for the exertion of strong ownership powers. These powers may be further enhanced through the use of shares with multiple voting rights, so-called A and B shares. This system, which allows for high-voting shares with up to 10 times the votes of other shares, is currently in use by about half of Swedish listed companies. From a Swedish point of view the system is generally defended on the grounds that the principle of freedom of contract should be allowed to prevail for actors with full legal capacity on the capital market as long as the rights of all shares are fully disclosed. It is also seen to counteract a development towards increased ownership power of various forms of institutional investors, some of them with a relatively short investment horizon, at the expense of long-term 'flesh and blood' owners.

As has already been mentioned, it is not only tolerated but generally expected by other shareholders, as well as Swedish society at large, that a controlling owner will take a special, long-term responsibility for the company by holding on to his or her shares in less prosperous times for the company and by taking an active part in the governance of the company. The latter may involve not only the exertion of ownership rights at the shareholders' meeting but also, invariably, taking seats on the board of the company. Thus, Swedish rules of board independence requires only two board members to be independent of major owners (defined as owners of more than 10 per cent of the capital or votes of the company), whereas they require a majority of the directors to be independent of the company.

Another outcome of the Swedish belief in strong ownership power is the way the concept of nomination committees has been applied in Sweden. Contrary to the situation in most other countries, where the nomination committee is a subcommittee of the board, Swedish nomination committees are appointed by the shareholders and made up predominantly of major shareholders or their representatives. The rationale behind this is the belief that the board should not nominate its own members, but instead nominations should be made by a body representing the shareholders.[2]

The different role of the auditor as compared to that in some other countries is also an important feature of Swedish corporate governance. The auditor of a Swedish company is appointed by and reports to the shareholders' meeting, and has a duty not only to examine the annual accounts and the accounting practices of the company but also to review the performance of the board and the CEO (see Figure 6.14.1). As part of the report to the shareholders' meeting, the auditor is obliged to make a recommendation on the issue of discharge from liability of the board and CEO and to report the fact if any board member or the CEO has acted in a way that may give cause for liability for damages. This has important repercussions for the relationship between the auditor and the board.

Most fundamentally, it means that a Swedish board is not the issuer of the auditing assignment, but is subject to auditor review. It also means that neither the board as a whole nor its audit committee may issue instructions to, or otherwise try to influence the work of, the auditor.

6.14.5 Protection of Minority Rights

Balancing the strong ownership powers just outlined, the Swedish Companies Act provides for relatively far-reaching protection of shareholder minority rights. This is obtained primarily in three ways.

First and foremost is the strict legal obligation of Swedish companies to treat all shares equally, unless otherwise prescribed in the articles of association (for example, they might prescribe shares with different voting rights). Furthermore, the Companies Act contains a strong general clause prescribing that the shareholders' meeting, the board or any other company body may not make a decision that might give undue advantage to some shareholders at the expense of the company or other shareholders. Any such decision would be legally invalid if challenged.

Second, individual shareholders have strong rights, by tradition inherent in the Swedish corporate governance system. Thus, most of the provisions of the EU Shareholders' Rights Directive have long since been included in Swedish legislation. For example, any shareholder, regardless of the number of shares held, has the right:

- to have items and resolution proposals included on the agenda of the shareholders' meeting;
- to ask questions at the meeting and have these answered by the board or the CEO as long as such answers can be given without causing harm to the company;
- to file counter-resolutions at the meeting;
- to exercise the voting rights of all his or her shares.

A weak point in this context has been the traditional requirement of presence in person or by proxy to vote at Swedish shareholders' meetings. This has caused practical difficulties for some shareholders, in particular for foreign institutional investors, to exercise their shareholder rights. A first step to cope with this problem was taken with the new Companies Act, which provided for a form of postal voting by proxy. The next step will be taken with the implementation of the Shareholders' Rights Directive, which will probably open the possibility for companies to provide for postal voting fully in line with standard international procedures.

The third line of defence of minority shareholding rights is the possibility that minorities of various sizes can block certain resolutions at the shareholders' meeting, for example decisions regarding amendments of the articles of association, mergers and de-mergers, and changes in the share capital structure, and to force other decisions such as to call an extraordinary shareholders' meeting, to make a minimum dividend distribution and to appoint a special minority auditor and/or a so-called special examiner. The size of minority holding required ranges from a third down to 10 per cent for blocking certain shareholder's meeting decisions and for forcing the actions mentioned.

6.14.6 Far-reaching Transparency Standards

The Swedish self-regulatory system was early in adopting the requirements of openness to the shareholders and the capital market at large of modern corporate governance, in particular those dealing with the remuneration of board directors and top management staff. Many of these provisions have subsequently been taken over by law, whereas others are now incorporated in the Code. The current main requirements are in brief as follows.

By law, all remuneration of board members and the CEO of public companies, split into its main components, including pension schemes and severance pay obligations, is to be disclosed at an individual level. The law further requires guidelines for the remuneration of senior management of the company to be presented for adoption at the annual shareholders' meeting. Furthermore, the remuneration of this group as a whole, split into its main components, is to be disclosed in the annual report. The Code requires all share-related incentive programmes to be approved by the owners at the shareholders' meeting.

Additional key disclosure requirements are full disclosure of all related-party transactions, where related parties are defined as large shareholders, board members, the CEO, and employees of the company and its group companies. In addition, large transactions with related parties require approval by the shareholders' meeting.

6.14.7 Future Challenges

As should be evident from this short account, Swedish corporate governance reflects certain circumstances regarding ownership structure, legislative tradition and other specific features characteristic of this market. At the same time, foreign ownership of Swedish listed companies has increased significantly during the past decade and amounts today to more than a third of the total stock market. The investors behind this development, mainly large institutional investors of British or US background, sometimes find it difficult to fully comprehend and appreciate some of the specific features of Swedish corporate governance.

In the long term this will place increasing pressure on Swedish corporate governance to adapt to 'international' – in reality Anglo-American – governance standards. In fact this process is already going on. On the other hand, it is of vital importance for Swedish corporate governance to be solidly founded in the preconditions prevailing in this market. This balancing act of adapting to international governance standards while maintaining a strong foothold in local traditions and market preconditions presents a key challenge for the future development of Swedish corporate governance.

Notes

1. See the Board's website: www.corporategovernanceboard.se.
2. For a more comprehensive discussion of this matter, see Lekvall, P (2008) *Nomination Committees in Swedish Listed Companies*. The International Corporate Governance Network 2008 Yearbook.

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The Swedish Corporate Governance Board is an independent, self-regulatory body, responsible for monitoring and fostering the Swedish Corporate Governance Code. It comprises 10 individually appointed, high-ranking representatives of the Swedish private business sector, with professional backgrounds ranging from board and management experience to private and institutional ownership. The Board is one of four bodies within the framework of the Association for Good Practice on the Securities Market, which administers the private business sector self-regulation in Sweden. For further information, go to www.corporategovernanceboard.se.

6.15

New Zealand

Richard Croad, Ian Niven and William Whittaker, Institute of Directors in New Zealand

6.15.1 Legal Framework: Laws, Models and Codes

The corporate governance legal framework in New Zealand is based upon common law, statutory laws and regulations, and governance codes. Of central importance is the Companies Act 1993, along with a number of other Acts such as the Securities Act 1978 and the Securities Amendment Act 1988, the Financial Reporting Act 1993, and the Takeovers Act 1993. A board has responsibility for ensuring compliance with all legislation. In addition, directors may be personally liable for breaches by their companies.

Specific legislative requirements affect each organization, industry or sector, such as the Dangerous Goods Act 1974 or the Machinery Act 1950, as well as more general legislative requirements such as the Commerce Act 1986, the Fair Trading Act 1986, the Contracts Enforcement Act 1956, the Insolvency Act 2006, the Consumer Guarantees Act 1993, the Privacy Act 1993, health and safety requirements, building codes, environmental legislation and so on.

The Companies Act 1993 includes the following provisions:

- a non-mandatory constitution in place of memorandum and articles of association;
- the enabling of companies to purchase and finance the purchase of their own shares;
- a solvency test to be passed if the company is to pay dividends or make other distributions, acquire its own shares, provide financial assistance or redeem shares;
- the retention of shareholder control over major transactions;
- the strengthening of shareholder remedies;
- streamlining amalgamation procedures;
- the simplification and clarification of liquidation procedures;
- the widening of the ability of companies to indemnify and insure their directors and their employees.

The board also has responsibility for ensuring that the company is compliant with its constitution (rules).

6.15.2 Patterns of Ownership (eg Family Control, State Influence, Cross-shareholding)

There are approximately 225 New Zealand incorporated companies listed on the stock exchange, now called NZX. The total number of companies registered in New Zealand is over 500,000. Businesses are relatively small, with more than 85 per cent employing five or fewer employees. It is therefore apparent that the New Zealand corporate scene is dominated by small to medium-sized enterprises. The following information was obtained from the Companies Office and is valid as of 30 June 2007:

New Zealand companies	474,212
Overseas companies	1,353
Incorporated societies	22,178
Charitable trusts	17,000

Industrial and provident societies	289
Business societies	16
Unit trusts	308
TOTAL	**515,356**

The limited liability company has been the most significant business structure over the past century. The affairs of the company are managed by, or under the supervision of, a single board of directors who may also, but need not, be shareholders. The directors have powers conferred on them by the Constitution and the Companies Act. In the case of smaller companies, directors are often also employees and take an active part in management.

6.15.3 Regulators and Supervisors

6.15.3.1 The Commerce Commission

The Commerce Commission enforces legislation that promotes competition in New Zealand markets and prohibits misleading and deceptive conduct by traders. It also enforces a number of pieces of legislation specific to the telecommunications, dairy and electricity industries.

6.15.3.2 The Securities Commission

The Securities Act 1978 established the Commission as an independent body to promote the efficient and cost-effective regulation of New Zealand's capital markets and govern the issue of securities to the public. The Commission defines 'securities', maintains oversight of securities market activities and has powers to investigate insider trading, substantial security holder disclosure, and disclosure by listed companies and their directors. It recommends securities law reform and cooperates with international associate commissions to combat cross-border fraud.

The Securities Markets Act 1988 regulates activities on the securities markets, including registration of stock exchanges, regulation of insider trading, market manipulation, disclosure by listed companies and their directors, disclosure of changes to substantial securities holdings and dealing in futures contracts.

6.15.3.3 The Takeovers Panel

Established as a body corporate under the Takeovers Act 1993, the Takeovers Panel is responsible for both the operation of the Takeovers Code 2000 and promotion of public awareness of issues relating to takeovers. The Code ensures that takeovers proceed in an orderly fashion. It establishes standards of proper disclosure and requires equal treatment of all shareholders.

6.15.3.4 NZX (the New Zealand Stock Exchange)

NZX's functions include supervizing listed issuers' compliance with Listing Rules, supervizing market participants such as NZX firms and NZX advisers, and assisting the Securities Commission as a co-regulator as required under the Securities Markets Act 1988.

6.15.3.5 Requirements of a Registered Exchange

NZX is the only registered securities exchange in New Zealand. Conduct rules govern the relationship between the registered exchange and the entities and the rules that govern the conduct of business on the market, and persons who are authorized by the exchange to conduct trading activity.

The Act also includes provisions relating to the imposition of a control limit (which is the highest percentage of voting rights in the body corporate that may be held or controlled by any person) on a registered exchange.

NZX also has a 10 per cent control limit, which the board has included in NZX's constitution.

6.15.3.6 Continuing Requirements Once Registered as a Securities Exchange

As a registered exchange, NZX also assumes a number of reporting obligations to the Securities Commission, which has monitoring powers conferred by the Securities Markets Act 1988. Under the Act, NZX must:

- notify the Securities Commission where it takes any disciplinary action for breach of its rules;

- notify the Securities Commission where it knows or suspects that a person has committed, is committing or is likely to commit a significant contravention of NZX's conduct rules or certain laws;
- pass on any material information disclosed to it under its Listing Rules to the Securities Commission;
- provide information, assistance and access to the Securities Commission or Takeovers Panel where such information, assistance and access is required to assist those bodies discharge their functions.

The Act also confers on the Commission the power to give directions to NZX to suspend trading in a listed issuer's securities or a class of securities in certain limited circumstances.

In recognition of the importance afforded to the continuous disclosure provisions in NZX's Listing Rules, NZX must consider any submissions that the Commission may make in considering applications for the determination of the continuous disclosure Listing Rules. A memorandum of understanding (MoU) with the Securities Commission states that the shared goal of NZX and the Securities Commission is to ensure the optimum regulation of New Zealand's securities markets, to enhance the performance and reputation of NZX's stock markets as fair, efficient, deep, well-informed and internationally competitive markets and to facilitate appropriate levels and quality of disclosure.

The MoU recognizes NZX's role as the front-line regulator of its securities markets and details how NZX and the Commission will work with each other in overlapping areas of responsibilities.

6.15.3.7 Listing Criteria for Flotations

The New Zealand Stock Exchange (NZX) runs and regulates two equity markets:

- the NZSX Market (NZX's stock market main board);
- the NZAX Market (NZX's alternative market).

There is a diverse range of companies listed on the NZSX Market, but the majority of listed companies are large New Zealand enterprises and established businesses with solid track records of positive cash flow and earnings. Such companies generally have:

- existing boards and governance procedures in place, independent directors and an audit committee;
- a history of audited accounts;
- securities held by at least 500 members of the public holding at least 25 per cent of the securities;
- market capitalization greater than NZ$5 million (NZX has discretion to refuse to consider an applicant for listing on the NZSX Market if its capitalization is below this level).

New Zealand Securities Act requirements apply in full to NZSX listing, including the requirement for a detailed prospectus and investment statement.

There is also a diverse range of companies listed on the NZAX Market, but the majority are small to medium-sized businesses. These companies generally have:

- existing boards and governance procedures in place; there is no requirement for independent directors in an NZAX-listed company;
- a minimum of 50 shareholders;
- no requirements for minimum or maximum market capitalization;
- no requirement for a trading record (though a listing on the NZAX Market is most suited to companies with turnover of more than NZ$5 million per annum).

The Securities Act (NZX-NZAX Market) Exemption Notice 2005 provides for a simplified offering document with lesser requirement for prospective financial statements, enabling more efficient ongoing capital-raising options for NZAX-listed companies.

6.15.4 Board Structure and Roles

What has practice been traditionally?

There are a significant number of smaller businesses in New Zealand, many of which do not have a formal board or governance structure. Listed companies and Crown entities must have a board and governance processes in place.

How has the size and composition of the board changed?
There is little evident change in the size and composition of boards with six to eight members, the usual size in medium-sized to large firms. The many smaller companies in the country can normally operate quite satisfactorily with a lower number. Under NZX Listing Rules the minimum number of directors (disregarding alternative directors) is three. Community and Iwi (Maori tribal) groups often have far larger numbers on their board of trustees – up to 20 members. There is an increasing awareness of the benefits in reducing these numbers.

The state sector leads the way in initiatives that target the increase of women on boards, with the government aiming to achieve parity by 2010 in the 400 state-sector boards it is consulted on. In the private sector, New Zealand does not fare well in international comparisons, with only 8.65 per cent of boards on NZX containing *any* women.

How are the roles of top executives defined?
Typically, only the CEO has his or her role determined by the board of directors. Other roles may be approved specifically by the board but the determination of the role rests with executive management.

All board authority conferred on management is delegated through the CEO, so that the authority and accountability of management is considered to be the authority and accountability of the CEO so far as the board is concerned. The board must agree to the levels of sub-delegation immediately below the CEO.

Typically, the roles of chairman and chief executive are separate when a formal board and governance structure is in place. For a number of smaller businesses the managing director–owner overlap means that by default there is an overlap where no formal board or process is followed.

What is the role for independent directors?
'Independent' means independent of management and free from any business or other relationship or circumstance that could materially interfere with the exercise of a director's independent judgement. For example, a director would not be independent if he or she had recently been employed by the company or had a contractual relationship with the company (other than as a director), or if was related to a major shareholder.

In terms of the NZX Listing Rules, an independent director is a director who is not an executive of the company and who has no disqualifying relationship. A disqualifying relationship means any direct or indirect interest or relationship that could reasonably influence, in a material way, the director's decisions in relation to the company. For example, a director would be deemed to have a disqualifying relationship if he or she had a substantial security holding or if the director is likely to derive, in the current financial year or the company, a substantial portion of his, her or its annual revenue during such financial year. NZX considers a 'substantial portion' to be generally 10 per cent of a director's annual revenue.

Note that a non-executive director is not necessarily an independent director, but that all independent directors are non-executive directors.

Directors must protect the interests of shareholders and monitor the behaviour of management. The independence of non-executive directors is becoming increasingly valued, particularly in providing assurance of disinterested decisions on matters in which board members might be thought to have conflicting or competing interests.

6.15.4.1 Conflicts of Interest

New Zealand is a small country, and conflicts of interest are inevitable. In dealing with conflicts of interest, actual or potential, regard should be had to legislation and best business practice and convention. The Companies Act 1993 requires that directors must act in good faith in the best interests of the company. A director must not take improper advantage of his or her position. His or her personal interests, or the interests of any associated persons, must not conflict with the interests of the company. The test in deciding whether a conflict is present in any given situation is whether a reasonably informed objective observer would infer from the circumstances that the director's judgement is likely to be influenced to the detriment of the company's best interests. Dealing with conflicts of interest should balance the protection of the legal and ethical positions of those involved with the general principle that a company should be entitled to the collective wisdom of all its directors.

There are complex and comprehensive rules set out in New Zealand securities legislation for dealing in company securities by 'insiders', designed to prevent misuse of company information and disadvantage to shareholders.

The IoD Principles of Best Practice 'Conflicts of Interest' sets out procedures for handling conflicts of interest. These include disclosure of interests, conflicted directors' rights to receive notices, attendance at meetings, participation in discussion etc. Best practice also promotes the use of an Interests Register. The Companies Act 1993 does not prohibit conflicted directors from voting. However, best practice in the circumstances, and/or company policy, may require that a director does not vote.

6.15.4.2 Board Committees

Initiating the establishment of committees of the board and nominating who should serve on each committee is the responsibility of the chairman, as is ensuring that committees achieve their objectives and operate within the limits of their terms of reference. As well as audit and remuneration committees, some organizations have seen a need for other committees to focus on nominations, quality, people development, business development, acquisitions/divestments/joint ventures, risk management and contingency planning, and environmental impact.

6.15.5 Shareholder Rights

The shareholders are the owners of the company. They contribute share capital to pay for their shares, which, subject to any restrictions in the company's constitution, are transferable. They have enforceable rights against the company, the company's directors and each other.

Shareholders receive the profits, or a share of them, by way of dividends, which will vary from year to year. They also carry the greatest risk of loss in the event of company failure. They rank last in line for income on a return on capital, behind creditors.

The general duties of directors are owed to the company, not to the individual shareholders. The 1993 Act does specify duties owed both to the company and the shareholders that are therefore able to be enforced by the shareholders [s 169(3)(a)–(c)]. These are: to supervise the share register (s 90), to disclose interests (s 140) and to disclose share dealings (s 148).

The duties owed to the company only, and so enforceable by the company, are set out in s 169(3)(d)–(i):

- to act in good faith;
- to act in the best interests of the company;
- to exercise powers for a proper purpose;
- to avoid reckless trading;
- not to agree to incurring certain obligations;
- a duty of care;
- not to disclose, make use of or act on company information.

What has traditionally been the status of domestic and foreign investors?

The past 30 years has seen a decline in the significance of New Zealand listed companies, with the shift of a number of these to overseas ownership, particularly Australian. The Overseas Investment Office now focuses principally on foreign investment in New Zealand land and other sensitive assets. It administers the Overseas Investment Act 2005 and related regulations under the Minister of Finance. The Act requires consent for an overseas investment in business assets, meaning the acquisition by an overseas person, or an associate of an overseas person, of rights or interests in securities of a person if:

- as a result of the acquisition, the overseas person or the associate (either alone or together with its associates) has a 25 per cent or more ownership or control interest in a company or an increase in an existing 25 per cent or more ownership or control interest; and
- the value of the securities or consideration provided, or the value of the assets of the company and its 25 per cent or more subsidiaries, exceeds NZ $100 million.

Although consent for such foreign investment is very rarely withheld, potential overseas shareholder control of major infrastructural assets can see intervention directly by the Minister and Cabinet, depending on the nature of the government of the day. In 2007–08 a

Labour-led coalition Cabinet amended the overseas investment regulations during an offer process by the Canadian Pension Plan to the shareholders of Auckland International Airport and subsequently blocked the transaction.

What is the level of shareholder activism?
The main shareholder organization is the New Zealand Shareholders' Association, whose membership is around 1,200. This small organization is quite vocal. Large shareholders can and do influence board composition; see below.

What is the power of shareholders to call general meetings and review the books?
Shareholders have powers set out in the Companies Act that enable them to retain overall control through their rights to vote on all matters put to them at annual meetings of the company, to appoint company directors, to adopt or alter the company constitution, to approve (or veto) major transactions (transactions affecting more than half of the value of total assets) and to place the company in liquidation. Listed-company shareholders are given additional rights under the New Zealand Stock Exchange Listing Rules; for example, shareholder approval is required for director remuneration.

Within a limited period after each annual balance date the company is required by the Act to prepare and send to its shareholders the annual report, following which the company must (unless at least 75 per cent of shareholders holding at least 75 per cent of voting shares decide otherwise) hold an annual meeting at which the shareholders have the right (as they do at other shareholder meetings) to hold the company's management to account and to vote on all resolutions subject to anything to the contrary in the constitution.

Powers reserved to shareholders by the Act include changes to the constitution, approval of a major transaction (that is, in general terms, transactions by which the company acquires or disposes of assets, or incurs liabilities, with a value greater than half the value of the existing assets), approval of an amalgamation with another company, and the placing of the company into liquidation. These powers can only be exercised by a special resolution (that is, by at least a 75 per cent majority vote).

6.15.5.1 Nomination of Directors by Shareholders

In theory, any shareholder can nominate a director and propose a resolution to effect an appointment at the company's AGM. In reality, the directors are charged with the running of the company and have a duty to run all its affairs, including the nomination and appointment of directors. NZX-listed companies are required to have the appointment of directors and levels of remuneration approved at the AGM. Unless its constitution provides otherwise, the same would normally apply to an unlisted company.

Large shareholders do influence board nomination and appointment processes, and it is essential for their views to be taken into account by directors in the nomination and appointment process.

