Introduction

What the book is about

This book will enable readers to:

- appreciate the nature, functions, and realities of boards of directors and other governing bodies;
- analyse board structures, systems, and procedures, including board committees, chairmen, and chief executives, board remuneration, board leadership, and board effectiveness;
- understand major aspects of corporate governance, including:
  - corporate governance principles and codes of practice;
  - the board's performance roles: strategy formulation and policymaking;
  - the board's conformance roles: executive supervision and accountability;
  - the board's responsibility for handling corporate risk;
  - assessment of board and director performance;
  - corporate governance rating systems;
- understand various theories of corporate governance;
- appreciate corporate governance processes around the world, including:
  - adopting an international and comparative perspective on the subject;
  - contrasting corporate governance regimes around the world;
  - understanding the cultural aspects of different approaches to governance;
- recognize the issues that are influencing corporate governance and board thinking, including strategic risk management, corporate social responsibility, sustainability, and business ethics.

Who the book is for

The book will be useful for students studying for:

- Master's degrees in corporate governance, directorship, and related topics;
- MBA degrees;
- degrees in law, accountancy, and business studies.

It will also be relevant at the professional level for:

- directors of companies and potential directors;
- members of the governing bodies of other corporate entities;

- managers working with boards and other governing bodies;
- corporate secretaries, auditors, lawyers, and corporate governance consultants advising boards and directors.

The book has been adopted by universities and colleges for director training and board development. At least one professional body has adopted the text for its professional qualifying examinations. Of course, the book will also be relevant to academics teaching and researching corporate governance.

The book recognizes that the subject of corporate governance is changing and expanding all the time. Consequently, readers are encouraged to explore developments through the many references to relevant websites and further reading. The book also combines detailed text and explanations with case studies.

The basis of the book

The book is based on material that the author has developed over the years for directors' courses at the Institutes of Directors in London and Sydney, the MBA programme at the Australian Graduate School of Management, executive Master's at Hong Kong University, Melbourne University, Hong Kong Baptist University, and an open-learning course for Hong Kong Open University, as well as corporate governance courses for Russian university teachers sponsored by the Canadian Government at the Schulich School of Business in Toronto.

Some of the material has been adapted from previous publications with the approval of the copyright-holders, including:

- *Business Ethics: A Stakeholder, Risk, and Governance Approach*, Bob and Gretchen Tricker, Routledge, Abingdon, 2014;
- *Corporate Governance: An International Review*, Blackwells, Oxford;
- *Corporate Governance*, seminal readings in the History of Management Thought series, R. I. Tricker (ed.), Ashgate, Aldershot, UK and Dartmouth USA, 2000;
- *The Economist Essential Director*, Profile Books, 2009;
- *Governance* (InfoAustralia).

How the book came to be written: a personal note from the author

My initial work in the field was sponsored by Deloittes, the international accountancy firm, in the 1970s. The aim of the project was to examine the growing use of audit committees in the United States and to explore the possibility of introducing them into British companies. Audit committees were standing subcommittees of the main board, made up mainly of outside independent directors, acting as a bridge between external audit firm and board. Unfortunately, it quickly became clear that the concept of the audit committee would not work in British listed companies because there were not enough independent directors to staff them. Worse, while the concept of non-executive directors was understood, the notion of director independence was not.

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2 Corporate Governance Defined

Learning Outcomes

In which we recognize:

- Definitions of corporate governance
- The scope of corporate governance
- The significance of constitutions for corporate entities
- The difference between governance and management
- The performance and conformance aspects of governance
- Alternative board structures
- Board diversity

Definitions of corporate governance

In the last chapter, we suggested that corporate governance is concerned with the exercise of power over corporate entities. While this is true, it is an overarching view that does not help in understanding the boundaries, levels, and processes of the subject. We now need to explore other definitions of corporate governance. Notice how the different definitions reflect alternative viewpoints on the subject.

An operational perspective

The definitions adopted by some authorities focus on governance structures, processes, and practices. The first corporate governance report, Sir Adrian Cadbury's *Report on the Financial Aspects of Corporate Governance* (1992), took such a view. This report defined corporate governance as 'the system by which companies are directed and controlled', and further explained that boards of directors are responsible for the governance of their companies, while the shareholders' role in governance is to appoint the directors and the auditors, and to satisfy themselves that an appropriate governance structure is in place. Hilmer (1993), writing in the Australian context, emphasized the strategic responsibility of the board, suggesting that 'the board's key role is to ensure that corporate management is continuously and effectively striving for above average performance, taking account of risk, (which) is not to deny the board's additional role with respect to shareholder protection'. The operational perspective was also adopted in the corporate governance code developed by the Organisation for Economic Co-operation and Development (OECD) (2001): 'Corporate governance is about the procedures and processes according to which an organization is directed and controlled.'

The operational perspective, focusing on the shareholders, the board, and the management, has been the basis for much work in corporate governance. Notions of best practice in the interactions between them is fundamental to the corporate governance codes.

A relationship perspective

However, the OECD report strengthened the operational perspective by including the relationship among various participants: 'The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization—such as the board, managers, shareholders, and other stakeholders—and lays down the rules and procedures for decision-making.' The Corporate Library (now GMI Ratings), an influential website (www3.gmiratings.com), described corporate governance as 'the relationship among the shareholders, directors and management of a company, as defined by the corporate charter, by-laws, formal policy, and rule of law'. This relationship perspective was reinforced by the California Public Employees Retirement System (CalPers), a significant institutional investor, which included in its definition 'the primary participants are: shareholders, company management (led by the chief executive officer), and the board of directors'. Monks and Minow (1995) agreed, but added the employees: 'Corporate governance involves the relationship among various participants, including the chief executive officer, management, shareholders, and employees, in determining the direction and performance of corporations.'

A stakeholder perspective

Notice that the OECD definition above includes 'other stakeholders', as well as the shareholders, board, and management. It takes a wider view of those involved in and affected by corporate governance. In the last chapter, we adopted this wider relationship perspective: 'Corporate governance is about the activities of the board and its relationships with the shareholders or members, and with those managing the enterprise, as well as with the external auditors, regulators, and other legitimate stakeholders.' Demb and Neubauer (1992) also took the stakeholder view: 'Corporate governance is the process by which corporations are made responsive to the rights and wishes of stakeholders'. We will consider later who the stakeholders in a modern corporation might be.

A financial economics perspective

Financial economists tend to see corporate governance through a different lens from that of the lawyer and management expert. 'Corporate governance deals with the way suppliers of finance assure themselves of getting a return on their investment' wrote Shleifer and Vishny (1997). Their principal concern was with the ownership concentration in corporate governance systems around the world and the legal protection available to investors. Nevertheless, financial economics has been the dominant contributor of scholarly research into corporate governance, applying agency theory to board-level activities.

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A societal perspective

Finally, we come to a perspective that places the corporate entity in society. In 1995, Blair set corporate governance in this context as 'the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated'. Many would now include all corporate entities, as well as 'public corporations'.

Sir Adrian Cadbury, addressing the Global Corporate Governance Forum of the World Bank in 2000, took such a viewpoint when he said:

> Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.

Such a perspective sets corporate governance at a high level of abstraction. It includes all of the stakeholders involved with the company, including the contractual stakeholders such as the shareholders, managers, and other employees, suppliers, customers, consumers, bankers, but also other stakeholders outside the company whose interests could be affected by corporate behaviour, including the local, national, and international societal interests. Such a perspective can raise interesting philosophical issues about relationships between the individual, the enterprise, and the state. The societal perspective is reflected in the growing interest in stakeholder theory, which we will consider in the next chapter, and corporate social responsibility.

Of course, these different perspectives are not mutually exclusive; they overlap. None are all-inclusive; each can be relevant in context. The vital issue is to adopt the perspective that is appropriate to the matter under review.

The scope of corporate governance

Figure 2.1 shows schematically the parties involved in the various perspectives on corporate governance.

Central to corporate governance thinking and practice are the shareholders, the board of directors, and the management. The corporate governance codes focus on this set of players, as does much company law. External auditors play a crucial role in corporate governance, although they are not often presented as central to its study. In the original 19th-century concept of the corporation, the shareholders appointed some of their own members to act as auditors, to check on the reports presented to them by their directors. Subsequently, they were replaced by professional auditors, as the accounting profession developed in the later years of that century. Later, we shall consider the implications of audit in the modern, global world, with just four massive, international firms of accountants, following the demise of the fifth, Arthur Andersen, after the Enron debacle, which we will study in Chapter 4. The importance of audit committees—standing committees of the main board, which are now required by all the codes of good practice in corporate governance—will also be studied in depth.

