Measuring Code Success -
Implementation & Monitoring
by
Christian Strenger.
Deputy Chairman of the World Bank/IFC's Global Corporate Governance Forum
Member of the 'German Government Commission on Corporate Governance'
Director, Corporate Governance Center, Handelshochschule Leipzig
Member and Chairman of Supervisory Boards

I. Measuring the Success of the Implementation of a Code – Background and Important Prerequisites

- In order to measure properly, one has to accept that the parameters of 'success' depend strongly on country specifics such as:
  - Economic and capital market environment and development
  - 'Culture' of the capital market participants (i.e. general ownership structures and 'licence to operate' issues; example: UK: ownership driven vs. Japan: stakeholder driven)
  - Legal structures of the country and outside influence (EU)
  - Existence and quality of enforcement of capital market regulation

- However, common prerequisites exist: Necessary for successful measuring and implementation of sophisticated governance codes is a close alignment of monitoring and enforcement.

- In order to discuss how to achieve adequate 'enforcement', one needs to define what this means. The suggestion by the Forum is: 'Whether or not expressly covered by law, a system that translates violations into regulatory sanctions or recovery for those harmed'.

- Efficient enforcement requires excellent cooperation and division of labour (instead of duplication) by the public regulatory and supervisory bodies for the capital markets and the banking system.

---

- Ways of enforcement are: (i) by contract (i.e. via listing rules), (ii) by judicative institutions, (iii) by private institutions (i.e. banks, rating agencies).

- Sufficient resources with an adequate number of people with appropriate expertise are imperative to monitor the acceptance of a code. A coordinated approach between the stock exchanges, the financial supervisory authorities and other relevant bodies is essential for convincing code enforcement. Centralized competencies for court procedures are also necessary for an efficient enforcement process.

- In short: good governance quality requires a good code, a sound legal background and their efficient enforcement by competent bodies.

- Main enforcement mechanism in Europe: The 'Comply-or-Explain' principle as a legal requirement or a listing obligation

  Relevant examples are:

  - UK: self-regulation based on the 'comply-or-explain'-mechanism; overall governance structure determined by a series of regulatory bodies and the LSE listing requirement.
  - Germany: self-regulation based on 'comply-or-explain'-declaration demanded by German company law § 161. (Works satisfactory on the whole but still room for improvement: missing explanations in case of deviations, superficial declarations of conformity).

- Difficulties for developing- and emerging countries: quality and adequate coordination of courts, judges and public and semi-public enforcement agencies. To attend to these deficiencies, is a prerequisite to attract financing from the international markets on a longer term basis.

II. How to Measure Successful Implementation of the Code

- Good governance quality can only be achieved through a long term process, not through a 'quick fix'-approach. Therefore, apart from 'formal' compliance with a code, it is key to pro actively support good corporate governance quality on a permanent basis.
The experience shows that good governance quality can only be achieved by intensive implementation efforts by the top management and concerted monitoring by all public, semi-public and private bodies.

Companies: Should monitor their corporate governance obligations through a system of coordinated checks with particular attention to:

- The compliance with the individual stipulations of the particular code.
- The stringent fulfilment of corporate governance responsibilities of the board committees (i.e. of the audit, risk and compliance committees).
- The implementation and proper functioning of efficient corporate governance monitoring structures within the company.

External monitoring sources are:

1. Public Bodies: Ministries of finance and justice, financial supervisory authorities, courts.

2. A Governance Commission with official support: In order to continuously improve a code according to the latest developments of best practice, a standing commission should be appointed that regularly reviews a code.

3. Stock Exchanges: Stock exchanges can/should set out relevant listing requirements and require the compliance with a code (such as the UK (LSE) and the USA (NYSE)).

4. Analysts: To determine governance quality, analysts increasingly check the governance quality of a company. Many use a corporate governance scorecard.

5. Institutional Investors: Such as CalPERS and TIAA-CREF in the US, Hermes and Aviva in the UK, ABP and PGGM in the Netherlands and DWS Investments in Germany² have been instrumental in setting international standards for good governance.

---

6. Proxy Advisory and Voting Firms: Such as RiskMetrics (formerly ISS) and IVOX give institutional investors an efficient way to vote on important governance matters.

