The globalisation of corporate governance

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Led by investor demand, the discussion as to what constitutes effective corporate governance and why it is important for individual companies on a national and a global level continues to gather momentum. In this two-part feature, Holly. J. Gregory identifies the issues that in-house counsel should be aware of when advising on cross-border capital market access, M&A and JVs

In mid-July of this year, over 350 participants from more than 25 countries convened in New York City to explore their common interests in corporate governance at the sixth annual meeting of the International Corporate Governance Network (ICGN) (*see www.icgn.org*).

The gathering brought together securities regulators, representatives of securities dealer associations, stock exchanges, the OECD and the World Bank, prominent accounting and legal professionals, captains of industry, labour leaders, and, most notably, investors representing US$10 trillion (EUR10.8 trillion) in investment capital. These remarkably diverse participants all share the view that corporate governance is critical to the global economic system (*see box "Global Developments In Corporate Governance" on page 7*).

Demand for investment capital is increasing throughout both the developed and developing world. At the same time, governments and multilateral agencies are cutting back on aid. As barriers to the free flow of capital fall, policy makers have come to recognise that the quality of corporate governance is relevant to capital formation. They also realise that weak corporate governance systems, combined with corruption and cronyism:

- Distort the efficient allocation of resources.
- Undermine opportunities to compete on a level playing field.
- Ultimately hinder investment and economic development.

In a McKinsey survey issued in June 2000, investors from all over the globe indicated that they will pay large premiums for companies with effective corporate governance (*see box "The McKinsey Survey" and diagrams "Paying For Good Governance" and "Premiums Investors Would Pay"*).

This finding is supported by a recent survey of investors in Europe and the US which found that approximately half of European investors, and 61% of US investors, have decided not to invest in a company, or have reduced their investment, because of poor governance practices (*Russell Reynolds Associates, Corporate Governance in the New Economy – 2000 International Survey of Institutional Investors. Copies of the survey can be requested from www.russreyn.com*) (*see boxes "Importance Of Factors Influencing Investment Decisions" and "Evaluating Corporate Governance" on pages 12 and 13*).

In-house counsel, who frequently advise both management and the

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board of their companies, can play an active part in encouraging companies to adopt effective governance standards. They are often called on to address legal issues related to the governance of the corporation, for example:

- Companies seeking to exchange equity for capital (whether issuing shares to the public or through a private placement) need guidance on governance mechanisms favoured by the investing community (as well as advice on relationships with shareholders). Given differences in national legal systems and stock exchange listing requirements, this need is more acute where cross-border listings (and the expectations of foreign investors) are involved.
- Lawyers advising on mergers and acquisitions and joint ventures need a solid understanding of governance issues (as well as of the relevant laws, regulations, listing rules, norms of best practice and local governance cultures), as the parties contemplate the governance structure of the emerging entity. Again, these issues are more complex in cross-border transactions.
- Even on a national level, counsel need to understand governance responsibilities and best practice recommendations and how they impact on the potential liability of directors and officers. This is the case both in countries where director and officer duties are heavily regulated, and in countries such as the US that rely heavily on private litigation to ensure corporate compliance with the law.
- In-house counsel can provide significant value when they advise companies and their subsidiaries on the implications of following, or departing from, recommended best practices. They are also likely to be involved in drafting the specific guidelines to be adopted by the company, and otherwise ensuring that the existing governance documents are in good shape.

To achieve these aims, particularly in a multi-jurisdictional context, in-house counsel must have a clear understanding of the technical legal rules that apply, as well as a solid grounding in governance best practice and the context in which the current focus on governance arises. Specifically, in-house counsel should understand the following:

- What are the driving forces behind the heightened interest in corporate governance and how do those forces impact on the company? (*see "The Driving Forces" below*).
- What exactly is corporate governance and why is it important to the company? (*see "What Exactly Is Corporate Governance?" below*)
- What are the components of a successful approach to corporate governance for multi-jurisdictional businesses? (*see "The Multi-jurisdictional Dimension" below*)

The Driving Forces

Interest in corporate governance has exploded around the globe due to a host of factors:

- The spread of capitalism and privatisation.
- The growth of corporations.
- Deregulation and globalisation.
- Shareholder activism.
- The Asian crisis.

Capitalism And Privatisation

Market-based economic systems (dominated by voluntary private sector activity) have replaced command and control-based economic systems in the vast majority of nations. This is most apparent in the countries that have emerged from the former Soviet block, but it is also happening (although less dramatically) in China and elsewhere. In a related development, governments all over the world are relinquishing to the private sector their ownership interests in firms.

Corporate Growth

Private sector activity organised through the corporate form played an ever-increasing role in national economies throughout the whole of the 20th century. Corporations have proved to be most efficient organisers of economic activity. This efficiency has led to the growth of large multinational companies, some of which are perceived to have a global reach and economic and political power

The McKinsey Survey

In a 1996 McKinsey survey of US investors, two-thirds of those surveyed reported that they would pay more for a "well-governed" company (a company responsive to investors, with an independent board), all other factors being equal (*Robert F. Felton et al., "Putting a Value on Board Governance," 4 McKinsey Quarterly 170, 170-71, 174 (1996)*).

In June 2000, McKinsey replicated this survey in Asia, Europe and Latin America, and the same results hold. Over 200 institutional investors in the US, Europe, Asia and Latin America (representing US $3.25 trillion (EUR3.5 trillion) in assets) were involved in the survey (*McKinsey Investor Opinion Survey, June 2000*).

The size of the premium investors are willing to pay varies by country. It is lowest in the US and the UK, higher in Asia (Indonesia, South Korea and Japan) and highest in Latin America (Venezuela and Colombia) (*see boxes "Paying For Good Governance" and "Premiums Investors Would Pay" on pages 4 and 5*) .

This suggests that the quality of corporate governance at the company level is perceived as most valuable in situations where both:

- Mandated disclosure and legal protection for shareholders are weaker.
- Investors believe there is the most room for improvement.

See www.mckinsey.com/features/investor_opinion/index.html that transcend the reach and power of governments.

Deregulation And Globalisation

New communication and distribution technologies, and the removal of trade and investment barriers, have created truly global markets with global competition for goods, services and capital, and even corporate control (as shown by the recent boom in cross-border mergers and acquisitions). A whole new level of economic interdependence is emerging, as evidenced by the EU and the North American Free Trade Agreement (NAFTA). Deeper and broader cross-border business relationships between nations signal significant changes to all aspects of society, from culture to labour markets and political focus.

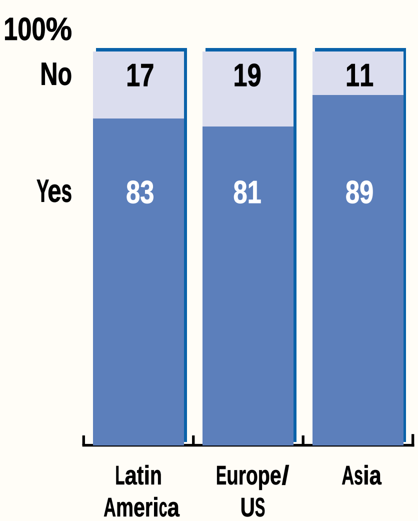
Shareholder Activism

Equity financing, which has long been important in the US and UK, is becoming a more important source of investment capital in many European and Asian nations. At the same time, capital available for equity investment in corporations has become concentrated in the hands of sophisticated financial intermediaries such as pension funds and mutual funds. This trend was first apparent in the US and the UK, but is spreading with the rise of private investment vehicles around the globe.

Paying For Good Governance

Are investors willing to pay more for a company with good board governance practices?

A clear majority say yes



Source: McKinsey & Company, Investor Opinion Survey – June 2000

Some of the largest and most activist US institutional investors, such as the Teachers Insurance & Annuity Association-College Retirement Equities Fund (TIAA-CREF) and California Public Employees' Retirement System (CalPERS) regularly support governance initiatives in relation to their international shareholdings. These investors, who view themselves as corporate "owners", see a link between sound corporate governance and lowered investment risk. They exercise their rights as investors to some degree on the basis of governance quality. TIAA-CREF, a private pension fund, is the largest pension fund (public or private) in the US, with assets of more than US$300 billion (EUR324 billion) under investment. CalPERS is the largest US public pension fund, with over US$170 billion (EUR183 billion) in assets under investment.

The sheer size of assets in the control of institutional investors exerts pressure on corporations to conform to shareholders' expectations on governance (*see box "The Anglo-American Influence" on page 6*). For example, a group of shareholders in Vodafone Airtouch recently objected to management's proposal to pay a £10 million (EUR16.24 million; US$15 million) bonus (half in cash and half in shares) to its chief executive, Chris Gent, for achieving the acquisition of Mannesmann, the first successful unsolicited offer for a German company (*see www.lawdepartment.net/global "A charm offensive", EC, 2000, V(5), 35*). They were led by the UK National Association of Pension Funds, whose members are reported to have more than £800 billion (EUR1,300 billion; US$1,200 billion) of assets. In an attempt to appease objecting investors, Chris Gent promised to spend half of his bonus on Vodafone's shares.

The Asian Crisis "Wake-up"

The financial crisis that began in East Asia, and rapidly spread to Russia, Brazil and other areas of the globe, showed that systematic failure of investor protection mechanisms, combined with weak capital market regulation, in systems that rely heavily on "crony capitalism," can lead to failures of confidence that spread from individual firms to entire countries. Insufficient financial disclosure and capital market regulation, lack of minority shareholder protection, and failure of board and controlling shareholder accountability all supported lending and investing practices based on relationships rather than on a prudent analysis of risk and reward (*see Ira M. Millstein, "The Basics of a Stable Global Economy," The Journal of Commerce (30th November, 1998)*).

