



Private Sector Opinion

Issue 14

A Global Corporate
Governance Forum
Publication

USES AND LIMITS OF CONVENTIONAL CORPORATE GOVERNANCE INSTRUMENTS: ANALYSIS AND GUIDANCE FOR REFORM – PART ONE

Foreword

Although we are still in the middle of the crisis, not knowing when it will stop, it is useful to start to reflect about the future, about what went wrong and what lessons are to be learnt. And many things went wrong, as this paper by Prof. Wong indicates. In general I agree with his observations. And would like to add some additional elements along the lines his has indicated.

On transparency, he is absolutely right: it is no alternative to regulation. In fact it often serves not to inform investors but to protect issuers and underwriters. Hence the increase in volume, boilerplate texts—e.g. endless risk factors and disclaimers—and publication by reference to texts which are almost impossible to find. And this was not due to the regulators, but to the investment banks and their lawyers.

On boards, we will have to rethink their function, which is still not clearly defined, and work on a balanced composition scheme: the three-pronged composition supported by Wong is indeed the most credible. But we should also refrain from advancing strong statement merely based on conceptual thinking: where boards were managed by CEOs or former CEOs, their resistance to the crisis was notably better (see the research by Nestor Advisors¹). And concentrated ownership—e.g. in the Spanish banks—allowed from stricter monitoring of the management and its remuneration. Wong also criticizes independence of directors as key to better governance: I share his doubts about the independence of directors that have to be re-elected every three years, process in which the CEO de facto plays a crucial role. The question is more general: the management is over-powerful and the board is not armed to deal with the complex issues, information being accessible only to the extent allowed by the management. A new equilibrium will have to be found.

For all these questions there are no ready answers, and quick fixes will not do. In the old days, people would have referred to personal ethics that lead directors to behave honourably. Perhaps that after the era of fast money, there will be a

¹ www.nestoradvisors.com

revival for more fundamental values, more prudence and more sense of duty. But humans being as they are, a clear legal and regulatory environment will contribute. Therefore the question I see coming up with ever greater insistence is that of “regulation”. Self regulation—including corporate governance codes—has been too weak to achieve a major change in behaviour. And not all rules can be laid down in hard law either. We should try to devise intermediate forms of regulation, such as strictly enforced self regulation.

A general remark: beware of the economic theories and their statements about aligning interests, the need to split chair and CEO, the sacred grail of the independent director, the virtues of dispersed ownership, the dangers of tunnelling and what have you: do not lose out of sight the essence!

To conclude:

There is plenty of food for thought in this paper and congratulations to Prof. Wong for having stated these questions so clearly and so explicitly.

*Prof. Eddy Wymeersch
Member of the European Corporate Governance Forum,
and Member of the Global Corporate Governance Forum Private Sector Advisory Group
Chair of the Committee of European Securities Regulators (CESR)*

USES AND LIMITS OF CONVENTIONAL CORPORATE GOVERNANCE INSTRUMENTS: ANALYSIS AND GUIDANCE FOR REFORM – PART ONE

By Simon C.Y. Wong

Adjunct Professor of Law, Northwestern University School of Law; Former Head of Corporate Governance, Barclays Global Investors Limited; and Member of the Forum's Private Sector Advisory Group

This *Private Sector Opinion* is organized in two parts. Part I, the essay herein, examines the uses and limits of five conventional corporate governance instruments—transparency, independent monitoring, economic alignment, shareholder rights, and financial liability—and suggests ways to improve their application. Part II, to be published separately, will recommend how policymakers could approach corporate governance reform generally.

Introduction

The global financial crisis is forcing policymakers to again consider the most appropriate governance arrangements for publicly listed companies. It was only a few years ago, in response to corporate scandals in North America, Europe, and elsewhere, that significant reforms were undertaken—through legislation, best practice guidance, and judicial decisions—to strengthen the corporate governance regime.

While the specific measures have varied from country to country, corporate governance reforms in recent decades have generally drawn upon the same instruments:

- Improving **transparency** through greater disclosure in such areas as annual accounts, executive compensation, and conflicts of interest
- Enhancing **independent monitoring** of management by the board of directors
- Strengthening **economic alignment** between principals and agents through performance-based compensation and other financial incentives
- Bolstering **shareholder rights** through such mechanisms as cumulative voting, board nomination rights, and vote on executive remuneration
- Imposing **financial liability** on corporate officers and directors, external auditors, investment bankers, and other intermediaries to ensure diligence, loyalty, and honesty

As policymakers return to the drawing board to devise new reforms, it may be instructive to assess the uses and limits of the standard set of corporate governance instruments so widely employed globally.

This *Private Sector Opinion* seeks to demonstrate that while conventional governance mechanisms can be highly effective in many situations, they are not appropriate remedies in all contexts. In some cases, the prescribed medicine actually exacerbated the governance ailment that it was designed to cure. To illustrate, the rapid growth of executive compensation persisted—and in some markets, accelerated—after the introduction of individual executive pay disclosure. In the financial sector, the shift toward a board dominated by independent directors—perceived by many to be key for effective monitoring of management—ultimately proved to be its Achilles' heel as weak industry knowledge meant that non-executive directors were unable to pick up on warning signs of imprudent risk taking by management.

*“While conventional governance mechanisms can be highly effective in many situations, they are not appropriate remedies in **all** contexts.”*

This paper draws upon experiences in developed and developing markets although, given the author's background, there is greater emphasis on Anglo-Saxon countries.

Conventional corporate governance instruments – uses and limits

This section will examine how the core set of corporate governance instruments—comprising transparency, independent monitoring, economic incentives, shareholder rights, and financial liability—has been applied to different issues and contexts. It will discuss the extent to which these mechanisms have been effective and analyze the limits of their application by surveying cases where they have failed to work as intended. In addition, it will set forth proposals to improve the use of specific tools and suggest how certain governance issues should be addressed.

Transparency

Transparency is quite possibly the most widely employed corporate governance instrument. Perceived by many as an unquestioned and absolute good—that is, the more the better—its value can be summed up by the oft-repeated quote from former US Supreme Court Justice Louis Brandeis that “sunlight is the best disinfectant.”

