

CORPORATE GOVERNANCE: WHAT IT IS AND WHY IT MATTERS

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It has been said that “[t]he governance of the corporation is now as important in the world economy as the government of countries.”¹ This sentiment underscores the critical position corporations have come to play in both our economic and social lives. It may also speak to the global reach and political power of corporations, which, in many cases, now transcend the reach and power of governments.

However, the current vogue among policy makers for corporate governance reform, and the related interest in reducing corruption and cronyism in business affairs, is primarily grounded in economics and belief in the allocative efficiency of free markets. As demand for investment funds increases in developed and developing nations, and barriers to the free flow of capital fall, policy makers have come to recognise that corporate governance is relevant to the ability to attract capital. They also realise that weak corporate governance systems, together with corruption and cronyism, distort the efficient allocation of resources, undermine opportunities to compete on a level playing field and ultimately hinder investment and economic development.

In the wake of the financial crisis that began in East Asia and rapidly spread to other developing parts of the world, policy makers have learned 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 nations. Insufficient financial disclosure and capital market regulation, lack of minority shareholder protections, 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.² The not-surprising result in the “miracle” economies of East Asia was over-investment in non-productive and often speculative activities by corporations.³

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¹ James D. Wolfensohn, “A Battle for Corporate Honesty,” *The Economist: The World in 1999* at 38.

² Ira M. Millstein, “The Basics of a Stable Global Economy,” *The Journal of Commerce* (Nov. 30, 1998); Federal Reserve Board Chairman Alan Greenspan, “Lessons from the Global Crisis,” Remarks to The World Bank Group and International Monetary Fund Program of Seminars, Washington, D.C. (Sept. 27, 1999).

³ See Campbell R. Harvey and Andrew H. Roper, “The Asian Bet” *in* *Financial Markets & Development: The Crisis in Emerging Markets* at 29, 144, (Harwood, Litan & Pomerleano, editors 1999) (citing deficiencies in Asian managers’ risk management practices -- specifically their “bet the company” strategy of increasing leverage in the face of declining performance -- as a factor in the

A. Defining “Corporate Governance”

Providers of corporate finance -- whether they are individuals or pension funds, mutual funds, banks or other financial institutions, or even governments -- require assurances that their investments will be protected and will generate returns. These assurances are at the heart of what effective corporate governance is all about.

The term “corporate governance” is susceptible of both narrow and broad definitions. Narrowly defined, it concerns the relationships between corporate managers, directors and shareholders. It can also encompass the relationship of the corporation to stakeholders and society. More broadly defined still, “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, generate profit, and meet both legal obligations and general societal expectations.⁴

This definitional range underscores the reality that corporate managers, directors and investors all function within a larger business and legal environment that shapes behaviour.⁵ But no matter what the definition, at its heart corporate governance concerns

crisis); Michael Pomerleano and Xin Zhang, “Corporate Fundamentals and the Behavior of Capital Markets in Asia” *in* *Financial Markets & Development* at 117, 147 (finding that “the evidence casts doubt on the economic allocative efficiency of emerging markets in Asia,” the authors conclude that these markets failed to adequately price risk and exert effective financial discipline on corporations, in part because Asian markets lacked high standards of disclosure and transparency); Stijn Claessens, Simeon Djankov and Larry H.P. Lang, “Corporate Ownership and Valuation: Evidence from East Asia” *in* *Financial Markets & Development* at 159, 175-176 (large insider control may have contributed to the weak performance and risky investment of East Asia companies; the heavy concentration of corporate ownership among a few families or interrelated corporate groups that is typical in East Asia has likely influenced the legal and regulatory institutions and resulted in weak protections for minority shareholders and less transparency).

