Chapter 11

Epilogue: The Future of Corporate Governance

11.1 About Epilogues

The *Encarta Dictionary* defines an *epilogue* as “a short Chapter or Section at the end of a literary work, sometimes detailing the fate of its characters.” While this book clearly does not merit the label “literary work,” this epilogue does try to provide at least a partial answer to the question, “What is next in corporate governance?”

Specifically, we look at three sets of forces that are likely to shape corporate governance systems, principles, and practices in the years to come. We begin with the forces of *globalization*. Societies and corporations are connected by two inter-related sets of laws. The first is the rule of law as defined by local and national legislatures, multilateral agreements, and an emerging body of international law. These legal structures vary greatly from one part of the world to another. Most have deep and ancient societal roots, were shaped through centuries of cultural, political, and economic change, and exhibit a high degree of inertia. Proactive convergence of these structures, therefore, is unlikely, but a new global regulatory framework may be needed.

The market defines the second set of laws. Here we see a very different picture. No matter where a company operates or what it produces, these laws affect, or even determine, its fate. It should not come as a surprise, therefore, that this second set of laws is becoming—within the boundaries of applicable legal structures—the dominant force in the evolution of corporate governance practices around the world.

The second set of forces for change reflects new developments on the *domestic* corporate governance front. As companies continue their struggle to fully comply with the Sarbanes-Oxley Act, new accounting rules and disclosure requirements, and new pressures by institutional investors for greater *shareholder democracy*—principally focused on access and accountability—virtually guarantee further rule changes. The number of shareholder resolutions filed in the most recent proxy season on issues such as majority voting and ballot access has reached an all-time high. Proactive intervention by lawmakers in areas, such as “Say on Pay,” is also not out of the question. At the same time, while the trend toward *private equity*–dominated transactions appears to have been dealt a setback by the subprime and leveraged loan financial crisis, the large, privately owned corporation that uses public and private debt rather than public equity as its principal source of capital is likely to be a permanent feature of the global corporate governance landscape.

For the final set of forces, we return to the opening paragraph of the book, which introduced corporate governance in the context of the historical tension between individual freedom and institutional power. As noted in Chapter 9 "Responding to External Pressures and Unforeseen Events", the forces behind the Corporate Social Responsibility (CSR) movement have changed the governance landscape; they effectively have widened the range of players deemed to have a legitimate role in shaping corporate decision making and controlling the exercise of corporate power. Faced with this challenge, the appropriate response by boards is to develop a fuller appreciation of the new governance environment that is emerging. We describe this new environment in terms of a *new compact between business and society*. A key feature of this environment is the increasing pressure on corporations to involve stakeholders in the corporate governance system and holding the corporation answerable to the social claims and demands for nonfinancial information made by stakeholders, just as it is answerable to the financial claims and demands for information made by shareholders.

11.2 The Global Convergence of Corporate Governance Practices

The introduction of corporate governance regulations and best practices in one country or region increasingly affects corporate governance practices elsewhere in the world.This section draws on the 2006 Global Institutional Investor Study "Corporate Governance: From Compliance Obligation to Business Imperative," by Institutional Shareholder Services (2006). For example, in 2002 the United Kingdom became the first country to require companies to submit executive compensation proposals to a shareholder vote.The "Directors Remuneration Report Regulations" became part of U.K. company law in 2002 and took effect the following year. The government adopted the regulations in response to concerns about excessive pay for poor performance. The new requirement is mandatory for all companies listed on the LSE index—a total of 980 companies as of March 2006. These companies must submit a remuneration report that contains a wide range of information, including cash pay, share and option grants, and performance targets for long-term plans. Companies must put the remuneration report to a nonbinding shareholder vote at the annual general meeting. Though nonbinding, the votes enable shareholders to voice their concerns on corporate compensation packages. A year later, the Netherlands took the same practice one step further by requiring companies to submit compensation reports to a binding vote by shareholders.The Tabaksblat Code of December 2003 requires that proposed remuneration policies be submitted to the general shareholders meeting for approval. If shareholders vote the report down, the company must either keep the previous compensation plan or else call an Extraordinary General Meeting of shareholders for a new vote. In 2005, Sweden and Australia both adopted requirements for nonbinding shareholder votes on compensation.This element of the Swedish Code of Corporate Governance took effect on July 1, 2005. As noted earlier, in the United States, new SEC rules mandate disclosure of executive compensation plans. In addition, a number of recent shareholder resolutions seek an advisory vote on compensation committee reports.

