CORPORATE GOVERNANCE

A US/EU COMPARISON

<u>Course outline</u>

by

Miguel A. Mendez

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COURSE OUTLINE

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Objectives

1. To introduce students to what corporate governance really entails.

2. To point out how corporate governance is the result of certain realities; shareholding patterns, economic and legal environments, cultural idiosyncrasies.

3. To sketch the key characteristics of the corporate governance models in use across the EU and in the US.

4. To explore how executive compensation is also an element that is influenced by the governance model in use.

1. Introduction to corporate governance

a. Introduction

Corporate governance remains an obscure issue for business students. Most often it is amalgamated and confused with the issue of ethics. Although ethical behavior is expected from all the “actors” that take part in the corporate governance process, and specifically from directors and executives, corporate governance at its core is about the characteristics of a governing process and not about a particular behavioral trait.

The recent wave of financial scandals to hit the US has prompted renewed focus on corporate governance. In this context a comparison with European corporate governance is most instructive.

b. Defining corporate governance

There are many different definitions of corporate governance. They all invariably address the following central theme.

Corporate governance is the framework of laws, rules, and procedures that regulate the interactions and relationships between the providers of capital (owners), the governing body (the board or boards in the two-tier system), seniors managers and other parties that take part to varying degrees in the decision making process and are impacted by the company’s dispositions and business activities. Corporate governance defines their respective roles and responsibilities and their influence in steering the course of the company.

Calpers definition is as follows;

“ the relationship among various participants in determining the direction and performance of corporations”

Power Point slides for this section

Power point slide 1 “A comparison between the US and the EU”

Power point slide 2 “ What is corporate governance**”**

Power point slide 3 “Roles and prerogatives of the key players**”**

2. Factors that shape corporate governance

Corporate governance does not occur in a vacuum. It reflects the economic, historical, cultural and legal characteristics of a country, its business history and corporate landscape.

It is also shaped by the ownership structures and patterns of that economy and by the financing options available to businesses. We are referring to the role played by the financial markets, the banking/insurance sectors and in some countries the government as shareholders and providers of capital.

Differences in these areas account for some of the notable differences in the governance models found on either side of the Atlantic.

a. Impact of ownership and control structures and patterns on corporate governance

Corporate governance is inextricably linked to the ownership, control structures and patterns prevalent in an economy.

Distinguishing between ownership and control and explaining the agency factor, i.e. the owners of the firm hire managers (agents) who "control" and manage the assets of the firm is an intrinsic feature of the corporation and one that is central to any corporate governance model.

Ownership and control patterns that prevail in the EU

The European corporate ownership map can be broadly categorized in two groups:

- ⇨ The financial markets dominated model prevalent in the UK, is characterized by a dispersed ownership and control structure and the prevalence of the institutional investors. According to the recent British Paul Myners report individual share ownership has fallen from over 50% of the market in the 1960s to less than one fifth today.
- ⇨ The bank oriented model prevalent in Continental Europe is characterized by a certain degree of ownership concentration, and more importantly a great degree of control concentration, in the hands of one or a handful of shareholders the "blockholders". It is bank oriented, instead of financial markets oriented, because of the central role played by financial institutions (banks and insurance companies) in providing capital to the corporate sector. It is insider dominated

instead of outsider dominated because these institutions are closely involved in the affairs of the companies, and are generally represented on the board.

How do these ownership and control landscapes translate into differences in the corporate governance models.

The corporate governance weakness that arises from the ownership landscape prevalent in continental Europe is one of ***strong blockholders, weak dispersed owners***. The dispersed owners that in the aggregate hold the majority of the capital are often at the mercy of blockholders that appoint the managers and devise strategies that tend to further their own interest instead of that of the majority of shareholders.

In the UK on the other hand the ownership and control landscape can be broadly described as dispersed and highly fragmented, a direct consequence of central role of the financial markets. The dispersion produces a weakening of the ownership/control link thus allowing the board a degree of power over the direction of the company that is unparalleled in Continental Europe. When ownership is dispersed the incentives to perform direct monitoring are weak, one of the alleged weaknesses of the Anglo-Saxon system.

Ownership and control patterns that prevail in the US

The American ownership landscape is even more dispersed than its British counterpart , but the similarities stop there. The dispersion of shareholdings is unparalleled in any other developed economy. This dispersion has come about with the rise of the institutional investor.

The high dispersion and impediments to exerting influence have converge to produce a weakening of the ownership/control link thus allowing **managers** a degree of power over the direction of the company that is unparalleled in other governance models.