Transparency seeks to achieve several overlapping objectives, including:

- Providing sufficient information on corporate performance, prospects, and risks to facilitate investment decisions on individual companies
- Ensuring adequate standardization of information to enable evaluation of the relative merits of different companies

- Equalizing access to information between insiders and outsiders to the extent possible, and reducing the possibility of abuses stemming from continuing information asymmetry
- Encouraging desired behavior without resorting to formal regulation
- Managing conflicts of interest arising among owners, management, intermediaries, and other parties

On the whole, transparency has been successful in achieving these objectives. For example, requiring full and timely disclosure of a company's strategy, operational results, financial health, governance arrangements, and other relevant matters has been critical to informed investment decision-making and has improved the efficiency of the capital market. Compelling listed companies to prepare financial statements according to a uniform set of accounting standards has facilitated comparative analysis of firms. Likewise, steps taken to encourage dissemination of information over the Internet have greatly increased access to company information. In addition, disclosures on sustainability issues have helped companies to engage with, and be accountable to, a broader set of stakeholders.

“Transparency does not always achieve its intended objectives, and it is sometimes misapplied.”

Empirically, there is substantial evidence that poor transparency can exact significant costs, particularly in times of economic stress when investors—having lost confidence in the quality of information disclosed—may indiscriminately sell their investments in a country or across a region. During the 1997–1998 Asian financial crisis, opaque accounting standards exacerbated the crisis of confidence and led to the wholesale withdrawal of foreign portfolio investors from the region. In addition, surveys of institutional investors have consistently shown that transparency sits at the top of investment considerations.²

Despite its benefits, transparency does not always achieve its intended objectives, and it is sometimes misapplied. A common issue with transparency is the quality of disclosure, in particular boilerplate and formulaic disclosure. In the US, criticisms have been leveled over the years at the prevalence of boilerplate language in the management discussion and analysis (MD&A) section of corporate annual reports.³ A study conducted by the US Securities and Exchange Commission (SEC) several years ago of MD&A disclosures by Fortune 500 companies found that 90 percent of the language stayed the same over a three-year period.⁴ In the UK, while the board evaluation section in annual reports typically describes the process followed in great detail, disclosures of evaluation findings is often sparse, with many saying no more than “the board and its committees are operating effectively.”

² See, for example, Institutional Shareholder Services, “2006 Global Institutional Investor Study,” PricewaterhouseCoopers (Singapore), “Corporate Governance: Survey of Institutional Investors 2005,” and McKinsey & Company, “Global Investor Opinion Survey on Corporate Governance,” 2002.

³ Boilerplate disclosure is also common on such topics as risk factors, accounting policies, and auditors' opinions.

⁴ Louis Thompson, “The CD&A: Communicate Beyond Compliance,” Compliance Week, October 23, 2007.

Furthermore, the ever-expanding scope and detail of mandatory reporting creates a real risk of inundation of information. Annual reports and related disclosures, for instance, have continued to lengthen (reaching several hundred pages for some firms), resulting in ample data but perhaps less useful information. In addition, producing information can be quite costly, in terms of time, expense, and potential loss of competitiveness. To stem information overload and ensure proportionality between costs and benefits, regulators should be required to periodically review and explain the continuing suitability of existing areas of disclosure. It might also be sensible to compel them to prioritize topics for disclosure, including eliminating those that have become less pertinent, when they propose new disclosure requirements.

In certain situations, transparency rules have caused serious side effects. Take the disclosure of executive compensation on an individualized basis. As originally conceived, greater transparency on pay was intended to constrain excessive compensation, in part by invoking a sense of shame and embarrassment and in part by compelling shareholders to act.⁵ In practice, however, many have pointed out that such disclosure has had the opposite effect. According to a veteran UK-based remuneration consultant, “Greater transparency on individual compensation started the continuous ratchet of executive pay that we have seen over the past 15 years in the UK and US.” Whereas the typical US chief executive made 40 times more than the average worker in 1980, this ratio climbed to 350 in 2008.⁶

While executive compensation information is intended primarily for shareholder use, it also enables executives to compare themselves against peers inside and outside of the company. According to the remuneration consultant mentioned above, “Many executives want to be the top dog and, if someone gets a certain amount, then he wants to get the same, if not more. It is about equity and fairness.” Paradoxically, identifying the compensation of specific individuals may have over-personalized it and fueled the envy that has helped to perpetuate high executive pay.⁷ To bolster board and management accountability without ratcheting pay, disclosure of executive compensation could take different forms, such as disclosure of pay in bands, disclosure of the ratio between the highest and lowest paid,⁸ and disclosure of pay without revealing the names of the individuals concerned.⁹

Quarterly reporting of financial results is another area where transparency has brought about deleterious repercussions. Many have argued that quarterly reporting

⁵ It also reflected a policy decision to address high levels of compensation through disclosure rather than by capping pay via regulation.

⁶ “Let Us Pray,” *Globe & Mail*, March 27, 2009, p. 42.

⁷ Broader societal developments, such as the increasing tendency to equate wealth with professional achievement and self-worth, may have also contributed to executives’ obsession with pay.

⁸ The UK Combined Code on Corporate Governance requires companies, when setting executive compensation, to take into account remuneration levels elsewhere within the organization. In the US, a few companies have put a cap on executive compensation by establishing a maximum ratio between the highest and lowest paid employees.

⁹ Some companies in New Zealand have adopted this approach.

has resulted in excessive short-termism, as management obsesses over meeting analysts' earnings forecasts for each quarter because missing the "consensus estimates" by even one cent could pummel the share price and discredit management. One academic study showed that out of 400 US CFOs surveyed, 55 percent indicated they were willing to delay investments in projects to meet short-term earnings expectations, even when it meant sacrificing long-term value creation.¹⁰ As a result, some countries have decided not to introduce quarterly reporting while others, such as the European Union, have scaled back the information that must be furnished quarterly. If a key objective of quarterly reporting is to reduce the potential for abuse by insiders, perhaps the combination of more stringent rules on immediate disclosure of material developments, longer blackout periods on insider dealing, and tighter insider dealing reporting would be sufficient to achieve this goal.

"If a key objective of quarterly reporting is to reduce the potential for abuse by insiders, perhaps the combination of more stringent rules on immediate disclosure of material developments, longer blackout periods on insider dealing, and tighter insider dealing reporting would be sufficient to achieve this goal."