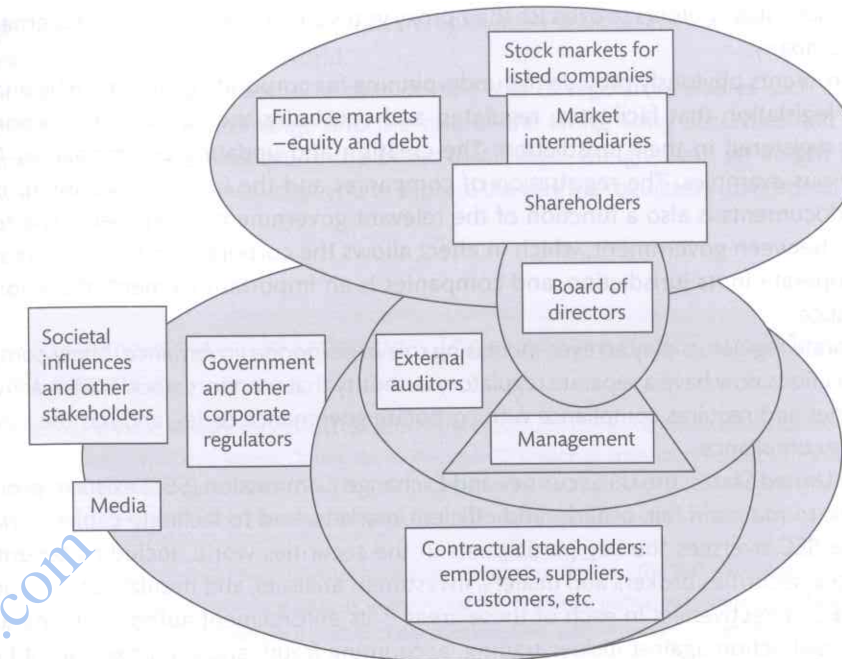

Figure 2.1 The scope of corporate governance

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For public, listed companies, the stock markets and their listing rules are, clearly, vitally significant to corporate governance. The rules that govern the stock market on which the company's shares are listed and in particular the requirements laid down for listing are fundamental to the effective governance of listed companies. Stock markets around the world also play an important role in the creation and policing of corporate governance codes.

Another perspective focuses on the interrelations between the company and its shareholders, including any dominant owners, and institutional investors, minority shareholders, and stock exchanges where a company is listed. The governance interests of any providers of non-equity debt capital also need to be included. In public companies, market intermediaries play an increasingly important role in modern corporate governance. In the original model of the corporation, shares were held by individual shareholders who interacted directly with their company. Today, although individual investors do have a significant share in some markets, institutional investors play a very significant part in most. The institutional investors may include an array of financial institutions such as pension funds, investment funds, life assurance funds, unit trusts, hedge funds, and other investment houses. There can be a raft of intermediary institutions between the company and the ultimate investor in its shares. Investment bankers may act as underwriters in launching shares in an initial public offering (IPO) of shares. Brokers, merchant bankers, and other institutions can hold shares on behalf of others. A further complication can arise if the financial institution holding shares lends them as security for other transactions. This situation can make it difficult for companies to know who their voting shareholders are,

and for those shareholders to exercise their proxy votes and to take part in the governance of the company.

Governments obviously provide the underpinning for corporate governance by enacting the legislation that facilitates, regulates, and constrains the activities of corporate entities registered in their jurisdiction. The creation and updating of Companies Acts are obvious examples. The registration of companies and the filing and access to corporate documents is also a function of the relevant government department. The relationship between government, which in effect allows the corporate entity to be created and to operate in its jurisdiction, and companies is an important element of corporate governance.

Corporate regulators play an ever-increasing role in corporate governance. Many company jurisdictions now have a separate regulatory authority that monitors stock market activity, determines and requires compliance with corporate governance codes, and has the power to ensure compliance.

In the United States, the US Securities and Exchange Commission (SEC) exists to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation. The SEC oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisers, and mutual funds. Crucial to the SEC's effectiveness in each of these areas is its enforcement authority, being able to take legal action against insider trading, accounting fraud, and the provision of false information.

Some commentators and researchers widen the focus of corporate governance to include contractual stakeholders—that is, those with whom the company has contractual relations, including employees, suppliers, and all those in the upstream and downstream added-value chains from suppliers of original goods and services, other contractors and supply firms, through distributors, wholesalers, and retailers, to the final customer and consumer. Government and other corporate regulators are also basic components of the corporate governance system. This includes the effect of the company law, the legal institutions, and the regulatory mechanisms of the country concerned. Previously, the press showed little interest in business affairs unless there were major catastrophes. But, in recent years, the media has shone a spotlight on corporate activities, and the investigative media now play a useful role in the corporate governance process and have to be considered by practitioners.

Finally, the growing importance of societal influences and other stakeholders in corporate governance needs emphasis. In earlier days, companies tended to be left alone to carry on their activities in the pursuit of profit without interference, provided that they abided by the laws of the jurisdictions in which they operated. This is no longer the case. Today, many people expect companies to adopt a socially responsible attitude to their activities, for example by not doing objectionable things, such as exploiting workers, polluting the environment, or wasting energy.

Corporate social responsibility (CSR) reflects what some commentators see as companies' obligations to everyone who might be affected by the company's activities (the stakeholders): not only contractual stakeholders, such as employees, suppliers, and customers, but local neighbourhoods who could be affected by a plant closure, cities and states affected by the loss of jobs and tax revenues by a company's strategy to move activities elsewhere, and even

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larger international society for companies' employment policies, environmental impacts, or marketing policies around the world.

At this stage it may be useful to consider the role of regulatory bodies such as the US Securities and Futures Exchange and the role of the Hong Kong Securities and Futures Commission. This information, in the boxes that follow, will give you an insight into the regulatory process and encourage you to explore the way the regulatory institutions operate in your own country.

Corporate governance in action 2.1 The role of the US SEC and EDGAR and XBRL reporting

The SEC was created following the Great Crash of 1929. Previously, there was little support for federal involvement in corporate matters. During the 1920s, over 20 million shareholders set out to make their fortunes on the stock market. Of around US$50 million in new securities issued, half became worthless. Countless fortunes were lost. Many banks failed. Depression followed and confidence in the markets collapsed.

Congress passed the 1933 Securities Act to restore investor confidence. The SEC was set up to enforce the new laws designed to promote security in the market by requiring public companies to tell the truth about their business, their securities, and the risks involved, and requiring security dealers to treat investors fairly and honestly.

The mission of the SEC is to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation. Unlike the banking world, where deposits are guaranteed by the federal government, stocks, bonds, and other securities can lose value. The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and as long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security.

The SEC oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisers, and mutual funds. Crucial to the SEC's effectiveness in each of these areas is its enforcement authority. Each year, the SEC brings hundreds of civil enforcement actions against individuals and companies for violation of the securities laws. Typical infractions include insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them.

To support investors, the SEC provides a mass of information, including the EDGAR database of disclosure documents that public companies are required to file with the Commission. From 2011, the SEC required filings of all necessary corporate documents to be XBRL-based. XBRL (eXtensible Business Reporting Language) is an open, free, global standard system covering financial data and facilitates the creation, distribution, and use of business reports.

The SEC is the primary overseer and regulator of the US securities markets, and works closely with many other institutions including Congress, other federal departments and agencies, the self-regulatory organizations (e.g. the stock exchanges), state securities regulators, and various private sector organizations. In particular, the Chairman of the SEC, together with the Chairman of the Federal Reserve, the Secretary of the Treasury, and the Chairman of the Commodities Futures Trading Commission, serves as a member of the President's Working Group on Financial Markets.

(For more information, see www.sec.gov and www.xbrl.org.uk)

Corporate governance in action 2.2 The role of the Hong Kong Securities and Futures Commission

The Securities and Futures Commission (SFC) is an independent non-governmental statutory body outside the civil service, responsible for regulating the securities and futures markets in Hong Kong, for administering the laws governing the securities and futures markets in Hong Kong, and for facilitating and encouraging the development of these markets.

The statutory duties of the SFC are:

- to maintain and promote the fairness, efficiency, competitiveness, transparency, and orderliness of the securities and futures industry;
- to promote understanding by the public of the operation and functioning of the securities and futures industry;
- to provide protection for members of the public investing in or holding financial products;
- to minimize crime and misconduct in the securities and futures industry;
- to reduce systemic risks in the securities and futures industry;
- to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

As the statutory regulator of the securities and futures markets in Hong Kong, the Commission places great importance on corporate governance: 'We always strive to enhance our accountability to the public and the transparency of our work. We adopt and implement corporate governance practices commensurate with the best standards applicable to public bodies.' All important policies and decisions are discussed and approved by the board, which meets regularly every month and holds additional meetings as necessary. Divisional staff attend board meetings to explain policy proposals, reporting on important operational matters and regulatory issues. Members are also briefed on the financial positions of the Commission and provided with monthly financial statements.

(For more information, see www.sfc.hk)

The significance of constitutions for corporate entities

Every corporate entity needs a constitution

A corporate entity is formed whenever a group of members organize a company, institution, society, association, or other entity to serve their purpose. Being artificial, corporate entities have to be created. For that, they need some form of constitution, which may be formal under the law, for example under company law or the law registering co-operatives, or it can be informal, consisting of little more than a name, a purpose, and a set of rules. As the name indicates, corporate governance is about the way in which these corporate entities are governed.

In each case, the entity has an existence separate from its members, runs activities, and needs to keep separate financial accounts. Its constitution should define the rights and duties of its members, and lay down the rules about the way in which it is to be governed. Typically, the constitution will define the nature of the governing body, its role, and how its members are elected or chosen.