⁴ Ira M. Millstein, “The Evolution of Corporate Governance in the United States,” Remarks to the World Economic Forum, Davos, Switzerland (February 2, 1998) (“The term “corporate governance” has many definitions. It can broadly encompass all of the corporation’s relationships: relationships among capital, product, service and human resource providers, customers and even society at large. It can encompass all the laws designed to hold the corporation accountable to shareholders and the public, as well as the workings of the market for corporate control. It can refer to audit practices and accounting principles, and it can refer to shareholder activism. Even more narrowly, the term can be used to describe just the role and practices of the board of directors [T]he common denominator for all these definitions is this: Corporate governance concerns the relationships between a corporation’s managers and shareholders, based on the foundation that the board of directors is the shareholders’ agent to ensure that the corporation is managed in the shareholders’ best interests. The paradigm is simple: Managers accountable to boards and boards accountable to shareholders.”).

⁵ The broader environment is shaped by stock exchange listing rules as well as a host of laws and regulations concerning: disclosure requirements and accounting standards; the issuance and sale of securities; company formation; shareholder rights and proxy voting; contests for corporate control; mergers and acquisitions; fiduciary duties of directors, officers and controlling shareholders; contract enforcement; bankruptcy and creditors rights; labor relations; financial sector practices; and 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, general understandings of

the means by which a corporation assures investors that it has well-performing management in place and that corporate assets provided by investors are being put to appropriate and profitable use.

Of course, differences remain between nations concerning the issue of the corporate polestar: For whom is the corporation governed? Different national systems of corporate governance articulate the primary objective of the corporation in different ways. 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 countries in Asia. Other nations 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. By focusing the corporate objective on shareholder value, the right to this “residual” becomes meaningful. A bright line standard -- accountability to shareholders for a single objective -- also avoids the risk of diffusing the accountability of managers and directors. This view of corporate governance is associated with the United States, Canada and the United Kingdom.

Stakeholder and shareholder interests are not mutually exclusive, however. Corporations do not succeed by consistently neglecting the expectations of employees, customers, suppliers, creditors, and local communities, but neither do corporations attract needed capital from equity markets if they fail to meet shareholders’ expectations of a competitive return.⁶

B. Why Corporate Governance Matters

As markets become more open and global, and business becomes more complex, societies around the world are placing greater reliance on the private sector as the engine of economic growth. In both developed and developing nations, a growing proportion of economic activity takes place in firms organised as corporations. Corporations are creatures of law; societies allow corporations to be created by law because they recognise that incorporation provides an efficient form of organisation, and society benefits as a result.

Corporations mobilise and combine capital, raw material, labour, management expertise and intellectual property from a variety of sources to produce goods and services

corporate citizenship and societal expectations about the corporate objective, and competition in product, service and capital markets, as well as in the markets for management and labor and the market for corporate control.

⁶ In addition, maximising long term shareholder value encourages investment capital to be put to the most efficient economic use, and this benefits society. Business Sector Advisory Group Report to the OECD on Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets at 9 (April 1998).

that are useful to members of society. In so doing, corporations purchase goods and services, generate jobs and income, distribute profits, pay taxes, and contribute to foreign exchange. In sum, corporations contribute to economic growth and development, which lead to improved standards of living and poverty alleviation, which in turn should lead to more stable political systems. Corporate governance is important because the quality of corporate governance impacts: (1) the efficiency with which a corporation employs assets; (2) its ability to attract low-cost capital; (3) its ability to meet societal expectations; and (4) its overall performance.

(1) Effective corporate governance promotes the efficient use of resources both within the firm and the larger economy. When corporate governance systems are effective, 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 helps protect and grow scarce resources, and helps 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.⁷

(2) For related reasons, effective corporate governance assists firms (and economies) 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).⁸ For corporations to succeed in competitive markets, corporate managers must innovate relentlessly and efficiently, and constantly evolve new strategies to meet changing circumstances. This requires that managers have latitude for discretionary action. However, as Adam Smith recognised long ago, managers may have incentives to deviate from acting in the interests of capital providers.⁹ Therefore, rules and procedures to protect capital providers are necessary.¹⁰ These

⁷ These efficiency effects -- both as to scarce resources and the quality of managers -- should apply whether a firm is a state owned enterprise, a private closely held firm owned by a family group, or a publicly traded corporation on a stock exchange.

