ICGN

International Corporate Governance Network

ICGN Yearbook 2010

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Chairman's letter

2010 has been a watershed year for corporate governance reforms around the world. The ICGN has been both an active and focused participant in global reform initiatives and in particular in the UK, US and Europe. Thankfully, we also find ourselves in a stronger position financially than a year ago, and I am pleased to report that we have many initiatives underway to make the ICGN organisation stronger in the years to come. Below, I wish to recap the highlights of the past year and give you a preview of what's to come.

Thought leadership on behalf of investors

Our members and the Secretariat have been very actively engaged in the legislation, regulation and consultations that will ultimately strengthen our institutions in major markets around the world.

Most noteworthy is the strengthening of shareholder rights in the US resulting from the Dodd-Frank legislation, where shareholders have new rights to nominate directors and stronger provisions on executive compensation in both clawback and say-on-pay provisions among others. Given that the financial crisis originated in the US, where shareholder rights are quite weak and 20% of U.S. shares are owned by non-US investors, these reforms are in some ways the most encouraging. Other significant changes in the US in disallowing uninstructed broker votes and the push toward majority voting for director elections are important elements of the sea change that is taking place there to make board rooms more democratic.

The new stewardship code in the UK and also emerging practice in the EU are other examples of important change that has come from the financial crisis that results in greater responsibilities and opportunities for shareowners, as well as greater transparency for beneficial owners on the activities of their investment managers. I am pleased to report that the ICGN has actively participated in these and many other reform initiatives around the world, that strengthen shareowner rights. Although it seems like it has been a long time coming in many jurisdictions we are beginning to realise the benefit of decades of hard work to improve the rights and responsibilities of owners.

Committee work

The ICGN's committees have been very busy over the past year. We issued new guidelines for our Global Corporate Governance Principles and guidelines for Non-executive Director Remuneration Policies last November and March respectively. Special thanks must go to Paul Lee and Ted White, who chaired those Committees. Next month, we plan to issue new Corporate Risk Oversight guidelines resulting from an outstanding effort led by Stephen Davis and Erik Breen. Future work projects include strengthening the committee work for shareholder-director communication as well as guidelines for better transparency in political contributions to corporations. Almost without exception, the ICGN committees have had an active and prolific year at an important time. Carl Rosén's report that follows in this Yearbook goes into more depth on the extensive work of the committees.

Conference programme

I am pleased to say that both the London and Toronto conferences were financially successful and strong in both content and attendance. Key to these conference successes were strong hosts in Toronto with the Ontario Teachers' Pension Plan and the Canadian Pension Plan and strong local organising and board leadership in both regions. In Toronto, we were pleased to have over 435 delegates representing 35 countries. The upcoming San Francisco conference, focusing on sustainability, also promises to be a big success, again due to strong hosts in the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) as well as a thoughtful organising committee.

Our spring conference will be hosted in Kuala Lampur, Malaysia between 28 February and 1 March 2011. Furthermore, next year's annual conference and general meeting will be in Paris between 12 and 14 September 2011. We hope to see you there – and in Rio de Janeiro in 2012.

Strategic review

Our new Executive Director, Carl Rosén, has been very active over the last year on several fronts.

First, Carl and the Board have undertaken a strategic review of the many initiatives at the ICGN, with an eye toward focusing on better utilisation of resources and diversifying our lines of business to provide more financial stability in the years to come. Toward this end, currently under consideration

is an initiative to provide 'masterclasses' to institutional investors to better educate shareowners on best practice in executing their ownership responsibilities on a global basis.

Second, Carl has traveled extensively around the world to reach out to the world's largest shareowners, regulators and standard setters to engage them in the ICGN's work programme and to contribute toward the many consultations that are addressing the global financial crisis. Finally, Carl is focused on growing our membership, continuing to support our committee work program and the organisation of our three conferences every year.

There are two items of note that were approved by the membership at the recent annual meeting in Toronto. First, the membership charged the By-Laws and Procedures Committee with the task of reviewing Board member tenure. The Committee will consider ways to improve the continuity of the ICGN Board and consider changes to be voted on at the Paris annual meeting. Secondly, a special committee has been formed to consider potential modifications to the membership fee structure, with the intent to strengthen the ICGN's business model and provide for a more financially sustainable future.

Thanks

None of these achievements or endeavours would be possible without the contribution of a large number of people, most of whom are volunteers. As a membership organisation, the ICGN relies on its volunteer members to organise conferences, author best practice guidelines, staff and chair committees and serve on the Board. Thanks to all those who contributed to such a productive year.

I would also like to thank the many organisations that support the ICGN, including the Institute of Chartered Secretaries and Administrators and Weil Gotshal & Manges for their pro bono legal advice.

Similarly, we owe a debt of gratitude to our new Executive Director, Carl Rosén, and the Secretariat of Kerrie Waring, Audrey Hart and Tina Chande, who are doing an excellent job with conferences, supporting the Board and the committees. Without them the ICGN's global reach and high quality work would absolutely not be possible.

Looking forward

As this letter goes to print, we find ourselves two years into the worst financial crisis most of us have ever witnessed. In most jurisdictions, we see unfolding a multi-faceted response to the crisis of increased and better regulation, improved risk management at corporations and increased engagement of shareowners in the companies they own.

In jurisdictions where shareowners have won newfound rights, investors have been presented with a tremendous opportunity to positively impact the governance of corporations for generations to come. This is an enormous leadership opportunity for the ICGN to leverage its membership to responsibly engage companies to enhance long-term shareholder value creation. Through thoughtful and responsible collaborative engagement, I believe we will demonstrate that there are significant long-term benefits that come from active ownership.

The 2010 Yearbook provides a good sampling of the thoughtful discourse and collective engagement for which the ICGN has become known. We hope you enjoy the Yearbook.

ABOUT THE AUTHOR

Christianna Wood
Chairman, ICGN Board of Governors

International Perspectives

“In the 1970s and 1980s, the issue was whether we were going to have capitalism; now the issue is how we can make it work properly.”

Alistair Ross Goobey, 1945-2008

Carl Rosén, Executive Director, ICGN

A year in review

Carl Rosén explains how the last 12 months have seen ICGN's policy activities move to the next level.

The last year has not only been a important one for the global economy – it has also been a year of breakthroughs for ICGN in terms of policy action.

We are particularly grateful for the work from our six policy committees and two working groups, which are populated by more than 100 dedicated experts from all major markets globally. They develop and maintain our global guidelines, respond to consultations from regulators, law-makers and standard-setters and take forward initiatives where needed.

On a global level, the coordinated responses to the global financial crisis have resulted in a changed power structure in the world of financial regulation. The G20, including the Financial Stability Board, is becoming increasingly important as policymakers strive for better global coordination helped by co-operation with IOSCO, the federation of securities regulators. The ICGN is regularly in dialogue with these organisations as well as the OECD, UNCTAD, the World Bank, national stock exchanges and regulators.

In the field of accountancy and audit the main theme on the ICGN agenda is the global convergence to IFRS, which we believe must be done with a high level of quality. The coming year will be intense: it will see a focus on new parts of IFRS, the US response to the convergence timetable and the governance structure of global standard setters.

The Shareholder Rights Committee is focusing on protection of minority shareholders and the balance between the role of financial regulators and shareholders in the governance of financial institutions. The Committee has also been fighting a proposed introduction of poison pills in South Korea and have been instrumental in the major regulatory changes in the US. For more on shareholder rights, see the box opposite.

The Shareholder Responsibilities Committee has worked intensely with its sub-committee, the Task Force on Risk Oversight, and will launch new guidelines in the fall of 2010. Other important issues are concert party rules, the development of stewardship codes and voting procedures in Asia. In addition, the Cross-border Voting Procedures Sub-committee is preparing to respond to extensive consultation documents from both the SEC and the EU.

The remuneration committee has developed the *2010 Non-Executive Director Remuneration Guidelines & Policies* and have initiated a comparative study on mandatory say-on-pay practices globally. This includes exploration around the approaches to monitor pay practices globally.

"The last year has not only been a important one for the global economy – it has also been a year of breakthroughs for ICGN."

The non-financial business reporting committee has participated in several initiatives including the formation of IIRC, a global initiative for integrated reporting. The committee is also engaging in the development of global reporting standards for greenhouse gas emissions.

The working group set up to produce the *2009 ICGN Statement and Guidance on Anti-corruption Practices* is continuing to spread the word of good practice by engaging with the OECD, Transparency International, ICC, World Economic Forum and UNPRI.

The Director-Shareholder Dialogue Project is also gathering new pace, whereby the ICGN is striving to facilitate better communications between corporates and shareowners in all major markets. Following the success of meetings in 2008 and 2009 with the Business Roundtable and the National Association of Corporate Directors, the ICGN will be hosting a seminar arranged together with The Rock Center of Corporate Governance at Stanford Law School in San Francisco this October.

All in all, it has been a very constructive year for the ICGN. The future looks equally busy, with continued policy engagement around the globe, new best practice guidance under development and the organisation of our leading corporate governance conferences around the world – with Malaysia and Paris already in the diary.

Going forward, we aim to highlight the inmportant work of the ICGN to even more stakeholders including business organisations (like the Institute of Directors and Institute of Chartered Secretaries) and industry bodies as well as investor organisations. Together, we can bring about long-term improvements in corporate governance from which we can all benefit.

ABOUT THE AUTHOR

Carl Rosén is Executive Director of the ICGN.

Right to reply

Stronger shareholder rights in the United States and more focus on shareholder responsibilities in Europe are two major corporate governance improvements achieved during the last year. Indeed, changes are afoot on both sides of the Atlantic which represent major wins for the policy work of the ICGN. Impressive progress is also being made in Asia, with a focus on building an effective regulatory infrastructure for investor influence.

The USA

The ICGN has advocated stronger shareholder rights in the US since its inception. In particular, we welcome four major changes to shareholder rights which will give investors more powers and responsibility.

Firstly, in mid-2009 the so-called broker-vote rules were abolished. This overturns the traditional procedures, whereby on average 17% of shares – those registered with brokers – are automatically voted in favour of proposals from the board. Going forward, brokers will need to consult with beneficial owners as to how to vote or be given discretion to do the same.

The second major change is the gradual introduction of majority voting on the election of directors in US companies – a sea change from the system of plurality voting whereby an uncontested director is elected on the basis of a single affirmative vote, regardless of the number of shareholder votes withheld. Now, approximately 70% of the companies at S&P 500 have voluntarily adopted a simple majority voting system – although the ultimate decision on the election of directors still resides with the board, which may or may not uphold the sway of the shareholder vote.

The third improvement on shareholder rights is the new ability for shareholders to nominate board members on corporate proxies. This was part of the Dodd-Frank bill of financial regulation that was signed by President Obama in July 2010. The focus is now on how the SEC will implement the rules of proxy access in terms of ownership threshold levels and holding periods.

Last, but certainly not least, a greater focus on say-on-pay in the US is encouraging. The possibility of a mandatory vote on directors' remuneration was another important milestone included in the Dodd-Frank bill and President Obama was recently quoted as saying:

'I propose a set of reforms to empower consumers and investors, to bring the shadowy deals that caused the crisis into the light of day and to put a stop to taxpayer bailouts once and for all... Shareholders will also have a greater say on the pay of CEOs and other executives, so they can reward success instead of failure.'

All these reforms have weaknesses and can be improved, but the combination means that shareholders in US corporations have more rights and possibilities to influence – for our part, the ICGN has proactively been part of the debate for reform in the US and it is encouraging to see change finally happening.

The UK and Europe

In the UK, we were delighted with the launch of the Financial Reporting Council's first Stewardship Code for shareholders which was, in part, inspired by the ICGN's 2007 Principles of Shareholder Responsibilities. It is an important step for stronger shareholder responsibilities and it presents on opportunity for shareholders to voluntarily adopt visible improvements if they are to avoid possible mandatory regulation in future.

The ICGN advocates similar codes in the European Union and it is encouraging to see that the European Commission are referring to the *ICGN Principles in their Green Paper on Financial Institutions and Corporate Governance*, published in June 2010.

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Carl Rosén, Executive Director, ICGN

Meetings of minds

2009 and 2010 saw a packed conference schedule. Here are the highlights.

Washington, November 2009

Improving dialogue

The ICGN Washington DC conference was amongst the most timely in the history of ICGN. Sweeping reforms under consideration in US corporate governance (say-on-pay, the abolished uninstructed broker votes and access to the proxy) required new demands on communication between shareholders and boards. The event was hosted by the National Association of Corporate Directors (NACD) and their CEO, Ken Daly. The conference was a first between NACD and ICGN and an important step to restore public confidence in the financial markets.

Highlights of the event included:

ICGN's Chairman Christianna Wood launched the new *ICGN Global Corporate Governance Principles: Revised (2009)*

Morning keynote speaker Kayla Gillan, deputy chief of staff at SEC, described a busy agenda for the agency, including changes in the regulatory framework. Among the topics under review are; investment advisors, muni-securities issuers, money market funds, naked short selling, flash trading and so on. Gillan also signalled a major overhaul of the shareholder voting and disclosure system in the United States.

Ira Millstein, senior associate dean for corporate governance at Yale, commented that U.S. companies do not have to wait for legislation to implement reforms. They can make governance changes voluntarily to 'stay ahead of the curve'.

Mark Anson, president of Nuveen, led a panel on board effectiveness in overseeing risk. Leslie Rahl, president of Capital Market Risk Advisors, explained that successful risk management starts with a risk-cautious culture, an environment where you weigh reward against risk and where the board can actually produce a risk appetite statement. Reatha Clark King, board member of Exxon Mobil and Lenox Group and a member of the NACD task force on risk oversight, guided the conference through the latest guidelines from NACD, and Karen Horn, senior managing director at Brock Capital, pointed out that a higher level of competence was needed by companies in the financial industry.

Duncan Niederauer, the lunchtime keynote speaker and CEO of NYSE Euronext, said that the present financial crisis was not a corporate governance crisis but rather a crisis of the financial system. He discussed ideas emanating from the NYSE Euronext Commission on Corporate Governance. He also questioned why companies have to report quarterly: maybe less frequent reporting will lead to long-term thinking.

Senator Charles E. Schumer, in his afternoon keynote speech, said that active, vigilant shareholders are much better than government regulations; this was the most important backdrop to the Shareholder Bill of Rights which Senator Schumer sponsored. In the recent Dodd Frank Bill these proposals were picked up again and the Bill aims to legislate say-on-pay, proxy-access, to require explanations if companies do not split CEO and chairman positions, and require certain financial firms to have a risk committee. Furthermore, the Bill would enable the SEC to be a self-funding entity.

London, March 2010

Will shareholders rise to the ownership challenge?

In March 2010, over 250 global governance practitioners convened in London's Guildhall for the ICGN's conference on the subject of how regulatory reform helps or hinders the ability of shareholders rising to the ownership challenge. On the back of the FRC's Stewardship Code, the UK was leading the charge on prescribing guidelines to investors in the form of a code regarding how they fulfil their ownership responsibilities, particularly in relation to voting disclosure and corporate communication.

This was the focus of discussion laid out by Sir David Walker, who made a keynote speech at the dinner the evening preceding the event. Sir David presented highlights from his extensive consultation on the governance and regulatory framework as applied to banks and beyond, as well as the role of shareholders in helping make the recommendations work in practice.

Highlights of the conference included:

Candid remarks from Lord Paul Myners CBE who, when emphasising

the importance of more shareholder participation in governance, stressed that 'the most profound shortcoming is the hidden cost of public ownership and consequential ownerless corporation ... and that acting as an owner requires commitment for the long haul.'

Stephen Haddrill, the CEO of the FRC, focused on the Stewardship Code and highlighting what it can realistically achieve and over what timescale. Also, Sir Richard Lapthorne suggested that pressure was unrealistic on shareholders, and questioned whether they are really equipped well enough to take on the role of 'the governors of governance'.

Helen Alexander, president of the CBI, said that good corporate governance provides a climate of openness and challenge in the boardroom. It depends on behaviour, not process, and it is therefore difficult to set out rules. She was followed by Fabio Gali, director general of Assogestioni, who presented the challenges from an Italian perspective where the issue is between control disparities between majority and minority shareholders, and Suzanne Hopgood from the US National Association of Corporate Directors, who spoke about the threat of regulatory change in the US being a driving force behind voluntary change.

Sir Christopher Hogg, then chairman of the FRC, presented the background and vision for the introduction of the Stewardship Code.

The final session of the day concentrated on how to get beneficial owners to step up to the plate. This featured Lindsay Tomlinson, managing director of BlackRock and chairman of the NAPF, who stressed that if shareholders do not act then the concept of an 'ownerless corporation' will become a reality, and Donald MacDonald, trustee of BT Pension Scheme and chairman of PRI, who closed the session with an air of caution by questioning whether the investment community is in a position to prevent the next crisis.

Toronto, June 2010

The changing global balances

ICGN's keynote event for 2010 took place in Toronto, and investigated how the business world is changing in the wake of the global financial crisis.

Highlights from the event included:

Canada's Minister of Finance, Jim Flaherty, talked about politicians' responses to the global financial crisis and how governments are working together in an unprecedented fashion to achieve a global consensus on the way forward (see page 14 for more on this).

Antonio Borges, Christian Strenger and George Lewis, discussed the European sovereign debt crisis and ways forwards (see page 18 for more on this).

Eli Sætersmoen, Faye Wattleton, Daniel Ferreira and Deborah Gillis, discussed the business case for more women on boards – with the general view that more diversity on boards is a good thing in many ways.

David Collyer, Brian Ferguson, and Hal Kvisle, defended energy companies' records on ESG issues, with Mr Collyer arguing that oil, especially oil which is produced in Canada, is responsible energy. Damon Silvers, responding to this: while he agreed that there is a need for fossil fuels, he noted the industry's 'horrifying history' of social exploitation and environmental destruction.

Lowell Bryan, director and senior partner of McKinsey & Company, discussed the recent fundamental shifts in the world's economy. He advised organisations to take scenario planning seriously, manage strategic investments more dynamically, continue to invest in improving risk/reward management skills, pay greater attention to banking relationships, err on the side of being over-capitalised, over-liquid and over-prepared, and to re-examine the critical assumptions based in business models.

Lucien Bebchuck, Friedman Professor of Law and finance director of the Program on Corporate Governance at Harvard Law School, delivered a lunch keynote on how to fix pay structures to link executive payoffs tightly with long-term performance while avoiding excessive risk-taking incentives. He also noted that in order to tie executive compensation to long-term results there must be a focus on equity compensation.

José Luiz Osório, founding partner of Jardim Botanico Partners, discussed the current state of corporate governance in Brazil, and noted that there are now much better governance practices in place in the country and that the government has taken many steps, though new regulations, in order to improve protection in the investment markets.

YRK Reddy, founder trustee of the Academy of Corporate Governance, spoke about how India is handling corporate governance issues. He noted the exponential growth in the economy in the last several decades and how the strong holding in state-owned and family businesses may need to be reduced so that minority shareholders are protected.

Jamie Allen, secretary general of the Asian Corporate Governance Association spoke about China's implementation of corporate governance practices. There is still a strong influence from the Communist party, and all state-owned enterprises have a committee that looks out for the interest of the state. Mr. Allen also noted the growing diversity in companies. Despite this, he stated that lack of freedom of the press has had an impact on minority shareholders and will likely constrain China's growth at some point.

The Honourable James M. Flaherty PC MP, Minister of Finance, Canada

Striking the balance

Should governments be focusing on fiscal stimulus or cutting the deficit? Jim Flaherty explains Canada's position.

We are in the midst of a promising but fragile global recovery. This recovery is no accident. It is thanks to the unprecedented cooperation in the G20.

The world requires new approaches and continued global cooperation. To fully understand the importance of where we are today, it's important to look back a little bit and to remember where we were and how serious the crisis was back in the autumn of 2008. It was the morning of Friday 10 October 2008 when we in Canada announced we would take certain steps to make sure our financial institutions were able to maintain a level playing field because of the action other countries had taken over banks. We agreed to purchase some insured mortgages to ensure adequate liquidity in our financial systems.

Later that day, we were in Washington DC, meeting in the Cash Board of the Treasury with the G7 central bankers and finance ministers. This was a meeting not like other meetings. I've been to many of them over the course of more than four years. Usually, communiques are prepared in advance of meetings. I guess it's to avoid elected people making serious decisions at these meetings. At this meeting, we threw away the script – we tore up the communique. It was a serious discussion. At that point some German banks had failed, the United Kingdom government had had to take over and effectively nationalise some banks and Lehman Brothers had just failed the month previously. It was an intense discussion, with some blaming of others taking place. However, by the end of that meeting, we had created a five-point plan.

The reason I'm telling you this is to remind you that this was a very serious crisis. The markets were unstable. It was unclear whether some markets would even open on the following Monday. Secondly, because the international bodies – the G7, G20, the International Monetary Fund and the World Bank – all got together that weekend in Washington and all adopted this same five-point plan, we created certainty and direction. We were not going to let any more financial institutions fail: that was the fundamental commitment.

At that time, we were dealing largely with investment banks, as well as banks generally. In 2010, the European challenge – which is a challenge for all of us – relates to sovereign debt. We are all agreed in the G20 that fiscal consolidation is mandatory: not just fiscal consolidation among those countries that need to reduce their level of indebtedness, but also the will to follow it through.

After that weekend in October 2008, there followed the first G20 Summit in Washington in November 2008, led by President Bush. Again, there was a high degree of cooperation among the leaders and the finance ministers who were present, firstly in Washington and then later in New York. We agreed about the need for stimulus, and all of the G20 countries agreed to create stimulus in their economies: 2% a year over the course of two years, or 4% of GDP.

Fiscal discipline

We did that in Canada, thanks to the cooperation of the provinces and territories. Together, we created a two-year stimulus package in excess of 4% of GDP. There's much talk about exit strategies in the G20. We've built in our exit strategy in that the majority of our spending is infrastructure spending and it is being terminated as of the end of March 2011.

In the budget that I delivered in January 2009, which contained the stimulus package, we made it clear from the beginning that we would spend the money we would spend it over two years but then it would end. That's important, because that gives us the opportunity as of the next fiscal year to cut our deficit in half, by the following year by two-thirds and then move to balance in three to four years.

We were running balanced budgets in Canada before the crisis. We listened to businesspeople, ordinary Canadians and the investment community in Canada, and decided to run a fairly sizable deficit over the course of a couple of years in order to stimulate the economy. It is working. The Canadian economy in the first quarter of this year grew 6.1% in real GDP terms: that is above expectations. We're pleased with that result. We are still concerned with the unemployment rate, which is about 8.1% right now, but relatively speaking it's better than what the United States is experiencing in terms of unemployment.

"Because the international bodies all adopted this same five-point plan, we created certainty and direction."

In Europe, financial markets are looking with concern at the debt situation of some countries. In Canada we have a controlled debt situation, as I say, and we'll move to balance in the intermediate term.

We also have a good brand these days. The World Economic Forum calls Canada's financial system the most sound in the world. I can recall being in China, in January 2007, and some concerns being expressed by my counterparts there about Canada's banking system being 'boring and risk-averse'. When I went back in May, I didn't hear much of that. I heard things

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"Leadership is measured not by what we say, but by what we do."

> like 'healthy','stable', 'solid' and 'prudent': that's the Canadian financial system.

Our overall tax rate on new business investment this year will be the lowest in the G7, and below the OECD average. We're reducing corporate taxes. The opposition tells us we shouldn't do that, but we have a long-term plan to get our federal corporate tax rate down to 15%. It was a little bit over 22% when we took office more than four years ago, and we've been reducing it every year. We'll get it down to 15% by 2012. I have encouraged the provinces to join us in that, get their corporate rate down to 10% – in Canada both the provinces and the federal government levy corporate tax. So by 2012-13 we will have a combined corporate tax rate in most of Canada of 25%, which will be easy to communicate and a clear brand for Canada. We have reduced our consumption tax by 2%, as we promised to do. And this year we got rid of tariffs on manufacturing inputs. Canada is now the first tariff-free country on manufacturing inputs in the G20. All of this is part of a competitive advantage.

In terms of fiscal discipline, Canada today has the lowest debt-to-GDP ratio in the G7. The IMF expects Canada to have the strongest recovery in the G7 over the next two years. All of this is as a result of fiscal discipline, which I, as an elected person, realise is not always the easiest thing to do. I understand the challenges faced by some of my colleagues elsewhere, but the need is there to pay down substantial amounts of debt in Canada. In our first three years, we paid down almost $40 billion of debt before the crisis and the recession happened. That helped us to be able to go into deficit briefly and then come back out of it without creating a structural deficit. If Canada is going to call on other nations to follow through on fiscal consolidation, which we are, we had better do it ourselves. We need to make sure that we're leading by example.

I am encouraged by the cooperation that we see in the G20. There's much discussion on the number one issue: strong, sustained and balanced growth. Our intent is to get a clear agreement on the principles needed to achieve real progress on reducing deficits and debt burdens. We need clear, credible, concrete, timely fiscal consolidation plans that will reduce and eliminate our deficits to put debt burden on a downward and sustainable path. It is critical for all economies to go in this direction.

When the levy breaks

On financial sector reform, there has been a lot of talk about bank levies and so on.

We all agree on the principle that to the extent a financial institution contributes to a crisis in the future, it is the debtholder and shareholders of the financial institution that should bear the cost of that contribution, and not taxpayers. There are different ways of getting resolution of that principle: one which Canada has suggested is an embedded contingent capital provision. We've provided some detail of that to our colleagues and that is being looked at as well as one of the solutions.

Fundamentally, we are opposed to a bank tax, an *ex ante* bank tax, for several reasons: the most important of which, and we share this with the majority of G20 countries, is that we did not put taxpayers' money into our financial institutions during the crisis. To impose a tax on our financial institutions now would inevitably flow through to customers as a cost of doing business. In Canada we would be imposing a tax on Canadians, whose money was not used to bail out banks during the difficult time. We're not going to do that. I've had this discussion with my colleagues in the G20 but, as I say, the majority of countries in the G20 will not be imposing an *ex ante* tax. But one size does not fit all on this issue. There are a few countries that are interested in an *ex*

The Honourable James M. Flaherty PC MP, Minister of Finance, Canada

ante bank tax and they may proceed in doing that. But there will not be a global tax of that nature.

