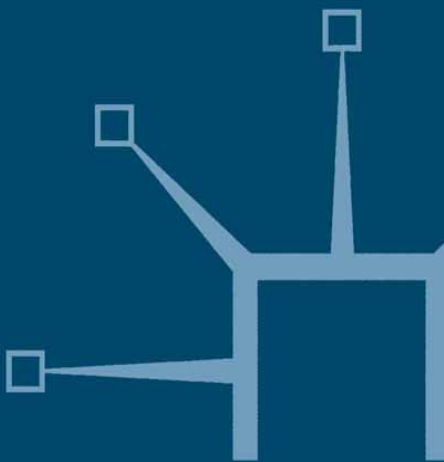
palgrave
macmillan

Corporate Governance in the US and Europe

Where Are We Now?

Geoffrey Owen, Tom Kirchmaier and Jeremy Grant



Corporate Governance in the US and Europe

This page intentionally left blank

Corporate Governance in the US and Europe

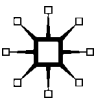
Where Are We Now?

Geoffrey Owen, Tom Kirchmaier and Jeremy Grant

This book is based on a conference organised by the London School of Economics and New York University, held in London on 4 and 5 November 2004.

The conference brought together academics and practitioners from both sides of the Atlantic to review recent developments in corporate governance, focusing in particular on the lessons to be learnt from the stock market boom and bust and from the corporate scandals that came to light in 2001 and 2002. A list of conference participants is on pp. ix–xi. This book comprises, first, an overview of the themes that were discussed at the conference together with some comments on unresolved issues where further research is needed, and, second, summaries of the contributions made by conference speakers. The appendices contain details of recent changes in corporate governance rules that have been introduced in the US, Germany and the UK, together with an account of events leading to enactment of the European Takeover Code.

palgrave
macmillan



Softcover reprint of the hardcover 1st edition 2006 978-1-4039-9866-8

First published 2006 by
PALGRAVE MACMILLAN
Houndmills, Basingstoke, Hampshire RG21 6XS and
175 Fifth Avenue, New York, N.Y. 10010
Companies and representatives throughout the world

PALGRAVE MACMILLAN is the global academic imprint of the Palgrave Macmillan division of St. Martin's Press, LLC and of Palgrave Macmillan Ltd. Macmillan® is a registered trademark in the United States, United Kingdom and other countries. Palgrave is a registered trademark in the European Union and other countries.

ISBN 978-1-349-54717-3 ISBN 978-0-230-51245-0 (eBook)
DOI 10.1057/9780230512450

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

Corporate governance in the US and Europe : where are we now? / [edited by] Geoffrey Owen, Tom Kirchmaier, and Jeremy Grant.
p. cm.
"A report on a conference organised by the London School of Economics and New York University, held in London on November 4th and 5th, 2004."
Includes bibliographical references and index.

1. Corporate governance–United States–Congresses. 2. Corporate governance–Europe–Congresses. I. Owen, Geoffrey, 1934– II. Kirchmaier, Thomas, 1968– III. Grant, Jeremy. IV. London School of Economics and Political Science. V. New York University.

HD2741.C7758 2005
658'.045'0973–dc22 2005049326

10 9 8 7 6 5 4 3 2 1
15 14 13 12 11 10 09 08 07 06

Contents

Foreword

In the fall of 2004 a small group of leading corporate governance thinkers from across the territory of the European Union and from the United States gathered at the London School of Economics to share insights and challenge conventional thinking respecting the governance of the large publicly financed business corporation. These institutions, in a sense, dominate the production of goods and services in the modern economy, not only in the US and Europe but also in Japan, Australia, Canada and other 'advanced' economies. That large publicly financed corporations function efficiently and in the public interest is a matter of high public importance. Indeed, while it is less than 25 years since the term 'corporate governance' entered the English language as a commonly heard phrase, none can today doubt the importance of the set of legal rules and social practices that form the structure within which individuals guide the activities of these entities.

If our understanding of effective corporate governance concepts and techniques is to be advanced, insights from academic study in law, finance and economics must be integrated with real world insights and experiences of practitioners of the art, as well as from government regulators. Thus, at the London meeting leading legal and finance scholars from both the US and the EU were joined by regulators from several jurisdictions, as well as leading US and EU practitioners. This book constitutes a summary of the proceedings of that meeting. The meeting was an intellectually exciting event and this book represents an effort of the organising institutions to make the benefits of that discussion available to those unable to attend.

The meeting in London was the result of the joint work of the London School of Economics and the New York University Center for Law and Business. It was the initial meeting in what is hoped to be a series of annual meetings alternating between London and New York that address current issues in corporate governance from a multi-jurisdictional prospective. I was pleased to be one of the organisers of the conference and I was joined in that effort by Sir Geoffrey Owen of the London School of Economics, who, with his colleagues,

has written the overview of the conference proceedings that introduces this book, and Martin Lipton, Esq. of the New York bar, long recognised as a leading thinker in this field.

William T. Allen

Jack Nusbaum Professor of Law and Business
New York University
Director, NYU Center for Law and Business
Former Chancellor of the Court of Chancery of
the State of Delaware

Conference Participants

William T. Allen, Nusbaum Professor of Law and Business, Director of the Center for Law and Business, New York University

Hon. Paul Atkins, Commissioner, Securities and Exchange Commission

Marco Becht, Professor of Finance and Economics, Université Libre de Bruxelles, Executive Director of the European Corporate Governance Institute

Tim Besley, Professor of Economics and Political Science, London School of Economics and Political Science

Tim Clark, Senior Partner, Slaughter and May

G. Michael Crooch, Board Member, Financial Accounting Standards Board

Paul L. Davies, Cassel Professor of Commercial Law, London School of Economics and Political Science

Sir Howard Davies, Director, London School of Economics and Political Science

Antoine Faure-Grimaud, Professor of Finance, London School of Economics and Political Science

Professor Guido Ferrarini, Professor of Law, Genoa University

Roddy Gow, Chairman, Gow & Partners

Jeremy Grant, Graduate Institute of International Studies, Geneva

David Henderson, Visiting Professor, University of Westminster

Gerard Hertig, Professor of Law and Economics, Swiss Federal Institute of Technology, Zurich

Hans Hirt, Manager, European Corporate Governance, Hermes Investment Management

Michael Jensen, Managing Director, Organizational Strategy Practice, The Monitor Group

Steven Kaplan, Neubauer Family Professor of Entrepreneurship and Finance, Graduate School of Business, University of Chicago

Tom Kirchmaier, Lecturer, Interdisciplinary Institute of Management, London School of Economics and Political Science

Martin Lipton, Founding Partner, Wachtell, Lipton, Rosen & Katz

Mrs Susan Lipton

Sir Sydney Lipworth, Trustee of the International Accounting Standards Committee Foundation, former chairman of the Financial Reporting Council

Brian Main, Professor of Economics, University of Edinburgh

Colin Mayer, Peter Moores Professor of Management Studies, Said Business School, Oxford University and Leo Goldschmidt Visiting Professor at the Solvay Business School in Brussels

Kevin Murphy, E. Morgan Stanley Professor of Business Administration, Marshall School of Business, University of Southern California

Sean O'Hare, Head of Executive Compensation, KPMG

Sir Geoffrey Owen, Senior Fellow, Interdisciplinary Institute of Management, London School of Economics and Political Science

Krishna G. Palepu, Ross Graham Walker Professor of Business Administration and Senior Associate Dean, Director of Research, Harvard Business School

John Plender, *Financial Times*

Jonathan Rickford, Director, Company Law Centre, British Institute of International and Comparative Law

Roberta Romano, Oscar M. Ruebhausen Professor of Law, Yale University

Joshua Ronen, Professor of Accounting, Stern School of Business, New York University

Alastair Ross Goobey, Chairman, International Corporate Governance Network

Andrei Shleifer, Whipple V. N. Jones Professor of Economics, Harvard University

Chief Justice Myron T. Steele, Delaware Supreme Court

David Webb, Professor of Finance, London School of Economics and Political Science

Axel von Werder, Professor of Organisation and Management, Technical University of Berlin

Anne Willcocks, Director, Modern Company Law, Department of Trade and Industry

Sarah Worthington, Professor of Law, London School of Economics and Political Science

Luigi Zingales, Robert C. McCormack Professor of Entrepreneurship and Finance, University of Chicago Graduate School of Business

1

Corporate Governance in the US and Europe: Where Are We Now?

Geoffrey Owen, Tom Kirchmaier and Jeremy Grant

Introduction

During the 1990s, and especially in the second half of that decade, the US economy markedly outperformed that of most European countries and Japan. While the reasons for the acceleration in US productivity growth are disputed, it was widely believed during those years that part of the explanation lay in the depth and vitality of US financial markets. The American financial system, it was thought, ensured that badly managed firms were reorganised or taken over, that entrepreneurs with promising projects had easy access to capital, and that resources were swiftly transferred from slow-growing to fast-growing sectors of the economy. The focus on shareholder value as the principal measure of a company's performance was seen to be a powerful force for concentrating the minds of managers on making their businesses more efficient and more profitable.

The apparent superiority of the American system encouraged other countries to look for ways of injecting greater dynamism into their financial markets. This meant, among other things, upgrading the importance of shareholder value and embracing, at least partially, the market for corporate control as a means of imposing discipline on publicly quoted companies. In Europe, and to a lesser extent in Japan, additional pressure to make these changes came from the growing influence of American institutional investors as shareholders in European companies.

G. Owen et al., *Corporate Governance in the US and Europe*

Then came the stock market crash, followed by Enron, WorldCom and other corporate scandals. The US model of corporate governance lost much of its appeal, especially in those Continental countries where the concept of shareholder value maximisation did not fit easily with long-established habits and attitudes. Yet there was also recognition – arising from scandals at such companies as Parmalat, Ahold and Vivendi – that corporate governance in Europe was far from perfect. These European corporate disasters highlighted some of the same issues – the role of boards of directors as monitors of management, the independence and effectiveness of auditors, the adequacy of external regulation – which have been at the centre of the post-Enron debate in the US. Thus in Europe as well as the US corporate governance reform remains high on the agenda, and all parties to the debate – governments, investors, managers, professional advisers – are searching for the right way forward.

Why is corporate governance important? Corporate governance can be defined as the set of control mechanisms and institutions which protect the suppliers of capital to a company, particularly suppliers of equity capital, the shareholders, who have only residual protection after all other claimants have been satisfied. Product market competition provides an incentive for managers to deploy capital efficiently, but only effective corporate governance can ensure that interests of shareholders are protected. Weak corporate governance impedes the flow of savings into investment, and increases the risk that corporate assets will be used suboptimally.

In the last few decades the profile of shareholders has shifted from private investors to institutions, principally pension and mutual funds, which aggregate the savings of millions of ordinary citizens. Institutional investors have long been dominant in the UK and US, and are becoming increasingly important in Continental Europe. They have a big role to play in ensuring that the companies in which they hold shares are well governed. But they represent only one of a number of mechanisms, some internal to the company and others external, which can contribute to improved corporate governance. The strength of these mechanisms, and their influence on the way managers of companies behave, vary from country to country, depending on their particular histories, institutional arrangements and ownership structures. These differences are reflected in the different ways in which countries are tackling corporate governance reform.

Differences between countries

Comparisons are often made between Anglo-American capitalism and the rest, and it is true that the US and the UK do share some common features which distinguish them from most Continental European countries and Japan. But such generalisations obscure important differences on both sides of the divide. For example, British institutional investors tend to be more interventionist than their American counterparts. Hence British boards of directors are more exposed to investor pressure on such issues as the composition of the board, the appointment of new directors, and executive pay. British boards also tend to have a balanced mix of inside and outside members, whereas in the US it is not uncommon for the chief executive (who is usually also the chairman) to be the only full-time manager on the board. As Jonathan Rickford points out in Chapter 3, the British system is in some respects more shareholder friendly than that of the US, not least because of the ability of shareholders to call an extraordinary general meeting (EGM) with 10 per cent of the share capital, and remove the board with a plurality of the votes.

That said, the major distinction is between the US/UK and Continental Europe as both operate under distinctly different legal systems. Andrei Shleifer argues in Chapter 17 that shareholder rights are stronger under the Anglo-American common law tradition than under civil law which prevails in Continental Europe. The principles-based concept of the common law system makes it more difficult to circumvent them than the alternative rules-based system. As a consequence, common law countries are better at protecting minority shareholders against expropriation and limiting the exploitation of private control benefits by dominant shareholders.

Possibly for this reason, the majority of firms in Continental Europe are owned by dominant shareholder(s), which together have legal control over the firm. Their strong position naturally extends into the boardroom, leading to the likely capture of the board by its controlling shareholders. For example, of the 13 members of the Parmalat board, the CEO and chairman was Calisto Tanzi, the founder, and the other 12 were either members of the Tanzi family, employees of Parmalat or business associates of the family. Often, there is also limited or no representation of minority shareholders on the board of directors. In this respect, newly introduced corporate

governance codes often only require an 'appropriate number' of independent directors.[1] Examples include Germany, where the two-tier board system also faces other problems in relation to discharging its monitoring function. It usually suffers from its large size, inadequacy of information flows, infrequent meetings and in the past the underdeveloped structure of the board committees.[2] The inclusion of labour representatives on the board runs counter to its objective of representing the rights of the suppliers of capital and creating a counterbalance to unions in particular and the interests of labour in general. This conceptual inconsistency of the sizeable labour representation might further weaken the two-tier board structure.[3] Regardless of the one-tier or two-tier board structure, boards in Continental Europe are often weak and as the primary mechanisms for protecting the rights of minority shareholders less effective than their Anglo-American counterparts. Equally, concentrated ownership also means that external corporate governance mechanisms such as the market for corporate control and investor activism are less effective in protecting the suppliers of capital.

The differences in ownership have important implications for the gatekeeper role of accountants, security market analysts and credit rating agencies. Gatekeepers function as intermediaries between firms and investors, pledging their long-established reputations on client firms' behalf to verify current operational data and future projections. While gatekeepers failed under both dispersed and concentrated ownership structures, they nevertheless failed in different ways.[4] In the US we have observed a considerable number of accounting restatements over the last few years. In many of these cases, firms had to correct downwards inflated earnings statements as they had tried to 'borrow' earnings from future periods to improve their current profits.

It has been argued that this premature revenue recognition was in part motivated by lavish compensation packages for senior executives that allowed them to extract millions of dollars in incentive compensation from the companies through inflated earnings statements. As auditors were appointed, compensated and dismissed by management, there was a considerable imbalance in power, leaving the auditors in a weak position to stand up to management. For example, Grant (2005) reports that auditors often had relatively little interaction with the audit committees, and in many cases only

with senior management present. The imbalance between management and auditors was further heightened by the economics of the audit industry itself. The by then 'Big Four' accountancy firms viewed their audit businesses as loss leaders for cross-selling higher margin consultancy services (including the very tax and corporate finance advisory services which allowed client firms to 'enhance' earnings). On average client firms bought about three times as much consulting services as auditing services (Coffee, 2003).[5] These issues were compounded by the difficulties of the audit profession to attract new high-quality staff since the mid-1970s, as the function became commoditised and lost its prestige.

These imbalances have been in part corrected by Sarbanes-Oxley, and the formation of the Public Company Accounting Oversight Board (PCAOB). The Sarbanes-Oxley Act mandates the introduction of strong audit committees that are manned exclusively by outside directors and appoint the auditors. Also, it bars auditors from certain non-audit services for their audit clients. Whether these reforms go far enough to ensure the independence of auditors is open to doubt. Ronen in Chapter 16 makes the case in this book for his novel idea of a financial statement insurance. Such insurance would protect shareholders against losses suffered as a result of misrepresentation or omissions in financial reports. As the insurer would appoint the auditor and publicise the premium paid, the proposed solution would solve the problem of conflicts of interest for the auditor. In addition, it would provide a market signal about the quality of the auditing processes. In summary, such a financial statement insurance would therefore improve the audit quality and with it the quality of financial statements, and reduce the average equilibrium losses.

Another suggestion is for the mandatory rotation of all auditing functions in a five-year cycle, which should ensure a peer review of the audit process and so improve its quality further. Critics point out that in the case of Parmalat, where Italian law requires such a mandatory rotation, it did not stop the misappropriation of capital. However, Italian law does not require the rotation of the auditing functions for related firms, with the consequence that the vehicles that were used to book false transactions continued to be audited by the same firm, Grant Thornton. Other critics point to the high costs of auditor rotation, which in many cases might only be a

small fraction of the loss in market capitalisation that results from earnings restatements (Healey, 2004; Coffee, 2005).

In contrast to the US where we have seen the overstatement of earnings by management, concentrated ownership as seen in much of Continental Europe is prone to a different risk – the expropriation of minority investors through the controlling shareholders. Here, the overstatement of earnings is not an issue, as the controlling shareholder can guide 'his' firm though command and control mechanisms and does not have to rely on indirect incentive mechanisms to motivate its management and guide its operation. Therefore, compensation packages have been historically less generous[6] and the incentive for management to engage in earnings manipulation minimal. The most prominent case of accounting fraud involving dominant shareholders is Parmalat in Italy. In this case the controlling shareholder dominated the board, and was able to expropriate considerable amounts from minority shareholders through false accounting. Here, over €17.4 billion of assets listed on the balance sheet could not be traced, and at least €2.3 billion were siphoned off in related party transactions to affiliates of the founding Tanzi family (Melis, 2004).

Given that the underlying causes of falsified financial information are different from the US, the solutions to correct this problem have to be different. Strong audit committees, for example, are most likely to make only minor positive contributions to the audit quality, as these committees will continue to be dominated – in one form or another – by insiders. Here, the compulsory rotation of auditors should form an important cornerstone of the revision of the auditing function in Europe, as the peer revision within the accounting profession could turn out to be one of the most important self-correction mechanisms.

Securities analysts, the second group of gatekeepers and normally employed by brokers and investment banks, aim at producing forward-looking earnings estimates and financial valuations. Recent media coverage has focused on the role of a number of high-profile analysts in the technology and telecommunications area such as Jack Grubman of Citibank and his role in the downfall of WorldCom, and Henry Blodgett of Merrill Lynch. Both promoted various telecom and Internet stocks to clients, while Blodgett privately described them as POS's.[7] However, a broader perspective demonstrates that

problems with information flows within the industry were widespread. For example, in October 2001, on the eve of Enron's filing for Chapter 11 bankruptcy, 16 of the 17 analysts covering the stock had it on a buy or strong buy recommendation. More generally, a survey by Thomson/First Call of analysts' ratings in the late 1990s found that the ratio of buy to sell calls was 100 : 1 (Coffee, 2003a).

The information content and conflicts faced by the industry can be explained in relation to the changes in its structure during the 1990s. While equity research was never a stand-alone product and was always based on generating trading revenues, in these years it became increasingly subsidised by investment banking advisory mandate revenues. The connection was strengthened by the rise of star analysts (such as Grubman and Blodgett) who were substantial revenue generators for their respective investment banking divisions. For example, Blodgett generated income through his ability to tout 'hot' IPOs to investors, and Grubman through his ability to convince investors of the merits of WorldCom's highly valued stock (which in turn kept the share price up and allowed the firm to continue its acquisition spree, with advice from Grubman's employer Citigroup).

Finally, credit rating agencies are the third group of gatekeepers. Credit rating agencies have escaped much of the opprobrium heaped upon the auditors and equity analysts. Perhaps this is due to the fact that majority of their revenues are generated by selling subscriptions of their ratings data to market participants – as opposed to collecting fees from the corporations they rate.[8]

There are historical reasons, as Colin Mayer explains in Chapter 4, why ownership of most Continental publicly quoted companies is more concentrated than in the US or the UK. Before the First World War the ownership of listed companies was similar in the UK and Germany. In both countries a large number of firms were listed on stock exchanges, and ownership was widely diffused. The depressed economic conditions of the inter-war years led to a retreat by the private German investor, and this continued after the Second World War. It was during the 1950s and 1960s that German capitalism acquired its distinctive ownership structure – the emergence in most, though not all, publicly quoted companies of one or two large, semi-permanent investors, usually families or other industrial companies. This concentrated ownership is one of the reasons why

hostile takeovers have been so rare in both Germany and Continental Europe. Where a single investor controls a large proportion of the shares, has a long-term commitment to the business, and exerts a dominant influence on the board, a hostile bidder has little chance of success.

Another major difference in Germany is the emphasis on the stakeholder view of the company, obliging managers to take into account the multiple interests of all stakeholders in a firm, as opposed to the more clearly defined interests of shareholders only. Michael Jensen (2000) has argued that the stakeholder view of the firm is theoretically inconsistent, while other authors, such as Margaret Blair (2003), defend its validity. This topic has been the subject of debate for decades and will not be easily resolved; however, it affects the role of the firm in society and with it the working of corporate governance institutions.

Given these different histories, it is not surprising that only partial convergence has taken place between national corporate governance systems. An important question for policy-makers in Europe is whether such convergence should be positively encouraged, for reasons of economic efficiency, or whether, for social as well as economic reasons, national peculiarities should be preserved.

Directions of reform

In considering how best to improve corporate governance, policy-makers on both sides of the Atlantic have to assess the appropriate balance between compulsion – in the form of new laws and stronger powers for regulatory agencies – and self-regulation. The US has opted for the first route, principally through the Sarbanes-Oxley Act; the Act has been supplemented by new rules and regulations imposed by the Securities and Exchange Commission. The Sarbanes-Oxley Act has been the first major federal legislation of corporations since the New Deal in the 1930s, taking significant power away from the states on this matter. In addition, both the New York Stock Exchange (NYSE) and the NASDAQ have improved their listing standards, and among other initiatives the PCAOB has been created to regulate the accounting profession.

In the UK the current Labour government has for the most part eschewed statutory interference in corporate governance matters,

preferring to build on the principle of voluntary compliance with non-statutory codes of conduct which was first articulated by the Cadbury Committee in 1992. Subsequent committees of inquiry into corporate governance – the most recent being the Higgs Committee in 2003 – have developed the concept of 'comply or explain', based on a set of good corporate governance practices to which all listed companies are expected to adhere; if they do not, they are required to explain to their shareholders why, in their particular circumstances, non-compliance is appropriate and justifiable. In Continental Europe, the general trend has been to follow the British example of promoting improvements in corporate governance through codes of conduct. Examples include the Cromme Code for Germany, the Preda Code for Italy and the Viénot/Bouton Reports for France. These national efforts have been reinforced at the European Union level by strong intervention on the part of the European Commission. At the end of 2004 the Commission adopted two recommendations under Article 211 of the EU Treaty. These involved: first, the adoption of a 'comply or explain' regime for listed companies to include a balance of independent directors on boards and the establishment of three board committees on remuneration, nominations and audit; and, second, a mandatory regime for board remuneration, including disclosure of individual directors' pay and a vote at the annual general meeting on the company's remuneration policy, although the vote would probably have only an advisory status. The Commission is also considering binding directives that would cover board responsibility for financial statements, publication of corporate governance rules and disclosure of transactions between directors and associated parties.

If these directives are introduced and fully implemented, they would bring Continental Europe into line with the US and UK on the composition of boards (both the NYSE listing rules and the UK Combined Code require a majority of independent directors) and on the fiduciary duties of board members. However, there is also a danger that a uniform code may be drafted at such a high level of abstraction, with considerable discretion left to the member states, as to make it ineffectual. In addition, it is not clear how these rules will be applied to Germany, where the co-determination laws require half the board seats in the largest companies to be assigned to company employees or trade union officials.

Much more controversial has been the Commission's attempt to develop agreement among member states on the subject of hostile takeovers. The market for corporate control in Europe has been underdeveloped, partly because of concentrated ownership, partly because of the extensive use of protective devices aimed at warding off unwelcome takeover bids. The Commission has taken the view that the removal of these obstacles would allow European capital markets to work more efficiently, facilitating an increase in cross-border mergers and acquisitions. As the Commission has stated,

> European-wide rules for takeover bids are considered vital to the objective of improving Europe's competitiveness, notably facilitating cross-border consolidation of industry. The Commission's aim is to create a vibrant takeover market, providing mechanisms for takeovers and changes in the management of poorly run firms, and reducing the scope for management to extract private benefits.[9]

Yet some member states, principally Germany, have strongly resisted this directive. The version that was eventually passed in 2004 allowed both countries and firms to opt out of the two main articles (9 and 11) which would have required post-bid board neutrality and allowed bidders to break through takeover defences once they had gained 75 per cent of the cash flow rights. This compromise, far from creating a level playing field, has produced greater complexity in the European market for corporate control.

The battle over the takeover directive raises two questions. Is it desirable for corporate governance in the European Union to converge more closely with US practice, and how important is it that, within the European Union, member states should be subjected to the same rules? The first is largely a political issue, and relates to the broader issue of the role of companies in society, which is discussed later in this overview. On the second, it is at least arguable, as Colin Mayer suggests in Chapter 4, that the European Union would benefit from competition between different corporate governance regimes. Corporations could be allowed to change their seat of incorporation to a jurisdiction that fits more its takeover protection needs. If investors have a clear idea about the different levels of protection that are offered, they can price their investment accordingly.

This would allow the market to pick the winning regime rather than the regulator. Examples of this can be seen in the fund management industry, where some firms split their real seat from the seat of incorporation, while others that want to signal a higher quality of regulation keep their real seat and seat of incorporation united.

Leaving aside the question of convergence between the US and Europe, and within the European Union itself, all these countries are grappling with a similar set of corporate governance problems. All of them want to improve the effectiveness of internal and external control mechanisms. The next two sections discuss the changes that are being made, or seem likely to be made, in the way these mechanisms are constructed.

Internal control mechanisms

The most important internal control mechanism is the *board of directors*. While executive directors are charged with running the firm, the non-executive directors are responsible for monitoring their activity while providing advice to the executive directors. As they meet regularly and have most information available about the firm, they are best positioned to correct arising issues early and at low cost. However, the board's effectiveness in protecting the interests of shareholders can be distorted either by dominant management (in the UK and US) or by controlling shareholder capture (in Continental Europe). For example, the US system has seen failures in monitoring by non-executive directors (NEDs) that are too close to management – often other CEOs or NEDs with material relationships in the firm. As discussed later (see Lipton in Chapter 7), the solution of complete independence (which includes cutting all social and philanthropic ties between the CEO and board members, and demanding that all should be independent) may detract from the collegial nature of the institution necessary to its function of participating in the defining and implementation of corporate strategy.[10] Lipton argues that a collegiate atmosphere, well-constructed board policies, use of outside advisers reporting directly to the compensation committee and an ethical corporate culture are the essential ingredients for the effective functioning of the board and will allow it to discharge its sometimes conflicting duties.

It is generally accepted that the independent or non-executive directors should represent the interests of shareholders, when these are in conflict with managers (or controlling shareholders). Non-executive directors are the first line of defence for the protection of shareholders' interests. However, Andrei Shleifer in Chapter 17 argues that current perspectives on the non-executive directors' duties are unrealistic, as the limited amount of time they spend on it is insufficient to be successfully involved in the management of a large company. The historical antecedents of the board are as an institution mainly concerned with preventing conflicts of interest and self-dealing by managers. The origins of the business judgement rule (see Lipton) are to protect the directors from liability for problems stemming from the day-to-day operations of the firm. Shleifer believes it is impossible to ask individuals who devote only a few days a year to the task (many of them have full-time jobs in other companies) to take responsibility for the management of increasingly complex and large public firms. Insistence on expanding responsibility and liability is likely to make the position of an independent director economically unviable, thereby reducing the available non-executive talent pool. Shleifer's solution is *ex-post* shareholder litigation – and a call to increase the rights of private actions and enforcement within the disclosure and liability rules. However, a clear cost–benefit analysis of this proposal is still outstanding. Overall, the effective functioning of the internal mechanisms, of which the board is the most important, is more cost-effective than *ex-post* failure mechanisms – hostile takeovers, proxy fights and lawsuits. These not only require expensive advisers, but divert directors' time away from their main duties.

It is now accepted practice to have at least three board subcommittees focusing on audit, remuneration and appointments. Additional committees are added depending on the individual needs of the firm. Of particular importance is the audit committee. This committee comprises outside directors, and is charged with hiring the auditors. Auditing is the essential input factor for effective governance, as it provides the information on which market participants base their decisions. A misrepresentation of the financial position is very costly to society as it leads to a substantial misallocation of capital. It also impedes the other corporate governance mechanisms from functioning.

One of the board's key responsibilities which has figured prominently in the corporate governance debate is *executive pay,* the setting of remuneration for the chief executive and other senior executives. The trend in the US since the early 1980s has been to shift from straight salary to share-based compensation, and, as Steve Kaplan points out in Chapter 5, this had the salutary effect of aligning the incentives of managers with the interests of shareholders. In some circumstances, as recent events have shown, stock option schemes can have perverse effects.

