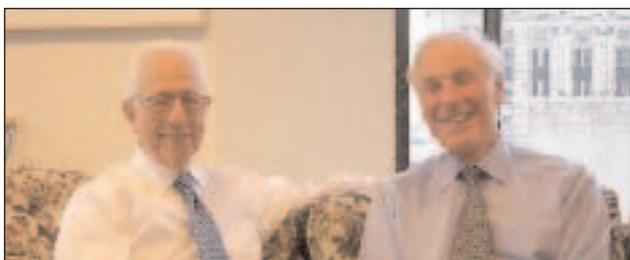


The New Agenda for ICGN

Adrian Cadbury and Ira Millstein*



The International Corporate Governance Network's (ICGN) tenth anniversary in 2005 provides an opportune moment to reflect on how far we have come in promoting corporate governance best practice and to set the agenda for governance reform programs going forward. After a decade of debate, it has become apparent that matters of governance are interconnected. Many of the issues the ICGN debates have implications for a broader constituency than just corporates and their investors. And, as with any evolutionary process, change is the only constant.

At its highest and broadest level governance is now concerned with holding the balance between economic and social goals, and between individual and communal goals

A complete understanding of the full context of governance as presently understood requires appreciation of the history of corporate governance, and its expansion to the term "governance." The need to govern a public corporation has been present for as long as the corporate form has existed. It stems from the simple fact that a corporate entity deals with other people's money and that money will not be forthcoming without some trust and protection.

What then does "governance" mean and why has it come to assume its present importance? The word "governance" is derived from the Latin, *gubernare*, to steer, and it is helpful to keep that root in mind. The task of the helmsman is to set the course for the ship and to maintain her on that course. Those assuming a governance role must, therefore, direct and control, leaving those with an executive role to carry out the day to day tasks. It might also be helpful to think of the role of the ICGN in similar terms - steering the debate, keeping it on an even keel and providing sufficient momentum to keep it afloat and moving forward.

Corporate governance originated as a response to perceived problems in the manner in which individual corporations were directed and controlled. In particular, governance codes aimed to use market forces to extend best practice as widely as possible throughout the corporate sector. In addition, accounting standards were tightened and market regulation was backed by statutory regulation where necessary. Market regulation, however, could only be effective provided the market played its part in the process. The key to effective market involvement was the concentration of shareholdings in the portfolios of institutional investors. It changed the balance of power between boards, managers and shareholders. The capacity of institutional investors to influence and to intervene, as a result of their collective shareholding power, has been the single most important factor in the development of corporate governance to date.

The ability of institutional or individual investors to influence and intervene effectively depends on their understanding of the manner in which corporations are being directed and controlled. Disclosure, therefore, is the basis on which the practice of corporate governance has been built, and disclosure remains fundamental to its further development. There is no doubt that, as best practice has spread and standards of governance have been raised, corporations have become more accountable to shareholders and to society. In particular, corporations have become more accountable to the institutional investors who own such a high proportion of their shares. The loose end in the chain of accountability is to whom are those investing institutions accountable and to whom should they be? This issue should move up the governance agenda.

Perhaps the most striking aspect of the development of corporate governance has been the way in which its scope, its impact and its possibilities have broadened. The first governance codes were aimed at improving the way in which corporations were directed and controlled by spreading best practice. Their focus was on boards of directors and they had a measurable impact on national corporate governance standards. Building on that experience, corporate governance extended its influence in two directions. It developed international governance guidelines in addition to national ones, and its aims widened to those of encouraging economic growth and the free flow of capital. Through these developments, corporate governance has become more than a means of enabling corporations to be better directed and controlled to the general benefit. It is now concerned at its highest and broadest level with holding the balance between economic and social goals, and between individual and communal goals. The governance framework is in place to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. As a consequence, corporate governance is developing into a means of aligning as nearly as possible the interests of individuals, corporations and society. This is a remarkable transition.

So, we can take comfort that progress, which at times has seemed glacial in pace, has been significant. In determining its future work programme, the ICGN must continue to promote best practice, prevent back-sliding on the achievements to date, and push for measures that will strengthen the chain of accountability. There are a number of critical weak points, as set out below.

Investors

There are numerous potential conflicts within financial institutions, which are not eliminated by Chinese Walls that are often porous and, in any event, difficult to police. This leads to questioning the validity of opinion and analysis, as well as investment policy and proxy voting, which shareholders and beneficiaries should be able to depend on.