It also concerns me as a finance minister, when countries are running deficits and talking about imposing some kind of bank levy with the idea is that this bank levy money will be used later on when there's a crisis. One wonders whether the money would really be there later on: I say, as someone who has to manage budgets and looks at deficits, that the tendency would be for any government to use that money to reduce their deficit when they have it at hand rather than have it put aside for another time.

Security in numbers

I've also been working on securities reform for several years. Canada does have a strong financial system. We have an effective regulatory system. As you know, most of the financial institutions that failed during the crisis were regulated – perhaps not well, but they were regulated. So, in our discussions, I always emphasise with my colleagues the importance of effective supervision and not just having a supervisory framework. In Canada we have an effective supervisory framework through the Office of the Superintendent of Financial Institutions. We also have the Financial Consumer Agency of Canada, and I know some other countries are looking at that type of agency. The Bank of Canada is responsible primarily for monetary policy, and there's the Canada, Deposit Insurance Corporation and my department, the Department of Finance.

The leaders of the institutions that I just mentioned meet regularly. That's our macro-economic overview in Canada. But what we are missing is a common securities regulator in Canada. Right now, we have 13 provinces and territories in the business of securities of regulation so in the five budgets that I've done here we have consistently proposed that we would work with participating provinces and territories to create a Canadian securities regulator. We have created a Canadian Securities Transition Office.

Ten of the provinces and territories have been working with the Government of Canada toward creating the Canadian securities regulator. We have in fact created the draft law, the bill which has been tabled in the House of Commons. We also referred the bill to the Supreme Court of Canada for a constitutional interpretation. Our view is that the federal government has the constitutional authority in the Canadian context to legislate in this area, but we want to have certainty for investors and business, and certainly in the securities area, so we are asking our highest court to give us that ruling.

We would then be able to fill what is really the empty chair at the table with the Department of Finance, the Office of the Superintendent of Financial Institutions, the Bank of Canada, the Canada Deposit Insurance Corporation and the Financial Consumer Agency of Canada. I expect that we'll see the ruling of the Supreme Court of Canada in ten to 18 months. Even so, we've made more progress than has ever been made before on creating a Canadian securities regulator.

Actions, not words

To conclude, let's go back to the big picture for a moment.

Leadership is measured not by what we say, but by what we do – and that includes in the G20. In so many ways, Canada has done well during the crisis. We have a world-leading financial system. We have a competitive advantage through tax relief and we have had budgetary prudence.

We still have to work with our colleagues in the G20 to make sure that we have a sound basis for sustainable growth going forward. This doesn't mean growth at any cost. It means sustainable growth over time. The discussions that we have had were largely about fiscal consolidation, but also about mutual assessment practices so that we will be able to be assured that there is financial system integrity from country to country. The concern is, given the weakness in some of the vulnerable European sovereign states, that their need to exercise fiscal consolidation will have a negative effect on growth. It is important, therefore, that the emerging economies like China increase domestic demand. In fact, China is going in that direction intentionally, increasing domestic demand to help balance the effects of fiscal consolidation in some of the developed economies.

It is important that we make progress in this global arena, and we are all agreed that we need to push forward, seeking concrete results in a cooperative and committed way so that we can truly have balanced growth.

ABOUT THE AUTHOR

James M. Flaherty is Canada's Minister of Finance. He was recently awarded Euromoney Magazine's award for Finance Minister of the Year. Mr Flaherty is a governor of the World Bank and the International Monetary Fund. This article is based on his keynote speech at the 2010 ICGN Conference in Toronto.

Antonio Borges, Chairman of the Hedge Fund Standards Board and the European Corporate Governance Institute; George Lewis, Group Head, Royal Bank of Canada; Christian Strenger, Government Adviser and Director, DWS Investment GmbH, Germany

New world order

What role can investors play in forging a new economic order from the ashes of the old? Antonio Borges, George Lewis and Christian Strenger discuss.

The post-global financial crisis world is a volatile one. It seemed that the global financial system had only just started to get back on its feet when the European sovereign debt crisis knocked it sideways. So, what caused the European sovereign debt crisis? Could it spread to infect the burgeoning recovery elsewhere? What role should investors and regulators play in stabilising and rebuilding the global economy.

These were the questions considered in a lively and occasionally heated discussion at the ICGN Conference 2010 in Toronto, extracts from which are published below. The participants were Antonio Borges, Chairman of the Hedge Fund Standards Board and the European Corporate Governance Institute; George Lewis, Group Head, Royal Bank of Canada; and Christian Strenger, Government Advisor and Director, DWS Investment GmbH, Germany. The discussion was moderated by Chrystia Freeland, Global Editor-at-Large at Reuters.

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Chrystia Freeland: Antonio, what is happening with sovereign debt issues in Europe, and how much of a threat does this pose to the rest of the world?

Antonio Borges: I think we are at a very interesting time. Our main focus now must be how we organise our world as a consequence of what happened over the last two or three years: how we put good governance in place, and what lessons we draw from the experiences of the last few years.

Chrystia Freeland and Antonio Borges

What's happening in Europe now is an indication of where we should focus. Here we are, two years after the beginning of the financial crisis. At the beginning of the year, we were in a very confident recovery process: all of a sudden, things are derailed by events in a tiny European country. Greece is a small country – how can we have the worst months on record in terms of financial instability because of it? Well, the parallel with 2008 is striking. Lehman Brothers was not that big compared to the whole financial system, but the collapse of a single institution was enough to generate a wave of panic that spread throughout the entire system, to the point where it was on the verge of a massive collapse. The same thing is happening now: Greece is just the tip of the iceberg. There is a great deal of concern about contagion. When investors start looking, they realise that the situation in Greece is not that different from a few other countries. Where do you draw the border. Portugal? Spain? Italy's in pretty bad shape as well, and the UK has these massive deficits. All of a sudden, this could become a much bigger problem than people initially thought.

The channel in which this instability communicates to the rest of the market is exactly the same as in 2008 – the

banking sector, and to a certain extent insurance companies as well. Banks and insurance companies have massive investments, as you would expect, and even though they may have very little in terms of Greek assets, if they incur any kind of significant loss that by itself would be billions of dollars which they cannot afford to lose The concern is that what starts with a tiny little bit of Europe may contaminate other countries and create the same amount of fear and instability that took place in 2008.

My concern is that, in Europe in particular, governments are blaming the markets. Instead of asking 'how come for ten years no-one raised the flag about Greek or Portugese financial policies, and how can we correct it quickly', people are saying 'it's the markets – it's the fault of irrational market speculators'. They don't understand that, if you are managing a portfolio of investments in a big insurance company and you see that Greece is getting into a bit of trouble, it is your responsibility to protect your investors' and your clients' money and take the consequences of the analysis you make of the situation. I'm concerned that we may be moving away from relying more on market signals and understanding, and letting policy be guided by them, to a situation of government intervention – which will just make the problem bigger.

CF: Christian Strenger, do you agree with Antonio's concerns that markets are being blamed too much or are market participants to blame?

Christian Strenger: I totally agree with Antonio that one of the key problems is the breakdown of communication between politicians and financial institutions. Particularly in Europe, politicians and the general public see the 'speculators and the greedy traders' as the culprits for the current crisis. The leaders of the financial market so far have failed to impress the public that the root causes were, and they still are, the fundamental deficits in budgetary discipline, accounts-cheating, and lack of stringent supervision by the supervising authorities. If people don't come together again to solve the crisis together and make the general public aware of the real problems and the solutions it will continue to be a very messy situation.

Christian Strenger

CF: George Lewis, how concerned are you with the implications for Canada, North America and the global economy of these European problems? Will we now see a European banking crisis?

George Lewis: I am reasonably confident: policymakers are reasonably aligned in diagnosing the underlying causes of the global financial crisis: namely, global trade and fiscal imbalances, the need of the US and certain European countries to focus on savings rates and investment, less so on consumption, and the importance of the BRIC countries to increase consumption. There seems to be agreement at the general level, but the devil is in the detail and the fact is that this is a very difficult issue to address. The sources of instability that we're still seeing in the European banking system are sourced from this financial system's ability to try to accommodate those imbalances – both trade and fiscal. I think that governments, as they try to address fiscal consolidation, should also address global trade flows as well. I would also say that it's important to watch for large market distortions that governments can introduce.

However, I am reasonably optimistic in that lessons do seem to have been learnt from the past 18 months and we'll see, in terms of the progress going forward.

CF: Christian, do Germans have to consume more, and are Germans prepared to do that?

CS: I think the important thing is that Germany has no choice but to stay competitive, and continue to do things that convince our customers worldwide that we have the right product with sufficient ingenuity.

AB: I agree. Europe as a whole is in balance, so the German surplus actually compensates for the deficits of quite a few countries. There is no reason to blame Europe for slowing down the world economy. The second point that

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"Politicians and the general public see the 'speculators and the greedy traders' as the culprits for the current crisis."

George Lewis

Christian made about competitiveness is also key. Countries that are competitive and that can grow rapidly will always continue to attract capital easily, and they will use it efficiently to generate more wealth: therefore they'll be fine over time. I'm quite unconcerned about the US over time for precisely this reason.

On the other hand, if you go to the southern European countries, they joined the Euro in the hope of getting a lot of capital flowing into those countries – which they did. But they misused that capital in the most extraordinary fashion you can imagine. These countries now have foreign deficits of up to 10% of GDP and, in the case of Greece and Portugal, this has been going on for more than 10 years. You very rapidly accumulate this terrible foreign debt, which looms over what you can do. If you don't grow because you've used all this money wastefully and you've lost competitiveness in the process your fiscal problem will never go away. Moving from debt to surplus through austerity measures by itself will not be enough: the real problem is competitiveness and growth. We can learn from the Germans: they lost a lot of competitiveness at the time of unification, went through eight years of tough policy and eventually became a healthy economy.

We also have to better understand the importance of savings. Greece and Portugal have a very low savings rate. Italy, meanwhile, has terrible public finance, but has such a high domestic savings rate that it is less of an issue. If they want to waste their money on public deficits its their problem – it does not bother the others. Whereas in Greece or Portugal, and to a large extent Spain as well, it's foreign money that's at stake and that creates enormous vulnerability.

Ethical behaviour

CS: I'd like to make a general comment about ethics. Too often things were 'permissible', but I think we all had this feeling they were not entirely in conformity with our sense of ethics. One has to rethink the ethics side of business – at least partly to convince the general public that, while the financial institutions and investors aren't without fault, we are doing things that correspond to their expectations. There's nothing wrong with making $100 million a day, perhaps, but it is incomprehensible for most people in the world that you can make so much money from dealing in practically invisible things.

I would strongly advise that again, in order to bring together the general public and financial institutions, we rethink our view on ethics and we should come to a common culture of ethical values: display a consistent tone from the top and live by example. I think that is what has been deficient. Of course, we cannot describe perfect ethical behaviour – an ethical code would be difficult to construct – but we know what is certainly not ethical, and I would vote for making an effort in this direction.

CF: Can that come from inside institutions or does it have to be imposed by regulators?

CS: Regulators will have a tough time: they can perhaps try an impose an ethical committee, as the US has, but that doesn't help. It has to come from inside: the people involved must rethink the focus of their activities and the wider order of how the relationship between the general public and financial institutions should be constructed.

GL: I'd echo that. The protection of a financial institution's reputation is a crucial part of risk management responsibility and, from the point of view of the regulators, a key pillar of financial services reform should be a reinforcement of the role of fiduciaries and agents.

As Christian mentioned the regulators can set rules and regulations and carry out effective supervision, but good governance essentially comes down to the actions of each individual financial institution, the boards of those institutions, and the shareholders and debtholders. As a regulator and public policymaker, if I can create a framework where fiduciaries and agents are rewarded by doing their duty, then I've got a lot of people working with me straightaway. That can extend to things like fiduciary standards for an investment business dealing with retail customers; it can include empowering shareholders and boards to a greater extent; it can also extend to providing a duty of care in providing credit products. If you step back and think about it, if the provision of mortgage products in the US was regulated even to a modest extent as investments are – in terms of suitability and duty of care – we would not have had the problems on main street in terms of the selling of inappropriate mortgage products.

Market forces

AB: As we build this new world and try to avoid these crises, who should be in

charge? Who should have a bigger say? There are calls for more regulation and more intervention from authorities: in my view that may be necessary and inevitable, but we should never ask regulators to do more than they can do.

On the other hand, there are others that can be extremely helpful in this process of enforcing new discipline. I was an academic myself for many years and I chair the European Corporate Governance Institute, which is a research organisation throughout Europe, so we pay a lot of attention to what academics say. One of the joint winners of last year's Nobel Prize in economics was Elinor Ostrom, who highlighted the point that sometimes the public good is better delivered by getting the interested parties around the table, getting them to organise the proper rules and getting them to enforce them. This is something that we should learn from: we need to find out who the key people interested in financial stability are. Many investors are very knowledgeable, sophisticated, powerful and so forth – perhaps we should rely on them to emphasise better rules. In the UK, there is an increasing emphasis on active investors and on so-called investor stewardship: to what extent can we mobilise sophisticated, knowledgeable investors to achieve these goals? We can leverage more investor power and go a lot further towards building a safer world.

CF: Do you agree that activist investors will be more powerful than regulators in helping us to strike a new global economic balance?

CS: Active investors have to play their role, and they haven't played it enough. Sometimes the regulators and the companies have been against them, but as a whole they have to do more and that will involve some effort.

There is something else that should be looked into, which in my view comes from a faulty development in the field of corporate ownership. Capital markets have developed their own dynamics through derivatives and similar instruments as sources of income and risk. These are completely unrelated to the companies whose shares are traded. This results in the decoupling of control rights from the financial rights: while this has made many a trader very rich, these dynamics have overtaken the original function of capital markets: intermediating monies of all sectors to provide long-term funding for companies.

"We need people running companies to understand that if they don't do a good job someone will fire them. Without that we will have prolonged value destruction, as you find in many European countries."

High-frequency and derivative trading related to underlying and uncovered securities lending are mostly unrelated to the company and its governance, but they have an enormous and still growing impact on it as large parts of the company's share are too often not voted. That is a hidden problem that we fail to address much too often. That is something that we should openly discuss and see if, together with regulators, we can balance better.

GL: I would add that it's important to align ownership rights with control rights, but I think that the key pillars which regulators should focus on are sound and straightforward regulation of individual financial institutions through capital ratios, reasonable average leverage limits and creating a level playing field; the reinforcement of the role of fiduciaries, which is an underutilised muscle of the financial reform debate that's taken place to date; and creation of contingent capital for financial institutions, with the underlying hope that that would encourage debt investors to become more rigorous in their analysis of financial institutions.

AB: I'd disagree with Christian's view of the financial markets. He says that financial markets exist to provide long-term capital to companies. This is only a tiny part of what financial markets should be doing. One of the most important roles of financial markets is imposing discipline on investment and getting a good return for investors; requiring a high rate of return on investments, giving more authority instead of subsidising more wasteful investments, either by governments or by companies. If financial markets were more powerful, there would be a higher discipline on return of capital, this would be in everybody's interest.

Second, and perhaps more important, is the markets' role in handling risk. How can we imagine an advanced economy without risk taking – it's out of the question. Providing risk management is absolutely fundamental, as is doing this well, including through instruments and mechanisms that most people do not understand but without which our lives would be impossible. That is why innovation takes place,that sometimes goes too far: that's why there are regulators and that's why these things have to be kept under proper control and that's why we have to understand their value. Otherwise, our markets will be underdeveloped.

My final point – and perhaps the most important one – is that it is through the financial markets that shareholders should control or decide who controls corporations. The financial market should be the framework for corporate control, and we need this desperately. We need people running companies to understand that if they don't do a good job someone will fire them. Without that we will have prolonged value destruction, as you find in many European countries.

CF: Antonio, Christian, George, thank you for your participation.

Nuno Fernandes, Professor of Finance and Governance, IMD Business School and Lamfalussy Fellow, European Central Bank

Sovereign possibilities

Sovereign wealth funds are an increasingly important force on the global stage. Nuno Fernandes asks 'are they friend or foe'?

To say that there are currently substantial shifts in global capital market forces is something of an understatement.

During the last few years, we have seen an enormous rise in the participation of sovereign wealth funds (SWFs) in capital markets, which have shown an increasing appetite for risk, and thus investment in equity-based asset classes. While the role of SWFs is paramount in current capital markets, their investment strategies and potential political agendas remain controversial. Although SWFs have been widely discussed, much of the commentary on them is based on anecdotal evidence. Regulators question whether SWF investments benefit shareholders, while numerous critics claim that SWF investments are done with political motives in mind.

In this article, I will provide some evidence on the impact of SWFs on firm valuation and performance, based on the IMD Working *Paper Sovereign Wealth Funds: Investment Choices and Implications Around the World*. We provide evidence on SWFs strategies, the kind of stocks they buy, the impact SWFs have on firm valuation and performance. The potential implications for institutional investors' strategies are huge.

The main results we find based on SWF portfolio choices is that SWFs have a stabilising role on firms, and their ownership is positively valued by the market.

SWFs can be valuable strategic investors: they have a positive impact on a firm's strength as an acquirer and value as a target; they allow firms to leverage political connections when accessing new markets; they guarantee stable long-term finances; and, as a cheap source of capital, they reduce firms' cost of capital.

The controversy

Understanding the role of SWFs is critical for institutional investors. These 'new' players manage assets worth more than $3 trillion. Some estimates suggest that SWFs will manage more than $10 trillion by 2015.

Therefore, for the institutional investor's world, it is important to understand SWFs' behaviour, criticisms of them, and impact they have on companies. First, in terms of regulation, several multilateral institutions have been arguing that there needs to be additional scrutiny into and regulation of SWFs. The lack of transparency of their investment strategies and their potentially destabilising effect on markets has frequently been compared to the impact of hedge funds. Second, and probably more importantly, SWFs are large players, and have implications for all investors, in particular, for institutional investors exposed to global equities.

Although definitions vary, SWFs are essentially state-owned investment funds that invest in international financial markets. They have existed at least since the 1950s – the Kuwait Investment Office

was set up in 1953 – but their total size worldwide has increased substantially over the past 10 to 15 years. The biggest is the Abu Dhabi Investment Authority (ADIA), with assets under management of more than $850bn – making it a comparable player to Vanguard.

The first wave of SWFs was set up by oil producers after the price increases in the 1970s and 1980s. The underlying idea was to allow governments to spread the benefits of oil income across generations by investing in financial assets, since oil is a non-renewable resource. A second wave of SWFs followed debt crisis in East Asia in the late 1990s. After the crisis, most emerging markets in the region experienced a shift from debtors to creditors. Savings have thus begun to accumulate in SWFs.

In principle, SWFs invest in equities with the purpose of maximising the return on a country's reserves. By taking sizeable stakes in corporations, they perform a desirable corporate governance role that should be welcomed by other shareholders. Unlike other controlling shareholders, SWFs pursue nothing but stock return maximisation. They are typically long-term investors, well-governed themselves, so managers should feel pressure to perform – even if SWFs have until recently been reluctant to sit on boards of directors. On the other hand, being powerful investors, there is no reason why we should not expect SWFs to expropriate minority shareholders.

However, with some noteworthy exceptions (such as the Norway Government Pension Fund), SWFs are generally opaque in their objectives and strategies. An argument has been made that they may hinder competition because the industries where they invest are not open to foreign investment in their own countries. Politicians' responses in general suggests a fear of hidden political agendas. For example, President Nicolas Sarkozy stated in early 2008:

'I believe … in globalisation but I don't accept that certain sovereign wealth funds can buy anything here and our own capitalists can't buy anything in their countries. I demand reciprocity before we open Europe's barriers.'

Where do SWFs invest?

SWFs invest in virtually all countries in the developed world, and a few emerging market economies. As market players they are certainly a driving force, holding positions in virtually one out of every five firms worldwide.

The typical position taken by an SWF is not a controlling stake. On average, an SWF takes 0.74 per cent of the shares outstanding in a firm, and in dollar terms the average position is $46.3m. Indeed, their level of control only reaches 50% in less than 1% of their investments.

The average firm held by an SWF has total assets of $229m, annual sales growth of 15%, and a leverage ratio of 24%. In terms of visibility indicators, the average firm is tracked by 13 analysts and 32% of its sales are international. Compared to typical firms in the world market, firms invested in by SWFs are significantly larger, more liquid, and have proven records of profitable growth. Firms held by SWFs also tend to have significantly higher institutional ownership and analyst coverage than the rest.

SWFs are often opportunistic investors. They step into companies when their stock prices fall: indeed, the International Monetary Fund has praised them for their stabilising role in financial markets. They are also more prone to investing in countries where legal protection of investors is stronger. In other words, they may bring in good governance, but only to the extent that the legal regime guarantees a minimum protection to their investment. As with other non-sovereign investment vehicles – CalPERS being a good example – corporate governance considerations are therefore important determinants of SWF investment strategies.

Despite the previously-noted preference for visible firms and demand for stocks with high analyst coverage, SWFs do not reveal any strong demand for firms that belong to the major stock indices, such as the Morgan Stanley Composite Index. Index membership irrelevance is interesting, as SWFs, contrary to regular mutual funds or hedge funds, have no business concerns in terms of performance and flows. The money that flows into the fund is independent of its performance (or any benchmarking) and relies heavily on the health of the domestic economies of each of their countries. Belying one political argument traditionally raised – that SWFs try to invest in Western corporations as a means of corporate intelligence – SWFs do not have any particular preference for high-tech or R&D intensive firms among the universe of public firms.

The impact of SWFs

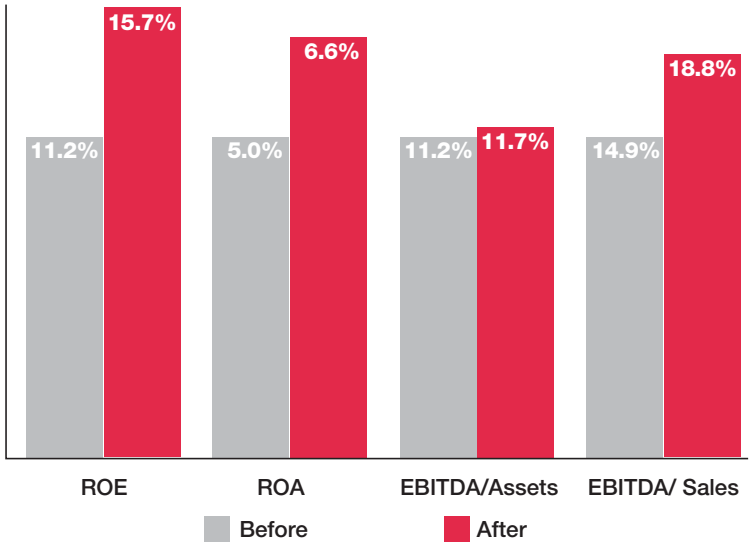
We know how politicians react to foreign investment by SWFs. We think the best way to judge SWFs is to ask how regular shareholders react. Financial markets are forward-looking, bring together thousands of different opinions, and can efficiently assess the economic impact of SWFs holdings. How do stock prices react when SWFs invest in a firm?

The valuation impact of SWFs is sizeable. The econometric analysis shows that, in the year when a SWF invests in a firm, the ratio of the market value of the firm to its book value increases by 15%. Put simply, this suggests that other shareholders, including hedge funds that are long on these companies, benefit – and benefit a lot – from SWFs investing in their firms. Furthermore, the impact of SWFs goes beyond that of the typical institutional investor: the market pays on average a much higher premium for firms >

"With some noteworthy exceptions, SWFs are generally opaque in their objectives and strategies."

where SWFs have a stake than firms owned by general institutional investors. Everything else equal, the market prefers SWFs to any other institutional investor. Why?

The figure below presents evidence of the impact of SWF on different measures of firms' operating performance. We use return on assets (ROA), return on equity (ROE) and operating profit margins (defined as EBITDA/sales and EBITDA/ assets) as measures of operating profitability. The results show that after a SWF invests in a firm, overall operational performance improves.



The benefits of SWF ownership and implications for investors

There are several potential benefits to SWF ownership which can make them more effective at enhancing firm value:

First, SWFs can be more proactive in the takeover market and block value-reducing acquisitions by the companies they invest in. Because of their interest in stock returns, SWF stay away from strategies that purely pursue value-destroying consolidation and scale.

Second, SWFs increase the takeover premiums in the companies where they invest. In late 2008, Norway's Government Pension Fund opposed MidAmerican's bid for Constellation, where the Fund had a 4.8% stake. The bid by MidAmerican, which is a unit of Warren Buffett's Berkshire Hathaway, was interestingly backed by Constellation's management itself. However Norway's SWF considered the price insufficient and brought MidAmerican to court. As this episode shows, powerful, non-controlling shareholders can exert external pressure.

Third, SWFs can be efficient internal corporate governance mechanisms, bridging any gap between shareholders and the top executive. As a substitute for the legal system, one expects the value effect of SWFs to be larger when they invest in companies coming from countries with a weaker legal system. However, our analysis of SWF holdings in the last five years shows that the SWF premium that we report above is the same no matter what the level of the country of origin's investor protection is.

Fourth, and unlike other types of institutional investors, SWFs are usually willing to provide capital in case of future funding needs and therefore reduce the uncertainty regarding the firm's future financing ability. There are two characteristics of SWFs which make them more desirable than regular institutional investors: they are larger and do not invest heavily in equities. As SWFs have access to massive funds, the market rewards the unlimited access to capital of the firms where they invest. Current estimates suggest that SWFs are still significantly underexposed to equities as compared to a regular pension fund or other institutional investors. Hence, the expectation is that SWFs will gradually increase their exposure to equities in the coming years (to about 40%).