Brian Main shows in Chapter 11 that boards have often underestimated the cost of option grants for their executives, while at the same time executives value them less (due to the overconcentration of wealth) than their economic value. Historically, boards and remuneration committees saw them as free money, as firms were not required to expense and report them in some countries like the US. There, accounting policies towards stock options have changed now, and firms have to report the full costs from the middle of this year. As to be expected, this underpricing of stock options led to its oversupply. As Main suggests, it may be that the whole process of executive remuneration is structured suboptimally, with options failing to align managers and shareholders' interests. There is little individualisation of compensation packages, which thus fail to take into account individual managers' risk profiles. Managers can be significantly overinvested in a firm through their regular income and stock options and as a consequence undervalue options grants by up to 50 per cent; this may make managers also more risk-averse.

As Kevin Murphy points out in Chapter 10, Europe is trailing the US trend of increased CEO compensation in the late 1990s, both in terms of equity and cash. The lower European executive pay may reflect the fact that overall European accounting and taxation systems have better aligned the perceived and economic costs of options.

The increase in executive pay in Europe has been partially driven by increased disclosure requirements leading to a 'ratchet' effect, with each CEO demanding that he be paid as well as his colleagues. It is argued that these compensation increases were often unrelated to performance. Moreover, the introduction of compensation committees in the UK and Europe witnessed executive pay rising even more rapidly than before, as rewards were legitimised through being

subject to due process. A similar effect was seen in Switzerland, where the introduction of mandatory executive remuneration disclosure led to the explosion of executive pay. Putting aside the obvious point that compensation committees are not created to 'hold down' executive pay, these could be viewed as cases where improved corporate governance may have had negative unintended consequences.

Finally, to put all of the above in perspective, there is the deceptively simple question asked by Andrei Shleifer: should an individual who creates $50 billion of shareholder value be entitled to receive $500 million in compensation?

External control mechanisms

The *market for corporate control* has been an effective mechanism for disciplining managers in the US, and for restructuring corporate assets in a more efficient way. Hostile takeovers are a disciplining device for poorly performing management, and allow more competent managers to bring more assets under their control, thus increasing shareholder returns. It is not just a disciplining device, but one that allows the exploitation of increased scale and scope.

Although the number of hostile takeovers has declined in the 1990s, it is argued that many deals that would have been hostile a decade ago are now agreed. This is due to the evolution of directors' duties through the litigation process, and the incentive for incumbent managers to accept takeover offers through the granting of generous options packages that vest upon the change of control.

A second external mechanism is investor activism. How far can *institutional investors* bring about improved corporate governance in the companies in which they hold shares, and what impact does this intervention have on the performance of those companies? Academics are sceptical as to whether a scientific link can be proven between effective governance and performance (Becht *et al.*, 2002), as the study of these effects is constrained by methodological issues. However, this attitude can be contrasted with that of practitioners who are convinced that there is indeed a strong positive link between good corporate governance and firm performance (see Ross Goobey, Chapter 9 and Lipton, Chapter 13). MacAvoy and Millstein (2003, p. 41) state, 'it is intuitively correct that to maximise the cor-

poration's wealth producing capacity we must ensure that the accountability mechanism provided in the legal structure of the governance system works'. In fact, the practitioners are increasingly being backed up by an emerging body of research from both academia (Gompers *et al.*, 2003) and market participants (see recent surveys by ISS and Deutsche Bank/Grant, 2005).

Improving and encouraging increased shareholder activism is on the legislative agenda in both the US and UK. However, the nature of investor activism in the two countries differs and is shaped by the different rights of shareholders. In the UK, the law gives investors the right to call an extraordinary general meeting (EGM) with just 10 per cent of share capital, making the board much more receptive to shareholder proposals. It is therefore of no surprise that, as Ross Goobey points out, UK activism hardly ever has to resort to the nuclear option to call an EGM with the intent to remove management, and most of the dialogue usually takes place behind closed doors.

In the US, on the other hand, the rights of shareholders are severely constrained between annual general meetings, making it difficult for institutional investors to gain access to the board if it does not wish to cooperate. One of the few options available is to organise a very costly proxy fight, which on average has a positive effect on the share price. Other forms of US shareholder activism are voting campaigns and voting initiatives. In voting campaigns, investors vote against proposals by the management, while in voting initiatives investors put proposals of their own to the shareholders in AGMs. While the latter is the most common form of institutional activism, neither appears to have a significant effect on share prices. This can in part be explained by the nature of the most active investors, public sector funds, which are often dominated by union members or other public sector institutions. They often table proposals which do not necessarily aim at increasing shareholder value but follow other political interests and considerations. In addition, many of the US institutional investors are asset management divisions of large financial institutions that conduct business with the firms concerned, and are therefore reluctant to antagonise the management of those firms.

Meanwhile, many European institutional investors face similar conflicts of interest to their US counterparts, while in addition the

fiduciary responsibilities of boards in Europe are often unclear, making activism difficult.

An important area for future research is the rise of hedge funds – these are increasingly at the forefront of shareholder activism in both the US and Europe. In Europe they have often campaigned to ensure that securities laws be enforced by the regulator and shareholders rights protected. This is illustrated in the failed takeover attempt of the London Stock Exchange by the Deutsche Börse, which was stopped by institutional investors and hedge funds. In the US, hedge funds have gone as far as launching their own hostile takeover bids. It may be that, by leading the charge, hedge funds will encourage many of the more traditional institutions to become more activist, following the methods used by Hermes in the UK, as described by Alastair Ross Goobey in Chapter 9. Martin Lipton predicts an increase in activism in the US on such matters as the dismantling of staggered boards, poison pills and independence of directors/chairmen.

The third external control mechanism is the *legal system and external regulation*. The legal system should impose well-defined and enforceable fiduciary duties on management and directors to shareholders, discouraging self-dealing and other transactions which disadvantage minorities. Independent judges, an accessible and equitable legal system and ability to seek *ex-post* enforcement and compensation are also vital. Access to the legal system is increased through devices such as class action lawsuits, derivative suits and contingency fees, although there is also a danger of frivolous litigation.

How should the performance of companies be measured?

Underlying all these issues is the question of what are companies for: what do societies expect of their companies, and how should their contribution to welfare be judged? Jürgen Schrempp, chief executive of Daimler Chrysler, commented in a recent interview that he did not wish his performance as head of that company to be judged simply by reference to the 'bottom line'. What mattered, he said, 'is whether we have made a contribution to society'.[11] Coming from a German manager who in earlier years had been a strong proponent of shareholder value, this was a surprising comment. But it served to highlight the fact that there is no consensus about the role of companies in society.

One line of argument, presented by advocates of corporate social responsibility, is that companies should pursue a balanced set of objectives, giving as much weight to social and environmental responsibilities as to the interests of shareholders. The danger of this approach, discussed by David Henderson in Chapter 14, is that it leads to the rise of inconsistent goals for firms. From the outset it is not clear why and how a firm can serve society better by introducing a new set of social and environmental goals (which are not determined in a political process and do not necessarily reflect the will of society as a whole) rather than by maximising profits within the normal framework of laws and norms.

Even if the primacy of shareholders is accepted as the basic measure of performance, the experience of the last few years, especially in the US, suggests that the concept of shareholder value needs to be treated with some caution, and defined more precisely. Michael Jensen, a long-time advocate of shareholder value, points in Chapter 2 to some disturbing phenomena during the stock market boom of the late 1990s – the problem which he describes as the agency costs of overvalued equity. He shows that the corporate governance mechanisms which are designed to alleviate the principal–agent problem – oversight by the board of directors, and an active market for corporate control – can become ineffective when a firm's equity becomes overvalued. For example, the market for corporate control fails to function to correct excess valuations – as nobody wants to buy an overvalued firm to correct the overvaluation. Boards of directors have seemingly no idea how to react when their firms become overvalued. They cannot fire the CEO for creating 'too much value', even if it ultimately proves to be ephemeral. Boards have had little insight into the overwhelming systemic forces that kick in when equity becomes overvalued. In fact they have been part of the problem, agreeing managerial compensation mechanisms, such as the generous issuance of stock options in the late 1990s, that give senior managers clear monetary incentives to keep equity prices artificially high by whatever means possible, or what Jensen refers to as 'managerial heroin'. For example, Enron, a firm that was valued at $70 billion at its height, but was probably worth less than half of that (see Jensen, 2005). The fraudulent defence of excessive market capitalisation subsequently destroyed it.

To map the way forward, all market participants must recognise that growth in itself is not a desirable target alone, and that the maximisation of value is not necessarily identical with the maximisation of share prices. Senior managers must understand what drives value in their organisation, and align internal goals with those drivers. This might go as far as supplementing the share price-based performance pay with additional performance measures.

In general, there is a lack of language, understanding and theory of shareholder value to deal with the problem of overvalued equity. Such a new language and theory would enable firms to bring their valuation in line with realistic expectations, while not penalising the firm and its management.

Unresolved issues: where do we go from here?

In most of the countries discussed in this book, there have been improvements in corporate governance. This is due partly to improved laws and more stringent listing rules, and partly to a wider understanding of the importance of good corporate governance for the welfare of the firm and society. But there are still many unresolved issues. Looking to the US, recent problems have stemmed in particular from board-level monitoring failures, the undervaluation and overpayment of options, the inability of corporate governance institutions to deal with weaknesses in the auditing process, and the issue of overvalued equity. While some of these problems have been addressed by legislation, there is a risk that the vitality of the US financial system could be damaged by excessive regulation.

Europe has faced different problems. Short-term earnings manipulation and excessive stock option awards have been much less important than in the US. The main issues, especially in Continental Europe, relate to the protection of minority shareholders, the independence and fiduciary responsibilities of boards, and the failure to develop an active market for corporate control. A big question for the future is how far these problems should be tackled by legislation or regulation, whether at the national or European Union level.

Academic research can and should contribute to the solution of these problems. Here, we want to give some pointers about possible future research directions. This list does not represent the views of the conference participants, but rather is intended to stimulate debate about research priorities in the corporate governance field.

1. Very little is known about the costs (both direct and indirect) of the newly introduced regulation. It is possible to imagine that it would be beneficial to accept another Enron or WorldCom – given that criminal behaviour can never be fully eliminated – rather than burden business with extensive and possibly unnecessary regulation. Would greater scope for private litigation be better than further government enforcement? Another line of research should compare the costs and benefits of rules-based Sarbanes-Oxley regulation against the principles-based 'comply-and-explain' regime.
2. There is very little systematic evidence available about the functioning of boards. Most of the knowledge available is derived from catastrophic cases like Enron or Parmalat, from which we then derive policy conclusions. However, most firms function well, and most managers have no criminal intent. What is needed is systematic independent research into the functioning of a board, and its success variables. There is also a certain risk that the role of the board is pushed into the direction of a monitoring board, and loses its role as a valuable source of advice. Essentially, this would transform one-tier systems into two-tier ones. Here, this would mean considerable costs of over-regulation, as the consequence would be lower-quality decision making. Again, the debate should focus on finding the right balance between control while enabling well-measured risk taking by entrepreneurs.
3. The functions, responsibilities, remuneration and legal liability of non-executive directors should be more clearly defined, and the importance and exact definition of independence discussed.
4. Institutional activism is a potentially powerful corporate governance mechanism, but it is not necessarily used to the benefit of shareholders. What changes are needed to make this instrument more effective?
5. How far does an improvement in Europe's economic performance depend on a uniform approach to corporate governance, including the removal of restrictions which inhibit cross-border takeovers? Given the very different histories and traditions of the countries concerned, the value of competition between different national systems, as opposed to top-down standardisation, needs to be carefully assessed.
6. There are inadequacies in the auditing process, arising partly from the dependence of auditors on the companies they are

auditing. How best can the incentive structure be changed in a way that will enhance the independence of auditors and the quality of their work?

7. Further research is needed on the design of remuneration packages for senior executives, taking into account both the US experience of the last decade and the most recent studies of the link between pay, motivation and performance.

2

Michael Jensen on Agency Costs of Overvalued Equity[12]

Michael Jensen addressed the agency costs of overvalued equity, a subject that is both in contrast and a complement to his earlier work on the agency costs of just the contrary, undervalued equity. Historically, he has been a strong proponent of the proposition that the maximisation of shareholder value is the objective of the firm, and he still is.

The foundation of the Jensen view of shareholder value lies in the 1970s and 1980s, when firms in the US suffered from a multitude of performance problems. They were often not run in the interest of their owners/shareholders, which resulted in the much cited misuse of company resources. Market valuations were often below asset values. The principal–agent problem was at the core of the undervaluation of US equities.[13] However, these agency problems can be mitigated through well-structured incentive contracts and good governance systems.

It can be argued that Jensen's theory is now suffering from its own success. During the 1990s, firms were generally healthy and the economy strong. They were, in principle, managed to increase shareholder value. This was very much in contradiction to what had been observed in the two previous decades. However, towards the late 1990s, equities were increasingly overvalued as the stock price exceeded the value of the cash-generating power of the firm. This overvaluation was in part driven by the excitement of the new (Internet), but was also the result of misleading data provided by managers as the agency relationships broke down within firms, and with gatekeepers like banks and auditors.

G. Owen et al., *Corporate Governance in the US and Europe*

The strong alignment of firm performance with managerial pay, and the 'addictive' character of excessively high equity valuations created perverse short-term incentives for managers to maintain those valuations or even to drive them further away from reality. Valuations became increasingly hard to justify, while at the same time abundant cheap capital was available to firms. This situation was difficult to manage – especially when boards and managers were unaware of the challenges – and led in many cases to the destruction of parts or even all of the firm. On the one hand, this created an incentive to overinvest on a massive scale and to engage in often value-destructive M&A activity. On the other hand, as the performance targets required by the market to justify the excessive valuations were, by definition, impossible to achieve, a strong incentive was created to falsify the accounts. Managers faced with the stark market penalties associated with not meeting the market's expectations for performance often took fraudulent actions to postpone the inevitable downward market valuations.

This issue was reinforced by the fact that financial markets are expecting managers to meet their targets, and punishes those severely that miss them. Given the inherent uncertainty about forecasts, firms have an additional incentive to engage in 'earnings management' in order to meet their predictions. This implies that, in these cases, firms are forced to make economically poor decisions for the long term in order to meet the target in the short term, in the process destroying value. More importantly, firms are implicitly forced to give the wrong picture about the state of the firms in order to meet the expectation. Once started, this systematic misrepresentation, or lying, opens the door for ever bigger 'adjustments' to the accounts. In an environment of a strongly growing financial market, going hand in hand with increasingly hard to meet expectations, every report will gradually increase the degree of 'adjustment', and with it the degree of criminal activity to meet these expectations.

For example Enron, a firm that was valued at $70 billion at its height in late 2000, was worth closer to $30 billion at the time. The fraudulent defence of the $40 billion excessive market capitalisation destroyed the viable and value-generating businesses at the firm's core. Other examples of a value-destroying acquisition spree is Nortel, which in four years acquired 19 companies for combined consideration of $33 billion – only to witness its share price collapse

by 95 per cent after the bursting of the bubble. Nortel's response was to write off its acquisitions and to close most of them down. Ultimately, Nortel destroyed both the economic and social value of the firms it acquired.

Market forces should have corrected the overvaluation of equity, but they did not. Partly, this can be explained by the fact that markets had the wrong information and therefore were pricing stocks on the basis of wrong assumptions and information. More importantly though, it is risky for investors to engage in inter-temporal arbitrage and it can in fact be optimal for the individual investor to follow the market trend. Some firms that attacked the bubble, like Soros's HF fund, faltered before the market started to decline. And while the market for corporate control had solved many of the worst excesses in the previous decades, it is entirely unsuitable to attack overvalued equity through the control market, as there is no incentive to take over an overvalued target. The issue of overvalued equity cannot be solved by incentive systems alone.

Good governance mechanisms are therefore the remaining alternative that provides a solution to this problem. Over the last few years the corporate governance system failed to stop the corruption and the associated destruction of value. Efforts have been made to correct the shortcomings. However, Jensen argues that this is not enough in itself.

In what he calls the 'enlightened shareholder value' approach, Jensen argues that the business and financial community must recognise that growth in itself is not a desirable target alone. 'Senior managers must understand what drives value in their organization, and must align internal goals with those drivers, not with analysts' expectations.' It has to become clear that the maximisation of value is not necessarily the maximisation of share prices, and that there are inherent dangers in overvalued equity.

However, there is a lack of language, understanding and theory of shareholder value to deal with this problem. Jensen acknowledges that it would have been quite inconceivable to think that boards would have been open to the suggestion by management that efforts have to be made to reduce the share price, not to increase it, in particular if it was in line with the wider industry trend. Such a new language and theory would enable firms to bring their valuation in line with realistic expectations, while not penalising the

firm and its management. Value resetting, as he calls the process, would be clearly distinguishable from value destruction. In conclusion, this also means that the managerial drive to create short-term shareholder value did not create long-term firm value, and indeed in many instances actually destroyed it. He argues that one potentially valuable source of information regarding overvaluation for boards of directors can be obtained by direct communication between the board and short sellers of the firm's stock. But that would have to overcome the strong antagonism on the part of managers and boards toward short sellers.

However, as was pointed out in the subsequent discussion, there are many practical issues that have to be overcome. So far, accounting firms do not have to provide an independent valuation of the firms they audit. Consequently, it is almost impossible for boards to know what the 'true' firm value is. In addition, talking down the value of the company would increase the likelihood of a takeover by possibly overvalued companies. It was pointed out that the biggest form of 'short selling' is actually conducted by the firms themselves in the form of equity issues. But this raises deep issues about the obligations of managers and boards to treat all shareholders equally, including both current and future shareholders.

3

Jonathan Rickford on Corporate Governance Systems – How Much Convergence?

Corporate governance systems have converged to a certain degree across Europe, the US and UK. However, there is not a unified move towards a single set of global corporate governance standards, but rather convergence on selected issues and within regional blocs.

Jonathan Rickford discussed the origins and nature of the respective systems in the US, UK and Europe, and analysed how much convergence there has been, how much there will be and should be. He argued that the debate on convergence is far too often based on an imperfect understanding of different corporate governance systems, and the incorrect assumption that systems in other countries are (or should be) the same as one's own.

The nature of the corporation: origins, ownership and consequences

The legal nature of the corporation is distinctly different in the US from that in the UK, and is again different from Continental Europe (which contains its own internal variations). Therefore, analysis synthesising US and UK firms under a single Anglo-Saxon 'umbrella' (and making the traditional distinctions with Continental Europe) is often misleading.

In the US, the legal corporate status of the firm is based on a theory of concession, with the board being its residual controller. Collectively, the board maintains the power to change the articles and by-laws in many circumstances, and to approve or reject shareholder-initiated changes. At the same time, the board can

G. Owen et al., *Corporate Governance in the US and Europe*

ignore resolutions of the firm's general meeting on ordinary business, or so-called ordinary business proposals. In fact, shareholders have only very limited power to interfere with the course of the company in between general meetings, as for example, they cannot demand an extraordinary general meeting (EGM) or table proposals to the board outside the general meeting. The only residual right that remains in this case is to organise a very expensive proxy contest. De facto, shareholders rely entirely on the effective functioning of the board for the protection of their interests. The US board is seen by many as sitting at the core of any firm's governance structure. The strong position of the board faces 'absentee owners' in form of institutional shareholders with voting blocks considerably smaller than in any European country. The ownership structure reinforces the dominance of the board and often the power of the 'imperial CEO', as he sits astride, and effectively controls, the information stream to the board.

UK law on the other hand recognises the firm as an association of members (shareholders). The members are the company. The essence of the board is that its members are delegates or agents of the company's shareholders. For example, an ordinary shareholder resolution with a bare majority of those present can be employed to dismiss a board member without cause. Changes to the Articles of Association can be initiated by a 10 per cent majority (or 5 per cent in an AGM) and adopted by a qualified majority. The standard default constitution confers a power on the general meeting to give directions to the board on any matter by qualified majority. Therefore, the residual power over the firm resides with the general meeting, not with the board as in the US. Shareholders are clearly in the driving seat, with boards as contractual agents of the general meeting. The UK pattern of ownership and control is characterised by the dominance of large institutional investors, with much greater levels of holdings as compared with Continental Europe. This, combined with the mandatory shareholder powers, means that a few institutions are in a position at any time to threaten the board and thus exercise control. The power of the institutions is also reflected in the regulatory environment. For example, the City Code on Takeovers protects shareholders from two-tier bids,[14] boards that erect post-bid takeover defences, and distributes control premiums equitably. The scale of pre-emption rights and the adherence to the

one share, one vote principle are further examples of such influence. US regulation on all these issues differs substantially. In the UK, most of these conventions and rules started out as 'self-regulation', but have subsequently been backed by the force of law. In turn this has reinforced institutional investors' power in the UK.

In Continental Europe, a strong state concession theory underlies the origins of corporate law, and is articulated in the stakeholder perspective with a clearer focus on a 'public interest' as opposed to the primacy of shareholders. This broad generalisation, however, encompasses many different systems across the continent, and with it many different 'shades' or styles of corporate control across the many countries in Continental Europe. For example, the supervisory boards dominated by banks in Germany began as state surrogates. Therefore, issues of residual control are more opaque than in the US and UK. Ownership and control structures are still typically dominated by families, banks and the state. There is a widespread suspicion about the benefits of shareholder control. This manifests itself in the real seat doctrine, which states that the choice of law should be governed by reference to the location of the real seat, or centre of economic activity. There should be no corporate 'cuckoos in the nest' established in that state but operating under the law of an alien jurisdiction.

Tools: rules, best practice and self-regulation

Comply or explain, the UK's innovative system which combines self-regulation with legislation, has been a model for other countries. Overall a set of norms, which are recognised as best practice, are laid down as general standards while giving firms the flexibility to divert from the stated norm if it is out of line with its business model. When diverting from the norm, firms have to give an explanation justifying why they cannot or should not comply. It is legally mandatory under the Financial Services and Markets Act (2000) to explain such divergences. In turn, this facilitates market (and particularly shareholder) regulation, as the requirement to report exceptions allows market participants to examine the motivation and consequences, while allowing greater scope for innovation and flexibility where non-compliance is justified. However, the effectiveness of this system is driven by the UK ownership and institutional structure

which gives greater influence over the board of directors to institutional investors than in either the US or Continental Europe. The overall effect has been increasing compliance with the norms in the codes, although with some notable exceptions such as Rupert Murdoch's decision to adopt a father and son relationship for chairman and CEO role in BSkyB. However, the system has its flaws and can break down when market participants have conflicts of interest as has been demonstrated in the area of board remuneration, where institutional investors' managers may be unwilling to 'rock the corporate boat' or may be the direct or indirect beneficiaries of excessive policies themselves as directors or senior managers of listed companies. The future for UK corporate governance is likely to entail more of the same – emphasis on CEO discipline, increased independence for the chairman, and more pressure on shareholders to be active.

The US style of mandatory securities regulation – the Sarbanes-Oxley rules (which apply to British and European companies listed on Wall Street) – is a threat to such best practice regulation of corporate governance. For example, the mandatory Sarbanes-Oxley audit committee consists entirely of independent directors and imposes a uniform board structure in that respect. It also drives out the European principle of collegiality by putting the audit committee in the driving seat. Ironically, the New York Stock Exchange maintains a 'comply or explain' regime for foreign registrants.

Post-Sarbanes-Oxley, the future of reform in the US seems likely to entail more rules and regulations. But there is evidence of a trend towards convergence in some respects. For example there is increasing questioning of the wisdom of the 'imperial CEO' (for example in the Breeden Report on Worldcom).

The supervisory or non-executive component of boards in France and Germany tends to be relatively weak – for example, it is rumoured that the supervisory board of Daimler was only briefed on the merger with Chrysler the night before the deal was announced publicly. French boards share some characteristics with US ones, often being dominated by powerful PDGs (*président-directeur général*). Reforms already show a strong degree of convergence on the UK model, increasing the monitoring capabilities and independence of boards but adopting the flexible 'comply or explain' approach. However, this will differ across countries. Such moves will be impeded by the split nature of the board in Germany and the partici-

pation of worker directors (who are clearly not independent) on the supervisory board. There has been a trend towards greater choice of board structures and divisions of power in France, Germany, Italy and Spain.

Regulators, judges, markets: liabilities and standards

In the US, directors' fiduciary duties are towards the firm itself, and not shareholders. The Business Judgement Rule developed by the Delaware courts gives power to the management along with stakeholder statutes, indemnities and poison pills. However, while strong legal remedies do exist for shareholders, the introduction of indemnification for boards acting in good faith has reduced the scope of such actions and the development of the 'pill' has weakened the threat of takeovers. Easy exit, through the sale of the shares, can be a less costly solution in light of the free rider problem. However, there have been recent indications that the Delaware Chancery Court may be moving in the reverse direction again by adopting a broader concept of 'bad faith'. This may restore value to the derivative action.

In the UK, shareholders are the company. The expected codification of directors' fiduciary duties should lead to their strengthening. While legal remedies are weaker than in the US in respect of procedural availability, this is offset by a more active takeover market and stronger institutional investor voice.

Directors' fiduciary duties are weak in Continental Europe, although there are various structural responses to minority protection. The criminal law has often substituted for shareholder and board governance; examples are the cases of Rosenberg in France and Mannesmann in Germany. Recent proposals for stronger shareholder remedies in Germany appear to be encountering opposition and have been withdrawn.

Conclusions

A certain movement of convergence of corporate governance standards can be observed across Europe, the US and UK, but it has not been uniform in character and has rather been centred around diverse issues. While uniform rules have the benefit of raising the

standards of corporate governance, their mechanical application can also carry costs for some firms. A certain degree of flexibility in terms of the application of these rules is beneficial.

4

Colin Mayer on Corporate Governance Systems – How Much Convergence?

Competition between states with different corporate governance frameworks could be beneficial, as it enables firms to choose the most appropriate place of incorporation for their business model. Against this background, it is not surprising that difficulties have been encountered in trying to implement a European Takeover Directive. Opposition to it reflects fundamental differences of view about the role of markets in corporate control in promoting capital market efficiency and the rights and obligations of shareholders.

A brief history of convergence and divergence

At the beginning of the twentieth century, there was a high degree of convergence around market-based financing, and its requisite corporate governance structures. For example, both Germany and the UK had thriving stock markets at the beginning of the twentieth century, with significant numbers of initial public offerings. The total number of companies listed on the Berlin stock exchange alone was approximately 2000 in 1910 compared to 700 on all German exchanges today.

The high level of stock market activity at the beginning of the twentieth century had an effect on the concentration and control of the companies involved. The pattern of convergence towards market financing of firms could be found across the world. Countries that had high levels of family ownership, such as the US, Japan and Canada, witnessed this dissipation over the next 30 years. This trend only began to reverse itself during the economic woes of the 1930s,

G. Owen et al., *Corporate Governance in the US and Europe*

with an increased role of the state in countries such as Japan and Germany. However, the major differences in ownership and control that we witness today are a post-Second World War phenomenon of the 1950s and 1960s. Subsequently, European ownership structures appear to have been stable.

Therefore, the twentieth century saw a dramatic convergence in the first half, followed by an equally dramatic divergence or reversal in the second. Corporate Europe has now reached a point where there is again significant pressure pushing the divergent systems of finance and governance towards convergence. Some of this pressure is from across the Atlantic via Sarbanes-Oxley and other US listings regulation. However, the most important source of convergence in Europe consists of directives from the European Commission.

The European Takeover Directive

The Commission views investor protection as vital to developing an effective and integrated European capital market, and this strategy is most evident in its policy on European corporate governance and takeovers.

In the area of takeovers, it is the aim of the European Commission to increase the pressure on firms to change and it views the breakdown of barriers in the European market for corporate control as essential for the establishment of an integrated European financial market. With this in mind, it introduced the takeover directive, adapted from the UK's City Code on Takeovers. The takeover code enshrines strong principles of investor protection in the takeover process including a mandatory bid threshold, equal price provisions, principles of board neutrality, prevention of post-bid defences and pre-bid statutory ones such as poison pills (because of pre-emption rights).

The European Directive was aimed at facilitating the replacement of poor management and the breakup of traditional family and corporate ties in Europe. Lack of a level playing field was viewed as an impediment to European restructuring, and raised issues of fairness. It was also a further step towards an integrated European capital market, creating benefits such as a lower cost of capital.

To achieve these aims, the directive dealt with a number of technical issues designed to protect minority shareholders such as mandatory bid thresholds, equal price provisions, squeeze-out and

sell-out rules. However, the legislation also contained two more controversial articles. Article 9 enforced post-bid neutrality, which would prevent the creation of defences once an offer had been made, without the approval of the shareholders.

European firms already have significant impediments to hostile takeovers – dual share classes, pyramids, staggered boards, cross-shareholdings, voting rights caps, golden shares, etc. Therefore, the European Commission suggested a breakthrough rule to deal with some of these barriers in Article 11. This stated that an acquirer with 75 per cent of the cash flow rights can break through any voting rights and share transfer limitations at this level.