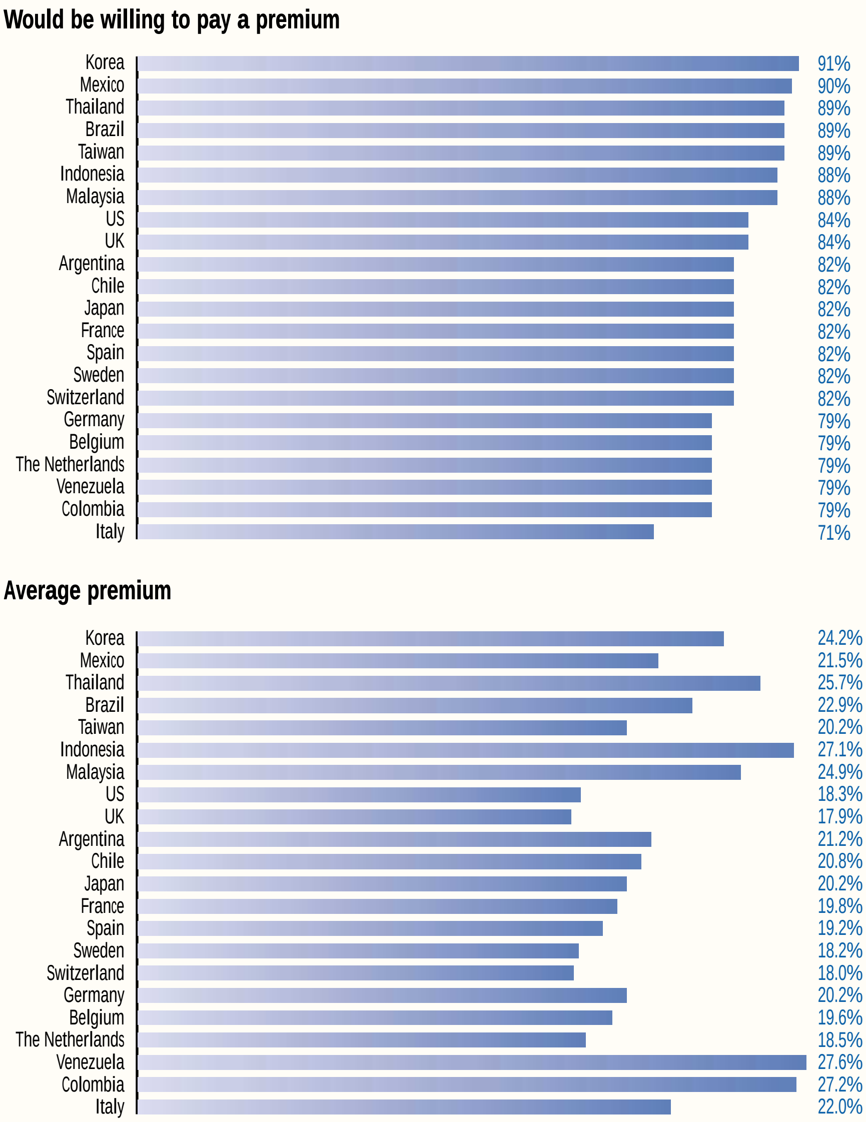
In hindsight, the not-surprising result was that companies over-invested in non-productive and often speculative activities. When capital fled these economies in 1997 and 1998, the G7, the World Bank and other multilateral agencies recognised that the efforts to strengthen the global financial architecture needed to include governance reform.

What Exactly Is Corporate Governance?

Economic theory holds that when a sole proprietor manages a firm, profits and value will tend to be maximised because they are directly linked to the owner-manager's self interest (the value of the owner-manager's investment and income). But when firm ownership is separated from control, the manager's self interest may lead to the misuse of corporate assets, for example through the pursuit of overly risky or imprudent projects. Corporate financiers (whether they are individuals or pension funds,

Premiums Investors Would Pay

Investors' willingness to pay a premium for a well-governed company by country.



Source: McKinsey & Company, Investor Opinion Survey – June 2000

mutual funds, banks and other financial institutions, or even governments) need assurances that their investments will be protected from misappropriation and used as intended for the agreed corporate objective. These assurances are at the heart of what effective corporate governance is all about (*see box "The Views Of Leading Voices" on page 13*).

Narrowly defined, corporate governance concerns the relationships between corporate managers, directors and the providers of equity capital. It can also encompass the relationship of the corporation to stakeholders and society. More broadly defined, corporate governance can encompass the combination of laws, regulations, listing rules and voluntary private sector practices that enable the corporation to:

- Attract capital.
- Perform efficiently.
- Achieve the corporate objective.
- Meet both legal obligations and general societal expectations.

All these factors underscore the reality that corporate managers, directors and investors (as well as those advising them, such as lawyers and accountants) function within a larger business and legal environment that shapes behaviour (*see box "The Corporate Governance Environment" on page 6*).

National differences exist as to what constitutes the *raison d'être* of companies (the corporate objective), and the answer to the question "For whom is the corporation governed?" will vary from country to country (*see "National Differences" below*). But whatever view prevails, effective governance ensures that boards and managers are held accountable for pursing the corporate objective, however that objective is defined (*see "The Importance Of Corporate Governance" below*).

National Differences

Different governance systems articulate the corporate objective in different ways, depending on which of two primary concerns is taken as the main focus:

- Societal expectations.
- Ownership rights.

Some nations focus on the need to satisfy societal expectations and, in particular, the interests of employees and other stakeholders (variously defined to include suppliers, creditors, tax authorities and the communities in which corporations operate). This view predominates in continental Europe (particularly Germany, France and The Netherlands) and in certain countries in Asia.

Other countries emphasise the primacy of ownership and property rights, and focus the corporate objective on returning a profit to shareholders over the long term. Under this view, employees, suppliers and other creditors have contractual claims on the company. As owners with property rights, shareholders have a claim to whatever is left after all contractual claimants have been paid. This "residual" right is given weight by companies focusing the corporate objective on shareholder value. Associated with the US, Canada, the UK and Australia, this view of the corporate governance objective is generally justified on the following grounds:

- Accountability to shareholders provides a single measurable objective that avoids the risk of diffusing the accountability of managers and directors. If managers and directors are accountable to a whole range of stakeholders, almost any action can be justified as in the interest of some group of stakeholders, and this gives managers and directors unfettered discretion.
- Focusing on long-term shareholder value encourages investment capital to be put to the most efficient economic used from a market perspective and this should benefit society broadly.

In advising clients on how to reconcile the two approaches, in-house counsel should bear in mind that, although much ideological debate has arisen about which of the two descriptions of the corporate objective should prevail, as a practical matter the two concepts do not present inherent conflicts (except when posed in the extreme). Generally, viewed in the long term, stakeholder and shareholder interests are not mutually exclusive. Corporations do not succeed by consistently neglecting the expectations of employees, customers, suppliers, creditors, and local communities, but neither do corporations attract necessary capital from equity markets if they fail to meet shareholders' expectations of a competitive return.

In the extreme situations in which the short-term interests of various stakeholders collide, a clear understanding of who legal duties are owed to assists boards and managers to take necessary, timely, but difficult actions.

The Corporate Governance Environment

The corporate governance environment is shaped by stock exchange listing rules and a host of laws and regulations concerning:

- Disclosure requirements and accounting standards.
- The issue and sale of securities.
- Company formation.
- Shareholder rights and proxy voting.
- Mergers and acquisitions.
- Fiduciary duties of directors, officers and controlling shareholders.
- Contract enforcement.
- Bankruptcy and creditors' rights.
- Labour relations.
- Financial sector practices.
- Tax and pension policy.

The corporate governance environment is also defined by:

- The quality and availability of judicial and regulatory enforcement of these laws and regulations.
- A general understanding of corporate citizenship.
- Societal expectations about the corporate objective.
- Competition in product, service and capital markets, as well as in the markets for management, labour and corporate control.

The Importance Of Corporate Governance

No matter what view of the corporate objective is taken, effective governance ensures that boards and managers are accountable for pursuing it. The role of corporate governance in making sure that board and management are accountable is of broad importance to society for a number of reasons. Effective corporate governance:

- Promotes the efficient use of resources both within the company and the larger economy. Debt and equity capital should flow to those corporations capable of investing it in the most efficient manner for the production of goods and services most in demand, and with the highest rate of return. In this regard, effective governance should help protect and grow scarce resources, therefore helping to ensure that societal needs are met. In addition, effective governance should make it more likely that managers who do not put scarce resources to efficient use, or who are incompetent or (at the extreme) corrupt, are replaced.
- Assists companies (and econo-

The Anglo-American Influence

The financial power of US and UK institutional investors, and their growing interest in foreign equity, is apparent from a recent study by the Conference Board (a not-for-profit business research organisation) (Institutional Investment Report: International Patterns of Institutional Investment (2000)) (www.conference-board.org)

According to the study:

- Institutional investors hold US$24 trillion (EUR26 trillion) in financial assets in the world's top five markets.
- Well over two-thirds (76%) of these assets are held by US and UK investors.
- The 25 largest US pension funds (who tend to be the more activist investors in the US market) account for two-thirds of all foreign equity investment by US investors.
- The percentage of foreign equity held in the individual portfolios of these top 25 US pension funds is rising (from an average of 8% of the portfolio in 1993 to a current average of 18% of the individual portfolio).

mies) in attracting lower-cost investment capital by improving both domestic and international investor confidence that assets will be used as agreed (whether that investment is in the form of debt or equity). Although managers need to have latitude for discretionary action if they are to innovate and drive the corporation to compete successfully, rules and procedures are needed to protect capital providers, including:

- independent monitoring of management;
- transparency as to corporate performance, ownership and control;
- participation in certain fundamental decisions by shareholders.

• Assists in making sure that the company is in compliance with the laws, regulations and expectations of society. Effective governance involves the board of directors ensuring legal compliance and making judgments about activities that, while technically lawful in the countries in which the company operates, may raise political, social or public relations concerns.

• Provides managers with oversight of their use of corporate assets. Corporate governance may not guarantee improved corporate performance at the individual company level, as there are too many other factors that impact on performance. But it should make it more likely for the company to respond rapidly to changes in business environment, crisis and the inevitable periods of decline. It should help guard against managerial complacency and keep managers focused on improving firm performance, making sure that they are replaced when they fail to do so.

• Is closely related to efforts to reduce corruption in business dealings. Although it may not prevent corruption, effective governance should make it more difficult for corrupt practices to develop and take root, and more likely that corrupt practices are discovered early

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Global Developments In Corporate Governance

The following are examples of recent corporate governance developments across the globe.