Transparency is also commonly employed to manage conflicts of interest among owners, management, intermediaries, and other parties. Rather than prohibiting activities that raise conflicts of interest, there has been a general preference—underpinned by the fear of thwarting innovation and the belief that the private sector can effectively police itself—to use disclosure as a tool to manage conflicts.

While disclosure may be adequate for managing conflicts of interest that are quantifiable—for instance, the difference in commissions to be earned by a financial adviser for different products—its ability to manage conflicts that are qualitative in nature—such as biased stock research reports—is questionable.

In this regard, a key limitation of disclosure is that, while it alerts the consumer about potential impairments to objectivity, it does not indicate the degree to which quality has been compromised. For example, with respect to stock research reports, there is no indication from the required disclosure which part of a conflicted analyst's report should be discounted.¹¹

As disclosure itself does not reduce the conflict, the principal disciplinary effect is the prospect that consumers will choose to purchase services from non-conflicted providers. However, in certain settings, non-conflicted providers may not be available or easily accessed. These include credit ratings where all the key players face conflicts due to the issuer-pays business model, provision of remuneration advice where the board

¹⁰ John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "Value Destruction and Financial Reporting Decisions," 2006. Available at <http://ssrn.com/abstract=871215>.

¹¹ Similarly, disclosure of a related-party transaction does not necessarily provide assurance that it was conducted at arm's length or fair value.

chooses the compensation consultant, and stock research for smaller companies where only the large Wall Street firms provide coverage.¹²

Given the limitations of disclosure, policymakers have recently displayed a greater willingness to resolve conflicts by prohibiting the contemporaneous provision of services that give rise to them. These include audit and certain non-audit services, involvement of research analysts in investment banking transactions, and credit rating agencies evaluating debt issues that they helped issuers to create.

Yet, other severe conflicts remain. For instance, there is the conflict of interest arising from remuneration consultants advising the board on compensation for senior executives while simultaneously serving the human resources department on broader, but more lucrative compensation matters, such as share options plan advice or retirement benefits administration. This conflict is especially serious because it involves an issue that is deeply personal to the executive team—their own pay. The solutions proposed have included developing an industry code of conduct to ensure the ongoing independence of remuneration consultants and granting shareholders the right to ratify their appointments at the annual shareholders meeting.

Continuing conflicts involving financial institutions serving buyers and sellers of securities—for instance, a firm with investment banking and stock research or asset management arms—may also be difficult to resolve through disclosure alone. This is because investment banking clients may not distinguish between the different parts of a bank, especially if they operate under the same umbrella brand, or be sympathetic to explanations that the stock research and asset management units must operate autonomously. As a result, there may be constant pressure—overt and subtle—to refrain from displeasing investment banking clients. While policymakers may understandably be reluctant to forcibly separate these businesses, they could impose less draconian measures. For instance, the asset management arm could be required to outsource to an independent third party the voting of the shares of all the financial institution's clients. The US Bank Holding Company Act employs a similar approach to prevent a bank from exercising control over other financial institutions through its asset management unit.

A further objective of transparency has been to facilitate comparative assessment of companies domestically and internationally. This has led to efforts to standardize information through, for example, the adoption of International Financial Reporting Standards (IFRS) by nearly 100 countries. But given marked differences in economic development, there are limits to which standardization is appropriate or achievable. For instance, compared to their application in developed countries, fair value

¹² With respect to research coverage for smaller companies, a key determination for policymakers is whether some information—even if highly biased—is better than no information.

accounting may be less appropriate for emerging markets as active and liquid markets may not exist for a broader array of assets.

The desire for common standards has also led—perhaps inadvertently—to a strong preference for, and greater focus on, objective and quantitative data over qualitative information. Presently, a significant proportion of companies with substantial exposures to derivatives employ Value at Risk (VaR) to comply with the US SEC market risk disclosure requirement. This metric has become highly popular because it is able to reduce market risk to a single number. However, the ease with which VaR enables market risk exposures to be quantified and compared across companies must be balanced against the potential for oversimplification and crowding out material qualitative considerations.

Independent monitoring by the board of directors

In most countries, the board of directors occupies a strategic position in the corporate governance system, and its role has grown over the years. Today, much is expected from the board. In Anglo-Saxon firms, not only must the board monitor management on behalf of shareholders in a robust and dispassionate manner, it is also expected to actively contribute to strategy development, lead succession planning, and ensure integrity of the financial reporting process. In the wake of the current financial crisis, the board is now expected to delve much more deeply into risk management. To top it off, all these tasks are expected to be accomplished in eight to ten board meetings held each year.

“In many countries, boards now consist of highly qualified individuals, operate more professionally, and undertake substantive work. Despite these developments, the overall effectiveness of boards continues to be questioned.”

Considerable efforts have been exerted in recent years to improve the board's ability to effectively carry out its responsibilities and be held accountable for its actions. These include introducing independent directors, separating chairman and CEO roles, establishing dedicated board-level committees on nominations, compensation, and audit, giving the board access to external advice, and subjecting directors to annual elections.

While progress has varied, there have been noticeable improvements in the structure, composition, and functioning of boards in countries that have pursued serious reforms. In many jurisdictions, boards now consist of highly qualified individuals, operate more professionally, and undertake substantive work.

Yet, despite these developments, the overall effectiveness of boards continues to be questioned. In fact, when corporate scandals erupt, boards are almost certainly blamed. In part, this reflects the high expectations placed upon boards by regulators, shareholders, and the public. Given the persistent doubts over the board's effective-

ness, an appropriate starting point of analysis may be to ask whether the board can ever meet the expectations thrust upon it.

In Anglo-Saxon and perhaps other countries, boards confront a number of structural issues that impact their ability to be an effective oversight body. To start, boards are tasked with potentially conflicting oversight functions—specifically, between a general “watchdog” monitoring role and active involvement in strategy development, the latter of which risks drawing non-executive directors (NEDs) too close to management and thereby compromising their independence.

Furthermore, NEDs are outsiders who serve part-time in their board roles. This means that their exposure to, and understanding of, the company will necessarily be limited. Moreover, they will rely heavily on executive management for information.

Lastly, there is the influence of the human character, specifically the desire of people to “go with the flow” and identify with a group, personal insecurities about sounding less than intelligent in an environment where everyone is likely to be highly accomplished, and limits on an individual’s capacity to rapidly process new and complex information. As one NED who was elected by minority shareholders acknowledged, “You feel enormous pressure to go along with the majority.” Another outside director observed that “dissent is unproductive and everyone wants to be a team player.”