Because of institutional lethargy and conflicting goals and objectives, active shareholders have been limited to a few public funds and some mutual funds. To call for shareholder activism may be hollow until more institutions are capable of being conflict-free and acting independently.

Shareholders are neither monolithic nor static - they are diverse with different goals and objectives, and the shareholding of companies is constantly in flux. Moreover, the bottom line may not be acceptable as the singular shareholder guideline in all regions of the world. There is no single stockholder polestar; all shareholders do not value the same results. However, the lowest common denominator is likely to be profit. This being so, management has a fair hand in determining just how to satisfy profit objectives and thus can - and often does - fall back on short term results.

Boards

Not all boards are taking "best practices" seriously; they see reform as a box-ticking process - rather than a prescription for fundamental change.

Board members are not ordinarily trained before embarking on their responsibilities and may not fully understand the meaning and application of their fiduciary responsibility.

The selection of directors is usually in the hands of the directors, with shareholder choice limited to "electing" the single slate proposed by the board itself, often without the ability to vote "no." Boards are, in fact, still self-perpetuating, absent a calamity.

In the past, indemnification and D&O insurance may have given directors a false sense of security.

Anti-takeover devices such as poison pills have been overused to entrench boards and management, rather than to create an auction environment to benefit shareholders.

Compensation

CEO compensation is often tied to relatively immediate results.

Stock-based compensation including options and other such devices, became protean. They expanded from a convenient and often necessary means to compensate employees in newly-formed technology companies, to becoming embraced by managers as a way of aligning incentives. This resulted in outsized, and in some cases preposterous, compensation which was totally out of line with actual performance and often not expensed.

Other issues

Whistleblowers and internal auditors are often not sufficiently protected from management retaliation.

Accounting rules have become so complex that loopholes and interpretation are a constant factor in permitting earnings and expense management techniques which mask the true financial condition of the company.

Gatekeepers, such as lawyers and accountants, may often become blinded by loyalties to the management team that has traditionally hired them, rather than to boards and shareholders.

Regulatory reform is often at risk of being resisted or watered down by interest groups lobbying the government to oppose reform.

For governance reform efforts to succeed, those involved should appreciate that the board of directors, its make-up and performance, and its adherence to its responsibilities to shareholders and other corporate constituents, is the foundation of the entire governance paradigm. Shareholders, particularly institutional investors, are, through necessary disclosure by corporations, positioned to insist on appropriate board composition and performance. Without that insistence, through the many means available, the governance system, and hence the entire market system, will not perform as intended for the benefit of shareholders, constituents, and society.

As the governance system continues to evolve towards this standard, the key role of institutional investors becomes more evident. However, their fulfillment of this role may be hampered by their credibility being impaired by conflicts of interest, short termism, and their own internal governance failures. Each of these issues should be addressed so that governance reform efforts can move forward. First, we urgently recommend that a study be undertaken under the leadership of the ICGN, of the causes of this lack of credibility, and what might be done to remedy it. Second, and assuming the credibility of institutional investors is improved, we recommend that ICGN focus on institutional activity, by prioritising the important governance issues in need of reform. Institutional investors should focus reform efforts on both emerging markets and developed markets.

In emerging markets, institutions can use the capital at their disposal to shape governance boundaries by refusing to invest in markets that do not have robust legal and governance frameworks in place - they should make it clear that they will invest at market rates only in countries and companies they can trust and that are free of corruption. Available capital can be a strong voice urging local governmental and corporate reforms, and it enables investors to improve the investment landscape for themselves and others.

The board of directors is the foundation of the entire governance paradigm

The key governance features investors should be insisting upon in emerging markets have been developed by and are shaped according to market forces. They are nothing less than universal rules that direct and allocate capital. They are the product of no nation and can be modified by local usage and custom. Of course, each and every country and company is free to ignore these core concepts - joining the global economy is a matter of choice. It is not compulsory. However, it is in the interests of developing nations to join the worldwide economic community. Only then will they be able to harness their vast potential. To do so will require emerging markets to establish strong governance frameworks.

In developed markets with governance frameworks that are already robust, we urge the ICGN to lead institutional investors in our steps to: first, improve the quality of directors through reformed director selection and election processes that better reflect shareholder choice; second, bring compensation to more acceptable levels; third, improve financial disclosure so that it represents the true and fair condition of the company; and finally, articulate when the legal boundaries, surrounding voluntary self-help procedures, should be expanded or contracted.

Institutional investors have the power - particularly when acting credibly and collectively through a vehicle such as the ICGN - to refine governance boundaries by self-help, in a way that will further strengthen capital markets and boost investor confidence.