Brazil

The eighth largest economy in the world is facing reforms of the legal and regulatory framework designed to help Brazilian companies tap into global capital. In particular, legislation to reform the Corporation Law would strengthen protection for minority shareholders and reduce reliance on non-voting preferred shares. It is expected to be passed in some form by early autumn 2000.

Internal private sector pressure for reform is expected to increase with the creation of three investment funds focused on corporate governance activism under the management of established fund managers (Dynamo, Fator/Sinergia and Bradesco-Templeton).

EU

The adoption of a common European currency, the freer flow of capital, goods, services and people across EU borders, and increased merger activity among large European companies (and Europe's largest stock exchanges) have all created tremendous interest among European issuers and investors, member states and the Commission in:

- The shared aims, as well as the differences, in corporate governance practice across Europe (reflected in corporate governance codes).
- Any related barriers to the development of a single EU financial market.

Numerous corporate governance codes have been adopted by different groups in many of the 15 member states, and other entities (such as the OECD, EASD and ICGN) have also adopted codes that may relate to practice in member states. Prominent codes include the following:

- Belgium (Cardon Report).
- France (Vienot I and II; Lévy-Lang Report).
- Germany (German Panel Report).
- Greece (Capital Market Commission Report).
- Ireland (IAIM Guidelines).
- Italy (Draghi Report).
- The Netherlands (Peters Code).
- Portugal (CMVM Recommendations).
- Spain (Report of the Special Committee).
- The UK (Cadbury Report, Hampel Report, Greenbury Report, Combined Code).

France

A new report issued in 1999 by the French business association, Medef (the second Vienot Report), recommends that boards of public companies that have a single-tier board structure should be allowed to separate the post of *président du conseil d'administration* into separate chairman and CEO positions (*the report is available at www.medef.fr*). It also calls for expanded disclosure to shareholders as to:

- Executive remuneration policy.
- Stock options schemes.
- The total amount of directors' remuneration.
- Individual directors' remuneration for attendance at board meetings.

Another French business association (Afep) also has recommended that listed companies voluntarily disclose the compensation of directors.

A legislative initiative currently under way would expand these recommendations and take them forward. On 15th March, 2000, the Council of Ministers adopted draft legislation that would enable both listed and unlisted companies to separate the roles of chairman and CEO. The draft would also require

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listed companies to publish the remuneration of the 10 most high paid corporate officers. This legislative initiative faces significant opposition from the business community.

Germany

A package of tax reform measures pushed through parliament on 14th July, 2000 by Chancellor Gerhard Schröder will eliminate by 2002 the current 50% capital gains tax imposed on corporate sales of shares in other companies (*see www.lawdepartment.net/global "Business tax reform 2001", EC, 2000, V(4), 58*). This will:

- Encourage the unwinding of cross-shareholdings among German companies.
- Open German companies to a wider shareholder base, which could lead to an increase in merger and acquisition activity as well as an increase in shareholder activism.

In December 1999, Deutsche Bank's mutual fund:

- Supported the ranking of German companies on the quality of disclosure, board governance and shareholder rights.
- Released a study that finds a positive correlation between the size of foreign ownership and the quality of governance.

In January 2000, a panel of governance scholars, shareholder activists and corporate executives issued a set of corporate governance guidelines referring to the OECD Principles and encouraging companies to be more transparent on governance and compensation.

Italy

In the past decade, Italy has undertaken significant reforms to securities laws and market regulations. In addition, a number of state-owned enterprises (including the Italian Stock Exchange (Borsa Italiana SpA)) were privatised to reduce budget deficits and meet European Monetary Union requirements.

In 1998, the legislature approved a Decree based on the work of the Draghi Commission, with provisions designed to:

- Discourage cross-ownership among companies listed on the exchange.
- Permit shareholder agreements.
- Simplify rules for tender offers.
- Strengthen shareholder rights by enabling minority shareholders to call a shareholders' meeting.
- Enable shareholders to bring claims on behalf of the company.
- Enable shareholders to appoint a member of the board of statutory auditors.

In July 1999, the Borsa Italiana SpA issued a set of non-mandatory governance guidelines for listed companies.

Japan

Over the past two years, corporate governance changes have become visible in Japan:

- In July 1999, 37 companies joined with Sumitomo Bank and Nissan when they sought shareholder approval to reduce the size of their boards from 20-40 directors to about 10. These companies were following the examples set by Sony in 1997, when it became the first Japanese company to reduce the size of its board.
- In January 2000, Japan saw its first home-grown hostile takeover bid for a public company. Ultimately, Yoshiaki Murakami failed in his bid to gain control of Shoei, an under-performing property developer, with nearly 66 billion yen (US$609,249,515; EUR673,708,114) in reserve.
- In April 2000, the Japanese government began a two-year programme to revamp and modernise corporate governance statutes. The main targets of reform are laws affecting disclosure, the structure and duties of boards, and shareholder rights.
- More companies are nominating outsiders to their boards. Within the past year, Softbank and Orix have nominated non-executive outsiders.
- In June 2000, at their AGM, Sumitomo Bank revealed the compensation packages of their executives. This candour came in response to a dissident resolution filed by a group of individual investors, and marks the first time that a financial institution in Japan has revealed information of this nature.

Korea

Korea's Commercial Code has been amended three times in the past five years (in 1995, 1998, and 1999). Reforms include the following:

- A heightened fiduciary duty has been imposed on directors. In addition, directors must report any information that may damage the company to the company's statutory auditor.
- The minimum holding requirements for shareholders have been lowered with respect to any of the following:

  - gaining injunctive relief against directors who have acted in contravention of the articles of incorporation;
  - bringing a shareholder derivative action on behalf of the company;
  - convening a special shareholders meeting;
  - compelling the production of financial records.

- If provided for in the articles of incorporation, shareholders may vote in writing without having to attend a shareholders meeting.
- Shareholders may request cumulative voting for the purpose of electing directors, and companies must respect this unless the articles of incorporation explicitly forbid it.

In spring 2000, a shareholder-activist group, PSPD, pressed for and achieved board changes at Dacom, a large telecoms concern. The reforms included measures to ensure that the chairman of the board is a non-executive and at least half of the board is independent. A fully independent audit committee will monitor related party transactions to ensure they are done at arm's length.

The Netherlands

For a European jurisdiction often chosen by multinational companies as a location in which to establish their holding companies, there have been remarkably few developments in the sphere of corporate governance.

In 1997 the Peters Committee on Corporate Governance, established by the Association of Securities Issuing Companies and the Amsterdam Stock Exchange Association, issued a code of best practice recommendations for effective corporate governance. Compliance with the Peters Code is wholly voluntary (it is not mandated by statute or encouraged through mandatory disclosure).

After a survey of companies concluded that many of the Peters Code recommendations were not being followed, the ministers of economic affairs, social affairs and labour and justice announced in May 1999 a regulatory initiative aimed at reforming certain governance practices relating to transparency and accountability. The reform effort, however, appears to have stalled.

Russia

Russia has had to mould a free market system from the ground up, and much of the efforts to date have focused on putting into place a basic framework of laws and regulatory capacity. Unfortunately, the broad perception is that protection of minority shareholder rights continue to lag, although, in 1999, a Federal Law on the Protection of Rights and Legitimate Interests of Investors in the Securities Market was enacted. Foreign investors have attempted to press their rights, with little success to date, although there have been rumours that Putin has intervened on foreign investors' behalf several times.

In late June 2000, the Putin government set out its economic programme, with some governance-related initiatives. The "Gref plan" includes proposals to:

- Improve the protection of property rights.
- Clamp down on interested party transactions.
- Improve disclosure.

In an attempt to improve the credibility of Russian companies and their securities, State Street Bank and George Soros have helped to launch the Vasiliev Institute for Corporate Governance. The Institute intends to increase the information available to foreign investors by rating Russian listed companies based on the effectiveness of their corporate governance. In addition, the Institute will lobby for more stringent investor protection.

UK

The broad view of company law initiated by the Department of Trade and Industry has resulted in a consultative paper (published in March 2000 by the Company Law Review Steering Group) proposing key governance reforms. Although there has been much debate on whether or not a more stakeholder-focused model would be beneficial, the steering group has recommended that a "shareholder-oriented, but inclusively framed, duty of loyalty" is most likely to lead to "optimal conditions for companies to contribute to the overall health and competitiveness of the economy."

The steering group considered and rejected the adoption of the two-tier board structure common in many EU countries, but recommends:

- Implementing direct legislation or rules to create clear monitoring obligations for non-executive directors.
- Requiring an increase in the proportion of non-executive directors on boards.
- Changing the non-executive directors' appointment method to minimise the role which executive directors play in appointing non-executive directors.
- Tightening the definition of director independence.
- Strengthening the independence of the chairman.

In June 2000 the National Association of Pension Funds (NAPF) (*see main text "Shareholder Activism"*) published an extensive set of corporate governance standards to serve as proxy voting guides for member funds. The NAPF's standards follow the Combined Code, but push for stronger requirements in some areas, by recommending:

- Separation of the positions of chairman of the board and CEO.
- A ten-part test to determine board member independence.
- Avoiding re-pricing share options in situations of underperformance.
- An annual shareholder vote on the report of each company's remuneration committee.

US

In 1998, SEC concerns about corporate financial reporting led the New York Stock Exchange and National Association of Securities Dealers to convene a private sector Blue Ribbon Committee to recommend ways to improve audit committee oversight of financial reporting. The Committee's Report, issued in February 1999, focused on:

- Strengthening the independence and qualifications of audit committee members.
- Improving audit committee effectiveness.
- Improving the mechanisms for discussion and accountability among the audit committee, the outside directors and management.

After a period of public comment, the SEC approved related amendments to listing rules and SEC disclosure requirements, adopting the key recommendations of the Committee. Both the NASD and the NYSE now require listed

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and eliminated. Effective governance is a check on the power of the relatively few individuals within the corporation who control large amounts of other people's money (*see www.lawdepartment.net/global "Steering clear of bribery", EC, 2000, V(4), 37*).