After 12 years of consultation, the takeover directive was rejected by the European Parliament by the smallest possible margin in 2001. The parliament objected to the ban on post-bid defences, lack of employee protection and the failure to achieve a level playing field with the US. The proposal would have dealt with voting rights restrictions and dual share classes – but left other devices which distort the distribution of voting and cash flow rights, such as pyramids and non-voting shares, untouched. Countries that employed these devices argued that the directive would create an even more uneven playing field.

Eventually, the Commission was forced to introduce a series of exemptions as a political compromise to ensure that the Takeover Code was passed by the European Parliament. These were as follows:

1. Member states are not required to adopt Articles 9 and 11.
2. If a state does not adopt them, firms within that state can go ahead and opt in. However, they would also have the option to opt out again.
3. If a firm has opted out, it cannot use the breakthrough provision to acquire a firm which has opted in.

Ultimately, the directive creates even greater variation and complexity in the market. Firms that want to protect themselves from bids can incorporate in countries that opt out of Articles 9 and 11, while those that want to pursue cross-border acquisitions will gravitate towards countries that have adopted the articles (although they can adopt them at the firm level even if their home country has opted out). Therefore, diversity will persist at both the country and firm levels.

This compromise reflects the fact that uniformity is very hard to achieve where states have differing perspectives on the takeover process and the role of the corporation in society. The Commission viewed the code as an instrument to create more efficient ownership and control structures. On the other hand, many member states viewed corporate ownership and control as embedded in their national production and social structures. These reflect the differing competitive advantages of nations. For this fundamental reason, the European Union will continue to have a diversity of governance and financial systems. Convergence is more likely to be driven by competition between these regimes, than by directives from the Commission.

Freedom of incorporation vs the real seat doctrine

In this context, there is a strong argument that the market, and not the regulator, should pick the winning takeover regulation. In fact, regulation should promote diversity and encourage freedom of movement and incorporation across borders, and let the market decide about the best fit between particular firms and industries on the one hand, and takeover regulation on the other.

Competition implies that firms must have the freedom to incorporate in the country of their choice, which may or may not correspond with the location of the business, or their main area of activity. According to the freedom of incorporation principle, firms have the ability to split the seat of incorporation from that of their economic activity; however, according to the real seat doctrine they do not.

This trend towards competition between diverse systems is likely to be further intensified by developments in the European court system. In a series of landmark judgements, the European Court of Justice has begun to define the degree to which firms should be free to reincorporate across borders. The court has decisively undermined traditional Continental European legal principles that firms should be incorporated where their real activities and/or headquarters are located. In the Centros case (1999), the court ruled that firms are free to choose their location of incorporation irrespective of the location of their productive activities. Therefore, they can choose to reincorporate in locations where governance structures are most efficient for the firm.

There are natural costs of regulation that are borne by savers, financial institutions and the users of capital (firms), and there might be benefits in varying degrees of takeover regulation, while at the same time a predefined standard of investor protection remains as given across Europe.

It is sometimes argued that regulatory competition leads to a run to the bottom, resulting in weaker corporate governance, and weaker protection of (minority) shareholders. Despite some differences in systems, a comparison with the US is helpful. The difference constitutes itself in the form that competition in the US is within the system and in the EU between systems. This situation has some parallels with the US in that it incentivises efficiency of legal design, although such analogies should not be taken too far. The US has competition between states within an overarching financial/corporate system which has efficiency as its guiding principle.

Europe presents competition between systems marked, as already discussed, by differences in the nature of corporations, identity of shareholders (families vs institutions), size of their shareholdings, takeover defences and the ability of boards to self-elect. European firms will now be faced with the option of migrating to a country where they can create more effective takeover defences or to leave one to escape social legislation. For this system to work, investors must have a clear view of the level of protection they are being offered through the different national regulatory systems in which firms are incorporated. Therefore, disclosure requirements are key.

The fund management industry (collective investment schemes, money market funds and hedge funds) is one area where we increasingly see such a split between real seat and the state of incorporation. While firms still operate out of London, they are incorporated either in Dublin or Luxembourg to benefit from more lenient regulation. Other funds that want to signal a higher standard of regulation do not follow this trend and remain incorporated in London.

Conclusion

In conclusion, there are clear benefits to diversity as contrasted with a uniform system of legislation. Attempts to harmonise Europe's takeover regulation have failed. Freedom of incorporation may allow firms to undertake a matching of corporate activities with legal regimes, and encourage efficiency in legal design. It is unlikely

that convergence will arise through the imposition of uniform regulatory systems, but as a consequence of competition between diverse regimes.

5

Steven N. Kaplan on the State of US Corporate Boards and Governance: What is Right and Wrong?

Since 1980, the structure and overall performance of US corporate boards appear to have improved in terms of setting executive compensation, monitoring CEOs and independence of top management. The large increase in the equity component of executive compensation has been an important part of this shift as it has significantly increased senior managers' focus on the creation of shareholder value. US boards, however, have performed less well in a number of key areas, particularly monitoring accounting manipulation and effectively valuing the options granted to senior executives. Recent reforms have had a positive effect on these issues (although they have imposed a substantial increase in compliance costs, particularly in the short term). Boards can still go further in improving executive compensation by restricting the liquidity of options grants and expensing all stock options.

The US corporate governance system as a whole is better than its reputation. It has been unfairly demonised in light of recent scandals such as Enron, Worldcom, Tyco, etc. A relentlessly negative picture has been painted by both the media and academics of ineffectual boards, imperial CEOs and the fraudulent destruction of billions of dollars of equity value. However, an examination of US corporate performance versus the rest of the world tells a very different story. Over a 10- or 20-year time frame, US stock markets have outperformed both Europe and Asia. The same holds true for the period of January 2001 to December 2002 when many of the high-profile corporate governance scandals emerged. Over the same periods, US productivity grew faster than that of the rest of the world.

G. Owen et al., *Corporate Governance in the US and Europe*

Naturally, stock prices and productivity gains are influenced by many factors outside the control of management. Therefore it is difficult, if not impossible, to establish a clear causality between US corporate performance and the role of boards. However, it is safe to say that any shortcomings of the governance system have not caused US companies and markets to underperform other global markets.

Incentive compensation

Among the key tasks of any board is to set the compensation level for the management, to structure their performance incentives, to hire and fire the CEO, and to advise top management. Boards appear to have significantly improved their performance in all these areas over the last two decades. Before 1980, performance measures for senior managers focused on accounting measures such as growth in earnings per share or sales growth, variables that are not necessarily aligned with the creation of shareholder value (see Donaldson and Lorsch, 1983; Jensen, 1993). Compensation was mostly cash based. The median compensation for an S&P 500 CEO was $1 million (inflation adjusted) in 1980. Managerial equity ownership was low, and options grants infrequent. More than half of all CEOs of S&P 500 companies did not receive any equity-based compensation. This reflected the fact that shareholder interests were not the primary focus of boards or managers. Managers often regarded themselves as representing the corporation as an entity in itself, and having the duty to balance the interests of stakeholder constituencies. Directors, therefore, were not particularly active in protecting shareholders' interests, and did not create incentives for management to do so.

However, by the early twenty-first century, the median compensation of an S&P 500 CEO was $6 million; the equity-based compensation component of the typical CEO package had increased to 63 per cent. The level of CEO pay had increased by a factor of six, and the equity sensitivity of the average CEO's pay packet had increased by a factor greater than ten times (Hall and Liebman, 1998; Hall and Murphy, 2002).

The effect of this shift towards equity-based compensation has been a strong alignment of the CEO's and senior managers' interests with those of shareholders, creating clear incentives for manage-

ment to focus primarily on the creation of shareholder value. This trend has been subsequently followed by firms in other countries. For example, Hall and Murphy (2002) found that the European firms award by now almost as many options to their CEOs as North American ones. Equity-based/option compensation has also been widely utilised by private equity investors. Both points underline the effectiveness of equity-based compensation packages.

Beyond shifts in CEO incentive structures, board monitoring practices also appear to have changed significantly. Twenty years ago, boards were often dominated by management, and their monitoring was ineffectual. Today, boards are increasingly likely to fire CEOs, as well as hire senior managers from outside the firm (Huson *et al.*, 2001). CEO turnover for S&P 500 firms rose from 12.5 per cent (1996–99) to 17.6 per cent (2000–3).

Boards have also become smaller, more independent and more aligned with shareholders (as the equity component of directors' compensation has risen in line with that of the CEOs they monitor from virtually none in 1980 to over 60 per cent in the late 1990s). Board actions, composition and compensation, therefore, have changed in ways that most observers would view as positive. In fact, these changes were recommended in an influential book by Lorsch and Maciver (1989).

However, in light of the harsh critique of board performance over the last few years, the question remains, have the improvements in board performance gone far enough? There are a number of dimensions in which boards have failed or could have done better. The fact that share options are difficult to value and, in the past, did not have to be expensed, led some boards to make options grants that were sometimes extravagant. The median CEO compensation figure may be $6 million, but the data include a number of awards of over $100 million which were viewed as controversial. Examples include awards made to John Chambers at Cisco and Michael Eisner at Disney.[15] These large awards seem to be far greater than would have been necessary to retain and motivate those CEOs.

In turn, this sometimes lavish component of equity-based compensation created a perverse incentive for senior managers to manipulate and smooth accounting earnings. Boards found it difficult to monitor these accounting manipulations. And boards tended to place limited restrictions, if any, on the liquidity of the options they

granted managers, allowing the managers to cash in their options at any time. Therefore, while boards have increased their effectiveness since the early 1980s, there is still room for further improvement. This is something directors themselves consistently acknowledge. Surveys for Korn Ferry in 2002 (pre-Sarbanes-Oxley) and McKinsey in 2004 found that directors wanted to increase their ability to monitor.

Effects of reform: making a good system better

Three positive shifts in board practices have occurred subsequent to the introduction of the Sarbanes-Oxley Act of 2002 (and reflected in NYSE and NASDAQ listing rules), which effectively address these board shortcomings. First, Sarbanes-Oxley requires the audit committee to hire the outside auditor. This entails the auditor working for the audit committee (and its chairman), rather than for senior management. The committee itself must be made up of outside directors with no financial ties to the firm. The legislation has also strengthened the independence and expertise of the committee chairman. Therefore, going forward it should be more difficult for management to manipulate financial statements and for management to pressure auditors to allow them to do so.

The second positive reform was the creation of a requirement for regular executive sessions. These are meetings of independent board members – without management present – and chaired by the senior independent director. This allows all directors to pool information more easily and to discuss possible future problems freely. Directors had found this difficult in the past, as they had to inform the CEO if they wanted to hold such meetings. For example, Jack Welch vehemently opposed such independent sessions when he was CEO of General Electric. In contrast, his successor Jeffrey Immelt has moved towards creating executive sessions and appointed a senior independent director even before there was a regulatory requirement to do so.

Finally, the recent trend of compensation committees to hire their own independent consultants makes it more difficult for managers to manipulate their own compensation schemes.

The primary offset to these improvements, however, is Section 404 of Sarbanes-Oxley which should be viewed as a less successful component of the new regulation. This clause imposes very strict

requirements for internal controls and appears to be extremely costly – in top management time and attention, in auditor costs, and in favouring reporting skills and form over innovating skills and substance. Although these compliance costs are likely to decline over time, it is not at all clear that the costs generate much in the way of direct benefits.

It also is possible that ambiguities in new and existing legislation – particularly in those areas that can be interpreted as contradicting state corporate law – may expose managers and directors to increased civil and criminal liability which, in turn, will adversely affect their attitude towards risk, experimentation and investment.

Conclusions and future reform

Overall, the effects of recent corporate scandals have largely been to make a good system better. The primary caveat to this conclusion is the increase in compliance costs and the potential risk of additional excessive regulation.

While it is not clear that the median levels of executive compensation are excessive, particularly since they are in line with comparable jobs in investment banking, fund management and private equity, there is still room for improvement. Top executives should be paid well when they perform and not so well when they do not perform. To strengthen this, boards should restrict the liquidity of options grants, as is the case for managers in leveraged buyouts. While requiring managers to hold substantial amounts of stock, boards should cap the number of options they can exercise and shares they can sell in any one year. Executives should also be prevented from hedging their own stock positions via the derivatives market. These measures would ensure that executive compensation is aligned with the long-run performance of the firm, and reduce the incentive to manipulate earnings for short-term financial advantage.

In addition, all options issued by the firm should be expensed, and reported in the firm's income statement. This allows all parties – board members, shareholders and managers – to fully understand the costs of compensation, and is likely to reduce the most egregious and uneconomic awards of equity-based compensation.

6

Paul Davies on Boards of Directors: the European Perspective

UK company legislation has traditionally had a paradox at its heart. While it has been highly prescriptive in terms of laying out the residual rights of shareholders, it is silent on the role of the board of directors. This gap has been filled in recent years by the introduction of the combined code on corporate governance. The implications of the code, with its emphasis on the monitoring role of non-executive directors, are to push the UK towards a de facto two-tier board system. Similarly, many European countries are introducing choice, between one- and two-tier boards, as to the optimal board structure.

Under UK corporate legislation, there is limited prescription for the structure, composition and functioning of the board of directors of a public company, other than the fact that it has to have a minimum of two directors (under the Companies Act 1985). There is a statutory requirement that the board produces annual financial reports for shareholders. The law in this respect is currently being changed, subsequent to the Company Law Review,[16] to add forward-looking and soft data to the mandatory reporting requirements. However, even with these reforms, there is very little guidance on how the board should discharge and balance the managerial and monitoring functions upon which it must report annually. Absence of statutory guidance and regulations on these issues contrasts both with the presence in the UK statutes of powerful mandatory regulations on the removal of directors by an ordinary majority of shareholders, and with the highly prescriptive nature of Continental European legislation.[17]

G. Owen et al., *Corporate Governance in the US and Europe*

Shareholders in the UK have the legal power to tell the board what to do at any point in the financial year, not just at the AGM, if a large enough group can coordinate their actions. Therefore, they are guaranteed the ultimate residual control of the board, but the board itself has no statutory guidance as to how it should operate. Again, this contrasts with many Continental European jurisdictions. For example, in Germany there are over 40 sections in the company law legislation dealing with the duties and functioning of the supervisory board.[18]

Moreover, in the UK this perspective is not altered if one examines the evolution of case law. Take, for example, the law of negligence. The courts have traditionally formulated the standard of care of directors in highly subjective terms, while there are indications that the law is evolving towards an objective standard of care. For example, in recent litigation, the directors of Barings Bank were disqualified essentially on a theory of negligence. The Court found that the directors were negligent in not putting in place adequate reporting systems in relation to the bank's Singapore activities.

The rise of the code: from managing to monitoring

Therefore, this black hole relating to the board's composition and structure still exists in the UK in relation to the legislation, but has been filled by the combined codes on corporate governance which started with Cadbury in 1992. Overall, this is a positive development as the code is relatively flexible with its 'comply or explain' provisions, and firms can opt out entirely by delisting. However, the introduction of the Combined Code emphasised the board's monitoring function for the first time, complementing the traditional role of setting corporate strategy. On a functional level at least, this moved the UK towards the traditional European two-tier board.[19]

The Code was a response to a number of Enron-style corporate collapses that had taken place in the UK in the late 1980s such as Polly Peck and Maxwell. These cases had occurred because there had been insufficient board-level scrutiny over powerful CEOs. The perception that lack of effective monitoring is at the heart of the corporate governance problem has survived subsequent reviews. For example, Hampel in 1996 was sceptical as to the Cadbury approach, and questioned whether monitoring was getting in the way of the

board's primary function of driving the business forward.[20] However, throughout the 1990s, the number and role of independent non-executive directors have increased to a point where post-Higgs they should constitute 50 per cent of the board, and there is a very strong recommendation to separate the chairman and chief executive roles.

A consensus seems to have arisen. Research by the UK Company Law Review suggests that levels of compliance with the Combined Code norms by UK companies are high, and that corporate behaviour has changed in that it has imposed a higher level of CEO turnover on poorly performing firms. However, the jury is still out on whether the Combined Code has had a significant impact on performance.

One- and two-tier boards, and the German exception

The question remains of the implications for one- and two-tier boards of the Combined Code. However, this debate on the effectiveness of both structures may be passé if you accept monitoring as a major function of the board. The monitoring function of the upper board in the two-tier system was emphasised as one of its major advantages, but this obligation is now built into the one-tier system. Therefore, the distinction is much less important than it used to be.

The one exception relates to the German system of co-determination which is mandatory under the Corporate Law Act (*Aktiengesetz*). This employs both a supervisory board (*Aufsichtsrat*) which monitors and a management board (*Vorstand*) which leads the firm and sets strategy. Employee representation is found on the *Aufsichtsrat*. Therefore, German boards are not solely concerned with managing relationships with shareholders, but also have a wider role relating to the historical processes of networking and labour contracting. Since the nineteenth century, appointment to the supervisory board was intended to nurture relationships between the firm and other financial (suppliers of capital) and non-financial institutions which are key stakeholders. The legislative intent behind the mandatory imposition of the two-tier system in 1870 included the protection of the public interest. The networking function fitted in effectively with the protection of a notion of the public interest, as did the

later introduction of employee representation in 1920 and again in 1952. In both cases this reform was intended to promote national solidarity after the social collapse of Germany subsequent to the two world wars.

It should be noted that many commentators, such as Pistor (1999), view German co-determination as a socio-political model with governance externalities. The overall effects of the system on social governance are positive, while the effects on the control of management are negative. This is because the antagonism of the social governance structure is incorporated in the firm's governance structure, preventing coalition building with shareholders. Instead, it institutionalises a tripartite structure consisting of management, employees and shareholders, giving management the strongest role in choosing its coalition partners.

Moreover, there are questions regarding the effectiveness of monitoring by the supervisory board. For example, Hopt (1998) notes the inadequacy of information flows from the management board to the supervisory board, as well as from the chairman of the supervisory board to other board members. There are also issues relating to the effectiveness of the supervisory board in relation to its large size, infrequent meetings and underdeveloped structure of the board committees such as audit, nominating and compensation.

Placing networking functions aside, the question is whether monitoring is best performed by directors who are responsible for setting corporate strategy as in the one-tier system, or whether it is better to put the directors charged with this function on a separate board as in the two-tier system. The unitary board scores highly in terms of information flows, although this is less true if the only executive on the board is the chief executive. In the UK, the latest version of the Combined Code (Higgs), states that there should be a strong presence of executive directors, while at least half the places should be taken up by non-executive directors. This is designed to provide the non-executive directors with a number of sources of information on the management side. However, there is always the danger of a form of 'regulatory capture', i.e. that those who both set and monitor the strategy of a firm will become too committed to it to be critical monitors.

Therefore, the choice between one- and two-tier boards in Europe is not clear-cut, and certainly should not be a matter for legislative

prescription. Europe has been moving in the right direction by giving firms much more choice between structures. In fact, proposed European legislation makes the choice between one- and two-tier boards mandatory. Here France led the way in the 1960s by giving firms the option of adopting a two-tier structure. Some 20 per cent of CAC 40 firms have adopted a two-tier structure which is quite significant, although the French system does not mandate similar levels of employee representation to Germany. The reforms of 2001 have added the option of an alternative one-tier structure which separates the roles of chairman and CEO, and mitigates the role played by the *président-directeur général*, who traditionally presides over both management and supervision. Therefore, French firms have a number of options to introduce more effective monitoring. The Italian reforms of 2003 are along similar lines.

Conclusion

There has been a degree of convergence between board structures across Europe. The UK started off leaving board structure, composition and function entirely to corporate choice. However, it has now moved towards regulation since the Cadbury Code was introduced in 1992, albeit flexible in nature. Because of the increased emphasis on the monitoring function, UK boards have moved in the direction of European two-tier boards, at least functionally.

On the other hand, Continental European countries have traditionally had mandatory rules relating to board structures, but have now introduced an element of choice by increasing the number of options available to firms in terms of structuring their boards – ironically with the exception of Germany.

7

Martin Lipton on the Role of the Board of Directors

In general, the function of the board of directors is both to help define the strategy of the firm, and to monitor its implementation. However, to balance these sometimes conflicting roles, a collegiate board culture is necessary. An overemphasis on director independence could detract from the board's ability to function effectively. Maintaining a balance between the roles of monitor and coach, and creating an ethical corporate culture, enables the board to discharge its other duties efficiently, including CEO compensation, succession planning and investor relations. Looking forward, the nature of the board structure continues to evolve, and the rising influence of institutional investors will likely lead to the dismantling of some traditional takeover defences such as staggered boards and poison pills.

American corporate law states that the firm is 'managed' by, or under the direction of, its board of directors. This description does not differentiate between the functions of monitoring and disciplining management on behalf of shareholders, and helping to define corporate strategy and coach its implementation. There is a general consensus that a combination of these two functions is optimal. However, such a combination can only be successfully implemented by a collegiate board. The importance of collegiality must not be overlooked, especially in light of some of the more extreme definitions of director independence currently being proposed.

G. Owen et al., *Corporate Governance in the US and Europe*

Setting and monitoring corporate strategy

A key board function is the approval of management's long-term strategy for the firm. Corporate strategy should initially be formulated by senior managers, and then be improved through an interactive process with the board. This can differ among firms, with individual boards determining which issues they should focus on and how to allocate time and responsibilities. Overall, it is essential that the board achieves a balance and resists the temptation to place too much emphasis on the monitoring function at the expense of its role in the development of corporate strategy.

Director independence

There is currently too much emphasis on board independence. This is to the detriment of promoting a dynamic well-functioning board and effective partnership with senior management, which ultimately benefits shareholders. The NYSE, after thoughtful consideration, decided to require only that a majority of directors be independent. Nevertheless, many shareholder advisory services, institutional investors and academics are continuing to urge that all directors, other than the CEO, be independent, and that social and philanthropic ties among the directors and the CEO be considered as impugning independence. These requirements are the antithesis of the kind of collegiality that is necessary for the board and CEO together to promote the appropriate tone at the top, to agree on corporate strategy and to work collectively to enhance the firm's competitive position. The concept of the board as remote strangers and as the agency for the discipline of management, rather than as a partner in setting a strategic course, will not lead to better performance. Tension between the new norms of independence and the overarching objective of better performance, unless modulated and maintained in perspective, can cause the former to overwhelm the latter.

Creating corporate culture

The other vital function of the board is participation in defining the firm's corporate culture, and ensuring that senior managers set a tone and carry out their functions within the expectations of this

culture. These duties include codifying the ethical considerations of managerial decision making. Codes are an effective form of communicating ethical values across the organisation, and once communicated there should be a zero tolerance policy for non-compliance. Codes can help to define relationships with other constituents such as customers, suppliers and the community in general. Equally, they can also be used to set a tone resistant to external pressures for unethical behaviour, particularly the short-term temptation to engage in creative accounting to meet financial markets' quarterly earnings expectations.

If an efficient balance between monitoring and coaching can be maintained, and an ethical corporate culture defined, the duties of directors can more effectively be discharged and controversial issues dealt with smoothly. These include the following.

Separation of chairman and CEO roles and succession planning

Firms now have the option of having a non-executive chairman of the board. However, this is not mandatory, and both ISS and TIAA-CREF leave this decision to the discretion of the board, provided there is a lead director who presides over its executive sessions. The board should also play an active role in grooming an internal successor to the current CEO. Succession planning should be a primary function of the non-executive chairman or lead director.

Executive compensation

The setting of executive compensation is currently one of the most controversial tasks facing boards. To maintain its independence, the board should retain independent compensation consultants, who report directly to it. Compensation decisions should be driven by the principles of rewards for performance and retention needs. Areas such as severance provisions (golden parachutes) and retirement benefits such as the non-disclosed use of corporate aircraft and apartments need to be scrutinised further.[21]

Information flows

To meet its duty to monitor performance, the board and management together need to determine the information the board should receive. Here, 'more can be less'. The board should not be overloaded with information, and it is not necessary that it receive all data that the CEO and senior management receive. The board

should get financial information that enables it to understand results of operations, variations from budget and trends in the business, the corporation's performance relative to peers, and any other information that the board determines to be useful in its work.[22] The whole monitoring process should be subject to annual review and opinion of counsel as to its adequacy.

Committee functions

The work of the board is facilitated by establishing the appropriate relationship between the board as a whole and its committees. This prevents the work of the committees being duplicated by the board, while allowing the significant actions of the committees to be understood by the board as a whole and integrated into its overall work.

Sarbanes-Oxley requires all public companies to set up audit, compensation, governance and nomination committees. Where appropriate, firms should move to set up other standing committees including an executive committee, risk management, compliance and public responsibility. Special investigation committees can also be useful in relation to extraordinary events such as shareholder litigation, hostile takeover bids and proposed management buyouts. Special independent counsel services should be made available for the board and its committees, where appropriate.

Crisis management

Boards must be proactive in dealing with governance, compliance or business crises affecting the firm. At the same time, they need to be cautious not to overreact to any given situation and thereby create a crisis. In most instances, when a crisis arises, the directors are best advised to manage events as a collegial body. Outside advisers (counsel, auditors, consultants and bankers) can play a useful role in getting at the facts of a given situation and shaping the right result. However, the directors should maintain control and not cede the job of crisis management to outsiders.

Investor relations

With the rise of proxy advisory organisations, corporate governance scorecards and increasing investor activism via Rule 14a-8 resolutions[23] and campaigns to withhold votes for directors, boards should regularly review the firm's shareholder relations programmes.

Where there are performance or compliance issues, direct board contact with shareholders may, in some cases, forestall a proxy initiative. In addition, the corporation should weigh carefully opposition to shareholder proxy resolutions that can be accommodated without significant difficulty. It is prudent to do a risk–reward analysis of shareholder resolutions rather than to routinely oppose them.

Consideration of major transactions

Consideration of major transactions (acquisitions, mergers, spin-offs and new financings) needs to be carefully structured so the board receives the information necessary in order to make a reasoned decision. The firm may have the internal expertise to analyse the requisite data and present it in a manner that enables the board to consider the alternatives and assess the risks and rewards. In these cases the board is fully justified in relying on the management presentation without the advice of outside experts. Overall, experience shows that a major transaction is best addressed by the full board. There is no need for the board to create a special committee to deal with a major transaction, even a hostile takeover.

Looking forward

The basic concept of the board of directors is changing. This entails an informal evolution not to a two-tier board structure, but to a de facto three-tier one. Boards now comprise directors who serve on the audit committee, which is a 'super board' in relation to transparency and compliance, and directors who serve on the compensation and nominating committees. Senior managers will meet internally once a week. Meanwhile, the board of directors meets approximately once a month, and its committees are meeting more frequently than in previous years. The rise of the three-tier structure has implications for the increasing independence of directors and power of institutional investors.

In the next decade the US is likely to follow a UK model as institutional investor influence increases. The power to withhold votes from directors will give the institutions significant leverage. The results will be that public firms will increasingly unstagger their boards, separate the offices of CEO and chairman and redeem poison pill defences.

8

Roberta Romano on Institutional Shareholders and Corporate Governance in the US

Public sector funds like CalPERS and NYCERS are the most activist investors in the US. They mainly employ voting initiatives to make their voice heard. However, empirical studies demonstrate that such initiatives have no impact on corporate performance; in cases where funds are entitled to subsidies for their voting initiatives they actually destroy – on average – shareholder value.

Institutional investors are becoming increasingly active over corporate governance issues. They employ three main strategies to make their voice heard. Firstly, voting campaigns related to proposals put forward by management (which they are often required to submit to shareholders under the by-laws of the corporate charter and increasingly under securities legislation). US institutional investors have begun to vote 'no' or withhold their votes on issues such as the election of directors (for example, the recent campaign to withhold votes from Michael Eisner and George Mitchell at Disney). Secondly, voting initiatives with the aim to place shareholder proposals on corporate ballot papers. This can be done at no cost to the sponsor if qualified under Securities Exchange Commission (SEC) proxy rules (14a-8). Finally, proxy proposals/contests which allow shareholders to remove the board of directors. Here the sponsor bears the full costs, which are often considerable, although some state laws allow reimbursement if the contest is successful.

G. Owen et al., *Corporate Governance in the US and Europe*

Investor activism and voting initiatives

The second form of investor activism, voting initiatives, is an inexpensive method of institutional shareholder activism. These initiatives are primarily undertaken by public sector pension funds in the US. Three in particular are the most active: the California State Pension System (CalPERS), the New York State System (NYCERS), which is controlled by the State Comptroller, and the Wisconsin State System (SWIB). These are joined in their activist stance by TIAA–CREF, the general and pension funds of the US school and university system, and also the funds of the labour unions federated under the AFL-CIO. From 1986 until the early 1990s, public pension funds accounted for over 20 per cent of all proposals. In recent years, the unions have tabled an increasingly large number of initiatives (an estimated 300–400 in 2003 alone).[24]

Roberta Romano (2002) looked at the objective of voting initiatives over the 1980s and 1990s. These voting initiatives can be categorised into four main groups:

1. Enhancing the independence of board directors. Such proposals often included the nomination of more outside directors, or reorganising the structure of board committees;
2. The elimination of takeover defences such as poison pill charter amendments and staggered boards;
3. Restricting executive compensation;
4. The introduction of confidential voting.