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Corporate entity	Members	Constitution	Governing body
Limited liability company	Shareholders	Memorandum and articles of association	Board of directors
Professional organization	Qualified members of the profession	Charter and membership rules	Council
Local football club	Club members	Rules	Committee
Trades Union	Registered members	Constitution and Branch rule books	General Executive Council
Oxford College	Fellows of the College	Founding statute or Royal charter	The Governing Body

Figure 2.2 Examples of the governance arrangements in different corporate entities

Figure 2.2 provides some comparisons of corporate entities, showing the separation between corporate entities and their members, with examples of different constitutions and governing bodies.

The governing body usually wields governance power over the corporate entity. However, in the case of companies, particularly public companies, other drivers of governance power can include shareholder activists, institutional investors, corporate raiders, and holders of blocks of shares, as well as threats of hostile takeover bids.

Whether the constitution is formal, as required under law, or an informal set of rules, it is a fundamental underpinning of the corporate entity and, hence, its governance. Yet, amazingly, many people appointed as directors of limited companies or elected to councils or committees of other bodies have never read that entity's constitution. An important part of the induction of every company director should be to study and understand the company's articles of association, particularly the rules about its governance.

Incorporating a joint-stock limited-liability company

The incorporation of a limited-liability company involves the registration of formal documents, in line with the company laws of the jurisdiction in which the company is to be incorporated. Typically, the founding members (shareholders) of the company have to prepare and submit the articles of association for the proposed company to the companies' registrar. In some jurisdictions a memorandum is also required stating the company's name, share capital, registered office and, sometimes, its purpose. Alternatively, the promoters of the company may buy a company 'off the shelf', from a business that specializes in setting up companies, and simply change the name of the company to the one they want.

The companies' registrar will check the proposed company name to ensure that there is no duplication and that the name is not undesirable (for example, in the United Kingdom, names that suggest a connection with the royal family or involvement with unacceptable activities are not allowed). On incorporation, the company's name is entered on the companies' register and the articles of association become public documents, available for scrutiny by anyone.

Discussion questions

China Unicom has expressed its commitment to fulfilling the demands of Section 404 to report on internal control systems. The details provided above by China Unicom are impressive. But are you satisfied that all companies reporting under Section 404 are competent? Should these statements be independently audited?

(For more information, see www.chinaunicom.com.hk)

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Self-test questions

1. What is the role of the OECD Principles of Corporate Governance?
2. What does Section 404 of the US Sarbanes–Oxley Act require?
3. How does the SOX Act define an INED?
4. Is it necessary for companies covered by the SOX Act to adopt and disclose a code of business conduct and ethics for directors, officers, and employees?
5. What are the responsibilities of the board according to the OECD Principles?

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6 Models of Corporate Governance

Learning Outcomes

In which we consider:

- How context and culture affect corporate governance
- The US rules-based model
- The UK/Commonwealth principles-based model
- The continental European two-tier model
- The Japanese business network model
- The Asian family-based model
- Corporate governance: convergence or differentiation?
- Institutions necessary for successful corporate governance

How context and culture affect corporate governance

We compared unitary boards and two-tier boards in Chapter 2, and in the last chapter we saw conceptually different approaches to corporate governance between the legalistic, rules-based, and the discretionary, principles-based approaches. In this chapter, we widen our search for the basic underlying models of corporate governance around the world. Five broad classifications are identified: the American rules-based model; the UK/Commonwealth principles-based model; the continental European two-tier model; the Japanese stakeholder-orientated network model; and the Asian family-based model. We consider why such differences have occurred, and consider whether corporate governance systems around the world are converging, as some suggest. We will explore corporate governance in the Islamic countries, the *chaebol* in South Korea, and the BRIC nations—Brazil, Russia, India, and China—in a later chapter.

Two primary influences can be suggested for the basic differences in corporate governance around the world: context and culture. Looking first at the context in which corporate governance is practised, we review the implications of different patterns of ownership, alternative markets for corporate control, and different ways of financing corporate entities. Then we consider the cultural influences on corporate governance.

Patterns of ownership

Ownership in listed companies around the world varies, from the highly dispersed to the singularly concentrated. Table 6.1 shows, country by country, the proportion of voting shares held by individuals, institutional investors, banks and government, holding companies, and overseas investors.

Table 6.1 Balance of listed company ownership

Country	Individuals	Institutional investors	Banks and government	Holding company	Foreign
Australia	20%	34%	4%	11%	31%
Canada	15%	38%	8%	14%	25%
France	23%	12%	14%	14%	37%
Germany	17%	15%	17%	39%	12%
Italy	18%	14%	40%	18%	10%
Japan	20%	21%	23%	28%	8%
Sweden	23%	30%	8%	9%	30%
Netherlands	14%	21%	1%	23%	41%
UK	19%	58%	5%	2%	16%
USA	51%	41%	3%	0%	5%

Notice how, in the United States, individuals and institutional investors together account for 92% of the shareholdings and in the United Kingdom 77%, whereas in France it is only 35%. In fact, the dispersed ownership found in UK and US companies is the exception rather than the norm around the world. In Germany, Japan, and the Netherlands, many listed companies are held within corporate groups and their boards find themselves responsible to a holding company. The foreign investors in countries such as the Netherlands (41%) or France (37%) may be an overseas parent company, or the holdings may be dispersed among overseas shareholders.

In a company in which the voting shareholders are highly differentiated—that is, where the shares are held by many dispersed external shareholders as in the United States and the United Kingdom—the directors need to respond to their varied expectations, while recognizing that shareholders can, occasionally, act together. On the other hand, where there is a dominant owner, with the other shareholders being in a minority, the directors need to respond to the expectations of that dominant shareholder, while protecting the rights of the minority. Examples include a listed company that is nevertheless part of a corporate group, a company with a dominant shareholder such as a government or financial institution, or cases in which there is a block of connected shareholders.

Obviously, in the longer term, the pattern of ownership fundamentally affects the ability of a board to exercise power over a company. In a company that has a wide spread of shareholders, a board will have more freedom to act on its own initiative than in one the shares of which are dominated by a single or block of investors. Boards need to be acutely aware of which parties have the potential to influence their decisions. Unfortunately, some commentators on corporate governance fail to make this distinction.

Markets for corporate control

In countries with a high proportion of external investors, as in the United States and the United Kingdom, a board can be faced with a hostile takeover bid and a consequential loss of control. In other words, the market for corporate control is strong. Merger and acquisition activity is likely to be widespread. In countries with a relatively low proportion of external

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investors, the market for corporate control will be weaker, and merger and acquisition activity less. Hostile takeover bids in British companies have been commonplace for generations: the first contested takeover bid for a German company occurred in the 1990s.

Financing corporate entities

In countries where equity markets are relatively large, with high liquidity and significant turnover, shareholdings are often widely spread. So boards can wield significant power over their companies, even though ultimate power lies with the voting shareholders. In other countries, however, where stock markets are relatively small, listed companies may rely on non-equity loan capital. In companies that have leveraged their equity capital, with a high loan to equity gearing, ultimate power over the company may be in the hands of the lender through the terms of the loan agreement.

Cultural influences on corporate governance

Intuitively, board-level behaviour differs from culture to culture. Later in this chapter we will see how, around the world, board relationships and activities vary, directors' expectations differ, and individual directors behave differently. So, apparently, corporate governance has a cultural component. Not everyone agrees. David Webb, a Western commentator based in Hong Kong, has written:

> People who defend bad corporate governance on the grounds of Asian values or some cultural difference are talking nonsense. Yes, there is a different structure of ownership; it's somewhat Victorian in that most companies (in Asia) are family-controlled, but had I been around in Victorian times in England I think I would have seen similar bad corporate governance.

The position taken in this book is that cultural differences do exist and that, while they should not be used to defend poor governance practices, failure to appreciate their significance is short-sighted. We will now review the context and culture of corporate governance using the five basic models—US rule-based, UK and Commonwealth principles-based, continental European two-tier based, Japanese stakeholder-orientated networks, and the Asian family-based model

The US rules-based model

In the early days of corporate governance thinking experts tended to write about the Anglo-American (or Anglo-Saxon) unitary board model of corporate governance contrasted with the continental two-tier board model. Indeed, many expected a convergence of corporate governance practices towards the Anglo-American model, but, as we saw, some fundamental differences have appeared between the US rules-based and the UK/Commonwealth principles-based models. So we need to explore each model separately.

The American model reflects corporate governance practices throughout the United States and in other countries influenced by the United States. Companies in the United States are

incorporated in individual states and are subject to those states' company law and corporate regulation. Investor protection, auditing requirements, and financial disclosure of public companies, however, are federal responsibilities, predominantly overseen by the US Securities and Exchange Commission (SEC). Company law is based on common law, which is rooted in legislation that evolves with a continually growing body of case law at both the federal and the state levels.

The basic governance model for public companies in the United States is the unitary board, with a predominance of independent outside directors. The SEC and stock exchange listing requirements also call for mandatory audit, nomination, and remuneration committees of the board. In the United States, shareholders have little influence on board membership, other than expressing dissatisfaction by not voting, selling their shares, or resorting to litigation.