⁸ According to a 1996 McKinsey survey of institutional investors, two-thirds of those surveyed reported that they would willingly pay on average well over ten percentage points more for a "well-governed" company, all other things being equal. A "well-governed" company was defined as a company that was responsive to investors and had a board that was sufficiently independent of management to hold management accountable to shareholders. Robert F. Felton et al., "Putting a Value on Board Governance," 4 *McKinsey Quarterly* 170, 170-71, 174 (1996).

⁹ "[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-partnership 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).

¹⁰ 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 value of the owner-manager's investments 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 pursuit of overly risky or imprudent projects. See

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

(3) To be successful in the long term, corporations must comply with the laws, regulations and expectations of the societies in which they operate. Corporations have proven to be neither inherently good nor bad. Many corporations take their responsibilities as corporate citizens seriously and contribute greatly to civil society. Unfortunately, however, some corporations are opportunistic and seek to profit, for example, from the use of child labour or without regard to environmental impact. Such examples represent not only failures of corporate responsibility -- and firm governance -- but larger failures of government to provide the framework needed to hold corporations responsible on issues that are important to a given society. (All too frequently government corruption is implicated in the problem.)

(4) When corporate governance is effective, it provides managers with oversight and holds boards and managers accountable in their management of corporate assets. This oversight and accountability -- combined with the efficient use of resources, improved access to lower-cost capital and increased responsiveness to societal needs and expectations -- should lead to improved corporate performance. Effective corporate governance may not guarantee improved corporate performance at the individual firm level; there are simply too many other factors that impact firm performance. But it should make it more likely that managers focus on improving firm performance and are replaced when they fail to do so. The empirical evidence of a link between governance and performance is mixed (due to the difficulty in factoring out governance from all the other influences on firm performance). Nonetheless, the connection between effective governance and firm performance makes considerable intuitive sense.¹¹

Effective corporate governance is also closely related to efforts to reduce corruption in business dealings. Effective governance systems should make it difficult for corrupt practices to develop and take root in a company. Strong governance may not prevent corruption, but it should make it more likely that corrupt practices are discovered early and eliminated.

C. Elements of Effective Corporate Governance

Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* (1976); "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers," *American Economic Review* (1986); Andrei Shleifer and Robert Vishny, "Managerial Entrenchment: The Case of Manager-Specific Investment," *Journal of Financial Economics* (1989); Michael Jensen and Richard Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics* (1983).

¹¹ See Ira M. Millstein & Paul W. MacAvoy, "The Active Board of Directors and Performance of the Large Publicly Traded Corporation," 98 *Columbia Law Review* 1283, 1291-1299 (June 1998) (data analysis from 1991-95 showing that U.S. corporations with active and independent boards of directors generated higher economic profit supports the "reasonable assumption" that corporate governance matters to corporate performance).

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

In developed countries, the discussion of corporate governance improvement tends to assume 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 to prevent bribery that enable corporations to transform -- to merge, acquire, divest and downsize -- and even to fail; anti-corruption laws to prevent bribery and protections against fraud on investors; sophisticated courts and regulators; an experienced accounting and auditing sector, and significant corporate disclosure requirements. Developed countries are also more likely to have well-developed private sector institutions, such as organisations of institutional investors, and professional associations of directors, corporate secretaries and managers, as well as rating agencies, security analysts and a sophisticated financial press.

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 nations often need to focus on the fundamental framework. Reform needs vary, but often include basic 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, and a change in culture and laws against bribery and corruption as an accepted way 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 infrastructure and corporate governance. These differences in culture may make certain concepts difficult to accept. For example, concern in some Asian cultures with personal integrity and reputation can pose barriers to the concept of bankruptcy. Likewise, the long history of communism in Russia may have impacted that culture's understanding of property rights.¹²

Ultimately, corporate governance and the framework that supports it must have relevance to a nation's own unique legal environment and cultural values. While common elements of effective governance can be identified to enable national systems to attract global capital and heighten investor confidence -- and some market driven convergence of

¹² See Greenspan, "Lessons from the Global Crisis," *supra* note 2, noting that the development of financial infrastructure and all the institutions that support it is "invariably molded by the culture of a society."

systems may be inevitable -- governance reform is largely a matter for each nation and the private sector within each nation to determine.