However, even among the most activist funds, there are differing focuses of emphasis, and these emphases change over time. For example, CalPERS's recent proposal activity has been focused solely on board independence and the removal of takeover defences. NYCERS has pushed the takeover defence issue, along with shareholder communication (particularly shareholder access to board members) and executive compensation. TIAA–CREF has also focused on executive compensation, while the AFL-CIO has as well, unsurprisingly, pushed this issue. The unions have also focused on board and auditor independence and offshore incorporation, representing a broader political agenda that is not necessarily shareholder value enhancing.

Investor activism and performance

A review of the empirical literature finds that investor activism has an insignificant effect on the performance of the firms targeted. In the seven studies of proxy proposals reviewed, there are no significant performance effects found using both risk-adjusted short- and long-term stock prices and accounting measures of earnings. Nine studies on the performance effects of negotiated outcomes found mixed results. These were positive in the early years, but negative later. Only the studies focusing on proxy contests, the most drastic and expensive form of shareholder activism to remove the board, discovered strongly positive performance effects. Interestingly, firm performance improved even if the dissident shareholders lost the proxy contest. This can be explained by the fact that even unsuccessful proxy battles will create a change in strategy such as asset disposals or the dismissal of the CEO. However, proxy contests are far more expensive to mount than shareholder initiatives.

Categorising the proposals by objective, for example proposals dealing with independent boards, executive compensation and confidential voting, one finds that the actions proposed in these categories themselves have no significant positive performance effects. The performance effects of the defensive tactics that are the substance of proposals relating to the lifting of takeover defences were variable, depending on the time frame, and were often firm-specific. These findings provide a plausible explanation of the absence of any performance effects from activist investors' introduction of proposals.

The implications of the performance review literature are stark. As we have seen, investor activism has on average no effect on share price performance. Therefore, the question arises as to why so much time and effort are devoted to activities that at the least are non-value added, and may even be value destroying considering the subsidies from all shareholders involved. The answer to this question can be found in the nature of the most activist institutions. These are public sector pension funds, not private ones. Also, as highlighted earlier, labour unions are tabling increasing numbers of proposals that do not necessarily enhance shareholder value. In fact, these institutions and the individuals within them often receive private benefits such as enhanced political reputation, collective bargaining goals, and progress on labour rights in the case of unions

that are not extended to other shareholders, and may actually harm their interests.

Restrictions on investor activism

The incentives and private benefits received by public and union funds contrast with the perspective of private sector funds. While these are clearly focused on shareholder value, they are faced with a free-rider dilemma. If they incur the costs in time and resources to undertake effective activism, they do not receive benefits distinct from other shareholders. The fact that most public corporations in the US are widely held, with average voting blocks of less than 5 per cent, only heightens this problem. Private institutions also face the potential loss of assets under management as the firms they take an activist stance against switch their pension funds to other managers in retaliation.

Moreover, there are regulatory restrictions on the activities of private pension and mutual funds. For example, when Fidelity increased its activism in the 1980s, it was prosecuted for insider trading, and faced scrutiny by a Congressional Committee. Even CalPERS has encountered a similar problem, and as a result now more carefully tailors its proposals to issues that will meet regulatory and popular approval. These factors may also have discouraged a widespread use of the more effective proxy contest mechanism.

In conclusion, private sector funds bear the full costs of undertaking the activism, possible loss of funds and political/regulatory scrutiny in relation to any value generated for a small stake in a balanced portfolio. Meanwhile, the performance benefits are split between all shareholders. Because of these issues, a quiet exit becomes the optimal strategy for dealing with an underperforming firm in an institutional investor's portfolio.

Proposed reforms

Reform proposals include the removal of subsidies investors receive once they table proposals under the SEC proxy rules. An SEC survey in 1997 found that the average proposal cost $87,000 in terms of managerial time of assessing it, presenting a response and distributing documentation to shareholders. Romano (2002), surveying

1997/98 data, calculated that the aggregate cost of all shareholder proposals ranged between $315 million and $2.1 billion.[25] Although ultimately these costs are marginal compared to the capitalisation of US public markets, the figures do not include costs expended on omitted proposals. Moreover, costs will have subsequently risen as the number of proposals put forward has risen significantly between 1997/98 and today.

One option would be to withdraw the subsidy unless the proposal is successful, or receives a certain percentage of the vote (for example more than 40 per cent). This would shift the financial burden of proposals back onto the activist shareholder. The underlying logic of this proposition is to create a better cost–benefit analysis and incentivise institutional investors to forward more shareholder value-maximising proposals. The greater the value created by a proposal, the more support it should receive from other shareholders. Ironically, reforms currently proposed by the SEC, such as the shareholder access proposal, will have exactly the opposite effect.

Conclusions

Empirical evidence demonstrates that a growing form of institutional shareholder activism, shareholder ballot proposals, is ineffectual in improving corporate performance. One explanation is that the institutions that utilise this instrument are public sector funds, and are often not forwarding propositions that create shareholder value. In turn, this would suggest their principals may be pursuing other private benefits such as political advancement. A significant reform to incentivise these funds to forward more value-maximising proposals would be to reduce the subsidy they receive for tabling proposals. This is in contrast with the more costly proxy contest mechanism, which does create value for shareholders.

9

Alastair Ross Goobey on Institutional Shareholders and Corporate Governance – a UK Perspective

In the UK, both public and private sector funds are more engaged in pragmatic investor activism as compared to the US, as they do not face the same conflicts of interests. Unlike in the US, British pension fund trustees are legally independent, and are not an extension of the CFO's office. Dialogues between shareholders and firms take place in the context of the 'nuclear option', the right of shareholders of calling an extraordinary general meeting within three weeks with 10 per cent of the votes.

From an academic perspective, the link between good corporate governance and firm performance is not strong. However, there is a growing body of literature from market-oriented institutions demonstrating that good governance structures outperform bad ones. For example, a recent study by Professor Lawrence Brown of Georgia State University, sponsored by Institutional Investor Services, found that firms with poor governance structures in the US have lower returns over 3-, 5- and 10-year periods, than comparable firms with good governance structures.[26] Deutsche Bank has conducted research on the same topic in Europe with similar conclusions.

From Alastair Ross Goobey's career experience, he is convinced that good governance matters, even if it cannot be proved to the satisfaction of many academics. Over his career as an institutional investor, he has witnessed positive changes in corporate governance in the UK, particularly from the 1970s onward with the introduction of professional non-executive directors on boards replacing traditional appointees such as aristocrats, generals and admirals.

G. Owen et al., *Corporate Governance in the US and Europe*

Hermes Focus Fund and shareholder activism in the UK

Ross Goobey has spent his career as an institutional investor in the UK and managed one of its largest institutions, Hermes, the manager of the British Telecom (BT) and much of the Royal Mail pension schemes, which own approximately 1.5 per cent of the UK equity market and manages £50 billion. The size of its holdings often meant that it could not just proceed with a quiet exit from firms with governance problems. Having taken a more activist stance for a number of years, a separate Hermes Focus Fund was set up in 1998 as a purely activist fund with a strong emphasis on corporate governance. The fund management business is 100 per cent owned by the BT pension fund to insulate it from external pressures. However, the Funds (a UK large cap, a UK small cap and a continental European Fund) have also attracted substantial third-party commitments from both the public and private sectors across the world, who view them as a means of fulfilling their fiduciary responsibilities.

Hermes Focus itself invests in underperforming firms with a view to changing the governance structure (or elements of it such as the board, management or strategy), and/or capital structure of the firm concerned. Hermes employs approximately 50 people focusing on corporate governance issues, 10 times more than any other fund in the UK. The skill sets of its employees are often completely different from most fund managers, and it is a very labour-intensive business requiring substantial expertise and investment. Taking this into account – on top of the conflicts of interest that most large financial services organisations face in this area – activism can be very problematic.

Hermes corporate governance-focused investment process

When Hermes Focus has identified an undervalued firm, it analyses the soundness of the underlying business to decide whether there is a value creation opportunity by changing the governance structure. If there is, Hermes will approach the executive management and talk to them about their views on the firm's strategy. Sometimes the management are willing to engage the fund in dialogue. However, if they do not progress with the management, they then will approach the chairman and non-executive directors. Hermes makes it very

clear that their proposals are just that, and it is the board's ultimate decision as to whether to accept them or not. If not, Hermes is very open to hearing other ideas on how to improve shareholder value. Eventually, if no progress is made, other institutional investors may be engaged and the process is escalated. The ultimate sanction is to call an extraordinary general meeting (EGM) and vote out the entire board. Ross Goobey has only witnessed this once in his career. The firm involved was a small investment company, but this residual power illustrated the big difference between the options available to institutional investors in the UK and US to influence a board. Therefore, US shareholders are relatively disadvantaged, as they lack the 'nuclear option' of calling an EGM within three weeks with just 10 per cent of the vote.

Institutional differences between the UK and US

In the UK, and in contrast to the US, private sector pension funds are as active as public ones (e.g. local government). This situation is helped by the fact that the separation of powers between the trustees of the pension fund and the corporation itself is clear-cut, as the trustees are legally independent. For example, at the BT pension scheme, BT nominates four trustees, and four are nominated by the unions and are presided over by an independent chairman. In contrast, US pension fund trustees are a department of the CFO's office. Consequently, UK trustees are much more independent from the firm and cannot be bullied into favouring their own firm. In cases where firms addressed the chairman of BT about Hermes's activities, he correctly directed their complaints towards the trustees of the pension fund as a legally independent entity over which he had no power. Under the UK Pensions Act 1995, a corporate pension fund must consult with the firm itself regarding its investment policy and asset allocation, but has no duty to go any further. This limited duty was inserted into the report that led to the Act by Ross Goobey himself.

Public sector pension funds also take an activist stance as do the insurance companies. Therefore, coalition building is easier in the UK between public and private funds than in the US. Other private funds are happy to have Hermes stir things up. This is not to say that such coalitions are never deployed in the US. For example,

Highfields Capital Management will often look at firms that have underperformed, and then organise a small group of three or four investors with approximately 15–20 per cent of the capital, to prompt the firm to change strategy, or even a takeover. Therefore, they try to build shareholder coalitions which can talk to management quietly, without being designated a concert party, and will often be joined in these coalitions by public sector funds such as TIAA–CREF. This approach is closer to relational investing as practised by Warren Buffet. If they fail in this approach, they will have to disclose their shareholdings and discussions with management.

Another method allowing shareholders to place pressure on management has been the recent campaigns to withhold votes to re-elect certain directors (for example, the withholding of votes from CEO Michael Eisner and George Mitchell in the case of Disney). Many of the non-executive directors have placed pressure on the CEOs to deal with the issues, by threatening to resign. However, withholding votes is not as powerful as being able to vote out the entire board. Although such events are rare, as discussed, this power allows investors to place substantial pressure on firms. Moreover, coalitions in the UK can be formed between the independent directors and the investors against senior management, with the independent chairman and certain board members attempting to remove senior management.

Conclusions

Shareholders in the UK are much better positioned to express their voice thanks to both the legal independence of the pension funds themselves, and the residual power they have to call an EGM with 10 per cent of the share capital.

10

Kevin J. Murphy on Executive Compensation: Is Europe Catching Up with the US, and Should it Do So?

Executive compensation has risen sharply over the last few years in both Europe and the US, although the level of compensation in the US is still considerably higher than in Europe. The steep rise in compensation is driven in part by the ratchet effect induced by more stringent disclosure rules, and in part by inefficiencies in, and governance failure of, the CEO hiring process.

Historically, detailed compensation disclosure requirements existed only for the US, UK and Canada, limiting the extent to which European compensation characteristics could be studied and compared with the US. A new data set, compiled by the compensation consultants Towers Perrin, should help to get a closer insight into the current executive compensation trends in both Europe and the US. Towers Perrin consultants in each country were asked to quantify the typical pay package of a CEO presiding over an average manufacturing firm with US$300 million of revenues. Structuring the question in this way helps to control, to a degree, for pay differences across industries and different firm sizes.

The focus of this research is to establish if Europe is catching up with the US in terms of executive pay, and if so whether this is a desirable outcome.

Is Europe catching up with the US?

The results of the most recent Towers Perrin survey, covering the years from 2001 to 2003, demonstrated significant shifts in both

G. Owen et al., *Corporate Governance in the US and Europe*

the size and composition of executive compensation packages in Europe.

European CEOs were able to considerably increase their compensation in this relatively short time frame. The highest increase was in Switzerland, where CEO pay went from an average of US$405,000 in 2001, to US$1.1 million in 2003, an increase of 194 per cent. Germany witnessed the second largest increase with pay rising from US$455,000 to US$955,000, an increase of 110 per cent. A number of other European countries saw average pay increase between 40 per cent and 70 per cent over this two-year period. At the other end of the scale, executive pay in Belgium was flat at US$679,000.

There has been a significant upward movement in executive compensation in Europe over the two-year period. We can explain this via the widespread introduction of long-term incentive plans. In 2003, they were standard in 80 per cent of Swiss and 95 per cent of German firms, versus about 20 per cent in 1997. The main component of long-term incentive programmes are stock options.

Increased disclosure was another important driver behind the rise in compensation. The new-found transparency led to a ratchet effect on pay, with every CEO demanding to be paid at least as well as his 'colleague'. These pay increases were often unrelated to performance, and superfluous.

While we witnessed a dramatic increase in executive pay in Europe in these two years, the average US compensation is still about twice that of the highest paid executive in Switzerland. It amounted to US$2.25 million on average.

United Kingdom vs magic kingdom – continuing divergences

A single example from the US illustrates the gap between Europe and the US, particularly in relation to the top end of CEO income. For example, in 1997 the top 500 CEOs in the UK earned in total US$537 million, of which US$417 million was cash and US$120 million was equity compensation. This can be contrasted with the salary of one CEO in the US: Michael Eisner of the Walt Disney Corporation earned US$576 million, US$6 million of which was in cash and the rest in stock options which he exercised that year.

Putting this single example into a broader context, the average salary of an S&P500 CEO rose from US$3.5 million in 1992 to

US$14.8 million in 2000, and since then fell again to an average US$8.8 million in 2003, or about the level of 1997. After an initial dramatic rise in stock options, they are now being gradually replaced with restricted stock programmes. The main reason is that many of the options granted are out of the money (i.e. worthless) and had to be replaced with more material remuneration.

Another major difference between the US and Europe is that, in America, the dispersal of options down the corporate hierarchy has been much greater. In 1992, the average S&P500 firm rewarded its employees with options worth US$22 million; in 2003 the total came up to US$100 million. At the peak of the last stock market boom in 2000, this sum amounted to a total of US$240 million. Of that, approximately 90 per cent went to management and 'ordinary' employees, about 5 per cent to the CEO and another 5 per cent to the five highest-ranking managers underneath. However, the income spread between the average worker and the CEO has consistently widened over time; from about 25 times in 1970 to over 100 times in 2003.

A number of issues can help to explain the continuous increase of executive pay. For one, the number of senior executives hired from outside the firm has increased dramatically since the mid-1980s. External hiring costs a premium and CEOs increasingly come to the negotiating table with their own agents in a manner similar to movie or sports stars. Compensation committees are often ill-equipped to handle such sophisticated bargaining. Also, a number of strategic mistakes weaken the position of the compensation committees further. For example, they choose (and even publicly announce) the prospective CEO before they negotiate. This shifts enormous bargaining power into the hands of the candidate and his advisers. Moreover, the compensation committee often abrogates its responsibilities, placing detailed compensation negotiations in the hands of the senior vice president of human resources. This creates an obvious conflict of interest and hence a serious corporate governance issue, as the VP will end up reporting to the new CEO.

Governance solutions

To correct these deficiencies, compensation committees must take control of the processes, policies and procedures for hiring senior

managers – and no longer allow these to be subsumed within the corporate human resources function. Directors should not view themselves as employees of the CEO, and automatically ratify the decisions of senior management. The directors on the compensation committee should retain outside compensation consultants who report directly to them.

Directors also need to tackle the problems presented by options. In the US, these have often been lavishly disbursed. Boards often regarded them as practically free, as there was no accounting cost, no initial cash outlay, and until recently it was not required to get shareholder approval. The firms even received tax benefits. As the decision making about options was based on the perceived costs being practically zero, and not the true economic costs, boards naturally granted too many options to too many people.

In the future, boards must understand and communicate to shareholders the full costs as well as the benefits of equity-based compensation plans. The cost of stock options should, and under new accounting rules will, be recognised on the firm's accounting statement and expensed straight away. Directors also need to understand the costs (and benefits) of broad-based options grants to employees – as these are often very bad value for risk-averse, underdiversified employees. There are no studies that have documented any benefits to dispersing stock options lower down the corporate hierarchy.

Conclusion: should Europe catch up?

In regard to the aggregate size of executive compensation, this is ultimately a question of how much wage inequality a country wishes to bear. The US system has always been more tolerant of greater inequality, particularly based on performance, than the European one. In this regard, Europe faces a classical trade-off between a bigger pie with fewer slices versus a smaller pie with more slices. However, in relation to stock options, European tax and accounting systems have been more rational, better aligning economic and perceived costs. Therefore, instead of catching up, Europe should spend more time learning from mistakes made in the US when designing its own compensation systems.

11

Brian G. M. Main on the Question of Executive Pay

Current executive compensation appears to be structured suboptimally in many ways. This is partly the outcome of the inefficient use of stock options, which are undervalued by both executives and the board; the over-reliance on extrinsic versus intrinsic motivation, and structural weaknesses in the compensation negotiation process. In empirical research and in the practical design of compensation, a more holistic approach is needed – one that takes into account the underlying assumptions of design, the prevalent institutional influences, and the psychology of human motivation.

Executive compensation has been studied extensively since the 1970s, theoretically based on the principal–agent theory and empirically based on extensive data provided by increasing disclosure requirements on CEO pay in the US. While there is, in principle, a well-functioning labour market for CEOs, there are also clear imperfections that cast doubt on the efficiency and effectiveness of the current compensation programmes. For example, a meta-analytical study by Tosi *et al*. (2000) found that size explained on average 40 per cent of variances in CEO compensation, while performance only related to 5 per cent.

It appears that the misalignment of corporate compensation structures is rooted in incorrect assumptions that underlie compensation schemes. These assumptions are products of the prevalent institutional influences and basic psychology of human motivation.

G. Owen et al., *Corporate Governance in the US and Europe*

Are options plans inefficient?

One major reason for the misalignment of compensation is that options are more costly to both the issuer and employee than is often realised (see Murphy in Chapter 10). They are viewed by boards as a low-cost compensation mechanism, partly because of favourable accounting and tax treatment.

The second important issue is the cost borne by executives receiving these options as compensation. Managers are not marginal portfolio investors with widely diversified holdings. Instead, they are significantly overinvested in the firm through their human capital, current equity holdings and outstanding options. Therefore, options are of less value to the employee than their economic costs, with discounts ranging from 30 per cent to 50 per cent.

Executives perceive options – rightly – as risky, for which they seek compensation. Two forces influence this perception. Firstly, higher volatility of the underlying stock means higher risk to the individual overinvested executive (who, with human capital and much financial capital tied up in the fortunes of the firm, is far from the stereotypical widely diversified portfolio investor). Consequently, the executive seeks additional compensation for such risk. In addition, as a significant proportion of the compensation package is now based on the value of volatile stock, senior managers have a strong incentive to focus on managing income and to smooth the stock price, and with it their own inter-temporal income stream. This might influence management to be more cautious in their decision making, and might be in conflict with optimal risk taking from a firm's perspective and with its shareholder value maximisation strategies.

Therefore, an optimal compensation package needs to take account of the personal characteristics of senior managers, including their financial situation, assets and liabilities, current equity holdings and stage of career. The board should consider the positions of individual executives when awarding options, and not a stereotypical average. It is also important to ask how far the share price has to rise to compensate for the extra assumption of risk for each individual assessed. Therefore, it is the differentiated structures of the compensation package that are most important in aligning principals and agents, rather than the aggregate size of a compensation reward. A recent survey of FTSE 350 senior executives confirmed

that – for the majority – the effect of options issuance was to make them more conservative (Skovoroda *et al.*, 2004).

To summarise, options are more expensive for the firm than often perceived by the board, but are also undervalued by senior managers. In addition, options skew the incentive structure for managers so they become more risk-averse, leading to possible overall welfare losses. Options certainly do not perfectly align the interests of managers and shareholders in a widely held firm.

Institutional context

In general, the compensation setting process remains free of much statutory guidance in the US and UK, and thus places great discretion in the hands of boards of directors, and particularly those directors who comprise the remuneration committee.[27] Doubts are often cast on the effectiveness of the Anglo-American unitary board in avoiding CEO capture. The chief executive derives considerable influence via the withholding of resources and control of information, or equally through persuasion and social influence in a collegial environment. The unitary board is also charged with the dual role of advising the CEO on setting strategy, and monitoring its implementation which could be perceived as creating a conflict of interest.

Within this socially constructed environment, board members often focus on issues of dealing with uncertainty and enhancing legitimacy. The best way to do this is by imitating what others have done and following precedents. When remuneration committees were introduced in the UK, many believed that this step would hold down executive pay. In fact, it had the opposite effect of legitimising higher pay awards, as these were perceived as having been subject to due process.

Psychological factors

Evidence from the field of psychology has emerged which indicates agents react to compensation plans in a way that contradicts traditional principal–agent theory. Until the early 1990s, executives were paid like bureaucrats, however as Murphy has shown, a considerable variable performance-related component has now been introduced

to executive pay (Murphy in Chapter 10; Jensen and Murphy, 1990).

A recent survey by Beer and Katz (2003), for example, found that senior executives react much less to extrinsic motivation (e.g. monetary compensation as a measure of praise and recognition) than anticipated, and that even the highest paid executives are motivated to a large degree by intrinsic motivation (competence, self-esteem and a sense of accomplishment). This would seem to suggest that too much emphasis is placed on extrinsic motivation, as opposed to intrinsic motivation, in the design of pay awards.

Remuneration committees, while driven by institutional factors to follow other comparable examples for the purpose of gaining legitimacy, are often led to believe in the central importance of extrinsic motivation. Board members often demonstrate an extrinsic motivation bias. They believe that others, as compared to themselves, are more driven by external rewards and they act accordingly in designing executive pay packages.

Currently, we see a trend towards both increasingly complex and large compensation contracts for CEOs. This may actually have a negative effect on managers' individual performance. The effectiveness of intrinsic motivation is dependent on the agent feeling in control of his own situation and destiny; if large extrinsic rewards make agents feel they are being controlled this may, in fact, lead to a decline in intrinsic motivation, and hence a decline in effectiveness. Greater extrinsic rewards might in fact do more harm than good, and be economically inefficient.

Conclusions

Executive compensation appears to be badly aligned with performance. This can be explained in part by the mispricing of options grants. Equally, there are significant information and motivation failures within the institutional context of the board and its remuneration subcommittee. These incentivise directors to deal with the inherent uncertainty of setting compensation by enhancing legitimacy through adherence to precedent. In turn, research in psychology indicates that these processes may destroy shareholder value, as large extrinsic rewards destroy the intrinsic motivation, and so have an adverse effect on managerial effectiveness.

Options mispricing can be corrected thorough greater individualisation of the issuance process to take account of the personal characteristics of grantees. However, institutional failures would indicate that broader reforms of the assumptions underlying processes and mechanisms are necessary.

12

Sean O'Hare on UK Compensation Trends

While the UK is in general following the compensation trends set in the US, its shareholder approval process of top management compensation is less formal and mechanical. In turn, this allows more firm-specific flexibility. Changes to the UK tax law that considerably lower the ceiling on tax-favoured pension arrangements from April 2006 will have an important impact on the compensation structure of UK executives in the near future.

The UK is, in general, following the US lead in terms of executive compensation. Traditionally, options were the main long-term incentive with grants to chief executives in the UK amounting to about one to two times base salary. Currently, the 'standard' award is approximately two times salary per annum under an option plan, and in addition executives also benefit from alternative performance share plans with an average award of one times salary. However, in some extreme cases during the heyday of the late 1990s, some companies obtained shareholder support to award packages amounting to up to 12 times salary. The current political environment and increased media scrutiny have recently led to a moderation in executive compensation.

Over the last two years, the largest 100 UK firms (FTSE 100) have shifted to performance share plans (award of free shares which vest after three years subject to performance conditions) and in addition there has been a significant increase in the use of deferred annual bonus plans (part of the bonus is used to acquire shares which are

G. Owen et al., *Corporate Governance in the US and Europe*

mandatorily held for at least three years). The number of firms employing these schemes has gone up from about 20 per cent to 65 per cent.

The role and responsibilities of non-executive directors have been more precisely defined over the last few years. Consequently, their newly defined roles and responsibilities are leading to increased time commitment and public scrutiny, and we are beginning to see the fees for this group increasing significantly.

The aim of incentive contracts in many companies is not to change people's behaviour, but rather to enable the motivation and retention of key individuals over a significant period of time. The principle is to pay a fair reward for work that would be done anyway.

The executive pensions crisis?

There are dramatic changes in the structure of executive pension schemes that have not received adequate publicity. Currently there is no limit on tax-approved final salary pension plans. Rather it is a function of base pay in the last year (or in some cases three years) before retirement. As base pay has increased this has resulted in some significant pension plans for executives, with the disclosed plans being as large as £15 million. However, the government has announced a ceiling on these tax-favoured pension plans of £1.5 million from April 2006 onwards. Many executives will therefore receive a significantly lower pension payment after retirement unless companies compensate in some other element of the package. Many companies are already considering how this might work post-2006.

Differences between the US and UK

Boards/remuneration committees and institutional shareholders spend greater time discussing individual executive remuneration plans in the UK than in the US. Boards in the UK also work very closely with consultants such as KPMG to prepare presentations which are given to the top eight to ten shareholders before an AGM. These institutions therefore actively engage themselves in the design of compensation packages.

In contrast, companies engage less with institutional shareholders in the US and have historically relied instead on putting matters to a vote at the AGM. This, however, is changing and shareholders are encouraging US companies to explain in more detail the rationale for new plans and consider amendments before putting such plans to a vote at the AGM.

In a small way therefore we are seeing convergence of UK and US practice.

13

Martin Lipton on the Role of the Corporation in Society

As a corporate lawyer involved in a number of the major takeover battles of the 1980s, Martin Lipton has influenced the jurisprudence of the law regulating mergers and acquisitions. In 1982, he created the 'poison pill', a takeover defence mechanism that provided many target firms with the means to withstand some of the more rapacious corporate raiders of that era. Subsequently, Mr Lipton has continued his advocacy of a wider role for the corporation in American society.

The business corporation in the US has undergone a rapid transformation in the twentieth century. Until the unification of the American national market at the end of the nineteenth century, most corporations were owned and managed by entrepreneurs and their families. Faced with the need to raise capital to exploit new opportunities for scale and scope, but hindered by the owner's wealth constraints and risk aversion, corporations moved to widely held ownership structures with professional managers. However, these managers often continued to retain strong ties to the founders and maintained traditional relationships with local board members and strong identification with the surrounding communities. The primary focus of senior managers was to balance the interests of corporate stakeholders such as employees, customers, suppliers, communities and even the nation itself.

In the 1970s efficient market theory, principal–agent models and a focus on short-term returns came to dominate academic research in finance. At the same time, the rise of the market for corporate control provided a testing ground for many of these theories.

G. Owen et al., *Corporate Governance in the US and Europe*

Influenced by academic theory (see Jensen in Chapter 2) and the poor performance of the US economy in the 1970s, the US went through a period of significant corporate restructuring in the late 1970s and 1980s. Managers of public corporations divested many of their historical relationships. Boards become more independent of traditional ties, although not necessarily of management as they were often composed of other CEOs. The primary focus of managers shifted from balancing the interests of corporate stakeholders to a narrow focus on the maximisation of the share price. This focus was further strengthened by reforms which tied executive compensation to share price performance (see Murphy and Main in Chapters 10 and 11).

Legal background

This evolution in corporate focus has taken place in the context of shifting legal constraints. In the twentieth century, these included the creation of anti-trust, consumer protection, environmental and labour regulation. These areas were all subject to a degree of consensus across developed economies. However, the role of the corporation in society, defined as the obligations of the board to other constituencies beyond the shareholders, remains controversial, and this is one of the key differences between models of market capitalism across the world. This issue has been dealt with at two key points in US corporate jurisprudence – firstly, in relation to directors' duties to multiple stakeholders in general and secondly in relation to their obligations to stakeholders when faced with a hostile takeover offer.