In the United States, governance is regulated by legal statute and mandatory rules, which are inherently inflexible. Litigation levels are high. Directors face legal penalties for non-compliance. The 2002 Sarbanes–Oxley Act strengthened this emphasis on governance under penalty of law, with disclosure requirements that proved more expensive and burdensome than expected. The role of the regulators is to ensure that the rules are being obeyed. The American financial markets are the largest and most liquid in the world, but their lead, particularly in initial public offering (IPOs), has been eroded.

Generally accepted accounting principles (GAAP) in America call for compliance with the rules. There are signs that the United States is moving towards international standards.

The UK/Commonwealth principles-based model

The law that recognized the incorporation of the joint-stock, shareholder limited-liability company originated in the United Kingdom in the mid-19th century. Purists might argue that France can claim a slightly earlier form of legal incorporation, but that only granted limited liability to investors who were not involved in managing the company. Membership of the old British Empire, in the later 19th and early 20th centuries, meant that UK company law influenced the development of company law in Australia, Canada, Hong Kong, India, New Zealand, South Africa, Singapore, and indeed throughout what is now known as the Commonwealth.

As in the American model, company law in the UK/Commonwealth model is based on common law, rooted in legislation extended by case law. But, by contrast with the American model, in the United Kingdom and in Commonwealth countries, corporate governance is 'principles-based'. Codes of corporate governance principle or good practice determine board responsibilities, not the rule of law. Companies are required to report that they have followed the governance principles laid down in the codes or to explain why they have not. Consequently, this model is often referred to as the 'comply or explain' approach to corporate governance. Self-regulation is the underlying theme. Compliance is voluntary, with the sanctions being the exposure of corporate governance failings to the market and, ultimately, delisting from the stock exchange. The role of the regulators is to ensure that investors and potential investors have accurate information on which to base their judgements.

Throughout the Commonwealth, corporate governance codes for listed companies, although differing slightly in detail, all call for independent non-executive or outside directors,

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audit, remuneration, and nomination committees of the board, and high levels of transparency and accountability. The codes also call for a separation between chairman and CEO.

The principles-based versus the rules-based view of governance is also reflected in accounting standards. The UK/Commonwealth countries apply standards that are predominantly based on international accounting standards, which emphasize compliance with principles.

In the United Kingdom, unlike the United States, shareholders with 10% of the voting rights in a public company can force an extraordinary meeting and vote on strategic decisions or the removal of a director. Even though that seldom occurs, the possibility can affect board actions.

In a consultation paper[1] in 2014, the UK Financial Reporting Council proposed some changes to the UK corporate governance code, including:

- greater emphasis to be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind;
- companies to explain when publishing the AGM results how they intend to engage with shareholders when a significant percentage of them have voted against a resolution;
- companies should robustly assess their principle risks and explain how they are being managed and mitigated.

The continental European two-tier model

Company law in continental European countries is typically rules-based. In France, for example, it is based on Napoleonic law, in which required corporate behaviour is determined by legally binding rules and evolves by further legislation, not by the precedents of case-based common law. Judges not juries play the dominant role. In these European countries, finance markets tend to be smaller and less liquid. The market for corporate control is weak. Bank and loan finance is widely used to fund companies, and banks wield more influence on corporate affairs, particularly in Germany. Investors tend to be more concentrated, often with dominant family shareholdings, particularly in France and Italy. As we will explore later, gearing chains of companies are sometimes used to leverage controlling shareholders' investment.

Two-tier boards are required in Germany and Holland and are found in France and Italy. Moreover, in line with the social contract found in many European societies, corporate governance practices frequently have a social component. For example, the co-determination rules in Germany require one half of the supervisory board to represent labour, with employee representative directors elected through the trades unions; the other half, representing capital, elected by the shareholders. Many countries in the European Union also require works councils in which representatives of the employees wield power.

The European company (the *Societas Europaea*), enacted under the rules of the European Union, provides for either Anglo-American or continental European approaches. But, despite

[1] https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/April/Consultation-on-the-UK-Corporate-Governance-Code-p.aspx

the political orientation of many European countries towards social democracy and the traditional stakeholder orientation in companies, in recent years some continental European firms have nevertheless lent towards strategies based on the maximization of shareholder value.

Critics of the continental European model of corporate governance argue that the management board is often dominated by top management and lacks the information inputs, advice, and wise counsel that can be provided by outside independent non-executive directors on unitary boards. Other critics question the effectiveness of supervisory boards, their lack of real power, and their ability effectively to control the management board. Some argue that the representative character of the supervisory board produces conflicts of interest.

There was a time when countries that employed the two-tier board believed that this was a superior model to the unitary board. Indeed, at one time, the European Union tried to impose the two-tier model on all companies in member states—a proposal strongly resisted in the unitary board countries. Today, the benefits and limitations of each model are more widely recognized.

The Japanese business network model

Keiretsu are networks of companies in Japan connected through cross-holdings and interlocking directorships. Member companies tend to inter-trade extensively. Frequently, the network includes a financial institution. The classical model of the *keiretsu* reflects the social cohesion within Japanese society, emphasizing unity throughout the organization, non-adversarial relationships, lifetime employment, enterprise unions, personnel policies encouraging commitment, initiation into the corporate family, decision-making by consensus, cross-functional training, and promotion based on loyalty and social compatibility as well as performance. This model is currently under pressure, as we will see, but first let us review this traditional approach to corporate governance in Japan.

In the classical *keiretsu* model, boards of directors tend to be large and are, in effect, the top layers of the management pyramid. People speak of being 'promoted to the board'. The tendency for managers to progress through an organization on tenure rather than performance means that the mediocre can reach board level. A few of the directors might have served with other companies in the *keiretsu* network, and in that sense might be able to represent the interests of suppliers or down-stream agents; others might have been appointed to the company's ranks on retirement from the *keiretsu's* bankers, or even from among the industry's government regulators (known as a *amakaduri*, or 'descent from heaven').

But independent non-executive directors, in the Western sense, would be unusual, although the proportion is increasing. Many Japanese do not see the need for such intervention 'from the outside'. Indeed, they have difficulty in understanding how outside directors operate. How can outsiders possibly know enough about the company to make a contribution, they question, when the other directors have spent their lives working for the company? How can an outsider be sensitive to the corporate culture? He might even damage the harmony of the group. A study by the Japanese Independent Directors Network, in November 2010, showed that of all the companies on the Nikkei 500 index, outside directors made up 13.5% of the board, women 0.9%, and non-Japanese 0.17%.

The Japanese *ringi* approach to communication encourages dialogue up and down the management hierarchy, leading, over time, to an agreed position. This means that boards tend to be decision-ratifying bodies rather than strategic decision-initiating and decision-taking forums, as in the West. Indeed, in some companies, meetings of the entire board tend to be ceremonial, with honourable titles used on social occasions, although that aspect of society is in transition.

Chairmen and senior directors of companies in the *keiretsu* meet regularly and have close, informal relationships. Meetings of the managing directors with the directors in their teams are also crucial, as are the informal relationships between the top echelons of the board. Ultimate power lies with the top managers, particularly the president and the chairman.

The Japanese Commercial Code calls for 'representative directors' to be elected by the board. Whereas, from a Western viewpoint, these might be expected to represent the interests of various stakeholders in the firm, their actual role is to represent the company in its dealings with outside parties such as the government, banks, and other companies in the industry. Typically, the representative directors include the chairman and president and other top directors. The Code also calls for the appointment of individuals as full-time statutory auditors. They report to the board on any financial problems or infringements of the company code or the company articles. They can call for information from other directors and company employees, and can convene special meetings of the board. These internal board-level auditors, of course, liaise with the external professional auditors.

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Japanese company law does provide for independent outside directors, where they exist, to form a separate committee outside the board. Although the basic governance model is of a unitary board, this committee could be seen as a form of supervisory board. Recently, some independent outside directors have been appointed, usually under pressure from international investors.

Traditionally, investors have played a relatively small part in corporate affairs. The classical model of Japanese corporate governance had a stakeholder, not a shareholder, orientation. Power lay within the *keiretsu* network. There was no market for corporate control since hostile takeover bids were virtually unknown.

However, in recent years, the extent of cross-holdings of shares between companies has fallen and the first apparently hostile takeover in the Tokyo Stock Exchange was reported in 2007.

With the Japanese economy facing stagnation from the 1990s, traditional approaches to corporate governance were questioned. A corporate governance debate developed and the bank-based, stakeholder-orientated, rather than shareholder, corporate governance model came under scrutiny. The poorly performing economy had weakened many of the banks at the heart of *keiretsu*. Globalization of markets and finance put further pressure on companies. The paternalistic relationship between company and lifetime 'salary-man' slowly began to crumble. Some companies came under pressure from institutional investors abroad. Company laws were then redrafted to permit a more US style of corporate governance. But few firms embraced them. More emphasis has, however, been placed on shareholders, with board restructuring and directors receiving performance incentives. Some companies experimented with alternative, hybrid forms of governance structure. Consequently, there is now more diversity in the approaches to corporate governance in Japan, although changes tend to be gradual and incremental. But some have predicted moves towards the US or UK/

Commonwealth models, as Japan responds to the pressures of the globalization of business and finance.