The disclosure of corporate governance practices is a requirement of the NZX Listing Rules and is increasingly regarded as good practice in the private unlisted, government-owned and not-for-profit sectors. Generally, these disclosure statements describe the process whereby appointments are made to the board, creating greater transparency and the opportunity for debate among all shareholders at the AGM.

6.15.5.2 Protection for Minority Shareholders

Minority shareholder protection mechanisms are included in the Companies Act 1993, the Takeovers Act 1993 and the Takeovers Code.

Under the minority buyout provisions of the Companies Act, minority shareholders have enjoyed protection for some time in the event that they vote against a 'major transaction'; that is, one involving more than 50 per cent of the value of the company's assets and requiring a 75 per cent majority vote (ie by special resolution). The definition of these transactions encompasses the sale of the business of the company or the amalgamation of the company into another company. Under an amendment to the Companies Act recently passed, shareholders who have unsuccessfully opposed a major business transaction and wish as a result to sever their relationship with the company are better protected than before. In particular:

- The company is now obliged to send to each shareholder a statement setting out their rights when a special resolution triggers the minority buy-out provisions in the Companies Act.

- The price offered for the shares reflects a 'fair and reasonable' assessment of the value as at the close of business on the day before the day on which the resolution was passed and valued on a pro rata basis to all shares of the class of which they form part.
- Arbitration is required if the shareholder and company cannot come to an agreement on the value of the shares.

The takeovers regime was introduced to fill a gap in the Companies Act where a takeover is effected by the acquisition of shares or of control of the voting rights attaching to those shares. Protection is provided to minority shareholders in takeovers under the Takeovers Code, where any share acquisitions in a company above a shareholding threshold of 20 per cent are allowed to proceed only by way of a full or partial offer made on equal terms to all shareholders (unless a majority of the latter approve other terms). This prevents the bidder paying a premium to one or more large shareholders and ensures that any control premium is available to all shareholders.

Other measures designed to ensure equitable treatment of minority shareholders include the NZX Listing Rules, which are based on a requirement that all shareholders should be treated fairly and equitably, and the Institute of Directors Code of Practice for Directors, which is binding on members and requires that directors 'ensure all shareholders and classes of shareholders are treated fairly according to their different rights'. The Companies Act 1993 requirement that directors act at all times in what they believe to be the interests of the company is itself a mechanism for equitable treatment of all shareholders.

6.15.6 Disclosure and Transparency

Every company is required by the Companies Act to prepare an annual report about the company's affairs and send it to shareholders each year. The Financial Reporting Act 1993 requires directors to ensure that, within the time limits prescribed by the Act, regular financial statements that comply with the Act are completed in relation to their company. Under the Act, financial statements must, except in the case of exempt companies as defined by the Act (ie normally the very smallest companies) comply with Generally

Accepted Accounting Practice (GAAP); and in instances where statements do not give a true and fair view, directors must add such information and explanation as will give such a view.

In addition to legal requirements, financial statements must be seen to be reliable and credible (ie believable) by a number of parties who seek confidence when making decisions about the nature of their involvement with the company. These parties include shareholders, lenders, suppliers, bankers, employees, and intermediaries such as analysts and merchant bankers.

Financial statements should therefore not just present a true and fair view of a company's position without adequate information on the performance and position of the company. It is in the company's interest that, unless there is a good reason to the contrary, there should be consistency in accounting policies, and clarity and completeness in the statements themselves.

6.15.6.1 Disclosure of Price-sensitive Information

NZX operates the markets in a co-regulatory framework with the Securities Commission. NZX is the front-line regulator of the markets, and in this role NZX formulates rules and practices that listed issuers and market participants must abide by. These rules and practices reflect the following core principles:

- All shareholders should be treated fairly and equitably.
- Listed issuers should provide full, timely and accurate disclosure of material information.
- Investors and market intermediaries should be protected against systemic risk.
- Any unfair share trading practices should be detected and met with effective remedies.

The continuous disclosure requirements for both NZX- and NZAX-listed issuers are central to application of these principles. NZX and NZAX issuers have obligations under the NZX Listing Rules to keep the market constantly informed on matters that may affect the price of their securities. The obligation to continuously disclose material information was introduced on 1 December 2002 in the NZX Listing Rules and the Securities Markets Act 1988. Under the Listing Rules, financial information must be released to the market at specified times in prescribed formats. Such disclosure is also subject to the requirements of the Financial Reporting Act 1993, which requires compliance with international financial reporting standards as codified in NZ IFRS.

Material information must be disclosed to NZX via the Market Announcement Platform (MAP). This is an electronic platform that allows listed companies to market announcements directly to NZX before sending them to normal media and distribution channels. NZX has a broad range of subscribers who receive this information, including news groups, information companies such as Bloomberg & Reuters, NZX advisers, fund managers and market analysts. Dissemination by NZX is almost immediate.

Recently amended securities legislation includes a range of features designed to protect shareholders generally, as well as ensure the integrity of markets. These include:

- disclosure when a person becomes a substantial security holder (set at a threshold of 5 per cent of issued voting shares);
- a wide-ranging prohibition against any conduct related to any dealings in securities that is likely to mislead or deceive;
- rules and heavy penalties preventing information insiders trading in securities or disclosing information to others to trade on or hold securities.

While aimed at preventing market manipulation, these measures also help remedy asymmetry of information between large and small shareholders and the range of market participants. In that respect they also serve as a mechanism for minority protection.

6.15.6.2 Risk Controls

Good risk management practice is promulgated by best-practice guidance and the operation of skilled management, directors and advisers within companies in New Zealand. Although also related to the annual financial audit process and aspects of financial reporting such as the quantification and disclosure of contingent liabilities, focus on the non-financial drivers of these financial effects is enshrined in good company practice rather than any form of law or regulation.

The New Zealand Institute of Directors teaches risk management for directors on its Company Directors Course and backs this with best-practice guidance on risk as part of its publication *Principles of Best Practice for New Zealand Directors: The four pillars of effective board governance*, distributed to all members. In addition, there are risk management standards in place such as Standards New Zealand's 4360 that are widely applied within New Zealand organizations. The practice of a number of professional organizations in this respect is, too, including that of the New Zealand Society for Risk Management Inc.

6.15.7 Responsibility

6.15.7.1 Ethical Conduct, Social Responsibility and Environmental Sustainability

Ethical requirements and expectations for directors are set out in the codes of conduct of professional bodies such as the New Zealand Institute of Chartered Accountants. These codes provide guidance for members in all professional situations. In addition, the Institute of Directors publishes its own Code of Practice for Directors and a guideline on ethics that forms part of its *Principles of Best Practice for New Zealand Directors: The four pillars of effective governance* collection of best-practice guidelines. Codes are mandatory and provide grounds for disciplinary action if not complied with by members. Many organizations encourage compliance by adopting their own codes of ethics, which they describe in the 'disclosure of governance practices' section of their annual report.

The Institute of Directors Code of Practice sets out some key areas in which ethical issues may arise and provides guidance to members on what principles to apply, for example in the handling of conflicts of interest, treatment of confidential information, purchase and sale of securities, and the organization's attitude to legal compliance generally. It demonstrates that by displaying and encouraging high standards of ethical behaviour and treating legal compliance as the minimum standard – to be exceeded – directors positively influence the culture, reputation and success of their companies.

The requirement for ethical behaviour is underpinned by the Companies Act 1993 in areas such as the fundamental duties of directors (for example, they should act in the best interests of the company, not act recklessly, ensure exercise of powers for a proper purpose) and a range of other legislation including securities trading legislation, the Fair Trading Act (1986), the Financial Reporting Act (1993) and the Resource Management Act (1991).

A relatively recent phenomenon is the enactment of 'whistle-blowing' legislation – the Protected Disclosures Act (2000). To have regard to the Act, boards need to ensure that there is an effective process for handling internal company disclosures of dishonest, fraudulent, criminal or otherwise inappropriate actions or events where the person offering the information might otherwise be discouraged from using normal communication channels.

Sustainability and sustainable development reporting (SDR) are becoming increasingly important topics in New Zealand boardrooms. Directors are aware of the increasing demand for information about their organizations' social, environmental and economic impacts, as well as the potential competitive advantage that good performance in this area can provide. An important example of this lies in the vulnerability of New Zealand agricultural export business to erosion of markets through the spread in popular consciousness of the concept of 'food miles'. Participants in New Zealand's primary industries must be able to measure and report on their environmental impact and how this compares to that of competition in export markets.

The New Zealand Institute of Chartered Accountants' Sustainable Development Reporting Committee (SDRC) has as one of its objectives to contribute to SDR improvements in New Zealand. Leading New Zealand organizations in the area of SDR tend to be government- or local-government-owned corporations in the energy and water sectors. For example, Watercare Services Ltd – the Auckland regional water storage and distribution company – regularly receives awards for the measurement, control and reporting of its environmental and social impacts.

Over the past few years an increasing number of New Zealand companies have produced 'triple bottom line' reports, mostly as a result of the promotional efforts of the New Zealand Business Council for Sustainable Development (NZBCSD). A lack of legal requirements or mandatory reporting standards, however, means that the uptake of such reporting is voluntary and not widespread beyond the 70 corporations that are Council members. It is likely that these numbers will be boosted by New Zealand's signing of the Kyoto protocol and the related and recently enacted emissions trading legislation. Companies and sectors need to measure and report on environmental impacts, not least because they need to collect objective data with which to test and challenge assumptions made in the drafting of legislation in the area.

6.15.8 Directors

6.15.8.1 Duties and Liabilities

Under the Companies Act, management of the company is the responsibility of the board. Section 128(1) of the Companies Act states that the business and affairs of a company must be managed by, or under the direction or supervision of, the board of the company. Section 128(2) states that the board of a company has all the powers necessary for managing, and for directing and supervising the management of, the business and affairs of the company. Section 130 enables the board, subject to restrictions in the constitution, to delegate powers and functions to management for the day-to-day operations of the organization. The functions that the board is unable to delegate include issuing shares, making distributions and providing shareholder discounts, redeeming shares, transferring shares and so on. A board that does delegate its powers under this section remains responsible for the exercise of the powers by the delegate as if the power had been exercised by the board.

Exceptions to this include if the board 1) believed on reasonable grounds at all times before the exercise of the power that the delegate would exercise the power in conformity with the duties imposed on directors of the company by this Act and the company's constitution; or 2) believed that it had monitored, by means of reasonable methods properly used, the exercise of the power by the delegate.

6.15.8.2 Directors' Duties and 'Acting in the Best Interests'

The core provisions of the Act that affect the conduct of directors in their role are contained in section 131 of the Companies Act 1993 and described in section 3.2 of the New Zealand IoD's Code of Practice for Directors as follows:

> Company directors have a fiduciary duty to act in good faith and generally in what they believe to be the best interests of the company.
>
> Directors have a duty of care, diligence and skill requiring them to be active and inquiring in the conduct of their duties.

> Directors also have a duty not to act recklessly by permitting a company to carry on business in a way likely to result in substantial loss to creditors, or to incur an obligation unless the company can perform against it.

An exception lies in section 131(2) of the Companies Act 1993, according to which a director of a company that is a wholly owned subsidiary may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner that he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company. Similarly, a director may act in the best interests of, say, a major shareholder if the constitution permits and the board has approved the action. This formal approval, however, is rare, and it could be divisive at the board if sought.

Therefore, although directors appointed by specific shareholders may be expected to bring the views of their 'constituencies' to the board table, they make their decisions on the basis of what they themselves believe to be in the best interests of the company. After full, free and frank discussion, it is the best interests of the organization, not the interests of other individuals or groups, that must prevail.

6.15.8.3 The Duty of Reasonable Care, Diligence and Skill

Section 137 of the Companies Act states that 'a director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances…' What constitutes appropriate care, diligence and skill will vary according to the circumstances. The IoD Code of Practice for Directors states that the Companies Act requires directors:

> to be active and inquiring in the conduct of their duties. Directors should consistently attend board meetings and devote sufficient time to make and keep themselves familiar with the nature of the company's business and the environments in which it operates. Directors should ensure the organisation has a sound governance and management framework which fosters both performance and compliance. They should engage with management on the company's strategy and performance monitoring, as well as observing high ethical standards.

With respect to reckless trading, sections 135 and 136 of the Companies Act provide some guidance:

> A director of a company must not agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

As far as duty in relation to obligations under s 136 is concerned, a director must not agree to the company incurring obligations unless the director believes at the time on reasonable grounds that the company will be able to meet the obligation when it is obliged to do so.

Legal action against a director is most likely to happen under s 137 (requirement to exercise care, diligence and skill) or s 135 (reckless trading), and this generally would occur when a company has gone into receivership and creditors have lost money. Trading when insolvent is a situation that directors need to be particularly vigilant to prevent.

Acting in the best interests of the company, otherwise known as the 'first duty', is a mildly worded but very powerful concept that distinguishes corporate governance from other forms – for example, political governance, where constituents elect politicians to act in their interests. In politics, constituent representation often clashes with the need for MPs to vote on matters in line with party policy or on issues that affect the entire population. As a principle, 'acting in best interests of the company' guides company directors through the maze of potentially conflicting shareholder and stakeholder interests.

6.15.8.4 Director Development and Training

For listed companies the code of practice recommends that directors undertake appropriate training to remain current on how best to perform their duties. The IoD *Principles of Best Practice for New Zealand Directors*: *The Four Pillars of Effective Governance*, note that any improvement in the performance of boards, and of individual directors, will add value to their company and is accordingly in the interests of the company and its shareholders. Therefore, as part of their fulfilment of legal and ethical obligations to the company and shareholders, directors should be constantly looking to achieve such improvement. There is recognition that regular formal evaluation can bestow benefits. Follow-up actions can include education and training, and rest with the board to determine.

6.15.9 Executive Pay and Performance

As elsewhere, the remuneration of executives has received attention in New Zealand. In magnitude it does not compare with the very high levels achieved by CEOs of the largest US and European corporations. The remuneration of today's managers typically comprises base salary, fringe benefits and rewards under incentive schemes, both long term (the issue to employees of shares or options) and short term (bonuses, profit sharing or target-based incentives).

The issue to employees of shares and options in their company and the distribution by companies of a portion of their profits on a purely discretionary basis at the end of the year have for some time been recognized in New Zealand as means of motivating employees. With increasing exposure to world markets comes a growing awareness that the reward system requires a degree of alignment in order to attract and retain the top executive talent.

6.15.10 Further Details

Material has been drawn mostly from statues and guidelines such as the NZX Listing Rules. The IoD *Principles of Best Practice for New Zealand Directors: The four pillars of effective board governance* (2007) has been a major source of information on contemporary and best practice.

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The Institute of Directors in New Zealand Inc promotes excellence in corporate governance, represents directors' interests and facilitates their professional development through education and training. It is a membership organization of over 4,500 individuals representing the spectrum of New Zealand enterprise, from the public and private sectors. For further information, go to www.iod.org.nz.

6.16

Finland

Olli V Virtanen, Finnish Association of Professional Board Members

During the past two decades, Finland's corporate governance framework has developed into one of the most advanced in the world. Part of the relatively homogeneous Nordic financial markets, the Finnish corporate governance model by and large emulates Anglo-Saxon principles, with a one-tier board structure and clearly defined roles and responsibilities for corporate bodies.

Several reasons have contributed to the development. The cornerstone was laid in the mid-1980s, when larger Finnish companies made their first serious inroads into the international capital markets through private placements to selected institutional investors, most notably George Soros. This opened doors to dialogue between companies and the investment community, which helped develop best practice.

Regulators also caught up with the progress. In 1985 the Helsinki Stock Exchange renewed its rules and established an ethics board. This was followed by the Securities Market Act (SMA) in 1989 and the law on finance inspectorate in 1993. The same year, 1993, Finland removed restrictions on foreign ownership of shares (which had typically curbed international holdings at 20 per cent in most listed companies). The SMA has been updated since the late 1980s, most recently in 2007. The Company Act, like the SMA, by and large sets the framework for business operations. The corresponding laws in Sweden, say, are more detailed and based on case-law principles.

The Finnish securities market is supervised by the Financial Supervision authority, which operates within the Bank of Finland, the country's central bank. The Helsinki stock exchange, currently part of the Nordic OMX Group, which recently merged with NASDAQ, has its own regulations for companies listed on the stock market.

Corporate governance codes supplement the regulatory framework. The first code, launched in 1997, was jointly authored by the Stock Exchange, the Central Chamber of Commerce and the Central Association of Finnish Industries, the employers' umbrella body. The document's international impact was limited since it was only available in Finnish. A new version of the code, the Corporate Governance Recommendation for Listed Companies, was written by the same bodies and also translated into English. It came into force on 1 July 2004. This code emulates many of the key principles established in the United Kingdom's key codes. The stock exchange requires listed companies to adhere to the recommendations on a 'comply or explain' basis. The code is currently 'owned' by the Securities Market Association, the original author (www.cgfinland.fi). The Association is currently conducting a process of updating the code, which was finalized in late 2008.

Finland's listed companies have adapted to the laws and codes relatively well. The country has been without major corporate scandals of the kind that have rocked the United States, Germany, Italy and even Sweden. Breaches in Finland have mostly concerned insider trading. Top management and board members have traded in shares with prior knowledge of corporate moves that could have a material impact on the share price. Yet to judge by the amounts concerned – which hardly ever reach six figures – many cases have sprung from pure carelessness.

Reasons for strict adherence range from the example of Nokia, which in various surveys has been named as Europe's best in investor relations and corporate governance, to the nature of the Finnish people, who often self-deprecatingly call themselves the best pupils in the (European) class; in other words, they have a go-by-the-book mentality. A notable character description comes from Transparency International, which has frequently named Finland as the least corrupt country in the world.

6.16.1 The Board

The vast majority of Finnish companies have adopted the one-tier board structure consisting of a board of directors elected by shareholders at the annual general meeting. A supervisory board, intermediate between shareholders and the board of directors, exists only in companies with a large equitable base of shareholders, such as cooperatives.

State-owned companies, which used to have politically appointed boards of directors as well as supervisory boards, have moved during the 2000s to the one-tier board principle and have largely replaced politicians with professionally qualified directors. The majority of directors of state-owned companies, or companies in which the state has a substantial minority share, are now non-executive and independent. The same applies to listed companies. In fact, Finnish firms have gradually removed executives, including the CEO, from their boards. In this respect, Finnish firms are 'purer' than boards in the Anglo-Saxon corporate world. The logic behind this principle is that of transparency, which requires clear division of roles and responsibilities between corporate bodies. Since one of the key tasks of the board is to appoint and release the CEO, having him or her sitting on the board may make the task more difficult. However, the Company Act gives the CEO the right to attend all board meetings.

Hence, the non-executive and independent chairman ideally acts as an objective sparring partner to the CEO. This principle is not mandated by law, nor is it a recommendation in the corporate governance code. The code simply recommends that majority of board members shall be independent of the company, and at least two of those should be independent of any significant shareholder of the company. While most companies adhere to the principle of having non-executives on boards, exceptions do exist. The most notable is Nokia, which used to combine the duties of chairman and CEO in one person, Jorma Ollila, but now he has left the position of CEO. Ollila remains chairman and his successor as CEO, Olli-Pekka Kallasvuo, is also a member of the board.

6.16.2 Shareholder Rights

Shareholders are the ultimate decision makers in Finnish companies, but their role is strictly limited to having a voice and a vote at the AGM. Shareholders appoint all members of the board annually. Most will be re-elected but it is up to the shareholders, by majority vote, to decide the composition of the board. In most listed companies only one or two directors will change at any given AGM.

Average attendance at AGMs is low, but even so, 'coups' are relatively rare. This is due to the fact that some 50 per cent of the stock market cap is held by international institutions. Some international institutions traditionally give proxy votes to a local custodian bank in Finland with instructions to file opposition to selected resolutions but without calling for a vote. This is to retain the possibility of suing the company afterwards if need be. International attendance at Finnish AGMs is still relatively low as a result of complicated laws and requirements, and shareholders' own choice not to register their shares. Some Finnish companies still retain a system of dual share series, by which longer-term owners (as opposed to short-term investors) can have a majority of votes with a minority of the shares. Typically the vote difference is 1–10. However, many companies have moved to having a single share series in order to increase liquidity and transparency.

Shareholder activism is not widespread and usually focuses on specific topical issues such as plant closures and environmental issues. Chairmen of AGMs, who usually are independent lawyers, tolerate activism and let activists speak, although only on matters that are deemed to need to be handled at the AGM. Shareholders can oppose and demand a vote on practically any item on the AGM agenda, but for practical purposes the chairman can judge the amount of opposition without resorting to a vote, either closed or open.

While most decisions are made by majority vote, minorities have certain rights. For instance, 10 per cent of shareholders can call for an extraordinary audit, or in practice appoint their own auditor in addition to the one decided on by the AGM by a majority vote. Likewise, 10 per cent of shareholders can demand that the company pay a minimum dividend, which amounts to half of profit of the financial year, but no more than 8 per cent of equity.

Shareholders are well protected by law and by corporate governance codes. All profit and loss accounts and balance sheets are public information in Finland. Furthermore, listed companies have to disclose detailed information about remuneration, pension plans and other benefits to directors, the CEO and top management.

6.16.3 Responsibility

There is constant debate in corporate Finland about social responsibility, ethical conduct and environmental issues. Many companies have taken action on these the issues, although a widespread movement is yet to arise.

6.16.4 Directors

The board of directors is by law collectively responsible for all company matters except those that are deemed to be the responsibility of other parties, such as the CEO or the AGM. According to the Company Act, the board and the CEO are the legally responsible bodies in companies. Other bodies, such as top management, do not have legal responsibilities. Corporate governance has further underlined the pivotal role of the board. Directors approve all financial documents, appoint and release the CEO and define the company's strategy. Furthermore, directors observe and monitor the company's performance.

Considering the tasks involved and the constantly increasing challenges, board training has not developed at the same pace. This may be due to the fact that most directors are non-executive and independent, holding several board positions. Average age is also relatively high – although today companies are appointing more diverse boards. In fact, board diversity is becoming a key issue, and not just as a reflection of the popular demand for more women on boards. The board is increasingly viewed as a collective body representing key expertise and backgrounds that the company as a whole needs at board level. Larger companies, for example, have appointed international board members from markets that are vital to the company. The corporate governance code recommends that listed companies have at least five board members. There is no maximum term in office, although some companies have set an age limit at around 65 years in their articles of association.