In conclusion, when voting power is dispersed (the US case) the incentives to perform direct monitoring are lacking. On the other hand when voting power is concentrated, (Continental Europe), there are incentives to conduct direct monitoring, and temptations to extract private benefits. In the US recent scandals and corporate excesses clearly indicate that senior managers through their presence and unchecked influence on the board extracted exorbitant benefits for themselves and in most cases for other board members. It is readily evident that in Europe and the US different ownership and control structures and patterns result in different governance models that exhibit different weaknesses. In either model when voting power is concentrated but ownership is not, the incentives, temptations to extract private benefits for the management team or for a group of shareholders (the blockholders) are strong. How strong they are depends on the device that is used to separate ownership and control. In the US the issue is one of **strong managers, weak owners,** in Europe (with the exception of the UK) the issue is one of **strong blockholders, weak dispersed owners.**

Hence in Europe, and the US monitoring and supervision have different focuses. In Europe monitoring must focus on insuring that large voting blockholders represented on the board look after the interest of **<u>all</u>** shareholders not merely their own interest. In the US on the other hand monitoring must focus on insuring that the management team that generally wields great influence on the board look after the interest of the share-holders instead of seeking to maximize their own interests.

b. <u>Influence of the economic model on corporate governance</u>

The economic model in use is another factor that shapes and influences corporate governance. The relationships and interactions between the economic actors that prevail in an economy shape corporate governance. The economic models of the US and Germany are generally put forward as examples of these two very distinct models.

The US model is often characterized as market oriented with more emphasis on ‘unbridled” competition. The government provides the regulatory framework and lets market forces and actors fight it out. The “winner take all” criteria.

The German model places greater emphasis on cooperation and consensus between the different economic and market actors.

Each of these two models and the many variations that exist in various countries do in turn have implications and ramifications on the corporate governance model.

⇨ Involvement of employees in the corporate governance process.

The role of employee co-determination and work councils within the German, Dutch, Swedish corporations and/or the rights given employees of companies of a certain size, to information regarding the company's economic and financial situation and/or major events such as mergers, restructurings etc., underline employee participation and influence over the governance process. The absence of these mechanisms in the American governance model underscores the exclusion of employees from the governance process.

c. Influence of legal systems on corporate governance

A large majority of states in the US, including Delaware, where many companies are incorporated, stipulates the primacy of the shareholders over other stakeholders.

In the EU, the law and/or the various governance codes, in a majority of countries stipulate the primacy of the company's interest i.e. the combined interest of the various stakeholders.

This is a fundamental difference with broad implications. The American reasoning goes somewhat as follows; if directors look out for the long term interest of shareholders they will also be deemed to have taken care of the corporation's other stakeholders, European reasoning for the most part stresses the interest of the company as a separate entity from its shareholders and as a confluence of different interest that must be balanced. Directors are expected to look after the interest of the company. Indeed in many European countries a shareholders cannot bring legal action against a director only the company can take such action.

Power Point slides for this section:

Power point slide 4 "Factors shaping corporate governance"

Power point slide 5 "Corporate governance models: Anglo Saxon vs Continental-Rhineland"

Power point slide 6 "Whose interest is the board looking after"

Power point slide 7 " Ownership and control patterns"

Power point slide 8 " Separation of ownership and voting power"

Power point slide 9 " One share one vote restrictions in Europe"

Power point slide 10 " The rise of institutional ownership"

3. Key characteristics of the American governance model and those in use across the EU

a. Role of the governing body

On both sides of the Atlantic the governing body is entrusted with two distinct functions

- To oversee, monitor and control (appoint, dismiss) the management of the company and all critical functions of the corporation.
- To set the company's strategic direction.

There are two features in any governance model that shape the interactions and relationships between the various parties in the governance process

- ⇨ Board structure: the organizational framework the governing body operates under.
- ⇨ Board composition: who is represented on the governing body.

Board structure

The organizational frameworks that governing bodies operates under, on either side of the Atlantic can be broadly categorized as follows;

- ➢ The unitary system; the governing body is comprised of a single board.
- ➢ The two-tier system; the governing body is comprised of two separate boards, a supervisory board and a management board.

The two-tier board institutionalizes a clear distinction and segregation between the supervisory and monitoring functions on the one hand, and the managerial functions on the other hand. The unitary board combines both functions although certain governance models through various mechanisms achieve a certain degree of segregation of these functions.

In turn within each of these two broad categories there are subcategories exhibiting significant differences. This is particularly true of the unitary system.

b. Board structure in the EU

The EU landscape can be broadly categorized into three groups:

1. Those countries where the two-tier system is mandatory, that is embedded in

the law, for corporations of a certain size. Austria, Germany, The Netherlands.