In April 1998 an influential report detailed the common principles of corporate governance from a private sector viewpoint. The OECD Business Sector Advisory Group on Corporate Governance, chaired by renowned governance expert Ira M. Millstein, 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 focused on four essential areas:

- Ensuring the protection of shareholder rights, including the rights of minority and foreign shareholders, and ensuring the enforceability of contracts with resource providers (Fairness);
- Requiring timely disclosure of adequate, clear and comparable information concerning corporate financial performance, corporate governance and corporate ownership (Transparency);
- Clarifying governance roles and responsibilities, and supporting voluntary efforts to ensure the alignment of managerial and shareholder interests, as monitored by boards of directors (Accountability); and
- Ensuring corporate compliance with the other laws and regulations that reflect the respective society’s values (Responsibility).¹³

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, boards and managements.

D. Basic Principles and the OECD

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 “core standards” of corporate governance: fairness, transparency, accountability and responsibility. That proposal led the OECD to convene an Ad-Hoc Task Force on Corporate Governance comprised of representatives from the 29 OECD member nations as well as interested international organisations, and business and labour representatives. The Task Force also sought input from non-OECD nations (as well as broader public comment through its web site). In April of 1999 the Task Force issued a set of corporate governance principles that embody the consensus views of the Task Force members on the fundamentals. These Principles build on the four essentials articulated by the OECD Business Sector Advisory Group. While they are intended to be non-binding, they provide thoughtful guidance to nations seeking to improve corporate governance.

¹³ Business Sector Advisory Group, Report to the OECD on Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets at 20 (April 1998) (the “Millstein Report”).

Fairness: The OECD Principles expand on the concept of “fairness” with two separate principles. Principle I states that: “*The corporate governance framework should protect shareholders’ rights.*” Generally, this Principle recognises that shareholders are property owners, and as owners of a legally recognised and divisible share of a company, shareholders 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.

Principle I also recognises that shareholder generally 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 shareholder meetings and to call extraordinary shareholder meetings.

Principle II also relates to “fairness” in holding that: “*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.*” This means that 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. Rules that regulate transactions by corporate insiders and impose fiduciary obligations on directors, managers and controlling shareholders -- and mechanisms to enforce those rules, such as shareholder derivative actions -- are some examples.

Transparency: Principle IV states that: “*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.*” This 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 audit should be subject to an annual audit by an independent auditor. This provides an important check on the quality of accounting and reporting. (Of course, 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, identity of board members and key executives and executive compensation, is also important to potential investors and shareholders and is a critical component of transparency.

Accountability: Principle V states: “*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.*” This Principle implicates a legal duty 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.

This Principle also recognises that the board is charged with monitoring the professional managers to whom the discretionary operational role has been delegated and holding them accountable in the use of firm assets.¹⁴ In this respect, the board provides a mechanism for reducing the agency problem -- described by Adam Smith in 1776 -- that is inherent in the separation of ownership and control.¹⁵ If the board is to serve as an effective monitor of managerial conduct, however, it must be sufficiently distinct from management to be capable of objectively evaluating management. (A board comprised wholly or primarily of management cannot be expected to effectively minimise agency problems.) This generally requires that some directors are neither members of the management team nor closely related to them through family or business affairs.¹⁶

Clearly, the quality of corporate governance also depends on the quality of directors. Objective oversight requires the inclusion of professionally competent non-executives and independent directors, who have the capability, fiduciary commitment and

¹⁴ Directors are generally charged with the following responsibilities: hire, compensate, monitor and when necessary replace senior management; advise management on corporate strategies, plans and major decisions; provide strategic oversight; ensure compliance with law and regulation and the integrity of accounting and financial reporting; consider the relationships of the corporation with stakeholders and society at large; and organise board structure and process.

¹⁵ 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); Adolph Berle & Gardiner Means, *The Modern Corporation & Private Property* 123 (1932); Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 305, 309 (1976).