6.16.5 Board Remuneration

International exposure has contributed to the rapid rise in board remuneration, which has gradually reached competitive levels. The tendency is to pay the greater part of the compensation in full-value shares, and the rest – meant to pay tax on the shares received – in cash. Very few listed companies offer remuneration in stock options. According one rule of thumb, directors' annual fee is equivalent to the CEO's monthly salary without extras. The chairman of the board typically receives twice the amount that an average member receives.

Most listed companies have established various committees, which the corporate governance code also recommends. Typical committees include audit, nomination and compensation committees. The code recommends that all committees be composed of board members, and they are preparatory bodies for the board. A committee cannot make any decisions, and it does not have legal responsibilities.

In Brief: Auditing in Finland

The main set of Finnish regulations relating to audit is the Auditing Act (459/2007), but many other statutes (eg the Companies Act and Partnership Act) include audit-related provisions.

Most bodies that are obliged to keep accounting records also have an obligation to appoint an auditor. Unless otherwise provided elsewhere in the law, however, there is no obligation to appoint an auditor for a corporation where not more than one of the following conditions was met in both the past complete financial year and the financial year immediately preceding it:

- the balance sheet total exceeds 100,000 euros;
- net sales or comparable revenue exceeds 200,000 euros; or
- the average number of employees exceeds three.

Also, a branch of a foreign enterprise registered in Finland has no obligation to appoint an auditor if the enterprise's financial statements are prepared, audited and published in accordance with the regulations of the European Union or in a similar manner. For example, the Finnish branch of a UK company does not need to appoint an auditor, but that of a US company does.

In Finland, statutory audit covers the audit of the accounting records, the financial statements, the annual report and the administration.

Under the current Auditing Act, all auditors need to be authorized. There are three types of authorizations: an HTM auditor (authorized by the local chamber of commerce) is qualified to audit most companies, but a KHT auditor (authorized by the Central Chamber of Commerce) is needed, for example, to audit listed companies and foundations. JHTT auditors (authorized by a particular public body) specialize in public-sector audits and have only limited competence to audit commercial entities.

Auditors are required to comply with the International Auditing Standards (to the extent that they have been adopted by the European Union) and principles of professional ethics, and have an obligation to observe good auditing practice. They must maintain and develop their competence. Auditors are required to be independent and arrange their activities in a manner that ensures independence.

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6.17

Republic of Ireland

Bob Semple, PricewaterhouseCoopers

There has never been a more appropriate time for writing about corporate governance, whether internationally or in the Republic of Ireland. In late 2008 – with turmoil in the markets, rapidly changing economic conditions and a desire to determine who should bear responsibility for enormous losses – a survey of corporate governance is very timely.

6.17.1 General Principles

Corporate governance in Ireland has been most influenced by the United Kingdom and its Anglo-Saxon-based legal system (from which Ireland's legal system is derived) and, more recently, by the impact of EU law and regulation.

The foundation legislation for companies in Ireland is the Companies Act 1963. It has been amended subsequently through 14 amending Acts and numerous Statutory Instruments. A major reform of this legal framework is expected to take place in 2010 (see below).

Since the Cadbury Report was first issued, in 1992, the United Kingdom has systematically developed its corporate governance guidelines through a series of reports including Greenbury, Hampel, Combined Code (2003, 2006 and 2008), Turnbull, Higgs, Smith, Tyson and Turnbull. Because of its close alignment with its London counterpart, the Irish Stock Exchange has adopted these guidelines for application in Ireland with only minor changes.

6.17.2 Operation of Boards

Ireland uses a unitary board system. The key distinguishing characteristics of listed company boards in the United Kingdom also apply to Irish boards, namely:

- accountability of the board to shareholders for performance of the entire business, including the setting of appropriate strategy and policies;
- separation of the roles of chairman and CEO;
- separation of matters reserved to the board versus those delegated to the CEO;
- emphasis on a mix of independent non-executive directors as well as executive directors;
- use of specific committees of the board (typically audit (sometimes including risk), remuneration and nomination) with formal terms of reference, appointed chairman, and clear reporting responsibilities;
- annual evaluation of all directors and of the chairman;
- corresponding disclosures in the annual report.

6.17.3 The Role of Director – and 'Acting Responsibly'

'Acting responsibly' in good faith and in the interests of the company as a whole is the principal duty of any director. The

Companies Acts contain a variety of sanctions to underpin that duty; for example, if a company is wound up insolvent, its directors will be restricted under company law from holding the position of director unless it can be shown that they have acted honestly and responsibly. In practice, that means directors must be able to demonstrate how they carried out their duties under common law, equity and statute.

Irish law makes no distinction between executive and non-executive directors. While, technically, this implies that there is no difference between the duties of executive and those of non-executive directors, a recent Supreme Court judgement suggests that there is 'yet unmet need' to distinguish the respective duties of an executive director, a non-executive director, and a non-executive director appointed for a particular purpose (for example, where appointed to represent a specific class of shareholders).

6.17.4 Board Committees

Board committees play an important role in the corporate governance framework for listed companies:

- A remuneration committee comprising only non-executive directors is responsible for determining the remuneration of executive directors.
- An audit committee comprising only non-executive directors (one of whom should have 'recent and relevant financial experience') usually takes responsibility for external and internal audit, risk management oversight and related tasks.
- A nominations committee is used to identify new directors.

Depending on the particular circumstances, boards may also form other committees, either standing or for a defined time period. Examples include acquisitions, health and safety, IT and treasury committees.

Although there have been some calls to adopt the supervisory board approach instead of the unitary structure, there is no clear evidence that such a change would have avoided the recent substantial losses suffered.

6.17.5 Key Roles

After setting the strategy, the board usually relies on the chief executive to deliver it. It is up to the chief executive, acting within the powers delegated, to determine how this is achieved.

The company secretary plays an important role in supporting non-executive directors and the chairman in the running of the board and in compliance matters generally.

The board is responsible for the system of internal control and is required to review its effectiveness at least annually – covering both financial and non-financial controls. While much of the detailed work is often delegated to board committees and carried out by management, the board is required to satisfy itself that internal control is effective and that necessary actions are taken to remedy significant internal control weaknesses.

6.17.6 Executive Pay and Performance

In Ireland an amending Companies Act (1990) introduced much more explicit disclosure requirements concerning directors' remuneration. Thereafter, disclosure obligations for listed companies have, largely speaking, followed the emerging requirements from the United Kingdom: Cadbury (1992), Greenbury (1995), Hampel (1998), Turnbull (1999) and Higgs (2003).

6.17.7 Shareholder Rights

Shareholder rights derive from contract, the constitution, the Companies Acts, secondary legislation and related case law. The articles of association of a company set out the respective powers of members and of directors. They generally provide that the business of the company is managed by the directors, subject to the provisions of the articles of association and to such directions as are given by the members in a general meeting.

The principal rights of shareholders are:

- the right to a dividend – but only when proposed by the directors;
- pre-emption rights (in private companies);
- the right of notice of and the right to attend general meetings of shareholders;

- the right to participation in a winding up;
- the right to apply for the restoration of a company that has been struck off;
- the right to appoint inspectors to investigate and report on the affairs of the company;
- the right to petition for the winding up of the company and for relief in cases of oppression;
- the right, for certain classes of shareholders, to vote at general meetings and in relation to written shareholders' resolutions.

As in other jurisdictions, the proportion of shares held by institutional shareholders in Irish-listed companies compared to those held by personal shareholders has increased significantly in recent years. In Ireland the Irish Association of Investment Managers (IAIM), which was founded in 1986, is the representative body for institutional investment managers and represents virtually the entire industry. According to its website, the 12 members of the Association manage assets of 260 billion euros on behalf of Irish and international clients. While the IAIM has not been particularly outspoken about corporate governance matters, it did in early 2008 take a public position on a corporate governance matter, effectively precipitating the resignation of the executive chairman of a publicly quoted company.

6.17.8 Corporate Responsibility

6.17.8.1 Corporate Social Responsibility

While there has been an increased interest in corporate social responsibility, any initiatives taken by companies have been voluntary. There are as yet no legislative or regulatory requirements on companies in this area, apart from specific legislation that addresses health and safety, environmental protection etc.

6.17.8.2 Corporate Manslaughter

A Corporate Manslaughter Bill was introduced in 2007 but has not yet been enacted. The intention of the bill is to reform the law on corporate manslaughter to ensure that undertakings or persons can be held accountable when deaths of workers are caused by neglect of workplace health and safety, whether through established bad practice or through mismanagement. An offence under this Bill may also give rise to a civil action by a dependant of the deceased. Such an action may be grounded in principles of negligence and breach of statutory duty – in particular, health and safety legislation.

6.17.9 Codes, Standards and Best-practice Guidelines

As in the United Kingdom, the Combined Code is the most important corporate governance framework. Although it applies only to publicly listed companies, many large private companies and commercial state bodies adopt it voluntarily to align themselves with best practice. State bodies are also bound by the Code of Practice for the Governance of State Bodies, which applies broadly similar principles. A small number of companies that are foreign private issuers (ie listed on a US exchange) are also bound by the provisions of the Sarbanes–Oxley Act, as are certain significant Irish subsidiaries of US-listed parent companies.

One significant local difference arises from the Companies (Amendment) Act 2003, which for the first time set out in statute a series of provisions concerning audit committees. To date, however, these provisions have not been commenced through Ministerial Order.

6.17.10 Legal, Regulatory and Institutional Bodies

Like that of the United Kingdom, much of Ireland's corporate governance framework is underpinned by a series of regulatory bodies that between them oversee a wide range of corporate governance issues.

The mission of the Companies Registration Office (CRO) is to ensure a high level of filing of returns due, a rapid turnaround of the information on those returns and assurance that the information provided complies with the relevant statutory provisions. The most important sanction for non-compliance is strike-off: in 2007, for example, the Office struck off (dissolved) over 4,000 companies (of just over 180,000 on their register) for failure to file returns. Although the CRO also prosecutes directors for non-compliance, the level of prosecution is low: in 2007, only 16 directors were prosecuted (of whom 15 were convicted).

A separate agency also pursues non-compliant directors, namely the Office of the Director of Corporate Enforcement (ODCE). Established in 2002, its mission is stated as being 'to improve the compliance environment for corporate activity in the Irish economy'. In practical terms the ODCE provides company officers and others with information about their duties and powers under Ireland's Companies Acts and takes enforcement action, including prosecution of offenders before the courts. The number of cases is low but they attract considerable media attention because of the potential damage to the personal reputation of those being prosecuted.

A listing of useful websites and publications, including the key legal, regulatory and institutional bodies, is set out at the end of the chapter.

Finally, amid the considerable increase in legislation and regulation the government sought to reduce the burden of compliance by the introduction of a 'Better Regulation' initiative a number of years ago. This initiative aims to drive greater competitiveness, growth and job creation in the Irish economy.

6.17.11 Reform of the Legal Framework

The entire body of company law in Ireland is about to be brought together in a single new Act in the biggest reform in company law since the 1963 Act itself was introduced. In May 2007 the Company Law Review Group (CLRG) presented its report on the General Scheme of Companies Consolidation and Reform Bill to the Minister for Enterprise, Trade and Employment and the Minister for Trade and Commerce, along with a draft of the Bill, which runs to nearly 1,300 sections.

The architecture of the so-called General Scheme is inspired by the reality that 90 per cent of companies currently registered at the Companies Registration Office are private companies limited by shares. Therefore, Pillar A of the General Scheme sets out the law as it applies to this, the most common company type. Pillar B then states how this law is applied, disapplied or varied for each other company type, such as the public limited company (plc) or company limited by guarantee. In this way, it is intended to introduce a greater clarity and simplicity into the layout of company law.

The General Scheme contains a number of significant reforms of Irish company law:

- The most commonly used company type, the private company limited by shares (CLS), becomes the model company under the legislation, with all the provisions pertaining to it contained in a single volume – Pillar A.
- A CLS may have a single director and a company secretary (who may not be the same person).
- If the members of any CLS consent, a formal annual general meeting need not be held, as the meeting can now be carried out by written procedure.
- A CLS will have a single-document constitution, thereby replacing the previous need for two documents in the form of a memorandum and articles of association.
- There has been a root-and-branch review of all criminal offences arising under the Companies Acts, which has led to a proposed fourfold categorization of all but a handful of the most serious offences, resulting in the standardization of language and grading of all offences.
- A new uniform validation procedure may be used to enable companies to carry out certain transactions, subject to the required verification of solvency, and with built-in safeguards for creditors and shareholders.
- By removing the requirements to have an objects clause in a memorandum of association, the doctrine of *ultra vires* is removed for the CLS, which will now have the legal capacity of a natural person.
- For companies that wish to retain a limited purpose in an objects clause, and a consequent limit on the powers of the company, the General Scheme provides for the designated activity company.
- It will be eligible for audit exemption provided it meets the requirements for availing itself of the exemption.

Another major change is the codification of directors' fiduciary responsibilities. Currently, a director, in addition to any specific contractual duties, has a wide range of statutory and common law-based duties. These duties will now be clearly set out in the new legislation for the first time, including the duty to act bona fide in the interests of the company and to avoid conflicts of interest and secret profits.

6.17.11.1 Reforming the Law on Financial Statements

In Part 6 of Pillar A the CLRG has proposed that the law applicable to company accounts, or financial statements, be restructured, rewritten and modernized. No area of company law has been the subject of more widespread piecemeal reform in recent years than the law applicable to financial statements and audit. Many, but not all, of these initiatives were EU driven and they include:

- the Seventh Companies Directive on group accounts (SI 201/1992);
- the Companies (Auditing and Accounting) Act 2003;
- the EU Directive on Fair Value Accounting (SI 765/2004);
- the modernization of the Fourth and Seventh Accounting Directives (SI 116/2005);
- compatibility of accounts prepared under International Financial Reporting Standards (IFRS) for the first time (SI 840/2005);
- the Investment Funds, Companies and Miscellaneous Provisions Act 2006.

Part 6 of Pillar A contains all of the law contained in these Acts, Directives and Statutory Instruments in addition to the provisions contained in the other Companies Acts, particularly the 1963 Act and 1986 Act in relation to financial statements, and the 1990 Act and 2001 Act in relation to auditors.

The procedures surrounding the signing of financial statements will be made more transparent and it is also proposed to provide a mechanism whereby defective financial statements can be revised.

The General Scheme prepared by the CLRG was approved by the government and is currently with the Parliamentary Draftsmen's Office to be rewritten as a Bill. It is not expected to be enacted until 2010 at the earliest.

6.17.12 Useful Website Links and Publications

6.17.12.1 Websites

- Accounting Standards Board, www.frc.org.uk/asb
- Attorney General's Office, www.irlgov.ie/ag
- a government information website, www.basis.ie
- Better Regulation, www.betterregulation.ie
- Chartered Accountants Regulatory Body, www.carb.ie
- Central Bank of Ireland, www.centralbank.ie
- Companies Registration Office, www.cro.ie
- Company Law Review Group, www.clrg.org
- Competition Authority, www.tca.ie
- Corporate Governance, www.corporategovernance.ie
- Courts Service, www.courts.ie
- Data Protection Commissioner, www.dataprivacy.ie
- Department of Enterprise, Trade and Employment, www.entemp.ie
- European Commission, europa.eu.int
- Garda Síochána (Irish police), www.gov.ie/garda
- Houses of the Oireachtas (Irish Parliament), www.irlgov.ie/oireachtas
- Information Commissioner, www.oic.gov.ie
- Institute of Chartered Accountants in Ireland, www.icai.ie
- Institute of Directors in Ireland, www.iodireland.ie
- Irish Association of Investment Management, www.iaim.ie
- Irish Auditing and Accounting Supervisory Authority, www.iaasa.ie

- Irish Bankers Federation, www.ibf.ie
- Irish Business and Employers Confederation, www.ibec.ie
- Irish Financial Service Regulatory Authority, www.ifsra.ie
- Irish Stock Exchange, www.ise.ie
- Office of the Director of Consumer Affairs, www.odca.ie
- Office of the Director of Corporate Enforcement, www.odce.ie
- Pensions Board, www.pensionsboard.ie
- Tackling Bribery and Corruption, www.anticorruption.ie

6.17.12.2 Publications

- *Company Law for the 21st Century*, www.clrg.org/_fileupload/1streport/CLRG-consolidation-report-2007.pdf
- *Non-executive Directors – The role and responsibilities*, www.pwc.com/ie/eng/about/svcs/funds/pubs/00360_non_executive_director_abas_sep06.pdf

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6.18

Hong Kong Special Administrative Region of the People's Republic of China

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6.18.1 Background

6.18.1.1 Historical Development

As a Special Administrative Region (SAR) of the People's Republic of China and a former British territory, Hong Kong is a jurisdiction operating under the Basic Law and a legislative system evolved from British and common law. Governed under the principle of 'one country, two systems', Hong Kong has since the return of sovereignty to China on 1 July 1997 continued to be a free-market economy characterized by a high degree of internationalism, a business-friendly environment, the rule of law, free trade and free flow of information, open and fair competition, well-established financial, transport and communication networks, a well-educated workforce complemented by a pool of efficient and energetic entrepreneurs, substantial foreign exchange reserves, a fully convertible and stable currency, and a simple tax system with low tax rates. The vibrancy of the economy is evidenced by the key statistics given in Table 6.18.1.

6.18.1.2 The Development of Corporate Governance

In Hong Kong the development of corporate governance has followed an evolutionary approach, with changes in the legal and regulatory framework representing improvements to meet the dynamic needs of the economy, to observe world trends and, at times, as prompted by crisis. Hong Kong has been adopting a disclosure-based regime of international standard over the past decades. Forces at work include legal and regulatory discipline, corporate discipline, market discipline and professional discipline,

Table 6.18.1 *Hong Kong in Statistics*

Population:	6,963,100	
Labour force:	3,652,400	
Per capita GDP:	HK$233,358	US$29,917.70
Number of companies on register:		
Local companies:	655,038	
Overseas companies:	8,081	
Total:	663,119	
Average number per year over the past five years:		
Companies incorporated:	74,340	
Companies dissolved:	43,964	
Companies registered in other regions:		
Companies with regional headquarters in HK:	1,246	
Companies with regional offices in HK:	2,644	
Number of listed companies on the Main Board:	1,057	
Number of listed companies on the GEM Board:	191	
Total market capitalization of the Main Board:	HK$18,254,867M	US$2,340,368M
Total market capitalization of the GEM Board:	HK$123,793M	US$15,871M
Average daily turnover value of the Main Board:	HK$76,343M	US$9,788M
Average daily turnover value of the GEM Board:	HK$330M	US$42M

Source: Census and Statistics Department, Government of HKSAR, December 2007, and the Stock Exchange of Hong Kong, May 2008
Note: GEM = Growth Enterprise Market.

all contributing towards inducing high standards of corporate governance. Government leaders take an active role in the promotion of good corporate governance.

Law and regulation enforcement is complemented by culture building, largely through private-sector initiatives. Professional bodies such as The Hong Kong Institute of Directors (HKIoD) actively promote good corporate governance among members and in the community.

6.18.2 The Legal and Regulatory Framework

6.18.2.1 Three-tiered Framework

Hong Kong operates a three-tiered legal and regulatory framework as summarized in Figure 6.18.1.

Key Bodies	**Roles**	**Key Documents**
Applying to all companies:		
Legislative Council	– Legislature	– *Companies Ordinance*
Financial Services and the Treasury Bureau	– Government policy bureau that facilitates and coordinates initiatives to upgrade overall market quality	
Standing Committee on Company Law Reform	– Review and drafting of proposed amendments	
Companies Registry (CR)	– Administrator and enforcer	
The listing regime:		
Securities and Futures Commission (SFC)	– Regulating, facilitating and encouraging the development of the securities and futures markets	– *Securities and Futures Ordinance*
Hong Kong Exchanges and Clearing Ltd (HKEx): • Stock Exchange of Hong Kong Ltd (SEHK) • Hong Kong Futures Exchange Ltd • Hong Kong Securities Clearing Ltd	– Administers a disclosure-based regulation of listing. For issuers in breach of rules and codes, SEHK has the authority of sanctions ranging from private reprimands to public censures.	– *Listing Rules and Codes*

Figure 6.18.1 *Hong Kong's legal and regulatory framework*

6.18.2.2 Continual Review and Dynamic Changes

After a series of changes over decades, the Companies Ordinance is in the process, by a phased and consultative approach, of being reviewed comprehensively and rewritten in its entirety to cover present-day issues and enhance corporate governance. One of the key issues for consideration is whether directors' general duties, which are mainly to be found in case law, should be codified.

To complement the Ordinances and Rules, guidelines and codes have been established, notably the following:

- Non-statutory Guidelines on Directors' Duties, issued by the CR.
- Code on Takeovers and Mergers, issued by the Securities and Futures Commission.
- Code on Corporate Governance Practices ('Code on CG Practices'), issued by the Stock Exchange of Hong Kong (SEHK). This is structured on two levels: a comply-or-explain requirement and best-practice recommendation, with provisions on directors' duties, directors' remuneration, accountability and audit, delegation by the board and communication with shareholders.

Two platforms of listing are provided, namely the Main Board and the GEM (Growth Enterprise Market) Board. The GEM Board, as announced by the HKEx on 2 May 2008, has been repositioned as a second board and a stepping stone towards the Main Board.

6.18.3 Rating

6.18.3.1 The Economy

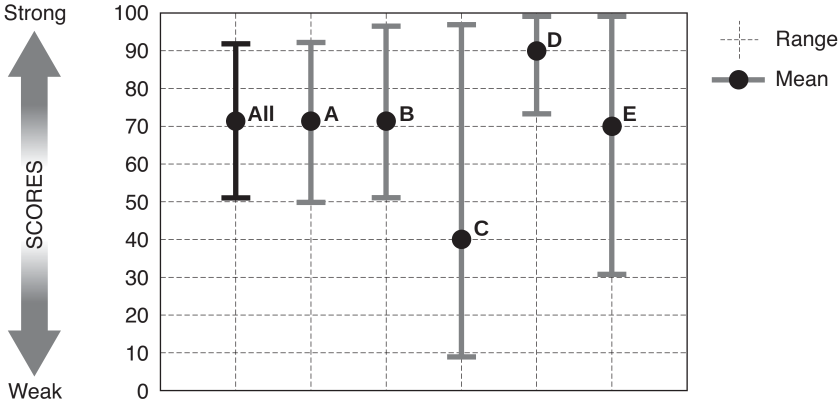
For the past 14 years, Hong Kong has retained its rating as the freest economy in the world in the *Index of Economic Freedom*, released by the Heritage Foundation. The International Monetary Fund classifies Hong Kong as an advanced economy. According to *Focus*, published by the World Federation of Exchanges in May 2008, among stock exchanges the SEHK ranks seventh in the world and third in Asia. In the *CG Watch 2007* rating the CG quality of markets in Asia, organized by the CLSA and the Asian Corporate

Governance Association, Hong Kong was ranked top in Asia. The *Global Financial Centres Index*, published by the City of London in March and September 2007 and March 2008, singled out London, New York and Hong Kong as the world's top three international financial centres, with regulatory environments forming a key criterion for selection.