Fifth, SWFs make companies more valuable because they reduce firms' cost of capital as a result of their commanding lower risk premiums. The opportunity cost of sovereign funds is to invest in risk-free instruments, like US bonds, as had been their common practice in the 1980s. Furthermore, relative to their size, a single SWF stake represents a small percentage of their total assets anyway (the typical fund in the sample invests in more than 100 stocks), and the marginal investor of the firms where they invest becomes a more global, international, less risk-averse investor.

Finally, SWFs provide valuable political connections. Brazil has recently established its own SWF, with the stated objective of buffering the country from the global financial crisis and helping Brazilian companies boost trade and expand overseas. It is likely that such international expansion is spurred by the Brazilian government's appeal with multinationals and other regulators.

The results from this study have important messages for investors worldwide.

SWF ownership is positively valued by the market, with a premium of about 15% of company value. This suggests that the controversy surrounding SWFs and its future regulation is more political than financial. Contrary to claims that SWFs expropriate investors and pursue political agendas, they, in fact, contribute to long-term shareholder value. The evidence from this study suggests that the majority of SWF investments do not involve partial or complete control of firms. Even for investments that are large (and may involve control), there is no evidence that they harm companies or extract inside information or technology.

The overall evidence is that firms perform better and are valued higher when SWFs invest in them.

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Held to account

Accounting is about more than numbers – getting it right goes to the very core of corporate governance, and getting it wrong can have disastrous results. Shyam Sunder explains.

Corporate governance is closely intertwined with various aspects of accounting – financial reporting, managerial control, compensation, internal and external audits, and taxation. It is often difficult to isolate governance from control, and fascinating to explore their interactions.

Financial reporting was indeed a root cause of the global financial crisis for two reasons. First, specific financial reporting standards such as mark-to-market valuation in the comforting guise of 'fair values', and delay in recognition of bad debts until loss is incurred, helped distort information and investment decisions and contributed to market failures. The role of financial reporting is to provide information for the markets so investors can independently value the securities, and not merely prepare financial reports from the market price of the securities.

Second, excessive dependence on written standards to the exclusion of 'true and fair' overrides based on global judgment created a spiral of interplay between financial reporting and financial engineering. This spiral ensured that the intents of any written financial standards could be defeated by financial engineers through the redesign of instruments, transactions, and organisations. This spiral fed the crisis, and contributed to the magnitude of its consequences.

The accounting and business community accepting greater responsibility for fairness of financial reports may help improve this situation. However, there are good reasons for scepticism. We should not hold our breath for significant improvement in spite of all the promises of reforms in the US and the rest of the world. Just as a good democracy requires vigilant and responsible citizens, good corporate governance also is not possible without vigilant and responsible investors.

Pro-cyclicity of mark-to-market

The pro-cyclic amplification of the business cycle promoted by mark-to-market accounting is the best known argument in favour of proving accounting was a root cause of the global financial crisis.

Most of the people who resisted the pro-cyclicity argument against mark-to-market accounting when we first made it early 2007 have now come around to recognise this problem. Lord Adair Turner, the chair of the UK Financial Services Authority, summarised it well in his January 2010 address to the Institute of Chartered Accountants in London:

'When credit is extended in a securitised form, with the market price of credit clearly visible from trading in credit securities, there is an inherent risk that credit supply and pricing can be subject to self-reinforcing herd effects, with originators of and investors in credit treating the market level of credit and credit default swap spreads as indicators of credit risk and thus of appropriate credit pricing. In the upswing this feeds the rising price of credit securities, falling spreads, increased origination, and a self-reinforcing willingness to invest in credit securities or indeed to lend on balance sheet.'

In addition to the pro-cyclical consequences of mark-to-market accounting for trading books, we should consider the pro-cyclical consequences of the current accounting rules for recognition of loan losses. Since these losses are recognised only when they are incurred, and not on an expected value basis, a downturn in the business cycle brings recognition of large loan losses, lowering bank income as well as capital, which in turn lowers the availability of credit, further reinforcing the economic downturn. The reverse happens in economic upturns.

However, beyond these well-known arguments for pro-cyclical effects of

current accounting rules is a larger structural problem of accounting rules that has received little attention in regulatory, governance or academic circles.

The structure of financial reporting rules and institutions

The presumed objective of financial reporting is to help make various decisions, and define and implement contracts through specification of constraints on contracting parties.

Since the introduction of federal securities laws in the US some 80 years ago, regulators and accountants have sought to achieve this end by moving away from what had originally been a common law construct called generally accepted accounting principles (GAAP). During these 80 years, there has been a progressive shift towards a quasi-statutory regime of formal written standards issued with the enforcement power of regulatory authorities. Under the US Financial Accounting Standards Board and the International Accounting Standards Board this process of transforming GAAP to a top-down prescription is almost complete; it no longer emerges bottom-up as a social norm of business practice.

This gradual but radical shift from broad scope for professional judgment to progressive 'clarification of rules' and 'guidance' has been popular not only with the regulators and accountants but is also demanded by many in the business and financial communities. What, one might ask, is the source of complexity, and what is wrong with having clear written rules to deal with it?

The elephant in the room: financial engineering

The reason is the accountants are not the only players in the arena of financial reporting; they have the formidable and adversarial company of financial engineers.

Financial engineering consists of the design, analysis, and construction of financial instruments, transactions and organisations to meet the needs of the enterprise. These 'needs' consist of goals like reducing indebtedness on the balance sheet and expense on the income statement, increasing revenue on the income statement, deductions on tax returns, and regulatory capital on the bank balance sheet. Financial reporting and engineering have diametrically opposed goals.

Financial reporting has no chance of winning this unequal battle. It may take a few years for the FASB or IASB to make its policy in form of a rule on an accounting issue (unless it is under pressure from the US Congress or a Gallic politician, in which case years are compressed into days). It takes mere hours or days for the financial engineer to circumvent the new accounting rules intended to put constraints on managers. While accountants are limited to doing the accounting for transactions chosen by the managers, the latter are free to devise the transactions, instruments, and even organisations (recall Enron's 3,000 special purpose entities) to circumvent the intent of the financial accounting rules. The history of leases and various kinds of financial derivatives and securitisation provides a wealth of evidence.

Financial engineering is the elephant in the room of financial reporting that nobody is willing to admit is present. Yet financial engineering has played a critical role not only in defeating the intent of financial accounting rules, but also pushing the rules towards increasing detail in fruitless attempts to plug the holes. Ironically, the more specific the rules get, the easier is the job of the financial engineer: specificity reduces uncertainty about violating the rules.

The current structure, which relies on top-down financial reporting standards, falls into this trap. It replaces accountant's judgement by increasing detail under the guise of 'clarification' or 'guidance'. Even IASB's so-called principles now cover some 3,000 pages – something unheard of in other learned professions where judgment dominates written rules.

What can we do?

Use effective yield rate to estimate loan loss reserves

I have two suggestions for dealing with these problems. On pro-cyclicity with respect to loan loss accounting on bank books, accountants can use the information on default risk associated with individual loans contained in the yield rate on the loans themselves since this yield is negotiated in an arms-length transaction.

For example, if a loan has a yield of 8% at a time when the risk-free rate on loans of comparable term is 5%, the difference of 3% is a reasonable estimate of the default risk. This estimated default risk can and should be used to recognise expected loan losses at the time of issue and subsequently. This process will make sure that the loan loss reserve is set up to match the magnitude of risk the bank has taken in giving the loan to a client. This is not a device to artificially smooth the income over multiple cycles, as some have suggested.

Balancing statutory and common law approaches in financial reporting

On the structural problems, we could seek a middle ground. Just as lawyers balance these two approaches without getting trapped in either end, financial reporting also could benefit from striving for a better balance. Unfortunately, regulatory monopolies granted to national or international boards in most jurisdictions can hardly be expected to strive for such a balance. Limited supervised competition among two or more standard setters might do better. In spite of frequent arguments about the race to the bottom in such a competition, there is plenty of evidence from various domains (state charters of corporations, universities, environment, etc.) that this fear is misplaced.

In a competitive mode, standard setters may rediscover that evolution with trial-and-error experimentation, and 'true and fair' override of rules based on judgement will limit complexity, improve financial reporting and help it withstand the incessant pressure of financial engineering. The mantra of a single set of high quality principles-based accounting standards for comparability across the whole world has been repeated often. Yet, even accountants deny that the application of IFRS across member countries of the European Union is uniform.

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Number crunching

Was accounting a root cause of the global financial crisis? Paul Cherry says 'no'.

Accounting is said to be 'pro-cyclical', overstating profits in good times and losses in bad times.

In the economic downturn, so the argument goes, net income and shareholders' equity plummeted because of fair value accounting, triggering regulatory requirements to infuse more equity capital. To meet these capital calls, institutions were forced to sell holdings in distressed markets, creating a vicious downward spiral. Four aspects of accounting have attracted particular criticism: fair value accounting, provisions for loan losses, off-balance sheet arrangements and excessive complexity.

Fair value accounting

Several recent studies in the US indicate that the exposure of the larger banks to fair value accounting was not a major factor; the impact on the regulatory capital was not large enough to be the driver of pro-cyclicality; and no evidence of distressed selling was found in the 2008 crisis period.

Fair value accounting did not create volatile prices but did report the highly volatile conditions in the global markets. Many investor-oriented organisations, including the Securities and Exchange Commission and the ICGN Accounting and Auditing Practices Committee, support fair value accounting as meeting investors' needs best. The question of which items should be measured at fair value or amortised cost is currently being debated. The International Accounting Standards Board (IASB) proposes a 'mixed measurement' approach based on the business model and the characteristics of the instruments held. The US Financial Accounting Standards Board (FASB), meanwhile, proposes a more innovative full fair value model.

Provisions for loan losses

Provisions are currently made on an 'incurred loss' basis. No provision is made until evidence of impairment arises after the loan is made even though the pricing of loans typically includes an allowance for credit risk.

For example, the coupon interest rate might be 7% but the lender actually expects to realise only 6%. Accounting practice today reports 7% as income until evidence of impairment arises; the 1% expected loss is recognised only when evidence is found that the loan is impaired. The FASB proposes to tweak the incurred loss approach to require more timely recognition of loan losses. The IASB, on the other hand, is proposing an approach whereby interest income based on the expected effective rate of 6% in my example is recognised over the life of the loan.

Some politicians and regulators propose going even further using 'through-the-cycle' provisions based on the expected outcome over entire economic cycles rather than the life of the loans actually held. This would build up reserves in good years to be released in bad years, thereby promoting 'financial stability'. The difficulty is that investors need unbiased, transparent information about the economic conditions that exist at

the reporting date. Investors would lose confidence if reported values were deliberately understated in good years and overstated in bad years. That said, coordination of accounting standards and prudential regulation is being improved but is challenging on a global basis.

Off-balance sheet arrangements

Off-balance sheet arrangements come in various guises: they were a major factor in the Enron debacle.

More recently, 'repos' have figured prominently in the demise of Lehmans. There are two accounting objectives: first, to qualify the transaction as a sale rather than a collateralised financing; and second, to avoid consolidation of the transferee by the transferor. Balance sheets look healthier by reducing leverage. Any latent risk exposure related to the assets transferred is obscured. Sadly, a third unstated objective seems to have been to make the deals so complicated as to defy understanding.

Under US GAAP, sales treatment often hinged on an arcane test of legal isolation of the transferred assets from the transferor. Unfortunately, these sales often had strings attached and, as the crisis worsened, it became evident that the 'isolation' test was flawed. The consolidation decision often involved complex quantitative tests that were prone to abuse. The FASB moved quickly to plug these accounting loopholes by relying more on accounting principles rather than detailed rules, bringing US GAAP and IFRS closer together. These changes have brought billions of assets and the related debt back onto the sponsors' balance sheets. Similar loopholes do not exist in IFRS.

The problem with complexity

There is growing recognition worldwide that complexity of financial reporting is a serious problem. Have we created an accounting monster we can no longer control? It is relatively easy to write brief standards based on robust principles, requiring professional judgment and without detailed application guidance. However, accounting standards must be compatible with the environment in which they operate. North America, especially the US, seems fixated on highly prescriptive accounting rules. Changing this mindset will be a slow and difficult process.

The trend to global standards

Global balances are changing, and IFRS is rapidly gaining acceptance worldwide. This trend seems likely to continue. Would we be better served if there was competition between the IASB and a few national standard setters? I used to think so, but now am not so sure. First, convergence isn't good enough. Consistent, high-quality financial reporting worldwide requires that we have identical standards everywhere. Otherwise, enormous time and effort will be spent identifying and 'gaming' every difference in the standards.

Second, when more than one treatment is supportable and none is clearly superior, investors generally want a single treatment (consistency). This is difficult if there is more than one board. We are already seeing evidence of this. The IASB and FASB meet jointly every month. On a few occasions, the substantial majority in the joint IASB/FASB session favoured one view, but when each board subsequently voted separately, they reached differing conclusions.

Finally, rather than a healthy competition where quality rises to the top, I fear a downward spiral fuelled by economic, political and other pressures. During the crisis the FASB and the IASB, under intense political and industrial lobbying, hastily changed the accounting for financial instruments. Each board was played off against the other using narrow, piecemeal analysis and ignoring other important differences in the standards. It is not obvious to me that these changes improved financial reporting for investors and the credibility of the standard setting due process suffered.

Improvements in financial reporting can and will be made. The FASB and the IASB are collaborating on new standards on the accounting for financial instruments, consolidation of special purpose (variable interest) entities and securitisations. This is a direct response to the G20 recommendations dealing with the financial crisis. The root cause of the current crisis, however, lies in the business practices nurtured by the economic boom – bad credit decisions, excessive risk-taking fuelled by low interest rates and ample liquidity, poor risk controls and the rapid growth of the originate-and-distribute model, and, yes, poor governance.

Churning out more accounting standards cannot compensate for those weaknesses. Strong governance is essential, including governance over the extensive professional judgments required in financial reporting. Three empirical studies of US banks' financial statements for 2008 indicate that stronger governance pays off in terms of higher asset multiples and lower liability multiples, especially for Level 2 and Level 3 measurements of fair values.

The global markets need a system that is effective, efficient, responsive and accountable. A single set of standards enhances effectiveness and efficiency by focusing on investors' needs, reducing opportunities for gaming among various national standards and facilitating flows of capital using a common accounting language. A global constituency poses new challenges. We need to expand the infrastructure to support the interpretation and application of IFRS and ensure that the IASB is responsive to current market conditions in various regions throughout the world. Strong governance of the standard setter is needed.

The IASB has been praised for being one of the most transparent organisations in the world. The International Accounting Standards Committee Federation Constitution is reviewed every five years. The second five-year review has just been completed. As a result, a Monitoring Board now provides a link to public authorities responsible for oversight of financial reporting, the IASB has been increased from 14 to 16 members (compared to five for the FASB) and the trustees are seeking a stable broad-based source of funding. Effects analysis before a standard is issued and post-implementation reviews have been introduced. The IASB is acting responsibly and proactively to ensure that the standards are in fact requiring relevant and reliable information for investors.

EDITORS DISCLAIMER

The views in this article are those of the author. Official positions of the IASB are determined only after extensive due process and deliberation.

Stilpon Nestor and Cynthia Mike-Eze, Nestor Advisors

Taking the initiative

The European Commission's Green Paper on governance in banks sets the scene for a transformation in how financial institutions are run. Stilpon Nestor and Cynthia Mike-Eze assess if Europe is headed in the right direction.

The European Commission's flexible approach to coordinating and strengthening corporate governance in Europe, as laid out in the Winter Report, has been successful. It dramatically increased the transparency of the EU corporate governance framework and resulted in the slow but important harmonisation of corporate governance norms and practice between member states. These achievements are well reflected in the impressive increase of cross-border investments by institutional investors during the last decade.

However, the 2007 financial crisis uncovered one area of significant governance weakness: the governance of banks. Bank boards did not have enough expertise to govern their banks, nor did they focus enough on understanding their strategic risk environment. Additionally, the incentives faced by bank decision-makers were severely skewed towards excessive risk taking. In its Communication of March 2009, *Driving European Recovery*, the Commission announced that it would examine corporate governance rules and practice within financial institutions, particularly banks and, where appropriate, make recommendations – or even propose regulatory measures – in order to remedy weaknesses.

The first shot across the bow came with amendments to the Capital Requirements Directive (CRD), currently in the last stage of its adoption. The 'new' CRD minutely regulates bankers' remuneration and requires banks to defer and pay part of bonuses in shares. Although too complex to be discussed in this short paper, some of the solutions mandated by the CRD are quite radical and will significantly change the way bankers – and not only those at the top – are remunerated.

In the recently published Green Paper, *Corporate governance in financial institutions and remuneration policies*, the Commission puts a broad array of issues for consultation prior to taking regulatory measures. The tone of the paper suggest that the Commission is about to launch a much more activist plan to address bank governance. As the Commission rightly observes in the Green Paper, existing principles of corporate governance already covered to a certain extent the problems highlighted by the financial crisis. Yet these principles were not effectively implemented. This failure seems to have generated considerable scepticism towards the comply or explain approach, at least as regards financial institutions. Also, there seems to be less willingness to allow member states too much freedom to create their own rules in a market that is significantly integrated, especially across the Eurozone, and where systemic shocks 'travel' across borders as easily as within national markets.

The Commission is also looking at increasing the role of supervisors in ensuring robust bank governance. Supervisory involvement in this area was rather weak in some important European jurisdictions. The UK FSA recently admitted in a consultation paper that its 'focus on the quality of governance and the intensity of [its] previous supervisory assessment of it did not adequately reflect its importance'.

The menu of issues in the Green Paper is vast: board composition, role and functioning; risk governance and risk management; external auditors; supervisory authorities; shareholders; implementation of corporate governance principles; and director remuneration.

A number of the initiatives proposed by the Commission can facilitate effective bank governance and supervisory oversight, but some of these ideas might prove counterproductive if embedded in mandatory regulation. They might actually weaken managerial responsibility and accountability to boards and promote perverse incentives.

When it comes to board composition and functioning, the promotion of board diversity and gender representation is a positive step that promotes fairness and would – at least, prima facie – facilitate the avoidance of group think. But its limited systemic importance suggests

that this should have a best practice rather than mandatory status. The same goes for the option to limit the number of boards on which bank directors may sit. By making more time in their busy schedules, such limits might enhance the capacity of directors to better understand the complex business of their financial institutions. Supervisors should frown at boards that include hyper-busy non-executive directors; however, setting a mandatory and arbitrary number as a limit might rob banks of precious talent.

It is the same for the proposals to prohibit banks from combining the functions of chairman and CEO. This is recognised best practice, but there is no evidence that banks with a combined chairman-CEO fared worse than their peers who had separated the roles. Supervisors (and investors) should always question such arrangements but they should be in a position to allow them in specific circumstances, following adequate explanation from boards.

In contrast we believe that the proposal to make externally-facilitated board evaluations compulsory and require that the outcome of these evaluations be communicated to supervisors could materially improve board effectiveness. As David Walker suggested in his recent review of corporate governance in UK banks, the scope of these evaluations should be broad enough to allow for a full assessment of the capacity of the board to discharge its core responsibilities. These assessments should be regular (every three years or so) and their conclusions should be discussed by the board. With a requirement to fully report to supervisors risks undermining the candour of assessments, the action points of these assessments should be discussed with supervisors. As for the largest systemically important banks, these discussions could take place during annual meetings between the leadership of the supervisory authority and the board, a proposal that Nestor Advisors has floated in a previous paper. In addition to helping supervisors form a more informed picture of macro-prudential risks, such discussions would provide them with an in-depth understanding of governance issues in the sector. It would also compel bank boards to develop an explicit point of view on key strategic, risk and governance issues.

As highlighted by the Commission, boards and supervisors' lack of understanding of the nature and scale of the risks faced by banks was one of the root causes of the financial crisis. It is therefore no surprise that a significant portion of the Green Paper is devoted to risk governance and management. One of the ideas floated would require boards to inform supervisors of any material risks they are aware of. This might create a huge disincentive for boards to deepen their view of risks and an incentive to rely on supervisors to do their risk oversight job for them. While boards should regularly discuss the overall risk profile of their banks with supervisors (as per above), the initiative and responsibility for risk management should remain within the bank.

A similar abdication of responsibility might occur at management level if boards were to be required to disproportionately increase their involvement in risk management, for example by approving all new financial products, or if chief risk officers (CRO) start reporting directly to their boards as do chief audit executives. While direct board access for CROs is important, the function should remain firmly within senior management. In a bank, risk management is as much about strategy as it is about control. The responsibilities of the board in risk management should be clarified along the lines proposed by the Basel Committee in its proposed principles for enhancing corporate governance: the board approves and oversees the implementation of the bank's overall risk strategy, including its risk tolerance/appetite, risk policy, risk management and internal control systems, including compliance policy.

The Commission is also considering extending the remit of external auditors to include the control of risk-related financial information and increasing their duty to alert boards and supervisors of possible serious matters discovered in the performance of their audits. The wisdom of requesting that external auditors second-guess senior management on risk-related information and report to boards and supervisors when they have doubts is questionable from a number of perspectives. Financial risk management, the core business of banking, is not within the area of expertise of external auditors appointed to express a view on the integrity of the financial information provided to investors. Should we also ask auditors to second-guess mining engineers in a mining company? Moreover, already-expensive audits will get even costlier and more boilerplate statements will be included in ever-lengthening annual reports. From a broader market perspective, the oligopolistic market power of the Big Four will increase, as the broader scope of audits will raise barriers to entry for smaller firms which may not be able to acquire these expensive new skills.

Finally, there is the 'elephant in the room'. Unlike other companies, it might not be appropriate for bank managers to be fully aligned with shareholders. In the capital structure of banks equity is vastly outweighed by debt, which makes full alignment with shareholders a very risky proposition. It is quite ironic that recent changes to the CRD seem to encourage more alignment to equity. We were early proponents of the idea, included in the Green Paper, to broaden the duty of care of bank directors so that it specifically addresses long term solvency issues. But we have also cautioned that such a move needs to be implemented with the outmost care, especially when it comes to attributing actionable rights to stakeholders other than shareholders.

Finally, we would like to conclude with a general note of caution. In many quarters the failings of bank boards and the need to supervise bank governance more actively is easily interpreted as a failure of the flexible approach adopted by Europe in regulating corporate governance. But this is far from the truth. Most of the crisis-relevant governance failings were bank-specific and they include excessive reliance on misguided regulation.

While the governance awareness of bank supervisors needs to rise, by abandoning flexible, disclosure based regulation of corporate governance Europe risks throwing out the baby with the bathwater.

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Cracking the code

The UK has introduced the world's first comply or explain code for investors. Peter Montagnon explains how it works

On 2 July this year, the UK became the first country in the world to launch a formal Stewardship Code for investors.

The Financial Reporting Council (FRC), the regulatory agency which already plays host to the UK Corporate Governance Code, unveiled a text against which institutional investors authorised to manage money on behalf of third parties will shortly be required to comply or explain.

Though the UK happens to be the first to launch, it is not alone. A number of other European countries are actively considering drawing up similar codes, and the European Commission announced in its recent Green Paper on corporate governance in banks that it will consider requiring all European institutions to disclose against stewardship codes. Investors in other jurisdictions, such as Australia, are also looking at the issue.

An emphasis on stewardship is thus an important part of the global response to the financial crisis. If successful, codes will strengthen the commitment of institutional shareholders to behave more like the owners that they actually are. This means taking account of corporate governance issues such as strategic decision-making, risk oversight, board composition and remuneration in their investment process.

Though governance failures did not cause the financial crisis, the failure of boards and shareholders to challenge banks' business and governance models certainly added to systemic vulnerability and starkly exposed the extent of the so-called 'agency problem' that arises when owners delegate the running of their business to managers whose interests may be differently aligned

If better monitoring and improved dialogue enhances the ability of companies to deliver sustainable returns over the long-term, this will not only benefit the economy more broadly. It will also improve the exercise of institutional investors' fiduciary duties to their end beneficiaries – the savers and pensioners whose money they are investing.

Still, implementation entails significant challenges. The UK Stewardship Code uses a comply or explain basis, recognising that engagement does not suit every investment model. Some institutions may use a quant model to which engagement is not necessarily relevant. Some may prefer to exercise their duty to clients by selling shares in companies where they have concerns. For the Code to be successful, however, requires a critical mass of long-term investors to commit to its principles.

For large UK investors, this should not be a problem. The FRC text is based on a version which the industry itself developed and which was then handed on by the previous government to the FRC. A critical mass of support, however, means also building up adherence among the overseas investors who now

control around 40% of the UK market. An important task now for the FRC, as well as for the UK long-term investment community, is to promote the Code with like-minded international investors.

In principle

The Code consists of seven principles, backed up by guidance. These call on investors:

- to disclose publicly how they discharge their stewardship responsibilities
- to have a robust policy on managing conflicts of interest
- to monitor companies in which they hold stakes
- to establish clear guidelines on when and how they will escalate their activities in order to protect value
- to act collectively when appropriate
- to have a clear policy on voting
- to report periodically to clients on their stewardship and voting activities

The current text is only a beginning. Like the UK Corporate Governance Code for companies, we can expect the Stewardship Code to evolve over time. When it consulted on the investors' text in the first part of the year, the FRC found a range of responses with some arguing for tougher language, for example, with regard to conflicts of interest and others for a softer approach, on verification and disclosure of voting.

Rather than seek to resolve these differences, which could require further extensive consultation, the FRC decided to take advantage of the good work already done by the investment industry and go ahead on the basis of what was on the table. It has added in only some modifications to bring the text into line with the references to the duties of shareholders in Section E of the former Combined Code on corporate governance, and which have now been dropped in the new Corporate Governance Code.

This is only the start of the journey, however. The FRC expects to monitor progress under the Stewardship Code and decide in the course of next year when and how to launch a revision taking account of the responses it received to the consultation.