Signs of movement included calls in 2008 by eight international investment funds for greater shareholder democracy, and a report from the Japanese Council for Economic and Fiscal Policy to the Japanese Prime Minister proposing that anti-takeover defences be discouraged and the takeover of Japanese firms be made easier.

Recognizing the importance of corporate governance to the long-term development of Asian economies and capital markets, the Asian Corporate Governance Association (ACGA) was founded in 1999 as an independent, non-profit membership organization dedicated to working with investors, companies, and regulators in the implementation of effective corporate governance practices throughout Asia. An ACGA report provided a critique of corporate governance in Japan:

> We believe that sound corporate governance is essential to the creation of a more internationally competitive corporate sector in Japan and to the longer-term growth of the Japanese economy and its capital markets. While a number of leading companies in Japan have made strides in corporate governance in recent years, we submit that the system of governance in most listed companies is not meeting the needs of stakeholders or the nation at large in three ways:
>
> - By not providing for adequate supervision of corporate strategy
> - By protecting management from the discipline of the market, thus rendering the development of a healthy and efficient market in corporate control all but impossible
> - By failing to provide the returns that are vitally necessary to protect Japan's social safety net—its pension system

In 2013, the ruling Liberal Democratic Party introduced a bill to enhance corporate governance. The bill called for audit committees, controlled by independent outside directors, to give opinions on personnel and other important issues; and for measures to ensure the independence of external auditors from boards of directors. Outside directors would not be made mandatory because of business resistance. But listed companies that lacked such outside directors would be required to explain why at annual shareholder meetings.

Professor Hideaki Miyajima of Waseda University suggests that Japanese corporate governance is evolving into 'a hybrid-type', in which market-based structures are merged together. His research suggests that 'the performance of some Japanese companies that have evolved through incorporating these hybrid-type structures is significantly higher. However, such hybridization involves new costs, as conflicts between differing modes cannot be avoided.' Corporate governance in Japan remains work in progress.

The Asian family-based model

'Overseas Chinese' is the term used to describe Chinese business people who, over the years, as a result of the Chinese diaspora from the mainland, now play a fundamental part in the business life of South East Asia. Many companies in the significant Asian economies—Singapore, Taiwan, Malaysia, Thailand, Indonesia, Hong Kong, and the Philippines—are in the

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hands of Chinese families. For example, nearly half of the share capital invested in Malaysian companies is owned by Chinese residents and a quarter by foreign-controlled companies. Fewer than twenty families control the companies that dominate the local stock market for Hong Kong Chinese companies (not mainland Chinese companies).

In the governance of overseas Chinese companies, the board tends to play a supportive role to the real exercise of power, which is exercised through relationships between the key players, particularly between the dominant head of the family and other family members in key top management positions. Some of these companies are quite diverse groups with considerable delegation of power to the subsidiary unit, but with the owner-manager, or a family-orientated small group, still holding a strategic hand on the tiller.

Research into the management of overseas Chinese companies has suggested some distinguishing characteristics, which may help to interpret the evidence on governance practices. These studies suggest that overseas Chinese firms are:

- family-centric with close family control;
- controlled through an equity stake kept within the family;
- entrepreneurial, often with a dominant entrepreneur, so that decision-making is centralized, with close personal links emphasizing trust and control;
- paternalistic in management style, in a social fabric dependent on relationships and social harmony, avoiding confrontation and the risk of the loss of 'face';
- strategically intuitive, with the business seen as more of a succession of contracts or ventures, relying on intuition, superstition, and tough-minded bargaining rather than strategic plans, brand-creation, and quantitative analysis.

With outside shareholders in the minority, the regulatory authorities tend to emphasize the importance of disclosure and the control of related-party transactions. Although many corporate governance codes require independent non-executive directors, the independence of outside directors is less important to the owner than their character, trustworthiness, and overall business ability. Of course, corporate governance problems exist in Chinese and overseas Chinese companies: corruption, insider trading, unfair treatment of minority shareholders, and domination by company leaders, to name a few. But these are unfortunate attributes of corporate governance that reflect human behaviour everywhere.

Corporate governance: convergence or differentiation?

Are corporate governance practices around the world converging? This is a question that is often posed by corporate governance practitioners and frequently answered in the affirmative. Certainly, there are many forces that could lead towards convergence, as the following factors show.

Forces for convergence

Corporate governance codes of good practice around the world have a striking similarity, which is not surprising given the way in which they have been influenced by each other.

Although different in detail, all emphasize the importance of independence, transparency, and accountability. The codes published by international bodies, such as the World Bank, the Commonwealth of Nations, and the Organisation for Economic Co-operation and Development (OECD), clearly encourage convergence. The corporate governance policies and practices of major corporations operating around the world can also be global influences.

Securities regulations for the world's listed companies are certainly converging. The International Organization of Securities Commissions (IOSCO), which now has the bulk of the world's securities regulatory bodies in membership, encourages convergence. For example, its members have agreed to exchange information on unusual trades, thus making the activities of global insider trading more hazardous.

International accounting standards are also leading towards convergence. The International Accounting Standards Committee (IASC) and the International Auditing Practices Committee (IPAC) have close links with IOSCO, and are further forces working towards international harmonization and standardization of financial reporting and auditing standards. US GAAP, although some way from harmonization, are clearly moving in that direction.

In 2007, the US SEC announced that US companies could adopt international accounting standards in lieu of US GAAP. However, American accountants and regulators are accustomed to a rules-based regime and international standards are principles-based, requiring judgement rather than adherence to prescriptive regulations.

Global concentration of audit practices into just four firms, since the demise of Arthur Andersen, encourages convergence. Major corporations in most countries, wanting to have the name of one of the four principal firms on their audit reports, are then inevitably locked into that firm's worldwide audit, risk analysis, and other governance practices.

Globalization of companies is also, obviously, a force for convergence. Firms that are truly global in strategic outlook, with production, service provision, added-value chain, markets and customers worldwide, calling on international sources of finance, and the shares of which are held around the world, are moving towards common effective, transparent, and accountable governance practices. Unfortunately, the composition of the boards of the parent companies of such groups seldom reflects such globalization, because they are still dominated by nationals of the country of incorporation. However, the proportion of 'foreign' directors—that is those not nationals of the home country—although small, has been increasing. Companies such as Arcelor incorporated in Belgium, Novartis in Switzerland, Cable and Wireless in the United Kingdom, and ABN Amro in the Netherlands do have a significant proportion of directors who are not from the 'home country'. Significantly, no companies incorporated in the United States figure in this list.

Raising capital on overseas stock exchanges, clearly, encourages convergence as listing companies are required to conform to the listing rules of that market. Although the governance requirements of stock exchanges around the world differ in detail, they are moving towards internationally accepted norms through IOSCO.

International institutional investors, such as CalPers, explicitly demand various corporate governance practices if they are to invest in a specific country or company. Institutional investors with an international portfolio have been an important force for convergence. Of course, as developing and transitional countries grow, generate and plough back their own funds, the call for inward investment will decline, along with the influence of the overseas institutions.

Private equity funding is changing the investment scene. Owners of significant private companies may decide not to list in the first place. Major investors in public companies may find an incentive to privatize. Overall, the existence of private equity funds challenges boards of listed companies by sharpening the market for corporate control. As the power of private equity grows, expect calls for more transparency, accountability, and control.

Cross-border mergers of stock markets could also have an impact on country-centric investment dealing and could influence corporate governance expectations, as could the development of electronic trading in stocks by promoting international securities trading.

Research publications, international conferences, and professional journals can also be significant contributors to the convergence of corporate governance thinking and practice.

Forces for differentiation

However, despite all of these forces pushing towards convergence, there are others that, if not direct factors for divergence, at least cause differentiation between countries, jurisdictions, and markets.

Legal differences in company law, contract law, and bankruptcy law between jurisdictions affect corporate governance practices. Differences between the case law traditions of the United States, United Kingdom, and Commonwealth countries, and the codified law of continental Europe, Japan, and China distinguish corporate governance outcomes.

Standards in the legal process, too, can differ. Some countries have weak judicial systems. Their courts may have limited powers and be unreliable. Not all judiciaries are separate from the legislature. The state or political activities can be involved in jurisprudence. In some countries, bringing a company law case can be difficult and, even with a favourable judgment, obtaining satisfaction is not always possible.

Stock market differences in market capitalization, liquidity, and markets for corporate control affect governance practices. Obviously, financial markets vary significantly in their scale and sophistication, affecting their governance influence.

Ownership structures also vary between countries. Some countries have predominantly family-based firms; others have external investors, but the proportion of individual investors compared with institutional investors differs; while some adopt complex networked, chained, or pyramid structures.

History, culture, and ethnic groupings have produced different board structures and governance practices. For example, contrast the governance in Japan *keiretsu*, continental European two-tier boards with worker co-determination, and family domination in overseas Chinese companies. Moreover, opinions differ on ownership rights and the basis of shareholder power between countries.