7. Rating Agencies: Proprietary governance rankings and scorings by the major commercial rating agencies such as S&P and Moody's offer alternative monitoring solutions. However, they are costly (€ 20,000 - € 40,000 for annual subscription and solicited ratings that start at € 50,000 per company) and not easily available for a broad application by all stakeholders.

8. Engagement Services: Such as British Hermes Equity Ownership Services (HEOS) help to represent their clients' interests on corporate governance matters by engaging with publicly listed companies through pro-active dialogues.

9. Private Shareholder Associations: They should analyze and monitor corporate governance of most publicly listed companies for their clients.

10. Media: Of particular importance are the media to single out important governance deficits and record progress on their improvement.

III. How to Help Companies Measure their Compliance with the Code

A stringent internal monitoring process must be implemented:

- Companies should monitor their corporate governance through annual reviews. In particular: board quality, transparency issues, conflict of interests, shareholder right issues, compliance issues and audit matters.

- This process has to be safeguarded by the top management and (Supervisory) Board members: they must ensure that the company regularly discloses its compliance with the code and explain any deviations in their annual reports and on their website.

- The Board also must on a regular basis enter a constructive dialogue with outside 'agents' (such as investors) on key governance issues (i.e. remuneration, NED nomination, matters of strategic importance).
IV. Would a Scorecard Approach Work?

Practical ways of making company executives do more than the minimum are therefore essential. One of the proven ways to achieve this is the systematic analysis of the governance situation by the market participants via a scorecard.

The case in Bulgaria shows this:

- The Code - developed by a task force comprised of private and public experts - was launched on October 9, 2007 and quickly adopted by the Bulgarian Stock Exchange.

- A country specific scorecard was developed that helped companies to better monitor and benchmark their compliance against the Bulgarian Governance Code. The listing rules require companies to comply with the Code or disclose and explain why they did not or could not comply with certain provisions. Listed companies also must disclose their specific scorecard-results.

What should a scorecard achieve?

- Facilitate the work of analysts and investors through a systematic and easy overview of all relevant issues of good governance.
- Enable companies to easily assess the 'reach' and the quality of their own governance situation.
- Enable comparisons across industries and countries.
- Be readily available to all interested parties via the internet.
- No or very little cost for implementation and application.
- Ensure high degrees of usage: the completion of the scorecard via programmed tools (MS Excel) should also enable active dialoguing.
- Allow to set minimum scores by investors for governance as part of general investment politics.

Conceptually, companies displaying an active corporate governance commitment and fulfilling all 'shall-recommendations' should reach a score of 75% / points. If the additional 'should-suggestions' of the Code and further international best practice standards are fulfilled, the maximum score of 100 % / points can be achieved. This 25% / points fulfilment gap is clearly meant to incentivise companies to pursue higher governance standards than just the
'shall-recommendations'. German companies with demanding governance standards today reach scores between 80% / points and 95% / points.

Its usage in Germany is difficult to determine, since only very few companies disclose their scorecard-result publicly.\(^3\) This shows how important it is to have the official support of stock exchanges or supervisory bodies.

On the international level, the scorecard has found good reception since first published in 2000. The general method of the governance scorecard is now also utilized with the relevant local adaptations in Bosnia, Croatia, Indonesia, Mazedonia, Serbia and Montenegro and the Philippines.

V. Developing Country Specific Measures

Obviously one size does not fit all (i.e. EU 27 countries = 27 Codes). However, international best practice (i.e. OECD\(^4\) and ICGN\(^5\)) encompasses the key elements which need to be fulfilled by all Codes.

Key elements that have to be tackled according to the prevailing conditions of the individual country:

- Transparency and fair disclosure to all stakeholders
- Equal treatment of all shareholders (particularly relevant for minorities)
- Unrestricted access and voting power for general meetings
- High qualification of board members: sufficient knowledge and industry experience
- Convincing independence for majority of Supervisory Board members
- Establishment of committees to concentrate complex board work (particularly audit committees)
- Sufficient expertise and convincing independence in audit-, risk- and compliance committees
- Sufficient independence of the auditors
- The state should be a normal shareholder without exercising undue control
- Credible enforcement by competent and fully cooperating authorities.

---

\(^3\) Such as Hannover Rueck, www.hannover-rueck.de.
\(^4\) www.oecd.org.
\(^5\) www.icgn.org.