Key to any revision will not just be an understanding of what is required to make engagement more effective. The FRC also understands the need to involve investors, so that the Stewardship Code makes sense to them and they want to apply it. A regulatory framework which both promotes adoption of a substantive Code and facilitates its application is only one side of the story. This must be balanced by investor enthusiasm, especially in the international community, and the FRC wants to work closely with investors to ensure the balance is achieved.

The FRC has also spelled out in a new preface its expectations with regard to disclosure. The Stewardship Code is principally aimed at larger institutional investors who manage money for third parties. They are expected to disclose how they apply each principle as well as publishing the information required under the code on their voting and engagement policies.

Each fund manager is expected to make only one statement. There is no need to disclose in respect of each fund, though the statement should say whether the application of the principles applies to all funds under management or whether it does not apply to those funds whose business model makes engagement less relevant.

Others in the investment chain are also encouraged to subscribe, particularly institutions like pension funds and charitable endowments which place mandates with large fund managers. For these institutions, adherence to the code is a means of showing that they take seriously their obligations to their beneficiaries. They should disclose against the principles insofar as they are relevant to them. Thus, while they may not engage directly with companies, they should make it clear what they expect from their fund managers who do.

The FRC will maintain a list of those disclosing on its website, starting in the early autumn when investors have had a chance to review their response.

UK investors should commit to apply the code's principles where relevant to their overseas holdings, while overseas investors who subscribe to a stewardship code in their own market may use their statements against that code as evidence of support for the UK code.

Over time, this should allow a matrix to develop under which institutional investors will be able to support good governance and stewardship principles in international markets without slavishly having to apply a differing set of detailed provisions in each market in which they operate, and without the need for a single European or international code.

The disclosures arising from the Code should meanwhile allow the market to build up a better picture of what the owners of assets want and what is on offer from those that manage their funds. The FRC hopes that this will drive standards higher and help the market and companies identify a critical mass of shareholders committed to high quality engagement.

Without such a critical mass, it is hard to see the principle of comply or explain working satisfactorily. In the aforementioned Green Paper, the European Commission went so far as to ask whether the experience of the banking crisis meant that the model of shareholder control could be relied on any more as a means of delivering good governance and avoiding systemic risk. That suggests we are at a crossroads

The precise nature of the alternative is not clear but it would certainly involve more regulation, probably both of companies and shareholders. The risk inherent in that approach is that entrepreneurialism ends up stifled and companies are less well-positioned to generate wealth, investment and jobs.

The Stewardship Code, in contrast, gives a central role to shareholders. It is an opportunity which must be seized.

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The tidal wave

Improving transparency, regulatory guidance, corporate action and more investor activism all signal that sustainability is gaining momentum. Bill McGrew reports.

CalPERS has a strong record of mobilising financial capital in innovative ways, consistent with the highest fiduciary standards.

CalPERS believes sustainable environmental, social, and governance factors can affect the long-term risk and return performance of investment portfolios across companies, sectors, regions and asset classes. Our goal is to meet our return target with a prudent level of risk, while fostering energy efficiency, sustainable growth and sound environmental practices.

As a shareowner, we can be instrumental in encouraging responsible corporate citizenship and investment practices, and we expect our portfolio companies to position themselves for a sustainable economy. Environmental, social and governance (ESG) issues are core to business performance and CalPERS is looking for companies that are managing risk, developing business opportunities, and disclosing their results.

Over the last year, we have seen momentum build around the issue of sustainability across the entire stakeholder spectrum of government, investors, civil society, consumers, business partners and suppliers, employees and corporations. A recent survey of more than 800 CEOs by the Global Compact and Accenture, *A New Era of Sustainability*, found that 93% said they believed sustainability issues will be critical to the future of their business. Meanwhile, 91% of the CEOs surveyed reported their companies will employ new technologies in areas such as renewable energy, energy efficiency, and information and communication technologies to address sustainability issues over the next five years.

In the meantime

How can we begin to address sustainability issues during that time? CalPERS firmly believes that transparency is the answer. In an article published in spring 2010, CalPERS CEO Anne Stausboll, New York State Comptroller Thomas DeNapoli and Pennsylvannia State Treasurer Rob McCord addressed the significance of transparency and the importance of the Securities and Exchange Commission's (SEC's) new climate change disclosure guidance issued in January.

Through the looking glass

Transparency is a cornerstone of our economy.

For investors, that means being entitled to hear about the risks of an investment before making a long-term capital commitment. You might not commit, for example, to a computer chip-maker whose silicon costs are about to triple, or a clothing manufacturer whose factories are caught up in civil unrest overseas. Or you might invest and then pressure the company to address its issues. That's why the SEC's new climate change disclosure guidance is important. It outlines the type of information that publicly traded companies facing material effects from climate change should be disclosing. This is what regulators are supposed to do – get ahead of the curve as business risks and opportunities change.

Climate change is a classic material risk to businesses. It is clear that a changing climate affects virtually all companies. Recent droughts and water shortages in California, for example, have led to dramatic reductions in hydropower use – and more than $1 billion in losses for the state's agriculture industry. Melting ice in the Arctic

is expected to have far-reaching effects on shipping and energy exploration.

Climate change is also a risk because it is altering behaviour. Governments at all levels, here and abroad, are mandating greenhouse gas reductions, cleaner electricity generation and energy-efficiency initiatives. Consumers are demanding change. Large emitters are facing lawsuits. To say that developments like these aren't altering companies' business models – and investors' calculations – is to ignore reality.

But climate change also offers opportunities. Not just for wind turbine or solar panel producers but for construction firms doing retrofits, retailers selling energy-saving products, farmers growing biofuel crops or companies that grab the competitive edge as early adopters of new technology. Eco-friendly products from companies such as General Electric, for example, are in growing demand. Revenues from GE's ecomagination business accounted for 9% of total sales last year and increased by 21% from 2008.

That's why the SEC's disclosure guidance matters. Analyses of the 10-K filings that many institutional investors, like the three of us, depend on, repeatedly show widespread climate disclosure deficiencies. Investors – and the American people – learnt the hard way during the recent sub-prime mortgage meltdown about the dangerous consequences of a lack of transparency on risk.

Make no mistake, climate risk can be an economic game-changer on a comparable scale if left undisclosed. That's why we have a hard time understanding the arguments of the SEC's critics in this matter. They say the commission has more pressing matters. But what is more pressing than identifying hidden risks – a key catalyst of the economic crisis – and requiring its disclosure?

Financial firms were not transparent about the risks that led to our market meltdown. These risks were poorly understood, making robust disclosure impossible. Of course, the SEC needs to protect investors from the Bernie Madoffs. But we live in a complicated, fast-paced and intricately interconnected time – and knowledge is indeed power.

Ensuring better investor understanding of risks is a proper and critical role for the SEC. Investors like us – we collectively control more than $400 billion of assets – have been urging the SEC to do this for several years. It now serves as a landmark of investor protection for it acknowledges basics of investing and capitalism: Without credible transparency and disclosure, there can be no risk-taking. And without risk-taking, there is no economic dynamism, no rising living standards and no leaving our kids a world where they can prosper as previous generations have.

CalPERS CEO Anne Stausboll, New York State Comptroller Thomas DeNapoli and Pennsylvannia State Treasurer Rob McCord

Legislation that drives new, robust regulation can bring about such transparency. Legislation should combine sensible regulatory rules, incentive and environmental policies; expanding investment opportunities in clean energy and reducing the risks of climate change to achieve sustainable, risk-adjusted returns must be a priority. CalPERS agrees with the Investor Network on Climate Risk that national policies must provide greater certainty about the direction of climate and energy regulation, ensure transparent markets, benefit consumers and workers, create jobs and allow the United States to seize new economic opportunities.

The wish list

CalPERS seeks the following.

Regulation to set and enforce standards

- short- and long-term greenhouse gas reduction targets to accelerate low-carbon deployment and strengthen investor confidence in climate policy;
- market-based policies that set a price on carbon emissions to enable profitable deployment of zero- or low-carbon technologies and sound investment in clean energy infrastructure; and
- policies that lead to significant increases in renewable energy and energy efficiency; establish adequate long-term incentives, subsidies and requirements; and provide increased funding for research, development and deployment.

Comprehensive disclosure to allow market pricing of risk and externalities

- the promotion of board oversight, management execution, public disclosure and performance verification;
- the accurate and timely disclosure of environmental risks and opportunities through adoption of polices or objectives associated with climate change
- policies that drive corporate behavior to measure and be accountable to stakeholders for performance toward the goal of sustainable development

Targeted government intervention to enhance market development and investor protection

- the ability to respond to key sustainability issues, including greenhouse gas emissions, toxic chemicals, and water use
- the development of more effective regulatory oversight of corporate activities that impact on society and the environment without impeding business progress
- enabling investors to meet their obligations, consistent with fiduciary responsibilities, in an unconstrained investment opportunity set

During the next 18 months, CalPERS will work to integrate ESG factors into investment decision-making, with a prominent place for ownership activities and collaboration with other investors. To achieve this, CalPERS must consider its mulit-asset class investment approach to responsible investment – including focus, structure, reporting requirements, and integration within the organisation. Four milestones to measure success will include:

- identifying best practices and challenges among a global peer group with differing perspectives and approaches to ESG integration and ownership
- developing a channel for ongoing dialogue among peers on areas for cooperation, including policy issues, ESG integration, corporate engagement, and cross-border voting
- drawing from the discussions to shape the groundwork for CalPERS' plan for total fund integration of ESG with investment decisions
- developing a plan to communicate CalPERS' ESG total fund integration process to the global market

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Ann Byrne, Chief Executive, Australian Council of Superannuation Investors

Growth industry

Implementing environmental, social and corporate governance into investment decision-making is one of the biggest challenges facing institutions at present. Ann Byrne presents the view from down under.

Investment professionals generally agree that environmental, social and corporate governance (ESG) issues can affect the performance of individual companies and investment portfolios. If this is the case, what inhibits the implementation of ESG risk into the investment models of mainstream investment managers?

This article focuses on the integration of ESG risk into Australian equity portfolios, the opportunities, the barriers and the need for action. It is a case study for action based on research and discussions between Australian superannuation funds and their investment managers.

What is ESG?

ESG refers to the system by which investors protect and manage their investments for the long-term through the consideration of environmental, social and governance risks in their investment decision-making processes.

In this context, in order for investors to mitigate ESG risks, companies need to be monitored for their commitment to applying and reporting high standards of corporate governance practices and how they manage the social impact of their activities, including the effects on the natural environment.

Australian superannuation funds recognise that companies will increasingly need to be monitored for the effects that the changing natural environment may have on their operations, how they manage their labour force and the integrity of supply chains, to name a few.

In addition to this broad definition, the Australian Council of Superannuation Investors (ACSI) recognises that the ESG issues also have one or more of the following characteristics:

- they are the focus of public concern
- they usually have a medium to long-term horizon, but may also have a short-term horizon
- in some cases, they are qualitative and not readily quantifiable in monetary terms
- they reflect externalities that are not yet well-captured by market mechanisms
- they are often the focus of a tightening policy and regulatory framework
- they may arise throughout a company's supply chain
- they focus on aspects of a company's operations that are not necessarily covered by traditional financial analysis

"ESG integration requires data: you cannot manage what you do not measure."

Trustee fiduciary duties and ESG

A new super scheme member joining the Australian workforce today will expect to work for over 40 years. Over that time the risk and returns on her superannuation investments will be influenced by environmental, social and governance factors. Therefore, it is imperative that superannuation funds manage these risks with a view to maximising shareholder value and increasing shareholder returns over the long term.

Australian superannuation fund trustees are legally obliged to maximise investment returns and minimise investment risks on behalf of members. In better ensuring member returns, the investment management process is framed within a risk management framework. The consideration of material investee ESG factors in companies are relevant considerations to superannuation fund trustees, and are consistent with duties in order to maximise returns and minimise risks to members' investments. This includes, but is not necessarily limited to, ensuring that a decision to invest takes account of all information about the company and its prospects, and deciding not to invest in certain securities or asset classes because the risk return profile is not suitable for a superannuation fund's time horizons.

The global financial crisis has shown that investment risk comes in many forms which do not always show up on the balance sheet. ESG issues are embedded in a company's corporate strategy; in fact, anything that affects a firm's business model can also affect the firm's financial performance and valuation, and ESG issues are no exception.

For superannuation trustees, properly understanding and assessing material risks and returns of their investments is an inherent requirement of fulfilling their fiduciary duties to their members. ACSI's members recognise that they can, and should, protect and manage their investments for the long-term through the consideration of ESG risks in their investment decision-making processes.

Integrating ESG into decision-making

If a case for the management of ESG investment risk has been proven, the next step is to integrate these risks into investment models. For this to be achieved, information on company ESG performance is required for investment managers to identify the most appropriate ESG company performance indicators, and to take ESG criteria into account in their investment risk analysis.

In 2009, research commissioned by ACSI and the Investment and Financial Services Association (IFSA) found that investment managers can and do integrate ESG in many ways including:

- stock selection and valuation processes through understanding how ESG factors affect the valuation of their investee companies and incorporating ESG into their fundamental research from a bottom-up perspective
- providing a view on the sustainability of a company and its business models with issues such as non-transparent boards, related party transactions and occupational health and safety

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failures as symptoms of sub-standard management, ultimately leading to underperformance or value destruction;
- capturing ESG factors in their investment processes through a ESG rating overlay as an input to the stock selection process
- research processes which evaluate ESG factors using a system of positive, negative and neutral indicators for valuing stocks
- using ESG factors to assist in the determination of the long-term competitive strength as a qualitative score in a positive investment screening model
- employing ESG factors in a more quantifiable way through the estimation of the potential effect on a company's earnings (e.g. cost of carbon emissions)
- accounting of corporate governance risks in valuations through the multiple applied to earnings or through a discount rate in a discount cash flow (DCF) valuation
- rating ESG factors to form the core of the fundamental risks which quantitative modelling can overlook
- using ESG practices as a proxy for assessing the quality of management and as a proxy for the quality of strategic management
- downside risk minimisation, as good quality companies operating at an environmentally and socially sustainable level are more likely to survive and deliver long-term shareholder value
- as a filter for buy/sell decisions.

The research also identified impediments to ESG integration, with the major finding being access to high-quality company data. This has resulted in ESG investment risk factors being hard to identify and ultimately hard to quantify. The first lesson therefore is that ESG integration requires data. This is not rocket science but a simple fact that reflects on that old management saying – you cannot manage what you do not measure.

Improving company disclosure

In order to raise the standard of company disclosure on ESG factors, ACSI has been benchmarking the sustainability reporting practices of Australia's largest companies. In March 2010, we released the third report in a series which examines the sustainability reporting practices of Australia's largest listed companies.

The principal objective of the study is to measure the progress of Australian listed companies with respect to sustainability risk reporting. The research aims to measure the relative performance of the entire ASX 200 and assist investors to track improvements (or otherwise) of both individual companies and the ASX 200 collectively. The review is based on the premise that the effective integration of ESG risks into investment decision-making practices is ultimately predicated on companies disclosing data on their sustainability performance.

Having conducted this research for three consecutive years, ACSI is now able to draw some significant conclusions about the sustainability reporting practices of the ASX 200 companies.

The main finding is that, despite the repeated message from investors that reporting on sustainability risks is integral to their investment processes, the 2010 study revealed a 5% decrease in the overall sustainability reporting practices of the ASX 200. A particularly startling revelation of the 2010 study was that of the 86 companies who have been assessed in each of ACSI's three Sustainability Reporting Journey papers there are six who continue to be rated as 'no reporting', and 25 who only report to a basic level. It is particularly disappointing that these companies continue to ignore the fact that investors require information on sustainability risk performance in order to make fully informed investment decisions. Overall, 57% of companies in the ASX 200 report to a basic or 'no reporting' level. Unfortunately, this indicates that there are 113 ASX 200 companies who do not understand the material nature of sustainability risks and the importance that investors place on the disclosures of performance against and effective management of these risks.

The main conclusion we draw from this research is that the majority of ASX 200 companies are yet to provide sufficient reporting on their performance against sustainability risks, thus indicating that they do not fully appreciate the materiality of these factors.

This year, ACSI intends to increase its efforts to improve disclosure of sustainability risks across the board. As in previous years, ACSI will engage with each ASX 200 company on the findings of this study, and will intensify its engagements with those companies who, after three years, continue to ignore the message being presented by investors. ACSI intends to ensure that all companies in the ASX 200 are aware of the material significance of these risks for investors and we expect to see vast improvements in future years.

Building on strength in governance

After the corporate collapses of the early 'Noughties', the Australian corporate governance regime was transformed into an 'if not, why not' approach, with reporting requirements challenging investors to utilise disclosure and engage directly with companies. Despite some further governance failures since then, there is a general view that Australian law makers struck a reasonable balance between black letter law and a principles-based approach to corporate governance.

The question for long-term investors is whether it is time to mandate the ESG risk disclosure within the 'if not, why not' regime, as it is only through high-quality disclosure of these issues that investment managers and superannuation funds can truly integrate ESG risk into investment portfolios.

We share the responsibility to lift the standards in this regard so that investment management can move one step closer to long term investing.

* * *

ABOUT THE AUTHOR

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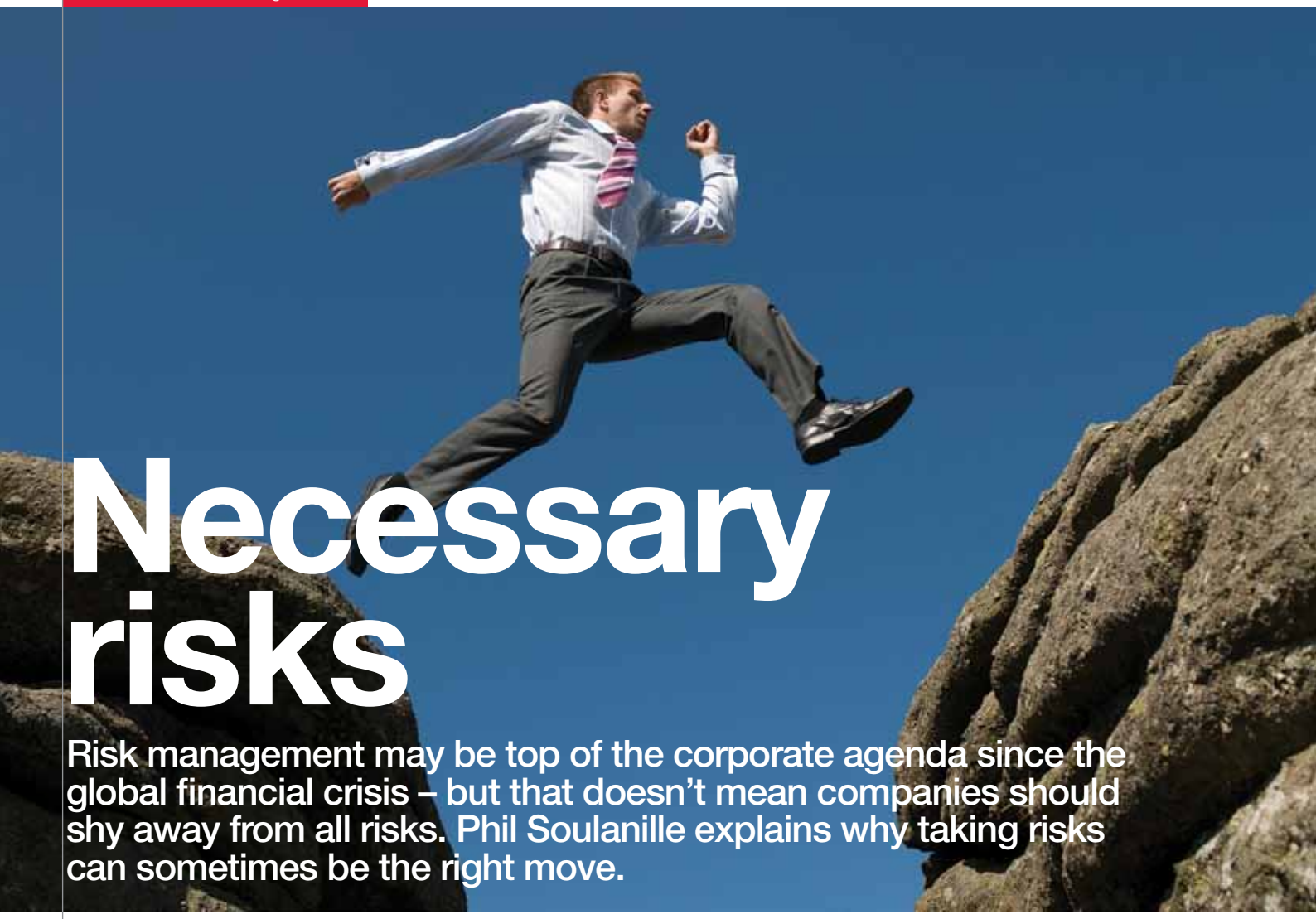

Necessary risks

Risk management may be top of the corporate agenda since the global financial crisis – but that doesn't mean companies should shy away from all risks. Phil Soulanille explains why taking risks can sometimes be the right move.

As global business leaders and politicians continue their search for answers to how they can prevent the next economic bubble or seismic business failure, shareowners are also taking this opportunity to reflect on their role in staving off the next crisis.

ICGN and Yale School of Management's Millstein Center for Corporate Governance and Performance collaborated on a response to the apparent need in the marketplace to look at the issue of what can and what should shareowners be doing to ensure that boards are effectively overseeing risk. The result was the ICGN Corporate Risk Oversight Guidelines, which were generated by an ad-hoc committee: the Taskforce on Corporate Risk Oversight (TCRO). The TCRO is co-chaired by Stephen Davis, executive director at the Millstein Center and Erik Breen, head of responsible investing at Robeco, and it operates under the umbrella of the ICGN's Shareholders Responsibilities Committee.

The response of ICGN members and others in September 2009 to a call for participation on the Taskforce resulted in what we described as 'an embarrassment of riches'. To keep the taskforce at a functional size while inviting broader input, the co-chairs formed a dual TCRO Committee and a Sounding Board Group (SBG), both comprised of representatives from academia, investor organisations, the accounting profession, and the business community at large.

You might ask, what did this group of diverse and well-intentioned thinkers come up with and whether it can be practically implemented? Indeed, the cynical might argue that this was just another attempt at theorising a way to a perfect world. I think it is safe to say that all involved would like to see meaningful change in the behaviour of investors, boards, and managements alike – and that their hope is that the Guidelines will help drive that change.

The Guidelines will, if nothing else, prompt investors to think about this aspect of their participation in the capital markets and how they might take more of an active role in ensuring stable long-term value creation at investee companies. After much research, discussion, and debate on the issue, I believe the Guidelines can help guide investors as they move forward in framing their own answers to the question of how we emerge from this crisis stronger and more prepared for the next.

The Guidelines

The mission set out for the TCRO began with the question of what role investors can play in assessing how well a portfolio company's board – whether unitary or supervisory – is effectively overseeing risk management. The responses were mixed. Some answered that it can't be done, and that investors can never really know. Others seemed to think that with the right amount of information,

investors would be able to pick up on the indicators; however, boards and management currently don't provide either enough information, or what is provided may be insufficient. Still others focused on the issue of communication between shareowners and boards. I think the possible answers set forth in the Guidelines address each of these perspectives in some facet or other.

The writers of the Guidelines did not set out to redefine or reinvent terms that had been addressed by other groups dealing with the subject of risk management. The Guidelines use a basic definition of risk, 'the effect of uncertainties on corporate objectives, recognising that the effect can be either positive or negative', which is borrowed from the International Organisation for Standardisation's publication, *ISO Guide 73*. It was from this starting point that the TCRO set out to address the issue of corporate risk oversight.

However, this simple definition also illuminates a key part of the debate and discussion on the topic of risk – which is that there is a positive aspect of risk. Much of the current discussion is focused on loss prevention, or the preservation of assets. However, opportunities and, in turn, missed opportunities can greatly contribute to or destroy long-term value. This is a tenet of risk management that cannot be reiterated enough. Many companies have failed or cease to exist today as a result of not taking enough of the 'right' or, as some would say, 'rewarded' risks. Failing to think about opportunities within the context of risk and risk management can be just as damaging to a company's strategy as not effectively managing the downside risk.

The Guidelines explore the broader issue of corporate risk oversight by looking at the board and company process for risk oversight and investor responsibilities, and they culminate with a section on board and company disclosure. The structure of the document is intentional and primarily the result of feedback received during the consultation process, which consisted of roundtable discussions among various constituents and circulation of the Guidelines for comment by ICGN membership. Central to the layout is the culmination of board and company disclosure as the means by which the two groups come together and one of the main forums through which they communicate.

Much of the discussion and debate during the development of the Guidelines centered on the definition of several key terms: risk, risk management, risk oversight, board, and shareowner. Some people may look at these as relatively easily understood terms. But as Jim Millstein, chief restructuring officer at the US Treasury, said during a recent panel at the 2010 Yale Governance Forum, 'We are all victims of our own experiences'. That was never more evident than during the process of exploring this topic. Each person participating in the development of the Guidelines seemed to have a slightly different or maybe more extensive definition of the aforementioned terms, each coloured by individual experience or area of expertise. Even so, consensus was reached among the TCRO and SBG, and in most cases people continue to suggest that the Guidelines do not go far enough and should be expanded to ever greater levels of detail and specificity.

One universal truth is emerging from the dialogue in the marketplace among investors, regulators, politicians, boards, managements, the TCRO and SBG: risk is fundamental to enterprise. The preamble of the Guidelines states this succinctly:

'For companies and investors alike, risk-taking is an inseparable element of strategy and a crucial driver in achieving objectives, including optimising value over time.'

Investor capacity

While the concept of risk and strategy as being inseparable was one that most, if not all, involved in the development of the Guidelines could agree upon, the issue of investor capacity and resources continues to be an area of considerable debate.