These structural factors mean that boards will never be as objective and challenging of management as shareholders and others wish them to be. Accordingly, other key actors—including regulators, shareholders, intermediaries, and the media—must also be relied upon to hold management accountable.

An equally important reason for tempering our expectations of the board is that we do not fully understand what drives individual directors and, correspondingly, how to incentivize them. While we have a much clearer understanding of the motivations of management, little is discussed about the motivations of board members. Perhaps it is the prestige of the role, hope of reputational glory or fear of reputational harm, sense of civic duty, fear of liability, desire for financial gain, or some other factor known only to the directors themselves. Until we have a fuller understanding of their motivations and have developed ways to harness them, we need to be realistic about what boards can achieve in practice.

“Structural factors mean that boards will never be as objective and challenging of management as shareholders and others wish them to be.”

Notwithstanding these constraints, there is scope to improve board performance. The formula for board effectiveness is straight forward—1) put in place the right structure in

“The formula for board effectiveness is straight forward; only a minority of boards, though, appear to have gotten it right.”

terms of size, mix, supporting organs, and leadership; 2) recruit people possessing high intelligence, suitable experience, and strong moral fiber who are unafraid to speak their mind; and 3) devise supportive board processes and a culture that will enable boards to work productively on key tasks. While this prescription does not appear too difficult to put into practice, only a minority of boards appear to have gotten it right.

Take the recruitment of non-executive directors. The tightening definition of “independence¹³” in recent years has led companies to populate the board with “generalist” captains of industry, in the belief that broad executive experience—rather than specific industry expertise—would translate well in the boardroom. With the benefit of hindsight, we now know that in certain sectors, such as financial services, boards failed to effectively monitor management precisely because they lacked industry knowledge.

In discussing the board's perceived failings, a bank chairman recently explained that the views of the former CEO stood largely unchallenged because the NEDs, all of whom were captains of industry or eminent individuals from other sectors, had a weak understanding of the banking business.

“The trend to construct boards with a substantial majority of independent directors has been somewhat misguided, starving some boards of skills critical for effectively discharging their responsibilities. This merits a reassessment of the optimal mix of executive, independent, and non-executive non-independent directors.”

The trend over the past decade to construct boards with a substantial majority of independent directors has been somewhat misguided because it has starved some boards of skills critical for effectively discharging their responsibilities. Specifically, it removed from the boardroom those individuals who—due to previous employment or other commercial relationships with the company—possessed deep industry and firm knowledge but who, by virtue of their past affiliations, were seen to be insufficiently “independent” and hence unsuitable NEDs. Moreover, the literature on group dynamics¹⁴ suggests that, given the vast information asymmetry between NEDs and management, a board comprised mostly of independent directors may be vulnerable to groupthink, particularly when there is a strong but conflicted leader at the helm, such as a chairman who also performs the CEO role. Empirically, a high level of formal board independence does not necessarily correlate with firm performance. For example, S&P 500 companies with the best and worst share price performance both feature highly independent boards.

Hence, boards should perhaps contain a substantial proportion, but not necessarily a significant majority, of independent directors. Crucially, this merits a reassessment of the optimal mix between executive, independent non-executive, and non-inde-

¹³ Defined generally as the absence of significant business or professional relationship with the company or its management.

¹⁴ See, for example, the work on groupthink by Irving Janis and others.

pendent non-executive directors so that the resulting board will feature a diversity of perspectives, substantial formal independence, and strong company and industry knowledge.

Although individual directors are loathe to admit it, independence of mind—the most critical facet of independence—is likely to erode over time as NEDs progressively identify with the corporate ethos, vision, and strategy. Accordingly, board membership should be regularly refreshed to bring in new perspectives and ensure that the board remains sufficiently detached from management.

When populating the board, it is also important to pay attention to the relative status of people in the boardroom, particularly vis-à-vis the CEO. Discussions with chairmen and direct observations of boardroom dynamics have revealed that CEOs are not always attentive to the views of non-executive directors whom they perceive to be less qualified than they are. At the same time, NEDs who are in awe of a CEO can be overly deferential to management. A senior UK board adviser, for instance, has observed a CEO-board power differential between the largest FTSE 30 and mid-size FTSE 250 companies. At mid-size firms, where the board usually contains some executives from larger FTSE 100 enterprises, the CEO is typically less influential in the boardroom than his counterparts at the largest corporations, where the NEDs are of comparable, and sometimes lesser, standing as the CEO. At a large emerging market financial institution, the NEDs tended to defer, on boardroom matters, to a fellow outside director who had been a two-time prime minister. Given this, boards should ideally be filled with non-executives whose individual statures are equal to or greater than the CEO's and comparable to each other.

Although it defies conventional notions of best practice, multiple-year board terms¹⁵ could actually enhance the independence of a non-executive director from management, other NEDs, and/or controlling shareholders by enabling him to exercise independent judgment without constantly worrying about re-election prospects. To illustrate, after a dispute with two independent directors, the founder of a Southeast Asian company sought to reduce director terms from three years to one year so that he could better control who sits on the board. In companies with dispersed ownership, where shareholders do not typically serve in management roles, equity holders should be given the right to remove a director at any time—as in the UK¹⁶—so that multiple-year terms do not contribute to board entrenchment.

“When populating the board, pay attention to the relative status of people in the boardroom, particularly vis-à-vis the CEO.”

¹⁵ While there is inevitably a degree of arbitrariness in setting an optimal board term, a term of three years appears to provide the appropriate balance between director autonomy and shareholder accountability, particularly if board terms are staggered so that an equal percentage of directors faces re-election each year.

¹⁶ Under UK company law, investors holding 10 percent of outstanding shares can convene a shareholders meeting at any time to remove a director. This right overrides any contrary provisions in a company's articles of association.

When looking to improve board performance, it is crucial to scrutinize how the board spends its time. Board roles and contributions will vary by company and over time, depending on firm maturity, ownership structure, performance, and management depth. In start-up enterprises and firms in distress, the board may adopt a more hands-on approach on strategy and operations while in mature, well-functioning companies, it may dedicate its time to setting challenging performance targets, directing succession planning, and keeping management egos in check.