¹⁶ For example, according to the King Report on Corporate Governance, at least two non-executives should serve on the board, and these non-executive directors should be:

- [I]ndependent of management and . . . not [receive] any benefits from the company other than their fee. This is not intended to exclude . . . non-executive director[s] who have a contractual nexus with the company for reward or to prevent a non-executive director from acquiring shares in the company by means independent from the company;
- Directors and managers of the company's holding company, or major investor, who have no executive responsibilities in the company;
- Former executive directors who are no longer employed on a full-time basis but nevertheless are capable of giving valuable input to the board arising from their past experience;
- Senior executive directors of major listed subsidiaries and associates of the holding company, who have no executive responsibilities in the holding company.

The Institute of Directors in South Africa, *The King Report on Corporate Governance*, ¶¶2.2, 4.2.1-4.2.4 (Nov. 29, 1994).

objectivity to provide strategic guidance and monitor performance on behalf of shareholders.

Much has been written about the practices that boards should follow to encourage board effectiveness. In general, board “best practices” suggest that the board should meet often. For most boards, this is at least once per quarter; and usually more frequently. In addition, the effectiveness of directors -- especially non-executives -- depends upon the quality of information that is made available to them. To ensure that “independent oversight” has meaning, directors must have access to important information and such information should be provided in advance of board meetings.

Board committees have provided a useful structure for performing detailed board work. In the U.S. and the U.K. it is common to rely on an audit committee, executive compensation (or remuneration) committee and a nomination committee (and staff them wholly or primarily with non-executives or independent directors).¹⁷

Responsibility: Principle III translates “responsibility” to mean that: “*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.*” This recognises that corporations must abide by the laws and regulations of the countries in which they operate, but that every nation 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 law and regulations, corporations should be encouraged to act responsibly and ethically, with special consideration of the interests of stakeholders, and in particular employees.

Increasingly, corporations recognise that active co-operation between corporations and stakeholders assists corporate performance, and that socially responsible corporate conduct is consistent with the principle of shareholder maximisation.¹⁸ In many nations, corporations go well beyond legal requirements in providing health care and retirement benefits, encouraging diversity of race and gender in employment and promotion practices, financially supporting education, and formulating and adopting environmentally friendly technologies. Similarly, many companies strive to avoid activities perceived to be socially undesirable even where not prohibited.

The four principles of corporate governance articulated in the Millstein Report -- fairness, transparency, accountability and responsibility -- as expanded into the five OECD

¹⁷ Typically an audit committee supervises a company’s internal audit procedures, and interacts with the external statutory auditor to ensure full financial compliance according to the law; an executive remuneration committee recommends the appropriate compensation package for the executive directors and senior managers of the company; and a nomination committee conducts a systematic search for appropriately qualified non-executive directors.

¹⁸ See Melvin A. Eisenberg, “Corporate Conduct that Does Not Maximise Shareholder Gain,” 28 *Stetson Law Review* 1 (1998).

Principles of Corporate Governance require both regulation and private sector initiative for implementation. Regulation ensures that minimum standards are met; private codes of conduct and voluntary behaviour can and in many cases should go well beyond minimum legal requirements.¹⁹

CONCLUSION

Increasingly, policy makers have come to recognise that effective corporate governance -- transparency, accountability and the fair and equitable treatment of shareholders -- is a necessary component of efforts to promote sustainable development. However, corporate governance reform requires both governmental and private sector support. In this regard, there is a need for a public-private partnership, both to raise awareness of the value of corporate governance improvement, and to assist in implementing corporate governance reform. To provide a framework for this public-private partnership on an international scale, the World Bank and OECD have announced the formation of a Global Corporate Governance Forum, which was launched in Washington, D.C. at the World Bank/IMF annual meeting late last month. This effort, together with the considerable efforts of Transparency International to reduce corruption and bribery, offers great promise.

However, reform efforts must take into account the fact that every nation has its own national personality and social and economic priorities. Likewise, every corporation has its own unique history, culture and business goals. All of these factors influence the optimal governance structures and practices for nations and individual corporations. Therefore, international agreement on a single model of corporate governance or a single set of detailed governance rules is both unlikely and unnecessary. Of course, 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.”²⁰

¹⁹ For a discussion of the largely voluntary codes of corporate governance that have recently issued in developing and emerging market nations, see the Annex to this essay.