The Multi-jurisdictional Dimension

Corporate governance practices vary across nations and individual companies. This variety reflects not only distinct societal values, but also different ownership structures, business circumstances and competitive conditions. It also reflects differences in the strength and enforceability of contracts, the political standing of shareholders and debt-holders, and the development, and enforcement capacity, of legal systems.

In developed countries, the discussion on how to improve corporate governance tends to assume that the following are in place:

- Well-developed and well-regulated securities markets.
- Laws that recognise shareholders as the legitimate owners of the corporation and require the equitable treatment of minority and foreign shareholders.
- Enforcement mechanisms through which these shareholder rights can be protected.
- Securities, corporate and bankruptcy laws that enable corporations to transform (to merge, acquire, divest and downsize) and even to fail.
- Anti-corruption laws to prevent bribery and protection against

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Global Developments In Corporate Governance

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companies to have wholly independent audit committees with at least three members, each of whom are financially literate. At least one member must have accounting or related financial sophistication or expertise.

SEC registered companies must include an audit committee report in the annual proxy statement stating whether the committee has:

- Reviewed and discussed the audited financial statements with management.
- Recommended to the board that the audited financial statements be included in the company's annual report.
- Discussed certain matters with the independent auditors, including the auditors' independence and the auditors' views on the quality of the company's financial reporting.

The audit committee charter must be included as an appendix to the company's proxy statements at least once every three years. Also, the proxy statement must disclose whether the audit committee members meet the independence standards provided in the applicable listing standard.

In the past two years, institutional investors have focused their activism on the "dead hand" poison pill, an anti-takeover mechanism that is illegal in Delaware but still used by companies incorporated in other jurisdictions. Dead hand poison pills provide that only directors who are in office for a specified period of time before a proxy fight may redeem or amend shareholder rights plans. Investors argue that dead hand pills serve only to entrench management. In the most recent proxy season, TIAA-CREF, the world's largest pension system, submitted resolutions to 17 companies asking them to remove the dead hand provision from the poison pills they use. Of these 17 companies, 15 complied with TIAA-CREF's request, which led the pension system to withdraw its resolutions.

Institutional investors are also targeting stock option schemes, out of concern for potential dilutive effect. Investors are particularly concerned about option repricing in situations where the company's stock price has decreased. Stock options are generally intended to be a form of incentive-based pay. Lowering strike prices when stock performance declines appears to reward executives for doing a poor job. This issue has received considerable attention with respect to high tech and e-commerce companies. For example, Microsoft has asserted that it must reprice options to keep its top employees from seeking more lucrative option packages elsewhere.

World Bank/OECD

Recognising that governance reform requires a combination of regulation and private sector initiative for implementation, the World Bank and OECD have joined together to sponsor a Private Sector Advisory Group on Corporate Governance and a Global Corporate Governance Forum, in addition to their separate activities related to governance reform. A Charter and World Programme for the Forum was formally approved by both the World Bank and OECD in June 2000.

The goal is to:

- Create a public-private partnership to raise awareness of the value of corporate governance improvement.
- Involve the private sector in the implementation of corporate governance reform in emerging market nations.

The Private Sector Advisory Group, comprised of prominent business leaders from around the world, has established an Audit/Accounting Task Force and an Investor Responsibility Task Force, and has been involved in a series of events in Brazil to raise the awareness of the local private sector of the need for reforms. A similar effort is planned for Russia this autumn.

The OECD Principles

The OECD Principles:

- Reflect the broad consensus reached by the 29 OECD member nations with regard to fundamental issues of corporate governance.
- Represent the first inter-governmental accord on the common elements of effective corporate governance.
- Provide significant room to take into account national differences, including differing legal and market frameworks, traditions and cultures.

The OECD Principles build on the four core standards set out in the Millstein Report (*see main text "The OECD Principles"*): fairness, transparency, accountability and responsibility.

Fairness. The OECD Principles expand on the concept of fairness with two separate principles:

- *The Corporate governance framework should protect shareholders' rights (OECD Principle I).*
- *The Corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights (OECD Principle II).*

Principle I recognises that shareholders are property owners, and as owners of a legally recognised and divisible share of a company, they have the right to hold or convey their interest in the company. Effective corporate governance depends on laws, procedures and common practices that protect this property right and ensure secure methods of ownership, registration and free transferability of shares. The Principle also recognises that shareholders have certain participatory rights on key corporate decisions, such as the election of directors and the approval of major mergers or acquisitions. Governance issues relevant to these participatory rights concern voting procedures in the selection of directors, use of proxies for voting, and shareholders' ability to make proposals at shareholders meeting and to call extraordinary shareholders meetings.

According to Principle II, the legal framework should include laws that protect the rights of minority shareholders against misappropriation of assets or self-dealing by controlling shareholders, managers or directors. Examples include:

- Rules that regulate transactions by corporate insiders and impose fiduciary obligations on directors, managers and controlling shareholders.
- Mechanisms to enforce those rules (for example, the ability of shareholders to bring a claim on behalf of the company in certain circumstances).

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

This Principle recognises that investors and shareholders need information about the performance of the company (its financial and operating results), as well as information about corporate objectives and material foreseeable risk factors to monitor their investment. Financial information prepared in accordance with high-quality standards of accounting and auditing should be subject to an annual audit by an independent auditor. This provides an important check on the quality of accounting and reporting.

In practice, accounting standards continue to vary widely around the world. Internationally prescribed accounting standards that promote uniform disclosure would enable comparability, and assist investors and analysts in comparing corporate performance and making decisions based on the relative merits.

Information about the company's governance, such as share ownership and voting rights, the identity of board members and key executives, and executive compensation, is also important to potential investors and shareholders and a critical component of transparency.

Accountability. *The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders (OECD Principle V).*

This Principle implies a legal duty on the part of directors to the company and its shareholders. As elected representatives of the shareholders, directors are generally held to be in a fiduciary relationship to shareholders and to the company, and have duties of loyalty and care which require that they avoid self-interest in their decisions and act diligently and on a fully-informed basis. Generally, each director is a fiduciary for the entire body of shareholders and does not report to a particular constituency. As the board is charged with monitoring the professional managers to whom the discretionary operational role has been delegated, it must be sufficiently distinct from management to be capable of objectively evaluating them.

Responsibility. *The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises (OECD Principle III).*

This Principle recognises that corporations must abide by the laws and regulations of the countries in which they operate, but that every country must decide for itself the values it wishes to express in law and the corporate citizenship requirements it wishes to impose. As with good citizenship generally, however, law and regulation impose only minimal expectations as to conduct. Outside of the law and regulations, corporations should be encouraged to act responsibly and ethically, with special consideration of the interests of stakeholders and, in particular, employees.

The principles are available in full text at www.oecd.org/daf/governance/principles.htm.

continued from page 10

fraud on investors.

- Sophisticated courts and regulators.
- An experienced accounting and auditing sector.
- Significant corporate disclosure requirements.

In addition, developed countries are also more likely to have well-developed private sector institutions, such as:

- Organisations of institutional investors.
- Professional associations of directors, corporate secretaries and managers.
- Rating agencies, security analysts and a sophisticated financial press.

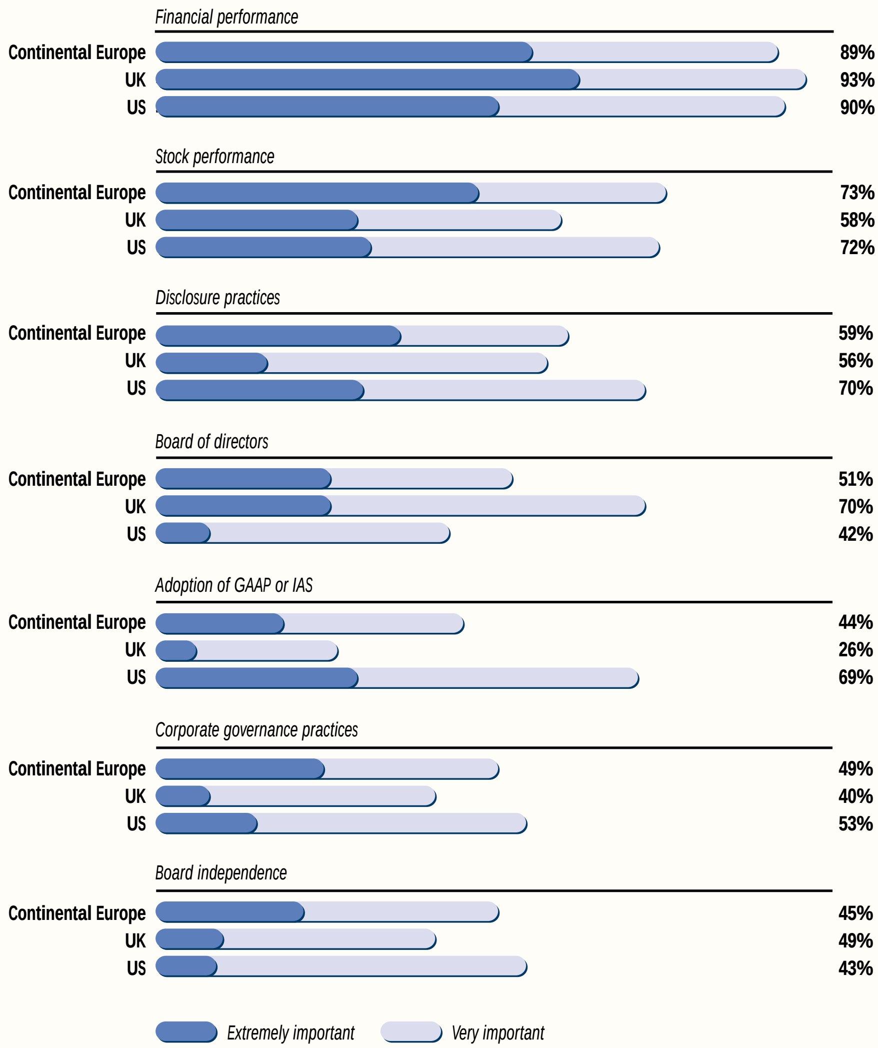
Conversely, many developing and emerging market nations have not yet fully developed the legal and regulatory systems, enforcement capacities and private sector institutions required to support effective corporate governance. Therefore, corporate governance reform efforts in these countries tend to focus on the fundamental framework. Reform needs vary, but often include:

- Stock exchange development.
- The creation of systems for registering share ownership.
- The enactment of laws for basic minority shareholder protection from potential self-dealing by corporate insiders and controlling shareholders.
- The education and empowerment of a financial press.
- The improvement of audit and accounting standards.
- A change in culture and laws against bribery and corruption as accepted ways of doing business.