2. Those countries where the two types of organizational structures i.e. unitary and two-tier, co-exist but the unitary board is the most common structure, and those countries where a quasi two-tier system is in used. In Belgium, Luxembourg, France and Greece both organizational structures are in use, and in Sweden, Finland, and Denmark, the quasi two-tier system is the norm. In the first group, where the two-tier and unitary system co-exist, the two-tier system is mostly used by the larger companies. In France it is estimated that some 25 % of large listed companies have a two-tier structure whereas virtually none of the smaller companies have it. A somewhat similar situation prevails in Finland where 15 of the 150 companies listed on the Helsinki stock exchange have a two-tier system.

3. Those countries where the unitary board is the only system. Ireland, the UK, Spain, Italy, and Portugal.

In all the countries that rely on the unitary board, (exclusively or as one of the organizational options), note the variations (alluded to earlier) related to the role of the non-executive Chairman of the board and that of the executive committee. One must also note that in Italy and Portugal a board of auditors, separate from the board is also required.

<u>Non-executive Chairman of the board</u>

In the UK and Ireland the non-executive chairman has become the norm. Said non-executive chairman is responsible for the smooth functioning of the board, setting the agenda, presiding at board meetings, guiding the process by which new directors are selected, determining committee membership and chairpersons and ensuring that directors are given adequate information. He or she also plays a role in the board's evaluation of the CEO's performance.

<u>Executive committee</u>

Also noteworthy in the unitary systems of Spain, Italy, Portugal, Belgium etc., is the role of the executive committee in the governance structure. Here the executive committee to whom the board delegates the executive powers to manage the company acts in a manner analogous to a management board. These are often comprised not only of the senior executives of the company but also of representatives of the most significant shareholders. Both the Portuguese and Spanish governance codes for instance underline the need for the Executive Committee to reflect the balance existing on the board between directors linked to significant shareholders and other directors.

See below section **4** **Functioning and leadership of governing bodies**

c. Role, number and type of committees

The separation between the supervisory and monitoring functions on the one hand and the executive functions on the other hand, is in one form or another (formal two-tier system, unitary system with executive committee or with non-executive chairman of the board completely unrelated to management team) a prevalent feature across Europe.

c. Board structure in the US

In the US the unitary system is the norm. The American unitary system does not exhibit any of the variances found in European governance models that are also unitary. Contrary to some European unitary board systems that have progressively moved or are moving to segregate the supervisory and managerial functions, the US unitary system remains attached to the combination of these functions in the figure of the chairman/CEO.

The resulting effect is a significant concentration of power in his hands. Indeed in more that 80% of US boardrooms the same individual combines both functions.

Recently following the spate of financial scandals, The Conference Board in its report entitled Commission on public trust and private enterprise, writes, “the commission believes that a crucial governance challenge facing American corporations involves establishing an appropriate balance between managing the company and providing the independent directors with the powers and resources they need to perform their role.” It also states “ the commission recommends that each corporation give careful consideration, based on its particular circumstances to separating the offices of the Chairman and Chief Executive Officer.” But other have advocated in favor of the status quo. Indeed the Business Round Table in its latest white paper on corporate governance states “ *Most American corporations are well served by a structure in which the CEO also serves as chairman of the board. The CEO serves as a bridge between the management and the*

board, ensuring that both act with a common purpose. Some corporations have found it useful to separate the roles of CEO and Chairman of the board to provide continuity of leadership in times of transition. Each corporation should make its own determination of what leadership structure works best, given its present and anticipated circumstances."
Yet, others, such as California Public Employees' Retirement Systems (CalPERS) advocate that when the chair of the board also serves as the CEO, the board designates, formally or informally, an independent director, to act as lead to coordinate the other independent directors. It adds further in its Corporate Governance Core Principles & Guidelines 1998.

" there has been much debate concerning the wisdom, and feasibility, of an "independent chair" structure in American corporate culture. Although this structure is more common in European corporations, it remains the exception in the United States. CalPERS believes, however that true board independence may ultimately -within the next decade- require a serious re-examination of this historic combination of powers."

d. Board composition in the EU and the US

Another area of significant differences both within the EU and with the US is that of representation that is the make up of the board. Board representation provides a good indicator of the influence of the various stakeholders over the governance of the corporation. Board representation also reflects certain regulatory imperatives.

Employee representation

Employee representation is without a doubt along with board structure, the other notable difference in the governance models in use within the EU and in turn with the US.