Boards can be most effective if they regularly review and prioritize their most important tasks in light of the company's situation. With growing confidence in senior management, one financial institution's board decided to reduce its involvement in operational matters, including lending decisions, so that it could devote more time to strategy. At a once-struggling industrial conglomerate, the board shifted its focus from "steadyding the ship" to exploring growth opportunities when it became clear that the firm's recovery was well underway. In this case, the realignment of board priorities was accompanied by changes in board membership, specifically the addition of NEDs with deep mergers and acquisitions and international experience.

For a board to function well, a steady stream of relevant information must flow to the NEDs, as knowledge positions them to understand the issues discussed at board meetings and robustly challenge management. In particular, deep industry and company knowledge may help NEDs to better appreciate the strategic significance of seemingly minor developments, such as a marginal increase in lending volumes to borrowers with lower credit ratings or a gradually widening gap between reported profits and cash flows. Seen in this light, knowledge may be the best guarantor of board independence.

In addition to relying on management for information, board members should proactively endeavor to acquire knowledge by visiting business units and factories, speaking with customers and suppliers, and keeping up with industry developments. One FTSE 100 chairman remarked that after site visits, "non-executive directors usually ask more insightful and penetrating questions."

Provided they are undertaken in earnest, board evaluations—of the board, its committees, and individual directors—can be a highly useful tool to improve board performance. One FTSE 100 chairman observed, "I was initially skeptical of their use but have found board evaluations to be valuable in helping the board to improve its functioning. It is a wonderful opportunity for reflection." While not required on every occasion, external facilitators can help ensure rigor and objectivity of the board evaluation process. Moreover, one-on-one interviews conducted by a skilled facilitator can help to surface significant people and behavioral issues that may otherwise remain hidden and unaddressed.

When transplanting board models across countries, special attention must be paid to the surrounding context. In markets where controlling shareholders are the norm, the board's oversight role will likely be substantially constrained because the NEDs are often elected by the same owner-manager that they are responsible for overseeing. Yet, policymakers in many of these countries continue to strive to replicate the board model in Anglo-Saxon countries, where the shareholder base is typically highly dispersed.

Economic alignment

Financial incentives are important tools to align the interests of principals and agents, such as corporate executives. In an era of declining employer-employee loyalty and given difficulties in inducing outside investors to actively monitor management, financial incentives arguably assume greater significance in ensuring that employees act in the firm's best interest.

Over the past two decades, companies have increasingly moved from a fixed-pay structure, where salaries constitute most or all of total compensation, to "performance-based pay," where a significant portion of total remuneration is highly variable and dictated by individual, divisional, and firm-level performance.¹⁷ While the proportion of compensation "at risk" varies by company, industry, and country, the central concept remains the same—to incentivize management to exert greater efforts in the hope that they and shareholders will both reap higher economic rewards.

To a certain extent, performance-based pay has worked. In the UK, there are fewer instances of "payments for failure" and incentive schemes are better structured in terms of contract length, inclusion of robust performance conditions, and overall balance between salary, bonus, and long-term incentives. However, in many markets (including the UK), executive compensation continues to rise at a worrying rate and there is an apparent lack of symmetry between executive pay and company performance, in up and down markets. In the US, the S&P 500 index fell nearly 40 percent in 2008 but, according to a *New York Times* survey, median CEO compensation at 200 large firms declined only 10 percent the same year.¹⁸

It is widely accepted that certain performance-based incentives employed in the recent past actually exacerbated the agency problems they were designed to solve. Stock options, with their emphasis on share price growth, were initially touted as a way to align management and shareholder interests. But the "mega" stock

"I was initially skeptical of their use but have found board evaluations to be valuable in helping the board to improve its functioning. It is a wonderful opportunity for reflection," said one FTSE 100 chairman.

¹⁷ For instance, thirty years ago only ten percent of UK executives received performance-related awards. At large UK companies today, base salary comprises only one-quarter to one-third of total compensation, with the rest consisting of annual bonuses and long-term stock incentives. Kate Burgess, "Floored boards," *Financial Times*, June 3, 2009.

¹⁸ Kathryn Jones, "Who Moved My Bonus? Executive Pay Makes a U-Turn," *The New York Times*, April 5, 2009.

“In many markets, executive compensation continues to rise at a worrying rate and there is an apparent lack of symmetry between executive pay and company performance, in up and down markets. Certain performance-based incentives exacerbated the problem.”

option awards at US companies in the 1990s induced management to take enormous risks and tempted some executives to manipulate earnings in order to maximize payouts. In this regard, US tax law limiting deductibility of base salary to US\$1 million and accounting rules allowing options to avoid being expensed contributed to their misuse. In any case, stock options suffer from a structural flaw in that they create an asymmetric risk profile between management and shareholders. From the perspective of management, stock options are often seen as a one-way bet with significant upside but zero downside potential. As a consequence, many companies have eliminated them or restricted their use.

In the financial sector, the potential for multi-million dollar payouts, coupled with calculating annual bonuses according to revenues generated in the current year, may have similarly led bankers to take inordinate risks, endangering the health of the individual bank and the financial system.

To a large extent, the problem with performance-based compensation has been its implementation, as the concept remains generally sound. Performance-based pay can be improved in a number of ways, some of which have been practiced by a small percentage of firms for years.

“The problem with performance-based compensation has been in its implementation, as the concept remains generally sound.”

When setting remuneration levels, a compensation committee usually constructs a peer group against which the firm’s executives are benchmarked. To constrain the ratcheting of pay, the board should carefully scrutinize the firms that are included in the benchmark group. For instance, given the significant disparity in company size within the FTSE 100 index and the correlation between firm size and compensation level, it would be improper for a recent FTSE 100 joiner to benchmark the remuneration of its executives against all the index constituents. Yet, many compensation committees have been accused of inappropriately including in their peer groups much larger firms or enterprises that are not genuine competitors. Similarly, companies need to be careful where they position pay against the relevant benchmarks. Targeting compensation at or above median will likely lead to a ratchet of pay, especially if companies regularly shift peer groups to include firms that are larger than themselves.

Given these shortcomings, and the limited scope for fixing them,¹⁹ boards should rely less on such comparative data when deciding remuneration and

¹⁹ For instance, given the risk of wounding the pride of executives, it may not be feasible for companies to position pay below median or to reduce salary when a company shrinks.

place greater emphasis on other factors, such as pay levels elsewhere in the firm, experience, and individual performance.