In addition to differences in the development of legal and regulatory systems and private institutional capacity, nations differ widely in the cultural values that mould the development of their financial infrastruc-

Importance Of Factors Influencing Investment Decisions

(Ranked according to aggregate response)



The percentages reflect the proportion of the total number of institutional investors surveyed who indicated that each of these factors was important to them.

Rank	Continental Europe	UK	US
1	Financial performance	Financial performance	Financial performance
2	Stock performance	Quality of board of directors	Stock performance
3	Disclosure practices	Stock performance	Disclosure practices
4	Quality of board of directors	Disclosure practices	Adoption of accounting standards/principles
5	Quality of corporate governance	Board independence	Quality of corporate governance
6	Board independence	Quality of corporate governance	Board independence
7	Adoption of accounting standards/principles	Adoption of accounting standards/principles	Quality of board of directors

Source: McKinsey & Company, Investor Opinion Survey – June 2000

The Views Of Leading Voices

On The Importance Of Corporate Governance:

"The governance of the corporation is now as important in the world economy as the government of countries."

James D. Wolfensohn, "A Battle for Corporate Honesty," The Economist: The World in 1999, page 38.

On The Role Of Government In Corporate Governance:

"Like a powerful river, the market economy is widening and breaking down barriers. Governments' role is to accommodate – not block the flow – and yet keep it sufficiently under control so that it doesn't overflow its banks and drown us with undesirable side effects."

Ira M. Millstein, Honorary Chairman's Opening Remarks, ICGN Annual Meeting (13th July, 2000).

On The Economic Theory Of Governance:

"[B]eing managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partner frequently watch over their own... Negligence and profusion, therefore, must always prevail more or less in the management of the affairs of [a joint stock] company""

Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 264-65 (Edwin Cannan, Ed., University of Chicago Press 1976) (1776).

ture and corporate governance. In practice, international agreement on a single model of corporate governance or a single set of detailed governance rules is both unlikely and unnecessary. Even among fairly similar systems, like the US and the UK, fundamental distinctions remain that are unlikely to be resolved. One of the most obvious distinctions, for example, is how business managers are kept in check. In the UK (like other European nations), regulation plays an important part in the process. In the US (uniquely), regulation focuses primarily on disclosure obligations and significant reliance is placed on shareholder derivative litigation (claims brought on behalf of the company) and class actions as enforcement mechanisms.

However, the reality of the demands of global capital markets has led to some international consensus on the basics of effective corporate governance.

The OECD Principles

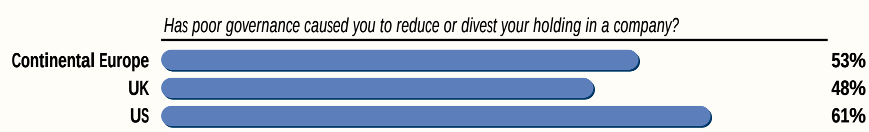
In April 1998, an influential report (known as the Millstein Report) prepared by the Business Sector Advisory Group on Corporate Governance (chaired by Ira M. Millstein) detailed the common principles of corporate governance from a private sector viewpoint (*Business Sector Advisory Group, Report to the OECD on Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets dated 20th April, 1998. Copies of the report can be requested from www.oecd.org*).

The Millstein Report focused on "what is necessary by way of governance to attract capital." According to the Millstein Report, government intervention in the area of corporate governance is likely to be most effective in attracting capital if it focuses on four core standards:

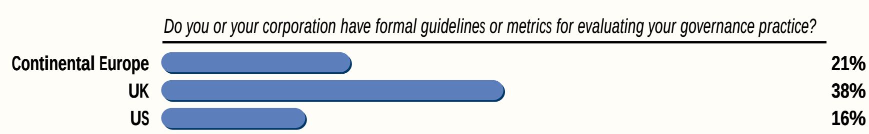
- Fairness, achieved by ensuring both:
  - the protection of shareholder rights (including the rights of minority and foreign shareholders);
  - the enforceability of contracts with resource providers.
- Transparency, accomplished by requiring timely disclosure of adequate, clear and comparable information concerning corporate financial performance, corporate governance and corporate ownership.
- Accountability, involving the clarification of governance roles and responsibilities, and supporting

Evaluating Corporate Governance

(Percent saying yes)



The Russell Reynolds survey points out that despite the importance investors place on corporate governance practices in their investment decision making (and the positive reception they give to companies whose boards adopt corporate governance guidelines), few say their organisations use formal guidelines to help them evaluate the corporate governance practices of the companies in which they invest.



Source: Russell Reynolds Associates, Corporate Governance in the New Economy – 2000 International Survey of Institutional Investors voluntary efforts to make sure that managerial and shareholder interests are aligned (and monitored by the board of directors).

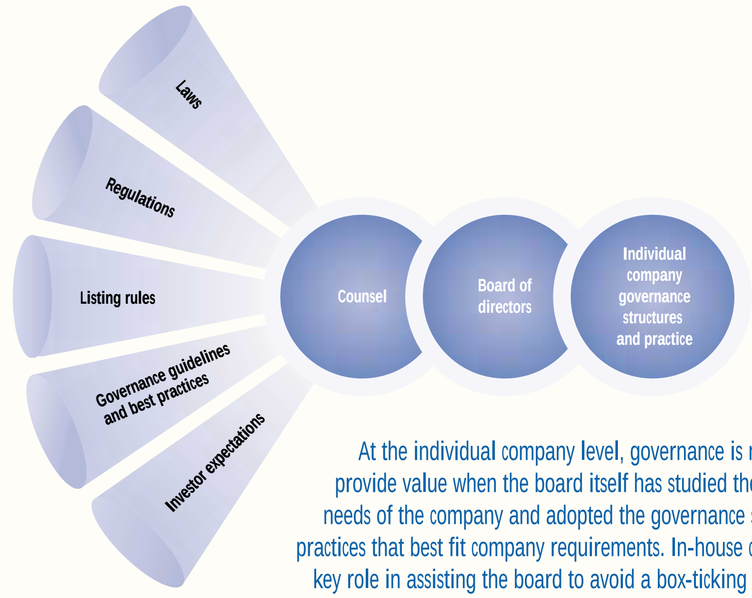
- Responsibility, achieved by ensuring corporate compliance with the other laws and regulations that reflect the respective society's values.

Underlying the Millstein Report is the notion that corporate governance depends on the private sector for implementation. While government provides the structure for governance, corporate governance happens inside the corporation, and depends on investors, the board and management.

When the Business Sector Advisory Group issued its Report to OECD Ministers at the height of the Asian crisis, it recommended that the OECD promote and further articulate the four core standards set out in the Millstein Report. The OECD convened an Ad-Hoc Task Force on Corporate Governance consisting of representatives from the 29 OECD member nations, interested international organisations, labour representatives and business representatives. The Task Force had direct input from non-OECD nations, as well as broader public comment through its website. In April 1999, it built on the four core standards and expanded them into five broad and non-binding principles (the OECD Principles) (*see box "The OECD Principles" on page 11*).

The ICGN (*see above*) ratified the OECD Principles shortly after they were issued and expanded on them from a more detailed investor viewpoint (*the document is available in full text at www.icgn. org/ documents/globalcorpgov.htm*). In February 2000, Euroshareholders (formerly known as Groupement des Actionnaires Européens (GAE)), an organisation of shareholder associations from eight European countries, adopted a set of governance principles based on both the OECD Principles and the ICGN guidelines (*the Euroshareholders' Corporate Governance Guidelines 2000, available in full text at www.dcgn.dk*). The Euroshareholders guidelines are interesting in that diverse shareholders all agreed that the corporate objective is to maximise long-term shareholder value (notwithstanding the continental tradition of emphasising employee interests).

Governance Framework



At the individual company level, governance is most likely to provide value when the board itself has studied the governance needs of the company and adopted the governance structure and practices that best fit company requirements. In-house counsel has a key role in assisting the board to avoid a box-ticking approach, by advising it on the governance framework in which the company operates and the structures and practices that can be adopted voluntarily and adapted to address company needs.

Governance Guidelines And Codes Of Best Practice

In addition to the emergence of the OECD Principles, the past decade has seen a proliferation of corporate governance guidelines and codes of best practice prepared by a wide range of national government committees (listing bodies, associations of investors and individual companies as industry models).

In-house counsel can play a vital role in:

- Distilling the principles in these documents and advising officers and directors on the similarities and differences that may impact on important cross-border deals, such as mergers and acquisitions and joint ventures.

- Assisting boards to adapt relevant principles into individual company guidelines, suitable for the company's or group's specific operations and circumstances.

The significance of these codes, and the management of issues such as the corporate objective, board responsibilities, board composition, board committees, corporate decision making and disclosure are all explored in the second part of this article.

In-house counsel play an important role in advising both management and the board of their companies on issues related to effective governance standards, for example when:

- Advising on governance structures required by law, regulation or listing requirements.

- Advising on approaches most likely to satisfy institutional investors or otherwise meet specific company needs, including the need to attract equity investment.

- Drafting new governance guidelines or a code for use by their company or group.