The business judgement rule

The business judgement rule protects directors from personal liability in discharging their duties if they have acted in good faith, with due care and within their authority. It also highlights director primary duties towards shareholders. Under *Dodge* vs *Ford Motor Company* (1919), the Michigan Supreme Court declared that they would not scrutinise boards' decisions on how to maximise profits, if they comply with the criteria which shield directors from liability:

> a business corporation is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or the non-distribution of profits among shareholders in order to devote them to other purposes.

Therefore, decisions which did not maximise profits would be subject to judicial scrutiny.[28]

The hostile takeover era

The 1960s witnessed the rise of conglomerates – a form of multi-business organisation that was supposed to allocate capital more efficiently than the market. By the 1970s, investors had become disillusioned with conglomerates and their value-destroying deals and internal capital markets, which allocated capital inefficiently often by political criteria rather than effective hurdle rates (see Schaferstein and Stein, 1997). Investors also realised that diversification of risk could be more efficiently created through a balanced portfolio of individual securities than via conglomerate structures. Therefore, hostile takeovers began to gain respectability as a way of releasing value from moribund corporate structures. Henry Manne published his seminal article describing the market for corporate control in which management teams compete to run public firms, in 1965.

The watershed hostile deal in the US was International Nickel of Canada's bid for EBS, partly due to the fact that the deal involved two blue chip firms, and also because Morgan Stanley, one of the corporate establishment's main investment banks, agreed to advise the predator.[29] Moreover, the 1970s also saw the rise of the junk bond (or subinvestment grade bond). This allowed 'creative' entrepreneurs to go after established firms, often with the intention of 'breaking them up' to release shareholder value.[30]

However, an increasing number of bids forwarded by raiders were two-tier or front-loaded ones. This meant that the raider offered a higher premium for the shares he needed to gain control, than for the rest of the outstanding share capital.[31] These offers often

unfairly induced shareholders to tender quickly rather than lose out on a significant premium.[32] This mechanism also prevented boards from searching for better offers. In turn, many of the deals were financed via junk bonds secured on the assets of the firm being taken over, which clearly had important ramifications for other stakeholders including legacy creditors, suppliers, customers and employees.

Business judgement rule and the poison pill

With a significant rise in the volumes of hostile activity, the question arose as to the duties of directors when faced with a hostile bid. Martin Lipton was called to advise a number of boards on these duties when on the receiving end of a hostile offer.[33] He informed them they had discretion to reject such offers, not only on the basis of the short-term benefit to shareholders, but also taking into consideration the impact on other constituencies and the long-term influence on the firm. This perspective was articulated in a seminal article in the *Business Lawyer* in November 1979. Mr Lipton argued that boards were well within their legal duties to turn down takeover offers for a myriad of reasons including price of the offer, its legality or concern for the effects of the takeover on the firm's employees and their community. Therefore, boards were under no 'absolute duty' to accept offers and the business judgement rule should be applied. Such decisions are not so different as to require a 'unique sterilization of directors in favour of direct action by the shareholders' (p. 104) – a takeover bid is no different from 'any other fundamental business decision' (p. 120) – thus should be reserved for the board. Therefore, a board should take account of all the major issues to pass the reasonableness test and discharge its legal duties – including looking at impact on employees, customers, suppliers and others with relationships with the firm. To give boards the ability to effectively reject such offers, he created the poison pill (the ability of the firm to issue stock to dilute the raider's stake) as a defence strategy.[34]

Constituency theory vs the rule of passivity

Mr Lipton's beliefs have fundamentally influenced his legal practice and brought him into vigorous debate with some of the pre-

eminent finance academics and advocates of shareholder value maximisation such as Michael Jensen at Harvard – (see Jensen's testimony during the *Household* case), Frank Easterbrook at Chicago (Easterbrook and Fischel, 1981) and shareholder activist Bob Monks (Rosenberg, 1999).[35] This perspective became known as constituency theory and contrasted with the rule of passivity as put forward by the Chicago School. This held that, faced with a hostile offer, the board should step back and be passive. They can only advise shareholders not to tender, and not take frustrating actions such as finding a white knight or launching litigation.[36]

Individual states had enacted anti-takeover statutes which allowed boards to frustrate hostile takeovers. However, the Supreme Court declared many of these unconstitutional in *Edgar* vs *MITE Corporation* (1982). The court declared that the Williams Act, passed by Congress in 1968, should be the primary legislation regulating the takeover process. The Act gave corporate boards just a 20-day respite to consider an offer and organise post-bid defences, which was too short to be effective.

Legal challenges were made against poison pills and the actions of directors in rejecting takeover offers. In two landmark cases in 1985, the legality of poison pills was upheld. Firstly, in *Unocal* (1985) the Delaware Supreme Court declared that more general defensive tactics were 'reasonable in relation to the threat that the board rationally and reasonably was posed by Mesa's [the raider] inadequate and coercive two-tier tender offer' (Wasserstein, 2000, p. 239). In justifying the decision, the court stated that the business judgement rule applied to directors' duties in relation to takeover defences. In essence, this meant that directors would not incur liability in taking the decision to reject a takeover bid as long as there are no conflicts of interest on their part and they discharged their duty of care. However, the court subjected directors to an enhanced duty of care and a test of reasonableness in relation to the threat faced. In formulating their decision, the Delaware courts drew on Lipton's article to justify their ordering of the takeover process.

In the *Household* case (1985), the Delaware Supreme Court upheld the legality of the defendant's poison pill.[37] This landmark decision set the poison pill up as a common defence in corporate America. Thus, the Delaware courts ordered the takeover process in light of differing stakeholder interests within the corporation itself. The

subtle balancing of interests can be illustrated in the court's decision to emphasise the necessity of the proxy mechanism for shareholders to ultimately remove the board if they disagree with its decision to reject a takeover bid.[38] Research has shown that the Delaware regime enhances firm value (Daines, 1999).

Subsequently, constituency theory became law. Following this, a majority of states passed statutes permitting directors to consider the interests of non-shareholder constituencies in making managerial decisions. These statutes expressly provide directors with the discretion to consider the interests of other constituencies.[39]

Conclusion

Mr Lipton continues to debate the more general role of the firm in society, questioning whether the corporation has been transformed from an institution of long-term wealth creation to one whose course is charted by the short-term concerns of financial markets, which may have a 'deeply flawed' pricing mechanism. Controversy remains over the introduction of corporate by-laws allowing shareholders to dismantle poison pills. Outside the area of takeovers, significant questions remain as to the duties of boards when faced with questions of excessive executive compensation and fraud. More generally, the question remains unanswered if the role of the corporation is the 'optimal' long-term creation of wealth and if socially responsible behaviour assists it.

14

David Henderson on Corporate Social Responsibility and the Role of Business Today

Defenders of corporate social responsibility argue that firms should widen their objective to include the society and the environment at large, besides their objective to maximise the return on capital. The argument is that by gaining a better reputation through CSR, firms will improve their long-term advantage. Henderson pointed out that it is not at all clear that firms serve their society better by including a notion of society and environment as a company's objective. In addition, as these objectives are not developed in a political process, there is the risk of capture by interest groups. This will eventually lead to the misallocation of capital and substantial costs for society.

A clear distinction should be made between the general notion of corporate social responsibility (lower case), which of course is not at all new, and the present-day concept, or doctrine, of Corporate Social Responsibility (upper case), which is new. It is generally undisputed that companies should act responsibly. Now as in the past, there are situations in which managers and directors, and sometimes shareholders, should ask themselves what is right for their company to do, as well as what is legally permitted or required of it.

However, this is distinctly different from the doctrine and programme of action of CSR, which argues that businesses should redefine their role, objectives and corporate mission. They should embrace the notion of 'corporate citizenship', and run their affairs, in conjunction with an array of different 'stakeholders', so as to pursue a common goal which all stakeholders share – namely

G. Owen et al., *Corporate Governance in the US and Europe*

'sustainable development'. They should promote 'multi-stakeholder engagement'.

Sustainable development is taken to have three distinct dimensions – 'economic', 'environmental' and 'social'. Hence, corporations are urged to set objectives, measure their performance, and have that performance independently audited, in relation to all three. They should aim to meet the so-called 'triple bottom line', rather than focusing narrowly on profitability and shareholder value.

Only by acting in this way (it is said) can businesses respond to what are now 'society's expectations' and earn from society their 'licence to operate'. In such behaviour lies the key to long-run commercial success, since profits depend to a substantial extent on reputation, which in turn depends on being seen to act in a socially responsible way. Hence CSR will, on balance, be good for profitability, at any rate in the longer term: it will bring support and custom, and deflect hostile criticism from outside the firm; and generate loyalty among employees internally.

Parties to a consensus

CSR has won a lot of ground. It has been endorsed by a substantial and increasing number of businesses and business organisations, academics, and a growing number of investment institutions which stand for what is termed 'socially responsible investment'. Outside the business milieu, CSR is typically favoured, and often demanded, by so-called 'public interest' non-governmental organisations (the NGOs). In many cases, the endorsement of CSR by companies has been, in part at least, a response to well-publicised attacks on them as greedy, secretive, exploitative and concerned only with making money. With few exceptions, the NGOs are hostile to, or highly critical of, capitalism, multinational enterprises (MNEs), freedom of trade and capital flows, and the market economy.

The support for CSR is by now official as well as unofficial. In the UK, there is a minister charged with the duty of promoting it. In Brussels, the European Commission has adopted a new strategy in favour of Corporate Social Responsibility in order to promote companies' contribution to the sustainable development of society.

Further, CSR has been formally endorsed by, and given expression in, international agencies – for example, within the UN Global Compact, and through the adoption of the 'Equator Principles' by the International Finance Corporation.

The CSR view of the world

The advocates of CSR argue that a new era has dawned, in which businesses should redefine their role and mission and change their ways of operating. CSR is presented as a far-reaching creative response by business to new problems and challenges. Among these supposed new problems and challenges, two stand out. One is globalisation, and another is society's expectations.

Globalisation, in the sense of closer international economic integration, is neither a new nor a worrying development. It represents the continuation of a long-term trend, and its effects are positive. It has chiefly resulted from deliberate decisions taken by governments, with good reason, to make international trade and investment flows freer. Henderson argues that it has not brought with it 'social exclusion', nor 'marginalised' poor countries. It also has not conferred on businesses undue benefits or new powers to determine events.

As to society's expectations, CSR advocates, including those in the business world, typically assume that these are given authentic voice by what radical critics of the market economy are currently saying. That assumption is open to challenge. In any case, not all public expectations, and the pressures on businesses that arise from them, are reasonable and well founded. When they are not, businesses and business organisations have a right to resist them, and to argue the case, on public interest grounds, for wiser courses of action.

Businesses that support CSR have typically failed to contest, or have even endorsed, the arguments and demands of anti-business activist groups. They have treated these arguments and demands as reflecting the views of 'society'. Their preferred strategy has been one of appeasement and accommodation. Besides giving currency to a false view of the nature and effects of globalisation, they have failed to make an informed and effective case for the market economy. Whether this is responsible conduct is open to doubt.

Making people poorer

Henderson believes that the consequences of giving effect to CSR would be harmful to society. Within enterprises, the adoption of CSR will tend to bring higher costs and impaired performance. Managers have to take account of a wider range of goals and concerns, and involve themselves in new processes of (so-called) 'multiple stakeholder engagement'. New systems of accounting, auditing and monitoring are called for. On top of this, the adoption of more exacting self-chosen environmental and 'social' standards is liable to add to costs – all the more so if, as is required by CSR, firms insist on observance of these same standards by their partners, suppliers and contractors – and even, on some interpretations, by their customers.

Contrary to what the adherents of CSR presume, the result of all this may not be to make the world a better place. CSR embodies two related ideas which are now widely accepted, but open to question. One is the notion of sustainable development as well defined and unassailable. In taking it as a goal therefore, companies will be following a well-marked path of virtue which everyone recognises as such. Both these assumptions should be challenged. Henderson believes that sustainable development is not well defined, and no such path of virtue exists. The second idea is that environmental and social progress lies in making norms and standards more stringent and more uniform, in part by corporations acting on their own account. Such a trend does not necessarily make the world a better place on balance. It may simply pave the way for various forms of over-regulation, from which the costs to people in general are greater than the benefits.

CSR and profitability

In their scheme of things, the advocates of CSR have unwittingly downgraded both the primary role of business, and the claim of profit-oriented private businesses to legitimacy and recognition. They see the defence of the market economy in terms of making companies more popular and respected, through redefining their mission and changing their practices to accord with what are seen as society's expectations. Such a way of thinking misses the main point. It may well be true, or eventually become true, that firms

have to take the path of CSR, in the interests of profitability or even survival, because of social pressures brought to bear on them or formal legal requirements. However, in so far as this trend weakens enterprise performance, limits economic freedom and restricts competition, the effect is not only to reduce welfare: it is to deprive private business of its distinctive virtues and rationale.

15

Krishna G. Palepu on Information and the Regulation of Markets

Despite the importance of audits and mandatory disclosure, recent accounting scandals indicate there is a need to improve the quality. There are major deficiencies on both the supply and the demand side of information, which need to be addressed for the system to function more effectively.

Enron, building on what was at first a highly successful business model of gas trading in the US, attempted to apply this model to other, often unrelated, products. Many of these diversifications turned out to be unsuccessful, which in the end led to the spectacular collapse of the firm. Beyond the obvious wrongdoing in the form of criminal activity, the case also illustrates problems of governance and incentives that can emerge in many other firms.

The core problems are rooted both in the supply and the demand sides of information. While public debate has focused on auditing and disclosure, or the supply side of information, the demand side of information driven by fund managers and other institutional investors is widely ignored.

With the supply side of information, policy-makers have focused on solving governance problems by imposing stricter accounting rules and improving mandatory disclosure requirements. However, it is debatable whether this will bring the expected remedies.

Why is accounting so complicated?

Accrual accounting has, by definition, a lot of information about the future of the firm built in. This makes it an interesting altern-

G. Owen et al., *Corporate Governance in the US and Europe*

ative to cash accounting, as it paints a more balanced picture about the state of the firm. However, this also requires significant judgement and is inherently – like everything about the future – uncertain. On the other hand, it allows the communication of more information, which becomes curtailed with a more mechanistic application of rules and guidelines.

Society faces a trade-off between a more informative but also more uncertain system that hands over a lot of discretion to the people that compile accounts, and a less informative system that provides more certainty. An ideal system would therefore hand over a lot of discretion to the managers so they can create informative accounts, but also give more importance to the role of auditors and capital markets as external monitors.

Over the years, substantial underinvestment has been made into the oversight, or auditing, functions. This is demonstrated by the fact that in some instances firms pay more for building security than for accounting. Ultimately, this demonstrates that they view accounting as a nuisance that does not add value.

Supply side

A number of issues might have contributed to this decline. First, auditing services are by now a commodity, with little differentiation between the accounting firms and low switching costs. This naturally leads to competition on costs and falling prices for the consumers of these services. With no money to be made, the audit firms saw their auditing arm as a loss leader that would enable them to win contracts for the consulting side. They stopped investing in it, and recruited the best talent for consulting services, and not for auditing. For example, the last Harvard Business School graduate that went into auditing was around 1975. Often, the auditor is now the least confident and talented person around the table, which is in clear contrast to the needs of such a role.

In addition, the litigation environment in the US allows shareholders to sue auditors based entirely on extensive share price movements. In defence, auditors created mechanical processes that would demonstrate their diligent work practices. While this certainly helped to protect the auditors, it did not necessarily help the quality of the audits. Quality was further thrown into doubt by

the fact that audits are paid for by the management, which can easily replace an auditor in the following years in case of disagreement between the two parties. Any auditor removed by management was also likely to lose the tied consulting revenues.

Possible solutions, which should be subject to further debate, could encompass the transfer of the oversight of audits to another third party with no vested interests in the firm. Audits should not be paid for by the firm itself, but funded through alternative mechanisms, like a trading tax. Such a tax would be minimal in size, at current estimates approximately 0.02 per cent of trading volume. One could also envision a construct whereby institutional investors, as the main consumers of financial information, take on the oversight and financing of auditing. The key issue is that the responsibility for auditing is taken away from firms, and that there is a clear separation between who pays for the audit, and the audited firm.

Another issue arises with the self-regulation of the standard-setting body. In the US, generally accepted accounting principles (GAAP) are set by an 'independent' body, the Financial Accounting Standards Board (FASB). This body comprises representatives from the accounting profession, industry, academia and public services. As auditors and industry representatives have the majority on the board, and accountants and their industry clients face the same constraints, one has to be very critical about the ability of this body to set regulation that creates a true picture of the firm and does not aim to protect the subjects involved in the process.

Demand side

As pointed out above, most of the focus of the public debate has been on the supply side of information. Issues concerning the demand side of information, or consumers of financial data, have so far not been adequately addressed. Historically, fund managers and other institutional investors were knowingly and willingly accepting, and partly following, advice from analysts with obvious conflicts of interest.

To understand this, one has to step back and look at the economics of the fund management industry, and the incentives of individual portfolio managers. A fund manager is rewarded not for absolute performance of the fund (which is in itself correct as the

individual manger has no way of influencing the economy), but the performance relative to a benchmark such as the FTSE 100. The individual manager is therefore primarily concerned with achieving the average performance, and ideally outperforming it. Therefore, following the market trend becomes a more important decision variable than understanding the individual firm. Not surprisingly, trading is driven by clear public signals like earnings announcements or forecasts. One can argue that the associated signal (buy/sell) of the research note becomes more important than the actual content.

Conclusion

To summarise, there are clear deficiencies on both the supply and demand sides for audit information. On the supply side, it is important that the business model of auditors is reassessed and conflicts of interests dealt with. The auditors' main task should be to critically challenge the information content in public accounts; they should be less concerned about audit processes. On the demand side, ways should be found so that fund managers have an incentive to scrutinise this information more carefully.

16

Joshua Ronen on Financial Statement Insurance[40]

It is suggested that financial statement insurance against omissions and misrepresentations can be an effective tool to improve both the quality of audits and financial statements, while reducing the equilibrium amount of losses. By delegating the hiring decision of auditors to the insurance company, the inherent conflict of interest between auditors and the management that hires them will be solved. Both the insurance coverage and premium paid will be publicised. This will work as an effective signal of the quality of audits and should help companies with good financial statements to lower their cost of capital.

A potential conflict of interest exists between auditors that verify financial statements, and management of firms that – effectively – pay for this service. Due to the strong alignment of pay with performance, management has an incentive to inflate stock prices for personal gain though legal and illegal means. Auditors have only a weak incentive to stop this, as the renewal of their contract depends on the approval of management. An example is the Enron case, where a significant proportion of the income of Arthur Andersen's Houston office was tied to only one client – Enron. Conflicts of interests as in this case can have a considerable negative effect on the audit quality. Investors base their capital allocation decision on the information they extract from the financial statements and other public sources. With the quality of the accounts and information being uncertain, this increases the risk and uncertainty for an investor and with it the cost of capital.

G. Owen et al., *Corporate Governance in the US and Europe*

Therefore, what is needed is a mechanism that eliminates the conflicts of interest auditors face, and an incentive structure that properly aligns the interests of the auditor with those of shareholders. In this principal–agent relationship, another third party other than the management should assume the principal's role.

It is suggested that a financial statement insurer could assume this role. Such an insurer would protect shareholders against losses suffered as a result of misrepresentation or omissions in financial reports. Insurance provides a number of benefits. First, as the insurer will appoint and pay the auditor, it solves the conflict of interest between the auditor and management. It also provides a clear signal (by publicising the coverage and premium) about the quality of the financial statement, thereby reducing the cost of capital for firms that comply and increases it for those that are in non-compliance. This way, firms have a strong incentive to improve the quality of financial disclosure, which in turn reduces the pressure on the auditor. Last, the risk of shareholder litigation is not carried by the shareholders themselves, but by an external body that can deal with this risk much more efficiently. In addition, shareholders are not getting 'punished' twice, through the misrepresentation and then by the payout of the class action suits. Instead, they will receive real compensation.

Auditing under the new framework

Process wise, the system would work in the way that a firm that wants to be insured solicits bids for financial statement insurance. In a first step, the insurer undertakes an underwriting review, in which the company's internal control and auditing processes are put under scrutiny. In addition, the managerial incentive structure and the company's history of surprise earnings announcements should be taken into consideration. Then the carrier of risk/insurer decides on the maximum coverage and the premium, and once the firm decides to buy a given coverage this information is made publicly available. The insurer also appoints and pays the auditor.

A revelation of a material omission or misrepresentation in the financial statements would automatically trigger the insurance. Such insurance can be provided by a classical insurer, by auditors or even investment banks.

Indirectly, there would be a quality competition among auditors. The best auditors will also have the lowest rate of omissions and misrepresentations, making them the most attractive candidates for the insurance firms. In reverse, the weakest ones will be forced out of business.

In summary, such an insurance against misrepresentations and omissions in financial statements would improve the audit quality and with it the quality of financial statements, and reduce the equilibrium amount of losses.

17

Andrei Shleifer asks Is There a Major Problem with Corporate Governance in the United States?

The distinction between civil law and common law countries comes down to the question of who has the ultimate trust of society, lawmakers (legislators) or law enforcers (judges). It is argued that common law, which puts much more trust in law enforcers and gives much greater discretion to the courts, is better placed to protect shareholders, and so fosters the development of efficient capital markets. The current tendency under Sarbanes-Oxley for more prescriptive capital market rules might be counterproductive.

Continental European civil law and Anglo-American common law systems are distinctly different in nature, shaped by different political and economic histories as far back as the twelfth and thirteenth centuries. The English system was formed at a time when the king exercised unified power over a relatively peaceful country, while the French one developed when the country was decentralised and significant power was held by local nobility. Both countries developed systems for effectively keeping the most powerful elements of society in check. To do this efficiently, the French needed a centralised system, and so over time developed the Roman traditions of civil law with state-employed judges and highly prescriptive statutes. In contrast, the English developed a common law system with independent judges, discretionary powers and reliance on precedent. Subsequently, the English exported their legal system to America and the Commonwealth, while Napoleon transferred the French legal system across Continental Europe at the beginning of the nineteenth century.

G. Owen et al., *Corporate Governance in the US and Europe*

The nature of these differing legal systems has fundamentally influenced the development of their respective financial systems, and subsequently shaped the nature of the corporate governance problems in these countries. Shareholder rights are significantly stronger under common law systems than civil law ones, and problems of expropriation from minority shareholders are rare.[41] The dilemmas faced in common law countries are related to excessive executive compensation, earnings manipulation to improve linked managerial compensation and the failure of internal monitors (boards of directors) and external gatekeepers (accountants/securities firms). Minority shareholder rights are comparatively less developed under civil law systems; hence, there has traditionally been a consequent requirement for the existence of controlling shareholders to monitor management. Corporate governance in Europe attempts to protect minority shareholders from major expropriation of corporate wealth and assets by these controlling shareholders and allied corporate insiders.[42]

The 'crisis' of executive compensation in common law countries should be placed in perspective. It mostly relates to hugely successful public companies where the CEO creates billions of dollars of shareholder value, and through various mechanisms, may manage to secure up to several hundred million dollars in income. Certainly, this is a significant amount of money, but relative to the amount of wealth created not necessarily material. In those relatively few examples of criminal activity, such as Enron and WorldCom, the courts have dealt with it swiftly and severely. While earnings manipulation and overinvestment remain issues, compared to corporate America 20 years ago, these have been corrected by focusing on the creation of shareholder value and the emergence of an active market in corporate control.

Limited failures of the US governance system

Clearly, shortcomings exist in the US corporate governance system. Firms are under enormous pressure to sustain a high stock price, expressed for example in a high price/earnings ratio (P/E). This high share price can successfully be used to acquire other companies and managerial talent, and raise capital. If it fails to sustain a high price,

a firm can become a takeover target itself, or lose any of the other benefits. The competitive pressure to sustain a high share price in effect promotes unethical behaviour, tempting managers to manipulate earnings statements in order to defend their position and remain in the league of 'successful' companies.[43]

In recent years, the role of boards in solving all corporate governance issues has been overemphasised. American law, however, sees the board as distant and not involved in the day-to-day running of the firm. In this respect, its governance role is very limited. Boards have been organised and designed to address the fundamental problems of conflicts of interest and self-dealing by managers. The business judgement rule, developed by the US courts, is vital as it protects board members from liability in relation to the daily running of the firm, and thus focuses directors' duties.[44]

Clearly, areas related to the management of the firm, self-dealing and conflicts of interest are not always separate, particularly in relation to issues such as resistance to hostile takeovers and executive compensation. Therefore, the boundaries of the business judgement rule are always subject to (re-)negotiation. One of the successes of the Delaware Court has been to prevent the boundaries from being moved as rapidly as in other states, i.e. they have resisted placing too many issues under the heading of conflicts of interest or self-dealing. This has allowed boards of directors to survive in their existing form, and avoided overburdening directors with risks.

Most directors have, or had, extremely successful careers in their primary occupation. They are paid an additional several hundred thousand dollars to spend 10 days a year as a director of another company, a small amount compared to their wealth. However, as directors they face the possibility, however remote, of financial ruin. It is an implausible notion that people who spend 10 days a year in a job alongside their main career and family commitments can be effectively involved in the management of a large public firm, and with it held responsible.

If competition is a vital part of the market system, but creates incentives for unethical conduct, how can salient corporate governance issues be solved? The answer is external regulation.[45] However, the characteristics and nature of this regulation are important in devising the optimal regulatory structure.

Private vs public regulation

This dilemma places great emphasis on the legal and regulatory framework and brings us back to the issues of the origins of the legal system. There are two general approaches: increased private or public enforcement. One solution is to increase the rights of private action and enforcement within the legal framework related to disclosure and liability rules. The other is to increase the powers of government regulators, to set mandatory standards and enforce disclosure. These two concepts can coexist with a public regulator setting standards for private enforcement.

Recent empirical work established a link between levels of private enforcement in a country, such as high disclosure requirements and enforceable liability through highly developed laws of contract and tort, and the overall development of financial markets.[46] Subsequent tests examining the power and independence of government agencies representing public enforcement with the development of financial markets found some weakly significant correlation between the two variables.

Therefore, if the legal and regulatory framework is the most important tool in terms of supporting the development of efficient capital markets, then the fundamental question that remains is how much corporate governance should be left to private enforcement and legal action, and how much should be codified through legislation.

Broadly, these two approaches represent the common and civil law systems. Of course, common law is governed by statute, and countries that employ it have effective regulation and enforcement agencies protecting their financial markets. The main distinctions between the two legal systems is that both judges and regulators have more discretionary power under common law, and it is easier for private citizens to bring enforcement lawsuits. However, reaction to recent corporate scandals in the US has prompted legislators to be more prescriptive through legislation such as Sarbanes-Oxley. There are clear trade-offs between the two approaches, summarised below.

Ultimately, these are trade-offs between rules and standards as guidelines, and between regulation and litigation as means of enforcement. Rules set out in excruciating detail what everybody is supposed to do, and standards describe in broad terms what should

be done. For example, standards state that firms must disclose material information in a prospectus, but enforcement is left to private actions in the court system. Evidence indicates that excessive legislative prescription can impede the development of broad and liquid capital markets. However, with Sarbanes-Oxley there is the risk that the US is now going down this path, against its own historical tradition.

This is the fundamental distinction which divides the Anglo-American world from the rest, and is based on cultural and historical context. Does one trust law enforcers or lawmakers? If the trust lies with law enforcers, then you prefer standards. On the other hand, if the trust rests with lawmakers, then rules are the preferred mode of regulation.

18

Luigi Zingales on the Importance of Bad News

It is of central importance, if not a precondition, that bad news is conveyed swiftly and precisely for both effective corporate governance, and the functioning of efficient capital markets. This contrasts starkly with human nature, which prefers to suppress bad news and finds it exceptionally hard to convey.

Negative news has very high information content. It allows for the timely correction of mistakes, while it gives financial markets the chance of updating their models and so avoiding the misallocation of capital. However, bad news does not travel well, as people find it very difficult to convey bad news. There are a number of reasons for this. First, the communication of bad news is clearly a mixed blessing. Firstly, this will lead to Bayesian updating by the board about the quality of the CEO, and enables the board to take supportive or corrective measures. Secondly, there is a clear cost/benefit asymmetry. While the bearer of bad news carries the concentrated loss as the messenger of bad news, he/she can enjoy only diffuse benefits.

In addition, there is a trade-off between loyalty and honesty. While there is a premium on loyal behaviour by employees, only honest behaviour allows bad news to emerge. However, whistleblowers who bring bad news to the attention of the wider public face enormous hostility and find it almost impossible to gain new employment. Loyalty, it seems, is valued more highly than honesty. Examples include the former US Treasury secretary, Paul O'Neill,

G. Owen et al., *Corporate Governance in the US and Europe*

who spoke out against the policy-making processes of the Bush administration. He was entirely clear that he could only do this as he was both financially independent and retired, so not dependent on future employment.

