Corporate Governance Codes -
A Question of Enforcement...

Baku, Azerbaijan

Keynote Address by Phillip Armstrong

Launch of Azerbaijan Corporate Governance Standards
Opening Remarks

The promulgation of CG Standards is a great achievement, marking a definitive milestone in building a national framework and culture for good corporate governance in Azerbaijan. It is a key piece in the puzzle of sustainable businesses and sustainable economies.

At the same time, it is the beginning of an even bigger challenge, namely enforcement and supervision measures to ensure that companies comply both in practice and spirit with the provisions of the CG Standards.

Today I want to focus my comments on this key aspect of enforcement. It is a common challenge that we observe worldwide at the Global Corporate Governance Forum, and not unique to Azerbaijan I should emphasize! It is a complex issue strongly influenced, or impeded, by resource and capacity constraints - but, essential to ensuring that CG Codes and Standards function as envisaged.

Due to my time limitation today, I can only offer some general observations that I believe will be relevant to implementation in the context of Azerbaijan. I share these thoughts as much in my own personal capacity, from my own experiences in drafting CG Codes, as I do from the point of view of the Global Corporate Governance Forum.

CG Codes—now the norm, not the exception

The history of CG Codes is a recent phenomenon in some respects that has accelerated with each and every crisis it seems - especially following the East Asian and Russian crises in the late 1990s.

We have come a long way since 1992, when the U.K. adopted the world's first-ever national CG Code, known as “The Cadbury Code”. By 1998, 12 additional countries had followed in the UK's footsteps, and then—with the adoption of the OECD CG Principles in 1999 on the back of the various crises globally at that time as just mentioned—there was a huge surge in development of CG Codes that was further stimulated by countries in this region following their advent to market-based economic systems.

Today CG Codes have become the norm across nearly all countries worldwide, and though commonplace, they differ greatly in scope and coverage. The spectrum is quite varied:

- from very comprehensive instruments, with supplementary interpretations and concrete guidance for implementation (e.g. Belgium, South Africa, etc.);
- to general and not too comprehensive in coverage of the OECD principles, BUT (a) very specific and prescriptive concerning implementation (e.g. Sarbanes-
Oxley), and/or (b) subject to rigorous disclosure requirements imposed by regulatory agencies (e.g. Brazil’s Novo Mercado, Colombia);

- to a proliferation of sector-specific codes for banks (e.g. Georgia), State-owned enterprises (e.g. Morocco), small to medium-sized companies (e.g. Lebanon) and codes developed by institutional investors (e.g. CalPERS, Hermes) and international organisations (e.g. Basel, IOSCO, etc.).

Many of these national CG codes are past their second or third revisions, as is the case with the most prominent and precedent-setting codes in the UK, South Africa and Brazil. However, effective supervision and monitoring of CG Codes and their enforcement continues to vex most regulators and policy makers. I think the recent global financial crisis really stressed this point!

Clearly the draconian measures of Sarbanes-Oxley in the United States failed to prevent the meltdown in its banking sector, with significant consequences for us all, and the so-called principles-based approach in the U.K. didn’t seem to fare much better either. I will come back to this!!

Forum Support to CG Codes in Emerging Markets

In the proliferation of corporate governance codes around the world – the Global Corporate Governance Forum has been involved in the development of nearly 50 new or revised CG Codes in just the past five years alone.

It is a demand that keeps growing, especially as CG Codes are adopted or revised to incorporate best practices that seek to address the limitations or attempt to close loopholes exposed by recurring corporate scandals, and most recently, by the global financial crisis.

I do not want to digress from the Forum’s work with the implications of the global financial crisis upon reforms of corporate governance standards, so I will also come back later to this important topic.

One key level of support provided by the Forum has been to facilitate peer reviews of code drafts by international experts on a pro-bono basis, many of them drawn from the Forum’s Private Sector Advisory Group (PSAG). This has been the case with Azerbaijan, where expertise and lessons from key developed and emerging markets informed draft formulations of the CG Standards.

The Forum depends a great deal on the advice and guidance of these group of private sector advisors, who represent over 60 business leaders, investors, professionals and corporate governance experts from around the world, to bring a practical and well seasoned perspective to our work with countries like Azerbaijan.
Another level of support that responds to country demand and to the pace of CG code adoptions worldwide is capacity building support to the institutions and individuals who drive the development and adoption of national CG Codes. Typically, this is conducted through bringing together countries within a region and with similar circumstances to share their challenges and experiences – as will be the case over the next two days here in Baku.

The Forum, with our colleagues in IFC, is strongly focused on encouraging countries to take ownership of their own priorities and issues and for us to provide the necessary guidance and experience that may help facilitate this process in a constructive and helpful way.

To support this process, the Forum has a comprehensive toolkit that sets out a step-by-step approach to develop, implement, and review a Corporate Governance Code of Best Practice.