There were some participants that expressed concern that, practically speaking, certain investors don't have the resources – or won't dedicate more resources – to engage on the issue of risk oversight. This is a reality that the Guidelines contemplate and allow for. However, investors, shareowners or their designated agents should evaluate the cost-benefit of engagement on risk oversight, as they do for engagement on any issue at investee companies. I would suggest two points to consider on this issue of resources: First, the Guidelines are not suggesting a new type of engagement, only that corporate risk oversight be an element of any pre-existing engagement programs; and second, as we have seen with the most recent downturn and the trillions in shareowner wealth across the world that has evaporated, the cost of not engaging may outweigh the immediate savings from not dedicating current resources to the issue.

This does not imply that there is only one type of investor or shareowner, or that all need to have the same perspective – which was a point of discussion among TCRO and SBG members. However, investors should make conscious choices regarding risk and its ultimate effects on beneficiaries of the investment process.

My hope is that the search for answers and solutions to protect us from the next looming crisis will lead to a better functioning global economy and capital markets. But my fear is that the current discussion on risk and risk oversight is isolating the most fundamental concept of enterprise and the capital markets into its own new discipline. The danger is that managements and investors will interpret this as yet one more topic to have a dialogue on, a disclosure for, or some rule to comply with.

In fact, I think what shareowners really want is to understand how managements and boards are ensuring that an enterprise's strategic objectives are sustainably executed.

ABOUT THE AUTHOR

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Alexander Juschus, Director, IVOX and Bram Hendriks, Specialist: Corporate Governance, APG Asset Management

The right tools for the job

Proxy voting: we can't live with it, we can't live without it. Alexander Juschus and Bram Hendriks examine efforts to make it more effective.

In the middle of the 1990s, Professor Noack from Düsseldorf University painted a frustrating picture about means of communication in stock corporation law.

'500 years ago, book printing was invented; 50 years ago, the facsimile became a new communication tool; and for five years the internet has been commonly in use. However, none of those inventions have made their way into stock corporation law,' he pointed out.

Over the last decade, proxy voting has attained growing importance for investors and has subsequently become a prospering industry. However, even though electronic communication made proxy voting much simpler in some markets over the last couple of years, it needs to be acknowledged that proxy voting is still in its infancy.

For most institutional investors proxy voting has become serious business. Much money is spent on proxy research and voting systems, and the proxy industry employs many solicitors and consultants advising companies on proxy-related issues. Despite this increased attention on proxy voting, it is well recognised that a number of challenges need to be addressed in order to make proxy votes work effectively. Some of the issues that need to be overcome in the cross border voting process include the completion of powers of attorney, share blocking, the timely disclosure of proxy materials, holdings in omnibus accounts and vote confirmation. The latter is probably the most serious issue that needs to be addressed in order to justify all the investments in the proxy process.

An effective and identifiable proxy vote can also be a means of communication between investor and company. If you believe that this is an important goal, the beneficial owner who voted against a certain resolution should be identifiable by the company. Indeed, in most cases issuers are interested in active shareholders, and see even a critical dialogue as positive – even though this might be just because they fear investors 'voting with their feet'.

However, as most shares are held in so called 'omnibus accounts' by global custodians, it is very difficult – if not impossible – for the company to identify who has voted in what way. Custodians collect the votes and the accompanying vote-instructions in these accounts for a large number of shareholders. For practical, and in some cases privacy, reasons, the omnibus account structure therefore causes the name of the global custodian bank to appear on the company's register instead of the beneficial owner's. While the custodian should be able to inform the company of individual shareholders' voting intentions this is impractical. For example, during the peak period in the shareholder season (March to June) the largest investors need to vote at/in 40 to 60 meetings on a daily basis: this makes it almost impossible to inform all companies about the votes that have been cast against outstanding resolutions.

So, if an individual investor wants to give the company personal notice of a vote against a certain resolution, this has to be addressed in alternative ways of communication. If companies had the ability to trace shareholders, they would be more easily able to inquire about the reasons for, say, limited support

"It is very difficult – if not impossible – for investors to verify whether the final votes have been cast in line with their actual intentions."

for a certain resolution. This could be a means for increasing dialogue and mutual understanding.

Ongoing proxy reform

In 2007, the EU Shareholder Rights Directive on the exercise of voting rights by shareholders was adopted. One of the main goals was to enhance the participation of shareholders in the proxy voting process.

Since the enactment of the Directive, participation in the general meeting by electronic means has become an important shareholder right and has boosted proxy voting activities. Another important aim of the Directive was the removal of certain impediments to the effective exercise of voting rights. It was determined that countries had to implement a record data system for all shareholder meetings in order to avoid share blocking. According to the Directive countries had to implement a record date system before August 2009, but since quite a few countries missed this deadline share blocking is still a concern to date. Italy will implement a record date system by the end of 2010, while for several member states it is unclear when this requirement will be transposed into law.

The proxy voting function has been characterised by non-standard, proprietary processes, with frequent requirements for manual intervention. Because of these inherent complexities, end-to-end vote confirmation is a struggle. It is very difficult – if not impossible – for investors to verify whether the final votes have been cast in line with their actual intentions. It is quite understandable that, if a shareholder pays a considerable amount so that his vote gets cast, he could expect a confirmation that his votes got counted.

Even so, vote confirmation is not dealt with in the Shareholder Rights Directive and is one of the most stringent issues that needs to be addressed. This year, a working group consisting of representatives from European member states will review the problems related to the voting chain and their findings might feed into a new Directive.

The US Securities and Exchange Commission (SEC) has also come to recognise that the current proxy voting system is somewhat outdated and that plumbing is required to bring it up to date. The SEC has confirmed that it will be issuing a green paper on proxy reform later this year, with the intention of soliciting detailed ideas about how to modernise this voting infrastructure. The SEC recognises that the current proxy voting and communications system lacks the proper means for brokers and other financial institutions to accurately account for shareholders entitled to vote on important corporate issues. The outdated system also hinders companies from fully using modern technology to track shares and, in many cases, communicate directly with individual investors. As soon as the SEC's Green Paper on proxy reform is published, the ICGN Cross-border Voting Practices Committee will provide a response.

Excessive voting deadlines also make it hard to cast an informed vote in time. To take an example, Italy's slate lists are seen as positive as they provide shareholders with the right to put forward their own suggestions for board candidates. Unfortunately, it does not help investors from abroad when those lists are published (depending on the issuer) 12 days before the meeting, when the voting deadline is 14 days.

Further issues involve hard copy requirements, lack of issuer information – too often, meeting notifications and annual reports are not being delivered to the investor abroad – intransparency of costs involved, holdings in omnibus accounts, share lending and more.

Nevertheless, thanks to a number of service providers, voting is not as cumbersome as it looks in the first place. By offering voting platforms, they allow their clients to cast their vote with a couple of mouseclicks on an informed level. Research which is often provided along with the voting platform gives the necessary insight into governance issues with the company. This additional source of information should not be underestimated, as often enough issuers provide a closer look behind the scenes to the proxy voting agents. In addition to that, a functioning voting platform also provides a reporting function, which makes life easier for the responsible.

The good news is that we are on the way to making proxy voting an efficient tool in the overall corporate governance concept. However, there is still a long way to go before cross-border votes are cast cost-efficiently in real time and with the crucial confirmation being provided accordingly. A number of obstacles still need to be removed and objections against improvement turned into agreement, and the technical development also needs to be pushed forward in parallel.

Consequently, making proxy voting an issue with legislators, supervisory authorities, issuers, custodians, registrars and other market intermediaries remains an important task for institutional investors wordwide.

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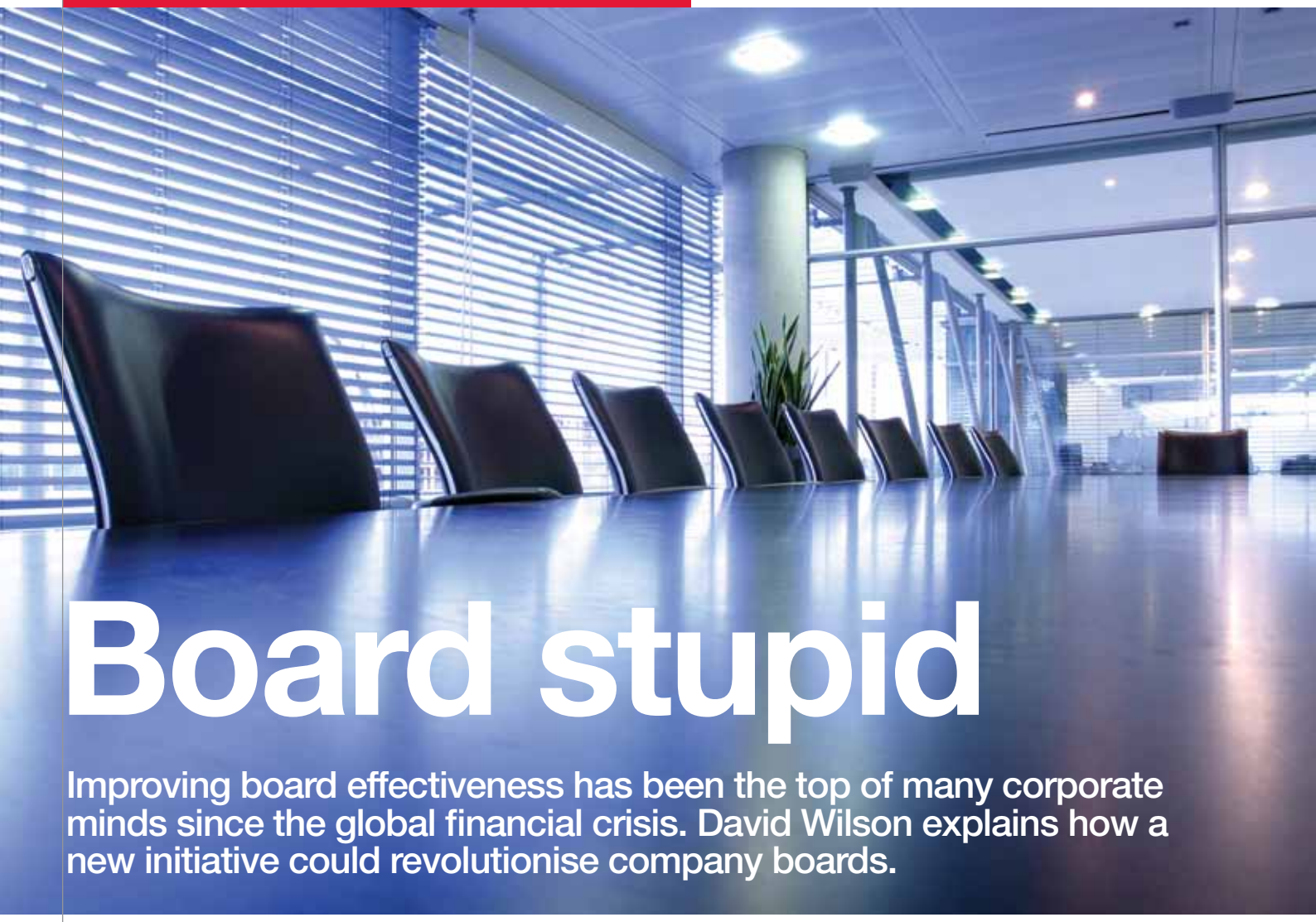

Board stupid

Improving board effectiveness has been the top of many corporate minds since the global financial crisis. David Wilson explains how a new initiative could revolutionise company boards.

When the seismic waves of the global financial crisis first hit the UK, and the scale of the damage to the financial services sector became clear, our approach to corporate governance came under intense scrutiny. What, commentators asked, was the point in having a set of principles if it failed to prevent such a catastrophe?

Quoted companies in the UK had always regarded corporate governance as a fairly straightforward process of comply or explain, in accordance with the flexible framework of the Combined Code on Corporate Governance. But, with a quarter of the globe's GDP being used to bail out the world's banks, it became increasingly evident that the current system of corporate governance in itself might not be enough, particularly when applied within a culture of unquestioning 'group think', as opposed to thoughtful and responsible stewardship.

The response to the crisis from the UK government, the Financial Reporting Council (FRC) and other regulatory bodies came hard and fast. First, the government commissioned Sir David Walker to review corporate governance in the banks and other financial institutions. This was followed swiftly by the FRC's declaration of its intention to review the Combined Code.

Given the skills and experience of the company secretarial community, ICSA was asked by Sir David Walker to distil this considerable body of knowledge to provide insight into the boardroom-behavioural aspects of governance. To assist ICSA in developing its report, expert views were gathered from colleagues and advisers operating in the boardrooms of major UK companies, including those from the FTSE 100 and 250.

The report concluded that appropriate boardroom behaviours are an essential component of best practice corporate governance, and that the absence of guidance on such behaviours represented a structural weakness in the current system of regulation. The report identified key aspects of appropriate behaviours – crucially, a supportive decision-making environment and constructive, principled and proportionate challenge within the boardroom. The degree to which these behaviours can be delivered was found to be shaped by a number of factors: the character and personality of the directors and the balance of the relationship between the key players, such as the chair and chief executive.

The report was well received, and many of its key findings, amongst them the necessity for a material change of culture in the boardroom, featured amongst Sir David Walker's final recommendations.

The FRC concurred with ICSA's recommendations on the need for change in boardroom culture. 'The principal lesson,' said its final report on the review of the Combined Code, 'is that those on boards must think deeply about their individual and collective roles and responsibilities'. Accordingly, the FRC commissioned ICSA to update the good practice guidance from the 2003 Higgs Report, which had focused on matters

such as the role of the chairman and non-executive directors in promoting company performance. In addition, ICSA was asked to consider whether additional guidance should be provided on a number of other issues relating to board leadership and effectiveness.

ICSA established a steering group to assist with the task of devising the guidance, and embarked on an extensive consultation exercise with FTSE chairs, company secretaries and other professionals. The outcome was overwhelming support for concise, non-prescriptive guidance to help boards to understand and implement the (now-renamed) UK Corporate Governance Code.

In July, ICSA published draft guidance, entitled *Improving board effectiveness*, on behalf of the FRC. Reflecting the insights gathered from the many seasoned board practitioners who contributed, the draft guidance contains much innovative thinking. In some areas, the content is pioneering – with its emphasis on the role of the executive director (which has never featured in corporate governance advice), the importance of decision-making, and the need for directors to think about diversity in terms of board composition.

There are areas where the draft guidance takes us further than we've gone before, in its focus on culture, values and behaviours (where the role of the chair is crucial), director development, performance evaluation, and disclosure. Direct language is used to identify governance challenges and give them their true name – the guidance talks about a 'line of sight' into areas of significant risk, the need to avoid 'no-go' areas, the importance of securing differences in psychological type among board members, the culture of challenge, the dangers of the dominant personality or group, and the problems associated with complacent and anchored attitudes.

Creating an effective board

The secret to creating an effective board, argues the guidance, lies in the leadership role of the chair, which requires 'living and upholding the highest standards of integrity and probity inside and outside the boardroom, through setting clear expectations in terms of culture and values, as well as in terms of the style and tone of board discussions.' Strong emphasis is placed on the role of the chair in managing the relationships between directors, and the relationship between the chief executive and the chair is singled out as being particularly critical.

'Higgs underestimated the role of the chair, who is responsible for getting the board to work well', says Sir John Egan, chair of the ICSA steering group. 'If anything goes wrong [in the decision-making process] it's the chair's fault'.

The original Higgs guidance included a section on the role of the non-executive director and in ICSA's updated guidance this is expanded upon, in line with the new Code. One of the contributory causes of the global corporate collapses was the lack of challenging questions in the boardroom. In order to ensure that they are well-equipped to ask such questions, non-executive directors are advised to refresh their knowledge and skills regularly and have a strong command of issues relating to the company's business so that their contribution to the board remains informed and relevant.

Uniquely, the role of executive directors in board meetings is discussed. Executive directors are expected to act as 'representatives of the owners of the business' rather than purely executive managers, to express their views frankly and encourage challenging questions from their non-executive colleagues – especially when issues of judgement are concerned.

With many boards having experienced periods of stress over the last few years, the guidance recommends that companies have a clear understanding of the circumstances when a senior independent director can be called upon to intervene. These can include resolving a dispute between the chair and chief executive, and where shareholders or non-executive directors have expressed concerns that are not being addressed by the chair or chief executive. The company secretary – who should be independent and impartial – is identified as a key player in ensuring governance processes deliver a high-performing board.

Given the strong evidence that poor decision-making in the boardroom had a major part to play in the downfall of some of the leading banks, the guidance advises that a well-designed decision-making process is one of the most important hallmarks of a strong board. Boards are warned to be on their guard against the dangers of not involving non-executive directors, a weak organisational culture and ineffective ethical standards. Suggested strategies to avoid making flawed decisions include seeking additional independent advice where appropriate and staging meetings over a period of time for important decisions.

The subject of diversity is being increasingly debated by corporate governance commentators, and gender diversity, in particular, is a hot political potato. Gender balance is important, says the guidelines, but so is diversity of personal attributes. If the board is to engender a culture of open debate, it needs to attract qualities such as intellect, courage, tact and the ability to listen and forge relationships.

Regular board evaluations, whether facilitated externally or internally, are also highlighted as a means of improving board effectiveness and identifying the scope for further development. Areas which should be explored in depth, according to the guidance, include overall composition, the adequacy of succession planning, the contribution and effectiveness of the chair, how the board works together and how the decision-making process works.

ICSA's Director of Policy, Seamus Gillen, summed it up best when he said: 'When the FRC publishes the guidance later this year, boards will need to take it very seriously indeed. It's a key element of the Code and, ultimately, if the Code isn't applied properly, the pressure for more intrusive regulation will build and build. Companies need to think carefully about how they're going to make their boards more effective – or face the consequences.'

ABOUT THE AUTHOR

David Wilson is Chief Executive of the Institute of Chartered Secretaries and Administrators (ICSA). For further information on the draft guidance, visit www.icsa.org.uk.

Courteney Keatinge, MBA, Corporate Social Responsibility

Hedging your bets

Hedge funds' growing presence in the market may play a large role in the future of corporate governance. Courteney Keatinge explains more.

Hedge funds have drastically varying investment strategies, some of which include improving corporate governance through direct activism and rewarding positive corporate behavior. With new regulations and hedge funds rising prominence in the market, it has yet to be determined how their presence and investment methodologies will affect the future of corporate stewardship.

At the 2010 ICGN Conference, Jane Buchan, Pacific Alternative Asset Management Company, Cliff Asness, AQR Capital Management, LLC, Eric Knight, Knight Vinke, Omar M. Asali, Harbinger Capital Partners and Christianna Wood, ICGN Chairman, a panel of current and former hedge fund managers, discussed the evolving role of hedge funds in corporate stewardship and various investment and engagement strategies used to promote better corporate stewardship. The panelists noted that, to the extent that hedge fund managers can make a correlation between better governance and higher returns, their increasing significance in the market could be a powerful force in moving industry toward better corporate stewardship. In this way, hedge funds are similar to many other funds in that they would be more likely to invest in companies with good governance if the returns can be directly correlated to the companies' stewardship efforts. Through the discussion on these funds' impact on the market, it is clear that hedge funds play an expanding role in the investment industry and that many hedge funds are actively pursuing strategies that aim to move the market towards better governance.

According to *Pensions & Investments*, investments by tax-exempt organisations in hedge funds constitute approximately $81.9 billion of the total $10.3 trillion in assets held by US tax-exempt institutions. This is more than US tax-exempt investments in private equity ($46.9 billion), timber ($17.7 billion) and infrastructure ($4.2 billion) combined. This large presence in the market has focused significant attention from the investment community due to issues relating to transparency and investment methodologies. Among the concerns expressed by regulators and tax-exempt organisations is the fear that the short-term view of many hedge funds exploits market conditions to the detriment of other players and companies, and provides inappropriate incentives for the companies in which these hedge funds invest. However, there are many examples of funds that focus on making companies better through activism and other investment strategies that are moving the market towards better corporate governance and performance.

Quantity versus quality

The basic nature of hedge funds allows for potentially higher returns, as the funds are typically structured to encompass a more volatile beta, which thereby increases the risk of the fund. According to Jane Buchan, the basic characteristics of hedge funds are: making hedged

investments; having incentive-driven compensation; having an investment strategy that is often highly focused in its application and/or number of positions; being highly adaptive to changing market conditions; not being focused on products; and having a weaker business and operational structure. However, beyond these basic characteristics of investments and methodologies of hedge funds vary drastically.

Because of these varying investment strategies and many of the funds' high risk-adjusted returns, hedge funds are becoming increasingly attractive to pension and other large investment funds. Especially during the recent financial crisis, hedge funds have been used as a supplement or alternative to the more traditional active investing done by many of these plans. Hedge funds' value to these plans derives from the fact that they tend not to behave like traditional asset classes, which enables them to improve the risk-adjusted return of the pension plan.

Quantitative hedge fund managers, for example, trade only on the numbers and look for preferable characteristics and qualities of companies, which are believed to lead to profits. While hedge funds have the ability to be more adaptive in a volatile market, it is important for these managers to not become overly innovative and active and risk losing returns. However, a fund's primary goal is to generate returns, and therefore it is prudent to constantly assess what strategies are profitable and which strategies are not.

Unfortunately, these quantitative investors do not necessarily see a correlation between good governance of a company and good financial performance. Despite this, good governance practices and democratic provisions in companies are important for investors to address on a larger level. While these funds may not see immediate or direct returns from their investments or activism in these companies, allowing for and working towards more democratic investor rights and better governance practices will eventually help investors see returns in the market as well as allowing for less need for and more ease of engagement.

"While hedge funds play a powerful role in the market, it can be very difficult for activist hedge fund managers to effect governance change."

In contrast, hedge fund managers who evaluate the performance of an investment using qualitative measurements, either instead of or in conjunction with quantitative measurements, will be able to more accurately track the economic benefits of good corporate management. These managers are typically more interested in engaging companies that are underperforming through activism in order to generate returns.

Making friends and influencing people

While hedge funds play a powerful role in the market, it can be very difficult for activist hedge fund managers to effect governance change, especially in larger companies.

Large-cap companies are an attractive investment for many hedge fund managers due to the availability of public information about these companies and the lower risk of takeover. However, despite the benefits of these large-cap companies, it is nearly impossible to effect significant change in their management. As a result, it is especially important for activist investors to align their interests with other stakeholders, as the public stockowners of the company typically do not have enough power to make the desired changes on their own. If engagement with these large-cap companies fails, investors do have the option to use the media to publicise their efforts toward change. This, however, can be a very risky option as the company is likely to suffer in the market, resulting in negative implications for many stakeholders, including lower-level employees and other investors. This is an option best used if all other avenues of engagement have been attempted and the company is entirely unwilling to address the desired changes.

Despite their large presence in the market, hedge funds still face many issues, including: transparency; liquidity; fiduciary responsibility; short-termism; and fraud. Many regulators and market participants criticise the short-sightedness and high-frequency trading associated with some hedge fund investment strategies. While there are many dangers in high-frequency trading, it also plays a significant role in the market, providing for more liquidity and moving the market towards improved price discovery. The new developments in high-frequency trading are disturbing to many and their long-term effect on the market and companies is still unknown. While many hedge funds do not employ this method of investing, its presence plays an important role in the current structure of the market. Many hedge funds also tend to focus on short-term returns; however, the high turnover in assets is typically rebalancing in nature. Many hedge funds see many assets as long-term investments and typically won't completely divest, but will only sell their securities in order to balance their funds.

US hedge funds are likely to see new regulation and higher levels of scrutiny in the very near future, due to upcoming financial reforms. New legislation may force hedge fund managers who advise investment funds and who have assets under management in the U.S. of $150 million or more to register with the Securities and Exchange Commission, which opens these previously lightly regulated entities to scrutiny from regulators. Additionally, a $25 million cap on federal regulation has been lifted, allowing advisors with less than $100 million AUM to be exempt from federal

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"It is imperative that institutional investors patronise funds that support their values and encourage good governance."

regulation if they are subject to state regulation. Because this legislation is in its early stages, it is unclear exactly what implication this will have for hedge fund managers, how their investments will be handled and the eventual governance implications. The immediate effects of this regulation, however, will be higher outlay for hedge fund managers and heightened reporting and compliance standards. It is important that these managers comply adequately in order to retain and attract new investments from the larger institutional investors. The legislation, however, could be a boon in some ways to many hedge funds as it restricts much of the private proprietary trading being done by banks. As such, hedge funds could see an influx of talent and capital that was once held by larger institutions.

In essence, hedge funds are a cottage industry with idiosyncratic trading strategies and their managers are very similar to other asset managers, but with a richer incentive compensation structure. A recent focus by some of these hedge fund managers on governance metrics has been an important force in the investment industry and its larger effect has yet to be determined. However, because investors are looking to drive returns and new regulation incentivising more private management of funds, hedge funds have and will continue to have a large presence in the market. Thus, it is imperative that institutional investors patronise funds that support their values in the market and encourage good governance practices, and that managers continue to promote better governance through activism and investment strategies.

ABOUT THE AUTHOR

Courteney Keatinge recently graduated with an MBA in Corporate Social Responsibility from Daniels College of Business at the University of Denver. She has previously worked in corporate governance at the Colorado Public Employees Retirement Association and the California Public Employees Retirement System.