The U.S. Sarbanes-Oxley, along with the implementing requirements that followed, is another example of a standard whose impact extends well beyond national borders. Investors throughout the world have taken notice of Sarbanes-Oxley, and their responses, positive or negative, are shaping the development of regulations and standards in their own countries.

In Japan, perhaps more than anywhere else, the global pressures for governance reform are being felt. And, while change is slow, progress has been made toward providing greater accountability and transparency, a key concern of international investors.

Increasingly, investors use the power of the ballot box to shape corporate governance standards overseas. The 2006 Institutional Shareholder Services (ISS) Global Institutional Investor Study shows that investors in the United States, Canada, and the United Kingdom are the most likely to cast proxy votes outside their home markets, with 73% of U.S., 67% of Canadian, and 60% of U.K. investors voting at least 50% of the shares they hold outside of their home market.ISS (2006), Global Institutional Investor Study (2006).

The globalization of corporate governance is also influenced by regulators and governments, especially in developing markets. Markets compete with each other to attract global capital, and that competition includes corporate governance standards. Increasingly, high–corporate governance standards are viewed as a way to make their markets more attractive to international investors.

11.3 Global Investor Concerns

The 2006 ISS Global Institutional Investor Study identified three governance issues that consistently rank among the top three concerns of international investors:Global Institutional Investor Study (2006), p. 36.

- *Better boards*—the independence of the full board and key committees, the process of nominating and electing directors to ensure independence and the right mix of skills and qualifications, the accountability of boards, and their responsiveness to shareholders—defined the number one issue in all markets except Japan. Investors in four markets ranked board structure, composition, or independence as their number one priority, and investors in all markets except the United States included it in their top three issues.
- *Executive pay*—linking pay to performance, disclosing performance metrics, and demonstrating the links justifying executive compensation—was judged critical in all markets but Japan. Some of the strongest concerns came from investors in the United States and Canada.
- *Financial reporting* was a key issue in every market but Australia– New Zealand. More than 70% of investors surveyed cited improved disclosure as the most needed improvement. The lack of trust in current financial reporting extended across markets with distinctive approaches to financial disclosure. U.S. Generally Accepted Accounting Principles (GAAP) came under criticism for its rule-based, sometimes inconsistent or less than informative approach to accounting. The concern over financial reporting was hardly confined to the United States, however. Investors in other markets also voiced concerns, including those that take more of a principles-based approach. In developed markets, the principal challenge was seen to "make sense of the numbers, to see the forest for the trees." In contrast, in developing markets like China, investors worried about obtaining reliable numbers in the first place.

A major conclusion of the survey was that institutional investors increasingly view corporate governance as a business imperative reflecting the recognition that their own business performance is largely driven by the bottom-line performance of the companies in their portfolios. They also signaled that corporate governance is likely to become an even more important factor in investment decisions in the future because of advances in the investment process, including global commercial databases on corporate governance ratings and the proxy voting records of institutional investors.

11.4 Global Convergence of Systems, Requirements, and Practices

In 1999 the **Organization for Economic Cooperation and Development (OECD)**[1] adopted the first multilateral set of guidelines. These "OECD principles" provide a conceptual framework for policymakers, companies, investors, and others to address corporate governance issues in terms that are commonly understood around the world.

The **OECD principles**[2] define basic requirements a country must meet to be regarded as having an adequate corporate governance environment; they do not target harmonization, per se. Negotiated by lawmakers from 30 major developed economies with widely differing governance standards, they leave considerable room for country differences. They do insist all differences be made transparent, and thereby are a force for convergence. Since their adoption in 1999, the OECD principles have been explicitly used as a benchmark by a number of investor-related initiatives to set guidelines: the International Corporate Governance Network (ICGN)The International Corporate Governance Network (ICGN) is an association of large institutional investors from around the world with more than 10 trillion assets, under management whose aim is to promote better governance globally. For more details about the ICGN, go to their Web site, http://www.isgn.org guidelines on corporate governance; the guidelines of some of the largest institutional investors, such as the California Public Employees' Retirement System (CALPERS) and the Teachers' Insurance and Annuity Association–College Retirement Equities Fund (TIAA-CREF) in the United States; and Hermes Asset Management in the United Kingdom. In 2001 the **International Institute of Finance (IIF)**[3], a grouping of the world's most prominent financial institutions, also issued a set of global guidelines.