Many European countries, those with a two-tier governance model or quasi two-tier governance model give employees a say in corporate governance. This is achieved either via their representation on the governing bodies or through other mechanisms. In Austria, Germany, Denmark, Luxembourg and Sweden companies of a certain size (the thresholds vary from country to country; 35 workers in Denmark, 300 in Austria etc) are legally required to have a determined number of employee representatives on the governing body. In Finland and France the company's articles may stipulate such a right. Also in France when the employee’s stake in the company reaches three percent (3%) (via an ESOP or similar plan), the employees are entitled to nominate one or more directors. Finally, one must note that in some countries (France, The Netherlands, etc.), employee representatives are entitled to attend board meeting but not to vote. Employee representation and/or right to be informed is therefore an established aspect of corporate governance in large portions of the EU.

In southern Europe, the UK and Ireland on the other hand employee representation does not exist, a situation similar to that of the US.

Shareholders representation

A second significant difference in board composition relates to the representation of shareholders on the governing bodies.

In Continental Europe the relative concentration of ownership and/or voting power that we have described previously and a conducive legal framework result in the powerful representation of significant shareholders on the board. Thus board representation and composition generally reflects the shareholding make up of the company.

In the US and the UK on the other hand shareholders/blockholders representation on the board is limited or non existent. The dispersed nature of the shareholding base that characterizes most companies has given rise to a very weak, symbolic or even non-existent representation on the board. Significant shareholders are not automatically given a seat on the board and without the acquiescence of the board to a specific director nomination, a shareholder wishing to be represented on the board must go through a costly difficult and uncertain proxy process. Most institutional investors behave more like traders than owners.

- US-UK; similar shareholding structures but different representation profile

In the UK it has become the norm for the Chairman of the board to be independent of the executive team (he is typically referred as non-executive) or of any shareholder. In the US on the other hand the norm is for the CEO to combine the functions of chairman. In both countries the limited influence of shareholders, allows the chairman of the board to play a central and decisive role in the director’s nominating process. In the US, the chairman of the board, a member of the management team, is inclined to favor directors “friendly” to the management team and that do not get in the way of his unchallenged rule. Thus the reputed independent directors representing shareholders are to a very large extent beholden to the CEO.

In the UK the chairman of the board is an independent member unrelated to the management team and as such his inclination is to favor other independent members to assist him in exerting oversight over the management of the company.

Management representation

Management constitutes another group of stakeholders whose presence on the governing body varies greatly across the American and European corporate governance models.

The extent of management presence on and influence over the governing body is a central element of any corporate governance model. It varies greatly from one corporate governance model to another. The two-tier system structurally restricts the role and influence of management over the governing body.

In the pure two-tier system (separate supervisory and management boards with distinct members) the management team is not represented on the governing body. In the hybrid or quasi two-tier system that prevails in much of Northern Europe the management presence on the governing body is very limited, most often to that of the CEO. In Sweden the governance code stipulates that the CEO should be the only executive to sit on the board, a similar stipulation applies in Belgium. In Denmark the code states ”We cannot recommend that managers of the company are also directors of the company”. In the unitary system used in the US and parts of Europe, management presence tends to oscillate between a quarter and a third. In France the law limits the number of executive directors to one third. In the US, according to one survey, one quarter of the board members are senior managers, and the number rises to one third when retired executives and partners i.e. bankers and lawyers are accounted for.

Management influence over the governing body reaches its zenith when the CEO is also chairman of the board. Conversely when the chairman of the board is a non-executive member, not a member of the management team and has no prior ties with the company, that is, he is not the previous CEO that retired and became chairman, the influence of management over the board is more likely to be checked. That is also the case in the governance models that feature an executive committee (a sort of management board). Said executive committee common in many European countries (Portugal, Spain, Belgium, Italy) result in a sharper distinction between the executive and supervisory functions, allowing the board to focus on the supervisory functions.

e. Director's nomination

Who nominates the directors is another indication of who wields power and influence.

In much of Continental Europe significant shareholders, that is, the blockholders have a predominant voice in the process whereas in the US and the UK, the board itself, either through its chairman or its nominating committee, have the determining input.

Power point slides for this section

Power point slide 11 " Role of the governing body"

Power point slide 12 " Organizational options"

Power point slide 13 " Variations in the unitary model"

Power point slide 14 " Two-tier structure details"

Power point slide 15 " Organizational framework"

Power point slide 16 " Concentration of power US vs UK "

Power point slide 17 " Board representation: the actors"

Power point slide 18 " Board representation: the "shakers and movers"

Power point slide 19 " Employee representation"

Power point slide 20 " Shareholders representation; who nominates directors ?"