- Ensuring that existing gover-

Corporate Objectives

The following are examples of how different codes of best practice or guidelines articulate the corporate objective:

- The General Motors Board of Directors represents the owners' interest in perpetuating a successful business, including optimising long-term financial returns. . . . In addition . . . the Board has responsibility to GM's customers, employees, suppliers and the communities where it operates – all of whom are essential to a successful business (*General Motors Board of Directors Corporate Governance Guidelines on Significant Corporate Governance Issues, Introduction*).
- The mission of the board of directors is to maximise shareholder value (*Brazilian Institute of Corporate Governance Code of Best Practices at 1*).
- [D]irectors should at all times be concerned solely to promote the interests of the company, . . . [which] may be understood as the overriding claim of the company considered as a separate economic agent, pursuing its own objectives which are distinct from those of shareholders, employees, creditors including the internal revenue authorities, suppliers and customers. It nonetheless represents the common interest of all these persons, which is for the company to remain in business and prosper (*Vienot Report I (France) at 5*).
- The Board of Directors represents the shareholders of the Society, and it has a duty to act in the interests of the shareholders (*Charter of a Shareholding Society (Kyrgyz Republic) 17.1*).
- There are no conceivable circumstances which can justify any relaxation of the principle that the management should be fully accountable to the providers of risk capital (T*he Peters Code (The Netherlands), Recommendation 5.1*).
- The board of directors . . . is the primary overseer of the company, monitoring management to ensure that it continually endeavors to maximise long-term corporate value for the shareholders, and is always accountable for its actions to all stakeholders, in particular the shareholders (*Japan Corporate Governance Forum Principles, Ch. 1.3*).
- [The Committee] recommend[s] establishing, as the ultimate corporate goal . . . the maximisation of corporate value or, to use an expression that has taken root in the market, the creation of shareholder value (*The Governance of Spanish Companies, II.1.3*).
- The single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders' investment (*Hampel Report (UK), Guideline 1.6*).
- Directors must act with enterprise and always strive to increase shareholders' value while having regard for the interests of all stakeholders (*King Report (South Africa) Ch. 5:27.7*).

nance documents are in good shape and reflect current practice.

Effective corporate governance is not formulaic and must be grounded on every company's unique circumstances. Nonetheless, whether in a national or multi-jurisdictional context, advising on governance requires a clear understanding of the fundamental issues:

- What are the driving forces behind the growing interest in corporate governance and how do those forces impact on the company?
- Why is the quality of corporate governance important to the company?
- What is the emerging consensus on basic principles of effective governance (for example, as expressed inn the OECD Principles)?

These issues were addressed in detail in the first part of this article (*see also www.lawdepartment.net/global GC "The globalisation of corporate governance", GC, V(7), 52*).

The past decade has seen a proliferation of corporate governance guidelines and codes of best practice designed to improve the quality of corporate governance, including, at the multinational level, the OECD Principles (*see box "Corporate Governance Guidelines And Codes Of Best Practice"*). An understanding of them, and of the broader trends they express, will assist in-house counsel in advising managers and boards to adopt governance practices that are relevant to their company's or group's needs (*see box "Governance Framework"*). This requires an understanding of the particular circumstances facing the company or group, as well as:

- The context in which the governance guidelines and codes of best practice are issued and the degree to which they apply to the company.
- The practical measures the company should consider adopting in relation to the corporate objective, board responsibilities, board composition, board committees and disclosure.

The Origin Of Governance Codes

Corporate governance guidelines and codes of best practice arise in the context of differing national frameworks of law, regulation and stock exchange listing rules, and differing societal values, and there is no single agreed system of good governance (*see box "The Corporate Governance*

Environment" in Part 1 of this article, at www.lawdepartment.net/global GC "The globalisation of corporate governance", GC, V(7), 52).

Although boards of directors constitute an important internal mechanism for holding management accountable for the use of company assets, effective corporate governance is dependent on the market for corporate control (takeover activity), securities regulation, company law, accounting, and auditing standards, bankruptcy laws, and judicial enforcement. Therefore, in order to compare one country's governance practices with another's, counsel need to understand not only the recommended best practice reflected in guidelines and codes, but also the underlying legal, enforcement and listing framework.

Types Of Code

Some governance codes are linked to listing or legally mandated disclosure requirements. Others are purely voluntary in nature, but may be designed to help forestall further government or listing body regulation. In the developing nations, governance codes are more likely to address basic principles of corporate governance that tend to be more established in developed countries through company law and securities regulation, such as:

- The equitable treatment of shareholders.
- The need for reliable and timely disclosure of information concerning corporate performance and ownership.
- The holding of annual general meetings of shareholders.

However, in both developed and developing nations, codes focus on boards of directors (whether single-tier boards or, in two-tier systems, supervisory boards) and attempt to describe ways in which boards can provide guidance and oversight to management, and accountability to shareholders and society at large.

CHECKLIST: Board Responsibilities

The commentary accompanying the OECD Principles (*see box "The OECD Principles" in Part 1 of this article, www.lawdepartment.net/global GC "The globalisation of corporate governance", GC, V(7), 52*) provides that the board should fulfil certain key functions, including:

- ✓ Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance, and overseeing major capital expenditures, acquisitions and divestitures.
- ✓ Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- ✓ Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.
- ✓ Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- ✓ Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place (in particular, systems for monitoring risk, financial control and compliance with the law).
- ✓ Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.
- ✓ Overseeing the processing disclosure and communications.

Source: OECD Principle V (Commentary D)

The modern trend of developing corporate governance guidelines and codes of best practice began in the early 1990s in the UK, the US and Canada in response to:

- Problems in the corporate performance of leading companies.
- The perceived lack of effective board oversight that contributed to those performance problems.
- Pressure for change from institutional investors.

The Cadbury Report in the UK, the General Motors Board of Directors Guidelines (the GM Guidelines) in the US, and the Dey Report in Canada have each proved influential sources for other guideline and code efforts.

Governance guidelines and codes have issued from stock exchanges, corporations, institutional investors, and associations of directors and corporate managers, as well as individuals companies (as in the case of the GM Guidelines). Compliance with these governance recommendations is generally not mandated by law, although the codes linked to stock exchanges may have a coercive effect. For example, listed companies on the London and Toronto Stock Exchanges need not follow the recommendations of, respectively, the Cadbury Report (which influenced and has been superseded by the Combined Code, but still remains highly influential around the world, and especially in Commonwealth countries (*see www.lawdepartment.net/global "Corporate governance after Turnbull: Is your company under control?", PLC, 1999, X(10), 43*) or the Dey Report, but they must disclose whether they follow the recommendations in those documents and must provide an explanation concerning divergent practices. These disclosure requirements exert a significant pressure for compliance.

In contrast, the guidelines issued by associations of directors, corporate managers and individual companies tend to be wholly voluntary. For example, the GM Board Guidelines simply reflect an individual board's efforts to improve its own governance capacity. Even wholly voluntary guidelines can have wide influence, however. In the case of the GM Guidelines in the US, institutional investors encouraged other companies to adopt similar guidelines.

In developing nations, both voluntary guidelines and more coercive codes of best practice have been issued as well. For example, both the Code of Best Practices issued by the Brazilian Institute of Corporate Directors and the Code of Corporate Governance issued by the Corporate Governance Committee of the Mexican Business Co-ordinating Counsel are wholly voluntary and provide companies with a framework they can aspire to. They are not linked to any listing requirements.

Similarly, the Confederation of Indian Industry Code and the Stock Exchange of Thailand Code are designed to build awareness within the corporate sector of governance best practice, but are not, at present, linked to stock exchange listing requirements. Conversely, Malaysia's Code on Corporate Governance, the Code of Best Practice issued by the Hong Kong Stock Exchange and South Africa's King Commission Report on Corporate Governance, are all based on some form of mandatory disclosure concerning compliance with their recommendations (and are in some cases linked to stock exchange listing requirements).

Independent Board Leadership

Many guidelines and codes seek to institute independent leadership by recommending a clear division of responsibilities between Chairman and CEO. In this way, while the CEO can have a significant presence on the board, the non-executive directors will also have a formal independent leader to look to for authority on the board.

Documents that place less emphasis on the need for a majority of independent directors seem to place more emphasis on the need for separating the role of Chairman and CEO. For example, the Indian Confederation Report expressly relates the two concepts. It recommends that if the Chairman and CEO (or managing director) are the same person, a greater percentage of non-executive directors is necessary (*Recommendation 2*). The Malaysian Report on Corporate Governance similarly emphasises that where the roles are combined, there should be a strong independent element on the board (*Best Practice AA.II*). This is in accord with the Cadbury Report (*see main text "Types Of Code"*), which states that, where the Chairman is also the CEO, it is essential that there should be a strong and independent element on the board (*Section 1.2*).

The following extracts show the different ways in which independent board leadership is defined in various codes:

- The Board should be free to make this choice any way that seems best for the Company at a given point in time. Therefore, the Board does not have a policy, one way or the other, on whether or not the role of the Chief Executive and Chairman should be separate and, if it is to be separate, whether the Chairman should be selected from the non-employee Directors or be an employee (*General Motors Board Guidelines (US), Guideline 4*).
- Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board whose authority is acknowledged. . . . The Commission recommends that there should be a clear division of responsibilities at the head of a company which will ensure a balance of power and authority (*Cardon Report (Belgium), Recommendation 1 & 1.3*).
- [C]onsidering that holding both [Chairman and CEO] positions is the most widespread practice in Spain and in surrounding countries, the Committee recognises that at present it is not proper to offer a general guideline. Nevertheless, the concern of maintaining optimal conditions for the proper fulfilment of the general function of supervision leads us to recommend that some cautionary measures be adopted whenever one individual is to hold the two positions. It is a question of creating counterweights allowing the Board of Directors to operate independently from the management team and to keep its power to control it (*The Governance of Spanish Companies, II.3.2*).
- There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. . . . A decision to combine the posts of chairman and chief executive officer in one person should be publicly justified (*The Combined Code (UK), Principle A.2 & Provision A.2.1*).

Convergence

International agreement on a single model of corporate governance or a single set of detailed governance rules is both unlikely and unnecessary. The influence of international capital markets will lead to some convergence of governance practices. This simply reflects the market reality that "[a]s regulatory barriers between national economies fall and global competition for capital increases, investment capital will follow the path to those corporations that have adopted efficient governance standards, which include acceptable accounting and disclosure standards, satisfactory investor protections and board practices designed to provide independent, accountable oversight of managers" (*Report to the OECD by the Business Sector Advisory Group on Corporate Governance*).