The concept of the company was Western, rooted in the notion of shareholder democracy, the stewardship of directors, and trust—the belief that directors recognize a fiduciary duty to their companies. But today's corporate structures have outgrown that simple notion. The corporate concept is now rooted in law, and the legitimacy of the corporate entity rests on regulation and litigation. The Western world has created the most expensive

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12 Directors' Appointment, Roles, and Remuneration

Learning Outcomes

In which we review:

- The appointment of directors
- Desirable attributes in a director
- Core competencies of a director
- Roles that directors play
- Directors' duties, rights, and powers
- Directors' disclosures, service contracts, and agreements
- Directors' remuneration

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The appointment of directors

Director appointments arise:

- on the initial incorporation of a company;
- on reappointment at the expiry of a director's term of office;
- to fill a vacancy; and
- on the creation of an additional directorship.

The rotation of directors

Companies' articles of association typically lay down the terms of service for directors, including how long they will act before coming up for re-election and when that should occur. In the past, many companies' articles called for a fixed proportion of the directors to retire each year. For example, if directors' appointments were for three years, a third would stand down each year, offering themselves for re-election if eligible. It was felt that this practice provided stability, since there would always be a proportion of directors on the board with experience of the company's business, enabling a longer-term strategic perspective to be taken. Critics of these so-called 'staggered' or 'classified' boards complain that, in a poorly performing company, underperforming directors become entrenched. Because the entire board cannot be replaced at a single election, staggered boards effectively block hostile takeover bids, and can be used as a takeover defence. Annual election of all directors allows a change of control

through a single successful proxy contest. Resolutions opposing staggered boards and calling for declassification have been high on shareholder activists' calls for change in the United States in recent years.

The size of boards

Many articles of association put upper and lower limits on board size. Some company law jurisdictions also have rules on board size, particularly the minimum number of directors; some prohibiting single director boards. Others do not allow corporate directors, insisting that directors are real persons. Where corporate directors are allowed, the directors of the corporate director take on the responsibilities of the directorship.

In practice, the case is often made for additional directors to join a board to remedy perceived weaknesses, to add necessary skills and experience, or to bring new knowledge or contacts. The case is seldom heard for a reduction in numbers. The ideal number, obviously, depends on the circumstances in each case, but boards can become too large. Beyond a certain number, psychologists say between eight and ten, a board ceases to be a cohesive, decision-making body. The time each director has to contribute to discussion is limited. Directors are more likely to form cliques or cabals. Chairmanship becomes difficult, so that leading the board to a consensus is more problematic.

Retirement, disqualification, and removal of directors

Company law in some jurisdictions puts an age limit on directors, often seventy. Elsewhere, the view is taken that this is ageist and that many older people have the wisdom, experience, and abilities to make significant contributions to companies. The important factor is to ensure that older directors are making that contribution and not being re-elected out of a misplaced sense of respect or loyalty. Many articles of association also have rules on directors' ages, calling for shareholder approval. Company law often imposes a minimum age on appointments to the board, frequently sixteen or eighteen.

Company law can also disqualify certain people from serving as directors, including becoming bankrupt, mentally ill, or being disqualified by the courts from being a director. Disqualification by the courts usually follows a guilty verdict of an offence in running a company or persistently defaulting in the filing of official returns.

In principle, the shareholders of a company have the right to appoint and to remove their directors. In practice, this can prove to be difficult. Subject to company law and the company's articles, members can propose a resolution calling for the removal of directors, and seek a shareholders' meeting to consider this resolution. Much depends on the voting power of the recalcitrant shareholders. The incumbent board may resist, adopt delaying tactics, and circulate contrary information at the company's expense, while requiring the challenging shareholders to cover the costs of their campaign.

How are directors appointed?

In the original 19th-century model of the limited-liability company, the founder of the business, the existing directors, and perhaps the shareholders suggested possible directors. The

shareholders then met, and a decision was reached. This is still the case in most private companies: decisions are taken by dominant shareholders, such as family members in a family firm, or the directors of the holding company in a corporate group.

But as listed companies became larger, more diverse and geographically spread, so did their shareholders. With a large number of shareholders located around the world, with varying interests in the company, it was no longer feasible for them to influence decisions on the choice of directors. Power had shifted from shareholders to directors, as Berle and Means had shown in 1932. Directors of major listed companies were now nominated by the chairman and existing directors, and then routinely approved by shareholders in their annual general meeting. Critics complained that boards became self-perpetuating clubs of like-minded people, routinely chosen from small networks of influence, typically those who came from similar backgrounds to themselves. In the United States, recommendations from business contacts, fellow members of the country club, or business school fraternity held sway. In England, director appointments were influenced by 'the old school tie' and social standing such as a knighthood. In France, those educated in the elite *grandes écoles* dominated both boardroom and government.

The board-level nomination committee is an attempt to overcome this dilemma. This is a standing subcommittee of the main board, made up wholly, or mainly, of independent non-executive directors, called on to recommend new directors. Relying on independent directors is intended to avoid a dominant director, such as the chairman or chief executive officer (CEO), pushing through his or her own preferred candidates.

Unfortunately, the supposed independence of outside directors on the nomination committee can be illusory. If the committee's members have themselves been selected by the chairman, and have worked with him or her for years, they are likely to feel an allegiance towards him or her and support his or her candidates. On the other hand, it can be argued that newly appointed directors need to be acceptable to the chairman if they are to work in harmony as part of an effective board team.

In the United Kingdom, Hong Kong, and some other countries, although listed companies have adopted most of the requirements of the corporate governance codes, the requirement to have a nominating committee has been resisted by some. This is not surprising, since the right to influence appointments to the board goes to the very heart of corporate power.

Shareholders in public listed companies still have little opportunity to influence the nomination of new directors, unless they hold a significant proportion of the voting shares. Various proposals have been put forward to enable shareholders to nominate directors. Some would have the institutional investors play a larger role; others would allow shareholders to create and vote on a 'slate' of directors, including those they had proposed. Another idea, from Shann Turnbull, is for shareholders to form a shareholders' committee, which would represent all of the shareholders in dealings with the company, including the nomination of new directors.

Desirable attributes in a director

In the first part of this book, we focused on corporate governance principles; in the second, on corporate governance policies. But behind the corporate constitutions, board structures, and corporate governance codes are people—people who bring a wide range of prejudices,

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political behaviours, and power plays to board affairs. So what personal attributes are needed to be a successful, professional director?

The primary prerequisite for every director is *integrity*. Directors are stewards of the interests of the company (that is, of the entire body of shareholders). The enterprise does not belong to the directors. They hold it in trust for the owners to whom they owe a fiduciary duty to act openly and honestly in their interests. This applies whether the company is a family business, with a few shareholders, or a vast, listed company.

What does integrity mean? It means being ethically aware, able to distinguish right from wrong, and able to judge corporate behaviour accordingly. It implies honesty, fairness, and sound moral principles. It means acting in the company interest, not self-interest, resisting the temptation to make a personal gain to the detriment of the company. Integrity also means being able to recognize and declare a conflict of interest. Essentially, integrity means acting honestly for the benefit of the company. A director with integrity is trusted, which is basic because the very concept of the company is based on trust.

In law, a company is a legal entity and enjoys many of the rights of an individual person. But, unlike a real person, a company does not have a conscience. The board has to act as the corporate conscience. Clearly, that means ensuring that the company obeys the laws of the jurisdictions in which it operates. Further, the board creates the company's value system, its corporate character establishing the way the whole organization operates, over and above just staying within the law.

In practice, as we have seen, many boards produce a formal statement of their corporate mission and the core values to which they aspire. In some cases, these statements are no more than pious aspirations, which do little to affect the way in which the company is run. In other cases, however, such mission statements can lead to rigorous policies, approved and monitored by the board on, for example, how the company treats its customers, its relations with employees, and its commitment to corporate social responsibility. The Microsoft statement of its corporate mission and values (see Corporate governance in action 12.1) provides an example.

In addition to integrity, high-calibre directors demonstrate other personal qualities. These can be summarized as intellect, character, and personality.

Intellect is what, in Oxford colleges, they call having 'a good mind'. It combines an appropriate level of intelligence, the ability to think at different levels of abstraction, and the imagination to see situations from different perspectives, rather than always seeing things from a fixed viewpoint. A sound intellect is able to exercise independent judgement, to think originally, and to act creatively.

Character traits, what some call 'strength of character', include being independently minded, objective, and impartial. A director needs to be capable of moving towards consensus. Yet, from time to time, a director needs to be tough-minded, tenacious, and resilient, with the courage to make a stand. Further, a director needs to be results-orientated, with a balanced approach to risk—neither risk-averse nor rash. Finally, some might add wisdom or just plain common sense to useful director character traits (even though common sense is not all that common).

Desirable *personality* traits in a director include the ability to interact positively with others, which from time to time may call for openness, flexibility, sensitivity, diplomacy, persuasiveness, the ability to motivate, and a sense of humour. Such interpersonal abilities are

Corporate governance in action 12.1 Microsoft corporate mission and values

Our Mission

At Microsoft, we work to help people and businesses throughout the world realize their full potential. This is our mission. Everything we do reflects this mission and the values that make it possible.