To spur executives to adopt a long-term orientation, their performance should be evaluated through a multi-year lens and, correspondingly, payouts should be staggered over several years. Regarding bonuses, particularly if they are high, it may be appropriate to replicate the bonus/malus approach of Swiss bank UBS. Under this model, an employee's annual bonus is placed into a bonus account, with only one-third of the balance paid out each year. Future bonuses will be added to this account and the outstanding balance will be reduced if a loss is recorded at the business unit or firm level, a significant restatement is made, or the employee engages in misconduct.²⁰ Outside of the financial sector, Singapore's Keppel Corporation operates a similar scheme that is tied to economic value-added (EVA) performance.

“Boards should rely less on comparative data when deciding remuneration and place greater emphasis on other factors, such as pay levels elsewhere in the firm, experience, and individual performance.”

Likewise, to help executives concentrate on sustaining and improving performance, it is extremely helpful to attach performance conditions to the vesting of share awards. In the UK, commonly utilized metrics include earnings per share (EPS), total shareholder return (TSR), cash flow, economic profit, and other return on capital measures. The most appropriate metrics would, of course, vary by industry and by company. For example, EPS may not be as appropriate as other measures for firms in highly cyclical industries, such as the semiconductor and financial services sectors.

To prevent undeserved rewards to executives in buoyant markets and unfair punishment in recessionary periods, companies have increasingly measured performance on a relative basis. For instance, instead of share awards vesting when a firm's share price reaches a particular level, they will vest only if the company outperforms a pre-set basket of competitors on TSR. In the UK, share awards using relative TSR will typically vest only when a firm's TSR performance matches or exceeds its peer group.

While the use of relative performance metrics has considerable merit, it can also lead to excessive risk taking because there is not an absolute level of performance where management is assured of a payout. Just like setting executive pay at median and above contributes to a ratcheting of compensation, employing relative TSR under which shares will vest only at or above median performance could create a similar ratchet, in this case by increasing a firm's risk profile. While current shareholders may be highly supportive of management relentlessly pushing themselves and the company to deliver ever higher performance, long-term shareholders—such as index

²⁰ Further information can be found at <http://www.ubs.com/compensationreport>.

investors—may worry that short-term out-performance is achieved at the cost of damaging the firm's long-term prospects.

Accordingly, for highly mature industries where there are real limits to organic growth or sectors where systemic risk is an important consideration, such as banking, it may be appropriate to temper the hazards of relative performance metrics by employing a mixture of relative and absolute targets. Provided the absolute target levels are positive and challenging, such a hybrid structure makes it explicit that management will share upside gain and downside pain with shareholders.

A further way to foster long-term orientation is to require executives to have “skin in the game” even after they have departed the firm. This can be achieved in several ways. Earlier this decade, a large Canadian bank began to require top executives to retain substantial share holdings—up to ten times base salary for the CEO—for up to two years after they have retired from the bank. Recently, a UK-headquartered pharmaceutical firm decided that, rather than accelerating the vesting schedule of share awards to the year that an executive departs, it will allow the vesting schedule to run its full course when an executive retires or is made redundant. This means that an executive will continue to be exposed to the firm's performance for up to four years after his departure. At UBS, the bonus balance for a departing executive will be kept at risk for three years so that any residual “tail risk” will be captured.

“One way to foster long-term orientation is to require executives to have “skin in the game” even after they have departed the firm.”

Clawback provisions have received much attention lately. While they are attractive in theory, these provisions may be hard to implement, particularly if judgment is required to determine the portion of payouts that should be returned to the company. Moreover, the legal wrangling that would inevitably ensue between employer and employee plus the issue of seeking a refund of income taxes already paid would further complicate matters. As discussed above, an escrow account whereby payouts are ordinarily released over three to five years may work better than a clawback. A further benefit of deferred payments is that the firm maintains control over funds that may subsequently need to be clawed back.

While it may be heresy for anyone who professes to be a supporter of market-based systems to discuss capping executive pay, this topic deserves mention because the possibility of receiving an extremely high quantum of pay over a short period can increase a person's risk-taking appetite to the detriment of a firm's long-term health. Mechanisms should therefore be put into place to compel employees to consider the long-term consequences of their actions. In addition to the tools discussed above, an absolute ceiling on payouts may be warranted in certain situations.

Notwithstanding the general utility of performance-based compensation, there are limits to the use of economic incentives as a motivational tool, the most significant being that people are motivated by more than the prospect of financial gains. In fact, excessive focus on economic incentives may blunt the effects of self-corrective mechanisms, such as values, that help steer executives to “do the right thing” when organizational and personal interests are being pulled in different directions.

Shareholder rights

Across the world, greater reliance on public equity markets to channel savings into companies with capital requirements has resulted in the steady expansion of shareholder rights, as policymakers responded to new agency issues that arose and other matters necessitating the strengthening of rights. In the current economic crisis, perceptions of poor stewardship by boards and management have led to calls to empower shareholders further.

Shareholder rights fall into five broad categories:

- **Ownership** – right to buy, sell, and transfer ownership, and to be protected from dilution
- **Information** – right to be informed about important matters in a timely manner
- **Influence** – right to participate in shareholder meetings and influence key decisions, such as election of directors, approval of material acquisitions, and modification of existing rights
- **Economic** – right to receive a pro rata share of economic distributions, such as dividends and proceeds from dissolution, and to sell shares at a “fair price”
- **Fair treatment** – right to be treated in an equitable manner vis-à-vis a controlling owner or other classes of shareholders

In recent decades, notable trends include the improved ability of shareholders to participate and vote in shareholder meetings, greater access to company information, and enhanced authority of minority investors to influence important decisions, such as elections of board directors.

Some of the rights granted to, or contemplated for, shareholders, however, have been somewhat controversial. These include the annual vote on remuneration, double voting rights for long-term shareholders, and the requirement that certain key decisions must garner majority support in terms of both share value and the number of shareholders physically present at a shareholders meeting.

In recent years, some of the hardest-fought battles to strengthen shareholder rights have occurred in developed markets. For instance, US companies only recently

began to switch from plurality to simple majority voting in director elections. Under plurality voting, shareholders are not able to vote “against” a director candidate; consequently, a single “for” vote is ordinarily sufficient to put that candidate on the board. In continental Europe, campaigns are continuing for the removal of various obstacles to voting, such as requirements to deposit shares with a custodian prior to a vote and comply with burdensome powers-of-attorney procedures.