6.18.3.2 The HKIoD Corporate Governance Score-card ('HKIoD CG Score')

A regular project organized by the HKIoD and executed by the City University of Hong Kong team led by Professor Stephen Y L Cheung and a benchmark quoted by the government and regulators, the HKIoD CG Score is a study of listed companies on the four Hang Seng Indices. These companies account for 90 per cent of the market capitalization and 80 per cent of the total market turnover. The study is a survey using financial information and reports of these companies, based on the OECD Principles of Corporate Governance and the SEHK Code on CG Practices. The five significant sections of assessment are: A) rights of shareholders; B) equitable treatment of minority shareholders; C) roles of stakeholders; D) disclosure and transparency; and E) board responsibilities.

The following is the gist of important findings in the Report on the HKIoD CG Score 2006, which assesses the 2005 reports of 174 companies. The mean Corporate Governance Index (CGI) for 2005 improved by 16.14 per cent compared with the mean CGI of 2002 assessed in 2004, showing significant improvements in the scores on sections A, D and E. On a scale of 0 to 100, the 2005 mean CGI was 70.87, with scores ranging from 51.33 to 92.35. Figure 6.18.2 shows the overall CGI scores and the scores for the five sections. The best performance is in section D, disclosure and transparency, with an average of 89.5. While some firms are clearly lagging behind their peers, many firms are outstanding and certainly achieving levels of best practice or world-class standards of corporate governance. Figure 6.18.3 shows the CGI plotted with the ratio of market value to book value, concluding that investors value corporate governance in Hong Kong-listed companies.



Section A: Rights of Shareholders
Section B: Equitable Treatment of Shareholders
Section C: Role of Stakeholders in Corporate Governance
Section D: Disclosure and Transparency
Section E: Responsibilities of the Board

Figure 6.18.2 *Corporate Governance Index (CGI) by survey section*
Source: *Report on the HKIoD Corporate Governance Score-card 2006.*

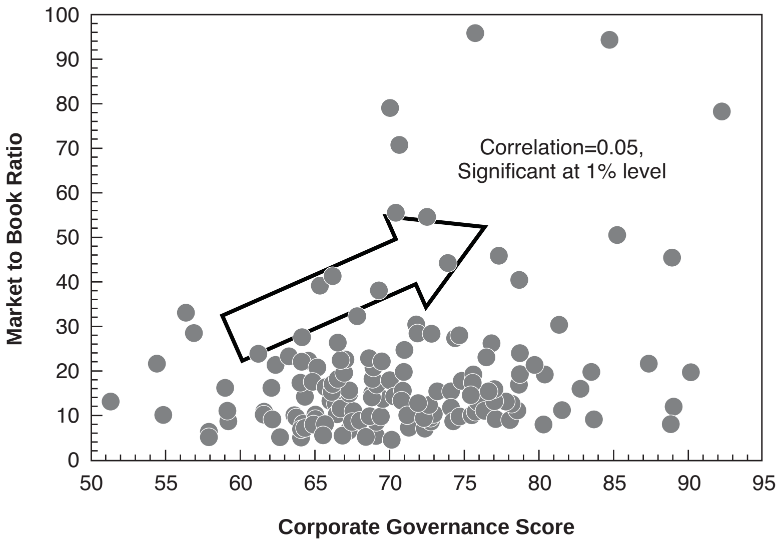


Figure 6.18.3 *CGI versus firm performance (market to book ratio)*
Source: *Report on the HKIoD Corporate Governance Score-card 2006.*

6.18.4 Landscape of Listed Companies

6.18.4.1 Listing Criteria

An independent Listing Committee comprising market practitioners and professionals reviews and approves public floats after stringent processes of vetting prospective issuers by the Listing Division of the SEHK. For the Main Board, the listing criteria include, *inter alia*, a three-year track record, a profit test or other financial tests, management continuity, ownership continuity and working capital statement. To be floated on the GEM Board, a stepping stone towards the Main Board, there is no requirement of financial standards, but the prospective issuers must demonstrate, *inter alia*, active business pursuits for a minimum of two preceding years.

6.18.4.2 Patterns of Ownership

In general, Listing Rules require that at least 25 per cent of an issuer's total issued share capital must be held by the public. As with many other Asian economies, family-controlled interests remain a prevalent characteristic of certain listed companies in Hong Kong, influencing shareholding patterns and board composition. This pattern, however, has been changing in recent years, as the number of companies from Mainland China listed in Hong Kong increases, ushering in more freely floatable and tradable shares.

6.18.4.3 Board Composition

The HKIoD CG Score 2006 found board sizes of the surveyed companies ranging from 5 to 24 directors, with an average of 12.21. On the stipulation of independent non-executive directors in each board, a minimum of 2 was introduced in 1993 and this stipulation was increased in 2004 to a minimum of 3 and best practice of one-third of the board. The HKIoD CG Score 2006 found the average number of INEDs to be 4. The ratios of executive directors (EDs) to non-executive directors (NEDs) to independent non-executive directors (INEDs) vary from company to company, but in the overall population of directors in the HKIoD CG Score 2006 the ratios of EDs to NEDs to INEDs were 42.64 : 23.95 : 33.41. An exemplary case is the board of HKEx, which has only one executive director (the chief executive), with all other board members, including the chairman, being non-executive in nature. One cannot imagine such a board composition having existed 10 years ago.

6.18.4.4 The Structure of Board Committees

The audit committee is mandatory and a majority of its members must be INEDs. Among the stipulated minimum of three INEDs per board, at least one of them must have financial expertise. The remuneration committee and nomination committee are in the provision and recommended best practice respectively of the Code on CG Practices. As revealed in annual reports, boards are maturing, with a structure that includes the essential committees and in some cases additional committees to address compliance and risk. The separation of the roles of chairman and CEO is under 'comply or explain' provision. A two-in-one situation is prevalent among companies at the entrepreneurial stage of development, whereas companies with a longer history tend to move towards a splitting of the two roles.

The addressing of connected transactions is well defined, with stringent provision whereby INEDs play an important role of review for the protection of minority shareholders' interests.

6.18.4.5 The Rights of Shareholders

Shareholders' rights are defined completely and accurately, and exercised freely and easily. Examples of these rights are the ability to participate in shareholder meetings, the ability to elect board members, the ability to register and transfer ownership stakes, and the ability to receive their respective share of profits and other capital distributions. Attention is drawn to equitable treatment, particularly where companies are dominated by large shareholders.

All listed companies, irrespective of their places of incorporation, are required to meet the requirements of the Listing Rules, which apply universally across the board for the Main Board companies and separately for the GEM Board companies. All companies must offer the same level of protection for investors. This is a key factor that has attracted investment on the Hong Kong market by international funds and professional institutional investors.

Shareholder activism has been increasing in the Asian region, and Hong Kong is experiencing the participation of vocal professional investors and individual shareholder activists.

6.18.4.6 Disclosure and Transparency

The Securities and Futures Ordinance requires notification to the SEHK on stringent change of interest by any person or entity. In addition, any director or chief executive is required by law to inform the listed company of relevant interests. A listed company is required by law to keep a register of this information and make it available for public scrutiny.

The Listing Rules also stipulate disclosure in the annual report of a listed company of significant holdings of each director and of any shareholder. The continuing listing obligations of disclosure must be observed by all listed companies to ensure that all users of the market have simultaneous access to the same information when it is expected to be price-sensitive, or related to specific circumstances, notifiable transactions, connected transactions etc. Since 25 June 2007 an Electronic Disclosure mechanism has been available whereby listed companies may publish documents on the HKEx website, which facilitates greater transparency for the benefit of investors in Hong Kong and overseas.

6.18.4.7 Corporate Reporting

In terms of financial reporting, all companies in Hong Kong must follow the International Financial Reporting Standards (IFRS) in financial reporting. The Code on CG Practices stipulates that the board should present a balanced, clear and comprehensible assessment of the company's performance, position and prospects in financial reporting. Quarterly reporting is mandatory for GEM Board companies and recommended best practice for Main Board companies.

6.18.4.8 Corporate Social Responsibility

The fulfilment of corporate social responsibility has become increasingly covered in annual reports. There is much talk about green audit among listed companies. Going forward, it is possible that listed companies, particularly those related to energy, power and transportation, may be required to disclose their efforts to conserve the environment.

To encourage companies to establish their codes of conduct, the HKEx, the HKIoD and the Hong Kong Institute of Certified Public

Accountants have jointly released and promoted among Hong Kong companies the guide *Defining and Developing an Effective Code of Conduct for Organizations*, produced by the International Federation of Accountants.

6.18.4.9 Directors

In addition to the reference of duty of care, skill, diligence and fiduciary duties in the Companies Ordinance, case law and the Non-Statutory Guidelines on Directors' Duties, the Listing Rules, the Code on CG Practices and Model Code for Securities Transactions by Directors of Listed Issuers address the responsibilities of directors of listed companies in terms of timely disclosure of information, financial reporting, internal control, risk management and conduct regarding transactions in securities of their listed companies. Regarding director qualification, the Code on CG Practices mandates proper induction for directors and recommends continuing professional training for directors as best practice.

Bearing ultimate responsibility for corporate governance, directors must approach their duties with professionalism and hence have a need for professional development. The HKIoD is probably the professional body in Hong Kong that has organized the largest number of training programmes to nurture director professionalism. Designed by directors for directors, the HKIoD's continuing professional development programmes are outlined in Table 6.18.2.

6.18.4.10 Remuneration and Performance

The Listing Rules prescribe that listed companies should reveal remuneration of directors on an individual and named basis. The Code on CG Practices provides that listed companies should establish a formal and transparent procedure for setting policy on executive directors' remuneration, which should be linked to performance. The level of INED remuneration is an area for improvement, in order to attract qualified, experienced and public-spirited candidates to take up this important board role. The HKIoD publication *Guide for Remunerating Independent Non-executive Directors* aims to address this area of improvement. The HKIoD CG Score 2006 found that although board practices are in general solid, few boards conduct an annual appraisal of their performance. This is another area that needs to be promoted and nurtured among boards.

Table 6.18.2 *HKIoD programmes for the development of director professionalism*

Categories	Programmes
Publications: Circulation 5,000–20,000	*Guidelines for Directors*: 1st edn: 1995; 2nd edn: 2005; 3rd edn: 2008 *Guide for INEDs*: 1st edn: 2000; 2nd edn: 2003; 3rd edn: 2006 *Guide for Remunerating INEDs*: 1st edn: 2005; 2nd edn: 2007 *Guidelines on Corporate Governance for SMEs in Hong Kong*: 1st edn: 2003; 2nd edn: 2008; sponsored by the SME Development Fund; publication + seminars *Corporate Governance Toolkit: From Guidelines to Implementation*: 2008; sponsored by the SME Development Fund; publication + seminars, workshops, conference and pilot projects *Report on HKIoD Corporate Governance Score-card*: Report 2006 *The 21st Century Director*: Quarterly magazine
Training programmes: Over 100 sessions (of 3 hours each) pa	Certificates in: Role of a Listed Company Director Role of INED Finance Core for Directors Risk Management for Directors Diploma in: Company Direction Essentials for Listed Company Directors Professional Diploma in: Company Direction Corporate Governance and Directorship SME Directorship Paths to Master's and Doctorate programmes of allied universities
Promotion of excellence	Directors Of The Year Awards: Annual project since 2001; 70+ project partners; nomination open to public Company categories: Listed, private, non-profit Director categories: ED, NED, collective boards Directors' Conference: A high-profile forum for world-class leaders to share experiences and wisdom in leading companies
Public forums	Outreach talks to groups: Professional bodies and community service groups Commissioned seminars for NGOs: Including seminars hosted by Social Welfare Department for welfare agencies, Education Bureau for schools, Leisure & Cultural Services Department for arts and sports groups, Home Affairs Department for building management groups

6.18.5 Culture Building in the Community

6.18.5.1 Non-listed Companies

An overview of corporate governance in Hong Kong would be incomplete without addressing the non-listed companies. The great majority of companies (by number, not by market capitalization) comprise private companies, mostly small and medium-sized enterprises (SMEs). These are the companies that need to be empowered to practise good corporate governance for continual growth and to help attract investment, via listing or otherwise. The HKIoD regularly organizes programmes specifically developed for SMEs (see Table 6.18.2), with substantial support from the SME Development Fund of the Trade and Industry Department.

NGOs operate with stakeholders' funds, be they government subsidy, members' contributions or public donations. Government funding bodies from time to time organize talks and workshops, with HKIoD participation, in order to educate NGO board members on corporate governance and accountability (Table 6.18.2). The focus in corporate governance is beginning to reach different sectors of the community.

6.18.5.2 Promoting Excellence

While the government and regulators play an enforcing role, handing out sanctions for failure to comply, private-sector professional bodies play the role of encouraging excellence by means of awards. The HKIoD's projects of Directors of the Year Awards and Directors' Conference and the HKICPA's Best Corporate Governance Disclosure Awards serve to recognize excellence, generate public awareness and share inspiring experiences.

6.18.5.3 Professional Discipline

Finally, as Hong Kong's premier body representing professional directors, the HKIoD demonstrates self-discipline by mandating its 1,300 members, comprising directors from listed, private and non-profit-distributing companies, to comply with a code of conduct and to undergo continuing professional development as a condition of membership.

6.18.6 Resources

- Best Corporate Governance Disclosure Awards, http://www.hkicpa.org.hk/professionaltechnical/corporategov/best_corp_gov.php
- *CG Watch 2007*, http://www.clsa.com/public/library/pdf/CLSA_ACGA_CGWatch2007_Extract.pdf
- Code on Corporate Governance Practices, http://www.hkex.com.hk/rule/listrules/Appendix_14.pdf
- Code on Takeovers and Mergers, http://www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H495
- Companies Ordinance, http://www.legislation.gov.hk/blis_ind.nsf/CurAllEngDoc?OpenView&Start=30&Count=30&Expand=32#32
- Companies Registry, http://www.cr.gov.hk
- *Defining and Developing an Effective Code of Conduct for Organizations*, http://www.hkiod.com/e_news/other_events/2008/ifac_guide.pdf
- Directors Of The Year Awards, http://www.hkiod.com/eng/dya_rollofawardees.asp
- Financial Services and the Treasury Bureau, http://www.fstb.gov.hk
- *Focus*, published by the World Federation of Exchanges, http://www.world-exchanges.org/publications/Focus508.pdf
- *Global Financial Centres Index*, http://www.zyen.com/Knowledge/Research/GFCI%203%20March%202008.pdf
- *Guidelines on Corporate Governance for SMEs in Hong Kong*, http://www.hkiod.com/publication/sme_guidelines_eng.pdf
- *Guidelines for Directors*, http://www.hkiod.com/eng/publication_director.asp
- *Guide for Independent Non-executive Directors*, http://www.hkiod.com/publication/guideined_eng.pdf
- *Guide for Remunerating Independent Non-executive Directors*, http://www.hkiod.com/eng/publication_remunerating_ineds.asp

- Hong Kong Exchanges and Clearing, http://www.hkex.com.hk
- Hong Kong Institute of Certified Public Accountants, http://www.hkicpa.org.hk
- The Hong Kong Institute of Directors, http://www.hkiod.com
- Listing Rules, http://www.hkex.com.hk/rule/index/rulesandguidelines.htm
- Model Code for Securities Transactions by Directors of Listed Issuers, http://www.hkex.com.hk/rule/listrules/Appendix_10.pdf
- *Non-statutory Guidelines on Directors' Duties*, http://www.hkex.com.hk/listing/dirduty/director_guide_e.pdf
- *Report on the HKIoD Corporate Governance Score-card 2006*, http://www.hkiod.com/eng/publication_scorecard2.asp
- Securities and Futures Commission, http://www.sfc.hk
- Securities and Futures Ordinance, http://www.legislation.gov.hk/blis_ind.nsf/CurAllEngDoc?OpenView&Start=568&Count=30&Expand=568
- Standing Committee on Company Law Reform, http://www.cr.gov.hk/en/standing/index.htm
- Stock Exchange of Hong Kong, http://www.hkex.com.hk

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The Hong Kong Institute of Directors (HKIoD) is Hong Kong's premier body representing professional directors working together to promote good corporate governance and to contribute towards advancing the status of Hong Kong, both in China and internationally. A former branch of the UK Institute of Directors from 1990 to 1997, the HKIoD remains an affiliate of the IoD International Network. A non-profit organization, the HKIoD is committed to its mission through providing directors with educational programmes and an information service, and establishing an influential voice in representing directors. Working with international perspectives in a multicultural environment, the HKIoD conducts business in both Chinese and English.

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Part 7

Regions

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7.1

Corporate Governance in Asia

Looking to the Future

Sharmila Gopinath, Research Director, the Asian Corporate Governance Association

Since the 1997 Asian financial crisis, governments across the region have taken steps to improve the corporate governance landscape, including implementing codes of corporate governance and rewriting their securities and companies legislation. However, reform progress in Asia varies considerably by country and by company, and despite the steps taken there is no shortage of corporate governance-related issues and cases in Asia: independent directors in Hong Kong and Singapore resigning their positions claiming inability to discharge their duties properly; incumbent Korean presidents continuing to pardon businessmen and politicians convicted of graft and other crimes, citing the good of the economy; and Japanese companies employing poison pills and cross-shareholding as anti-takeover defences. So the question that begs to be answered is: what exactly has changed in the past decade?

7.1.1 'CG Watch 2007' Country Rankings

In the latest ACGA–CLSA joint 'CG Watch' report in 2007, the fourth collaboration since 2003 between the Asian Corporate Governance Association (ACGA) and CLSA for Asia-Pacific markets, which ranked 11 Asian markets on their corporate governance practices, rules, enforcement and culture, we found that as markets and economies flourished over the past few years, regulators became complacent about their achievements, with some stating that all they needed to do now was 'refine their rules' and 'improve implementation' of best practices. And the changes in the market rankings from the previous 'CG Watch' in 2005 were a reflection of the degree of emphasis that regulators, issuers, intermediaries and investors placed on corporate governance in the past two to three years when markets were surging. However, as the US financial crisis makes itself felt in markets around the world, regulatory attention seems to once again be focused on enhancing rules and best practices.

Absolute scores fell for most markets, primarily because of changes made to the methodology. As in previous surveys, the questions ranged across five categories – CG Rules and Practices, Enforcement, Political/Regulatory, IGAAP and CG Culture – but in 2007 there were a total of 87 questions as opposed to 76 in 2005. Most of the new questions sought to draw sharper distinctions between rules and practices, and between the governance practices of large listed companies compared to those of small- and medium-sized companies.

7.1.2 Quality Counts

For the first time since the inception of the ACGA-CLSA 'CG Watch' collaboration in 2003, Singapore found itself occupying the number two spot; Hong Kong claimed top position with an absolute score of 67 per cent, two percentage points ahead of the city-state. There were a number of reasons for the change in positions, including complacency on the part of Singapore's regulators. They felt that its reform process had reached an acceptable plateau, with officials seemingly unconcerned that some key local rules and practices were not in line with global best practices, such as lack of voting by poll, the two-proxy rule – custodian banks are currently only allowed two proxies for shareholder meetings, thereby disenfranchising fund managers and other institutional owners of shares from attending AGMs of companies in which they invest – and the lack of mandated voting by poll for certain major and connected transactions.

Hong Kong officials, however, acknowledged the distance between local norms and international standards, and continued to tackle some difficult reform issues, such as undertaking a comprehensive review of the Companies Ordinance, which had not been 'substantially reviewed and amended' since 1984. Shareholder rights were also far stronger in the territory than elsewhere in the region, with regulators having closed off several loopholes that undermined investor protection, including disallowing discounted stock options, requiring an independent vote for any voluntary delisting, and mandated voting by poll on certain major and connected transactions.

7.1.3 Moving Up and Down

Taiwan and China were the only two markets to improve their rankings and scores from 2005, because despite their booming markets they continued with their reforms. Moving up one spot, Taiwan edged out Malaysia for fourth spot behind India with 54 per cent as regulators became increasingly open and willing to discuss strengths and weaknesses in their governance system, and made strides in improving not only their rules but enforcement as well. China, where achievements have been mostly in the regulatory realm, including major amendments to both its company law and its securities law, also moved up a spot, beating the Philippines to the ninth spot behind Thailand with 45 per cent. Malaysia fell two spots to joint sixth with Korea, with 49 per cent. Elsewhere in the rankings, Japan was formally incorporated for the first time in this survey, coming fifth with 52 per cent, while Indonesia once again brought up the rear with 37 per cent.

7.1.4 Issues Remain

The low scores, however, were not only due to the more stringent questionnaire; the corporate governance-related issues and cases around the region also helped to highlight loopholes in the system. As was stated earlier, Hong Kong and Singapore found themselves in the news because of high-profile independent director resignations as well as an investigation by the US Securities and Exchange Commission (SEC) of Hong Kong banker Dr David Li Kwok-po, chairman of the Bank of East Asia and a board member of Dow Jones, on alleged breaches of US securities laws, including insider trading rules.

On 16 February 2008, Dr Li was forced by public pressure to resign from Hong Kong's Executive Council (Exco), the city's quasi-cabinet, following a civil penalty payment of US$8.1 million to the SEC on 6 February 2008 'in order to settle the matter expeditiously…without admitting or denying liability'. He continues to be a member of the Legislative Council, where he represents the financial sector, and to sit as a director on the boards of several listed companies.

On 15 May 2008, David Webb, an independent non-executive director of the Hong Kong Exchanges and Clearing Ltd (HKEx) since 2003, resigned, citing lack of cooperation by HKEx management and interference by the government in policy making.

Less than a month earlier, on 23 April, Singapore's Lee Suet-Fern, an independent non-executive director on the board of China Aviation Oil (CAO) and chair of its audit and disclosure committees, resigned her posts, stating that it had 'become, as a result of the company's approach to information flow and the management of decision making, review and oversight, increasingly difficult for me to properly discharge my duties as an independent director of the company'.