Our Values

As a company, and as individuals, we value:

- Integrity and honesty.
- Passion for customers, for our partners, and for technology.
- Openness and respectfulness.
- Taking on big challenges and seeing them through.
- Constructive self-criticism, self-improvement, and personal excellence.
- Accountability to customers, shareholders, partners, and employees for commitments, results, and quality

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particularly important in interactions with the chairman and boardroom peers. Other desirable personality traits include being a sound listener and a good communicator, as well as being politically sensitive.

A successful director looks ahead, anticipates problems, and can articulate possible solutions. He or she is open, welcomes questioning, and seeks feedback. But he or she also listens, tries to understand others' points of view, and seeks consensus. Overall, he or she is reliable and trusted by his or her chairman and peers. On the other hand, poor directors tend to adopt a negative attitude, offering platitudes, and fail to face up to serious issues. Strategic thinking is replaced by reliance on past successes and rigorous risk analysis by hope. Obviously, an independent outside director needs to be genuinely independent. As the Cadbury Report put it, 'independent of management and free from any business or other relationships which could materially interfere with the exercise of their independent judgement'.

These attributes tend to be inherent in people by the time they are nominated for a board appointment, having been culturally determined and acquired over a lifetime. By contrast, there are certain core competencies that a director needs, which can be developed or acquired through director induction programmes, director training, and director development and updating.

Core competencies of a director

Every corporate entity and every governing body is different, and each director brings a different set of experience, skills, and knowledge to the board. But, in the aggregate, every board needs to have a mix of capabilities that provide a balanced and well-qualified team relevant

to that board and that company. So every director needs to have some basic core competencies appropriate to the type, location, and scale of the enterprise. What experience, skills, and knowledge should a director have?

The *experience* of outside directors should be used to supplement the knowledge available to the board, not to second-guess the executives in the company. For example, a director could bring experience about corporate governance, board procedures, or strategy formulation and policymaking from other (non-competing) companies. Or a director might have experience of overseas markets, frontier technologies, international finance, or other areas that supplement the experience of the existing board.

The essential director-level *skills* include:

- strategic reasoning, perception, and vision;
- a critical faculty capable of quantitative and qualitative analysis and financial interpretation;
- planning and decision-making capabilities;
- communication and interpersonal skills;
- network and political abilities.

Directors also need appropriate *knowledge* of the enterprise, its business and board-level activities, as well as relevant information about the company's political, economic, social, and technological contexts. If directors are to make sense of board information and contribute meaningfully to board discussions, they must have basic knowledge about the company itself, its business and the company's financials.

Knowledge of the company includes:

- a clear understanding of the basis of power (who the shareholders are and where the power lies to change membership of the governing body);
- the basis of law under which the company operates and what the governance rules and regulations are (for a limited company, these are company law and the company's memorandum and articles of association, plus the listing regulations for a listed company);
- the board structure, membership and directors' personalities;
- the board processes, including the use of board committees, the focus of board and committee activities, and the nature of board information.

An awareness of the history of the entity can also be helpful in understanding the board culture, interpreting the current situation, and appreciating the perspectives of the chairman and other board members.

Knowledge of the business embraces an understanding of the basic business activities and processes: its purpose and aims; its strengths and weaknesses, and how it measures success; the field of its operations (including markets, competitors, and its current operating context); the strategies being pursued; the structure of the organization; its culture, management, and people; and the form of management control and management control systems. Risk assessment is an important aspect of the board's role and all directors need to know where the enterprise is exposed to risk and its nature. Increasingly, knowledge of the company's

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stakeholders and its approach to corporate social responsibility and sustainability should form part of directors' knowledge base.

Knowledge of the financials includes knowing how the company is financed, a sound appreciation of its annual accounts and directors' reports, knowledge of emerging trends in key financial ratios, the criteria used in investment appraisals, the calibre of financial controls, and who the auditors are. Many board-level reports are presented in financial terms and the ability both to interpret them and to appreciate their strengths and weaknesses is important. It is not necessary to be an accountant to be a good director; indeed, some might argue the reverse! But an ability to appreciate the financial aspects of the company is vital.

Roles that directors play

Given their various personal attributes and different competencies, directors inevitably make a variety of contributions to their boards and can play a number of roles. Some of these roles contribute to the performance aspects of the board's work (strategy formulation and policymaking); others contribute to the conformance aspects (executive supervision and accountability).

The following are examples of some performance-orientated roles that directors play.

- *Bringing wider business and board experience* to the identification, discussion and decision-making. Identifying issues that the board, not management, should be handling. Directors tend to respect the wisdom of the director who brings to bear accumulated knowledge and experience in business and elsewhere on issues facing the board. As the Cadbury Report put it, 'the board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions'. Long-serving directors may well find themselves cast in this role by newer board colleagues. Accumulated wisdom can, of course, have limitations in rapidly changing situations.
- *Adding specialist knowledge, skills, and know-how* to board deliberations. Here, a director relies on his or her particular professional training, skills, and knowledge to make a contribution. For example, the specialism might be in the realm of accountancy, banking, engineering, finance, or law, or it could stem from specialist knowledge of a particular market, technology, or functional area, such as marketing, manufacturing, or personnel. In some newer, growing companies, outside directors are appointed to the board specifically to provide such specialist inputs until such time as the company can afford to acquire such skills in-house at the executive level. When a board is relying on such expertise, it is important to ensure that the director remains up to date in the subject, which can sometimes prove difficult for those operating at board level.
- *Being the source of external information* for board discussions—a window on the world for other directors. The director is used as a source of information on issues relevant to board discussions. Usually, this will be on matters external to the company, such as insights into market opportunities, new technologies, industry developments, financial

and economic concerns, or international matters. Obviously, it is essential that the information is relevant, accurate, and current. This is often a role specifically sought from outside directors, who are in a position to obtain such information through their other day-to-day activities. A danger is that directors, chosen because of their access to specific information, lose touch with it.

- *Being a figurehead or an ambassador for the company*, being able to represent the company in the outside world. The director represents the company in the external arena: for example, in meetings with fund managers and financial analysts, or in trade and industry gatherings. The chairman of the board often takes on this responsibility, perhaps being invited to join public committees, commissions, and the governing bodies of important public institutions, as well as joining the boards of other, non-competing companies. These days, this role can be taken by the director identified as the senior independent non-executive director. For many companies, a figurehead is increasingly important in dealing with the media.
- *Connecting the board to networks of useful people* not otherwise available to the board. This can be an important role for outside directors, who are able through their personal contacts to connect the board and top management to networks of potentially useful people and organizations. For example, the director might be well placed to forge contacts in the world of politics and government, to link the company with relevant banking, finance, or stock exchange connections, or to make introductions within industry or international trade. Retiring politicians are sometimes offered directorships on the assumption that they have useful contacts and influence in the corridors of power. Such a role may also provide advice on succession in the board and in top management.
- *Providing status to the board and the company, adding capability, reputation, and position.* This role is not as significant today as it was a few years ago. In the past, eminent public figures were often invited to join boards just to add status, rather than any specific contribution they could make to board deliberations. Previous service as a US Senator or a knighthood in the United Kingdom almost guaranteed an invitation to join the board of a public company in the past. But these days boards need professionalism ahead of prestige. However, the status role can be useful at times; for example when a particular listed company faced a financial crisis, the market was reassured when a well-known financier joined the board. Exposure to litigation may now deter some public figures from accepting directorships. However, even today, if a company has been experiencing problems, confidence may be restored if a high-profile, well-respected figure joins the board.

The following are examples of some conformance-orientated roles that directors play.

- *Providing independent judgement*, the ability to see issues in their totality and from various perspectives, leading to objective judgement—in other words, 'helicopter vision'. This can be a vital contribution of the outside director, who, obviously, has the opportunity to see board matters from an external and independent point of view. As the Cadbury Report suggested, 'non-executive directors should bring an

independent judgement to bear on issues of strategy, performance, resources, including key appointments and standards of conduct'. Such an objective evaluation of top management performance can overcome the tunnel vision sometimes found in those too closely involved with the situation, or the myopia brought on by being personally affected by the outcome. Overall, providing independent judgement brings wise counsel that leads to better decisions.