This convergence is evident in the growing consensus in both developed and developing nations that board structure and practice is key to providing corporate accountability (of the management to the board and the board to the shareholders) in the governance paradigm

Practical measures

Key elements of governance guidelines and codes of best practice include:

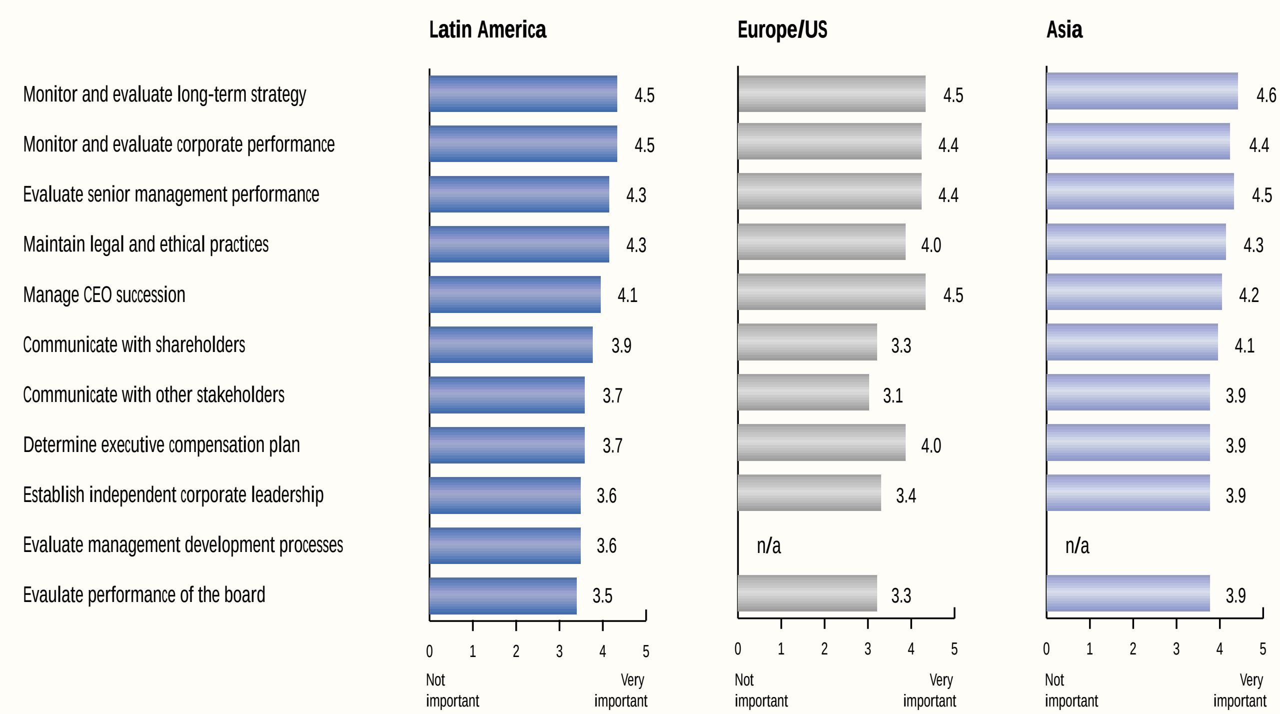
- The corporate objective.
- Board responsibilities.
- Board composition.
- Board committees.
- Disclosure issues.

In-house counsel should consider to what extent these issues should be addressed by the code or guidelines of their company. It may be that the laws and regulations of the country under whose law the company is organised and the jurisdictions in which its shares are traded already deal with some of these issues (for example the responsibilities of directors) in detail. If so, the document can focus on other aspects of corporate governance.

Also, as cross border investment increases, and investors around the globe focus on effective governance mechanisms to ensure their interests are protected, in-house counsel will be asked to advise boards and managers on how the expectations of foreign investors can best be met. Knowledge of the guidelines and best practices in the investors' own home market, and how they differ from the company's practices, can provide insights into the foreign investor's expectations and areas of concern.

Important Board Tasks

Investors agree on the important board tasks*
(average response)



* The list of board tasks was predefined. Investors were asked to rank their importance.

Source: McKinsey & Company, Investor Opinion Survey – June 2000

This will prove valuable when shareholder initiatives arise.

The Corporate Objective

Variations in societal values lead different nations to view the corporate objective or "mission" in different ways (see box "Corporate Objectives"). Expectations of how the corporation should prioritise the interests of shareholders and stakeholders such as employees, creditors and other constituents take two primary forms (*see "National Differences" in Part 1 of this article, www.lawdepartment.net/global "The globalisation of corporate governance", GC, V(7), 52*).

In the Anglo-Saxon nations (Australia, Canada, the UK and the US), where maximising the value of the owners' investment is considered the principal objective, governance guidelines and codes tend to emphasise the duty of the board to represent shareholders' interests and maximise shareholder value. Among developing nations, the Brazilian Institute of Corporate Governance Code, the Confederation of Indian Industry Code, the Kyrgyz Republic Charter of a Shareholding Society, the Malaysian Report on Corporate Governance and the Korean Stock Exchange Code of Best Practice, all expressly recognise that the board's mission is to protect and enhance the shareholders' investment in the cor-

continued on page 23

The Audit Committee

Audit committees attract special attention in guidelines and best practice codes because of the role of disclosure and legal compliance in protecting shareholder interests and promoting investor confidence. Certain countries specifically recommend the size of an audit committee. In India, the minimum size recommended is three members, as it is in Malaysia and the UK (and, through stock exchange listing rules, the US). Also, South Africa and India both emphasise the extra time requirements demanded of audit committee members and (as in the UK and US) the importance of written terms of reference for the committee. Malaysia also refers to the need for written terms of reference for audit and otter board committees.

The following are examples of how audit committees are dealt with in governance codes and guidelines:

- Special emphasis has been placed on the need for all listed company boards to establish audit committees to ensure the effective and efficient control and review of a company's administration, internal audit procedures, the preparation of financial statements and general disclosure of material information to investors and shareholders (*President's Message, Stock Exchange of Thailand Code and Guidelines, pp. iv-v*).
- [There should be] a mechanism that lends support to the Board in verifying compliance of the audit function, assuring that internal and external audits are performed with the highest objectivity possible and the financial information is useful, trustworthy and accurate. (*Mexico Code of Corporate Governance, Recommendation at 12-13*).
- [Independent directors . . . should account for at least one-third of the audit committee. . . . (*Vienot II (France) at 15*).
- The board should establish an audit committee of at least three directories, all non-executive, with written terms of reference which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent non-executive directors, should be named in the report and accounts (*The Combined Code (UK), Provision D.3.1*).

Nominating Directors

The process by which directors are nominated has gained attention in many guidelines and codes as a key element of ensuring that management does not dominate the board through that process. The following are examples of wording used:

- Boards should establish a wholly independent "nominating" . . . committee. . . . Creating an independent and inclusive process for nominating directors will ensure board accountability to shareholders and reinforce perceptions of fairness and trust between and among management and board members (*Report of the National Association of Corporate Directors Blue Ribbon Commission on Director Professionalism (US) at 3-4*).
- Unless the board is small, a nomination committee should be established to make recommendations to the board on all new board appointments (*The Combined Code (UK), A.5.1*).
- [T]he adoption of a formal procedure for appointments to the board, with a nomination committee making recommendations to the full board, should be recognised as good practice (*The Malaysian Corporate Governance Report, Explanatory Note 4*).

Corporate Governance Guidelines And Codes Of Best Practice

Numerous private sector and government-related organisations, institutional investors and stock markets have, in the past decade, become active in driving corporate governance reforms. One of their most influential efforts has been to issue guidelines (also called principles, policies, recommendations or codes or best practice). Adapted to their respective cultures and business structures, these guidelines and codes generally promote practices designed to enhance accountability to shareholders, improve board independence, and foster corporate responsibility.

The following is a partial listing of corporate governance guidelines and codes of best practice:

International

- European Association of Securities Dealers (EASD), *Corporate Governance: Principles and Recommendations* (12th April, 2000). *<www.easd.com/recommendations>*
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** Drafted from the viewpoint of the institutional investor.*

Detailed comparisons of these guidelines and codes are available from the author (at 212-310-8038). They are also available at <www.corporategov.com> in mid-October, 2000.

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poration. In other countries (for example, France, Japan and South Africa) more emphasis is placed on a broader range of stakeholders.

Overall, most governance guidelines and codes recognise that shareholder expectations need to be met to attract long-term, stable and low-cost capital. Likewise, there appears to be growing sensitivity to the need to address stakeholder interests in order to maximise shareholder value over the long term. For instance, the GM Guidelines (*see "Types Of Code" above*) provide that "the board's responsibilities to shareholders as well as customers, employees, suppliers and the communities in which the corporation operates are all founded on the successful perpetuation of the business". In other words, the General Motors board views shareholder and stakeholder interests in the success of the corporation as being compatible in the long run.

Board Responsibilities

Most governance guidelines and codes of best practice assert that the board (whether it has a single or two-tier system) assumes responsibility for the stewardship of the corporation and that board responsibilities are separate and distinct from management responsibilities (*see boxes "Checklist: "Board Responsibilities" and "Important Board Tasks"*).

However, the guidelines and codes differ in the level of detail with which they explain the board's role. For example, Canada's Dey Report, France's Vienot Report, Malaysia's Report on Corporate Governance, Mexico's Code of Corporate Governance, South Africa's King Report and the Korean Stock Exchange Code all specify the following as distinct board functions:

- Strategic planning.
- Risk identification and management.
- Selection, oversight and compensation for senior management. While some documents expressly refer to both the selection and replacement of senior managers (usually the CEO), other docu-

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Independent Directors

In the US, UK, Canada and Australia, best practice recommendations and certain listing requirements tend to suggest that boards of publicly traded corporations should include at least some independent directors. This viewpoint is the furthest developed in the US, where best practice documents call for a "substantial" majority of the board to comprise independent directors (and listing requirements specify that audit committees must consist of independent directors).