²⁰ Report to the OECD by the Business Sector Advisory Group on Corporate Governance.

ANNEX

OVERVIEW OF CORPORATE GOVERNANCE GUIDELINES & CODES OF BEST PRACTICE IN DEVELOPING & EMERGING MARKETS*

When a firm's management is separate and distinct from the providers of the firm's capital, managers have a responsibility to use assets efficiently in pursuit of the firm's objective. Ensuring that they do so is important to a firm's successful economic performance as well as to its ability to attract long-term, stable, low-cost investment capital. This is true whether the firm is publicly traded, privately held, family-controlled or state-owned. (It is only when the managers of a firm themselves own the entire firm -- and are committed to relying solely on their own capital -- that managers generally are free to apply corporate assets (as their own private property) inefficiently or for non-productive uses.) The fundamental concern of corporate governance is to ensure the means by which a firm's managers are held accountable to capital providers for the use of assets.

The responsibilities and functions of the corporate board in both developed and developing nations are receiving greater attention as a result of the increasing recognition that a firm's corporate governance affects both its economic performance and its ability to access patient, low-cost capital. After all, the board of directors -- or, in two-tier systems, the supervisory board -- is the corporate organ designed to hold managers accountable to capital providers for the use of firm assets. The past five years has witnessed a proliferation of corporate governance guidelines and codes of "best practice" designed to improve the ability of corporate directors to hold managements accountable. This global movement to emphasise that boards have responsibilities separate and apart from management, and to describe the practices that best enable directors to carry out these responsibilities, is a manifestation of the importance now attributed to corporate governance generally and, more particularly, to the role of the board.

Corporate governance guidelines and codes of best practice arise in the context of, and are affected by, differing national frameworks of law, regulation and stock exchange listing rules, and differing societal values. Although boards of directors provide an important internal mechanism for holding management accountable, effective corporate governance is supported by and dependent on the market for corporate control, securities regulation, company law, accounting and auditing standards, bankruptcy laws, and judicial enforcement. Therefore, to understand one nation's corporate governance practices in relation to another's, one must understand not only the "best practice" documents but also the underlying legal and enforcement framework.

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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, and the holding of annual general meetings of shareholders. However, in both developed and developing nations, codes focus on boards of directors and attempt to describe ways in which boards can be positioned to provide some form of guidance and oversight to management, and accountability to shareholders and society at large.

Overview

The modern trend of developing corporate governance guidelines and codes of best practice began in the early 1990's in the United Kingdom, the United States 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, and pressure for change from institutional investors. The Cadbury Report in the U.K., the General Motors Board of Directors Guidelines in the U.S., and the Dey Report in Canada have each proved influential sources for other guideline and code efforts.

Over the past decade, governance guidelines and codes have issued from stock exchanges, corporations, institutional investors, and associations of directors and corporate managers. 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 the Cadbury Report (as amended in the Combined Code) and the Dey Report, but they must disclose whether they follow the recommendations in those documents and must provide an explanation concerning divergent practices. Such 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. Such guidelines can have wide influence, however. In the case of the GM Guidelines, institutional investors encouraged other companies to adopt similar guidelines.

In developing nations, both voluntary guidelines and more coercive codes of best practice have 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 aspirational and 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 this time, linked to stock exchange listing requirements. In contrast, 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, all contemplate mandatory disclosure concerning compliance with their recommendations.

Some of the key elements of governance guidelines and codes of best practice, particularly as issued in developing nations, are summarised below:

The Corporate Objective

Variations in societal values lead different nations to view the corporate objective or "mission" distinctly. Expectations of how the corporation should prioritise the interests of shareholders and stakeholders such as employees, creditors and other constituents take two primary forms. In the Anglo-Saxon nations -- Australia, Canada, the U.K., and the U.S. -- maximising the value of the owners' investment is considered the primary corporate objective. This objective is reflected in governance guidelines and codes that 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, and the Malaysian Report on Corporate Governance, all expressly recognise that the board's mission is to protect and enhance the shareholders' investment.