- *Being a catalyst for change*, questioning existing assumptions, introducing new ideas and approaches, and stimulating developments. This role can be played by a director who questions the board's assumptions, and makes others rethink situations. Catalysts point out that what appears to be an incontrovertible truth to some board members is, in fact, rooted in some questionable beliefs about the company, its markets, or its competitors. They highlight inferences that are masquerading as facts. They show when value judgements, rather than rigorous analysis, are being used in board deliberations. Most valuably, catalysts stimulate the board discussions with new, alternative insights and ideas.
- *Being a monitor of executive activities*, offering objective criticism and comments on management performance and issues such as the hiring and firing of top management. The entire board is responsible for the monitoring and supervision of executive management, but independent non-executive directors can bring a particular focus to this role.
- *Playing the role of watchdog*, able to provide an independent voice and protect the interests of minority shareholders or lending bankers. Directors cast in this role are seen as protectors of the interests of other parties, such as the shareholders or, more often, a specific interest group. As we commented in Chapter 3, nominee directors inevitably find themselves in this position, as they look out for the interests of the party who nominated them to the board. This might be a representative of a major investor in the case of a director on the board of an American or British listed company, a representative of the employees for a director on a German supervisory board, or a representative of the *keiretsu* group interests for a director on the board of a major Japanese company. Every director has a duty to be concerned with the interests of the company as a whole (that is, with the interests of *all* of the shareholders without discrimination), so the watchdog role has to be applied with care.
- *Being a confidante or sounding board for the chairman*, the chief executive or other directors; a trusted and respected counsellor in times of uncertainty and stress; someone to share concerns about issues (often interpersonal problems) outside the boardroom. Political processes at board level inevitably involve the use, and sometimes abuse, of power, and the confidante can sometimes make a valuable contribution. But it is vital that he or she commands the trust of all of the directors, otherwise the problem can be reinforced rather than resolved.
- *Acting as a safety valve*, able to act in a crisis in order to release the pressure, prevent further damage, and save the situation. A classical example would be when a company has run into financial problems, management performance has deteriorated, or the chief executive has to be replaced. Another example might be if the company faces an

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unexpected catastrophe. The sensible and steadying counsel of a wise member of the board could overcome an otherwise disastrous situation.

Directors' duties, rights, and powers

Duties

As we saw in Chapter 4, directors around the world have two fundamental duties: a duty of trust and a duty of care—a duty of trust to exercise a fiduciary responsibility to the shareholders, and a duty of care to exercise reasonable care, diligence, and skill. Beyond those two broad duties, directors' responsibilities are often enshrined in laws designed to protect consumers, employees, the environment, and so on. Directors' duties in case law countries have not been specifically laid down by statute, but developed through cases. In Australia, for example, directors' duties are designed to promote good governance and to ensure that directors act in the interests of the company, which means putting the interests of the shareholders ahead of their own. In particular, a director in Australia has a statutory duty:

- to act bona fide (in good faith) in the interests of the company as a whole;
- not to act for an improper purpose;
- to avoid conflicts of interest;
- not to make improper use of position;
- not to make improper use of information;
- not to trade while insolvent;
- as well as duties of care and diligence.

The US Sarbanes-Oxley Act of 2002 added some directors' duties to statute, including the need to confirm the effectiveness of the company's reporting and management control systems, and the handling of strategic risk.

The United Kingdom is an exception to the general rule that directors' duties are not specifically defined by statute law. The UK Companies Act 2006 attempted to consolidate the common law duties of directors in a definitive statement. In the United Kingdom, directors must act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard to:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers, and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company to maintain a reputation for high standards of business conduct;
- the need to act fairly, as between members of the company.

Notice that, for the first time, statute law explicitly required directors to recognize their corporate social responsibility to employees, other stakeholders, the community, and the environment. The Act links responsible business behaviour with business success.

In civil law countries such as Germany, the managing director is given the responsibility for managing the company and acts as its legal representative. He or she must employ the diligence of an orderly businessman, specifically to:

- pursue the business purpose;
- manage the company properly;
- be loyal to the company;
- not disclose confidential information or company secrets;
- not take advantage of his or her position.

Rights

Companies' articles of association determine the power of the directors. They typically grant a wide degree of freedom, but could, for example, restrict corporate activities by defining the purpose for which the business was created, or limit borrowing powers. The website of the UK Companies Registry has a model set of articles (go to www.companieshouse.gov.uk and use the search facility).

All directors have the right to knowledge about the company, its business, and its situation. This right to information goes beyond routine board papers and reports, to receiving answers to any question a director wants to ask about the company's affairs. All directors have a right to attend and take part in board meetings and meetings of the shareholders.

Powers

In general, boards have a wide discretion to take business decisions, provided that they act within the company's constitution and respect their duties of trust and care. The directors run the company for the benefit of its shareholders—to contract, invest, pledge its assets, buy and sell, hire and fire, set its strategies and corporate policies, and supervise management. Directors must act within powers granted by the company's articles and only exercise powers for the purposes for which they were conferred. It is the board's role to take risks in pursuit of business. Should the company run into trouble as a result, the courts will not usually question decisions taken by the directors in the normal pursuit of business. Provided that the directors have acted within the company's constitution and not failed in their duties of trust and care, they will not normally be held liable for any resulting loss suffered by the company.

The detail of the law surrounding directors' duties, rights, and powers varies between jurisdictions and can be complicated. Obviously only a general indication of basic practice can be given here. If a director is in any doubt, he or she should raise the matter with the company secretary, who might well be in a position to explain the situation, discuss the matter with the board chairman, and if necessary seek legal advice.

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Directors' disclosures, service contracts, and agreements

Conflict of interest and conflict of role

A conflict of interest arises if a director could benefit personally from a situation involving the company or from a decision taken by the board. A conflict can arise directly from a director's own interests or indirectly if a family member or close associate is involved. For example, a conflict of interest would arise if a director:

- owned a business that supplied the company or was a major customer, sometimes called 'connected transactions';
- served on the board of another company that had business dealings with the company;
- had a significant personal shareholding in another company that the board was considering as an acquisition target;
- interviewed a relative or close friend in a recruitment exercise;
- had the personal use of property belonging to the company;
- used company information for his personal benefit.

Every director has a fiduciary duty to recognize and disclose any conflict of interest they perceive. As commentators have pointed out—if someone perceives a conflict of interest, they have one. Recognizing potential conflicts is sometimes glaringly obvious to everyone involved, but in other cases the conflict may only be known to the person involved, so making the decision to declare the conflict and lose the personal benefit is an ethical choice based on that person's own moral compass; although the risk to personal finances and reputation can be significant if a failure to disclose is found out.

In some jurisdictions reporting conflicts of interest is required by company law. Many companies have policies on the handling of conflicts of interest and include rules on their identification and disclosure in their code of conduct. Conflicts can also exist with other employees and professional advisers to the company, such as lawyers and accountants. Of course, the obligation to disclose conflicts of interest also applies to those involved in other non-commercial public sector organizations.

Having disclosed the interest to the chairman of the board, typically before the board meeting through the company secretary, the director with the conflict should not take part in any board decision-making on the matter, until the chairman and fellow directors have decided on the appropriate action. The director might be asked to leave the meeting while that matter is discussed; or to listen but not participate in the discussion and abstain from voting; or having noted the declaration of a personal interest decide that it is not material and allow the director to participate in the decision-making. Should the chairman of the board be the one declaring the conflict of interest, someone else should chair the meeting for the discussion of that agenda item.

Directors should ensure that any conflict of interest they have declared is clearly recorded in the minutes with the board's ruling in response. This provides written evidence should there be a subsequent challenge.

In some cases shareholder approval may be needed on a board decision involving a conflict of interest. For example, in a listed company with dominant shareholders, such as the founding family, the approval of the minority public shareholders might be required. The company's articles, the listing rules of the stock exchange, and company law would be relevant.

A conflict of roles can arise if an executive director holds more than one position in the company: for example, as chief executive and chairman of the board. As chief executive, the role is that of the head of the management team; as chairman the role involves ensuring a full discussion of issues including dissenting views, and leading the board towards consensus. Most corporate governance codes, of course, consequently call for these two posts to be held by separate people.

In fact, a similar challenge faces all executive directors during board deliberations, if the responsibilities and interests of the executive post conflict with what appears to be best for the company as a whole. Role conflict can then arise, particularly if the individual concerned is a dominant personality—as such people often are. Members of the management team report to the chief executive; but as directors their responsibility is to the company, which may mean disagreeing with the chief executive. In some smaller companies the role of company secretary may be held by the finance director, again introducing potential conflicts of interest. In larger companies the work of the company secretary is usually sufficiently demanding to require a separate person.

Insider dealing

Directors of listed companies have to be particularly careful not to trade in their company's shares when they are in possession of inside or privileged information, such as the company results just prior to publication and before the stock market has that information. The company secretary will often inform directors when the window of opportunity for trading in the company's shares is open and, more importantly, when it is closed. The listing rules of many stock exchanges lay down a 'blackout' period, just prior to the announcement of a company's results, during which time directors may not trade in shares in that company.

Insider dealing, sometimes called insider trading, involves the buying or selling of shares in a listed company on the basis of privileged, share-price-sensitive insider information. Insider dealing may involve making a secret profit by buying shares in the privileged knowledge of events that would drive the price up, or avoiding a loss by selling shares on the basis of privileged intelligence that would cause the price to fall. Insider dealing laws do not apply only to directors, officers, and senior executives of companies. Anyone with access to privileged information, however obtained, can be held liable.

The argument against the practice is not so much that it is morally wrong or unfair, or that it involves a misuse of information, but that insider dealing destroys the credibility and the integrity of the stock market. Insider dealing is a breach of a director's fiduciary duty: it is also illegal in almost all countries. Japan, Hong Kong, and Germany were among the last jurisdictions to make insider trading a criminal offence.

It can be difficult to obtain convincing information to support a prosecution, which is why some jurisdictions waited so long to introduce anti-insider legislation. The United States has the most severe penalties for insider dealing. China has added more quite recently. Listed companies often include statements about insider dealing in their corporate ethics or values codes, using compliance officers to ensure that directors and employees do not trade on privileged, insider information.

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