4. Functioning and leadership of governing bodies

How the governing body functions, and organizes itself, how frequently it meets, how many members it counts, how responsibilities and powers are distributed, are all elements of relevance when analyzing and comparing American and European(s) corporate governance models

a. Two-tier board system: functioning and leadership

The two-tier board system in use in a number of European countries is characterized by a clear distinction and separation between the monitoring/supervising functions on the one hand and the executive functions (managing the corporation) on the other. Indeed the supervisory board delegates to the management board the managerial duties of running the company.

From a leadership standpoint the two-tier system can be characterized as “ dual chairmanship” as both the supervisory and management board have distinct chairmen with distinct powers.

The quasi two-tier system prevalent in most of Northern Europe offers a more diluted distinction between two fundamental tasks of the governing body, but is greatly more agile in its functioning than the formal two-tier system. Although this board system is in appearance unitary, as it relies on a single board, it is considered quasi two-tier because the management of the company is formally delegated to a Managing Director (CEO), that is legally a separate managing organ.

The recent focus on corporate governance that sprang from the various corporate scandals has prompted two-tier boards to sharpen this separation and clarify the relationship between the two boards. In the process the supervisory boards are being strengthened.

b. Unitary board system: functioning and leadership

Unlike the two-tier system that structurally has a built-in separation between the management and supervisory functions the unitary board combines both functions. In some unitary systems some segregation is achieved through the use of board committees, non-executive chairmanship, Presiding or Lead directors.

The unitary system presents strikingly different functioning and leadership modes arising from the diversity of organizational structures. These range, from the American unitary board system that combines the CEO and Chairman functions, to the British unitary board that relies on a “non executive chairman “, on to the unitary board system that operates with an active and powerful executive committee, analogous to the two-tier management board.

In the unitary board system the role of the chairman of the board takes on added relevance because he enjoys unchallenged leadership. He must contend with the dual and at times conflicting functions of the unitary board i.e. oversight and management. Invariably all codes underscore this point.

When a single person combines the roles of chairman & CEO the concentration of power and influence is undeniable and emanates from the following realities.

- Knowledge: The CEO's grasp of company's affairs is a significant source of power. Outside directors do not have the intimate knowledge and understanding that a CEO enjoys and is expected to have.
- Presiding board meetings: He creates the agenda, determines what information directors receive in advance, presides and leads the discussions of the board. This is a truly powerful function because by determining what items are discussed he determines what decisions and actions are taken.
- Selection of board members both executive and non-executive; As previously pointed out the chairman plays an important and sometimes crucial role in the selection process thereby invariably having the majority of directors beholden to him.
- Relations and interactions with shareholders: As the focal point of communication he shapes and presents the company's side to the outside. This is another crucial function that adds to his unchallenged power and dominance.
- Control over the purse: Through his control of the purse, he controls all the actions of the board; contracting of advisors to assist the board etc.

This concentration of power is widely recognized as a source of many of the ailments that have afflicted the American governance model and has recently prompted an array of measures to create within the board a counterweight to offset that of the Chairman/CEO.

c. Role, number and type of committee

The use of board committees to carry out specific tasks and responsibilities is a feature of governance models on both sides of the Atlantic. There is however a great diversity in the extend of their use, both in the type and role of committees.

The reliance on board committees is more widespread in the unitary governance model than the two-tier model. This arises because the committee system allows for the segregation away from the full board of functions requiring a degree of independence and objectivity, that the entire board with its intermingling of executive and non-executive responsibilities does not achieve.

The powers, independence, autonomy that the Sarbanes-Oxley legislation bestows upon and demands of the audit committee is an illustration of the phenomenon. The recent spate of scandals in the US has undoubtedly led to a significant strengthening of the committee system and in particular the role and powers of the audit committee.

- European governance models:

Uniqueness of the executive committee

The executive committee found in most European corporate governance model is unlike any other committee of the board. It is an executive organ that brings together the executive team and in many instances non-executive directors that represent selected shareholders. It acts in many respects as the management board found in the two-tier system. There is generally significant overlap in the membership of the executive committee and the board. In most countries where the unitary board is flanked by an executive committee the former is generally numerous (upwards of 15 members) very formal in its functioning and gathers a few times a year (half a dozen times). The executive committee on the other hand is much less numerous, less formal, gathers regularly and plays a central role in dealing with important facets of governance particularly those related to defining the strategic direction of the company. Its role is all the more important given the presence, in many cases, of non-executive directors representing selected shareholders.