There is also enormous social pressure to conform to general behaviour, and not to 'rock the boat' with dissenting views and critical comments. Criticism is viewed as antagonistic, and dissidents are excluded.

This explains in part the ineffectiveness of boards, and the existence of corporate fraud. Fraudulent behaviour is often widely known in organisations. In the case of Parmalat, people seemingly joked about the existence of false accounts, but had no incentive to speak up.

Solution mechanism

There is an important link between the media and the financial markets. In times of economic boom, the demand for information by the press and supply of it by firms seems to reinforce the dissemination of positive information. During downturns, however, we see the media to be more receptive to negative news. Short sellers play an important role during this time, as they appear to tip off the media about possible standards violations or other negative news. This in turn leads to a correction of the share price. The short seller benefits from his investment into researching the firm in greater detail, while the media receive valuable information.

Entrenchment, surprising as it may sound, might be another mechanism to solve the problem of how to break bad news. There is the famous example of IBM CEO Thomas Watson, whose own son broke the news about bad performance and the need for change. The privileged position of being the CEO's son protected him from future negative reprisals, and change was subsequently initiated.

Another mechanism might be the creation of two independent reporting channels, where the auditor reports directly to the audit committee (already enacted in the US under Sarbanes-Oxley), and a second independent channel through which employees can voice concerns about possible wrongdoings, in complete confidentiality, to an independent third party.

A corporate culture that encourages open, professional, honest and fair exchange based on facts, and not on superiority, is an additional mechanism that might help to facilitate the diffusion of bad news.

Possible policy proposals could include an active (financial) reward for whistleblowers, including a possible job guarantee, the creation of a 'position' of devil's advocate who challenges proposals as a matter of routine, a different corporate culture or more additional internal channels of information for the board (e.g. inviting senior management without the CEO present to a board meeting).

Appendices: Evolution and Summary of Corporate Governance Codes

Appendix I: UK

Evolution of corporate governance codes in the UK

The starting point for the evolution of what is now known as the UK's Combined Code of Corporate Governance was a series of corporate scandals which occurred in the late 1980s and early 1990s. The most shocking of these was the Robert Maxwell affair. Maxwell was a flamboyant entrepreneur who bought the *Daily Mirror* newspaper in 1984 and expanded his publishing group through a number of expensive acquisitions. By the end of the decade his debts had reached unmanageable proportions, and it was subsequently revealed that he had looted the *Daily Mirror* pension fund to keep his empire afloat. Maxwell died in mysterious circumstances in 1991.

The Maxwell case, though extreme, was not only the example of situations in which boards of directors in publicly quoted companies were apparently unable to exercise control over dominant chief executives. At the same time there was concern within the financial community over the quality of financial reporting and the ability of auditors to provide the safeguards which users of company reports were entitled to expect. This was the background to the decision by the London Stock Exchange, the Financial Reporting Council and the accountancy profession to set up a committee under Sir Adrian Cadbury to examine the whole issue of financial reporting and accountability, including the links between boards, auditors and shareholders.

The recommendations of the Cadbury Committee, published in 1992, were mainly directed at improvements in internal financial controls and in the effectiveness of boards. On the latter, the committee recommended an increase in the number and influence of non-executive directors, and the separation, where possible, of the posts of chairman and chief executive. Another key proposal was that all listed companies should establish audit committees consisting wholly of non-executive directors. The report also called for greater openness by companies on the subject of executive pay. 'Shareholders are entitled to a complete disclosure and explanation of directors' present and future benefits, including stock options and stock appreciation rights, and how they have been determined.' Boards were urged to appoint remuneration committees consisting wholly or mainly of non-executive directors.

The Stock Exchange incorporated Cadbury's code of best practice in its listing requirements for public companies, and over the next few years most companies set about revising their governance arrangements in line with the Cadbury principles. There was, however, one issue which continued to cause public concern. This was the escalation in executive pay, often in the form of stock options and other share-related incentives.

Since the 1980s, when the tax treatment of stock options had been made more generous, this form of remuneration had spread much more widely. Although the ostensible purpose of stock option schemes was to align the interests of managers with those of shareholders, the effect in some cases was to generate rewards which were not only very large in absolute terms, but also appeared to bear little relation to the performance of the managers concerned. A particular cause for concern in the early 1990s was the size of the pay packages awarded to managers of some of the newly privatised utilities.

Public disquiet over the so-called 'fat cats' prompted the Confederation of British Industry to set up another committee under Sir Richard Greenbury, chairman of Marks and Spencer, to examine directors' pay. The Greenbury Report extended the Cadbury Committee's proposals, calling for fuller disclosure of all forms of remuneration, including pension provision. It also suggested that stock options should be supplemented or replaced by long-term incentive plans (LTIPs), in which the award of shares would be tied to performance targets over a period of three years or more.

The next step in this exercise in voluntary reform was the establishment of another corporate governance committee, under Sir Ronald Hampel, chairman of ICI, to review what had happened since the Cadbury and Greenbury committees had reported, and to consider whether any further changes were needed. The Hampel report, published in 1998, was largely a consolidation of the two earlier publications, although its tone was somewhat different; it put more emphasis on the contribution which boards of directors should make to the commercial success of their companies. Hampel's main recommendations were brought together in the Stock Exchange's Combined Code. Every listed company was required to report each year on how it applied the principles of the code. It was also required either to confirm that it complied with the code provisions or, where it did not, to provide an explanation.

The effect of these three reports was to enhance the role and visibility of non-executive directors. According to a survey of 503 large companies carried out in 2000, the average board in that year had 9.2 directors, of which 4.9, or 53 per cent, were non-executive; the corresponding figure in the mid-1980s was 35 per cent. The number of companies which had separated the positions of chairman and chief executive was just under 90 per cent. There was also a high rate of compliance with the Combined Code on the composition of audit and remuneration committees (PIRC, 2000).

The authors of this study concluded that substantial improvements had been made since the Cadbury Report, but they expressed some doubt about the effectiveness of non-executive directors; some of them, they suggested, were probably not genuinely independent. This issue was addressed in the most recent of the UK's corporate governance inquiries, carried out by Sir Derek Higgs in 2003. The main thrust of the recommendations in the Higgs Report was to improve the effectiveness and quality of boards, to ensure that at least half the members of the board were genuinely independent, and to impose a stronger obligation on companies to separate the posts of chairman and chief executive. Non-executive directors should also have the dominant role in the three main committees of the board – the audit, remuneration and nomination committees.

While the initial reaction to the first version of the Higgs Report from much of the business community was hostile, subsequent consultation led to broad agreement on the main recommendations, and they were incorporated into the Combined Code.

The UK Combined Code on Corporate Governance (version from July 2003)
Preamble – Amended
[…]
4. The Code contains main and supporting principles and provisions. The existing Listing Rules require listed companies to make a disclosure statement in two parts in relation to the Code. In the first part of the statement, the company has to report on how it applies the principles in the Code. In future this will need to cover both main and supporting principles. The form and content of this part of the statement are not prescribed, the intention being that companies should have a free hand to explain their governance policies in the light of the principles, including any special circumstances applying to them which have led to a particular approach. In the second part of the statement the company has either to confirm that it complies with the Code's provisions or – where it does not – to provide an explanation. This 'comply or explain' approach has been in operation for over ten years and the flexibility it offers has been widely welcomed both by company boards and by investors. It is for shareholders and others to evaluate the company's statement.

[…]
6. Smaller listed companies, in particular those new to listing, may judge that some of the provisions are disproportionate or less relevant in their case. Some of the provisions do not apply to companies below FTSE 350. Such companies may nonetheless consider that it would be appropriate to adopt the approach in the Code and they are encouraged to consider this. Investment companies typically have a different board structure, which may affect the relevance of particular provisions.
7. Whilst recognising that directors are appointed by shareholders who are the owners of companies, it is important that those concerned with the evaluation of governance should do so with common sense in order to promote partnership and trust, based on mutual understanding. They should pay due regard to companies' individual circumstances and bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces. Whilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches. Institutional shareholders and their agents should be careful to respond to the statements from companies in a manner that supports the 'comply or explain' principle. As the principles in Section 2 make clear, institutional shareholders should carefully consider explanations given for departure from

the Code and make reasoned judgements in each case. They should put their views to the company and be prepared to enter a dialogue if they do not accept the company's position. Institutional shareholders should be prepared to put such views in writing where appropriate.

CODE OF BEST PRACTICE: MAIN AND SUPPORTING PRINCIPLES

SECTION 1: COMPANIES

A. DIRECTORS
A1. The Board

Main Principle
Every company should be headed by an effective board, which is collectively responsible for the success of the company.

Supporting Principles
The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

All directors must take decisions objectively in the interests of the company.

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

Code Provisions
A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.

A.1.2 The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees. It should also set out the number of meetings of the board and those committees and individual attendance by directors.
A.1.3 The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance (as described in A.6.1) and on such other occasions as are deemed appropriate.
A.1.4 Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.
A.1.5 The company should arrange appropriate insurance cover in respect of legal action against its directors.

A2. Chairman and Chief Executive

Main Principle
There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.

Supporting Principles
The chairman is responsible for leadership of the board, ensuring its effectiveness on all aspects of its role and setting its agenda. The chairman is also responsible for ensuring that the directors receive accurate, timely and clear information. The chairman should ensure effective communication with shareholders. The chairman should also facilitate the effective contribution of non-executive directors in particular and ensure constructive relations between executive and non-executive directors.

Code Provisions
A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established, set out in writing and agreed by the board.
A.2.2[47] The chairman should on appointment meet the independence criteria set out in A.3.1 below. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report.

A3. Board Balance and Independence

Main Principle
The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.

Supporting Principles
The board should not be so large as to be unwieldy. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business and that changes to the board's composition can be managed without undue disruption. To ensure that power and information are not concentrated in one or two individuals, there should be a strong presence on the board of both executive and non-executive directors. The value of ensuring that committee membership is refreshed and that undue reliance is not placed on particular individuals should be taken into account in deciding chairmanship and membership of committees. No one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee.

Code Provisions
A.3.1 The board should identify in the annual report each non-executive director it considers to be independent.[48] The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- has been an employee of the company or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

A.3.2 Except for smaller companies[49] at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.
A.3.3 The board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate.

A4. Appointments to the Board

Main Principle
There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.

Supporting Principles
Appointments to the board should be made on merit and against objective criteria. Care should be taken to ensure that appointees have enough time available to devote to the job. This is particularly important in the case of chairmanships.
The board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board.

Code Provisions
A.4.1 There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority of members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. The nomination committee should make available[50] its terms of reference, explaining its role and the authority delegated to it by the board.
A.4.2 The nomination committee should evaluate the balance of skills, knowledge and experience on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.
A.4.3 For the appointment of a chairman, the nomination committee should prepare a job specification, including an assessment of the time commitment expected, recognising the need for availability in the event of crises. A chairman's other significant commitments should be disclosed to the board before appointment and included in the annual report. Changes to such commitments should be reported to the board as they arise, and included in the next annual report. No individual should be appointed to a second chairmanship of a FTSE 100 company.[51]

A5. Appointments to the Board

Main Principle
The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

Supporting Principles
The chairman is responsible for ensuring that the directors receive accurate, timely and clear information. Management has an obligation to provide such information but directors should seek clarification or amplification where necessary.
The chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities.
Under the direction of the chairman, the company secretary's responsibilities include ensuring good information flows within the board and its committees and between senior management and non-executive directors, as well as facilitating induction and assisting with professional development as required.
The company secretary should be responsible for advising the board through the chairman on all governance matters.

Code Provisions
A.5.1 The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board. As part of this, the company should offer to major shareholders the opportunity to meet a new non-executive director.
A.5.2 The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should be provided with sufficient resources to undertake their duties.
A.5.3 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole.

A6. Performance Evaluation

Main Principle
The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

Supporting Principles
Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and

any other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

Code Provision
A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

A7. Re-election

Main Principle
All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.

Code Provisions
A.7.1 All directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years. The names of directors submitted for election or re-election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election.
A.7.2 Non-executive directors should be appointed for specified terms subject to re-election and to Companies Acts provisions relating to the removal of a director. The board should set out to shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual should be elected. The chairman should confirm to shareholders when proposing re-election that, following formal performance evaluation, the individual's performance continues to be effective and to demonstrate commitment to the role. Any term beyond six years (e.g. two three-year terms) for a non-executive director should be subject to particularly rigorous review, and should take into account the need for progressive refreshing of the board. Non-executive directors may serve longer than nine years (e.g. three three-year terms), subject to annual re-election. Serving more than nine years could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).

B. REMUNERATION
B1. The Level and Make-Up of Remuneration[52]

Main Principle
Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

Supporting Principle
The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance. They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

Code Provisions
Remuneration Policy
B.1.1 The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors keen incentives to perform at the highest levels. In designing schemes of performance-related remuneration, the remuneration committee should follow the provisions in Schedule A to this Code.
B.1.2 Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.
B.1.3 Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).
B.1.4 Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report[53] should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

B2. Procedure

Main Principle
There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Supporting Principles
The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.

The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

Code Provisions
B.2.1 The board should establish a remuneration committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, a statement should be made available of whether they have any other connection with the company.
B.2.2 The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.
B.2.3 The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.
B.2.4 Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

C. ACCOUNTABILITY AND AUDIT
C1. Financial Reporting

Main Principle
The board should present a balanced and understandable assessment of the company's position and prospects.

Supporting Principles
The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

Code Provisions
C.1.1 The directors should explain in the annual report their responsibility for preparing the accounts and there should be a statement by the auditors about their reporting responsibilities.
C.1.2 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

C2. Internal Control

Main Principle
The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

Code Provisions
C.2.1 The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

C3. Audit Committee and Auditors

Main Principle
The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code Provisions
C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.
C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;

– to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or reappointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

D. RELATIONS WITH SHAREHOLDERS

D1. Dialogue with Institutional Shareholders

Main Principle

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.[54]

Supporting Principles

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman (and the senior independent director and other directors as appropriate) should maintain sufficient contact with major shareholders to understand their issues and concerns.

The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

Code Provisions
D.1.1 The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend meetings with major shareholders and should expect to attend them if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.
D.1.2 The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about their company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion.

D2. Constructive Use of the AGM

Main Principle
The board should use the AGM to communicate with investors and to encourage their participation.

Code Provisions
D.2.1 The company should count all proxy votes and, except where a poll is called, should indicate the level of proxies lodged on each resolution, and the balance for and against the resolution and the number of abstentions, after it has been dealt with on a show of hands. The company should ensure that votes cast are properly received and recorded.
D.2.2 The company should propose a separate resolution at the AGM on each substantially separate issue and should in particular propose a resolution at the AGM relating to the report and accounts.
D.2.3 The chairman should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend.
D.2.4 The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

SECTION 2: INSTITUTIONAL SHAREHOLDERS
E. INSTITUTIONAL SHAREHOLDERS[55]
E1. Dialogue with Companies

Main Principle
Institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives.

Supporting Principles
Institutional shareholders should apply the principles set out in the Institutional Shareholders' Committee's 'The Responsibilities of Institutional Shareholders and Agents – Statement of Principles',[56] which should be reflected in fund manager contracts.

E2. Evaluation of Governance Disclosure

Main Principle
When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional shareholders should give due weight to all relevant factors drawn to their attention.

Supporting Principles
Institutional shareholders should consider carefully explanations given for departure from this Code and make reasoned judgements in each case. They should give an explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position. They should avoid a box-ticking approach to assessing a company's corporate governance. They should bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces.

E3. Shareholder Voting

Main Principle
Institutional shareholders have a responsibility to make considered use of their votes.

Supporting Principles
Institutional shareholders should take steps to ensure their voting intentions are being translated into practice.
Institutional shareholders should, on request, make available to their clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.
Major shareholders should attend AGMs where appropriate and practicable. Companies and registrars should facilitate this.

Appendix II: US – NYSE New Listing Standards

Following the Enron and other scandals, the New York Stock Exchange (NYSE) undertook a study of its listing standards and adopted new standards which impose stricter corporate governance requirements on its listed companies. These new standards became effective in November 2004. The focal points of these reforms are the role and qualification of directors, the responsibilities and composition of board committees and enhanced disclosure of corporate policies.

The new NYSE listing standards require that a majority of directors on the board of a listed company be free of any material relationship with the company. The board of directors of each company must affirmatively determine that an individual qualifies as an 'independent director'. Listed companies must publicly identify each such director and disclose the basis for the determination of independence. The NYSE has established certain categorical disqualifications for independence, such as employment with the company or the company's auditors.

Importantly, non-management directors of NYSE-listed companies are required under the new standards to hold regularly scheduled executive sessions. The company must disclose the name of the director who will preside at executive sessions or, if the position will be rotated, the procedure by which the presiding director is selected for each such session. In order for shareholders and others to communicate concerns directly to the non-management directors, the company must disclose a method by which the presiding director or the non-management directors as a group may be contacted. If the group of non-management directors includes directors who are not independent, then the independent directors are encouraged to meet in executive session at least once a year.

The NYSE now requires that the most important board committees – the audit committee, the nominating/corporate governance committee and the compensation committee – be composed entirely of independent directors. Each of these committees must have a publicly available charter that addresses certain of the committee's procedural and substantive responsibilities. The NYSE listing standards makes an exception for listed companies of which more than 50 per cent of the voting power is held by an individual, a group or another company; such companies are not required to have a majority of independent directors on their boards, nor are they required to have nominating/corporate governance and compensation committees composed entirely of independent directors.

Each listed company is required to have an audit committee whose members are, in addition to being independent, also financially literate. At least one member must have accounting or related financial management expertise, as such qualification is interpreted in the business judgement of

the board of directors. Boards of directors are encouraged to limit the number of public company audit committees on which their audit committee members serve to three or less; if a director serves on more than three, the board must publicly determine that such simultaneous service would not impair the director's ability to serve effectively on the company's audit committee. The audit committee is required to review at least annually the quality-control procedures and independence of the independent auditor. In addition, each company is required to have an internal audit function.

The NYSE now requires each listed company to adopt and disclose corporate governance guidelines that address director qualifications and responsibilities, responsibilities of key board committees, director access to management and independent advisers, director compensation, director orientation and continuing education, management succession, and annual performance evaluation of the board of directors. Furthermore, each listed company must adopt and disclose a code of business conduct and ethics for directors, officers and employees. The code must contain compliance standards and procedures that facilitate effective operation and must address conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of company assets, compliance with laws, rules and regulations, and the reporting of illegal or unethical behaviour. Any waiver of the code for directors or executive officers may be made only by the board of directors or a board committee and must be promptly disclosed.

The NYSE requires the chief executive officer of each listed company to certify to the NYSE each year that he or she is not aware of any violation by the company of the NYSE corporate governance listing standards. If the chief executive officer becomes aware of any material non-compliance with any of the corporate governance listing standards, he or she must promptly notify the NYSE in writing.

In deference to the requirements to which listed foreign private issuers are subject in their own countries, the NYSE permits such companies to follow their home country practice in lieu of the corporate governance listing standards of the NYSE, with only a few exceptions. In addition, foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic NYSE-listed companies.

Many of the NYSE's new listing standards reflect best practices of major US corporations and the recommendations of groups such as the Business Roundtable, the American Society of Corporate Secretaries and the Council of Institutional Investors.

NYSE Corporate Governance Rules

These final rules are codified in Section 303A of the NYSE's Listed Company Manual, and were approved by the SEC on November 4, 2003. The commentary provided is that of the NYSE, and is not provided by the authors.

1. Listed companies must have a majority of independent directors.

Commentary: Effective boards of directors exercise independent judgement in carrying out their responsibilities. Requiring a majority of independent direc-

tors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

2. In order to tighten the definition of 'independent director' for purposes of these standards:

(a) No director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organisation that has a relationship with the company). Companies must disclose these determinations.

Commentary: It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company (references to 'company' would include any parent or subsidiary in a consolidated group with the company). Accordingly, it is best that boards making 'independence' determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organisations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

The basis for a board determination that a relationship is not material must be disclosed in the company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. In this regard, a board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. A company must disclose any standard it adopts. It may then make the general statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors and the company. In the event that a director with a business or other relationship that does not fit within the disclosed standards is determined to be independent, a board must disclose the basis for its determination in the manner described above. This approach provides investors with an adequate means of assessing the quality of a board's independence and its independence determinations while avoiding excessive disclosure of immaterial relationships.

(b) In addition:

(i) A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship.

Commentary: Employment as an interim Chairman or CEO shall not disqualify a director from being considered independent following that employment.

(ii) A director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.

Commentary: Compensation received by a director for former service as an interim Chairman or CEO need not be considered in determining independence under this test. Compensation received by an immediate family member for service as a non-executive employee of the listed company need not be considered in determining independence under this test.

(iii) A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not 'independent' until three years after the end of the affiliation or the employment or auditing relationship.

(iv) A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee is not 'independent' until three years after the end of such service or the employment relationship.

(v) A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, is not 'independent' until three years after falling below such threshold.

Commentary: In applying the test in Section 303A.02(b)(v), both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

Charitable organisations shall not be considered 'companies' for purposes of Section 303A.02(b)(v), provided however that a listed company shall disclose in its annual proxy statement, or if the listed company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC, any charitable contributions made by the listed company to any charitable organisation in which a director serves as an executive officer

if, within the preceding three years, contributions in any single fiscal year exceeded the greater of $1 million, or 2% of such charitable organisation's consolidated gross revenues. Listed company boards are reminded of their obligations to consider the materiality of any such relationship in accordance with Section 303A.02(a) above.

General Commentary to Section 303A.02(b): An 'immediate family member' includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. When applying the look-back provisions in Section 303A.02(b), listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated. In addition, references to the 'company' would include any parent or subsidiary in a consolidated group with the company.

Transition Rule. Each of the above standards contains a three-year 'look-back' provision. In order to facilitate a smooth transition to the new independence standards, the Exchange will phase in the 'look-back' provisions by applying only a one-year look-back for the first year after adoption of these new standards. The three-year look-backs provided for in Section 303A.02(b) will begin to apply only from and after November 4, 2004.

As an example, until November 3, 2004, a company need look back only one year when testing compensation under Section 303A.02(b)(ii). Beginning November 4, 2004, however, the company would need to look back the full three years provided in Section 303A.02(b)(ii).

3. To empower non-management directors to serve as a more effective check on management, the non-management directors of each company must meet at regularly scheduled executive sessions without management.

Commentary: To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. 'Non-management' directors are all those who are not company officers (as that term is defined in Rule 16a-1(f) under the Securities Act of 1933), and includes such directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason.

Regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of executive sessions. There need not be a single presiding director at all executive sessions of the non-management directors. If one director is chosen to preside at these meetings, his or her name must be disclosed in the company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. Alternatively, a company may disclose the procedure by which a presiding director is selected for each executive session. For example, a company may wish to rotate the presiding position among the chairs of board committees.

In order that interested parties may be able to make their concerns known to the non-management directors, a company must disclose a method for such

parties to communicate directly with the presiding director or with the non-management directors as a group. Companies may, if they wish, utilise for this purpose the same procedures they have established to comply with the requirement of Rule 10A-3 (b)(3) under the Exchange Act, as applied to listed companies through Section 303A.06.

While this Section 303A.03 refers to meetings of non-management directors, if that group includes directors who are not independent under this Section 303A, listed companies should at least once a year schedule an executive session including only independent directors.

4. (a) Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.

(b) The nominating/corporate governance committee must have a written charter that addresses:

(i) the committee's purpose and responsibilities – which, at minimum, must be to: identify individuals qualified to become board members, consistent with criteria approved by the board, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; develop and recommend to the board a set of corporate governance principles applicable to the corporation; and oversee the evaluation of the board and management; and

(ii) an annual performance evaluation of the committee.

Commentary: A nominating/corporate governance committee is central to the effective functioning of the board. New director and board committee nominations are among a board's most important functions. Placing this responsibility in the hands of an independent nominating/corporate governance committee can enhance the independence and quality of nominees. The committee is also responsible for taking a leadership role in shaping the corporate governance of a corporation.

If a company is legally required by contract or otherwise to provide third parties with the ability to nominate directors (for example, preferred stock rights to elect directors upon a dividend default, shareholder agreements, and management agreements), the selection and nomination of such directors need not be subject to the nominating committee process.

The nominating/corporate governance committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. In addition, the charter should give the nominating/corporate governance committee sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms.

Boards may allocate the responsibilities of the nominating/corporate governance committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter.

5. (a) Listed companies must have a compensation committee composed entirely of independent directors.

(b) The compensation committee must have a written charter that addresses:

(i) the committee's purpose and responsibilities – which, at minimum, must be to have direct responsibility to:

(A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation; and

(B) make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans; and

(C) produce a compensation committee report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC;

(ii) an annual performance evaluation of the compensation committee.

Commentary: In determining the long-term incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years. To avoid confusion, note that the compensation committee is not precluded from approving awards (with or without ratification of the board) as may be required to comply with applicable tax laws (i.e. Rule 162(m)).

The compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or senior executive compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.

Boards may allocate the responsibilities of the compensation committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter.

Nothing in this provision should be construed as precluding discussion of CEO compensation with the board generally, as it is not the intent of this standard to impair communication among members of the board.

6. Listed companies must have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act.
Commentary: The Exchange will apply the requirements of Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the generality of the foregoing, the Exchange will provide companies the opportunity to cure defects provided in Rule 10A-3(a)(3) under the Exchange Act.
7. (a) The audit committee must have a minimum of three members.
Commentary: Each member of the audit committee must be financially literate, as such qualification is interpreted by the company's board in its business judgement, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgement. While the Exchange does not require that a listed company's audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 401(e) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise. Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC.

(b) In addition to any requirement of Rule 10A-3(b)(1), all audit committee members must satisfy the requirements for independence set out in Section 303A.02.

(c) The audit committee must have a written charter that addresses:

(i) the committee's purpose – which, at minimum, must be to:

(A) assist board oversight of

(1) the integrity of the company's financial statements,

(2) the company's compliance with legal and regulatory requirements,

(3) the independent auditor's qualifications and independence, and

(4) the performance of the company's internal audit function and independent auditors; and

(B) prepare an audit committee report as required by the SEC to be included in the company's annual proxy statement;

(ii) an annual performance evaluation of the audit committee; and

(iii) the duties and responsibilities of the audit committee – which, at a minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act, as well as to:

(A) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company;

Commentary: After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(B) discuss the company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under 'Management's Discussion and Analysis of Financial Condition and Results of Operations';

(C) discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

Commentary: The audit committee's responsibility to discuss earnings releases, as well as financial information and earnings guidance, may be done generally (i.e. discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance.

(D) discuss policies with respect to risk assessment and risk management;

Commentary: While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control

such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(E) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(F) review with the independent auditor any audit problems or difficulties and management's response;

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were 'passed' (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any 'management' or 'internal control' letter issued, or proposed to be issued, by the audit firm to the company. The review should also include discussion of the responsibilities, budget and staffing of the company's internal audit function.

(G) set clear hiring policies for employees or former employees of the independent auditors; and

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(H) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

General Commentary to Section 303A.07(c): While the fundamental responsibility for the company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review:
(A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies;
(B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgements made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements;
(C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company; and
(D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of 'pro forma', or 'adjusted' non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

(I) Each listed company must have an internal audit function.

Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control. A company may choose to outsource this function to a third party service provider other than its independent auditor.
General Commentary to Section 303A.07: To avoid any confusion, note that the audit committee functions specified in Section 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.

8. Reserved

9. Listed companies must adopt and disclose corporate governance guidelines.

Commentary: No single set of guidelines would be appropriate for every company, but certain key areas of universal importance include director qualifications and responsibilities, responsibilities of key board committees, and director compensation. Given the importance of corporate governance, each listed company's website must include its corporate governance guidelines and the charters of its most important committees (including at least the audit, and if applicable, compensation and nominating committees). Each company's annual report on Form 10-K filed with the SEC must state that the foregoing information is available on its website, and that the information is available in print to any shareholder who requests it. Making this information publicly available should promote better investor understanding of the company's policies and procedures, as well as more conscientious adherence to them by directors and management. The following subjects must be addressed in the corporate governance guidelines:

• **Director qualification standards.** These standards should, at minimum, reflect the independence requirements set forth in Sections 303A.01 and .02. Companies may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.
• **Director responsibilities.** These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.
• **Director access to management and, as necessary and appropriate, independent advisers.**
• **Director compensation.** Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the company makes substantial charitable contributions to organisations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.
• **Director orientation and continuing education.**
• **Management succession.** Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.
• **Annual performance evaluation of the board.** The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.

10. Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.