I should also add that in addition to our work assisting with the development of codes and standards: the Forum also works closely with institutions seeking to enhance their board leadership training capacity (e.g. Indonesia, Egypt); the training of financial journalists (e.g. Kazakhstan, Vietnam); and, assisting with the implementation of dispute resolution mechanisms to support private sector development and continuity (e.g. Bosnia, Colombia). If there is one key lesson from the Forum’s work over the last decade is that there is no single perfect model for corporate governance, but that the principles and values anchoring good corporate governance practices are central to building better companies and better societies.

➢ A Question of Enforcement...

Naturally, our collective responsibility is to ensure that the CG Standards being launched today take on effective application and practice, and that they contribute to enhancing the quality of board decisions and company performance. We know, however, that this does not happen simply because a CG Code comes into existence, or because the desired CG practices are articulated by a set of best practice standards.

The motivation behind most CG Codes stems from its power to advocate and motivate a set of good practices and behaviors among companies and directors not only in the private sector but also State-owned and other forms of commercial enterprise—yes, to aspire to a culture of good CG, to continuously improve on it, and to surpass best practices with new benchmarks.

The critical issue for CG Code effectiveness, therefore, and one that possibly demands foremost priority is the question of how to make it work, and what measures of enforcement will be necessary for this purpose!
Allow me to first address very briefly this critical issue of enforcement from a conceptual level and then proceed to the more important and more useful level of how to ensure that it happens in practice.

It goes without saying that the rule of law and due process is the fundamental foundation for effective enforcement. It provides certainty in the market that justice will be done, while signaling to companies and directors that their fiduciary and legal obligations are there to be fully observed for the benefit of a stable and vigorous economy.

The issue is not so much that scandals do and will take place - it is a function of free enterprise and business risk – but that very often through the process of prosecution we can learn about the events in a way that helps inform market and regulatory responses to address shortcomings or loopholes. This lesson is aptly illustrated by prominent cases that have followed the collapse of icon companies such as, for example HIH in Australia, Parmalat in Italy, and Enron in the United States.

In short, for market reliability and market consistency that is central to capital formation, the actions of regulators must clearly communicate that there are no exceptions when it comes to enforcing the full intent of existing laws and regulations. Enforcement is critical to the security sought by investors and by shareholders, especially knowing that their funds are safe and protected by a market provides the necessary mechanisms to actively secure their property rights in an objective and consistent way.

 Constraints on Capacity and Skills to Enforce....

Now let me turn to what I regard the more important practical level. Here, the issue of effective enforcement really centers at two integral levels:

- The first, as I have just alluded to, is about giving due process to the laws and regulations that are already on the books, in an effective and informed way.
- This brings us to the 2nd level—and in my mind the most significant: that is, ensuring that regulatory agencies have the necessary skills and capacity to discharge their regulatory mandate.

I want to reiterate that the key words are skills and capacity to enforce, and this aspect cannot be reiterated enough. It is perhaps among the most difficult challenges faced by emerging markets. It is a hurdle that holds back the progress of many countries, including advanced and mature capital markets. We only have to see what took place in the U.S. with all the resources at its disposal!!

Most CG assessments and reports repeatedly point to the first level—the lack of enforcement—as a major weakness, but rarely address dimensions of capacity or skills that account for enforcement weakness. In fact, the 2009 World Bank CG ROSC (Report on the Observance of Standards and Codes) for Azerbaijan finds that “the State Commission for Securities is unable to pay competitive salaries and has no real budgetary or
administrative independence. The need to oversee all 1,914 JSCs also strains its limited resources.”

To further illustrate: A country that I recently visited was recognized for having a corporate governance code that is on par with the best global standards. However, when I met with the Inspectorate of the Securities Commission, staff lacked a basic understanding of what constitutes corporate governance, which raises the obvious question of how they can be expected to enforce standards that challenge even the most sophisticated and experienced regulators.

➤ Making the Azerbaijan CG Standards work......

Against this background, it would useful to perhaps share with you some observations that might warrant consideration as you embark on the long journey of persuading companies to adhere to these CG Standards.

First, this will not be an overnight process, as I am sure you are all too aware. What I would like to re-emphasize, is the need to ensure that the agencies tasked with ensuring adherence with the CG Standards have the necessary capacities and skills. It is important that when you engage with companies on their adherence, that you are in a position to enter in a dialogue which is constructive and where you have a reasonably good grasp of the issues under consideration.

Given that the standards apply to a wide range of enterprises, this will present you with some particular challenges. My advice, as a start, would to be focus on those companies deemed to be systemically important to the economy, usually, listed companies, banks and State-owned companies. This may require the relevant authorities to issue guidance on what they would deem to be sufficient adherence to the CG Standards.

I talk of “adherence”, because the standards have been developed as voluntary guidance. This presents special challenges. The targeted enterprises that will be subject to these CG Standards will need to be clear just how “voluntary” you intend the standards to be – this can be very confusing for everyone, especially as this has been modelled on an approach first developed in the U.K. market and carried far and wide into markets where these concepts are not always readily assimilated or terms familiar.

Importantly, a clear distinction must be made between those areas of governance already covered by your company law and those aspects which are essentially considered to be standards of good practice by boards and companies.