Meanwhile, Malaysia, which used to score highly (around 90 per cent) for its rules, scored quite badly (44 per cent) in the 2007 survey as ACGA looked at corporate practices and drilled deeper into the rules themselves. The country itself found itself mired in accounting scandals in 2007. The worst one was at market darling Transmile, an air freight forwarder, which had substantially overstated its accounts for at least three years. Other Malaysian companies with accounting discrepancies that came to the fore in 2007 were Megan Media, a maker of optical discs, Welli Multi, a commodities firm, and Nasiocom, a telecom firm.

7.1.5 Above the Law?

Korea continued to frustrate investors domestically and internationally as judges and politicians treated errant *chaebol* (Korean conglomerate) chiefs with a light touch. In February 2007, Chung Mong-koo, Hyundai chairman, was sentenced to three years in prison after being found guilty of embezzlement. The sentence was overturned on appeal in September 2007 and Mr Chung given a suspended five-year sentence, like most *chaebol* directors who end up in court facing criminal prosecution. But to add insult to injury, President Lee Myung-bak issued pardons to 340,000 convicted businessmen, bureaucrats and politicians, of whom Mr Chung was one, in the hopes of reviving the faltering economy.

Mr Chung was not the only one who got off cheaply; Samsung chairman, Lee Kun-hee, escaped bribery charges in April 2008 following accusations by former Samsung lawyer-turned-whistleblower Kim Yong-chul of large slush funds used to bribe politicians, prosecutors and other civil servants. He was instead convicted of tax evasion charges in July and sentenced to – once again – a three-year suspended sentence. However, in what was seen as a first for Korean *chaebols*, Mr Lee stepped down as chairman in April 2008, apologizing to the Korean people for the trouble he had caused. Koreans were not as elated as one would suppose, suspecting that Mr Lee would continue to exercise power behind the scenes and that eventually his son and presumed heir apparent, Lee Jae-yong, would take up the reins after a suitable period of penance.

The rich may seem to be above the law, but shareholder activism is strong in Korea, unlike in other parts of the region, and in April 2008 Solidarity for Economic Reform (SER), a shareholder activist group, joined some minority shareholders of Hyundai Motor to bring a derivative suit against Mr Chung and Kim Dong-jin, an incumbent director and vice-chairman, claiming that 'the company suffered financial damage of approximately Won 563.1 billion [US $536.1 million] due to mismanagement of the company'. And in a surprise move the National Pension Service, which had a 4.56 per cent stake in Hyundai Motor, voted against the re-election of Mr Chung to the board, the first time the pension fund had voted against the re-election of a *chaebol* director.

7.1.6 Shareholder Activism versus Engagement

Japan indulged in nationalism and the bolstering of entrenched company management on its boards in 2007. The aggressive tactics of the US-based hedge fund Steel Partners in initiating a takeover of Bull-Dog Sauce, a condiments maker, in order to facilitate management changes, led to a showdown in the courts. The board of directors at Bull-Dog proposed an anti-takeover measure that would allow the company to issue new stock warrants to all shareholders except Steel Partners, thereby diluting the hedge fund's stake of 10.52 per cent to less than 3 per cent. Steel Partners took the case all the way to the Supreme Court, but ultimately lost the fight, and ended up being called an 'abusive acquirer' and a 'vulture investor' by the High Court in its ruling.

The *Steel Partners* v *Bull-Dog Sauce* case was not the only high-profile case of a foreign institutional investor fighting management for changes; another that has been dragged out in the media since 2007 was the Children's Investment Fund (TCI) against Electric Power Development Co of Japan (J-Power). TCI tried to force J-Power to accept its proposals for boosting profitability and raising dividends to shareholders, going so far as to seek approval from the Ministry of Economy, Trade and Industry (METI) to increase its stake in the J-Power from 9.9 per cent to 20 per cent. METI refused the fund's request on the grounds that it would 'prevent the maintenance of order in the public sphere'. And for two years running it has failed to get any of its shareholder proposals approved at J-Power's AGM.

Shareholder activism of this sort did not succeed as well in Japan as its proponents would have liked, but a less aggressive yet determined tack seemed to work better: Steel Partners made history by leading a proxy fight to oust seven members of the board of Aderans, the biggest wigmaker in Japan, at the company's AGM. The outgoing directors included the company's president, Takayashi Okamoto. And on 9 August 2008, the fund got one of its managing directors, Joshua Schechter, on to the Aderans board. The vocal fund did not submit any shareholder proposals in 2008 (after eight in 2007), ostensibly because 10 of the 30 firms it asked to carry out share buybacks did so.

Another piece of activism, which occurred on 15 May 2008, was the publication of the White Paper on Corporate Governance in Japan, a new policy document published by ACGA (http://www.acga-asia.org/public/files/Japan% 20WP_%20May2008.pdf). It was the first collaborative effort of its kind to focus on corporate governance issues in Japan and involved 10 global institutional investors. The paper discussed how Japanese listed companies were failing to meet the needs of stakeholders or the nation, including failing to provide for adequate supervision of corporate strategy, and so made recommendations on six key issues:

- recognition of shareholders as the owners of listed companies;
- the efficient use of capital;
- independent supervision of management;
- pre-emption rights and third-party share placements;

- poison pill takeover defences;
- fairness and transparency on shareholder voting.

The paper has received a great deal of media coverage and aroused the interest of government officials, who are worried about foreign investment in Japan.

7.1.7 Tomorrow's Issues

So what are investors looking for in the future from the region's regulators and companies? Simple things that would prevent most of the corporate governance issues listed in this chapter: improved financial reporting, strengthened shareholder rights, more effective enforcement, better board practices and a greater focus on environmental, social and corporate governance (ESG) issues.

7.1.8 Conclusion

So, let me answer the question about what has changed in the past decade. More stringent rules are in place, with regulators in the region showing greater willingness to enforce them; Asian companies have a keener awareness of best practices and are slowly – in some cases at a snail's pace – adopting them; and shareholders are more active in regard to their investments. And given the changing ownerships of companies in Asia, with a higher proportion of foreign owners, and the growing pressure on domestic and foreign institutional investors to play a part in corporate governance reform, one can expect changes to continue.

Sharmila Gopinath is the Research Director at the Asian Corporate Governance Association, an independent, non-profit membership organization dedicated to working with investors, companies and regulators in the implementation of effective corporate governance practices throughout Asia. Founded in 1999 and based in Hong Kong, ACGA is funded by a network of sponsors and corporate members, including leading pension and investment funds, other financial institutions, listed companies, multinational corporations, professional firms and educational institutions. Tel: 852 2160 1790; e-mail: sharmila@acga-asia.org; website: www.acga-asia.org.

7.2

Corporate Governance in Europe

**Roger Barker, Head of Corporate Governance,
Institute of Directors**

Over the past decade or so, evidence has been growing of a gradual shift in European corporate governance towards the shareholder model. Progress has been uneven across countries, and does not yet represent a full transformation. However, a corporate governance regime has been emerging in Europe that is more conducive to the interests of domestic and foreign minority shareholders. While the specific changes that have occurred in individual countries are described elsewhere in this book, we consider here the nature of the underlying direction in which European corporate governance has been moving.

First, internal governance mechanisms, such as boards and audit committees, have been strengthened in many countries. A function of the board of a company in a pro-shareholder system is to counter the influence of company insiders – such as management or blockholders – on behalf of external shareholders. However, in Europe, boards have traditionally done little to favour minority shareholders, although codetermination (ie the participation of employee representatives on company boards) has played a role in safeguarding the interests of employees (most notably in Germany). Recent regulatory reforms in Europe have sought to empower the ability of boards to monitor and oversee business processes that are of concern to minority shareholders, such as auditing, the setting of executive compensation, approval of related party transactions (ie company transactions giving rise to a conflict of interest) and disclosure of company information to outsiders.

Second, the legal rights of minority shareholders across Europe have been upgraded. It is now more feasible for shareholders to sue company management when their interests have been ignored or overridden. Furthermore, they have acquired more power to determine the outcome of deliberations at company general meetings. Measures have been taken to reduce the cost of voting at these meetings – which are often impracticable for minority shareholders to attend in person – and to mandate improved representation of minority shareholders on company boards. Some progress has been made, albeit unevenly, towards the objective of a 'one share, one vote' ownership structure through the abolition of multiple voting rights on particular classes of share. Such shares have traditionally been used by European blockholders to exert disproportionate influence over the operation of the firm.

Third, traditionally opaque European companies have been required to improve financial disclosure to outsiders. International accounting standards were adopted in all EU member states in 2006, and legislation has been introduced in many countries regarding the public disclosure of executive compensation, related party transactions and price-sensitive information (which could potentially be used for insider trading). Measures have been taken by governments to improve the enforcement of corporate governance regulation and increase the sanctions for corporate malfeasance.

Most substantive reform in European corporate governance regulation has been driven by regulators at the national level. However, a number of transnational organizations – most notably the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU) – have also played a role in promoting a pro-shareholder approach in Europe.

The OECD published its *Principles of Corporate Governance* in 1999 (and they were revised and reissued in 2004). Although the principles have no legal enforceability, they have become in recent years an influential benchmark in the design of European corporate governance codes and regulations. At the time of writing, national corporate governance codes operate in 26 out of the 27 EU member states. As with the OECD code, the national European codes have attempted to define the rights of minority shareholders, promote disclosure and transparency, and clarify responsibilities of the board.

European codes represent a 'soft law' alternative to the 'hard law' of national company law or EU directives. Most operate according to the principle of 'comply or explain' that was first introduced in the United Kingdom by the Cadbury Report in the early 1990s. Codes offer greater flexibility – both in drafting and in implementation – than company law, and their utilization was endorsed and encouraged in 2006 by the European Commission's influential Corporate Governance Forum. However, the effectiveness of codes in changing corporate behaviour is dependent on a high level of engagement between management and external institutional shareholders. They may be less capable of changing standards of governance in an environment in which corporate ownership is dominated by blockholders (as in continental Europe). Consequently, the impact of the new European codes on company-level corporate governance remains uncertain.

In recent years the European Union itself has signalled support for minority shareholder interests through a number of recent directives and the adoption, in 2003, of a Company Law and Corporate Governance Action Plan (see Table 7.2.1).

An EU law passed in 2002, for example, required that all listed corporations in the European Union prepare their accounts according to International Financial Reporting Standards (IFRS) from 2006 onwards. International accounting standards, as well as establishing a level playing field for the comparison of companies on a transnational basis, often require greater disclosure than many national accounting codes in respect of items such as hidden reserves, which have historically been used by European corporate insiders to retain resources within the company for strategic rather than profitability reasons.

The market abuse directive of 2003 defined the type of price-sensitive information to be disclosed by companies in order to prevent insider trading, and required directors and related persons to disclose trading activities. These requirements were incorporated into national law between 2003 and 2005.

In June 2007 a shareholder rights directive was adopted, which outlined measures to reduce the cost of voting for minority shareholders, to eliminate share blocking and to allow shareholders to question management and to receive relevant information regard-

Table 7.2.1 *Main EU directives and regulations concerning company law and corporate governance since 1990*

- Directive 2007/36/EC of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (14 July 2007)
- Directive 2006/68/EC of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital
- Directive 2005/56/EC of 26 October 2005 on cross-border mergers of limited liability companies
- Directive 2004/25/EC of 21 April 2004 on takeover bids
- Directive 2003/58/EC of 15 July 2003 amending Council Directive 68/151/EEC, as regards disclosure requirements in respect of certain types of companies
- Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards
- Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees
- Regulation (EC) 2001/2157 of 8 October 2001 on the Statute for a European company (SE)

Source: European Commission.

ing shareholder meetings. EU law requires that these protections be adopted into national laws by 2009.

However, the European Commission has also experienced setbacks when it has attempted to move too fast in the direction of pro-shareholder corporate governance reform. In July 2001 a draft directive to promote the development of a European market for corporate control was blocked by the European Parliament and several European governments. More recently, the European Commission announced, in October 2007, its abandonment of previously announced plans to enforce the principle of 'one share, one vote' across the European Union, following opposition from the French, Spanish and Swedish governments. Reflecting these nationally located political constraints, the Commissioner for the Internal Market, Charlie McCreevy, has conceded the impracticability of imposing a 'one-size-fits-all' corporate governance model on member states through EU legislation. There are no longer plans to develop a pan-European corporate governance code.

Although the reform of corporate governance regulation or codes of conduct may change the formal 'rules of the game' in which firms operate, they do not automatically imply a corresponding change in the actual corporate governance behaviour of companies. Nevertheless, a substantial body of evidence suggests that firm-level governance has also shifted in a pro-shareholder direction in many European countries since the early to mid-1990s.

A recent snapshot of how far firm-level corporate governance has come in Europe is provided by Aggarwal *et al* (2007). These researchers report details of a sample of several thousand international companies in terms of 44 corporate governance attributes. These attributes relate to board function and structure, audit approach, anti-takeover defences, and compensation and ownership (for a list of the 44 attributes, see Aggarwal *et al*, 2007, p 41). The scores for individual companies are aggregated by country to create a country GOV score (see Table 7.2.2). A higher score indi-

Table 7.2.2 *Shareholder orientation of firm-level corporate governance, 2005: aggregate country scores*

	GOV Score (%)	Number of Firms in Sample	Sample as Percentage of Total Market Capitalization
Austria	46	19	81%
Belgium	39	25	80%
Denmark	45	22	80%
Finland	56	31	87%
France	48	83	84%
Germany	50	85	74%
Greece	45	44	79%
Italy	41	71	82%
Japan	43	589	81%
Netherlands	51	47	52%
Norway	41	21	77%
Portugal	39	14	86%
Spain	46	54	88%
Sweden	43	43	85%
Switzerland	55	58	89%
United Kingdom	55	530	88%
United States	59	4,070	–

Note: The governance score for each firm is calculated as the percentage of governance attributes for which the firm meets or exceeds a minimum satisfactory standard. The 44 attributes evaluated in this process are listed by Aggarwal *et al* (2007, p 41). The scores relate to 2005. Sample as percentage of total market capitalization is calculated by dividing the market capitalization of the sample firms by the total market capitalization of all firms in Worldscope for a particular country.

cates that firm-level corporate governance is more oriented to the interests of minority shareholders.

The GOV scores suggest that by the end of 2005, minority shareholder orientation in two continental European economies – Finland and Switzerland – was comparable with that of corporations in the liberal market economies (eg the United Kingdom and United States). The gap between firm-level corporate governance in the Netherlands and Germany and the liberal market economies was also relatively small. In contrast, firm-level corporate governance in Belgium, Portugal, Italy, Norway and Sweden continued to exhibit significant divergence from that of the English-speaking world.

These conclusions are underscored by disaggregated data that summarize how companies perform in several specific corporate governance attributes, such as board independence, the role and independence of audit committees and the prevalence of different classes of stock (see Table 7.2.3).

A higher percentage score represents a greater shareholder orientation in respect of each particular attribute. With respect to these criteria, Finnish, Swiss and Dutch companies perform in a manner comparable to their British and American peers, in contrast to firms in Belgium and France.

However, an area where negligible progress has been made in Europe relates to takeover defences. It is argued in the finance literature that the threat of hostile takeover represents an important mechanism whereby minority shareholders can align management behaviour with their interests. However, the threat of takeover may be reduced by the ability of the firm to implement takeover defences, or by the behaviour of national governments, which may seek to deter or block advances from 'undesirable' (eg foreign) potential corporate suitors. Both of these types of takeover protection remain in evidence in continental Europe.

For example, at the end of 2005, the governor of the Bank of Italy, Antonio Fazio, was forced to resign, owing to allegations that he had attempted to thwart the foreign takeover of an Italian bank, Banca Antonveneta, by a Dutch bank, ABN AMRO. And in August 2005 the French government announced that it planned to protect 10 industry sectors from takeover by non-EU firms, following market rumours that PepsiCo of the United States was considering a bid for the French food company Danone. This provoked the European Commission to warn that France might overstep EU legal provisions relating to the protection of 'strategic sectors'.

Table 7.2.3 *Country scores in relation to specific corporate governance attributes (2005)*

	Board Ind.	Board Size	Chairman/ CEO Sepn	Board Structure	Audit Com. Ind.	Auditor Ratification	Stock Classes
Austria	0%	67%	100%	0%	0%	100%	100%
Belgium	25%	85%	60%	0%	20%	5%	95%
Denmark	71%	79%	100%	64%	7%	100%	57%
Finland	64%	80%	100%	84%	40%	100%	68%
France	28%	78%	49%	2%	22%	35%	38%
Germany	40%	82%	100%	0%	3%	100%	100%
Greece	3%	90%	90%	3%	7%	97%	100%
Italy	0%	87%	77%	0%	3%	33%	100%
Japan	1%	80%	0%	42%	2%	2%	100%
Netherlands	83%	73%	98%	7%	54%	51%	68%
Norway	69%	46%	100%	23%	15%	0%	100%
Portugal	43%	100%	43%	0%	0%	14%	86%
Spain	6%	80%	60%	3%	6%	89%	100%
Sweden	60%	97%	100%	100%	17%	14%	66%
Switzerland	75%	81%	98%	19%	58%	98%	98%
UK	32%	90%	96%	8%	68%	99%	99%
USA	89%	81%	41%	52%	88%	68%	94%

Note: The table shows the percentage of firms in each country that meet or exceed a minimum threshold for each governance attribute. The seven attributes are: **Board Independence**: board is controlled by more than 50% independent outside directors; **Board Size**: board size is greater than 5 but less than 16; **Chairman/CEO Separation**: chairman and CEO are separated or there is a lead director; **Board Structure**: annually elected board (no staggered board); **Audit Committee Independence**: audit committee composed solely of independent outsiders; **Auditor Ratification**: auditors ratified at most recent annual meeting; **Stock Classes**: only single share class, common stock (no dual class).

Source: Aggarwal *et al* (2007, p 46).

A revised EU takeover directive in 2004 aimed to curb a number of the main mechanisms – such as poison pill defences – used by European firms to deter hostile takeovers. However, the final draft of the directive was undermined by political compromises that allowed member states to opt out of provisions requiring companies to seek shareholder approval for poison pill defences after a bid had been announced (the board neutrality rule), and preventing voting restrictions, share transfers or multiple voting rights being used at the shareholder meeting authorizing such defensive measures (the breakthrough rule). Despite the voluntary nature of these two opt-out provisions, it was initially hoped by the Commission that they would not be exploited by most countries. However, a report by the European Commission in February 2007 observed that almost all member states had taken advantage of the opt-outs (the exceptions being those countries where the protections already existed), and concluded that the success of the directive in promoting an open European market for corporate control had been limited.

It appears, therefore, that differences between European and Anglo-Saxon corporate governance at the firm level remain, particularly in relation to the market for corporate control. However, it is also apparent that in areas such as shareholder rights, the role and functioning of boards, and corporate disclosure, European companies are much closer to their Anglo-American counterparts than in the mid-1990s, and in some cases the gap has entirely disappeared. Although 'convergence' may be an inappropriate description, European corporate governance has come a long way in the past 10–15 years.

7.2.1 Looking into the Future: The Rise of Politics

As observed in earlier chapters, different patterns of ownership can exert significant influence over corporate governance outcomes. Although this chapter has so far focused on the effects of blockholding – the traditional determinant of European corporate governance behaviour – two other forms of corporate ownership are growing in public profile.

The first arises from the growing importance of private equity in European corporate ownership. The private equity investment model involves professional money managers taking concentrated ownership stakes in individual companies, and then withdrawing companies from their public listings on stock markets, often as a prelude to a major corporate reorganization. While proponents of private equity claim that this governance model is enhancing of both efficiency and employment levels in the long run, critics argue that 'private equity is fundamentally subversive of continental Europe's stakeholder models of capitalism' (the words are taken from an article entitled 'Private Equity Cannot Escape the Public Eye' by John Plender, published in the *Financial Times*, 24 April 2007). It also runs counter to the tenets of the shareholder model, as corporations may disappear from public capital markets into a 'black hole', with a low level of transparency to outsiders.

Leveraged buy-out activity by private equity investors is still a relatively small-scale phenomenon in the European corporate sector (typically less than 1 per cent of GDP) – although there has been substantial growth in recent years – and is partly dependent on cyclical economic factors (eg the price and availability of debt finance). Nonetheless, its rising importance has already provoked a significant reaction from European politicians. For example, in April 2005 the chairman of the German Social Democratic Party, Franz Münterfering, described private equity companies as 'locusts' that 'destroy everything and move on', a sentiment that was widely supported in German opinion polls and echoed by other European politicians. The Swedish prime minister, Göran Persson, criticized the potential takeover of Volvo by private equity investors in September 2006, commenting that 'these venture capitalists will break the national capital structures into pieces'.

It is ironic to note that despite advocating pro-shareholder corporate governance reform as a means of unseating incumbent European blockholders, professional money managers themselves seek to benefit from blockholding in the context of private equity. The rise of private equity also suggests that the shareholder model of corporate governance – in which corporate activities are open to the scrutiny and discipline of public capital markets – is not necessarily viewed as the only (or the most efficient) way to govern corporations by external investors.

A second type of corporate governance change has arisen from the entry on to the European corporate scene of so-called sovereign wealth funds (SWFs). SWFs are government investment institutions (mainly from developing economies) with substantial pools of resources to invest in the global economy. The six countries with the largest SWFs (as of 2007) are (in order of size) the United Arab

Emirates, Norway, Singapore, Saudi Arabia, Kuwait and China. The International Monetary Fund (IMF) estimates that sovereign wealth funds control around $3 trillion in resources (as of 2007). This exceeds the $1.5 trillion managed by hedge funds worldwide, although it is still relatively small compared to the $53 trillion managed by institutional investors such as pension funds, endowments, insurance companies and mutual funds.

Whereas the main objective of most traditional institutional investors is the maximization of risk-adjusted financial returns, the nervousness regarding sovereign wealth funds arises from their potential to steer corporate activities on the basis of political or strategic considerations. Lawrence Summers makes this point as follows, in an article entitled 'Sovereign Funds Shake the Logic of Capitalism' published in the *Financial Times* on 30 July 2007: 'The logic of the capitalist system depends on shareholders causing companies to act so as to maximize the value of their shares. It is far from obvious that this will over time be the only motivation of governments as shareholders.' Such a development is likely to be particularly controversial if states with only a limited commitment to democratic governance attempt to exploit the market mechanisms of liberal democracies for political objectives.

The interventions of European governments during the financial crisis of October 2008 have further highlighted the uncertain implications of state ownership for corporate governance. It is yet to be seen whether European governments will manage their new ownership stakes in financial institutions in a manner that mirrors the investment behaviour of private-sector investors, or if non-economic factors will come into play.