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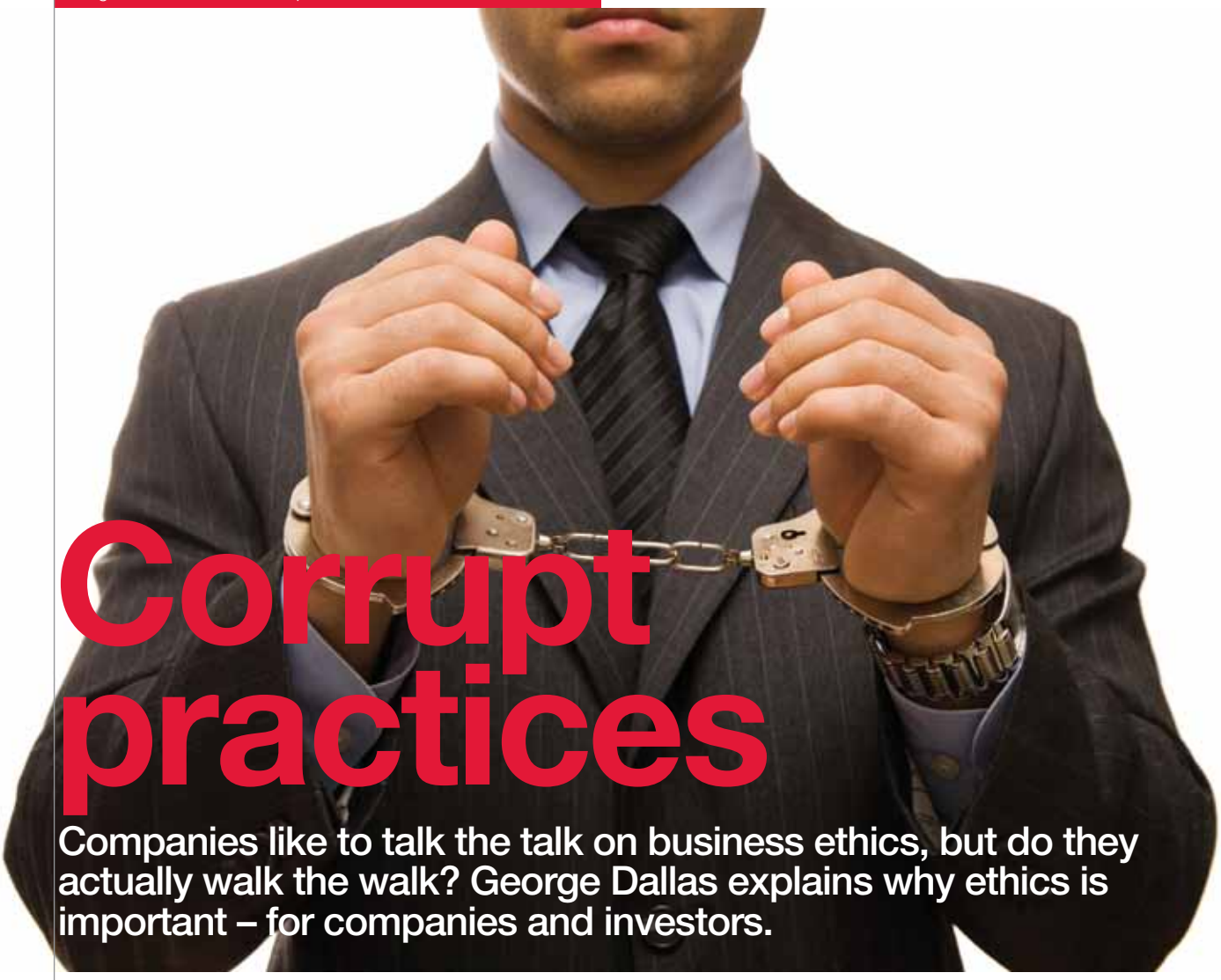
George Dallas, Director of Corporate Governance, F&C Investments



Corrupt practices

Companies like to talk the talk on business ethics, but do they actually walk the walk? George Dallas explains why ethics is important – for companies and investors.

In one of the more memorable lectures I attended while studying for my MBA many years ago, a professor – tongue firmly in cheek – declared that 'a business without a code of ethics is like a fish without a bicycle'. Since many fish seem to get along just fine without two-wheeled transport, the implication was that many businesses may perceive that they too can thrive without a moral compass.

Times have changed. Ethical misconduct increasingly is regarded as a fundamental business risk with potentially serious financial, operational and reputational implications. To avoid such risks – which can surface both in the near term and longer term – companies and their boards must clearly and explicitly promote a strong ethical culture, and support this culture actively with appropriate policies, management systems, incentives and disclosures. And investors must encourage companies to do so too.

Legal enforcement and civil society engagement

Bribery and corruption is a clear case in point. Since the 1970s, the US Foreign Corrupt Practices Act (FCPA) has set a tough standard with regard to anticorruption, affecting not only US companies but also companies domiciled in other jurisdictions that do business with US companies.

Importantly, the FCPA has an extraterritorial reach for acts of bribery and corruption outside US borders. Moreover, enforcement of the FCPA by the US Department of Justice and the Securities and Exchange Commission (SEC) is becoming more stringent. In Harvard Law School's edited weblog on corporate governance and financial regulation, a posting by the law firm Willkie, Farr & Gallagher LLP highlights increasing FCPA enforcement, citing 36 individual charges brought against companies and individuals in the first quarter of 2010 - a sharp rise as compared with 2009 and 2008.

Growing concern about anticorruption is also building outside the US. The US FCPA has been followed on a multilateral level by the OECD Convention on Anticorruption and the United Nations Convention Against Corruptions (UNCAC) – initiatives that have sought to combat bribery and corruptions in many jurisdictions around the world through stiffer legal sanctions.

A key recent development in this regard is the recent passage of the UK Bribery Act of 2010. The UK Bribery Act contains similar features to the FCPA, including extraterritorial reach outside the UK. The Act carries stiff criminal and civil penalties for acts of bribery or corruption, and is arguably as strong as, if not stronger than the FCPA – particularly with regard to the sometimes grey area of facilitation payments. Taken together, the FCPA and UK Bribery Act are raising the stakes for those companies that take the risk of corrupt behaviour either in the US or the UK – or in any jurisdiction involving US or UK companies or law. There is

also growing international cooperation in anticorruption investigations, with the BAE Systems settlement in 2010 marking the first time the Department ofJustice and the UK's Serious Fraud Office have joined forces to resolve this investigation.

Why should investors care?

The formation of the ICGN's Anticorruption Working group demonstrates a market-led approach to anticorruption by institutional investors, and has established anticorruption as a fundamental imperative of good corporate governance.

The Working Group's main achievement has been the drafting of the *ICGN Statement and Guidance on Anti-Corruption Practices*, which was formally launched in 2009. Since that time, the ICGN has become increasingly active in the global anticorruption debate and in giving visibility to the anticorruption guidance, which has included outreach to the OECD, the UNCAC and the World Economic Forum. It is also of note that the UN Principles for Responsible investment (UNPRI) has demonstrated its support of the ICGN guidance, and has made reference to it in a company outreach engagement project conducted through the UNPRI Clearinghouse.

But why should investors care about anticorruption? Isn't a $1 million bribe to obtain a $100 million contract simply good business that adds value for its investors? Is it also not naïve for investors to express concern about bribery and corruption given its ubiquity in many markets around the world?

The answer to these questions is an increasingly clear 'no'. The growing legal focus on corrupt activity, as cited above, suggests that the expected value – or more accurately expected loss of value – relating to corrupt activity is increasing both in terms of the magnitude of possible impact and the probability of increased enforcement. This loss of value can be expressed in both a micro (individual firm) and a macro (broader economy) context.

Micro factors

Getting caught with corruption offences is increasingly costly for individual companies. Siemens AG had fines totalling $1.6bn imposed on it by authorities in Germany and the US relating to various bribery charges – a substantial sum by any standard. Legal fees can also be onerous, involving thousands of billable hours for legal defence.

However, fines and fees paid are only the tip of the iceberg. The business implications of a bribery conviction can be even more profound. Corruption convictions for companies dependent on government contracts in the US, European Union or supranational bodies have the potential for contract blacklisting that could tear into the core of a firm's business. For example, Siemens' bribery scandal resulted in a two-year blacklisting from World Bank financed projects; news of this announcement had the immediate effect of reducing Siemens' share price by 5%.

Less quantifiable, but no less real, are the more qualitative impacts on individual firms. This includes the management disruption resulting from corruption investigations, which had the effect of causing both CEO and board turnover at both BAE Systems and Siemens. Not only can this distract management and the board from a full focus on business operations, competitive strategy and value creation, but there are also substantial risks relating to reputational damage, staff morale, customer loyalty and the corrosion of corporate values and culture. The corrosion of corporate values may seem to be a 'soft' issue, but it is ultimately the most acute in that it speaks to broader implications of corruption in a company – even if it is not actually caught in committing a corrupt act.

While emerging markets are often associated with high levels of corruption, recent bribery charges relating to BAE Systems, Siemens, Daimler, Rio Tinto, BHP Billiton and HP show that companies in developed markets are vulnerable as well. Increasingly, it is the case that for an individual company, the costs of engaging in corrupt activity offset potential benefits; the business case does not support corruption.

Macro factors

Corruption also has wider systemic effects. It imposes a cost on economies, often through tax avoidance and inefficient markets. In particular, and at least in the short term, non-corrupt companies can be disadvantaged by companies that do pay bribes or engage in other forms of corruption.

Corruption also has the effect of reducing transparency for investors seeking promising investment opportunities, and can destabilise free market activity. Corruption is a major contributor to country risk indicators, and for those countries regarded as having high levels of corruption, this can result in significant market discounts for companies listed in these jurisdictions. In turn, this can raise the cost of capital for companies and result in systemic loss of value for investors.

Governance implications

As outlined in the ICGN anticorruption guidance, anticorruption should be a governance priority for executive management and for boards.

Investors should demand that the board champion anticorruption, set a positive tone and drive the company's culture accordingly. This needs to be embodied in both audit and risk management functions of the company and should have explicit board oversight. Remuneration systems should not implicitly encourage corrupt activity; indeed, performance metrics and clawback mechanisms should provide financial incentives that motivate ethical behaviour and penalise corrupt activity.

Finally, transparency plays a key role. As sunlight can be the best disinfectant, investors should call for comprehensive reporting on a company's ethical initiatives, policies, procedures and reporting systems. Strengthening a company's own prevention of corruption risks will serve as an important protection for companies. Internal identifications of breaches will enable management to self-report and manage the breach with far less cost, disruption and reputational damage than if it were caught by the authorities.

ABOUT THE AUTHOR

George Dallas is Director of Corporate Governance at F&C Investments.

Around the world

“If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere.”

Arthur Levitt, former chairman, Securities & Exchange Commission

Sponsoring the future

Every year, the ICGN Foundation sponsors a number of market participants in emerging markets through the ICGN Scholarship programme. Over the next four pages, this year's Scholars share their thoughts, experiences, key challenges and hopes for the future.

Gustavo Adolfo Rojas Bermudez
Colombia, Alistair Ross Goobey Memorial Scholar 2010

Can you tell us about yourself and what you do?

Since 2006, I have been working on corporate governance topics in Colombia: first, as an advisor on corporate governance in the Financial Superintendence of Colombia, evaluating and assessing the key guidelines adopted by over 400 entities within the Colombian financial system. This involved inspecting on-site and off-site aspects of governance such as shareholder rights, the board of directors, disclosure and transparency, and so on.

Currently, I work with the Research and Development section of the same Colombian government agency as a legal advisor. My tasks includes the research and drafting of financial regulation in Colombia, covering issues such as financial groups, corporate governance, securities, derivatives, insurances and banking issues. My other responsibilities include the promotion of regulation with the financial industry, other agents of the government and multilateral organisations in other to preserve financial stability in the market.

How has being awarded an ICGN Scholarship assisted you?

I feel deeply honored to receive the 2010 Alastair Ross Goobey Memorial Scholarship. For me, it is especially meaningful not only because I have developed a great interest on the study of corporate governance, but also because on a daily basis I've seen the growth of corporate governance in Colombian's financial industry.

This growth has been slow but constant. Just a few years ago, corporate governance in Colombia was only carried out by great corporations, following practices and principles established by matrices overseas. Today, many Colombian entities and enterprises are leaders on the implementation of international standards and principles on corporate governance, becoming an example for other companies in Latin America.

The people that work on the supervision and oversight of corporate governance have a major responsibility and must continue the positive progress within our supervised entities into other forums such as small companies, state-owned enterprises and family-owned businesses.

What have you learnt from your attendance at the 2010 ICGN Conference?

The 2010 conference was a great chance to learn about subjects that are almost unknown in our country, such as the treatment and development of hedge funds and sovereign wealth funds.

What is your biggest challenge for the next year?

Right now, in coordination with the ICGN, I am preparing the final research paper, focused on related party transactions in my jurisdiction, and will be presented on the 2011 ICGN Conference to be held in Paris.

Dr. Vindel Kerr
Jamaica

Can you tell us about yourself and what you do?

I have been involved in corporate governance in Jamaica for the last eight years, and have contributed to building awareness of the role, importance and growing necessity for good governance in public and private sectors.

In 2001, following my return to Jamaica from the Manchester Business School, I was commissioned to write a regular

column for the Jamaican Financial Gleaner focusing on various aspects of corporate governance. This continued for nearly three years. In April 2005, I published my first book, *Effective Corporate Governance: An Emerging Market (Caribbean) Perspective on Governing Corporation in a Disparate World*, in Jamaica and the US, and I have produced a number of academic papers which have raised public awareness of the importance of corporate governance in Jamaica. I have also spoken at dozens of local, regional and international conferences.

I also served as founding member and sat as judge of the Jamaica Stock Exchange Best Practices Awards Competition for three years. This annual event recognises listed companies and securities houses for best practices in corporate governance. An evaluation of the program after its first three years highlighted significant improvement in timely reporting, the quality and content and coverage of various corporate governance issues. As a member of the Corporate Governance Committee of Private Sector Organisation of Jamaica, I have contributed to the realisation of its first Corporate Governance Code in 2006.

I have also pioneered the training and development of public sector boards throughout the Caribbean in corporate governance through GovStrat Limited, which I founded in 2003, and have since trained in excess of 4500 directors, senior executives and government ministers in 20 countries. Finally, as chairman and director of several corporate boards in Jamaica, I have also significantly influenced the creation of corporate governance, audit and social responsibility committees, improved board effectiveness and conduct, and implemented board evaluation practices.

What have you learnt from your attendance at the 2010 ICGN Conference?

The ICGN Conference 2010 was an eye opener for me. The general sessions, breakout sessions and the three committee meetings I attended were very intense, information-rich and extremely well-conducted.

My knowledge was particularly enriched by the information I gleaned on the role of pension funds in corporate governance, especially in the USA, UK and Canada, and by extension other institutional investors. My own research has shown that Jamaican institutional investors are mainly interested in investment premium when making investment decisions rather than the activities of their investee companies. I also thought Professor Lucian Bebchuk's presentation on executive compensation was the paper of the conference. My visit to Toronto – and the wonderful city tours – will be long cherished.

* * *

Charles Furaha
Rwanda

Can you tell us about yourself and what you do?

As the legal and corporate manager of the Capital Market Advisory Council, the sole regulator of capital markets business in Rwanda, my duties are directly related to corporate governance, legal framework and enforcement. They include: admitting members of the Rwandan over-the-counter market, where the issue of governance is given a priority in the screening process; approving companies that seek to list on the Rwanda Stock Exchange who meet our listing requirements; drafting of the laws and the regulations for the capital market industry, including the Rwandan corporate governance code; enforcement and supervision of rules and laws; and championing Rwanda's application to join IOSCO which may soon take effect.

What is your biggest challenge over the next year?

Rwanda has a history characterised by bad leadership in the past 30 years, which resulted in horrendous genocide. It is against this background that the new government has invested a lot in good governance as a tool to development.

However, this issue of bad governance has not spared the private sector and the business environment in general. Our biggest challenge therefore is reconcile good governance and corporate governance in a situation where over 80% of our companies are private companies and family-owned.

How has being awarded an ICGN Scholarship assisted you?

Being an ICGN Scholar has greatly contributed to my global understanding of corporate governance and its role in economic development. For example, I have managed to incorporate the new ICGN corporate governance principles into our existing corporate code and standards.

What do you hope to learn from participation in future ICGN events?

My expectations are really high, considering my background and my limited experience in corporate world. I look forward to learning a lot from ICGN members and global corporate governance experts, and to sharing our experiences and challenges.

* * *

Olga Koldasova
Kyrgyz Republic

Can you tell us about yourself and what you do?

I graduated from the Kyrgyz State National University with a degree in law. I have most recently worked as a legal advisor in the private sector, and before that had considerable experience as a senior lawyer on several economic/ business development projects for USAID.

Since 2008, I have been a part of the IFC Corporate Governance Project, where my main responsibility has become teaching fundamental corporate governance principles to the business community, government officials and the media, focusing more on in depth work with corporations and banks, continuing to support legislative reform, and building institutional capacity to create a sustainable environment to allow corporate governance improvements to develop.

How has being awarded an ICGN Scholarship assisted you?

I deeply appreciate the generosity of the ICGN members, sponsors and organisers for allowing me the opportunity to participate at the 2010 ICGN Annual conference in Toronto. Although corporate governance is quite a new topic for my country and there is a lack of widespread understanding in the region, it is considered as an essential element for building economy and attracting investors to the country.

Overall, the corporate governance practices and legislative frameworks within the Kyrgyz Republic are very weak. Throughout the region, cases of diluted ownership, secret beneficial owners, and weak management oversight in local companies have historically made international investors nervous about entering the Kyrgyz market, despite the fact that investment capital is greatly needed. the government of the Kyrgyz Republic currently has a great interest in corporate governance issues, as well as political will to improve corporate governance-related legislation.

What have you learnt from your attendance at the 2010 ICGN Conference?

As an official member of these working groups, I must say that participation at the ICGN Conference was very rewarding for me. Discussion of the most problematic corporate governance issues with people from different countries at the conference showed that corporate governance is a real challenge and that it is a solution for the problems within our local companies. I found particularly helpful the information I got from the sessions on 'what boards have learned from the financial crisis' and 'the business case for more women on boards'.

What is your biggest challenge for the next year?

The Kyrgyz Republic was greatly concerned as a result of the country's poor rankings in the World Bank's annual *Doing Business* reports in recent years. Following the publication of these reports, the government was eager to address deficiencies in legislation and convened working groups aimed at improving applicable legislation. I am leading the government's working group on Corporate Governance Code development.

However, these reforms are only the beginning of addressing the weaknesses in the corporate governance frameworks of the country.

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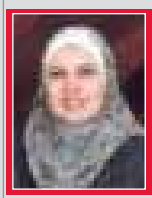

Amira El Saeed Agag
Egypt

Can you tell us about yourself and what you do?

I am the corporate governance operations officer serving the Middle East and North Africa (MENA) markets for the IFC). I have over 15 years' experience providing business advisory services to organisations in the areas of corporate governance, intern al controls, and organisational improvement. I have conducted corporate governance assessments for companies in various industries and has developed and delivered extensive client training, and presented at various conferences and workshops across the region aimed at raising the awareness of corporate governance for companies, banks, investors, and journalists. I have also provided assistance to regulatory authorities in the MENA region in drafting corporate governance codes and listing rules.

What have you learnt from your attendance at the 2010 ICGN Conference?

It is a great honor to be chosen as one of the 2010 ICGN Scholars and to attend the 2010 annual conference. I greatly benefited from the great networking opportunities and learnt from leading corporate governance practitioners on a range of issues. I realised that there's

a huge difference between the burning issues in different regions.

What are the key issues in your part of the world?

In the MENA region, interest in corporate governance is increasing as the region's countries undergo rapid transition, financial sector reform, and rising demands for private sector development. The region's diverse economic characteristics, however, pose tremendous challenges. At one end of the spectrum are Iraq and Yemen, with underdeveloped or absent capital markets and a private sector dominated by small and family-owned enterprises. At the other end are the Gulf Cooperation Council (GCC) countries. They are rich in resources, import labour, and have rapidly-developing capital markets. In between are countries as Egypt and Morocco. They have abundant labour, and thrive on a vibrant private sector that is heavily dominated by small and medium-sized family-owned enterprises.

In this sense, we strive to advance corporate governance to help companies improve performance and attract investment as a driving force for more economic growth and development. To achieve this goal we exert great efforts to equip company directors and managers with the tools needed to affect good corporate governance practices. We build local capacity to provide sustainable services and help codify corporate governance principles in the market place. Further, we engage with local companies and banks to assess their practices and assist them to improve it, to demonstrate the benefits of good practices.

I hope that ICGN in the future is able to create various regional networks of peers to encourage the sharing of different regional expertise, lessons learned, and exchange dialogue on corporate governance issues to emphasise global knowledge transfer.

* * *

Zufar Ashurov
Uzbekistan

Can you tell us about yourself and what you do?

I have been a PhD candidate in the Corporate Governance Department at the Tashkent State University of Economics since 2008, carrying out research on corporate governance. I am currently writing my PhD dissertation, entitled The Improvement of Organisational and Economical Mechanisms of Corporate Governance: The Case of Enterprises in the Chemical Industry. This research is aimed at exploring the organisational and economic mechanisms of corporate governance and working out scientific and practical recommendations for its improvement. The research is being carried out within the state chemical company, where I also hold a practice as corporate governance advisor.

What is your biggest challenge over the next year?

I think my current research on the improvement of corporate governance foreshadows the biggest challenge that both I and Uzbekistan are facing. While I am familiar with the concepts of corporate governance, there is a significant challenge in developing it in the context of my country. In Uzbekistan, corporate governance has been introduced in practice relatively recently, and therefore there are a number of problems which need to be solved.

How has being awarded an ICGN Scholarship assisted you?

The ICGN has encouraged me to intensify my knowledge and conception of corporate governance at a global level. Becoming an ICGN Scholar means that now I have a good chance to be part of international corporate governance community, with the opportunity to attend the ICGN events, contribute to the development of best practice guidelines, policy proposals and articles for discussions, as well as be aware of leading international corporate governance figures.

I am looking forward to cooperating with others on corporate governance-related projects, both in the ICGN's work programme or under individual collaboration. The projects I am interested in cover issues such as establishing good corporate governance in line with global standards and best practices in emerging economies, the improvement of effectiveness of board oversight activity in corporate governance, and how corporate governance can help prevent crises. In short, this is an unprecedented opportunity for sharing ideas across borders.

* * *

Pornchai Tavaranon
Thailand

Can you tell us about yourself and what you do?

I work at the Stock Exchange of Thailand in the corporate governance department. I'm in charge of implementing strategies to raise the quality of Thai corporations through better understanding and improving of corporate governance, corporate social responsibilty and investor relations. I am also responsible for helping investors to understand their rights as shareholders of listed companies.

How has being awarded an ICGN Scholarship assisted you?

Being included on the scholarship programme for 2010 will assist me develop innovative ideas to enhance corporate governance of Thai listed companies and SMEs to international levels. In addition, I hope to exchange knowledge, know-how, goodwill, understanding, concepts, ideas and opinions with the members of ICGN.

Dr Dimitrios N. Koufopoulos, Senior Lecturer, Brunel University and Scientific Director of the Hellenic Observatory of Corporate Governance

A Greek tragedy?

Greece has hit the headlines over the last year as one of the countries hardest hit by the sovereign debt crisis. But how does corporate governance in the country stack up? Dr Dimitrios Koufopoulos reports.

The financial crisis that nearly led to the collapse of the global economic system, has propogated a continuing discussion among professionals and academics. Many articles and papers have been written examining the causes of the crisis and to find possible ways to survive from this economic turmoil.

The deputy director of the OECD, Adrian Blundell-Wignall, explained the current financial crisis as being caused on two levels: firstly, by global macro policies affecting liquidity and secondly by a poor regulatory framework that, far from acting as a second line of defence, actually contributed to the crisis. Furthermore, the finger has also been pointed at corporate governance – not least since an increased pressure has been put on directors in order to improve transparency and accountability. It is widely acknowledged that some corporate failures in the recent years can find their root in weak corporate governance practices. Amongst other things, the issue of board composition is under extensive discussion: it has been suggested that in some cases boards were too big; that boards were not sufficiently independent; that some boards were too stale due to long non-executive and executive tenures; and that others were too old and too far from today's rapidly-changing financial markets.

Although the crisis is still at the centre of the global agenda, there are some countries that draw extra attention due to the severe economic situation they face. In Europe, there are a few countries that require special interest (Portugal, Spain), with Greece coming to the forefront early this year. The crisis in Greece is a result of a number of factors occurring during the last two to three decades; years of unrestrained spending, cheap lending and failure to implement financial reforms left Greece badly exposed when the global economic downturn struck. This situation also occurred in conjunction with partly-fiddled statistics covering debt levels and deficits that exceeded the limits set by the Eurozone.

This article aims to shed some light on the board characteristics of Greek companies in the context of the current financial volatility, by examining two important economic domains of the Greek economy: publicly-listed companies and state-owned enterprises (SOEs).

Evidence from Greece

A number of empirical studies have examined the extent to which Greek organisations follow recommended corporate governance principles.

The following section briefly presents findings on the board characteristics collected from five studies that have taken place since 2007 in Greece. All these studies were released by the Hellenic Observatory of Corporate Governance (HCOG) and capture the board characteristics of the Greek listed companies in the Athens Stock Exchange (ATHEX) for the years 2006 to 2008, and the features of Greek SOEs for the years 2002 to 2008.

Board size

The board size for listed companies has remained at consistent levels, with the average being between 7.8 and 7.9 members. The average board size for Greek SOEs was slightly higher, being from 8.0 to 8.8. Hence, we can assume that the majority of Greek boards that serve in listed companies and Greek SOEs follow the recommendations in Law

"The crisis in Greece is a result of a number of factors occurring during the last two to three decades"

2190/1920 that board size should not be more than 13 members. However, there are a few cases that exceed this number (mostly in the banking sector).

Board leadership structure

According to OECD recommendations and the new UK Corporate Governance Code, published this year, companies should split the roles of chair and CEO. Separating the roles guards against concentration of power, ensuring the chair can assess strategy and management objectively. Our sum of empirical data shows that the minority of Greek companies have a separated board structure, as most of them combine the above roles or, to be more precise, they do not have an independent leadership structure.

At a first glance, it seems that the majority of boards appear to have separate board structures. The percentage of the companies with a separate structure did not fluctuate significantly, varying from 56% to 57%. However, after a further examination, it was found that a high proportion of chairs and CEOs shared the same surname, and due to this fact it could be safely assumed that only 42% of boards had a separated and 'real' independent board structure without chair-CEO family ties. Therefore, we can presume that the majority of Greek listed companies either prefer the same person to hold the two positions or, in cases where there are two different persons, these are not truly independent.