Where the CG Standards have sought to plug a perceived gap in your corporate laws, then I would urge that this is urgently addressed through changes to and/or enhancement of these laws.
The CG Standards are the start of a journey, and it would be useful to review the efficacy of these standards over time after they have been tested in the market and you have learned what is working and what is not, and what is useful and what is no longer relevant. In the time available, I want to touch on two specific points covered by the CG Standards very briefly!

**Independent Directors**

The Azerbaijan CG Standards, as with most CG Codes worldwide, focus on the issue of independent directors. I want to caution against following a path of least resistance by assuming that increased requirements on numbers or qualifications of independent directors is a panacea for good governance!

The categorization is a structural issue, which the market artificially imposes in the absence of directors who are willing or even capable of fulfilling their legally imposed duties in a proper and effective manner.

I do not want to discourage the requirement for better qualified and more independent directors – not at all!

BUT the discussion that needs to carry more weight concerns the ability of any director to act not only with independent judgment, but with a level of competence appropriate to the position. To my mind, this is the bigger challenge that faces us all – director and board competencies.

It is a point worth pondering in light of the conclusion reached by the 2009 World Bank CG ROSC for Azerbaijan, which cites the “dearth of independent members of supervisory boards” as a remaining challenge.

As Azerbaijan’s economic growth becomes more integrated with global markets, shifting away from traditional drivers of internal demand, Azerbaijan’s companies will need to become more open. It will mean permitting more foreigners to be intimately involved in decision-making, individuals with different cultures, and intellectual foundations that support Azerbaijan’s business decisions and the country’s ability to sustain an externally-focused strategy of economic growth.

Key to this all, is the need to focus on a higher level of director professionalism on Azerbaijan company boards – which is not inconsistent with many other countries. Working with local institutions, the Forum’s Board Leadership Training Resources are tailored to the specific needs of each market, with the emphasis on local customs, laws, and practices to ensure relevance to the local business community BUT measured and guided by internationally recognized best practices drawn from developed and developing countries.

And, focused on building directors’ leadership skills and not just on CG rules and compliance.
**Board Effectiveness**

My reflections on enforcement capacity and director professionalism essentially loop back to the quality of boards, as well as the effectiveness of board committees and their functions in relation to the whole board and company management.

2009 CG ROSC for Azerbaijan identifies “the poorly defined powers and responsibilities for supervisory and management boards and related bodies like revision commissions,” and continues to explain that in practice, supervisory boards tend to play marginal roles in some companies.

On board issues, the ROSC concludes that “overall, the supervisory boards in many JSCs do not supervise key functions, including corporate strategy, financial reporting and risk management and policy.”

Effective performance at levels of both the Supervisory and Management boards and their committees, and finding the right expertise and experience to populate these structures, is going to be a particular challenge. Something that faces most markets the Forum has been engaged in!

From my own personal experience: **orientation, induction and education** are all critical components of board development, ensuring that individual directors and the supervisory board – particularly - and its committees understand their responsibilities, fulfill their legal duties, and reflect the highest standards of integrity, transparency and accountability.

Various remedies for board effectiveness are being suggested around the world, with the most trumpeted being regular board and individual director evaluations. However, this assumes an already well functioning and suitably qualified board under the effective leadership of a board chairman well equipped to lead such a process. It also presumes some measure of stronger regulatory oversight, especially in the banking sector with tighter “fit and proper” provisions.

To stress the point, Hector Sants, the former head of the U.K. Financial Services Authority, said in an interview—referring to **comply or explain** mechanisms that seem to be the bread-and-butter component of CG codes—that “...a principles-based approach does not work with individuals who have no principles.”

Azerbaijan’s CG Standards have to be understood from this perspective.

➢ **Looking Forward......**

In the final analysis, CG Codes are about practicing and building sound accountability and transparency frameworks, which always come down to values, to dimensions of leadership, and to how we design our governance frameworks to enhance, reward and embed values across the entire market and among its key participants.
A key lesson from the global financial crisis reveals that corporate governance principles remain valid and legitimate. But, this is not a role for regulators alone!

Respect for the laws by company boards must be beyond any measure of doubt. Boards must guard this reputation jealously. Nothing can be more damaging to business sustainability than the perception that laws and rules are things that are up for negotiation or can be readily arbitragd through inconsistencies in enforcement.

One bad example such as Enron and Lehman Brothers in the U.S, Parmalat in Italy and Satyam in India by way of examples quickly overtake the market and affects its entire integrity!!

A culture of sound, consistent monitoring and supervision of the CG Standards in a constructive but assertive way by regulators tasked with its oversight will determine the success of your efforts and those who have been responsible for developing Azerbaijan's CG Standards.

My congratulations to the individuals and institutions that have worked to make the CG Standards a reality. Your efforts have already made certain portions of the World Bank CG ROSC report obsolete, but more importantly, they will have lasting benefits for society and for future generations of entrepreneurs and corporate leaders.

Thank you! It has been an honor to address you today.