Tendency towards greater reliance on traditional board committees

The more traditional board committees, those dealing with audit and control, remuneration and director's nomination, have only recently started to appear or to be recommended by the various codes enacted in Continental Europe. Their role and power vary somewhat across the EU. Again, the UK stands out from the rest of the EU, because of its more extensive and longer established use of committees, and also because it bestows greater power upon them. In many Continental countries committees do not meet as frequently as in the UK and the US, an indication that the board relies on them to a lesser extent. The trend is however, toward greater reliance on board committees to help organize the work of the board particularly in those areas where the interest of the board and management may come into conflict. In most of Continental Europe, the role of committees is considered preparatory or advisory, with the governing body retaining the actual decision making responsibilities. The UK is unique in allowing, for the bylaws to stipulate, the delegation of any of the board powers to a board committee.

Use of alternative mechanisms

European governance models exhibit mechanisms and organs in the areas of audit/control and director's nomination whose functions and purpose is analogous to that of the board committees dealing with these matters.

- ⇨ Portugal and Italy rely on a board of auditors appointed by the shareholder with powers that exceed those of the audit committee.
- ⇨ France and other countries rely on a "dual auditorship", alongside the traditional auditing firm, a statutory auditor is legally appointed and mandated to review and give his opinion on the financial health, and control mechanisms of the company.
- ⇨ In Greece, an internal auditor appointed by the board is hierarchically integrated in the management of the company, but remains independent in the exercise of his duties. His appointment and dismissal must be reported to the market authorities.

As it relates to the nomination of directors, a similar situation prevails in a number of countries with organs that perform the nomination's committee work.

- ⇨ In Spain, the law provides for directly proportional board representation. Thus, if the board of a company is comprised of 10 members, each 10% stake or multiple thereof entitles its holder to nominate and appoint one member of that board.
- ⇨ In Italy, proposals for the election of directors are put forward by means of election lists submitted by the majority shareholder, or for lack thereof by the largest minority shareholders.
- ⇨ Similarly in Sweden, the nominating committee is the initiative of the shareholder's meeting and its composition reflects the ownership of the company.

Power point slides for this section

Power point slide 21 " Sources of the Chairman/CEO's power"

Power point slide 22 " Board committees and alternative governing organs"

5. Independence, accountability, transparency & disclosure

In many respects the issues of independence, accountability, and transparency are intertwined. The financial scandals of the past two years have thrust renewed attention on the issue of independence.

a. Governing body independence

The independence of the board, its ability to exercise an objective judgment in the pursuit of the interest of all shareholders, and more broadly on behalf of all stakeholders, is crucial.

The independence of the governing body is contingent upon how it is organized, who occupies the chairmanship of the board, and the leadership positions of other crucial organs (chairmanship of nomination and audit committees, vice-chairmanship etc). It is also contingent upon the composition of the governing body.

In the European governance models and in the US model, independence has a different meaning and has to be established and defended against a different set of interests and forces.

Independence impairments

There are numerous independence impairments that can be observed in the corporate governance models from either side of the Atlantic.

A common independence impairment found across most governance models is the practice of retired executives becoming board members of the company they have managed. The continuity and in depth knowledge of the company they bring to bear must be weighed against their tendency to advocate for the status quo, and to side with the management team they were instrumental in installing. In countries with the two-tier system the retired members of the Management board go on to serve on the Supervisory board. In the unitary board system retired executives become board members.

A second weakness, is for directors to be drawn from a very small pool of candidates emanating from restricted business circles. In many European countries, extensive cross-shareholding links give rise to cross-board memberships and reciprocal directorships.

One company holding a seat on the board of another company, which in turn has a seat on the board of the first company.

Board independence in the US

In the US, independence must be claimed and established vis a vis management that is forcefully represented on the board, and through its most senior member,(the CEO, also chairman of the board), casts a long shadow over the affairs and independence of this body.

The recent spate of financial scandals that have rocked the US have focused much attention on the issue of independence. The torrent of regulatory and/or best practice measures that has followed, has had three primary objectives all related to independence.

- ⇨ Firstly, to ensure that a significant number of directors are independent.
- ⇨ Secondly, that crucial functions of the board (audit and control, nomination and remuneration) are carried out with the required independence.
- ⇨ Thirdly, that the board as a whole acts independently.

From an organizational standpoint, the unitary board system is more prone to independence failures. This is simply because the combination of the management and supervisory functions will, if not adequately segregated and insulated from one another, result in either confusion or with one function over-shadowing the other. In the US the emphasis has been and remains on the management/leadership aspect of the equation and letting the "regulatory" bodies and the financial markets "supervise and sanction" the management of the company. This model has of late shown its shortcomings.