The mission of the board of directors is to maximise shareholder value. Brazilian Institute of Corporate Governance Code of Best Practice at 1.

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.

The single overriding objective [of] all listed companies . . . is the preservation and enhancement over time of their shareholders' investment.
Report on Corporate Governance (Malaysia), Introduction § 1, 3.3.

In other countries, more emphasis is placed on a broader range of stakeholders. However, this view is not strongly advocated in the governance guidelines and codes emanating from developing nations, although some documents recognise that stakeholder interests should be considered. (For example, the King Report from South Africa states: "Directors must act with enterprise and always strive to increase shareholders' value while having regard for the interests of all stakeholders." (Ch. 5:27.7)) This may be due to a convergence in perceptions about the corporate objective. There is a growing recognition that shareholder expectations need to be met in order to attract patient, low-cost capital. Likewise, there is growing sensitivity to the need to address stakeholder interests in order to maximise shareholder value over the long term. As the General Motors Board of Directors Mission Statement recognises, "the board's

responsibilities to shareholders as well as customers, employees, suppliers and the communities in which the corporation operates are all founded upon the successful perpetuation of the business.” Simply put, shareholder and stakeholder interests in the success of the corporation are compatible in the long run.

Board Responsibilities & Job Description

Most governance guidelines and codes of best practice assert that the board assumes responsibility for the stewardship of the corporation and emphasise that board responsibilities are distinct from management responsibilities. However, the guidelines and codes differ in the level of specificity 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 and South Africa’s King Report all specify board functions such as strategic planning; risk identification and management; selection, oversight and compensation of senior management; succession planning; communication with shareholders; integrity of financial controls; and general legal compliance, as distinct board functions. 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 Exchange. The different approaches among codes on this point likely reflect variations in the degree to which company law or listing standards specify board responsibilities, rather than any significant substantive differences.

The main functions of a board are. . . :

- *to direct the company both as to strategy and structure;*
- *to establish from time to time a strategy for the company, including a determination of the businesses that the company should be in and those that it should not be in;*
- *to ensure that the executive management implements the company’s strategy as established from time to time;*
- *to ensure that the company has adequate systems of internal controls both operational and financial;*
- *to monitor the activities of the executive management;*
- *to select the chief executive, ensure succession and give guidance on the appointment of senior executives;*
- *to provide information on the activities of the company to those entitled to it;*
- *to ensure that the company operates ethically;*
- *to provide for succession of senior management;*
- *to address the adequacy of retirement and health care benefits and funding.*

The King Report (South Africa), Ch. 4:1.

Board Composition

Most governance guidelines and codes of best practice address topics related to board composition including director qualifications and membership criteria, the director nomination process, and board independence and leadership.

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 specificity, but tend to highlight issues such as experience, personal characteristics (including independence), core competencies and availability.

Every non-executive director must ensure that he can give sufficient time and attention to the affairs of the issuer . . . and satisfy the Exchange that he has the character, integrity, experience and competency to serve as a director of a listed company.

The Hong Kong Stock Exchange Code, Code of Best Practice 10 and Guideline A.5.

The board should have a diversity of background, knowledge and experience.

The Brazilian Institute of Corporate Governance Code of Best Practice at 3.

[Non-executive directors should] *know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios, and have some knowledge of various company laws.*

The Confederation of Indian Industry Code, Recommendation 4.

[A] candidate should have integrity and independence of thought; the courage to express their independent thought; a grasp of the realities of business operations; an understanding of the changes taking place regionally, nationally and internationally; [and] an understanding of business and financial "language."

The King Report (South Africa), Ch. 9:8.2.