Commentary: No code of business conduct and ethics can replace the thoughtful behaviour of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognise and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the company. It will also give shareholders the opportunity to evaluate the board's performance in granting waivers.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code. Each listed company's website must include its code of business conduct and ethics. Each company's annual report on Form 10-K filed with the SEC must state that the foregoing information is available on its website and that the information is available in print to any shareholder who requests it. Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

- **Conflicts of interest.** A 'conflict of interest' occurs when an individual's private interest interferes in any way – or even appears to interfere – with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company.
- **Corporate opportunities.** Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.
- **Confidentiality.** Employees, officers and directors should maintain the confidentiality of information entrusted to them by the company or its customers, except when disclosure is authorised or legally mandated. Confidential information includes all non-public information that might be of use to competitors, or harmful to the company or its customers, if disclosed.
- **Fair dealing.** Each employee, officer and director should endeavour to deal fairly with the company's customers, suppliers, competitors and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair dealing practice. Companies may write their codes in a manner that does not alter existing legal rights and obligations of companies and their employees, such as 'at will' employment arrangements.
- **Protection and proper use of company assets.** All employees, officers and directors should protect the company's assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the company's profitability. All company assets should be used for legitimate business purposes.
- **Compliance with laws, rules and regulations (including insider trading laws).** The company should proactively promote compliance with laws, rules and regulations, including insider trading laws. Insider trading is both unethical and illegal, and should be dealt with decisively.

• **Encouraging the reporting of any illegal or unethical behaviour.** The company should proactively promote ethical behaviour. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure that employees know that the company will not allow retaliation for reports made in good faith.

11. Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

Commentary: Foreign private issuers must make their US investors aware of the significant ways in which their home-country practices differ from those followed by domestic companies under NYSE listing standards. However, foreign private issuers are not required to present a detailed, item-by-item analysis of these differences. Such a disclosure would be long and unnecessarily complicated. Moreover, this requirement is not intended to suggest that one country's corporate governance practices are better or more effective than another. The Exchange believes that US shareholders should be aware of the significant ways that the governance of a listed foreign private issuer differs from that of a US listed company. The Exchange underscores that what is required is a brief, general summary of the significant differences, not a cumbersome analysis.

Listed foreign private issuers may provide this disclosure either on their website (provided it is in the English language and accessible from the United States) and/or in their annual report as distributed to shareholders in the United States in accordance with Sections 103.00 and 203.01 of the Listed Company Manual (again, in the English language). If the disclosure is only made available on the website, the annual report shall so state and provide the web address at which the information may be obtained.

12. (a) Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards.

Commentary: The CEO's annual certification to the NYSE that, as of the date of certification, he or she is unaware of any violation by the company of the NYSE's corporate governance listing standards will focus the CEO and senior management on the company's compliance with the listing standards. Both this certification to the NYSE, and any CEO/CFO certifications required to be filed with the SEC regarding the quality of the company's public disclosure, must be disclosed in the company's annual report to shareholders or, if the company does not prepare an annual report to shareholders, in the companies annual report on Form 10-K filed with the SEC.

(b) Each listed company CEO must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of this Section 303A.

13. The NYSE may issue a public reprimand letter to any listed company that violates an NYSE listing standard.
Commentary: Suspending trading in or delisting a company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously. For this reason it is appropriate for the NYSE to have the ability to apply a lesser sanction to deter companies from violating its corporate governance (or other) listing standards. Accordingly, the NYSE may issue a public reprimand letter to any listed company, regardless of type of security listed or country of incorporation, that it determines has violated an NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties. For clarification, this lesser sanction is not intended for use in the case of companies that fall below the financial and other continued listing standards provided in Chapter 8 of the Listed Company Manual or that fail to comply with the audit committee standards set out in Section 303A.06. The processes and procedures provided for in Chapter 8 govern the treatment of companies falling below those standards.

Appendix III: Germany

Evolution of corporate governance codes in Germany

The Cromme Code combines existing – by international comparison often extensive – legal requirements with about 60 newly developed recommendations and seven suggestions for good corporate governance in Germany. The German Government Commission 'Corporate Governance' was chaired by Gerhard Cromme, and based its Code on earlier work by the Government Panel on Corporate Governance, chaired by Theodor Baums and completed in 2001. This panel developed a series of recommendations on improving and updating German corporate law and corporate governance standards. The reform initiatives were not in response to concrete high-profile corporate governance failures, but in response to the changing need and structure of corporate finance in Germany, bringing it increasingly in line with a market-based finance system. With the increasing globalisation of German industry, the post-war model of bank-based finance is being pushed back, allowing firms to successfully tap into the international capital market. Signs are, for example, the listing of many of the large German enterprises in the US, like Daimler-Benz in 1993. In another sign of slow but successful adaptation, Gerhard Cromme had himself successfully launched two – what can be judged as hostile – takeover attempts in Germany; the first one as head of Krupp vs Hoesch, another steelmaker, in 1991 and then again against Thyssen in 1997.

The corporate governance recommendations are legally binding, unless the firm discloses its non-compliance similar to the 'comply or explain' regime common in the UK. In contradiction to the 'comply or explain' regime though, firms only have to disclose but not explain their non-compliance with the code in Germany (Vetter, 2003). The remaining corporate governance suggestions are propositions of good corporate governance by the Cromme Commission, and firms are not required to follow them. It is expected that firms will bow to market pressure and supply the necessary information voluntarily; however, from the outset it appears that the Cromme Commission bowed to pressure from the historically more secretive German industry by allowing firms to choose what kind of information to disseminate. Also, this information has to be disclosed only annually, and not in a timely manner when the infringement occurs. This of course violates the idea of Corporate Governance Codes to improve transparency and to allow the investor/owner to make an informed decision about the allocation of capital.

The Cromme Code is supplemented by the new takeover law from 2002[57] which was drafted in reaction to the hostile takeover of Mannesmann by Vodafone, and focuses mainly on disclosure of information and the adoption

of a mandatory bid threshold for German companies. The takeover law was preceded by the voluntary Takeover Codes from 1995,[58] which was widely perceived as being ineffectual because of the low acceptance and weak enforcement rights associated with it (Baum, 2005).

Cromme Code: Government Commission Corporate Governance Code (as amended on May 21, 2003)
Foreword – Amended
This German Corporate Governance Code (the 'Code') presents essential statutory regulations for the management and supervision (governance) of German listed companies and contains internationally and nationally recognised standards for good and responsible governance.
The Code clarifies the rights of shareholders, who provide the company with the required equity capital and who carry the entrepreneurial risk.
A dual board system is prescribed by law for German stock corporations:

- The Management Board is responsible for managing the enterprise. Its members are jointly accountable for the management of the enterprise. The Chairman of the Management Board coordinates the work of the Management Board.
- The Supervisory Board appoints, supervises and advises the members of the Management Board and is directly involved in decisions of fundamental importance to the enterprise. The Chairman of the Supervisory Board coordinates the work of the Supervisory Board.
- The members of the Supervisory Board are elected by the shareholders at the General Meeting. In enterprises having between 500 or 2000 employees in Germany, employees are also represented in the Supervisory Board, which then is composed of employee representatives to one third or to one half respectively. For enterprises with more than 2000 employees, the Chairman of the Supervisory Board, who, for all practical purposes, is a representative of the shareholders, has the casting vote in the case of split resolutions. The representatives elected by the shareholders and the representatives of the employees are equally obliged to act in the enterprise's best interests.

[…]
The accounting standards of German enterprises are oriented on the 'true and fair view' principle and represent a fair picture of the actual conditions of the asset, financial and earnings situations of the enterprise.
The **recommendations** of the Code are marked in the text by use of the word 'shall'. Companies can deviate from them, but are then obliged to disclose this annually. This enables companies to reflect sector and enterprise-specific requirements. Thus, the Code contributes to more flexibility and more self-regulation in the German corporate constitution. Furthermore, the Code contains **suggestions** which can be deviated from without disclosure; for this the Code uses terms such as 'should' or

'can'. The remaining passages of the Code not marked by these terms contain provisions that enterprises are compelled to observe under applicable law. [Note: To make it more accessible for the reader, the authors have marked the recommendations in the text with [**R**], and the suggestions with [**S**]. Legal requirements are unmarked, but in one case we added a [**L**] to avoid confusion.]
For Code stipulations relating to not only the listed company itself but also its group companies, the term 'enterprise' is used instead of 'company'.
Primarily, the Code addresses listed corporations. It is recommended that non-listed companies also respect the Code.
As a rule the Code will be reviewed annually against the background of national and international developments and be adjusted, if necessary.

2. Shareholders and the General Meeting
2.1 Shareholders
2.1.1 Shareholders exercise their rights at the General Meeting and vote there.
2.1.2 In principle, each share carries one vote. There are no shares with multiple voting rights, preferential voting rights (golden shares) or maximum voting rights.
2.2 General Meeting
2.2.1 The Management Board submits to the General Meeting the Annual Financial Statements and the Consolidated Financial Statements. The General Meeting resolves on the appropriation of net income and the discharge of the acts of the Management Board and of the Supervisory Board. It elects the shareholders' representatives to the Supervisory Board and, as a rule, the auditors.
Furthermore, the General Meeting resolves on the Articles of Association, the purpose of the company, amendments to the Articles of Association and essential corporate measures such as, in particular, inter-company agreements and transformations, the issuing of new shares and, in particular, of convertible bonds and bonds with warrants, and the authorisation to purchase own shares.
2.2.2 When new shares are issued, shareholders, in principle, have pre-emptive rights corresponding to their share of the equity capital.
2.2.3 Each shareholder is entitled to participate in the General Meeting, to take the floor on matters on the agenda and to submit materially relevant questions and proposals.
2.2.4 The chair of the meeting provides for the expedient running of the General Meeting.
2.3 Invitation to the General Meeting, Proxies
2.3.1 [R] At least once a year the shareholders' General Meeting is to be convened by the Management Board giving details of the agenda. A quorum of shareholders is entitled to demand the convening of a General Meeting and the extension of the agenda. The Management Board shall not only provide the reports and documents, including the

Annual Report, required by law for the General Meeting, and send them to shareholders upon request, but shall also publish them on the company's Internet site together with the agenda.
2.3.2 [R] The company shall inform all domestic and foreign shareholders, shareholders' associations and financial services providers, who, in the preceding 12 months, have requested such notification, of the convening of the General Meeting together with the convention documents, upon request, also using electronic channels.
2.3.3 [R] The company shall facilitate the personal exercising of shareholders' voting rights. The company shall also assist the shareholders in the use of proxies. The Management Board shall arrange for the appointment of a representative to exercise shareholders' voting rights in accordance with instructions; this representative should also be reachable during the General Meeting.
2.3.4 [S] The company should make it possible for shareholders to follow the General Meeting using modern communication media (e.g. Internet).

3. Cooperation between Management Board and Supervisory Board
3.1 The Management Board and Supervisory Board cooperate closely to the benefit of the enterprise.
3.2 The Management Board coordinates the enterprise's strategic approach with the Supervisory Board and discusses the current state of strategy implementation with the Supervisory Board in regular intervals.
3.3 For transactions of fundamental importance, the Articles of Association or the Supervisory Board specify provisions requiring the approval of the Supervisory Board. They include decisions or measures which fundamentally change the asset, financial or earnings situations of the enterprise.
3.4 Providing sufficient information to the Supervisory Board is the joint responsibility of the Management Board and Supervisory Board.
The Management Board informs the Supervisory Board regularly, without delay and comprehensively, of all issues important to the enterprise with regard to planning, business development, risk situation and risk management. The Management Board points out deviations of the actual business development from previously formulated plans and targets, indicating the reasons therefore.
[R] The Supervisory Board shall specify the Management Board's information and reporting duties in more detail. The Management Board's reports to the Supervisory Board are, as a rule, to be submitted in writing (including electronic form). Documents required for decisions, in particular, the Annual Financial Statements, the Consolidated Financial Statements and the Auditors' Report are to be sent to the members of the Supervisory Board, to the extent possible, in due time before the meeting.
3.5 Good corporate governance requires an open discussion between the Management Board and Supervisory Board as well as among the members within the Management Board and the Supervisory Board. The comprehensive observance of confidentiality is of paramount importance for this.

All board members ensure that the staff members they employ observe the confidentiality obligation accordingly.
3.6 [S] In Supervisory Boards with codetermination, representatives of the shareholders and of the employees should prepare the Supervisory Board meetings separately, possibly with members of the Management Board. If necessary, the Supervisory Board should meet without the Management Board.
3.7 In the event of a takeover offer, the Management Board and Supervisory Board of the target company must submit a statement of their reasoned position so that the shareholders can make an informed decision on the offer.
After the announcement of a takeover offer, the Management Board may not take any actions outside the ordinary course of business that could prevent the success of the offer unless the Management Board has been authorised by the General Meeting or the Supervisory Board has given its approval. In making their decisions, the Management and Supervisory Boards are bound to the best interests of the shareholders and of the enterprise.
[S] In appropriate cases the Management Board should convene an extraordinary General Meeting at which shareholders discuss the takeover offer and may decide on corporate actions.
3.8 The Management Board and Supervisory Board comply with the rules of proper corporate management. If they violate the due care and diligence of a prudent and conscientious Managing Director or Supervisory Board member, they are liable to the company for damages.
[R] If the company takes out a D&O (directors and officers' liability insurance) policy for the Management Board and Supervisory Board, a suitable deductible shall be agreed.
3.9 Extending loans from the enterprise to members of the Management and Supervisory Boards or their relatives requires the approval of the Supervisory Board.
3.10 [R] The Management Board and Supervisory Board shall report each year on the enterprise's Corporate Governance in the Annual Report. This includes the explanation of possible deviations from the recommendations of this Code. Comments can also be provided on the Code's suggestions.

4. Management Board
4.1 Tasks and Responsibilities
4.1.1 The Management Board is responsible for independently managing the enterprise. In doing so, it is obliged to act in the enterprise's best interests and undertakes to increase the sustainable value of the enterprise.
4.1.2 The Management Board develops the enterprise's strategy, coordinates it with the Supervisory Board and ensures its implementation.
4.1.3 The Management Board ensures that all provisions of law are abided by and works to achieve their compliance by group companies.
4.1.4 The Management Board ensures appropriate risk management and risk controlling in the enterprise.

4.2 Composition and Compensation
4.2.1 [R] The Management Board shall be comprised of several persons and have a Chairman or Spokesman. Terms of Reference shall regulate the allocation of areas of responsibility and the cooperation in the Management Board.
4.2.2 [R] At the proposal of the committee dealing with Management Board contracts, the full Supervisory Board shall discuss and regularly review the structure of the Management Board compensation system.
Compensation of the members of the Management Board is determined by the Supervisory Board at an appropriate amount based on a performance assessment in considering any payments by group companies. Criteria for determining the appropriateness of compensation are, in particular, the tasks of the respective member of the Management Board, his personal performance, the performance of the Management Board as well as the economic situation, the performance and outlook of the enterprise taking into account its peer companies.
4.2.3 [R] The overall compensation of the members of the Management Board shall comprise a fixed salary and variable components. [S] Variable compensation should include one-time and annually payable components linked to the business performance as well as long-term incentives containing risk elements. All compensation components must be appropriate, both individually and in total.
[R] In particular, company stocks with a multi-year blocking period, stock options or comparable instruments (e.g. phantom stocks) serve as variable compensation components with long-term incentive effect and risk elements. Stock options and comparable instruments shall be related to demanding, relevant comparison parameters. Changing such performance targets or comparison parameters retroactively shall be excluded. For extraordinary, unforeseen developments a possibility of limitation (Cap) shall be agreed by the Supervisory Board.
[R] The salient points of the compensation system and the concrete form of a stock options scheme or comparable instruments for components with long-term incentive effect and risk elements shall be published on the company's website in plainly understandable form and be detailed in the annual report. This shall include information on the value of stock options.
[R] The Chairman of the Supervisory Board shall outline the salient points of the compensation system and any changes thereto to the General Meeting.
4.2.4 [R] Compensation of the members of the Management Board shall be reported in the Notes of the Consolidated Financial Statements subdivided according to fixed, performance-related and long-term incentive components. The figures shall be individualised.
4.3 Conflicts of Interest
4.3.1 During their employment for the enterprise, members of the Management Board are subject to a comprehensive non-competition obligation.

4.3.2 Members of the Management Board and employees may not, in connection with their work, demand nor accept from third parties payments or other advantages for themselves or for any other person nor grant third parties unlawful advantages.
4.3.3 Members of the Management Board are bound by the enterprise's best interests. No member of the Management Board may pursue personal interests in his decisions or use business opportunities intended for the enterprise for himself.
4.3.4 [R] All members of the Management Board shall disclose conflicts of interest to the Supervisory Board without delay and inform the other members of the Management Board thereof. All transactions between the enterprise and the members of the Management Board as well as persons they are close to or companies they have a personal association with must comply with standards customary in the sector. Important transactions shall require the approval of the Supervisory Board.
4.3.5 [R] Members of the Management Board shall take on sideline activities, especially Supervisory Board mandates outside the enterprise, only with the approval of the Supervisory Board.

5. Supervisory Board
5.1 Tasks and Responsibilities
5.1.1 The task of the Supervisory Board is to advise regularly and supervise the Management Board in the management of the enterprise. It must be involved in decisions of fundamental importance to the enterprise.
5.1.2 The Supervisory Board appoints and dismisses the members of the Management Board. **[R]** Together with the Management Board it shall ensure that there is a long-term succession planning. The Supervisory Board can delegate preparations for the appointment of members of the Management Board to a committee, which also determines the conditions of the employment contracts including compensation.
[S] For first-time appointments the maximum possible appointment period of five years should not be the rule. **[R]** A reappointment prior to one year before the end of the appointment period with a simultaneous termination of the current appointment shall only take place under special circumstances. An age limit for members of the Management Board shall be specified.
5.1.3 [R] The Supervisory Board shall issue Terms of Reference.
5.2 Tasks and Authorities of the Chairman of the Supervisory Board
The Chairman of the Supervisory Board coordinates work within the Supervisory Board and chairs its meetings.
[R] The Chairman of the Supervisory Board shall also chair the committees that handle contracts with members of the Management Board and prepare the Supervisory Board meetings. **[S]** He should not be Chairman of the Audit Committee.
[R] The Chairman of the Supervisory Board shall regularly maintain contact with the Management Board, in particular, with the Chairman or Spokesman of the Management Board and consult with him on strategy,

business development and risk management of the enterprise. **[L]** The Chairman of the Supervisory Board will be informed by the Chairman or Spokesman of the Management Board without delay of important events which are essential for the assessment of the situation and development as well as for the management of the enterprise. **[R]** The Chairman of the Supervisory Board shall then inform the Supervisory Board and, if required, convene an extraordinary meeting of the Supervisory Board.

5.3 Formation of Committees

5.3.1 [R] Depending on the specifics of the enterprise and the number of its members, the Supervisory Board shall form committees with sufficient expertise. They serve to increase the efficiency of the Supervisory Board's work and the handling of complex issues. The respective committee chairmen report regularly to the Supervisory Board on the work of the committees.

5.3.2 [R] The Supervisory Board shall set up an Audit Committee which, in particular, handles issues of accounting and risk management, the necessary independence required of the auditor, the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement. **[S]** The Chairman of the Audit Committee should not be a former member of the Management Board of the company.

5.3.3 The Supervisory Board can delegate other subjects to be handled by one or several committees. These subjects include the strategy of the enterprise, the compensation of the members of the Management Board, investments and financing.

5.3.4 The Supervisory Board can arrange for committees to prepare Supervisory Board meetings and to take decisions in place of the Supervisory Board.

5.4 Composition and Compensation

5.4.1 [R] For nominations for the election of members of the Supervisory Board, care shall be taken that the Supervisory Board, at all times, is composed of members who, as a whole, have the required knowledge, abilities and expert experience to properly complete their tasks and are sufficiently independent. Furthermore, the international activities of the enterprise, potential conflicts of interest and an age limit to be specified for the members of the Supervisory Board shall be taken into account.

5.4.2 [R] To ensure the Supervisory Board's independent advice and supervision of the Management Board, not more than two former members of the Management Board shall be members of the Supervisory Board and Supervisory Board members shall not exercise directorships or similar positions or advisory tasks for important competitors of the enterprise.

5.4.3 Every member of the Supervisory Board must take care that he/she has sufficient time to perform his/her mandate. **[R]** Members of the Management Board of a listed company shall not accept more than a total of five Supervisory Board mandates in non-group listed companies.

5.4.4 The election or re-election of members of the Supervisory Board at different dates and for different periods of office enables changing requirements to be taken into account.

5.4.5 Compensation of the members of the Supervisory Board is specified by resolution of the General Meeting or in the Articles of Association. It takes into account the responsibilities and scope of tasks of the members of the Supervisory Board as well as the economic situation and performance of the enterprise. **[R]** Also to be considered here shall be the exercising of the chair and deputy chair positions in the Supervisory Board as well as the chair and membership in committees.
[R] Members of the Supervisory Board shall receive fixed as well as performance-related compensation. Performance-related compensation should also contain components based on the long-term performance of the enterprise.
[R] The compensation of the members of the Supervisory Board shall be reported in the Notes of the Consolidated Financial Statements, subdivided according to components. Also payments made by the enterprise to the members of the Supervisory Board or advantages extended for services provided individually, in particular, advisory or agency services shall be listed separately in the Notes to the Consolidated Financial Statements.
5.4.6 [R] If a member of the Supervisory Board took part in less than half of the meetings of the Supervisory Board in a financial year, this shall be noted in the Report of the Supervisory Board.
5.5 Conflicts of Interest
5.5.1 All members of the Supervisory Board are bound by the enterprise's best interests. No member of the Supervisory Board may pursue personal interests in his/her decisions or use business opportunities intended for the enterprise for himself/herself.
5.5.2 [R] Each member of the Supervisory Board shall inform the Supervisory Board of any conflicts of interest which may result from a consultant or directorship function with clients, suppliers, lenders or other business partners.
5.5.3 [R] In its report, the Supervisory Board shall inform the General Meeting of any conflicts of interest which have occurred together with their treatment. Material conflicts of interest and those which are not merely temporary in respect of the person of a Supervisory Board member shall result in the termination of his mandate.
5.5.4 Advisory and other service agreements and contracts for work between a member of the Supervisory Board and the company require the Supervisory Board's approval.
5.6 Examination of Efficiency
[R] The Supervisory Board shall examine the efficiency of its activities on a regular basis.

6. Transparency
6.1 The Management Board will disclose without delay any new facts which have arisen within the enterprise's field of activity and which are not known publicly, if such facts could, owing to their impact on the asset and financial situations or general business development, substantially influence the price of the company's registered securities.

6.2 As soon as the company becomes aware of the fact that an individual acquires, exceeds or falls short of 5, 10, 25, 50 or 75% of the voting rights in the company by means of a purchase, sale or any other manner, the Management Board will disclose this fact without delay.
6.3 [R] The company's treatment of all shareholders in respect of information shall be equal. All new facts made known to financial analysts and similar addressees shall also be disclosed to the shareholders by the company without delay.
6.4 [R] The company shall use suitable communication media, such as the Internet, to inform shareholders and investors in a prompt and uniform manner.
6.5 [R] Any information which the company discloses abroad in line with corresponding capital market law provisions shall also be disclosed domestically without delay.
6.6 [R] The purchase or sale of shares in the company or of related purchase or sale rights (e.g. options) and of rights directly dependent on the stock market price of the company by members of the Management Board and Supervisory Board of the company or its parent company and by related parties shall be reported without delay to the company. Purchases based on employment contracts, as a compensation component as well as immaterial purchase and sale transactions (Euro 25,000 in 30 days) are excepted from the reporting requirement. The company shall publish the disclosure without delay.
[R] Corresponding information shall be provided in the Notes to the Consolidated Financial Statements. The shareholdings, including options and derivatives, held by individual Management Board and Supervisory Board members shall be reported if these directly or indirectly exceed 1% of the shares issued by the company. If the entire holdings of all members of the Management Board and Supervisory Board exceed 1% of the shares issued by the company, these shall be reported separately according to Management Board and Supervisory Board.
6.7 [R] As part of regular information policy, the dates of essential regular publications (including the Annual Report, interim reports, General Meeting) shall be published sufficiently in advance in a 'financial calendar'.
6.8 [R] Information on the enterprise which the company discloses shall also be accessible via the company's Internet site. The Internet site shall be clearly structured. Publications should also be in English.

7. Reporting and Audit of the Annual Financial Statements
7.1 Reporting
7.1.1 [R] Shareholders and third parties are mainly informed by the Consolidated Financial Statements. They shall be informed during the financial year by means of interim reports. The Consolidated Financial Statements and interim reports shall be prepared under observance of internationally recognised accounting principles. For corporate law purposes (calculation of dividend, shareholder protection), Annual Financial Statements will be prepared according to national regulations (German Commercial Code), which also form the basis for taxation.

7.1.2 The Consolidated Financial Statements will be prepared by the Management Board and examined by the auditor and Supervisory Board. [R] The Consolidated Financial Statements shall be publicly accessible within 90 days of the end of the financial year; interim reports shall be publicly accessible within 45 days of the end of the reporting period.
7.1.3 [R] The Consolidated Financial Statements shall contain information on stock option programmes and similar securities-based incentive systems of the company.
7.1.4 [R] The company shall publish a list of third party companies in which it has a shareholding that is not of minor importance for the enterprise. The trading portfolios of banks and financial services companies, on which voting rights are not exercised, are disregarded in this context. The following shall be provided: name and headquarters of the company, the amount of the shareholding, the amount of equity and the operating result of the past financial year.
7.1.5 [R] Notes on the relationships with shareholders considered to be 'related parties' pursuant to the applicable accounting regulations shall be provided in the Consolidated Financial Statements.
7.2 Audit of Annual Financial Statements
7.2.1 [R] Prior to submitting a proposal for election, the Supervisory Board or, respectively, the Audit Committee shall obtain a statement from the proposed auditor stating whether, and where applicable, which professional, financial and other relationships exist between the auditor and its executive bodies and head auditors on the one hand, and the enterprise and the members of its executive bodies on the other hand, that could call its independence into question. This statement shall include the extent to which other services were performed for the enterprise in the past year, especially in the field of consultancy, or which are contracted for the following year.
[R] The Supervisory Board shall agree with the auditor that the Chairman of the Supervisory Board will be informed immediately of any grounds for disqualification or impartiality occurring during the audit, unless such grounds are eliminated immediately.
7.2.2 The Supervisory Board commissions the auditor to carry out the audit and concludes an agreement on the latter's fee.
7.2.3 [R] The Supervisory Board shall arrange for the auditor to report without delay on all facts and events of importance for the tasks of the Supervisory Board which arise during the performance of the audit.
[R] The Supervisory Board shall arrange for the auditor to inform it and/or note in the Auditor's Report if, during the performance of the audit, the auditor comes across facts which show a misstatement by the Management Board and Supervisory Board on the Code.
7.2.4 The auditor takes part in the Supervisory Board's deliberations on the Annual Financial Statements and Consolidated Financial Statements and reports on the essential results of its audit.

Appendix IV: European Takeover Code

In July 2001, after 12 years of consultation, and the rejection by member states of various prior proposals, the European Commission put forward the 13th European Directive on Takeover Bids to the European Parliament for approval. The proposal had become part of the Financial Services Action Plan (1999), following the introduction of the single European currency, and was later endorsed by the member states as part of the Lisbon Agenda of March 2000, initiated to increase European competitiveness. The aim of the takeover directive was to create an active market in corporate control and encourage further consolidation, creating firms with pan-European scope and scale.

However, the directive was rejected in the European Parliament. The primary objection of opponents of the directive was the proposed ban on the enactment of post-bid defences (e.g. corporate restructurings, debt issuance) by managers and boards on the receiving end of a tender offer. Other objections stated at the time were the perceived lack of a level playing field with the US (due to the widespread availability of poison pills under US corporate law) and the lack of provision for employee consultation and protection.

In response to the narrow rejection, the Commission convened the High Level Group (HLG) of Company Law Experts chaired by Jaap Winter, to provide independent advice. In January 2002, the group issued their report endorsing the Commission's attempt to adopt regulation of European M&A based on the UK City Code on Takeovers and Mergers and certain fundamental principles, many of which were contained in the original proposal. These included:

1. Equality of treatment of all shareholders.
2. The banning of partial bids for control (through the use of a mandatory bid threshold).
3. The primacy of shareholder decision making in relation to a tender offer (through the requirement that all post-bid defences enacted by the board be subject to shareholder approval). The only frustrating measure boards should be able to undertake without shareholder approval is to seek out competing bids.
4. Where there existed a separation of cash flow rights and voting rights (through control devices such as dual class shares, golden shares, voting ceilings, etc.), these should be reunified for the purposes of deciding the outcome of a takeover contest. This should be done through allowing the bidder to break through such devices when he has acquired 75 per cent of the cash flow rights of a firm.
5. Squeeze-out and sell-out rules should be implemented.