Board independence in Europe

In the EU, with the exception of the UK, independence means independence from powerful shareholders, i.e. (the blockholders), that dominate the board and seek to further their own interests to the detriment of the rest of the shareholders. Independence from the blockholders is achieved by appointing independent directors in sufficient numbers.

The figure of the independent director, one not representing a shareholder and not tied or related to the management team, is a fairly new concept in Continental Europe. Indeed many of the governance codes enacted recently underline the need for companies to nominate independent directors (Spanish, French code, etc.). It is a recognition that "minority" shareholders lack representation in most of Continental Europe, and that their interests are too often trampled. The issue of independence, and the extent of an independent director's presence on the board is new and treated with varying importance in governance codes across the EU.

Independence from management influence is achieved across the EU via a combination of means:

- Distinct supervisory and managerial bodies in the two-tier or quasi two-tier system.
- Banning or severely restricting the presence of executive directors on the supervisory body.
- Segregation the function of Chairman and CEO.

The UK has undoubtedly the governance model that places the greatest emphasis on independence both from dominant shareholders and from management. Indeed, the recent 2003 Derek Higgs report recommends that at least half of the members of the board, excluding the chairman should be independent non-executive directors. It further provides a clear definition of independence. In view of the fact that in the British governance model the chairman is also independent, the British boards do certainly achieve the highest standard of independence of any the governing bodies on either side of the Atlantic.

b. Transparency and disclosure

Transparency and disclosure are issues closely linked to the type of shareholding structure that is prevalent in an economy. In economies with a majority of closely held companies most shareholders (their number is generally small) are represented on the governing body and have access to all critical information. In broadly held companies providing information to all shareholders and the markets at large become a complex and delicate endeavor. It follows that those economies characterized by a broad and dispersed shareholding base, (the UK and the US), present a high degree of transparency and disclosure. Conversely, Continental Europe with a fairly concentrated shareholding base presents on the whole a much lower degree of transparency and disclosure. However as financial markets across continental Europe become more developed and sophisticated, transparency and disclosure levels are raising.

c. <u>Accountability</u>

.A sound governance model relies on two distinct accountability relationships;

- Firstly, between the governing body and the shareholders, and other stakeholders
- And secondly, between the governing body and the management team.

Accountability is a direct consequence of the agency factor. The owner(s) of the firm hires managers (agents) who “control” and manage the assets.

The board is accountable to the shareholders and others for its supervision of management and its stewardship of the company, the management team in turn is accountable to the board and the shareholders and others for its stewardship of the operations of the company . The first leg of the equation is very much dependent on the involvement and militancy of the shareholders and other stakeholders, the rights granted to them under the law and the company’s bylaws and the type of participation mechanism available. All of which facilitates or hampers their involvement in the governance process. It results in a strong or feeble accountability relationship. Accountability is only as good as the quality and scrutiny of oversight exerted by the shareholders over the governing body and through it over the management team. It is contingent upon meaningful, timely and accurate information. The second leg of the equation is crucially contingent upon the board exercising its independent judgment, effective and prudent control of management. In the American governance model the accountability of management to the board is weak or non-existent. This is associated to the already indicated management dominated board.

The accountability of the governing bodies for the activities of the corporation is a central tenet of all governance models. How that accountability is expressed and to whom it is directed varies somewhat depending on how the primary objective of the corporation is defined. Subtle yet important differences surface across the EU and between the EU and the US.

Accountability is inextricably linked to constituencies. In continental Europe it is generally accepted that the board is accountable to different constituencies, this is particularly the case in those countries where employee are represented on the board. In the US the concept that directors are accountable to constituencies beyond the shareholders is gaining support. This would align more closely the accountabilities of directors with the role and impact of the corporation on society

Power point slides for this section
Power point slide 23 " Independence impairments"
Power point slide 24 " Accountability"

6. Executive compensation and governance model

One of the main duties of the governing body is to design and negotiate the pay package of the company's top executives. This is intertwined with the function of evaluating, hiring and firing the CEO and other senior members of the management team. Aligning the incentives of top managers with those of the owners is a particular concern.

European focus differ from American focus

Most EU governance codes stress the importance of designing a compensation architecture that takes into account the fundamental differences between executive and non-executive directors of the board. The primary function of the latter is to oversee, hire and dismiss the former. Any compensation scheme that blurs or erases this distinction, that is rewards both type of directors with stock options or similar devices that hinge on the short term performance of the company stock will weaken the indispensable independence of the oversight function. This is however not a concern in the American corporate governance debate. It further underlines that in the US the distinction and segregation between the oversight and executive functions of the board is not as much a focus of attention (it has become more so recently) and that remunerating executives and non-executive members with some of the same instruments i.e. stock options is not perceived as a problem. There are numerous examples in recent years of the perverse effects of this phenomenon amongst US companies. While most corporate codes in Europe (British, Dutch etc.) recommend against granting non-executive directors stock options or similar stock performance related incentive, (in France the law prohibit such practice) on the other side of the Atlantic, this issue has yet to find its way onto best practice recommendations.