Director Nomination. The process by which directors are nominated has gained attention in many guidelines and codes, which tend to emphasise a formal and transparent process for appointing new directors. The use of nominating committees is favored in the U.S. and U.K. as a means of reducing the CEO's influence in choosing the board that is charged with monitoring his or her performance. (See, in the U.S., the Report of the National Association of Corporate Directors Commission on Director Professionalism (1996), and the General Motors Board of Directors Guidelines (1994); in the U.K., the Hampel Committee Report (1998)). The Malaysian Corporate Governance Report expresses a similar view: "[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." (Explanatory Note 4.) At the same time, however -- and as advocated by the King Report (South Africa) -- it is generally agreed that the board as a whole has the ultimate responsibility for nominating directors.

Mix of Inside and Outside 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 exercise objective judgment concerning management performance. In the U.S., U.K., Canada and Australia, although not required by law or listing requirements, best practice recommendations generally agree that boards of publicly-traded corporations should include at least some independent directors. This viewpoint is the furthest developed in the U.S. and Canada, where best practice documents call for a "substantial" majority of the board to be comprised 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 still not be truly “independent” if he or she has significant financial or personal ties to management.) Nonetheless, 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.

The majority of the board members should be independent.

Brazilian Institute of Corporate Governance Code of Best Practice at 3.

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.

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 or subsidiary); provides no services or products to the company (and is not employed by a firm providing major services or products); and is not a close relative of any officer, manager or controlling shareholder.

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.

In February 1998, the Korea Stock Exchange adopted a listing requirement that will mandate that outside directors soon comprise at least a quarter of the board of every listed company. Included among the list of 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 KSE Listing Regulation.

In comparison, the Cadbury Code simply refers to directors who -- apart from their fees and shareholdings -- are independent from management and free from any business or other relationship which could materially interfere with the exercise of independent judgment. And many of the best practice documents -- such as the Cadbury Report and the National Association of Corporate Directors Report on Director Professionalism (U.S.) -- view the ultimate determination of just what constitutes “independence” to be an issue for the board itself to determine.

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. As explained by the National Association of Corporate Directors (U.S.): "the purpose 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" -- such as evaluating the CEO; chairing sessions of the non-executive directors; setting the board agenda; and leading the board in responding to crisis.

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 -- recommending 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 "[w]here 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, 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)

Board Committees

In developed nations, it is fairly well accepted that many board functions are carried out by board committees. For example, a *nominating committee*, an *audit committee* and a *remuneration committee* are recommended in Australia, Belgium, France, Japan, the Netherlands, Sweden, United Kingdom and the United States. While composition of these committees varies, it is generally recognised that non-executive directors have a special role.

The functioning and composition of the audit committee receives significant attention in most guideline and code documents because of the key role it plays in protecting shareholder interests and promoting investor confidence.

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 the 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 that the financial information is useful, trustworthy and accurate.

Mexico Code of Corporate Governance, Recommendation at 12-13.

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 United Kingdom. Also, South Africa and India both emphasise the extra time requirements demanded of audit committee members, and the importance of written terms of reference for this committee. Malaysia also refers to the need for written terms of reference for audit and other board committees.

Disclosure Issues

Disclosure is an issue that is highly regulated under securities laws of many nations. However, there is room for voluntary disclosure by companies beyond what is mandated by law. Most countries generally agree on the need for directors to disclose their own relevant interests and to disclose financial performance in an annual report to shareholders. Generally this is required by law, but some guidelines and best practice documents address it as well. 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 accurate information about the financial performance of the company, as well as information about agenda items, prior to the annual general meeting of shareholders. Many codes also itemise the issues reserved for shareholder decision at the AGM. 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. South Africa lays out the key points that the directors must comment on, whereas other countries do not go to this level of detail, but the distinction is not necessarily substantive since disclosure tends to be heavily regulated in many nations through securities laws.

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This brief review of the primary principles addressed by various guidelines and codes indicates that there is no single agreed upon system of "good" governance. Each country has its own corporate culture, national personality and priorities. Likewise, each company has its own history, culture, goals and business cycle maturity. All of these factors need to be taken into consideration in crafting the optimal governance structure and practices for any country or any company. However, the influence of international capital markets will likely lead to some convergence of governance practices.

As 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 (April 1998) (the Millstein Report).

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.