What is apparent is that the changing investor structure of corporate Europe – whether due to the rising ownership profile of private equity, SWFs or European governments – is increasing the political sensitivity of corporate governance. Far from being a technically arcane niche for legal specialists, European corporate governance is likely to have a much wider policy significance in the years ahead.

Reference

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7.3

The Middle East and North Africa

The Corporate Governance Journey Is Just Beginning – The International Finance Corporation/Hawkamah Survey on Corporate Governance in the MENA Region

The Hawkamah Institute

In the past seven years there have been major worldwide changes in the area of corporate governance. During this period there have been more than 90 legislative initiatives in 30 different countries, in addition to countless studies and initiatives to update best practice in corporate governance.

The Middle East and North Africa (MENA) region, too, has seen important changes in the field of corporate governance. Indeed, seven years ago corporate governance was a nascent, largely unknown concept. Today, hundreds of conferences on corporate governance have been held across the region, a number of MENA countries have adopted new or amended existing corporate governance codes and regulations, institutes of corporate governance or directors have been established,[1] and banks and companies themselves are starting to undertake corporate governance improvement plans.

A number of events have spurred the emergence of corporate governance as a leading reform initiative, including: 1) a number of domestic reform initiatives in the region, in particular the launch of Hawkamah; 2) the rise of international, regional and domestic investment in the region, coupled with stock market booms (and corrections) and the emergence of investor activism; 3) corporate governance programmes and projects implemented by international development institutions;[2] and 4) updates to the international corporate governance framework.

The following countries have launched or amended corporate governance codes or regulations:

- **Egypt**: Corporate Governance Code for Listed Companies (2005) and State-Owned Enterprises (2006);
- **Jordan**: Corporate Governance Code for Banks;
- **Lebanon**: Corporate Governance Code for Small and Medium-Sized Companies;
- **Morocco**: Corporate Governance Code (2008);
- **Oman**: Corporate Governance Code for Listed Companies (2002, update in process);
- **Kingdom of Saudi Arabia**: Corporate Governance Regulations (2006);
- **United Arab Emirates**: ADSM Corporate Governance Code (2006); ADSM Corporate Governance Listing Rules (2006); ESCA Corporate Governance Regulation (2007).

The following countries are in the process of launching codes or regulations:

- **Algeria**: Corporate Governance Code for Family-Owned Enterprises;
- **Lebanon**: Corporate Governance Code for Listed Companies and Banks;
- **Bahrain**: Corporate Governance Code for Listed Companies;

- **Tunisia**: Corporate Governance Code for Listed Companies;
- **West Bank and Gaza**: Corporate Governance Code for Small and Medium-Sized Companies;
- **Jordan**: Corporate Governance Code for Listed Companies;
- **Yemen**: Corporate Governance Code for Small and Medium-Sized Companies.

In 2007 the International Finance Corporation and Hawkamah Institute for Corporate Governance conducted a comprehensive survey of chief executive officers (CEOs) of banks and listed companies from 11 MENA countries on the subject of corporate governance. The primary objectives of the survey were as follows:

- to allow all stakeholders to gain an understanding of the extent to which banks and listed companies in the MENA region follow good corporate governance practices, in line with internationally recognized best practice;
- to assist both the private and the public sectors to close any gaps between best and current practice, by identifying areas for improvement;
- to provide corporate governance projects with a baseline on which to focus their corporate governance reform activities.

The following are some of the main findings and recommendations from the survey.

7.3.1 Demonstrating Commitment to Corporate Governance

- *A variety of stakeholders – in particular market and bank regulators, local corporate governance institutions and institutes of directors, as well as international organizations and development institutions – should continue to organize awareness-raising events that stress the* *benefits of corporate governance in the MENA region*. In fact, today a great majority of respondents – 76% of banks and 67% of listed companies – cite corporate governance as being either important or very important for their businesses. This is an encouraging sign and points to a growing awareness of corporate governance.

- *However, the region could benefit from more awareness-raising events, such as targeted seminars and workshops that focus on how to implement good corporate governance, so that the benefits of corporate governance not only are understood in theory but also may be translated into practice*. Indeed, 53 per cent of respondents were unable to define corporate governance properly, confusing the term with corporate social responsibility or corporate management. Further, most respondents cited improved compliance (60.7 per cent) and reputation (61.3 per cent) as benefits, rather than access to capital (34.7 per cent) or lower cost of equity (19.3 per cent). Most importantly, not a single responding bank or listed company could claim to have applied corporate governance reforms holistically; that is, to have followed a set of 32 indicators that could reasonably qualify a bank or listed company as following 'best practice'. Only five respondents, or 3 per cent, could be deemed to follow 'good practice', having implemented between 16 and 23 of the indicators. The great majority of companies, 92 per cent in all, fall into the 'emerging practice' or 'improved practice' sections (8–15 indicators). Five per cent had implemented only 0–7 indicators, qualifying them as following 'underdeveloped practice'.
- *Companies should formalize key governance structures, policies and processes*. The use of a company-level code of corporate governance or code of ethics is not widespread among banks or listed companies. Only 36.5 per cent have implemented such codes. A company-level code of corporate governance and an ethics code are excellent first steps in setting the overall tone for corporate governance reforms. Regulators may wish to include similar recommendations for disclosing such documents in voluntary codes of corporate governance.
- *The chairman of the board and the CEO should set the tone 'at the top' and champion corporate governance reforms with support from a professional company secretary*. Just under half of the surveyed

banks (47 per cent) and listed companies (49 per cent) assign the responsibility for corporate governance policies to the board – in line with good practice. However, only a small minority of respondents involve the CEO (8 per cent), chairman (4 per cent) and company secretary (4 per cent) in developing corporate governance frameworks; and only 11.3 per cent have implemented board-level corporate governance committees.

- *Policy makers and regulators should strongly encourage – possibly require – directors and senior managers to undertake a minimum of corporate governance-related training; banks and companies should, in turn, encourage their directors and senior managers to attend such events to pre-empt regulatory action. Corporate governance institutes and institutes of directors, too, may wish to build their expertise and capacity to meet the growing demand for specific corporate governance training*. The two largest barriers to the implementing of corporate governance reforms are a lack of internal corporate governance know-how, and the unavailability of external qualified specialists in the region (44.9 per cent for both barriers).

7.3.2 Implementing Good Board Practices

- *The survey demonstrates that the role of the board – to provide strategic guidance to and oversight over management – is not always understood in practice. Banks and listed companies should thus review, clarify and formalize the role of the board vis-à-vis management and shareholders in a corporate governance code or board charter*. Ninety-three per cent of banks and 87 per cent of listed companies stated that the board and not management was responsible for setting company strategy, contrary to good practice, which calls for management to develop strategy and the board to approve and then monitor management's execution of it. Moreover, most boards in the region may not have the necessary independence to properly fulfil their oversight function. Fifty-six per cent (56 per cent) of boards either do not have a single or have only one independent director, and only 26.4 per cent of boards have audit committees with a majority of independent directors. Finally, less than half of respondents (40 per cent) have a succession plan in place, again an indication that the board may not be fulfilling its strategic and oversight function.

- *Boards in the MENA region generally have the right board size.* The majority of boards in MENA have eight or more members. Bank boards are usually composed of 10 or more members, while the boards of listed companies typically have 8–10. These numbers generally appear to be in line with good practice, if slightly on the high size.

- *Banks and listed companies should gradually increase the number of independent directors who sit on their boards, and specify in their annual reports their understanding of what constitutes independence and which director is deemed independent*. Fifty-seven per cent of all listed companies and 54.3 per cent of banks do not have any or have only a single independent director on their board.

- *Banks and listed companies in MENA should ensure that there is an appropriate mix of skills on their boards*. An overwhelming majority of responding banks and listed companies require a combination of integrity (70 per cent) and professional experience (69 per cent), in line with best practice. However, 75 per cent of respondents chose 'being a shareholder' as the most relevant requirement for being a director, which may lead to the creation of insider or shareholder boards that often do not act in the interest of the company and all of its shareholders – in particular, when independent directors are not represented or only insufficiently represented on the board. With respect to female representation on the board, a vast majority of banks (78 per cent) state that they do not have a single female director, while only 1 per cent answered that they had more than one. On the other hand, one-third of listed companies had at least one or more female board members, a small but important step towards balancing the boardroom.

- *Company stakeholders, in particular shareholders but also regulators, should continue to encourage banks and listed companies to separate the position of chairman and CEO*. A significant majority of respondents (65 per cent) state that the positions of CEO and board chairman are held by different persons, in line with best practice. In particular, banks (72.2 per cent) follow this best practice, whereas 42.3 per cent of listed companies continue to combine these two functions.

- *Audit committees are well represented in the region. However, their independence needs to be strengthened. Companies should also explore* *the benefits of creating other board committees to streamline the board's work*. Eighty-one per cent of banks and 74.7 per cent of listed companies have audit committees, in line with good corporate governance. However, as has already been mentioned, only 26.4 per cent of these committees are composed of a majority of independent directors. Other committees are less prevalent in the region, with only a minority of respondents stating that their boards also have nomination (22.5 per cent) or remuneration (29.3 per cent) committees.

- *Banks and listed companies may wish to create board-level remuneration committees to develop executive and non-executive remuneration policies, thus ensuring that banks and listed companies in the MENA region are able to attract, motivate, and retain talent*. With respect to non-executive remuneration, 42.9 per cent of companies do not pay their directors an attendance fee; and only a minority of non-executive directors receive extra pay for taking on additional responsibilities, such as serving on committees (16.1 per cent) or chairing the board (11.3 per cent). With respect to executive remuneration, the survey demonstrates that the use of variable remuneration packages is, surprisingly, limited, with 53.8 per cent of respondents stating that they do not offer their executives variable packages. Stock options, too, are not commonplace and only 9.8 per cent of executives and 3.6 per cent of non-executives have such plans. Thirty-nine per cent of executives receive board fees, contrary to good practice. Finally, most banks and companies typically do not offer their executives pension or insurance benefits; only 5.4 per cent and 7.2 per cent respectively do so. Both pensions and insurance benefits are considered long-term incentives that can help tie executives to the company.

- *Board working procedures could be improved, in particular with respect to the number of board meetings per year and the development of a professional corporate secretary function*. The majority of banks and companies provide relevant information to their boards one to two weeks before board meetings, in line with good practice. With respect to banks, 46 per cent answered that their board met an average of three to five times per year, and 21 per cent stated that it met between six and nine times. Only 27 per cent of bank boards meet 10–12 times per year, in line with what is arguably considered best practice for banks. With respect to listed companies, 60 per cent responded that they effectively met on a quarterly basis, and only 15 per cent met between 6 and 9 times per year, in line with what most would conceive to be good practice.

- *The position of the company secretary needs to be professionalized and generally strengthened in most MENA-listed companies and banks*. Indeed, 45 per cent stated that the company secretary is a part-time employee, which while appropriate for smaller companies may not be appropriate for banks and large publicly listed companies because of the lack of time a part-time company secretary will have available to support the chairman in running the board. One-on-one meetings during the interview process revealed that the position of company secretary is generally underdeveloped.
- *Board evaluations and director training – both orientation and continuous professional education – should be furthered by banks and listed companies and, if necessary, by regulators*. Only 20 per cent of banks and 15 per cent of listed companies conduct board evaluations. Similarly, director training on corporate governance, whether in the form of director orientation or of ongoing training, remains scarce throughout the MENA region, with only 15.3 per cent of respondents offering such training for their directors.

7.3.3 Building a Robust Control Environment and Processes

- *Banks and listed companies should strengthen their risk management frameworks and practices, in particular by assigning responsibility for managing risks at the management level, and ensuring that the board has the necessary expertise to establish risk policies and effectively guide and oversee management in managing risks. Central banks in particular should provide the necessary guidance to, and oversight over, banks to ensure that banks have robust risk frameworks in place*. Overall, less than half of those surveyed (43 per cent) had a risk function in place, with 23 per cent of listed companies and 62 per cent of banks stating that they had a risk manager or risk department in place. Those banks and listed companies that do have a risk management function follow best practice in that the board oversees the risk management system as implemented by management.

- *Similarly, the internal control function needs to be strengthened by a majority of banks and listed companies in the MENA region to safeguard assets against unauthorized use or disposal, maintain proper accounting records and ensure the reliability of financial information*. Less than half of the respondents (47 per cent) have an internal control function; that is, a controller or control department. In those banks or listed companies with control functions, a significant majority assigned the board to oversee this function (80.3 per cent for banks, 69 per cent for listed companies); 35 per cent of respondents on the other hand assigned the CEO to oversee the company's internal controls. Best practice calls for management to set, implement and oversee internal controls, and for the board to assure itself that internal controls are robust and defensible.

- *Banks and listed companies should ensure that the chief internal auditor has unfettered access to an independent audit committee*. The internal audit function is well established in MENA, with 88.7 per cent of banks and companies reporting that they have a chief of internal audit (CIA). For 80 per cent of the respondents the CIA reports to the board. Best practice calls for the CIA to report to an independent audit committee. However, although the vast majority of respondents have audit committees, only 25 per cent of these audit committees can be considered independent.

- *Banks should strengthen (and central banks should strongly encourage) the establishment of a compliance function*. Most banks (64 per cent) have a compliance function in place; only 23 per cent of listed companies reported having a compliance function. All banks should strive to hire a chief compliance officer (CCO) and build a strong compliance function.

- *On the other hand, external audit practices are mostly in-line with best practice; however, independence needs to be strengthened throughout the region, both among banks and listed companies*. Ninety-one per cent of those surveyed had an external auditor, of which 77.2 per cent constituted internationally recognized audit firms. A majority of companies do not receive additional services from their external auditors (51 per cent) and are thus safeguarded from conflicts of interest. However, the idea of audit firm or partner rotation to ensure external auditor independence is not widely followed by banks and listed companies: of those surveyed, only 32 per cent have an audit firm or partner rotation policy in place.

- *The role of the audit committee is broadly understood. However, the role of the committee in ensuring that all control functions – risk, internal controls, compliance, as well as internal and external audit processes – interact properly needs to be strengthened. Moreover, audit committees need to improve their oversight over the compliance function*. Indeed, only 30.6 per cent of audit committees felt that they were responsible for assuring themselves that the compliance function was operating.

7.3.4 Strengthening Transparency and Disclosure

- *Banks and listed companies in the MENA region generally comply well with good practice and regulations for financial disclosures*. The vast majority (92.3 per cent) of respondents provided financial statements to shareholders, through either the local press (94.7 per cent), the AGM (93.4 per cent), the annual report (88 per cent) or the company's website (85.9 per cent), in line with good practice.
- *Non-financial disclosure on the other hand remains weak, and banks and listed companies should take steps to improve their disclosure in this area, in particular with respect to corporate governance-related information*. While 68 per cent of respondents disclose their corporate objectives, disclosure in other areas remains lacklustre, in particular the disclosure of corporate governance-related information, which is particularly weak among banks and listed companies. Indeed, 53.8 per cent of respondents cite that they do not make corporate governance-related information available to shareholders.
- *Web-based disclosure needs to be improved. Listed companies, and to a lesser degree banks, should publish their annual reports and other relevant information, for example regarding beneficial ownership, on their websites*. With respect to the annual report, 82 per cent of banks but only 61 per cent of listed companies stated that their annual report was published on their website, which typically (but not always) contains a full set of financial information. Only 22.7 per cent disclose on the company's website their articles of association or company charter, 28.7 per cent the company's beneficial owners and 24.7 per cent the company's dividend policy.

- *While financial disclosure in the annual report remains relatively strong at 88 per cent, non-financial disclosure again remains weak and should be an area for urgent reform, given the importance of the annual report for shareholders and investors*. The survey shows that few respondents included a section on 'management's discussion and analysis' (28 per cent), or indeed the bank's or company's policies towards corporate social responsibility (33 per cent) or corporate governance (32 per cent).

- *MENA lawmakers and rule makers should continue to push for the full adoption of internationally recognized financial reporting standards*. Sixty-seven per cent of respondents stated that they disclose information based on International Financial Reporting Standards (IFRS); only 4.6 per cent report according to US Generally Accepted Accounting Principles (GAAP). Because most central banks in MENA require the banking sector to report in accordance with IFRS, in contrast to the market regulators, 77 per cent of banks indicate that their financial reporting is done in accordance with IFRS, in comparison to 58 per cent of listed companies. This information should be carefully scrutinized as the majority of countries that have adopted IFRS have not done so completely, or have outdated versions of the IFRS framework, and so investors should take care to understand which specific standards have been omitted or are outdated.

- *Although a large majority of banks and listed companies that are a part of a group produce consolidated financial reports, the regulator should ensure full compliance with this best practice*. Listed companies are less likely to produce consolidated reports than banks, 73 per cent versus 84 per cent.

- *Most respondents continue to view disclosure from a compliance point of view, rather than as an effective tool for managing stakeholder relations and adding value to their business; thus, stakeholders should organize awareness-raising events on the role of disclosure in strengthening corporate governance*. The main barrier cited by banks and listed companies as to why they do not fully implement best practice in the area of disclosure is a lack of legislation, in particular in the area of non-financial disclosure, again confirming the compliance-driven understanding of corporate governance.

7.3.5 Protecting Shareholder Rights

- *Regulators should strengthen the ability of shareholders to vote at the AGM*. The vast majority of banks and listed companies, 75.4 per cent, confirmed relatively high attendance levels at general assemblies, demonstrating that shareholders are interested in and willing to engage with their companies. Voting at the majority of general assemblies is still conducted by a show of hands (66.2 per cent), and only slightly more than half of respondents (54.3 per cent) cited proxy voting as an alternative. At 1.3 per cent, electronic voting is virtually non-existent in the region. A basic shareholder right is the right to elect board members. In the MENA region, board members are elected by shareholders in the vast majority (81 per cent) of banks and listed companies surveyed. Only 17.7 per cent of respondents allow for cumulative voting. Finally, best practice calls for shareholders to be furnished with sufficient and timely information concerning the date, location and agenda of the AGM, as well as full and timely information regarding the issues to be decided at the meeting. It is generally thought that such information should be provided to shareholders at least 20 days in advance of the meeting. However, the survey shows that while slightly over half of banks (55 per cent) follow this best practice, only 22 per cent of listed companies do so.

- *The regulators should safeguard shareholder rights to share in the profits of the organization, focusing on the effective enforcement of existing legal provisions*. There are many ways in which the fundamental shareholder right to share in the profits of the organization can be evaded or eroded, primarily through insider dealing, conflicts of interest and/or related party transactions undertaken by company insiders, and regulators should be vigilant in enforcing violations against this best practice. Eighty-two per cent (82 per cent) of respondents stated that national laws or internal documents require them to disclose related party transactions. Moreover, the great majority of banks (80 per cent) and listed companies (71 per cent) have established policies on conflicts of interest and related party transactions; of those that had not, only 34.7 per cent of respondents showed interest in developing such policies in the future. However, such policies are effective only when they are respected by managers and directors. Unfortunately, 54.7 per cent of respondents thought that directors failed to avoid conflict-of-interest situations, and 62.7 per cent thought that directors used inside information for their own benefit, demonstrating an important gap between the law on the statute books and actual practice.

- *Shareholders should have a say on extraordinary transactions, and banks and companies should adopt specific processes regulating when and how shareholders approve extraordinary transactions in their articles of association*. A significant majority of the respondents, approximately 70 per cent, stated that their board is generally responsible for approving extraordinary transactions, regardless of their value. An important minority stated that the competence to approve extraordinary transactions above a certain threshold, eg over 50 per cent of book value, is assigned to the shareholders (40.8 per cent). And while there is much debate in the corporate governance community as to whether shareholders are best placed to vote on such transactions, or whether instead directors working with management, given their detailed knowledge of the situation, should do so for the sake of timely decision making, it may well be prudent to allow shareholders a final vote on such matters.

Clearly, more work needs to be done on corporate governance in the region. However, many regional companies are putting some semblance of corporate governance best practices in place in their companies. The regulatory frameworks are being put in place, but the region's corporate governance journey is just beginning.

Notes

1. Institutes that have been established in the region are the Egyptian Institute of Directors (2005), the Hawkamah Institute for Corporate Governance (2006) and the Mudara Institute of Directors (2008).
2. Notably the Center for International Private Enterprise (CIPE), the Global Corporate Governance Forum, the International Finance Corporation, the Organisation for Economic Co-operation and Development (OECD) and the World Bank.
3. The revised *OECD Principles of Corporate Governance* (1997, revised in 2004), the Basel Committee on Banking Supervision's *Guidance on Enhancing Corporate Governance for Banking Organizations* (1998, revised in 2006), the *OECD Guidelines on Corporate Governance of State-owned Enterprises* (2005) and the Islamic Financial Services Board's *Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Mutual Funds)* (2006).

Hawkamah, the Institute for Corporate Governance, was launched in February 2006 with the aim of advancing corporate governance practices in the Middle East, North Africa and Central Asia. As an autonomous association, Hawkamah is bringing together corporate governance practitioners, regulators and institutions to define and develop a homegrown – yet globally integrated – system of governance that promotes institution building, corporate sector reform, good governance, market development and increased investment and growth across the region. For further details, go to www.hawkamah.org.

7.4

Corporate Governance in Latin America

Daniel Blume, OECD and Felipe Alonso, Curtis, Mallet-Prevost, Colt and Mosle

There has been a remarkable level of recent activity to develop and improve voluntary corporate governance codes within a significant number of Latin American countries. Mexico (December 2006), Colombia (April 2007) and Argentina (October 2007) have all announced the issuance of improved national corporate governance codes, while Peru is currently working to update its code. In addition, Costa Rica (June 2007), and Chile (October 2007) have each just issued their first voluntary national code. In Brazil the Brazilian Institute of Corporate Governance (IBGC) has already issued three versions of its national code and has indicated an intention to update it again in 2009. The Andean Development Corporation (Corporación Andino de Fomento, CAF) has also been working to actively promote corporate governance in Andean countries through its regional code (2005, hereinafter the Andean Code) as well as its implementation processes. Finally, Panama also developed a code in 2003.

In its previous discussions the OECD Roundtable on Latin American Corporate Governance concluded that, while some desirable improvements could be achieved through further legal reform, major legal reforms have already occurred in Argentina,[1] Brazil and Chile (2000–01) and more recently in Colombia (2005) and Mexico (2006). Within this context, achieving further legal improvements would be politically difficult, so most countries have focused on improving enforcement and private-sector implementation as main priorities.