The British Derek Higgs report reads " non executive directors should not hold options over the shares of their company. If exceptionally some payment is made by means of options, shareholders approval should be sought in advance and any shares acquired by exercise of the options should be held until one year after the non-executive director leaves the board".

The Dutch code reads " the remuneration of the supervisory board members should not be linked to the company's profits. Supervisory board members must therefore not receive options".

Another area of significant differences between the EU and the US is overall remuneration, both in terms of the level and composition. There are philosophical and cultural differences that account for the remuneration gap across the Atlantic for senior executives or how non executive directors are compensated. But the many times higher overall remuneration of American senior executives and board members is also a reflection of the unchallenged dominance management exerts over the governing body with the complicity of non-executive directors.

Power point slides for this section
Power point slide 25 " Level and mix of CEO compensation 90-99"
Power point slide 26 " Key differences in the governance models"

7. Suggesting reading and sources for this course

Harvard Business Review
On Corporate Governance

Jay W Lorsch with Elisabeth MacIver
Pawns or Potentates: The reality of America's corporate board

Robert A.G. Monks, Neil Minow
Corporate governance

Ralph D. Ward
Improving corporate boards: the boardroom insider guide book

Margaret M. Blair, Bruce K Mc Laury
Ownership & control: rethinking corporate governance for the 21 century

Jay A. Conger
Corporate boards: new strategies for adding value at the top

Donald H Chew
Studies in international corporate finance and governance systems: a comparison of the US, Japan and Europe

Arthur Levitt , Paula Dewyer
Take on the street: what Wall Street and corporate America don't want you to know

John Carver, Miriam Mayhew Carver
Carver guide: Your roles and responsibilities as a board member

Adrian Cadbury
Corporate governance and chairmanship- a personal view
Oxford University Press

Fabricio Barca & Marco Becht
The control of corporate Europe
Oxford University Press

Christine Mallin
Corporate governance: an international review

Richard R Ellsworth
Leading with purpose: the new corporate realities
Stanford University Press

Governances codes and reports

List of corporate governance codes and reports relevant to the EU, its member states and the US

European Union

Comparative study of corporate governance codes relevant to the European Union and its members states (Jan.2002)

Belgium

Brussels Stock Exchange

Report of the Belgium Commission on Corporate governance recommendations

Cardon report (Dec.98) <www.cbf.be/pe/pec/en_ec01.htm>

Denmark

The Nørby Commision,

Recommendations for good corporate governance in Denmark (Dec. 01)

www.corporategovernance.dk

Finland

Ministry of Trade and Industry

Guidelines for handling corporate governance issues in state owned companies and associated companies (Nov.2000) www.vn.fi/ktm/eng/newsktmetu.htm

France

The Daniel Bouton Report

Promoting better corporate governance in listed companies (Sept. 02)

Germany

The Cromme Report

German corporate governance code (Feb.02)

Greece

Mertzanis Report

Principles on corporate governance in Greece: Recommendations for its competitive transformation (Oct.99) www.ecgn.org

Ireland

Irish Association of Investments Managers ("IAIM")

Corporate governance, share option and other incentive scheme guidelines (March 99)

www.iaim.ie

Italy

Preda Report

Committee for the corporate governance of listed companies (Oct.99) www.borsaitalia.it

The Netherlands

Peters Report

Corporate governance in the Netherlands- Forty recommendations (Jun.97)

www.ecgn.org

Portugal
Securities Market Commission
Recommendations on corporate governance (Nov.99) www.cmvm.pt

Spain
Olivencia Report
The governance of Spanish companies (Feb.98) www.ecgn.org

Sweden
Swedish shareholders Association
Corporate governance policy (Jan.2000) www.egn.org

UK
Higgs Report
Review of the role and effectiveness of non-executive directors (Jan. 03)

Smith Report
Audit committees –Combined code guidance (Jan. 03)

US
The conference board
Commission on public trust and private enterprise (Jan.03)

The Business Round Table
Principles of corporate governance (May.02)

Web resource
www.scgop.nl ***Foundation for corporate governance – research for pension funds- the Netherlands***
www.corpgov.net ***Corporate governance***
www.thecorporatelibrary.com ***The corporate Library***