For Greek SOEs, we have a completely different situation. The vast majority of firms had a separated leadership structure, and after 2005 dual roles become extremely rare.

Non-executive board members

The studies show that the number of non-executive board members represent more than one-third of the total number of directors in most boards, an instruction included in the Greek Law 3016/2002.

In the HOCG reviews, it was found that the average number of non-executive members in listed companies was 3.6 in 2006, 4.2 in 2007 and 4.3 in 2008. Based on an average board size of 7.9 directors, we can see that more than one-third of directors were non-executive. It is important to note the increasing presence of non-executive members in the boards of Greek listed companies through the years: this is a positive sign showing that companies are trying to follow corporate governance codes and their recommendations.

Independent non-executive board members

Notably, all studies show that the majority of boards in Greek companies have at least two independent non-executive members.

HOCG reports found that 58% of boards in 2006, 62% in 2007 and 68% in 2009 consist of at least two independent non-executive directors. Thus, we can surmise that most of Greek companies follow the law 2190/1920, which indicates that boards should consist of at least two independent non-executive directors.

In 2006, the average number of independent directors in listed companies was 1.7, suggesting that at that time many companies were not meeting the minimum requirement. This average has increased over the years to 2.4, which shows again that companies have made efforts to adapt.

Board committees

The Greek Corporate Governance Code recommends that boards should establish different committees (audit, remuneration, nomination etc.) that are responsible for the adequate internal operation of the organisation.

HOCG assessed the establishment of board committees in listed companies and found that only 12% of companies in 2006 had established committees: 11% had audit committees and 8% had committees regarding remuneration, nomination and succession. These percentages have considerably increased in both 2007 and 2008, with 32% and 24% of the companies having established committees.

Conclusions

An effort to improve the Greek corporate governance system is currently taking place.

A range of laws have been applied in order to help Greek boards to provide efficient corporate governance. However, the code published by the Committee on Corporate Governance in Greece has not been updated since 1999, and the last recommendations issued by the Federation of Greek Enterprises were in 2001. It is suggested that a reform of the code should be prepared, following the latest developments of codes from other countries.

Moreover, issues like induction and training of directors, included in the latest UK Corporate Governance Code, should be strongly suggested to Greek boards to update directors' skills, knowledge and familiarity with their companies so that they can fulfil their roles both on the board and on board committees.

ABOUT THE AUTHOR

Dr Dimitrios N. Koufopoulos is Senior Lecturer at Brunel University and Scientific Director of the Hellenic Observatory of Corporate Governance (HCOG). HOCG was established in 2007, to improve and disseminate corporate governance practices. It issues studies regularly on various economic sectors, and has already published reports on listed companies, SOEs, shipping companies and Greek football clubs. Its next report will be on the Greek healthcare organisations.

Janice Hester Amey, Portfolio Manager, Corporate Governance, CalSTRS

Rebuilding Wall Street

The long-awaited Dodd-Frank Wall Street Reform and Consumer Protection Act promises to transform US financial regulation. Janice Hester Amey explains.

On 21July 2010, President Obama signed one of the most important pieces of US financial legislation into law: the Dodd-Frank Wall Street Reform and Consumer Protection Act. It may not have the catchiest title, but the Act promises to change Wall Street – and US corporate governance – forever.

The official act brings the endless wrangle over this major piece of crisis-related legislation full circle – if not to a full stop. CalSTRS, CalPERS and many other investors formed an active working group – the Financial Reform Working Group – during the drafting phase of this Act and devoted many resources to helping the legislators shape the Act so that it would benefit investors and serve to aid in the evaluation of risk. Naturally, investors did not get all that they sought, but they can feel good about the official legislative support for the Securities Exchange Commission (SEC), the only official investors' advocate in the country. The Act's corporate governance reforms also give shareholders significantly greater power to participate in the governance of their portfolio companies.

The details that will emerge in regulation review and establishment will take quite some time to be revealed, and will likely make the Sarbanes-Oxley Act regulatory process seem short by comparison. There seems no way around that aspect; however, it is not unsurprising, since this is the most far-reaching legislation to touch on the banking, securities, derivatives, financial services industries, and shareholder community since the 1933 and 1934 Act.

The Act touches on so many parts of our regulatory apparatus that they cannot all be catalogued here, so this article focuses on the highlights, especially those provisions that relate to investors. The Act's broad scope includes the attempt to coordinate reform, to some degree on a global basis. As extensive as the reform bill is, the Act's provisions are staggered; some take effect one day after the enactment of the Act, several others have deferred effective dates.

Proxy access

The most attention-grabbing provision of the Act is the authorisation and recognition of the SEC's ability to adopt proxy access.

The Act authorises the SEC to adopt rules requiring public companies to make their proxy materials available to shareholders for nomination of their own candidates for election to the board of directors. At the time of writing, both investors and corporations were weighing in on the eligibility criteria for the use of this new right. The SEC is expected to present a final rule in mid-August. CalSTRS, CalPERS and countless other investors have been advocates for this right for nearly a decade and its final debut is a welcome event.

"The official act brings the endless wrangle over this major piece of crisis-related legislation full circle – if not to a full stop."

Say on pay and remuneration

President Obama was recently quoted as saying:
'I propose a set of reforms to empower consumers and investors, to bring the shadowy deals that caused the crisis into the light of day and to put a stop to taxpayer bailouts once and for all.

'[This] reform will also rein in the abuse and excess that nearly brought down our financial system. It will finally bring transparency to the kinds of complex and risky transactions that helped trigger the financial crisis. Shareholders will also have a greater say on the pay of CEOs and other executives, so they can reward success instead of failure.'

This brings us to one of the most publicised parts of the Act: say-on-pay. Say-on-pay is required in the Act; within six months after the enactment of the Act, corporations will be required to provide shareholders with a non-binding vote at least once every three years on the compensation paid to executive officers; and at least once every six years on the frequency of the say-on-pay vote. The choices are annual, biennial or triennial; in other words: every year, every two years or every three years. It sounds simple in theory, but this will be tricky as there is not uniform agreement among investors on the desired frequency of these votes. At any rate, investors will have no one but themselves to blame, since they have been given the keys to the car.

There is also a requirement that a separate, non-binding shareholder vote occurs on golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other triggering transactions. CalSTRS has had a guideline on this aspect of transactions for several years but shareholders did not get a separate vote on the change-in-control payments; now investors will be able to cast a discrete vote on this without having to vote down the whole transaction – unbundled voting, always a plus.

Institutional investment managers that are subject to Section 13(f) of the Exchange Act are now required to disclose how they vote on the say-on-pay and 'say on golden parachutes' provisions of the Act.

Executive compensation committees will have to be composed of independent directors only, or else the securities of the corporation will not be able to be listed on any exchanges. There is also a requirement for certain disclosures regarding compensation advisers and conflicts of interests.

The Act requires the adoption by the SEC of a rule prohibiting stock exchanges from listing the securities of issuers that do not have a policy regarding so-called 'clawbacks'. This provision generated a lot of heat from issuers as soon as it was disclosed and looks to be as great a challenge for the SEC's rulemaking as proxy access is.

The Act requires a clear description of the companies' 'pay versus performance' relationship, and a disclosure of the disparity between the CEO's compensation and the median employee compensation. Importantly, the Act requires that large financial institutions disclose all incentive-based compensation arrangements and prohibits so-called 'high-risk' arrangements. This provision is likely to be a briar-patch, but it will at least force compensation committees to consider the question – something that was absent in the latest crisis.

Credit rating agencies

Credit rating agencies are still having their turn in the barrel after their performance in the latest crisis.

They will no longer be entirely self-regulated; a new Office of Credit Ratings will be established within the SEC. This office will have substantial compliance and deregistration capabilities over these companies, and the Act also removes the liability shield that SEC Rule 436(b) gave to the ratings companies when their ratings were included in registration statements.

Conflict minerals

The Act also includes a section that imposes a new reporting requirement on publicly-traded companies that manufacture products that use so-called 'conflict minerals'. The report will have to be submitted to the SEC. A description of such minerals includes columbite-tantalite (coltan), cassiterite, gold, wolframite or their derivatives and other minerals specified by the Secretary of State. All of these minerals are used in the production of electronics, such as cell phones and other products.

This provision does not have a penalty aspect but the disclosure will certainly make it easier for investors and consumers to evaluate companies on this issue. The SEC only has nine months to finalise regulations on this provision.

The Act also has numerous provisions regarding asset securitisation, mortgage backed securities, municipal securities, clearing and settlement, credit cards and derivatives and swaps. I recommend sitting down with the table of contents and attacking the two-thousand-plus pages one section at a time.

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Jan Maarten Slagter, Managing Director, VEB and Vice-President, Eurosharehoilders

Going Dutch

The Netherlands has seen significant reform in corporate governance since the global financial crisis. Jan Maarten Slagter explains what it all means.

Dutch corporate governance has undergone some significant changes since the beginning of 2009. Supervisory boards are being strongly encouraged to take a more proactive role in controlling management and in their relationship with shareholders. Meanwhile, shareholders are being stimulated to engage more actively with companies, while at the same time their rights are being restricted.

The Corporate Governance Code

The Dutch Corporate Governance Code, in effect since 2004, has been updated by the Monitoring Commission, and entered into effect on 1 January 2009. Although the Code is a product of self-regulation, it has a basis in Dutch company law because companies are required to report on their compliance with the Code in their annual reports.

Relevant new provisions in the Code are:

- A shareholder shall exercise the right to put an item on the agenda only after he has consulted the management board. If the item entails a change in the company's strategy, the management board can stipulate – and the shareholder shall respect – a 'response time' of a maximum of 180 days before the vote can be held
- The management board will make sure the supervisory board is closely involved in the discussions regarding any takeover bid for the company
- The supervisory board will analyse several possible outcomes of the variable remuneration components and the effect they may have on the remuneration of the management board
- The supervisory board may recover from the management board members any variable remuneration awarded on the basis of incorrect financial or other data (clawback clause)
- The supervision of the management board by the supervisory board includes the company-shareholder relationship and corporate social responsibility issues that are relevant to the enterprise
- The company shall formulate a general policy on bilateral contacts with shareholders and publish this policy on its website
- Shareholders shall act in keeping with the principles of reasonableness and fairness. This includes the willingness to engage in a dialogue with the company and their fellow shareholders
- A shareholder who makes use of the voting advice of a third party (e.g. a proxy agency) is expected to form his own judgment on the voting policy of this adviser and the voting advice provided by him
- If a shareholder has arranged for an item to be put on the agenda, he shall explain this at the meeting and, if necessary, answer questions about it.

The Banking Code

The Netherlands Bankers' Association (NVB) has drawn up a Banking Code in response to the criticism fielded against this industry in the wake of the global financial crisis.

The Banking Code entered into force on 1 January 2010 and, like the Corporate Governance Code, works on the principle of comply or explain. The Banking Code mainly pertains to the responsibilities and requested expertise of the management and supervisory boards. It also contains provisions regarding risk management, audit and remuneration

Provisions of the Banking Code include:

- Each member of the supervisory board shall be capable of assessing the main aspects of the bank's overall policy in order to form a balanced and independent opinion about the basic risks involved
- The supervisory board shall pay special attention to the bank's risk management
- Maintaining a continued focus on its clients' interests is a necessary precondition for the continuity of the bank. The executive board shall ensure that the bank always treats its clients with due care. The executive board shall see to it that the duty of care for the client is embedded in the bank's culture
- The supervisory board shall annually

discuss the highest variable incomes at the bank and material retention, exit and welcome packages and shall assess whether they are consistent with the remuneration policy adopted by the bank to ensure that these packages are not excessive

- In the event of dismissal, remuneration may not exceed one year's salary (the 'fixed' remuneration component). If the maximum of one year's salary would be manifestly unreasonable for an executive board member who is dismissed during his or her first term of office, such board member shall be eligible for severance pay not exceeding twice the annual salary
- When variable remuneration is awarded to the executive board, the long-term component shall be taken into account as well as profitability and/or continuity of the bank and a material part of the variable remuneration shall be conditional and shall not be paid until at least three years have passed
- The variable remuneration of board members of the executive board shall not exceed 100% of their fixed income
- In exceptional circumstances – for example, if application of the performance criteria would result in undesired variable remuneration – the supervisory board shall have the discretionary power to adjust the variable remuneration if, in its opinion, this remuneration would have unfair or unintended effects.

Legislation

The Dutch legislature has also been uncharacteristically active in the field of corporate governance. The clawback clause mentioned in the Corporate Governance Code (there is a similar one in the Banking Code) will be implemented in Dutch company law – two bills to that effect (a general one and one for the banks) have been published for consultation. Under the new legislation, supervisory boards will be able to adjust variable compensation entitlements in takeover situations on the basis of reasonableness and fairness.

Furthermore, the recommendations in the final report of the Monitoring Commission on Corporate Governance (March 2007) have led to draft legislation on shareholders' rights and obligations, which is currently before parliament. Although the bill purports to enhance company-shareholder engagement, it actually restricts shareholders' rights in several ways. The percentage of shares required for a shareholder to put forward an agenda item for the AGM will be increased from 1% to 3%. At the same time, the threshold to file a shareholding with securities' regulator AFM will be decreased from 5% to 3%. In addition, this filing requirement will be accompanied by an obligation to state whether the shareholder agrees with the company's strategy. When the shareholders' view changes – and presumably when the company's strategy changes – a new filing should be made. Breach of these obligations (such as by publicly supporting a hostile takeover bid after stating agreement with the board's strategy) may result in a fine.

The bill also entitles the company to access the personal details of all shareholders (there is no threshold) so it can communicate directly with them in the 60 days before an AGM. Shareholders who also wish to communicate with their fellow shareholders require a minimum shareholding of 1% and need to direct their letter via the company. The company then applies a marginal check on the contents of such letter before sending it to the shareholders.

In its commentary on the bill, the outgoing government has also discussed the loyalty dividend and other ways of 'rewarding' long-term shareholders. Although there seems to be parliamentary support for legislation to facilitate a loyalty dividend - or a 'penalty on liquidity' as opponents dub it - the current cabinet has decided to leave this up to the next government.

Other moves

New legislation is also pending before the upper house of parliament, or senate, which focuses on management and supervision.

The bill facilitates the establishment of a one-tier board in Dutch companies. Several large listed companies already work with a one-tier set up, combining the management and supervisory boards in one body. Every director in a one-tier board shares responsibility for the general state of affairs in the company. He can be held liable for mismanagement, unless he can prove that he cannot be blamed. Tasks and responsibilities can be divided between board members. However, the bill states that non-executive board members cannot be stripped of their supervisory responsibilities and that the chairman of a one-tier board should be a non-executive director.

Apart from the provisions laid down specifically for a one-tier board, the bill also provides that a board member cannot be an employee of the company. In addition, a board member with a conflict of interest may not participate in the decision-making process regarding those interests (under present law, the whole management board loses its authority to represent the company when one of its members is in conflict). Non-executive or supervisory board members will also be limited to five outside directorships (a chairmanship counting double).

Furthermore, the bill states that a balanced composition of the board should consist of a minimum of 30% women and of 30% men. However, there is no sanction on non-compliance with this rule.

Government directors

As well as taking over the Dutch activities of Fortis and ABN Amro in October 2008, the Dutch government has also provided capital support to Aegon, ING and SNS Reaal, all listed financial companies.

The support has mainly been in the form of interest-bearing sui generis 'securities'. A condition for the capital injections has been the installation of two government-appointed directors to the supervisory boards of each of these companies. The approval of both of these government directors is required for certain major decisions. There is debate in Dutch legal literature whether this constitutes a conflict with the provision in Dutch company law that a single supervisory board member cannot out-vote the other members.

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Zhengjun Zhang, Senior Research Fellow, Development Research Center of the State Council, China

Enter the dragon

What can China learn from the development of corporate governance in Japan? Zhengjun Zhang explains.

The traditional corporate governance model in Japan has played an important role in facilitating long-term investments and generating organisational efficiency during Japan's 'golden age' between the 1950s and 1970s.

The traditional model of Japanese corporate governance has been generally regarded as dispersed shareholdings, bank finance, lifetime employment and seniority-related wages. These features have variously been described as relationship-oriented shareholdings and networks formed through cross-shareholding, main bank contingent governance, and the 'stakeholder' model, where employee's interests play a predominant role.

A linked element of Japanese corporate governance is the existence of a large number of board members, who are almost entirely promoted internally. Top management was ranked as the pinnacle of the career ladder for its permanent employees, while the board of directors functioned as a substructure of top management; and one of the main objectives of management was to provide steadily growing benefits to its permanent employees. Thus, the decision-making mechanism of the traditional corporate governance model embodied mixed features of top-down systems and bottom-up systems, induced by collective consciousness originated from seniority-related wages and lifetime employment within Japanese firms.

During the 'catch-up' or so-called 'golden age' of Japan during the 1950s and 1970s, the market and technological environment in Japan featured booming demand, moderate competition, a significant technology gap when compared to advanced countries, domestic production and overseas selling. The crucial factors of business success during this stage seemed to be production-orientation, high investment, the introduction of new technology and low labor costs. Corporate governance was required to provide businesses with stable operations and high execution efficiency.

The above features of traditional Japanese corporate governance supported meeting the above requirements. Corporate governance has played an important role in facilitating long-term investments and promoting cooperation, which generated organisational efficiency in developing and maintaining firm-specific capabilities. The complementary nature of these institutions supported a set of distinct comparative institutional advantages within Japanese firms, and the long-term nature of employment, high skill base, and co-operation with suppliers allowed Japanese firms to build strong organisational efficiencies.

Japan today

With globalisation emerging and deepening, Japan gradually entered into a 'middle growth' period in the mid-1970s until 1990, and then nearly twenty years of a stagnant economy since 1991.

During this 'global' stage of economic development, Japanese firms have faced sluggish domestic demand and gradually slowing growth rate of overseas demand, intensive global competition, and a 'winner-takes-all' phenomenon in IT sectors. Technological progress has also seen the gap with developed countries shrink, as emerging countries have caught up as the pace of innovation has increased. The main

characteristic of the modern Japanese business model seems to be one of global production for a global market. Thus, an overseas manufacturing base, global strategy, supply chain and marketing, key technology innovation and attraction of international capital gradually became crucial points of business operation.

These changes required faster and more accurate strategic decisions from firms. Localised manufacturing, supply chain organisation and marketing required a high degree of flexibility within organisations, and a focus on core technological innovations required to attract high-level business and technical talent. Meanwhile, attracting international capital needed a high degree of attentiveness to the needs of international investors. The requirements upon corporate governance were more multi-core decision making, greater decision-making powers for CEOs, flexible employment and remuneration, stronger incentives coupled with more importance of market value assessment on performance, and more transparency.

As a result, the following changes in Japanese corporate governance can be observed since the 1990s:

- External factors including financial structures, shareholding structures and M&A practice have changed dramatically, and there is an increasing consciousness of shareholder rights
- There are obvious changes in governance structures and organisation, such as large-scale downsizing of boards and more outside directors
- Changes have also occurred within internal governance mechanisms, such as more power going to CEOs, more incentives for performance in some firms' compensation, the introduction of outside directors, improved transparency and the introduction of flexible employment (to some extent)

However, these internal factors of corporate governance have changed in a passive way – and with strong resistance in some cases. For example, traditional nomination and incentive mechanisms have been retained in many firms. Meanwhile, market monitoring is constrained by the re-emergence of cross-shareholding, anti-hostile takeover measures, inadequate transparency and company culture.

Lessons and implications for China

When we compare the corporate governance of Japan and China, we can find similar structures. For example, in both models there is a governance body at the same level as the board of director, which has responsibility for monitoring company financial status and the legal compliance of the board of directors. Even so, big differences exist in many aspects of corporate governance between Japan and China, including shareholding structure, finance sources and governance mechanisms (see table below). Essentially, Japanese corporate governance is a 'stable but inside-oriented' model, while Chinese corporate governance is an 'unstable but capital-oriented' model.

It seems that China's current development stage is equivalent to Japan's 'golden age'. The urbanisation rate has increased at a rapid speed: the proportion of population in cities and towns was 44.9% in 2007. The economy also features booming domestic demand, particularly in the automobile and real estate sectors, large overseas markets, the introduction of advanced technology and adoption of industries policies. Key drivers for business include an orientation on production, lots of investment and low labour costs. All of these features are very similar to Japan's golden age.

However, there are some key differences. China is operating in an already-globalised market, which features intense competition from countries around in terms of attracting capital and industry shifts. Only a few firms can compete globally, and the main products being sold to abroad are low-cost ones. So, China probably faces greater challenges in terms of development than that Japan did in its 'golden age'.

In terms of corporate governance, this means that it would be very difficult for China to imitate the traditional Japanese corporate governance model. Therefore, it would probably be more practical for China to reform its governance more in line with the corporate governance reforms we have seen in Japan's 'global' stage. China should speed up the building of efficient markets through: market development, transparency, minority shareholder protection, and the attraction of international capital; the development of efficient corporate governance within SOEs, by improving the efficiency of the state shareholder's functions and continuing SOE reform; and the prevention of problems such as weak performance-related incentives, the development of income gaps and other social influences.

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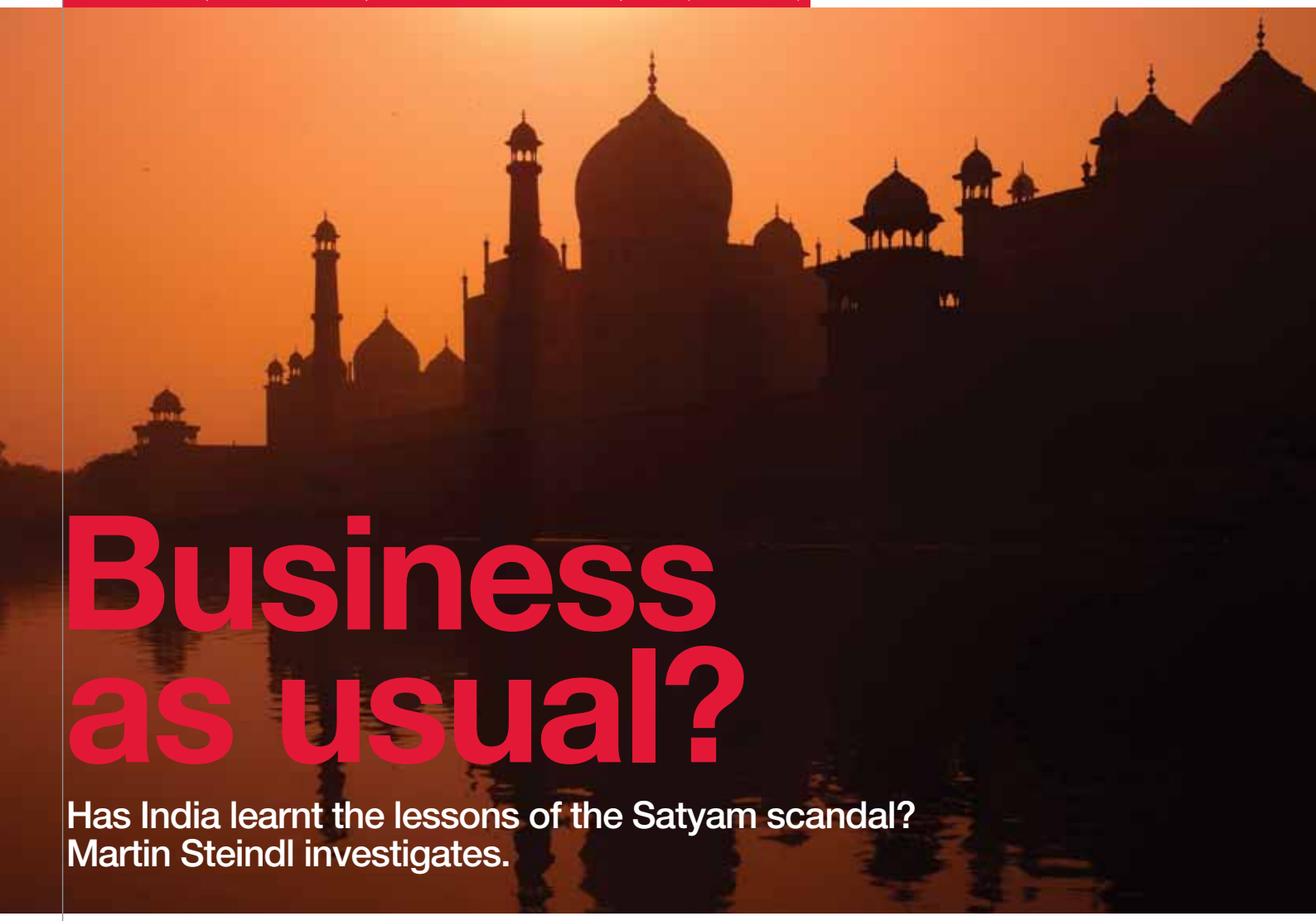
	Japan: traditional and J-hybrid listing firms	China: State (SOE)-controlled and private listed firms
Shareholding structure	Dispersed; certain degree of Cross-shareholding	Concentrated; controlling shareholders in many firms
Main finance source	Bond market for large firms; stock market; bank loans	Bank loans; stock market
Governance structure	Single tier with dual bodies	Single tier with dual bodies
Decision-making	Senior management; mixed 'bottom-up' and 'top-down'	Controlling shareholder and senior management; top-down
Nomination	Internal promotion (seniority and reputation are important)	Mainly internal promotion; outside appointment increasing
Incentives	Performance-related reward still weak; seniority-related wages and lifetime employment dominant	Rather strong with short-term performance; hybrid of long-term and short-term employment;
Monitoring	Increasing pressures from markets; erosion of main bank 'contingent governance' led to absence of pre-monitoring by outsiders;	Increasing pressures from markets; controlling shareholder, outside supervisors (SOEs); Growing role of managers market (only for some firms);

Martin Steindl, Corporate Governance Specialist, International Finance Corporation (Mumbai Office)



Business as usual?