Elsewhere, best practice recommendations are somewhat less stringent and seek to have a balance of executives and non-executives, with the non-executives including some truly independent directors. Although "non-management" or "non-executive" directors may be more likely to be objective than members of management, many code documents recognise that a non-management director may not be truly "independent" if he or she has significant financial or personal ties to management. A general consensus is developing throughout a number of countries that public company boards should include at least some non-executive members who lack significant family and business relationships with management.

Definitions of "independence" vary. For example, according to the Brazilian Institute of Corporate Governance, a director is independent if he or she:

- Has no link to the company besides board membership and share ownership and receives no compensation from the company other than director remuneration or shareholder dividends.
- Has never been an employee of the company (or of an affiliate subsidiary).
- Provides no services or products to the company (and is not employed by a firm providing major services or products).
- Is not a close relative of any officer, manager or controlling shareholder.

In comparison, the UK Cadbury Code (*see main text "Types Of Code"*) simply refers to directors who (apart from their fees and shareholdings) are independent from management and free from any business or other relationship that could materially interfere with the exercise of independent judgment. Many of the best practice documents, such as the Cadbury Report and the US National Association of Corporate Directors Report on Director Professionalism, view the ultimate determination of just what constitutes "independence" to be an issue for the board itself to determine. However, the New York Stock Exchange and the National Association of Securities Dealers in the US now provide guidance in their listing rules as to what does not constitute independence for the purposes of audit committee membership.

The following statements illustrate how governance codes and guidelines across the globe deal with the issue of independence:

- The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.... Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest (*OECD Principle V (Commentary E & E.1)*).
- [I]ndependent directors . . . should account for at least one-third of the . . . Board of Directors. . . . (*Vienot II (France) at 15*).
- The board of directors of every corporation should be constituted with a majority of individuals who qualify as unrelated directors (*Dey Report (Canada) Guideline 2*).
- The board shall include outside directors capable of performing their duties independently from management, controlling shareholders and the corporation (*Korean Stock Exchange Code of Best Practice at II.2.2*).
- The majority of the board members should be independent (*Brazilian Institute of Corporate Governance Code of Best Practice at 3*).
- A number of non-executive directors should be independent of the executive management and the dominant shareholders and free from any business or other relationship with the company which could interfere with their independent judgment, apart from their remuneration and shareholdings in the company. The number of independent directors should be sufficient for their views to carry significant weight in the board's decisions (*Cardon Report (Belgium) Recommendation 2.2*).
- No board should have less than two non-executive directors of sufficient calibre that their views will carry significant weight in board decisions (*The King Report (South Africa) 2.2*).
- [I]t is recommended that Independent Directors represent at least 20% of the total number of Board members (*Mexico Code of Corporate Governance, Principle at 6*).
- Every listed company should have independent directors, i.e., directors that are not officers of the company; who are neither related to its officers nor represent concentrated or family holdings of its shares; who, in the view of the company's board of directors, represent the interests of public shareholders, and are free of any relationship that would interfere with the exercise of independent judgment (*Malaysian Report on Corporate Governance, Explanatory Note 4.23*).
- Independent [directors are] non-exemptive directors who have no direct interests in the company (*Corporate Governance Forum Principles (Japan), Principle 5A*).

- Persons who do not qualify as "outside directors" are: controlling shareholders, a spouse or family member of a director who is not an outsider; current or recent officers and employees of the corporation, its affiliates, or of corporations that have "important business relations" with the corporation; and persons who serve as outside directors on three or more listed companies (*Article 48-5 Korean Stock Exchange Listing Regulation*).
- Independence is more likely to be assured when the director:
  - is not a substantial shareholder of the company;
  - has not been employed in any executive capacity by the company within the last few years;
  - is not retained as a professional adviser by the company (either personally or through their firm);
  - is not a significant supplier to or customer of the company;
  - has no significant contractual relationship with the company other than as a director (*Bosch Report (Australian), Guideline 1.1*).

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ments are silent as to replacement. This should not be read to mean that the board lacks the power to replace the CEO. Frequently that power is expressed in law or is implicit.

- Succession planning.
- Communication with shareholders.
- Integrity of financial controls.
- General legal compliance.

The Kyrgyz Republic Charter sets out a detailed list of matters requiring board approval. Other governance guidelines and codes of best practice are far less specific. For example, the Hong Kong Stock Exchange Code simply refers to directors' obligations to ensure compliance with listing rules as well as with the "declaration and undertaking" that directors are required to execute and lodge with the stock exchange. The different approaches among codes on this point reflect variations in the degree to which company law or listing standards specify board responsibilities, as much as any significant substantive differences.

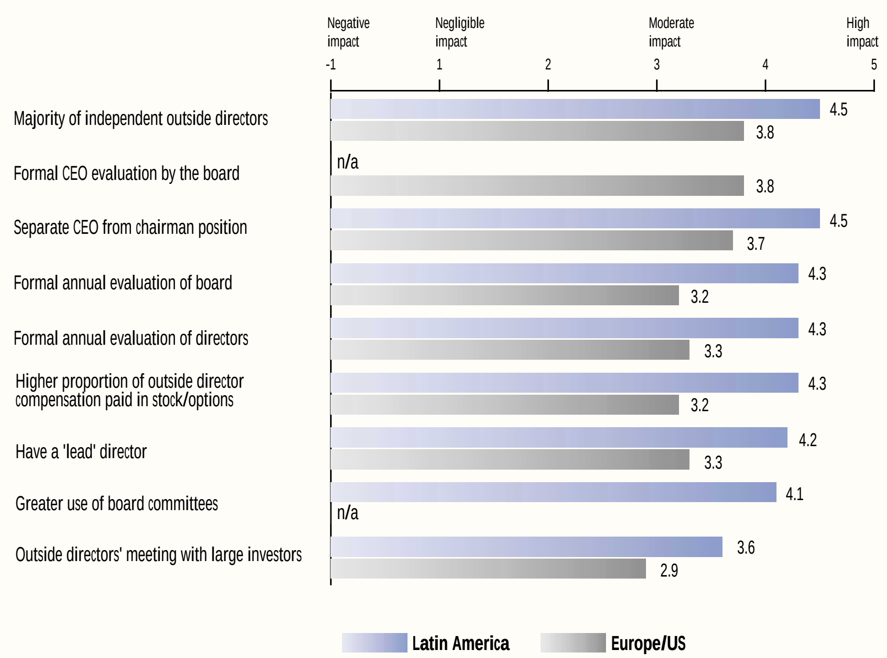
Board Composition

Most governance guidelines and codes of best practice address topics related to board composition (*see box "Improving Board Performance"*) including:

- Directors' qualifications and membership criteria. The quality, experience and independence of a board's membership directly affect board performance. Board membership criteria are described by various guidelines and codes with different levels of detail, but tend to highlight issues such as experience, personal characteristic (including independence), core competencies and availability.
- The director nomination process. Guidelines and codes tend to emphasise a formal and transparent process for appointing new directors. The use of nominating committees is a favoured in the US and the UK as a means of reducing the CEO's influence in choosing the board that is charged with monitoring his or her performance. At the same time, how-

Improving Board Performance

Investors agree on how to improve board performance*



* The list of practices was predefined. Investors were asked to rank their impact on board performance.

Source: McKinsey & Company, Investor Opinion Survey – June 2000

ever, it is generally agreed that the board as a whole has the ultimate responsibility of nominating directors (this is advocated by the Malaysia Corporate Governance Report (*see box "Nominating Directors"*).

• Having non-executive or independent directors. Most governance guidelines and codes of best practice agree that some degree of director independence (or the ability to exercise objective judgment of management's performance) is important to a board's ability to oversee management performance (*see box "Independent Directors"*).

• Independent board leadership. Independent board leadership is thought by some to encourage the non-executive directors' ability to work together to provide true oversight of management (*see box "Independent Board Leadership"*). The National Association of Corporate Directors in the US has stated, for instance, that the propose of creating an independent leader is not to add another layer of power, but to ensure organisation of, and accountability for, the thoughtful execution of certain critical independent functions. Those functions include evaluating the CEO, chairing sessions of the non-executive directors, setting the board agenda and leading the board in responding to crisis.

• The level of information provided to directors. The effectiveness of directors, especially non-executive directors, depends upon the quality of information that is made available to them.

Board Committees

Board committees provide a useful structure for performing detailed work. It is fairly well accepted that many functions should be delegated, whether for study and recommendation to the full board, or delegated outright to board committees. For example, an audit committed, a remuneration committee and a nominating committee are either mandated or recommended in Australia, Belgium, France, Japan, The Netherlands, Sweden, the UK and the US.

While composition of these committees varies, it is generally recognised that non-executive directors have a special role when management has a potential interest in the issue under discussion.

Typically:

• An audit committee supervises a company's internal audit procedures and interacts with the external auditor to ensure full compliance with financial disclosure and other legal, regulatory and listing requirements (*see box "The Audit Committee"*).

• An executive remuneration committee recommends the appropriate compensation package for the executive directors and senior managers of the company.

• A nomination committee conducts a systematic search for appropriately qualified non-executive directors (*see box "Nominating Directors"*).

Disclosure

Disclosure is an issue that is highly regulated under the securities laws of many countries. However, in many instances, companies may voluntarily disclose beyond what is mandated by law.

Most countries generally agree on the need for directors to disclose to shareholders (whether in an annual report or in another document) their own interests, as well as the financial performance of the company. Generally, this is required by law, regulation, or listing requirements, but some guidelines and best practice documents also address the issue.

Similarly, even though directors are usually subject to legal requirements concerning the accuracy of disclosed information, a number of codes from both developed and developing nations describe the board's responsibility to disclose, before the annual general meeting of shareholders accurate information about:

• The financial performance of the company.

• Agenda items.

Many codes also itemise the issues reserved for shareholder decision at the annual meeting of shareholders.

Generally, guidelines and codes of best practice place heavy emphasis on the financial reporting obligations of the board, as well as board oversight of the audit function. Again, this is because these are key to investor confidence and the integrity of markets. While some guidelines and codes specify the key points that the directors must comment on, others do not go into this level of detail. However, because securities laws often heavily regulate disclosure, the distinction is not necessarily substantive.

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