Overall, the report of the High Level Group endorsed the Commission's approach and called for a harmonisation of European takeover regulation and the creation of a level playing field between member states.

In October 2002, the Commission presented a new proposal based on the recommendations of the HLG. The proposal again provided for strict board neutrality when faced with a tender offer. It also added a breakthrough provision and rules on squeeze-outs and sell-outs.

The revised version of the directive again met significant hostility from Germany, the Nordic countries and France. Multiple share classes are common in both Scandinavia and France, and these countries argued that they would be disproportionately penalised by the breakthrough clause. This was because the directive did not cover certain other devices with separate cash flow and voting rights such as pyramids. On the other hand, German representatives in the Parliament argued that the ban on post-bid defences would leave their firms particularly vulnerable to raiders, as many were only protected by cross-holdings which are currently in the process of being unwound. Earlier legislation in Germany, the Control and Transparency Act (KonTraG, 1998) had outlawed most pre-bid defences.

Eventually, the Commission was forced to introduce a series of exemptions as a political compromise to ensure that the Takeover Code was passed by the European Parliament. These were as follows:

1. Member states are not required to adopt Articles 9 (board neutrality) and 11 (breakthrough).
2. If a state does not adopt them, firms within that state can opt in. However, they would also have the option to opt out again at a later stage.
3. If a firm has opted out, it cannot use the breakthrough provision to acquire a firm which has opted in.

Appendix: The European Takeover Directive – amended with commentary

DIRECTIVE 2004/25/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

21 April 2004 on takeover bids

Article 1

Scope

1. This Directive lays down measures coordinating the laws, regulations, administrative provisions, codes of practice and other arrangements of the Member States, including arrangements established by organisations officially authorised to regulate the markets (hereinafter referred to as 'rules'), relating to takeover bids for the securities of companies governed by the laws of Member States, […].

[…]

Article 3

General principles

1. For the purpose of implementing this Directive, Member States shall ensure that the following principles are complied with:

(a) all holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of a company, the other holders of securities must be protected;
(b) the holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company's places of business;
(c) the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid;
(d) false markets must not be created in the securities of the offeree company, of the offeror company or of any other company concerned by the bid in such a way that the rise or fall of the prices of the securities becomes artificial and the normal functioning of the markets is distorted;
(e) an offeror must announce a bid only after ensuring that he/she can fulfil in full any cash consideration, if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration;
(f) an offeree company must not be hindered in the conduct of its affairs for longer than is reasonable by a bid for its securities.
2. With a view to ensuring compliance with the principles laid down in paragraph 1, Member States:
(a) shall ensure that the minimum requirements set out in this Directive are observed;
(b) may lay down additional conditions and provisions more stringent than those of this Directive for the regulation of bids.
Article 4
Supervisory authority and applicable law
1. Member States shall designate the authority or authorities competent to supervise bids for the purposes of the rules which they make or introduce pursuant to this Directive. The authorities thus designated shall be either public authorities, associations or private bodies recognised by national law or by public authorities expressly empowered for that purpose by national law. Member States shall inform the Commission of those designations, specifying any divisions of functions that may be made. They shall ensure that those authorities exercise their functions impartially and independently of all parties to a bid.
[…]
Article 5
Protection of minority shareholders, the mandatory bid and the equitable price
1. Where a natural or legal person, as a result of his/her own acquisition or the acquisition by persons acting in concert with him/her, holds securities of a company as referred to in Article 1(1) which, added to any existing holdings of those securities of his/hers and the holdings of those

securities of persons acting in concert with him/her, directly or indirectly give him/her a specified percentage of voting rights in that company, giving him/her control of that company, Member States shall ensure that such a person is required to make a bid as a means of protecting the minority shareholders of that company. Such a bid shall be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price as defined in paragraph 4.

2. Where control has been acquired following a voluntary bid made in accordance with this Directive to all the holders of securities for all their holdings, the obligation laid down in paragraph 1 to launch a bid shall no longer apply.

3. The percentage of voting rights which confers control for the purposes of paragraph 1 and the method of its calculation shall be determined by the rules of the Member State in which the company has its registered office.

4. The highest price paid for the same securities by the offeror, or by persons acting in concert with him/her, over a period, to be determined by Member States, of not less than six months and not more than 12 before the bid referred to in paragraph 1 shall be regarded as the equitable price. If, after the bid has been made public and before the offer closes for acceptance, the offeror or any person acting in concert with him/her purchases securities at a price higher than the offer price, the offeror shall increase his/her offer so that it is not less than the highest price paid for the securities so acquired.

Provided that the general principles laid down in Article 3(1) are respected, Member States may authorise their supervisory authorities to adjust the price referred to in the first subparagraph in circumstances and in accordance with criteria that are clearly determined. To that end, they may draw up a list of circumstances in which the highest price may be adjusted either upwards or downwards, for example where the highest price was set by agreement between the purchaser and a seller, where the market prices of the securities in question have been manipulated, where market prices in general or certain market prices in particular have been affected by exceptional occurrences, or in order to enable a firm in difficulty to be rescued. They may also determine the criteria to be applied in such cases, for example the average market value over a particular period, the break-up value of the company or other objective valuation criteria generally used in financial analysis. Any decision by a supervisory authority to adjust the equitable price shall be substantiated and made public.

[…]

Article 9

Obligations of the board of the offeree company

1. Member States shall ensure that the rules laid down in paragraphs 2 to 5 are complied with.

2. During the period referred to in the second subparagraph, the board of the offeree company shall obtain the prior authorisation of the general meeting of shareholders given for this purpose before taking any action,

other than seeking alternative bids, which may result in the frustration of the bid and in particular before issuing any shares which may result in a lasting impediment to the offeror's acquiring control of the offeree company. Such authorisation shall be mandatory at least from the time the board of the offeree company receives the bid and until the result of the bid is made public or the bid lapses. Member States may require that such authorisation be obtained at an earlier stage, for example as soon as the board of the offeree company becomes aware that the bid is imminent.
3. As regards decisions taken before the beginning of the period referred to in the second subparagraph of paragraph 2 and not yet partly or fully implemented, the general meeting of shareholders shall approve or confirm any decision which does not form part of the normal course of the company's business and the implementation of which may result in the frustration of the bid.
4. For the purpose of obtaining the prior authorisation, approval or confirmation of the holders of securities referred to in paragraphs 2 and 3, Member States may adopt rules allowing a general meeting of shareholders to be called at short notice, provided that the meeting does not take place within two weeks of notifications being given.
5. The board of the offeree company shall draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business as set out in the offer document [...]. The board of the offeree company shall at the same time communicate that opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves. Where the board of the offeree company receives in good time a separate opinion from the representatives of its employees on the effects of the bid on employment, that opinion shall be appended to the document.
6. For the purposes of paragraph 2, where a company has a two-tier board structure 'board' shall mean both the management board and the supervisory board.
[...]
Article 11
Breakthrough
1. Without prejudice to other rights and obligations provided for in Community law for the companies referred to in Article 1(1), Member States shall ensure that the provisions laid down in paragraphs 2 to 7 apply when a bid has been made public.
2. Any restrictions on the transfer of securities provided for in the articles of association of the offeree company shall not apply vis-à-vis the offeror during the time allowed for acceptance of the bid [...].
Any restrictions on the transfer of securities provided for in contractual agreements between the offeree company and holders of its securities, or

in contractual agreements between holders of the offeree company's securities entered into after the adoption of this Directive, shall not apply vis-à-vis the offeror during the time allowed for acceptance of the bid [...].

3. Restrictions on voting rights provided for in the articles of association of the offeree company shall not have effect at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9.

Restrictions on voting rights provided for in contractual agreements between the offeree company and holders of its securities, or in contractual agreements between holders of the offeree company's securities entered into after the adoption of this Directive, shall not have effect at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9. Multiple-vote securities shall carry only one vote each at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9.

4. Where, following a bid, the offeror holds 75% or more of the capital carrying voting rights, no restrictions on the transfer of securities or on voting rights referred to in paragraphs 2 and 3 nor any extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of association of the offeree company shall apply; multiple-vote securities shall carry only one vote each at the first general meeting of shareholders following closure of the bid, called by the offeror in order to amend the articles of association or to remove or appoint board members. To that end, the offeror shall have the right to convene a general meeting of shareholders at short notice, provided that the meeting does not take place within two weeks of notification.

5. Where rights are removed on the basis of paragraphs 2, 3, or 4 and/or Article 12, equitable compensation shall be provided for any loss suffered by the holders of those rights. The terms for determining such compensation and the arrangements for its payment shall be set by Member States.

6. Paragraphs 3 and 4 shall not apply to securities where the restrictions on voting rights are compensated for by specific pecuniary advantages.

7. This Article shall not apply either where Member States hold securities in the offeree company which confer special rights on the Member States which are compatible with the Treaty, or to special rights provided for in national law which are compatible with the Treaty or to cooperatives.

Article 12

Optional arrangements

1. Member States may reserve the right not to require companies as referred to in Article 1(1) which have their registered offices within their territories to apply Article 9(2) and (3) and/or Article 11.

2. Where Member States make use of the option provided for in paragraph 1, they shall nevertheless grant companies which have their registered offices within their territories the option, which shall be reversible, of applying Article 9(2) and (3) and/or Article 11, without prejudice to

Article 11(7). The decision of the company shall be taken by the general meeting of shareholders, in accordance with the law of the Member State in which the company has its registered office in accordance with the rules applicable to amendment of the articles of association. The decision shall be communicated to the supervisory authority of the Member State in which the company has its registered office and to all the supervisory authorities of Member States in which its securities are admitted to trading on regulated markets or where such admission has been requested.

3. Member States may, under the conditions determined by national law, exempt companies which apply Article 9(2) and (3) and/or Article 11 from applying Article 9(2) and (3) and/or Article 11 if they become the subject of an offer launched by a company which does not apply the same Articles as they do, or by a company controlled, directly or indirectly, by the latter, pursuant to Article 1 of Directive 83/349/EEC.

[…]

Article 13

Other rules applicable to the conduct of bids

Member States shall also lay down rules which govern the conduct of bids, at least as regards the following:

(a) the lapsing of bids;

(b) the revision of bids;

(c) competing bids;

(d) the disclosure of the results of bids;

(e) the irrevocability of bids and the conditions permitted.

Article 14

Information for and consultation of employees' representatives

This Directive shall be without prejudice to the rules relating to information and to consultation of representatives of and, if Member States so provide, co-determination with the employees of the offeror and the offeree company governed by the relevant national provisions, and in particular those adopted pursuant to Directives 94/45/EC, 98/59/EC, 2001/86/EC and 2002/14/EC.

Article 15

The right of squeeze-out

1. Member States shall ensure that, following a bid made to all the holders of the offeree company's securities for all of their securities, paragraphs 2 to 5 apply.

2. Member States shall ensure that an offeror is able to require all the holders of the remaining securities to sell him/her those securities at a fair price. Member States shall introduce that right in one of the following situations:

(a) where the offeror holds securities representing not less than 90% of the capital carrying voting rights and 90% of the voting rights in the offeree company, or

(b) where, following acceptance of the bid, he/she has acquired or has firmly contracted to acquire securities representing not less than 90% of

the offeree company's capital carrying voting rights and 90% of the voting rights comprised in the bid. In the case referred to in (a), Member States may set a higher threshold that may not, however, be higher than 95% of the capital carrying voting rights and 95% of the voting rights.
3. Member States shall ensure that rules are in force that make it possible to calculate when the threshold is reached. Where the offeree company has issued more than one class of securities, Member States may provide that the right of squeeze-out can be exercised only in the class in which the threshold laid down in paragraph 2 has been reached.
4. If the offeror wishes to exercise the right of squeeze-out he/she shall do so within three months of the end of the time allowed for acceptance of the bid […].
5. Member States shall ensure that a fair price is guaranteed. That price shall take the same form as the consideration offered in the bid or shall be in cash. Member States may provide that cash shall be offered at least as an alternative. Following a voluntary bid, in both of the cases referred to in paragraph 2(a) and (b), the consideration offered in the bid shall be presumed to be fair where, through acceptance of the bid, the offeror has acquired securities representing not less than 90 % of the capital carrying voting rights comprised in the bid. Following a mandatory bid, the consideration offered in the bid shall be presumed to be fair.
Article 16
The right of sell-out
1. Member States shall ensure that, following a bid made to all the holders of the offeree company's securities for all of their securities, paragraphs 2 and 3 apply.
2. Member States shall ensure that a holder of remaining securities is able to require the offeror to buy his/her securities from him/her at a fair price under the same circumstances as provided for in Article 15(2).
3. Article 15(3) to (5) shall apply *mutatis mutandis*.
Article 17
Sanctions
Member States shall determine the sanctions to be imposed for infringement of the national measures adopted pursuant to this Directive and shall take all necessary steps to ensure that they are put into effect. The sanctions thus provided for shall be effective, proportionate and dissuasive. Member States shall notify the Commission of those measures no later than the date laid down in Article 21(1) and of any subsequent change thereto at the earliest opportunity.
[…]
Article 21
Transposition
1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive no later than 20 May 2006. […].

Notes

1 For example, the Preda Code in Italy and the Olivenca Code in Spain both require only an 'appropriate number' of independent directors on the board. This can be contrasted to the UK where there is a 'comply or explain' requirement that at least half the directors on the board be independent.
2 Two-tier boards are for example mandatory in Germany, Austria and the Netherlands.
3 It can be argued that the current structure of co-determination violates – in the worst case – EU law, and in the best case just its spirit. Globalisation means that many German firms employ by now the majority of their workforce outside Germany, but have only German labour representation on their board. This effectively means a discrimination against non-German labour representatives, as German labour has a voice on the board while non-German labour representatives are denied this privilege (Baum, 2005).
4 For a comprehensive discussion see Coffee (2003a, b; 2005), also MacAvoy and Millstein (2003).
5 The extreme example of Motorola is highlighted by Coffee (2003b). The firm was found in a 2002 investigation by the *Chicago Tribune* newspaper to have a consultancy to audit fee ratio of 16 : 1.
6 Kevin Murphy points out in Chapter 10 that improved transparency in executive pay in Europe had the unintended consequence that managers demanded higher pay in line with the best earning 'colleague', leading to a ratchet effect in managerial remuneration – although still leaving European executive compensation behind US levels.
7 POS: Piece of […].
8 It should be noted that some agencies, such as S&P, charge limited surveillance fees to corporates, and only provide ratings upon request.
9 Press release, European Commission, Statement No. 13, 2002.
10 The definition of independence is unlikely to be exhaustive. Rather it should list disqualifying factors such as a material relationship with the firm, and ensure transparency through disclosure.
11 *Financial Times*, 4 March 2005.
12 The full reference to this paper is: Jensen, Michael C., 'Agency Costs of Overvalued Equity' (January 2005). Harvard NOM Working Paper No. 04–26; ECGI – Finance Working Paper No. 39/2004. Forthcoming in *Financial Management*, Spring 2005, and available at: http://ssrn.com/abstract=480421
13 Principal–agent problems arise when principal and agent have divergent interests, and the management of these conflicting interests generates costs.

14 Two-tier bids are bids in which a higher price is paid for the first 50 per cent of the shares.
15 Since stock returns are calculated net of compensation payments, the fact that the US markets have outperformed the rest of the world would seem to indicate that even with excessive payments to management shareholders are better off in the US than elsewhere (Kaplan and Holmstrom, 2003).
16 The Company Law Review was the first initiative of the ongoing programme to modernise company law in the UK.
17 UK rules on the removal of directors effectively rule out staggered boards, which often act as highly effective takeover defences in the Europe and the US, thus bolstering the UK's market for corporate control.
18 Shareholders in Germany are not without similar residual powers in theory. For example, 10 per cent of shareholders can call an EGM to remove the supervisory board. However, unlike the UK, where only a simple majority is needed, in Germany 75 per cent plus is required. Another major issue is that the ownership structures of many German corporations differ from the UK in that they are controlled by dominant shareholders or groups who hold over 50 per cent of the voting rights.
19 This moved the UK towards Europe in the sense of having a 'de facto' supervisory board made up of non-executive directors charged with monitoring management. This change should not be confused with increased employee representation, which the two-tier structure is often associated with in Germany, as we shall see below.
20 All of the UK's corporate governance codes can be downloaded from the ECGI website: www.ecgi.org
21 Reports by advisory organisations have begun to set the tone in this area – see for example Business Roundtable, *Executive Compensation: Principles and Commentary*, Nov. 2003; Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, Dec. 2003.
22 This should include financial and budget reports, peer group comparisons, analysts' reports, press clippings and documentation related to any ongoing shareholder litigation and government investigations.
23 Rule 14a-8 provides an opportunity for a shareholder owning a relatively small amount of a company's securities to have his or her proposal placed alongside management's proposals in that company's proxy materials for presentation to a vote at an annual or special meeting of shareholders. It has become increasingly popular because it provides an avenue for communication between shareholders and companies, as well as among shareholders themselves. In 2003, 427 governance-related resolutions were forwarded under Rule 14a-8. Of these, 140 got more than 50 per cent of votes cast.
24 This may be an attempt by American unions to exploit a post-Enron window of opportunity to push a labour-oriented agenda.
25 Variations are driven by differing market risk premiums.

26 Available at: http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf
27 Since 1984, the Association of British Insurers has issued guidelines that stock-based compensation should not exceed four times salary. This is an excellent example of norms being enforced through professional organisations. Main (2005) discusses the development of these norms over time and examines their influences.
28 In *CNLBS* vs *Philip K. Wrigley* (1968), the Delaware Courts later reiterated, based on a previous ruling, 'Courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders.'
29 Of course, hostile takeovers were in themselves nothing new. Sigmund Warburg is credited with devising the first one of the modern era for the US firm Reynolds to acquire British Aluminium of the UK in 1959 (Chernow, 1993).
30 Entrepreneurs such as Ted Turner, Craig McCraw and Steve Wynn deployed them to build their early empires – while others such as Ronald Perelman went after established targets such as Revlon and became known as takeover entrepreneurs.
31 For example the raider would pay more for the first 51 per cent of the share capital than the remaining 49 per cent.
32 The SEC later prevented selective/two-tier tender offers.
33 Martin Lipton was born in New Jersey in 1931. After graduating from New York University Law School and going into private practice for a number of years where he specialised in advising on proxy contests, Lipton founded his own firm with Herbert Watchell in the mid-1960s.
34 The term 'poison pill' was not coined by Martin Lipton himself, but by an investment banker advising a raider in a comment to the *Wall St Journal* in 1983 – Lipton and Rowe (2001).
35 For the classic statement of the Chicago School perspective on the firm in society, see Milton Friedman's article 'The Social Responsibility of Business is to Increase its Profits'. *New York Times Magazine*, September 13, 1970.
36 The rule of passivity is based on the no frustration rule of the UK Takeover Panel.
37 This was despite the fact that the SEC filed a brief with the court arguing that the poison pill should be overturned.
38 The emphasis on elections over market transactions has been subsequently criticised by some legal scholars. Gilson (2001) argues that markets are a more efficient mechanism for resolving control contests than elections, because the latter are open to manipulation by incumbent management. See Lipton and Rowe (2001) for a response.
39 However, most of these statutes do not compel or mandate managers to take these constituencies' interests into account.

40 The full reference for this paper is: Dontoh, Alex, Ronen, Joshua and Sarath, Bharat, 'Financial Statements Insurance' (August 17, 2004). NYU Stern School of Business. It is available at: http://ssrn.com/abstract=303784
41 The Rigas family at Adelphia is an isolated example of controlling shareholders expropriating firm assets in the US.
42 The Parmalat scandal in Italy is an example of this on a grand scale.
43 In this context, competition should be distinguished from greed as a motivating factor (Shleifer, 2004).
44 The business judgement rule was defined by the Michigan Supreme Court in the case of *Dodge* vs *Ford Motor Company* (1919).
45 Regulation is necessary because of the characteristics of transactions in financial markets – parties have few repeated interactions and the markets are marked by asymmetries of power and information between players.
46 Clearly, the optimal level of regulation would have to avoid creating a lawyers' charter for frivolous litigation.
47 Compliance or otherwise with the provision need only be reported in the year in which it was made.
48 A.2.2 states that the chairman should, on appointment, meet the independence criteria set out in this provision, but thereafter the test of independence is not appropriate in relation to the chairman.
49 A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.
50 The requirement to make the information available would be met by making it available on request and by including the information on the company's website.
51 Compliance or otherwise with this provision need only be reported for the year in which the appointment is made.
52 Views have been sought by the Department of Trade and Industry by 30 September 2003 on whether, and if so how, further measures are required to enable shareholders to ensure that compensation reflects performance when directors' contracts are terminated: See 'Rewards for Failure': Directors' Remuneration – Contracts, Performance and Severance, June 2003.
53 As required under the Directors' Remuneration Report Regulations.
54 Nothing in these principles or provisions should be taken to override the general requirements of law to treat shareholders equally in access to information.
55 Agents such as investment managers, or voting services, are frequently appointed by institutional shareholders to act on their behalf, and these principles should accordingly be read as applying where appropriate to the agents of institutional shareholders.
56 Available at website: www.investmentuk.org.uk/press/2002/20021021-01.pdf
57 *Gesetz zur Regelung von öffentlichen Angeboten zum Erwerb von Wertpapieren und von Unternehmensübernahmen* (WpÜG).
58 *Übernahmekodex der Börsensachverständigenkommission beim Bundesministerium der Finanzen* of 14 July 1995, amended 1 January 1998.

Bibliography

Baum, H. (2005). 'Change of Governance in Historic Perspective: the German Experience'. ECGI – Law Working Paper No. 28/2005 (http://ssrn.com/abstract=695741).

Baums, T. (2002). 'Company Law Reform in Germany' (http://ssrn.com/abstract=329962).

Becht, M., P. Bolton *et al*. (2002). 'Corporate Governance and Control.' ECGI WP 02/2002.

Beer, M. and N. Katz (2003). 'Do Incentives work? The Perceptions of a Worldwide Sample of Senior Executives'. *Human Resource Planning* 26(3): 30–44.

Blair, M. M. (2003). 'Shareholder Value, Corporate Governance, and Corporate Performance'. In *Corporate Governance and Capital Flows in a Global Economy*, P. K. Cornelius and B. Kogut (eds), New York, Oxford, Oxford University Press.

Breedon, R. C. (2003). *Restoring Trust. Report to the Hon. Jed S. Rakoff – US District Court for the Southern District of New York on Corporate Governance for the Future of MCI, Inc*. New York.

Brown, L. and Caylor, M. (2004). 'The Correlation between Corporate Governance and Company Performance'. Research Paper, Institutional Shareholder Services.

Chernow, R. (1993). *The Warburgs*. London, Random House.

Coffee, J. C. (2003a). 'Gatekeeper Failure and Reform: the Challenge of Fashioning Relevant Reforms'. Columbia Law and Economics Working Paper No. 237 (http://ssrn.com/abstract=447940).

Coffee, J. C. (2003b). 'What Caused Enron? A Capsule of Social and Economic History of the 1990's'. In *Corporate Governance and Capital Flows in a Global Economy*, P. K. Cornelius and B. Kogut (eds), Oxford, Oxford University Press.

Coffee, J. C. (2005). 'A Theory of Corporate Scandals: Why the US and Europe Differ?' Columbia Law and Economics Working Paper No. 274 (http://ssrn.com/abstract=694581).

Daines, R. (1999). 'Does Delaware Law Improve Firm Value?' NYU Centre for Law and Business Working Paper.

Donaldson, G. and J. W. Lorsch (1983). *Decision Making at the Top*. New York, Basic Books.

Dontoh, A., J. Ronen *et al*. (2004). 'Financial Statements Insurance' (17 August 2004: http://ssrn.com/abstract=303784).

Easterbrook, F. and D. Fischel (1981). 'The Proper Role of a Target's Management in Responding to a Tender Offer'. *Harvard Law Review* 94.

Gilson, R. J. (2001). 'Unocal 15 Years Later (And What We Can Do About It)'. *Delaware Journal of Corporate Law* 26.

Gompers, P. A., J. L. Ishii *et al*. (2003). 'Corporate Governance and Equity Prices'. *Quarterly Journal of Economics* 118(1): 107–55.
Grant, G. (2005). 'Beyond the Numbers: Corporate Governance in Europe'. In *Global Equity Research: Strategy Focus*. London, Deutsche Bank.
Grossman, S. J. (1995). 'Dynamic Asset Allocation and the Informational Efficiency of Markets'. *Journal of Finance* L(3): 773–87.
Hall, B. J. and J. Liebman (1998). 'Are CEOs Really Paid Like Bureaucrats?' *Quarterly Journal of Economics* 113(3): 653–91.
Hall,7 B. J. and K. J. Murphy (2002). 'Stock Options for Undiversified Executives'. *Journal of Accounting and Economics* 33(1): 3–42.
Healey, T. (2004). 'The Best Safeguard against Financial Scandal'. *Financial Times*, London.
Hopt, K. J. (1998). 'The German Two-Tier Board: Experience, Theories, Reforms'. In *Comparative Corporate Governance: the State of the Art and Emerging Research*, Klaus J. Hopt, H. Kanda, M. J. Roe, E. Wymeersch and S. Prigge (eds), Oxford, Clarendon Press.
Huson, M. R., R. Parrino *et al*. (2001). 'Internal Monitoring Mechanisms and CEO Turnover: a Long-Term Perspective'. *Journal of Finance* 56(6): 2265–97.
Jensen, M. C. (1993). 'The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems'. *Journal of Finance* 6(4): 831–80.
Jensen, M. (2000). *A Theory of the Firm. Governance, Residual Claims, and Organisational Forms*. Cambridge, Mass., London, England, Harvard University Press.
Jensen, M. C. (2005). 'Agency Costs of Overvalued Equity'. *Financial Management* 34(1): 5–19.
Jensen, M. C. and W. H. Meckling (1976). 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure'. *Journal of Financial Economics* 3(4): 305–60.
Jensen, M. C. and K. J. Murphy (1990). 'Performance Pay and Top-Management Incentives'. *Journal of Political Economy* 98(2): 225–64.
Kaplan, S. N. and B. R. Holmstrom (2003). 'The State of U.S. Corporate Governance: What's Right and What's Wrong?' NBER Working Paper No. W9613.
Lipton, M. (1979). 'Takeover Bids in the Target's Boardroom'. *The Business Lawyer* 35: 101–30.
Lipton, M. and P. K. Rowe (2001). 'Pills, Polls and Professors: a Reply to Professor Gilson'. *Delaware Journal of Corporate Law* 27: 1–55.
Lorsch, J. W. and E. Maciver (1989). *Pawns or Potentates: the Reality of America's Corporate Boards*. Boston, Mass., Harvard Business School Press.
MacAvoy, P. W. and I. M. Millstein (2003*). The Recurrent Crisis in Corporate Governance*. Basingstoke, Palgrave Macmillan.
Main, B. G. M. (2005). 'The ABI Guidelines for Share-option Based Incentive Schemes: Setting the Hurdle too High?' Paper presented at the Royal Economic Society Meetings, Nottingham, UK.
Manne, H. (1965). 'Mergers and the Market for Corporate Control'. *Journal of Political Economy* 73: 110–20.

Melis, A. (2004). 'Corporate Governance Failures: To What Extent is Parmalat a Particularly Italian Case?' *Corporate Governance: an International Review* (Forthcoming).

PIRC (2000). Corporate Governance, Pension and Investment Research Consultants.

Pistor, K. (1999). 'Codetermination in Germany: a Socio-Political Model with Governance Externalities'. In *Employees and Corporate Governance*, I. M. M. Blair and M. J. Roe (eds), Washington DC, Brookings Institution Press.

Romano, R. (2002). 'Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance'. *Yale Journal on Regulation* 18(2): 174–251.

Rosenberg, H. (1999). *A Traitor to His Class*. London, John Wiley.

Schaferstein, D. and J. Stein (1997). 'Dark Side of Internal Capital Markets: Divisional Rent Seeking and Inefficient Investments'. Mimeo, Massachusetts Institute of Technology.

Shleifer, A. (2004). 'Does Competition Destroy Ethical Behaviour'. *American Economic Review* 94(2): 414–18.

Skovoroda, R., B. G. M. Main *et al.* (2004). 'The Minimum Assumed Incentive Effect of Executive Share Options'. Paper presented at the Academy of Management Meetings, New Orleans.

Tosi, H. L., S. Werner *et al.* (2000). 'How Much does Performance Matter? A Meta-analysis of CEO Pay Studies'. *Journal of Management* 26(2): 301–39.

Vetter, E. (2003). 'Deutscher Corporate Governance Kodex'. *Deutsche Notar-Zeitschrift* No. 10: 748–64.

Wasserstein, B. (2000). *Big Deal: Mergers and Acquisitions in the Digital Age*. New York, Time Warner Books.

Index