Has India learnt the lessons of the Satyam scandal? Martin Steindl investigates.

It is a little-known fact that India produced one of the first corporate governance codes in Asia, soon after the Asian financial crisis. Since then, India had always been considered one of Asia's better-governed markets. However, the Satyam scandal sent shockwaves through India's business and investment community. Markets plummeted within days, as investor confidence in the quality of corporate information was eroded.

Markets have recovered surprisingly quickly – indeed, stocks have bounced back 89% only 12 months after the fraud became public – but one question remains to be answered. Was Satyam an outlier, or does it touch upon more fundamental questions of corporate governance practices and investor protection in India?

Scandalous behaviour

Some emphasise that Satyam was a one-off incident and consider it unfair to generally criticise corporate governance standards in India. Others claim that Satyam is representative of some of the pitfalls that investors may face when investing in Indian listed companies that are still owned by a controlling shareholder (the so-called 'promoter').

Given the prominence of Satyam's board, which included deans and professors from renowned business schools in India and abroad, many are tempted to sideline the governance weaknesses this scandal brought to the fore. It may be true that no corporate governance system can ensure that such fraudulent behaviour is detected early on. Yet, the event that triggered the resignation of Satyam's CEO and chairman, B. Ramalinga Raju, discloses a promoter's conduct not sufficiently challenged by the board of directors.

In a last attempt to plug the hole in Satyam's balance sheet through the purchase of additional assets, Raju tried to convince the board to approve the purchase of two firms owned by Raju's family. While clearly conflicted, he remained in the meeting throughout the discussions. The board approved the purchase with only one member voicing concern but not dissenting. It needed the company's shareholders – in a country with remarkably little shareholder activism

> "Few investors in India would dispute that the corporate power of promoters remains too strong."

– to revolt and indirectly force Mr. Raju to admit his fraudulent behavior.

Recent Developments

Regardless of how you view the Satyam scandal, the episode certainly prompted the creation of several task forces and committees in India with the goal to review – and revise – the existing corporate governance practices and regulations. Additionally, several commentators believe that Satyam has spurred on efforts to reform the Companies Act, which has been on the cards for several years. This is expected to be debated in Parliament until the end of the year.

The Confederation of Indian Industry (CII), an association of major Indian firms, spearheaded the post-Satyam debate and issued a paper called *Corporate Governance Recommendations for Voluntary Adoption to the Ministry of Finance* in November 2009. Its key recommendations include:

- strengthening the role of independent directors through a recommended letter of appointment, better structured remuneration, and executive sessions of independent directors
- the constitution of nomination and remuneration committees consisting of a majority of independent directors
- the separation of chief executive and chair roles
- introducing whistleblowing policies
- a greater emphasis on risk management
- several suggestions to strengthen the independence and liability of the external auditor, including audit partner rotation

Furthermore, the task force recommends that the audit committee should only be comprised of independent directors and thus aims to close the loophole in the respective provision of Clause 49 (see box opposite). Finally, with regards to related-party transactions, the task force suggests that the newly-reformed audit committee should be given the

Corporate governance in India

By the mid-1990s, the Indian economy was growing steadily, and Indian firms started to look out for equity capital to finance expansion into markets that were created by liberalisation and the growth of the outsourcing industry.

Such need for capital also led to corporate governance reform. The Confederation of Indian Industry (CII) issued the first voluntary Corporate Governance Code in 1998. A few major firms voluntarily adopted the CII principles, but the general opinion was that the voluntary approach may not suffice to persuade outside investors to invest in Indian firms.

A year later, the Securities and Exchange Board of India (SEBI), through the formation of the Kumarmangalam Birla Committee, adopted many of the CII Principles in the form of a clause added to stock exchange listing requirements, known as 'Clause 49'. From the beginning, this clause mandated greater board independence, enhanced disclosure requirements, and introduced compulsory audit committees. More specifically, the clause requires that:

- companies should have an optimum combination of executive and non-executive directors, with no less than 50% of the board of directors comprising non-executive directors
- companies should be made up of 50% independent directors if the chief executive and chair are the same person; otherwise one-third of independent directors is sufficient
- companies should have audit committees in which two-thirds of the directors, as well as the chair of the committee, are independent
- companies should provide disclosure similar to those practices required for firms cross-listing in Europe

After the Enron scandal and the advent of Sarbanes Oxley, SEBI revisited Clause 49 and initiated another committee on corporate governance headed by the CEO of Infosys Technologies, Narayan Murthy. In 2003, this committee suggested an amendment to Clause 49; pursuant to which responsibilities of the audit committee and overall accountability of top management were enhanced, and the scope and quality of disclosure were further improved.

Since then, Indian listed companies have to file a compliance report on corporate governance with all stock exchanges in the country. Originally, not all listed companies had to abide by Clause 49: since 2005, however, no more exceptions exist for listed companies. Firms that do not comply with Clause 49 can be delisted and face financial penalties; even so, sanctions are imposed quite rarely.

authority to pre-approve material related-party transactions. Giving a theoretically independent audit committee such power would be a radical and innovative step for India.

In parallel, the Ministry of Corporate Affairs formed its own task force. In contrast to the Securities and Exchange Board of India (SEBI)'s approach back in 1999, it only issued voluntary guidelines in December 2009. While similar in content to the new CII recommendations, the Ministry's voluntary guidelines do not follow CII's suggestions regarding the audit committee and related-party transactions. Pursuant to the guidelines, it remains sufficient that companies have three-member audit committees with independent directors constituting the majority. The chairman of such committee should also be an independent director. This wording, however, would not close the existing loophole in Clause 49. In theory, even an executive director could become the member of the audit committee.

As a further regional initiative, a recent White Paper issued by the Asian Corporate Governance Association (ACGA) emphasiesd the need to strengthen corporate governance laws and regulations in India. It argues that the reform process so far has not effectively addressed the key challenge of corporate governance practices in India – namely, the accountability of promoters to other shareholders. The five key recommendations of the report include calls to: overhaul the 'weak' regime governing related-party transactions; regulate the misuse and abuse of warrants; improve voting at shareholder meetings; enhance disclosure practices; and finally consolidate the highly-fragmented Indian audit profession.

Remaining challenges

Few investors in India would dispute that the corporate power of promoters remains too strong.

Therefore, 'disciplining' the dominant shareholder and protecting the minority is arguably more important in India than it is in other markets. While ACGA's White Paper is directly tackling this thorny issue, the local reform approaches are not so adamant. In particular, the promoter's issuance of warrants and related-party transactions remain of concern and risk to continuously undermine the accountability of promoters to shareholders.

"Strengthening the independent director role would be a way to curb the powers of the promoter."

Warrants allow holders to acquire stock on a specific date at a pre-determined price – usually set higher than the market price. In India, promoters can acquire warrants on a preferential and discounted basis, thereby diluting minority shareholders. The underlying structures are frequently designed by the promoters themselves.

Requirements for the disclosure of related-party transactions are not as detailed as in other Asian markets. Clause 49 only foresees that audit committees should review significant related-party transactions (as defined by the audit committee) and that listed companies periodically give their audit committees a summary statement of 'transactions with related parties in the ordinary course of business'. Advanced practices in other Asian markets, including a distinction between 'one-off' and 'continuingly recurring' transactions, prompt disclosure of one-off transactions, or independent shareholder approval for certain related-party transactions, are not suggested in any of the local corporate governance reform initiatives.

Strengthening the independent director role would be a way to curb the powers of the promoter. The fact that committees, and in particular the audit committee, are not exclusively comprised of independent directors is difficult to understand. One reason for this may be that independent directors are difficult to find, and remain very much in demand in India. Indeed, one sad consequence of the Satyam scandal was that many independent directors resigned due to the fear of loss of reputation, as well as personal liability claims against them. Professor YRK Reddy's article in last year's *ICGN Yearbook*, mentions that about 265 independent directors resigned from listed companies within six months of the Satyam scandal. Yet, many forget that attracting and retaining the right independent directors also requires adequate remuneration. Most independent directors are still paid on the basis of sitting fees only. The additional element of compensation as foreseen by the law, namely to distribute 1% of the annual net profits, is not utilised on a revolving basis. As a result, remuneration of non-executives in India is still comparably low, and forms another obstacle to finding strong independent directors that could act as a counterpart to the promoter.

In light of the above, it remains SEBI's task to again consider reforming Clause 49. This may be necessary for the sole reason that the numerous voluntary guidelines and recommendations have raised questions in the market about the existing Clause 49. It would also create an opportunity to pick the best of the competing proposals described above, and finally resolve the issue of accountability of the promoter.

A scandal like Satyam can – and will – happen in any market. India still has the chance to reduce probability of such events to its absolute minimum by further strengthening its corporate governance framework. The diverse deliverables of local and regional initiatives, as described above, head in the right direction. When taken collectively into account, they also provide all necessary solutions. Whether India will seize such opportunity remains to be observed.

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DRRT

"Morrison v. NAB (US Supreme Court 2010)- What next for non-US investors?"

"As fiduciaries we represent the interest of our investors - To what extend do we have to get involved in securities litigation?"

"Class Actions outside of the U.S.? - Where does collective investor protection exits and what alternatives are available?"

While securities fraud had long been a global issue, 90% of securities litigation has always taken place in the U.S. Since the Supreme Court's decision in Morrison vs. National Australia Bank (June 24, 2010), institutional investors are forced to look beyond U.S. class action settlements for compensation. About 15% of all U.S. class actions per year will now have to be litigated outside the U.S.

DRRT is a specialty division of Diaz Reus & Targ LLP, a US-based international law firm that has become one of the leading investor protection advocates and consultants in the world. Protecting investor rights globally through legal activism and opportunism combined with sophisticated Settlement Claims Filing Services, DRRT represents institutional investors with over $3 trillion in combined assets under management. DRRT is a pioneers of collective settlements outside the U.S., and has obtained recovery for non-U.S. investors in the Royal Dutch Shell matter valued at over $500 million. Moreover, with cases in the Netherlands (EADS and Fortis), Germany (HRE, VW/Porsche) as well as in Canada, the UK and Australia, DRRT is leading the challenge for effective global investor protection.

"In my opinion, formed through our work with them over the years, DRRT is seasoned, responsive, and skilled. Based on the work product and professionalism demonstrated by DRRT in filing claims in securities class action settlements, we highly recommend their services." Major Claims Administrator

"DRRT has filed claims for its clients with us in many settlements and returned substantial recoveries for their clients." Major Claims Administrator

Sandra Guerra, Founding Partner and Chief executive, Better Governance

Room for improvement

Are the boards of Brazilian companies carrying out the duties they should be? Sandra Guerra examines the evidence.

The board of directors remains one of the most relevant internal mechanisms of corporate governance. Its practices and procedures are among the first elements that are analysed in order to determine the quality of governance in a company, and there is total agreement on the centrality of its role. However, the consensus of opinion does not extend much further than this; there are different views about the roles played by the board in a company, as well as the factors that interfere with these roles. Regardless, the importance of the role of the board in corporate governance is undisputed.

Multiple studies test the impact of board structure and composition on corporate value. However, most of these researches focus on external public data about the board – analysing, for instance, the overlap between CEO and chair, or the percentage of external non-executive directors – which can limit the comprehension of the actual role of the board.

Research trying to assess the board's tasks and activities can provide a deeper understanding of the internal mechanisms of corporate governance. In line with this, Better Governance carried out a research project which aimed to understand how the role of the board interacts with other corporate governance mechanisms. Through two survey questionnaires, containing questions about the board activities and work style, 122 executives and directors of 65 Brazilian listed firms presented their insider perception of the board's roles and activities, in line with the firm's characteristics and governance structure. The questionnaires were completed in the third quarter of 2008.

As far as we know, this is the first study to describe and to explore the control, direction (strategy and policy building) and service roles of boards, and their relevance to the corporate governance system of Brazilian companies listed on the São Paulo Stock Exchange (BM & FBOVESPA). The resulting paper aims to be a pioneer in describing the board roles in an important emerging market from an insider perspective, identifying its lacks and points of improvement. Using multiple statistical and econometric procedures, data was correlated using firms' ownership structure and board characteristics, and identified relationships between the board's roles and firm characteristics.

All results obtained in this study should be considered in light of two main characteristics of the sample concentration. First, the majority of companies are listed on the Novo Mercado and Level 2 – special listing segments dedicated to companies committed to better governance practices than those demanded by law – and those that issue ADRs (American Depositary Receipts). Therefore, it can be assumed that the results obtained in the research do not reflect the entire market, but rather the companies which generally adopt superior practices in relation to their peers in the market.

Second, the vast majority of companies are family-controlled or part of a controlling block, which in this case is consistent with the prevailing market environment. Brazil has a highly concentrated ownership environment: on

average, the top three shareholders have 62% of total shares in the firms analysed in this paper. Institutional investors, on the other side, have on average 22.5% of shares. Therefore, the majority of firms in the sample are controlled by a few familiar shareholder blocks.

A family affair?

In this study, the roles of the board are associated to its activities as described in the table opposite.

The research results make up a clear picture of the boards in listed companies in Brazil. The boards are largely dominated by controlling shareholders and the participation of independent directors is still well below the recommendation of a majority of independent directors in the Brazilian Institute of Corporate Governance's Code of Best Corporate Governance Practices.

The overlap between CEO and chair positions is not as frequent as in some markets. Of more concern is the presence of a CEO or chair from a controlling family or related to controlling shareholders. This represents a possible power concentration.

In addition, approximately 52% of directors in the study sample are the controlling shareholders themselves, or people associated with them. Less than 30% of board members are classified as independents. On the other hand, only 10% of directors are elected by minority shareholders.

The research also suggests that that the control role of boards is predominant among Brazilian firms, shown in survey results and also by the fact that the number of committees related to this role is almost twice the number of committees related to directing activities. The directing role is also important, however; indeed, it is the role of service which is least relevant. These relationships suggest a hierarchy of the roles of the board. Interestingly, however, the role of control seems to be negatively associated with the role of service. This finding may lead to speculation that boards dealing with control activities cannot or may not want to engage in service activities, which could be considered less important.

Furthermore, the results suggest that the board control role is weakened in companies managed by controlling shareholders. For example, when the CEO is a family member of the controlling group, the board is less involved in deciding on the hiring or dismissal of that CEO. It is worth noting that this is one of the primary tasks of a board.

As for their activities, we found that boards are often occupied with unnecessary issues, such as operational matters, and not concerned with the subjects that they should be dealing with. In this regard, the main gaps relate to management succession, risk monitoring, strategy, evaluation of executives' performance and not establishing contacts of interest.

The research also addressed additional factors such as board style and the degree of decision-making. The results showed that boards with a higher degree of decision-making are associated with a higher number of best governance practices. Also, the absence of a family-related chairman is associated with a more active, deliberative and relevant board of directors.

The evidence from this research shows that there are as number of possible points of improvement in Brazilian boards. In particular, the participation of independent directors is still very low, the presence of directors elected by minority shareholders could be significantly widened, and the controling and directing roles of boards could be strengthened.

These results can be useful to market agents, regulators and academics who want a realistic panorama of this central body of the corporate governance system.

ABOUT THE AUTHOR

Sandra Guerra is a Founding Partner and Chief Executive of Better Governance and a board director. She collaborates with the IFC, the OECD and the Global Corporate Governance Forum, and coordinates the Companies Circle of the Latin America CG Roundtable. She is a co-founder and former CEO of the Brazilan Institute for Corporate Governance.

Control Activities

Hiring and firing the CEO

- Approving the hiring (or dismissal) of the other executives on the proposal of the CEO
- Approving the remuneration and incentive packages for executives that will be sent to the shareholders' meeting
- Evaluating and monitoring the performance of executives and company
- Discussing and conducting matters of succession of key positions in the company
- Defining the responsibility of the CEO and his/her subordinates
- Overseeing the relationship of the executives with related parties

Monitoring the company's risks

- Appointing and replacing the independent auditors
- Directing Activities
- Making de facto decisions concerning the strategy of the company
- Making decisions (or proposing them to the shareholders' meeting) on the main facts of the company such as acquisitions, divestitures, capital structure, and dividends
- Dealing with and leading the matters relating to corporate governance
- Approving the code of conduct and internal regulation of the board

Service Activitie

- Establishing contacts with the external network of interest to the company and using it for the benefit of the company
- Facilitating the company's access to external resources, such as funding, for example
- Providing advice and guidance to the chief executive and his/her subordinates
- Playing the role of institutional representation of the company

Khalid Deeb, Director General, Abu Dhabi Center for Corporate Governance

The road ahead

The United Arab Emirates are leading the way in the Middle East in terms of corporate governance development. Khalid Deeb explains its approach.

The United Arab Emirates is one of the major countries in the Gulf region, ranked 32nd in the world for highest economic growth. At $199bn, it is the world's 39th-largest economy, and holds 7.8% of the world's total oil reserves. Indeed, the UAE is one of the most successful emerging oil-exporting economies – but it is also managing to reduce its dependence on crude oil exporting significantly.

Over the last two decades, the Gulf region – particularly the UAE – has witnessed an increase in international investors and development, especially in the real estate sector. In January 2000, the government established the Emirates Securities and Commodities Authority (ESCA) to regulate stock markets in the UAE. Subsequently, two stock exchange markets have been established in Dubai and Abu Dhabi, and the ESCA has implemented regulations for both publicly-listed companies and brokerage firms.

In 2007, and in light of global developments in corporate governance, ESCA issued a code of corporate governance that all publicly-listed companies should comply with by end of April 2010. A revision of this code was published in 2009 (see box opposite for the code's provisions). The code has been based on the OECD's Corporate Governance Principles, while taking into consideration local laws and the particulars of the country. Together with company and other related laws, the code sets out the basis for good corporate governance practices in UAE.

The private sector, represented by the Abu Dhabi Chamber of Commerce & Industry, believes in the importance of corporate governance to the competitiveness and growth and sustainability of the private sector entities, and in turn to the local economy in general. Therefore, it established the Abu Dhabi Center for Corporate Governance (ADCCG) at the beginning of 2009 in order to contribute to building an integrated corporate governance structure, which takes into consideration the current level of corporate culture and how to change it gradually, using a socio-ethical values approach, in publicly listed companies, state-owned enterprises, private shareholding companies and family-owned businesses.

It also looks to help improve the related legislation at three levels: locally, in order to integrate with related laws and regulations; regionally, taking into consideration the other Gulf Cooperation Council (GCC) countries' related regulations for possible future integration in this area; and internationally.

Voluntary adoption

In order to progress to a sound and effective corporate governance system, we must concentrate on the main weaknesses. The following points have been identified as priorities in order to achieve the desired goals: ethics and integrity; improving disclosure and transparency; and developing and promoting the idea of the good 'corporate citizen'.

Effective corporate governance is doubly important in emerging markets, in order to spread confidence and trust among investors and potential investors. Good corporate governance makes the market more attractive for foreign investors, and strengthens shareholder protection. The main challenging issue in rating and identifying the progress in implementation is quantifying the quality of different aspects of the system. The global financial crisis clearly showed the lack of integration in many corporate governance systems, including integration in terms of structural components, such as: principles and mechanisms for implementation; integration in control components, such as monitoring, evaluation and ranking; and integration with HR in order to reach required results.

These key points can be addressed on two levels, the national level and the corporate level. However, enforced implementation will not necessarily lead to the desired results. Rules and regulations are better understood and followed if derived from the environment within which companies are operating. ADCCG believes that loyalty is a key component in any corporate culture and ethics, but it has a powerful impact in relation-based governance environments compared to rule-based governance environments.

Indeed, there is clear evidence in the UAE and other GCC markets of relationship-based transactions which need to be controlled and monitored. An effective corporate governance system, which is subscribed to wholeheartedly at the company level, will contribute in eliminating the tendencies of such transactions.

A long-term process of education and awareness on these types of transactions and ethics needs to be done at the company level in order to eliminate such transactions and to put the company's and stakeholders' benefits as the priority of managers and directors.

Ethical dilemmas

We believe that the experiences of the global financial crisis should urge all developing countries' governments to accelerate the establishment of corporate governance systems and related mechanisms, as it has a direct impact on the national development in these countries.

One of the hard lessons which the world has to learn from the financial crisis is to enhance control mechanisms for ethics to an influential level. Ethics cannot be fully regulated, controlled and enforced unless there is a self-acceptance, adoption, belief and full acknowledgement of its potential role in strengthening corporate governance.

The UAE is one of these developing markets: corporate governance development is taking place, and the laws and regulations in place now form the basis for the companies and entities in UAE to grow – which will ultimately both improve the local economy and UAE competitiveness. Even so, the journey has only just started, and there's still a long way to go.

ABOUT THE AUTHOR

Khalid Deeb is Director General of the Abu Dhabi Center for Corporate Governance

The ESCA code of corporate governance

The major provisions outlined in ESCA's Corporate Governance Code are:

It is mandatory for all listed companies in the stock markets in UAE, with some exceptions for:

- companies fully owned by the federal government or any local government
- banks and financial institutions where they are regulated by the UAE Central Bank
- foreign companies which are listed in any international stock market

Companies are required to establish two board committees – an audit committee and a nomination and remuneration committee

At least one third of the board should be independent directors

The chair and CEO cannot be the same person

The roles and responsibilities of the board members, chair, and non-executive board members are outlined

Companies must apply a precise internal control system that aims to develop an assessment of its risk management means and measures, sound application of governance rules and verification of compliance with laws and regulations

An annual corporate governance report must be issued by the board, signed by the chair and submitted to the stock markets. This report must include an acknowledgement by the board of directors confirming responsibility of the board for the application, review and efficiency of the company's internal control systems

External auditors to any public shareholding company cannot perform any technical, administrative or consulting services that may affect its decisions or independence

Shareholders shall have all share related rights, in particular the right to receive dividends, attend and vote in the general assembly meetings and have access to company's financial statements. They may also request to have access to company's records and documents at the permission of the board of directors

Shareholders' voting process at the annual general assembly meetings must be based on a cumulative voting system, where each share equals one vote

The process for nomination and selection of board members is outlined

Companies are encouraged to have policies for board member development and board evaluation

About ICGN

The International Corporate Governance Network (ICGN) is a not-for-profit body founded in 1995 which has evolved into a global membership organisation of over 500 leaders in corporate governance in 50 countries, with institutional investors representing assets under management of around US$9.5 trillion.

The ICGN's mission is to raise standards of corporate governance worldwide. In doing so, the ICGN encourages cross-border dialogue at conferences and influences corporate governance public policy through ICGN Committees. We promote best practice guidance, encourage leadership development and keep our members informed on emerging issues in corporate governance through publications and the ICGN website.

ICGN members include institutional investors, business leaders, policy makers and professional advisors. Our members join from across the world and have a mutual interest in promoting good corporate governance. This enables the ICGN to draw on three unique strengths:

- breadth and expertise, which extends across the global capital markets to include senior decision makers and opinion leaders in the practice of corporate governance
- magnitude of institutional investors, who collectively represent funds under management in excess of US$9.5 trillion, giving a focus on the role of shareholders responsible for the long term savings of the wider community
- geographic diversity, with members drawn from every region including Africa, Europe, Latin America, the Middle East, North America, and South and East Asia

ICGN activities

The ICGN supports its membership in a number of different ways:

Advocacy

The ICGN is active as an advocate for policy reform but places equal if not more emphasis upon the importance of market-led solutions. In doing so, the ICGN draws on the expertise of its members to influence policies and proposals related to corporate governance by responding to consultations or proactively submitting comment letters to national and international bodies.

ICGN Foundation

The ICGN Foundation acts in the public interest to support corporate governance education worldwide. It advances the work of ICGN Academy which was launched at the 2007 Annual Conference in Cape Town with a remit to support leadership development for those working in low-income or difficult environments and to promote research into corporate governance in developing countries.

To date, over 35 people from around the world have benefited from ICGN Scholarships and become part of the ICGN network, thanks to generous contributions from individual ICGN Members and inaugural donors. Going forward, the ICGN Foundation will continue providing scholarships.

ICGN Conferences

ICGN Conferences bring together leading speakers and delegates from all sides of the corporate governance community including investment, business, the professions and policy-making. ICGN Conferences are held in every region of the world to ensure cross-border dialogue with international relevence on emerging issues in corporate governance.

We welcome members and non-members alike to join ICGN Conferences where delegates benefit from unique networking opportunities, receive free conference materials and learn from leading opinion formers on a range of issues.

Publications

The ICGN offers a range of corporate governance publications including the *ICGN Yearbook*, discussion papers, best practice guidance and newsletters. ICGN publications are available free of charge to ICGN members or can be purchased by non-members.

ICGN Yearbook

The ICGN Yearbook provides an overview of issues in corporate governance written by governance protagonists from around the world. It includes an international collection of country profiles written by local experts with unique insight into trends and developments in their markets or areas of expertise.

Best practice guidance

ICGN best practice guidance provides practical help to market participants in continually raising standards in corporate governance. Guidance evolves according to developments in the market and are kept under regular review to ensure they are timely and relevant.

Discussion papers

Discussion papers capture key debates at ICGN conferences and draws on insights from pioneers in corporate governance such as Sir Adrian Cadbury and Ira M. Millstein who wrote the *The New Agenda* for ICGN (2005), exploring the history of corporate governance and the role of shareowners.

ICGN News

ICGN News offers latest highlights on ICGN activities including summarises of conference debates, the latest on committee work and any new best practice guidance.

Reports and surveys

On occasion the ICGN commissions reports and surveys on issues of relevance to the ICGN work programme. ICGN members are invited to comment on a range of issues and their collective opinion serves as a useful basis for ICGN committees.

Online networking

Via 'Member Connections', the ICGN's virtual community, members can share experiences with peers and build relationships around the world.

Member Connections is hosted on the ICGN website. For more information, visit www.icgn.org

Audrey Hart

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