7.4.1 The Economic Background

Almost five years of uninterrupted economic growth in Latin America to 2007, although modest when compared to booming economies in Asia, brought relative economic stability to a region previously characterized by frequent financial crises. This stability, accompanied by global economic growth and liquidity in the financial markets, has also attracted increasing amounts of foreign investment. Most Latin American financial markets grew significantly during this period, while the demand for local equity now comes from both local and international investors. The stock markets of the largest Latin American economies have shared in this growth, with most stock markets expanding faster than their overall economies' gross domestic product (GDP).

The country whose capital market has attracted most attention is Brazil, because of the growth of the Novo Mercado special corporate governance listing tiers of Bovespa. Up to 2007 the number of listings on the special corporate governance listing tiers of Bovespa had been roughly doubling every year. This increase admittedly started from a low base, but has become increasingly significant, with 66 new listings in 2007.

While other countries in Latin America have not undergone as dramatic a transformation as Brazil, several countries, particularly Colombia and Peru, have also been seeing strong increases. And what we have seen in all of these countries, including also Mexico and Chile, whose markets have not been growing as fast, is that they are eager to prove their corporate governance credentials through legislative reforms or voluntary initiatives or a combination of both.

A second reason is the important role that institutional investors – particularly pension funds – play within the Latin American ownership structure, where there is typically a dominant majority shareholder or controlling group, with institutional investors often in a minority shareholder position.

The experience of Brazil and the interest of other countries in showing that they too are taking corporate governance seriously has promoted a vibrant debate in the region about the best way forward – through legal and regulatory measures combined with active enforcement programmes, or through more self-regulatory measures, such as adoption of 'comply or explain'-type corporate governance codes, or through the Brazilian Novo Mercado example.

7.4.2 Differing Code Objectives

The *OECD Principles of Corporate Governance* (*OECD Principles*) recognize the variable role of voluntary codes within a country's corporate governance framework: 'The desirable mix between legislation, regulation, self-regulation, voluntary standards… will therefore vary from country to country. As new experiences accrue and business circumstances change, the content and structure of this framework might need to be adjusted.'[2]

Not surprisingly, Latin American experience reflects this variability. Different countries have established different main objectives and elaboration processes for developing their codes, emerging from their particular legal and institutional frameworks. Some countries, notably Argentina, Brazil and, more recently, Mexico and Chile, have focused mainly on using their voluntary national corporate governance codes for educational purposes, providing a convenient benchmarking tool for company management, boards and other relevant players in the market to assess the level and potential for improving corporate governance practices in companies.

Others, including Colombia, Costa Rica, Panama, Peru, Spain and the recent regulator-led code in Argentina, while maintaining an educational value, have focused especially on using their codes as a means for enhancing disclosure and market understanding of company corporate governance practices through a 'comply or explain' reporting mechanism aimed at complementing the legal framework. CAF's Andean Code, while intended for educational purposes to support company adoption of corporate governance and country development of national corporate governance codes, also strongly supports 'comply or explain' mechanisms to help ensure that the codes are taken into account.

Behind these objectives is a debate over the appropriate balance between regulatory and voluntary approaches to corporate governance. In Brazil the educational and entirely voluntary nature of the code of the Instituto Brasileiro de Governança Corporativa (IBGC) reflects the fact that it plays a complementary role to the legal and regulatory framework combined with the self-regulatory approach of the Novo Mercado, which enables companies to commit voluntarily to higher corporate governance standards. Because listed companies already have a means of publicly disclosing their commitments to higher corporate governance standards by listing on one of the three corporate governance listing segments of Bovespa, there may be less demand in the market for a separate reporting/disclosure mechanism concerning voluntary measures. Rather, the IBGC, the author of the code, can focus on promoting good practices, particularly on issues not covered by the Novo Mercado, and also on reaching a wider audience than just companies adhering to Bovespa's corporate governance listing standards, including non-listed family-owned companies. The IBGC code is also intended to serve as an important benchmark or reference for the market and regulatory authorities, but it is left to the market to determine how it may best make use of the code, rather than requiring disclosure against its detailed provisions.

While most other Latin American countries are moving towards a 'comply or explain' mechanism referencing their voluntary codes, Mexico is another exceptional case in which the regulator decided to drop an earlier 'comply or explain' mechanism, because Mexico's recent Securities Law amendment established significantly stricter corporate governance standards across a number of areas. As a result, the private-sector leaders in the development of the revised 2006 corporate governance code have chosen to target the voluntary code to a broader audience, including non-listed companies.

In the case of Argentina, an 'educational' code was issued in 2004 by the Instituto Argentino para el Gobierno de las Organizaciones (IAGO), a non-profit private-sector institution (hereinafter IAGO's Code). Likewise, the Comisión Nacional de Valores (CNV), the securities market regulator, has just recently issued a 'comply or explain' code in order to complement the legal framework (hereinafter, CNV's Code). However, because of the recent appearance of the latter, this report will mostly refer to IAGO's Code unless indicated otherwise.

7.4.3 Code Developments

The first wave of codes came following the issuance of the *OECD Principles* in 1999, with Brazil and Mexico issuing their first voluntary corporate governance codes the same year. As global attention to corporate governance continued to increase, and the Latin American Roundtable on Corporate Governance, launched in 2000, worked to develop a White Paper on corporate governance in Latin America, various countries and organizations, including Colombia (2002), Peru (2002), Panama (2003), Argentina (2004), Brazil (updated versions of its code in 2001 and 2004) and CAF (2005), came out with codes. For this first wave of code development the main objective was to build awareness and educate companies and the market about good practices. While development of the Brazilian code began before the issuance of the *OECD Principles* and drew upon an international comparison of other voluntary codes, all other codes cite the *OECD Principles* as a main reference in setting the framework for issues addressed. For those adopted after 2003, the White Paper was an additional reference. Interestingly, while the *OECD Principles* are aimed foremost at the overall policy framework, the most successful codes in Latin America have tended to go into much greater detail concerning company practices.

A second wave of code development has begun, with Colombia and Mexico issuing new versions of their codes that have taken into account recent corporate governance legal reforms, while Peru has also undertaken a recent code review process. Most recently, new codes were issued in Argentina, Chile and Costa Rica. Most of these recent efforts have tended to move beyond basic awareness raising and education on good practices to also incorporate regulatory-mandated 'comply or explain' mechanisms to facilitate reporting on corporate governance compliance, and to create additional incentives for companies and the market to be aware of and make use of the good practices identified in their codes. Proponents of these new codes have in some cases acknowledged weaknesses in their original attempts and have attempted to incorporate lessons learned to ensure that their codes are suitably adapted to the purpose of 'comply or explain' mechanisms.

7.4.4 Main Actors

Corporate governance codes in Latin America were developed by a variety of public- and private-sector parties ranging from regulator-led initiatives in Panama, Peru, Spain and the recent CNV's Code in Argentina, to private-sector-led initiatives (with strong participation of the regulator) in Colombia and Mexico, to corporate governance institutes with mainly private-sector membership leading code development in Argentina (IAGO's Code), Brazil and Chile. In Costa Rica, the code was exclusively developed by the private sector and the stock exchange.

In some countries, institutional investors are already playing a role in promoting best practices through corporate governance codes. Colombia's case is of particular interest, because institutional investors are required to take into account and provide a detailed report on the corporate governance structure of each company, and to disclose the importance of this review within the investment decision-making process. However, this requirement does not imply that a poor evaluation of the company's corporate governance system will limit the investment in all cases.

In some other countries, including Brazil and Chile, certain pension funds have developed their own corporate governance codes. For example, in Chile, where no national corporate governance code was developed until very recently, Cuprum, a pension fund, developed a voluntary code that distributes among its investee companies in order to persuade them to adopt its recommendations. It also follows up and monitors this process through the directors it appoints to the boards of some investee companies. In this sense, a pension fund code can help the market by providing benchmarks that are higher than those legally required, and provide clarity on investor expectations and demand for good corporate governance practices.

However, a broader concern is to avoid creating multiple and conflicting standards that may lead to confusion for companies and the market. For this reason, it is considered good practice for such codes to reference and specify how they relate to voluntary national codes and other legal, regulatory and listing requirements.

Notes

1. Publication deadline before the Roundtable's December 2008 meeting in Mexico City did not allow for this chapter to take into account the most recent developments in the region. However, more recent reports are available on the Roundtable website.
2. Annotations to Principle I of the *OECD Principles of Corporate Governance* (2004).

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(Note on sources: This chapter is based on 'Synthesis Report: Voluntary corporate governance codes in Latin America' and 'Institutional Investors and Corporate Governance in Latin America: Challenges, promising practices and recommendations' by Daniel Blume and Felipe Alonso in the OECD Corporate Affairs Division, presented to the Latin American Corporate Governance Roundtable at its meeting in October 2007 in Medellín in Colombia.)

7.5

Corporate Governance in the Commonwealth

Arif Zaman, Commonwealth Business Council

Most human endeavour involves people working together towards common goals. Success depends on trust. Trust depends on sound principle and mutual respect. So it is with business. A responsible business must establish its legitimacy in the eyes of societies and opinion leaders, and regulate itself effectively and openly.

A company must conduct its business as a good corporate citizen. 'Quality governance' means combining corporate governance with corporate social responsibility. Its basic characteristics are legitimacy, transparency, accountability and measurability. Many Commonwealth countries have developing economies. Institutions that invest only in developed markets are missing out on an opportunity not only to harness the profit-making potential of emerging markets but also to improve the governance environment in those countries and thereby enhance the attractiveness of those investments. It is in the best interests of institutional investors to push for good governance frameworks. This leads to a lower cost of capital and increased corporate performance.

At its core, corporate governance is about creating value from the quality of decision making and leads to better business performance. This in turn can increase the attractiveness of a business for investments. In those developing Commonwealth countries where the regulatory environment or institutional capacity is still developing, a specific policy framework for investment, through a whole-of-government approach, can encourage a focus on corporate governance as a basis for business performance.

7.5.1 Benefits of Good Corporate Governance

A good corporate governance framework has the potential for these benefits:

- enhancing overall performance;
- preparing a small enterprise for growth, and so helping to secure new business opportunities when they arise;
- increasing attractiveness to investors and lenders, which enables faster growth;
- increasing the company's ability to identify and mitigate risks, manage crises and respond to changing market trends.
- increasing market confidence as a whole.

See Figure 7.5.1.

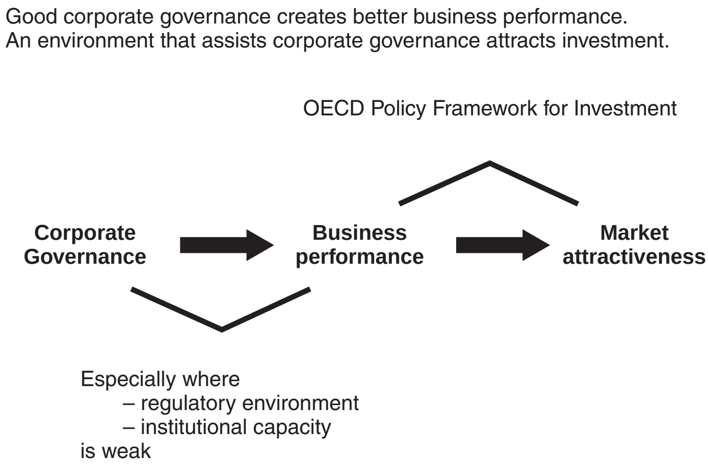

Figure 7.5.1 *Benefits of good corporate governance*

Corporate responsibility at Satyam and Madoff highlight the importance of reputational risk. Companies need to understand the role of governance in managing reputational risk as well as how to deal with the consequences on reputational risk when governance is weak and ineffective. For developing countries where information asymmetrics too often exist, the links between reputational risk for companies and countries are real and visible. When companies in developing countries are affected by poor reputational risk management, countries often are too.

7.5.2 Commonwealth Business Council Business Principles (2007)

Business principles govern how a company conducts itself. The Commonwealth Business Council (CBC) Business Principles are based on the firm belief that application of good principle is fundamental to business success.

The CBC Business Principles consist of core values, responsibilities to stakeholders and a set of principles for how a company is to conduct its affairs. All companies and entities, no matter what their size, should adhere to these business principles. The principles apply not just to private-sector entities but are relevant also to public bodies and in the voluntary sector.

The CBC Business Principles are established under three headings:

- core values;
- responsibilities to stakeholders;
- principles.

It needs to be emphasized that leadership is key to driving these principles. A proper mechanism for people to internalize core values is necessary and needs to be reflected through, for example, role modelling of behaviours by current or potential senior managers. One way of embedding the principles is through stronger links between talent management and leadership development.

7.5.2.1 Core Values

- Honesty, integrity, fairness and openness, respect for people, clearly stated and followed in practice.

- A commitment to contribute to sustainable development, reflecting corporate social responsibility. This requires balancing short- and long-term interests, and integrating economic, environmental and social considerations into business decision making.
- Transparency – being actively involved in structure, process and disclosure; establishing and maintaining communication with key stakeholders.
- Tackling corruption – adopting agreed codes; being persistent in enforcing them internally and in external dealings.
- Human rights – recognizing the implications for the business of respect for human rights; having a policy and acting on it.

7.5.2.2 Responsibilities to Stakeholders

Five areas of responsibility are recognized. It is the duty of management, through an accountable board, to discharge these inseparable responsibilities.

To Shareholders

- Protect shareholders' investment and provide a competitive long-term return.
- Conduct operations in accordance with internationally accepted principles of good corporate governance.
- Provide timely, regular and reliable information on activities, structure, financial situation and performance.

To Customers

- Provide products and services that consistently offer value in terms of price and quality, and that are safe for their intended use.
- Listen to customers' views and continually strive to improve the company's performance.

To Employees

- Respect the human rights of employees.
- Provide good and safe working conditions.
- Provide competitive terms and conditions.

- Ensure a workplace free of harassment.
- Invest in the development and best use of the talents of employees.
- Create an inclusive work environment where every employee has an equal opportunity to develop his or her skills and talents. Encourage diversity.
- Understand and value cultural differences.
- Encourage the involvement of employees in the planning and direction of their work. Provide them with channels to report concerns and enable appropriate employee consultation.
- Recognize that commercial success depends on the full commitment of all employees.

To Those with Whom a Company Does Business

- Establish mutually beneficial relationships with contractors and suppliers, and in joint ventures.
- Promote the application of these business principles or equivalent principles in such relations. The ability to promote these principles effectively will be an important factor in the decision to enter into or remain in such relationships.

To Society

- Conduct business as a responsible corporate member of society, in accordance with internationally accepted norms.
- Comply with applicable laws and regulations.
- Support fundamental human rights in line with the legitimate role of business.
- Give proper regard to health, safety, security and the environment.

7.5.2.3 Principles

Economic

- Profits and a strong financial foundation provide a basis for fulfilling a company's responsibilities.
- Criteria for investment and divestment decisions include sustainable development considerations (economic, social and environmental) and an appraisal of the investment risks.

Competition

- Free enterprise and fair competition are supported.
- Operations are conducted in accordance with the principles of fair and ethical competition and within the framework of applicable competition laws and regulations.

Business Integrity

- Honesty, integrity and fairness are applied in all aspects of business, and the same is expected in relationships with business partners.
- The direct or indirect offer, payment, solicitation or acceptance of bribes in any form is unacceptable. Facilitation payments are bribes and should not be made.
- Employees must avoid conflicts of interest between their private activities and their part in the conduct of company business.
- Employees must declare any potential conflicts of interest.
- All business transactions on behalf of the company must be reflected accurately and fairly in the accounts in accordance with established procedures and must be subject to independent audit and disclosure.

Public/Political Activities

- Legitimate business interests are promoted and defended.
- In the development of proposed legislation and other regulations that may affect legitimate business interests, the company may engage with governments, both directly and through bodies such as trade associations. Such engagement must be in accordance with values and business principles.
- There is no engagement by the company in party politics.
- If payments or donations are made to political parties, they are fully disclosed as to amount and purpose.
- Employees have the right to stand for public office provided it is appropriate in the light of circumstances.

Health, Safety, Security and the Environment

- A systematic approach to health, safety, security and environmental management is followed to achieve continuous performance improvement.
- Health, safety, security and environmental issues are managed as critical business activities. Standards and targets are set for improvement. Performance is measured, appraised and reported externally.
- There is commitment to making continuous improvement in the management of a company's environmental impact and to the longer-term goal of developing a sustainable business.
- Ways are continually sought to reduce the environmental impact of a company's operations, products and services.

Local Communities

- The ways in which a company contributes directly or indirectly to the general well-being of the communities within which it operates are continuously improved in order to be good neighbours.
- Social impacts of business activities are managed carefully. By working with others, the company enhances the benefits to local communities, including through private-sector and human development, and mitigates any negative impacts from its activities.
- A constructive, open dialogue with stakeholders is established, which aims to achieve a mutually beneficial outcome.

Communication and Engagement

- Regular dialogue and engagement with stakeholders is essential.
- There is commitment to reporting the company's performance, providing full, relevant information to legitimately interested parties, subject to any overriding considerations of business confidentiality.
- In interactions with employees, business partners and local communities, the company listens and responds in an honest and responsible manner.

Compliance/Obeying the Law

- Laws and regulations are complied with.
- Constructive support is given, where appropriate, if institutional capacity to ensure compliance is weak.

South Asia (India, Pakistan, Bangladesh and Sri Lanka)

As South Asia competes for global capital and inward investment, there has been a fresh focus on corporate governance. This section sets out some of the key drivers and challenges ahead. It also draws on the work of the CBC Working Group on Corporate Governance, which benefited from active stakeholder participation from across South Asia. This work has developed the business case for corporate governance, a set of principles, examples of best practice, and suggestions for training and development within countries.

There are three key messages:

1. The impetus and drive for enhanced corporate governance is increasingly coming from investment considerations rather than a tick-box approach to compliance – namely, as a crucial component of a strong investment climate and as part of an integrated policy framework for investment. The mantra of good governance in the public sector is also highlighting common areas of focus in private-sector governance that have collectively been called 'quality governance'.
2. There is now on the whole adequate guidance on paper for good corporate governance. The key challenge that remains in South Asia is in implementation, especially for mid-size companies and in disclosure / communication.
3. Specific concerns that need to be addressed in South Asia include corporate structure and approaches for small and medium-sized enterprises (SMEs).

A number of overarching themes and critical factors for good corporate governance are of particular importance in developing practical policies in South Asia.

An analysis of developments in South Asia underlines the point that corporate governance cannot be introduced in isolation from a range of other reforms (macro-economic, micro-economic, accounting, legal, banking and institutional), nor can these other reforms achieve all their objectives in the absence of corporate governance initiatives. The experience of India and Pakistan highlights the problems and market distortions that have built up from decades of varying government policies and from strong entrenched structures and interests in the private sector, and the complexity of picking apart the range of policies and targeting the reforms. Reform is a cumulative process, and one set of reforms uncovers the need for other reforms, so the challenges lie in policy management – in conceptualizing and implementing a road map of parallel and sequential reforms that constitute a comprehensive programme. Experience shows that this can be achieved, especially in vibrant democracies, but there is also the bitter experience that liberalization reforms without effective regulatory systems and agencies may have very high transitional costs (as India learned after 1994).

A second theme, closely associated with the first, is the need to monitor the trends in different sectors of the markets so as to try to avoid (or at least prepare for) a situation where a combination of several negative trends that individually might be manageable together form a crisis. Again, experience in India, Pakistan and Sri Lanka shows the dangers of multiple 'fault lines' in the financial and corporate sectors, such as the burden of non-performing loans, dependency on formal and informal protection and on state development finance institutions, structural imbalances between ownership and control and high agency costs, outmoded laws, and lack of inflow of investment capital.

A third theme is the need for a range of players to improve corporate governance, and the indication that a degree of 'stick' may be needed together with the 'carrots' of increased investment and performance. It is noticeable that in India the initiative for improved corporate governance came from the Confederation of Indian Industry (CII), which produced a voluntary code that it encouraged its members to follow and to demonstrate in highly advanced model annual reports, again designed by the CII. These model reports included sections of corporate social and environmental responsibility as well as corporate governance, and set out rigorous points of detail such as the board attendance record as well as the remuneration of individual board members. However, only about 20 companies followed these guidelines, and it required the intervention of the regulator (in the form of the Securities Exchange Board of India (SEBI) and the Ministry of Company Affairs) to significantly widen the application of corporate governance. Even then, progress has been slow, and both the Indian and the Sri Lankan experience reveal the significance of ratings agencies in demanding good corporate governance as well as financial management systems for better credit ratings. Sri Lanka in particular shows the roles of the regulators and credit agencies, combined with professional institutions such as the chartered accountants, chartered company secretaries, institutes of directors and chambers of commerce.

A fourth theme is the critical importance of the company and contract laws and the efficacy of the legal system. It is notable that most of the SAARC countries have developed special commercial courts of one sort or another to handle commercial disputes, but the reports all generate a sense of gloom when it comes to the efficacy of the law, and of the need to modernize bankruptcy and liquidation proceedings.

This is linked with the fifth theme, which is the critical importance of the traditional family ownership and control structures, and the concern that corporate governance is observed more in form than in substance. In Pakistan the family control system and the prevalence of the pyramid structures of control is a major factor (greater than for countries in South-East Asia), while in India there is a contrast between the costs of the conventional model of the separation of ownership and control and the model of interlinked ownership and control that characterizes Asian companies.

The way forward may lie in a new focus on 'growing the pie' even if it involves dilution in share ownership, so that families can increase and diversify their wealth by becoming investors in other companies instead of concentrating only on control of their own company.

A sixth theme is the significance of corporate governance for other types of enterprises such as state-owned enterprises (SOEs), which still loom very large across South Asia. In India, SOEs account for 34 per cent of India's corporate paid-up capital. In other countries there is also a need for good corporate governance practices for medium-sized enterprises and for non-governmental organizations, which often form important trading enterprises as well as crucial social development agencies.

These realities would compel a sense of caution about expectations of rapid improvement, but given the expanding body of experience and expertise in this area, it is reasonable to expect progress.

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The Commonwealth Business Council (CBC) was formed in 1997 at the Commonwealth Heads of Government Meeting (CHOGM) in Edinburgh. Its aim is to utilize the global network of the Commonwealth more effectively for the promotion of global trade and investment for shared prosperity. It provides leadership in increasing international trade and investment flows, creating new business opportunities, promoting good governance and corporate social responsibility, reducing the digital divide and integrating developing countries into the global market. In fulfilling its mission the CBC strives to provide a bridge between the private sector and governments, between emerging markets and developed markets, and between small businesses and the international private sector. It sees corporate governance as being central to its mandate in improving the quality of decision making, anchoring governance in values and encouraging a focus on emerging areas such as reputational risk.