“It is unclear from statistics such as compensation levels for executives and boardroom turnover at poorly performing firms whether strong shareholder rights in the UK have been put to good use.”

At the same time, it is arguable that strong shareholder rights have led to better oversight of management. In the UK, shareholders are armed with powerful tools, from a low ownership threshold for convening a shareholders meeting to the ability to remove directors any time to an annual advisory vote on remuneration. Yet, it is unclear from statistics such as compensation levels for executives and boardroom turnover at poorly performing firms whether these rights have been put to good use.

Shareholder rights can differ markedly among countries, including those with similar legal foundations. For example, pre-emption rights—which require any new issuance of shares by the company to be offered first to existing shareholders—are a bedrock feature in UK company law and considered sacrosanct by British institutional investors. But they are largely absent, and rarely raised as an issue, at US firms. Conversely, it is much more difficult for UK investors to launch a collective action claim against a company than their US counterparts. Likewise, the ability of shareholders to sign off on board and management activities through an annual “discharge” vote is confined largely to continental Europe. Even here, the “discharge” vote carries different legal consequences, from a near-complete release of liability in Greece and Switzerland to no legal impact in Spain and Germany.

In many markets, ownership structure exerts a non-trivial influence on the character of shareholder rights. To illustrate, given the prevalence of controlling owners in Italy and Mexico, the corporate governance regimes in those countries reserve space on the board for minority shareholders. In other markets where concentrated ownership is the norm, tools such as cumulative voting are often employed to provide a counterweight to the controlling owner’s influence. These mechanisms are largely alien to the UK and US, where ownership is generally much more dispersed and, hence, special rights for minority shareholders are not perceived to be necessary.

When fashioning reforms in this area, there are often difficult trade-offs to be made. Take the right of outside shareholders to appoint their own representatives to the board. Ideally, a nominations committee—which is better positioned than outside shareholders to know the balance of skills and background required by the board—should propose board candidates and shareholders should approve or reject the nominees through a simple majority vote. Moreover, direct appointment or nomina-

tion by shareholders risks damaging board cohesion and the appointee may also not possess the skills and experience required by the board. However, in companies with abusive or unresponsive controlling shareholders, boards, or management, or where transparency is abysmally poor, outside shareholder representation on the board may be the optimal outcome because the need to obtain information and monitor management directly may outweigh the potential loss of board collegiality and expertise.

While there is broad agreement that all shareholders should be treated equally, there may be occasions when deviation is justified. For instance, recognizing that large institutional investors often have greater incentives to monitor management, the UK Combined Code on Corporate Governance compels companies to consult their largest shareholders on major strategic and corporate governance developments. Similarly, the top three to five largest shareholders in Swedish companies are invited to sit on the nominations committee. In both cases, participating investors are prohibited from trading on any material, non-public information received.

As noted above, there have been calls to enhance the ability of shareholders to hold boards accountable, specifically through annual votes at shareholders meetings on such matters as executive pay and board oversight of risk. Since expansion of shareholder rights also implies greater investor participation, it is important to consider whether shareholders are well-positioned to exercise these rights.

Convinced that greater shareholder involvement is necessary to stem high executive pay, shareholder activists and others in Canada, Germany, Switzerland, and the US have called for a UK-styled advisory vote on remuneration.²¹ Before introducing such a measure, policymakers should consider whether shareholders will devote the necessary time and develop sufficient expertise to evaluate each pay proposal on its merits. In this regard, thoughtful assessment would entail understanding which performance metrics are most suitable in light of a firm's stated strategy, whether the specific targets proposed are sufficiently challenging, and, crucially, the impact of the proposed performance targets on a company's risk profile.²² If companies choose to consult shareholders on major changes to their pay practices, as UK firms tend to do, then the largest shareholders must be prepared to provide detailed responses to each firm.

“In companies with abusive or unresponsive controlling shareholders, boards, or management, or where transparency is abysmally poor, outside shareholder representation on the board may be the optimal outcome because the need to obtain information and monitor management directly may outweigh the potential loss of board collegiality and expertise.”

²¹ Australia, The Netherlands, and Sweden also feature votes on remuneration.

²² By insisting on ever higher performance targets each time a more lucrative pay package was proposed, UK investors may have, in recent years, unwittingly encouraged executives of investee firms to take inordinate risks.

“Since expansion of shareholder rights also implies greater investor participation, it is important to consider whether shareholders are well-positioned to exercise these rights.”

In addition, policymakers should determine whether diverse investor views on executive pay will serve as an impediment in holding boards accountable and whether the broader legal framework provides a sufficiently enabling environment. In the US, it is unclear whether SEC regulations permit institutional investors to engage privately with the company and to consult one another on pay matters.

In a similar vein, there have been demands for a vote on the audit committee report. Unlike compensation matters, where the availability of information on remuneration practices and company performance enables shareholders to ascertain the effectiveness of a compensation policy without great difficulty, the work of the audit committee is more complex and less observable from the outside. In most cases, deficiencies in audit committee oversight come to light only in the event of a scandal or the company's collapse. The key question for policymakers therefore is whether shareholders are well-positioned to evaluate an audit committee's effectiveness in the absence of a scandal or crisis.

More generally, there are limits to relying on shareholders to monitor boards and management, particularly in markets with dispersed ownership. These include free-rider problems, lack of competence (particularly for institutional investors with large portfolios), and conflicts of interest.²³

Financial liability

“There are limits to relying on shareholders to monitor boards and management, particularly in markets with dispersed ownership.”

Given that agents may further their own interests at the expense of those of their principals, the threat of financial liability has historically been relied upon to keep a variety of actors—from directors and officers of companies to auditors, investment bankers, and other intermediaries—in line. Although still a cornerstone of the corporate governance regime, personal financial liability has fallen into relative disuse as policymakers have sought to encourage entrepreneurship and risk taking by curtailing the circumstances under which liability might arise.