A key feature of the CBC is its global membership, comprising corporate members from both developed and developing countries. This gives it the capacity to make a special contribution by working with emerging markets and developing countries to achieve economic growth and sustainable development. Its Working Group on Corporate Governance is chaired by James Smith, Chairman of Shell UK.

Useful Organizations

Australia

Australasian Investor Relations Association (AIRA)	www.aira.org.au
Australian Chamber of Commerce and Industry	www.acci.asn.au
Australian Customs Service (ACS)	www.customs.gov.au
Australian Institute of Company Directors (AICD)	www.companydirectors.com.au
Australian Securities and Investments Commission (ASIC)	www.asic.gov.au
Australian Shareholders Association (ASA)	www.asa.asn.au
Australian Stock Exchange	www.asx.com.au
Australian Taxation Office	www.ato.gov.uk
Business Council of Australia (BCA)	www.bca.com.au
Centre for Corporate Governance, University of Technology, Sydney	www.ccg.uts.edu.au
Certified Practicing Accountants of Australia (CPA)	www.cpaaustralia.com.au
Chartered Secretaries Australia (CSA)	www.csaust.com
Department of Innovation, Industry, Science and Research	www.innovation.gov.au
Government Departments in Australia	www.australia.gov.au
Institute of Chartered Accountants in Australia (ICAA)	www.icaa.org.au
Invest Australia	www.investaustralia.gov.au

Investment and Financial Services Association Ltd (IFSA)	www.ifsa.com.au
Law Council of Australia	www.lawcouncil.asn.au
Reserve Bank of Australia	www.rba.gov.au

Brazil

Banco do Brasil	www.bb.com.br
Brazilian Association of Listed Companies (Abrasca)	www.abrasca.org.br
Brazilian Federal Tax Authority (Receita Federal)	www.receita.fazenda.gov.br
Brazilian Institute of Accountants	www.inracom.org.br
Brazilian Institute of Corporate Governance (IBGC)	www.ibgc.org.br
Central Bank of Brazil	www.bcb.gov.br
Ministry of Development, Industry and Commerce	www.mdic.gov.br
Ministry of Finance	www.fazenda.gov.br
Ministry of Labour and Employment	www.mte.gov.br
National Bank of Economic and Social Development (BNDES)	www.bndes.gov.br
National Confederation of Industry	www.cni.org.br
Securities and Exchange Commission of Brazil	www.cvm.gov.br
Securities, Commodities and Futures Exchange (BM&FBOVESPA S.A.)	www.bovespa.com.br

Canada

Bank of Canada	www.bank-banque-canada.ca
Business Development Bank of Canada	www.bdc.ca
Canada Business	www.canadabusiness.ca
Canada Revenue Agency (CRA)	www.cra-arc.gc.ca
Canadian Chamber of Commerce	www.chamber.ca
Canadian Coalition for Good Governance (CCGG)	www.ccgg.ca
Canadian Institute of Chartered Accountants (CICA)	www.cica.ca
Export Development Canada	www.edc.ca
Industry Canada	www.ic.gc.ca
Institute of Corporate Directors (ICD)	www.icd.ca
Invest in Canada	www.investincanada.gc.ca
Montreal Exchange	www.m-x.ca
Provincial Business Service Centres	www.cbsc.org/english
Toronto Stock Exchange	www.tsx.com

China

All China Federation of Industry and Commerce (ACFIC)	www.chinachamber.org.cn
China Association of Enterprises with Foreign Investment	www.caefi.org.cn
China Banking Regulatory Commission (CBRC)	www.cbrc.gov.cn
China Council for the Promotion of International Trade	www.ccpit.org
Chinese Institute of Certified Public Accountants (CICPA)	www.cicpa.org.cn
Chinese Securities Association	www.s-a-c.org.cn
Chinese Securities Regulatory Commission (CSRC)	www.csrc.gov.cn
Export-Import Bank of China (Chexim)	http://english.eximbank.gov.cn
General Administration of Customs (GAC)	www.customs.gov.cn
Ministry of Commerce	www.mofcom.gov.cn
Ministry of Finance	www.mof.gov.cn
Ministry of Labour and Social Security	www.molss.gov.cn
National Development and Reform Commission	www.ndrc.gov.cn
People's Bank of China	www.pbc.gov.cn
Shanghai Stock Exchange	www.sse.com.cn
Shenzen Stock Exchange	www.sse.org.cn
State Administration of Industry and Commerce	www.saic.gov.cn
State Administration of Taxation (SAT)	www.chinatax.gov.cn

Finland

Bank of Finland	www.bof.fi
Central Chamber of Commerce	www.chamber.fi
Confederation of Finnish Industries	www.ek.fi
Enterprise Finland	www.yrityssuomi.fi
Finnish Financial Supervision Authority	www.rata.bof.fi
Finnish Government	www.government.fi
Finnish Ministry of Finance	www.vm.fi
Finnish Ministry of Trade and Industry	www.ktm.fi
Finnish Trade Register	www.prh.fi/en/kaupparekisteri.html
Nordic Stock Exchange	www.omxgroup.com/nordicexchange

France

Association of Independent Directors (APIA)	www.apia.asso.fr
Banque de France	www.banque-france.fr

Chambers of Commerce and Industry	www.acfci.cci.fr
Companies Registry (Registre National du Commerce et des Sociétés, EURIDILE)	www.euridile.inpi.fr
Council on Financial Markets	www.cmf-france.org
Customs and VAT (Direction Générale des Douanes et des Droits Indirects)	www.douane.gouv.fr
Financial Markets Authority (Authorite des Marches Financiers, AMF)	www.amf-france.org
French Asset Management Association (L'Association Française de la Gestion Financière, AFG)	www.afg.asso.fr
French Banking Federation (Fédération Bancaire Française)	www.fbf.fr
French Business Federation (Mouvement des Enterprises de France, MEDEF)	www.medef.fr
French Corporate Governance Institute (IFGE)	www.ifge-eu
French Ministry of Economy, Industry and Employment	www.minefe.gouv.fr
Institute of Directors, France	www.iod.com/france
Invest in France	www.invest-in-france.org
Stock Exchange	www.euronext.com

Germany

Association of German Chambers of Commerce	www.dihk.de/english
Company Registration Portal	www.handelsregister.de
Bundesbank	www.bundesbank.de
Deutsche Boerse (German Stock Exchange)	www.deutsche-borse.com
Dusseldorf Exchange	www.rwb.de
Federation of German Industry	www.bdi-online.de
Federal Central Tax Authority (Bundeszentralamt für Steuern)	www.bzst.bund.de
Federal Ministry of Economy and Technology	www.bmwi.de
Federal Ministry of Finance	www.bundesfinanzministerium.de
Federal Ministry of Justice	www.bmj.bund.de
German Business Portal	www.german-business-portal.info
German Commission on Corporate Governance	www.corporate-governance-code.de
German Federal Government	www.bundesregierung.de
German Society of Investment Professionals (DVFA)	www.dvfa.de

Institute of Directors, Germany	www.iod.com/germany
Invest in Germany	www.invest-in-germany.com
National Agency for Supervision of Financial Institutions	www.bafin.de

Hong Kong

Business Licence Information Service (BLIS) of the Support and Consultation Centre for SMEs	www.success.tid.gov.hk
Chinese General Chamber of Commerce	www.cgcc.org.hk/en
Commerce, Industry and Tourism Branch of the Commerce and Economic Development Bureau	www.citb.gov.hk
Companies Registry	www.cr.gov.hk
Customs and Excise Department	www.customs.gov.hk
HK Financial Services and the Treasury Bureau	www.fstb.gov.hk/
HK General Chamber of Commerce	www.chamber.org.hk
HK Institute of Certified Public Accountants	www.hkicpa.org.hk
HK Institute of Company Secretaries (HKICS)	www.hkics.org.hk
HK Institute of Directors (HKIoD)	www.hkiod.com
HK Monetary Authority (HKMA)	www.info.gov.hk/hkma
HK Securities and Futures Commission (SFC)	www.sfc.hk
HK Trade and Development Council (HKTDC)	www.tdctrade.com
Inland Revenue Department	www.ird.gov.hk
Invest Hong Kong	www.investhk.gov.hk
Labour Department	www.labour.gov.hk
Overseas Company Registration Agents	www.ocra.com
Standing Committee on Company Law Reform (SCCLR)	www.cr.gov.hk/en/standing/index.htm
Stock Exchange of HK (HK Exchanges and Clearing Ltd, HKEx)	www.hkex.com.hk
Trade and Industry Department	www.tid.gov.hk

India

Associated Chambers of Commerce and Industry of India (ASSOCHAM)	www.assocham.org
Bombay Stock Exchange (BSE)	www.bseindia.com
Central Board of Excise and Customs (CBEC)	www.cbec.gov.in
Company Law Board	www.clb.nic.in
Confederation of Indian Industries (CII)	www.ciionline.org
Directorate-General of Foreign Trade	http://dgft.delhi.nic.in
Export-Import Bank of India	www.eximbankindia.com

Federation of Indian Chambers of Commerce and Industry	www.ficci.com
Indian Investment Centre	www.iic.nic.in
Indian Government Portal	http://india.gov.in
Institute of Chartered Accountants of India (IICAI)	http://icai.org
Institute of Company Secretaries of India (ICSI)	www.icsi.edu
Ministry of Finance	www.finmin.nic.in
National Stock Exchange (NSE)	www.nse-india.com
Reserve Bank of India (RBI)	www.rbi.org.in
Securities and Exchange Board of India (SEBI)	www.sebi.gov.in
UK India Business Council	www.ibpn.co.uk

Ireland

Chambers Ireland	www.chambers.ie
Companies Registration Office	www.crok.ie
Institute of Directors, Republic of Ireland	www.iodireland.ie
Irish government	www.irlgov.ie
Department for Enterprise, Trade and Employment	www.entemp.ie

Italy

Bank of Italy (Banca d'Italia)	www.bancaditalia.it
Companies Register	www.infocamere.it
Customs (Agenzia delle Dogane)	www.agenziadogane.it
General Confederation of Trade, Tourism, Services and Small- and Medium-Sized Enterprises	www.confcommercio.it
Italian Banking Association	www.abi.it
Italian Government	www.governo.it
Italian Stock Exchange	www.borsaitaliana.it
Italian Tax Agency (Agenzia delle Entrate)	www.agenziaentrate.it
Italian Union of Chambers of Commerce (Unioncamere)	www.unioncamere.it
Ministry of Economic Development	www.sviluppoeconomico.gov.it
Ministry of Economy and Finance	www.mef.gov.it
Ministry of Labour and Social Security	www.lavoro.gov.it
National Employers Confederation (Confindustria)	www.confindustria.it
National Financial Markets Commission (CONSOB)	www.consob.it

Japan

Accounting Standards Board of Japan	www.asb.or.jp/index_e.php
Association of Corporate Executives (Keizai-Doyukai)	www.doyukai.or.jp/en
Bank of Japan (BOJ)	www.boj.or.jp/en
Development Bank of Japan (DBJ)	www.dbj.go.jp/english
Financial Accounting Standards Foundation	www.asb.or.jp/index_e.php
Financial Services Agency (FSA)	www.fsa.go.jp/en
Investing in Japan (JETRO)	www.jetro.go.jp
Japan Bank for International Co-operation (JBIC)	www.jbic.go.jp/english
Japan Chamber of Commerce and Industry	www.jcci.or.jp/home-e.html
Japan Corporate Governance Forum	www.jcgf.org/en
Japan External Trade Organisation (JETRO)	www.jetro.go.jp
Japan Management Association (JMA)	www.jma.or.jp/indexeng.html
Japan Securities Dealers Association (JSDA)	www.jsda.or.jp/html/eigo
Japan Business Federation (Nippon Keidanren)	www.keidanren.or.jp
Ministry of Economy, Trade and Industry (METI)	www.meti.go.jp/english/index.html
Ministry of Finance (MOF)	www.mof.go.jp/english/index.htm
Ministry of Justice (MOJ)	www.moj.go.jp/english/index.htm
Ministry of Health, Labour and Welfare (MHLW)	www.mhlw.go.jp/english/index.htm
National Tax Administration (NTA)	www.nta.go.jp/foreign_language/index.htm
Organisation for Small and Medium Enterprises and Regional Innovation, Japan (SMRJ)	www.smrj.go.jp/utility/english/index.html
Securities and Exchange Surveillance Commission (SESC)	www.fsa.go.jp/sesc/english
Tokyo Stock Exchange (TSE)	www.tse.or.jp/english

The Netherlands

Confederation of Netherlands Industry and Employers (VNO-NCW)	www.vno-ncw.nl
Customs	www.douane.nl
De Nederlandsche Bank (DNB)	www.dnb.nl

Dutch Corporate Governance Code Monitoring Committee	www.commissiecorporategovernance.nl
Federation of Chamber of Commerce and Industry in the Netherlands	www.kvk.nl
IoD Netherlands	www.iod.com/netherlands
Ministry of Economic Affairs	www.minez.nl
Ministry of Finance	www.minfin.nl
Ministry of Justice	http://english.justitie.nl
Ministry of Social Affairs and Employment	www.employment.gov.nl
Netherlands Authority for the Financial Markets	www.afm.nl
Netherlands Foreign Investment Agency (NFIA)	www.nfia.nl
Netherlands Government	www.government.nl
Stock Exchange (Euronext Amsterdam)	www.aex.nl
Tax Service, Department of International Issues	www.belastingdiens.nl

New Zealand

Commerce Commission	www.comcom.govt.nz
Companies Office (Registrar of Companies)	www.companies.govt.nz
Inland Revenue Department	www.ird.govt.nz
Institute of Chartered Accountants in New Zealand	www.nzica.com
Institute of Directors in New Zealand	www.iod.org.nz
NZ Government	www.govt.nz
NZ Trade and Enterprise	www.nzte.govt.nz
NZ Stock Exchange (NZX)	www.nzx.com
Overseas Investment Office	www.linz.govt.nz/overseas-investment
Securities Commission	www.seccom.govt.nz
Takeovers Panel	www.takeovers.govt.nz
Treasury	www.treasury.govt.nz

Russia

Central Bank of the Russian Federation	www.cbr.ru/eng
Federal Service for Financial Markets	www.fcsm.ru/eng
Government Investment Corp (Gosincor)	www.gosincor.ru
Independent Directors Association	www.nand.ru
Ministry of Economic Development and Trade	www.economy.gov.ru
Ministry of Finance	www.minfin.ru/en

Moscow Stock Exchange	www.mse.ru/eng
National Council for Corporate Governance	www.nccg.ru/en
Professional Association of Registrars, Transfer Agents and Depositors (PARTAD) for Russian Securities Market	http://partad.ru/eng
Russian Chamber of Commerce and Industry	http://eng.tpprf.ru
Russian Government	www.government.ru
Russian Institute of Directors	www.rid.ru
Russian Trading System Stock Exchange (RTS)	www.rts.ru/en
St Petersburg Stock Exchange	www.spcex.ru/english/index.stm
State Registration Chamber	www.palata.ru

South Africa

Companies and Intellectual Property Commission	www.cipro.co.za
Competition Commission	www.compcom.co.za
Department of Trade and Industry (DTI)	www.thedti.gov.za
Financial Services Board (FSB)	www.fsb.co.za
Independent Regulatory Board for Auditors (IRBA) (formerly the Public Accountants and Auditors Board (PPAB))	www.paab.co.za
Institute of Directors, SA	www.iodsa.co.za
JSE Securities Exchange (JSE)	www.jse.co.za
National African Federated Chamber of Commerce and Industry (NAFCOC)	www.nafcoc.org.za
National Credit Regulator	www.ncr.org.za
National Treasury	www.treasury.gov.za
Public Investment Corporation	www.pic.gov.za
SA Chamber of Business (SACOB)	www.sacob.co.za
SA Institute of Chartered Accountants	www.saica.co.za
SA Reserve Bank (SARB)	www.reservsbank.co.za
SA Revenue Service (SARS)	www.sars.gov.za
Takeover Regulation Panel	www.srpanel.co.za

South Korea

Bank of Korea (BoK)	www.bok.or.kr/eng
Export-Import Bank of Korea	www.koreaexim.go.kr/en
Federation of Korean Industries (FKI)	www.fki.or.kr/en
Financial Supervisory Commission (FSC)	www.fsc.go.kr/eng
Invest Korea	www.investkorea.org
Korea Customs Service (KCS)	www.customs.go.kr/eng
Korea Employers Federation (KEF)	http://eng.kef.or.kr

Korea International Trade Association (KITA)	www.kita.org
Korea Trade-Investment Promotion Agency (KOTRA)	http://english.kotra.or.kr
Korean Trade Commission	www.ktc.go.kr/eng
Ministry of Strategy and Finance (MCF)	http://english.mofe.go.kr
National Tax Service (NTS)	www.nts.go.kr/eng
Small and Medium Business Administration (SMBA)	www.smba.go.kr/main/english/index.jsp

Spain

Association of Board Directors (Instituto de Consejeros-Administradores, ICA)	www.iconsejeros.com
Bank of Spain (Banco de Espana)	www.bde.es/homee.htm
Companies Register (Registro Mercantil Central)	www.rmc.es
Futures and Options Market (MEFF)	www.meff.es
Invest in Spain (INTERES)	www.investinspain.org
Madrid Stock Exchange	www.bolsamadrid.es/ing/portada.htm
Ministry of Economy and Finance	www.meh.es/Portal?cultura=en-GB
Ministry of Industry, Tourism and Commerce	www.mitys.es
Ministry of Labour and Social Affairs	www.mtas.es
National Securities Market Commission (Comisión Nacional del Mercado de Valores, CNMV)	www.cnmv.es
Spanish Confederation of Business	www.ceoe.es
Spanish Confederation of Small and Medium-sized Enterprises (Confederaci[oacute] n Española de la Pequeña y Mediana Empresa, CEPYME)	www.cepyme.es
Spanish Government	www.la-moncloa.es/IDIOMAS/9
Spanish Stocks and Markets (Bolsas y Mercados Espanoles, BME)	www.bolsasymercados.es/ing/home.htm
Tax Agency (Agencia Tributaria)	www.aeat.es

Sweden

Confederation of Swedish Enterprise	www.svensktnaringsliv.se/english
Invest in Sweden Agency (ISA)	www.isa.se
Ministry of Enterprise, Energy and Communications (Narings departementet)	www.sweden.gov.se/sb/d/2067

Stockholm Chamber of Commerce	www.chamber.se
Stockholm Stock Exchange	http://omxnordicexchange.com
Sveriges Riksbank (central bank)	www.riksbank.com
Swedish Business Development Agency (Nutek)	www.nutek.se
Swedish Companies and Registration Office (Bolagsverket)	www.bolagsverket.se/in_english
Swedish Corporate Governance Board	www.bolagsstyrningskollegiet.se/en/0000003.asp
Swedish Government	www.sweden.gov.se
Swedish Securities Council	www.aktiemarknadsnamnden.se/in-english__50
Swedish Tax Agency (Skatteverket)	www.skatteverket.se/international/inenglish
Swedish Trade Council (Exportradet)	www.tradewithsweden.com

United Kingdom

Association of British Insurers (ABI)	www.abi.org.uk
Accounting Standards Board	www.frc.org.uk/asb
Association of Chartered Certified Accountants	www.acca.co.uk
Bank of England	www.bankofengland.co.uk
British Bankers Association	www.bba.org.uk
Business Link	www.businesslink.gov.uk
Companies House (Registrar of companies)	www.companieshouse.gov.uk
Confederation of British Industry (CBI)	www.cbi.org.uk
Department for Business, Enterprise and Regulatory Reform (BERR)	www.berr.gov.uk
Financial Reporting Council (FRC)	www.frc.org.uk
Financial Services Authority (FSA) / UK Listing Authority (UKLA)	www.fsa.gov.uk
HM Revenue & Customs (HMRC)	www.hmrc.gov.uk
HM Treasury	www.hm-treasury.gov.uk
Institute of Chartered Accountants of England and Wales (ICAEW)	www.icaew.co.uk
Institute of Chartered Secretaries and Administrators (ICSA)	www.icsa.org.uk
Institute of Directors (IoD)	www.iod.com
International Business Wales	www.ibwales.com
Invest Northern Ireland	www.investni.com
London Stock Exchange (LSE)	www.londonstockexchange.com
National Association of Pension Funds (NAPF)	www.napf.co.uk

Scottish Enterprise	www.scottish-enterprise.com
UK Government	www.direct.gov.uk
UK Trade and Invest	www.uktradeinvest.gov.uk

USA

American Bar Association	www.aba.org
American Institute of Certified Public Accountants (AICPA)	www.aicpa.org
American Law Institute	www.ali.org
Association for Corporate Council	www.acc.com
Business Roundtable (BRT)	www.businessroundtable.org
Council of Institutional Investors	www.cii.org
Department of Commerce	www.commerce.gov
Department of Labour	www.dol.gov
Department of the Treasury	www.treas.gov
Economic Development Administration (EDA)	www.eda.gov
Export-Import Bank	www.exim.gov
Federal Trade Commission (FTC)	www.ftc.gov
Institute of Internal Auditors (IIA)	www.theiia.org
Internal Revenue Service (IRS)	www.irs.gov
NASDAQ and New York Stock Exchange (NYSE Euronext)	www.nasdaq.com www.nyse.com
National Association of Corporate Directors (NACD)	www.nacdonline.org
National Association of State Boards of Accountancy (NASBA)	www.nasba.org
National Investor Relations Institute	www.niri.org
New York Stock Exchange	www.nyse.com
Public Accounting Oversight Board (PCAOB)	www.pcaobus.org
Securities and Exchange Commission	www.sec.gov
Securities Transfer Association	www.stai.org
Small Business Administration	www.sba.gov
Society for Corporate Secretaries and Governance Professionals	www.society.org
US Chamber of Commerce	www.uschamber.org
US Customs and Border Protection (formerly US Customs Service)	www.cbp.gov

Cross-border organizations

Asian Corporate Governance Association	www.acga-asia.org
Commonwealth Association for Corporate Governance (CACG)	www.commonwealthfoundation.com
European Central Bank	www.ecb.int

European Corporate Governance Institute	www.ecgi.org
European Bank for Reconstruction and Development (EBRD)	www.ebrd.com
International Monetary Fund (IMF)	www.imf.org
Organisation for Economic Co-operation and Development	www.oecd.org/home
World Bank	www.worldbank.org

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Index