Through use of the relatively new limited liability partnership vehicle, accountants, lawyers, and other service professionals have been able to shield themselves from personal liability arising from their partners' actions. Some commentators have argued that allowing these professionals

²³ See discussion in Simon Wong, “Activism and mainstream institutional investors,” 2008. Available at <http://ssrn.com/abstract=1158592>.

to switch from organizing themselves under a general partnership (where a partner is jointly and severally liable for the actions of all partners) to a limited liability partnership (where a partner is personally liable only for his own negligence) has robbed the corporate governance system of an important quality assurance mechanism and, more worryingly, may have reduced the quality of the resulting services.

At the corporate level, UK company law now allows firms to enter into liability limitation agreements with their external auditors, and several other jurisdictions are debating whether to do the same.

Determining the appropriate level of liability is often difficult, as competing factors must be adequately balanced. Today, through a combination of the “business judgment rule,” directors and officers liability insurance, and indemnity provided by the company, non-executive directors in most jurisdictions—absent active participation in fraud and other bad faith conduct—face little risk of being forced to pay any potential settlements out of their own pockets.²⁴ Yet, if NEDs were to face increased prospects for incurring financial liability, fewer qualified individuals (particularly those with deep pockets) would be willing to serve on boards or, once in the boardroom, they may become too risk averse. Accordingly, the current equilibrium may be justified given that most NEDs receive relatively modest financial rewards and stand to suffer substantial personal reputational harm if things go wrong.

For intermediaries—such as investment bankers, accountants, and lawyers—whose sizeable financial incentives may conflict directly and severely with their contractual or statutory fiduciary obligations and who—from a systemic and prudential perspective—play an essential monitoring role, a renewed emphasis on financial liability may be desirable. Options in this area include personal liability in an individual capacity as well as collectively for the actions of all partners in a joint enterprise, the latter of which is intended to spur colleagues practicing together to closely monitor each other's activities. Structurally, a key advantage of a collective liability regime is that an intermediary's own colleagues are better positioned than say, shareholders and other outsiders, to monitor his actions because it is less problematic—from a legal perspective—for colleagues to access confidential and proprietary information in the course of carrying out their monitoring duties.

“For intermediaries whose sizeable financial incentives may conflict with their fiduciary obligations and who play an essential monitoring role, a renewed emphasis on financial liability may be desirable.”

Over the past year, several prominent service professionals who had operated under a general partnership structure during their careers have advocated a return to a collective liability regime as a way to shore up monitoring and accountability.

²⁴ See Bernard Black, Brian Cheffins, and Michael Klausner, “Outside Director Liability,” 2003, and Bernard Black and Brian Cheffins, “Outside Director Liability Across Countries,” 2003.

Conclusion

The instruments discussed in this *Private Sector Opinion* have certainly helped to improve corporate governance practices, but only when they were properly applied. While there are limits to the utility of these mechanisms, steps can usually be taken to improve their effectiveness. On each occasion when changes are contemplated, policymakers and others involved in the reform process should evaluate how the instruments they wish to again draw upon have worked in the past—at home and abroad—and seek to understand the factors that have contributed to their success or failure.

About the Author

Simon C.Y. Wong

Simon C.Y. Wong is an independent advisor and Adjunct Professor of Law at Northwestern University School of Law. Simon is also Chair of the ICGN Shareholder Responsibilities Committee and member of the Private Sector Advisory Group of the Global Corporate Governance Forum.

Previously, Simon was Head of Corporate Governance in the London office of Barclays Global Investors (BGI). In this role, Simon developed BGI's corporate governance guidelines, oversaw the voting of client holdings, and led engagement with boards and senior management of investee companies on matters of strategy, performance, and governance/sustainability. He also sat on the Association of British Insurers and Eumedion Investment Committees.

Before joining BGI, Simon was a management consultant at McKinsey & Company, where he served companies and governments in developed and emerging markets on a broad range of corporate governance, organization, strategy, and financial regulatory matters.

Simon started his professional career as a securities lawyer with Linklaters & Paines and Shearman & Sterling in London, and also served as Principal Administrator/Counsel at the OECD in Paris, where he focused on corporate governance, company law, and insolvency reform policy matters.

Simon speaks regularly on corporate governance and capital markets-related topics and has published articles in the *McKinsey Quarterly*, *International Financial Law Review*, *Corporate Governance International*, *Governance*, and other journals.

Simon holds a Juris Doctor degree from Northwestern University and is admitted to the New York bar.

OUR MISSION:

Established in 1999, the Global Corporate Governance Forum is a multi-donor trust fund facility located within IFC Advisory Services. Through its activities, the Forum aims to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crises, and provide incentives to corporations to invest and perform efficiently in a socially responsible manner.

The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform.

OUR FOCUS:

- Raising awareness, building consensus
- Disseminating best practices
- Sponsoring research
- Funding technical assistance and capacity-building

OUR DONORS:

- Austria
- Canada
- France
- Luxembourg
- The Netherlands
- Norway
- Switzerland
- International Finance Corporation

OUR FOUNDERS:

- World Bank
- Organisation for Economic Co-operation and Development





© Copyright 2009.
International Finance Corporation
2121 Pennsylvania Avenue, NW,
Washington, DC 20433

All rights reserved.

The findings, interpretations and conclusions expressed in this publication should not be attributed in any manner to the International Finance Corporation, to its affiliated organizations, or to members of its board of Executive Directors or the countries they represent. The International Finance Corporation does not guarantee the accuracy of the data included in this publication and accepts no responsibility for any consequence of their use.

The material in this work is protected by copyright. Copying and/or transmitting portions or all of this work may be a violation of applicable law. The International Finance Corporation encourages dissemination of its work and hereby grants permission to users of this work to copy portions for their personal, noncommercial use, without any right to resell, redistribute or create derivative works there from. Any other copying or use of this

work requires the express written permission of the International Finance Corporation.

*For permission to photocopy or reprint, please send a request with complete information to:
the International Finance Corporation
c/o the World Bank Permissions Desk,
Office of the Publisher,
1818 H Street, NW,
Washington, DC, 20433*

*All queries on rights and licenses including subsidiary rights should be addressed to:
the International Finance Corporation
c/o the Office of the Publisher,
World Bank,
1818 H Street, NW,
Washington DC, 20433;
fax 202 522 2422.*



**Global
Corporate
Governance
Forum**

2121 Pennsylvania Avenue, NW
Washington, DC 20433 USA
Tel: +1 (202) 458 1857
Fax: +1 (202) 522 7588
cgsecretariat@ifc.org
www.gcgf.org

PRINTED ON RECYCLED PAPER