Convergence[4] also does not imply a simple victory of one governance system over all others. Corporate ownership and control arrangements are deeply embedded in national laws and culture, and therefore will likely remain at least partly idiosyncratic. Rather, the focus of global alignment is on providing investors with a good understanding of how a company is governed in a particular country and the ability to fairly assess its performance and prospects. In other words, efforts to globally align governance systems and practices view the purpose of a high-quality corporate governance system in terms of generating trust in the investment community.

Convergence is principally occurring in three areas.

1. An international organization that helps governments with the economic, social, and governance challenges of being part of a democratic and global market economy.
2. The basic requirements that a country must meet to be regarded as having an adequate corporate governance environment.
3. A grouping of the world's most prominent financial institutions.
4. The global aligning of corporate governance systems and practices to generate trust in the investment community.

The first area concerns *regulations, listing requirements, governance codes, and best practices*. U.S. legislative changes have brought the American regulatory system closer to European norms, including

- the requirement that senior corporate officers must certify the fairness of corporate accounts or face criminal charges;
- the exposure of corporate executives and directors to criminal sanctions if they are found to have defrauded shareholders (the scope of criminal provisions on abuse of corporate property is broader in many continental jurisdictions, especially in France);
- a prohibition on company lending to senior executives (which is illegal in Germany).

Global convergence is also apparent in the new rule by the major U.S. exchanges requiring listed U.S. companies to adopt an internal corporate governance code and a code of ethics. Importantly, while the NYSE is not imposing its listing requirements on listed non-U.S. corporations, it does require them to explicitly comply or explain why they do not comply. This is another important way to stimulate convergence since many of the largest non-U.S. corporations in the world either have or aspire to have a NYSE listing. The new NYSE rules join a growing number of other "comply or explain" codes that have been adopted as part of listing requirements. This middle-of-the road approach between hard mandatory norms and purely voluntary market best practice was pioneered by the London Stock Exchange (LSE) when it integrated the various voluntary codes into a combined code that became a part of its listing requirements.

The second area concerns *board independence and structure, the role and definition of independent directors,* and *shareholder representation*. Board independence is also rapidly becoming a global benchmark. The new U.S. rules have set the independence bar high by requiring that a majority of directors be independent; that the audit, nominating, and compensation committees be comprised exclusively of independent directors and by tightening the definition of independence. But the main thrust of almost every code, whether international or national, is to enhance the independence of the board with regard to the controlling interests in a corporation: the managers in a widely held company or the controlling shareholder, where there is one. Almost all codes address this issue by requiring a "significant" number of independent, nonexecutive directors on the board. Most European codes do not specify a number; Korean listing requirements require that one fourth of the board should be independent; Malaysian listing requirements and the 2001 voluntary Singapore Code put the threshold at one third, following the example of the Vienot Code in France. According to the IIF guidelines, best practice consists in appointing independent directors to fill at least half of the board's seats.

Convergence can also be observed in the opposite direction. Japan, for example, amended its commercial code in May 2002 to allow companies to choose their structure of governance. The choice is between the old company law scheme of a board of directors and a separate audit board, and a new, more U.S.-like structure that provides for an audit committee of the board with independent directors as a majority. Change will be slow; Japanese companies have shied away from instituting a clear board committee structure that would give real responsibilities to a largely ceremonial board.

In Europe, Deutsche Bank made a landmark change in the way its management board is organized, moving away from a focus on collective responsibility to a system that emphasizes individual responsibility of senior officers and the CEO, like that found in the United States. Siemens recently decided to establish an audit committee on its supervisory board (albeit not wholly independent) and to review its own corporate governance annually.

The third area concerns *accounting, disclosure standards,* and *the regulation of the audit function*. The convergence of financial reporting and accounting standards around the world is improving the ability of investors to compare investments on a global basis. It also facilitates accounting and reporting for companies with global operations and eliminates some costly requirements. Still substantially incomplete, it has the potential to create a new standard of accountability and greater transparency.

The goal is an improved reporting model built on principle-based standards. In Phase I of the convergence process (from 2001 to 2005), the European Commission decided on the use of a common financial reporting language (the International Financial Reporting Standards [IFRS]) and required the adoption of IFRS by more than 8,000 companies worldwide. Inaugurated by the February 2006 Memorandum of Understanding between the **International Accounting Standards Board (IASB)**[5] and the **U.S. Financial Accounting Standards Board (FASB)**[6], Phase II (from 2006 to 2009) is reserved for rigorous market and regulatory testing of the IFRS and for generating further proposals aimed at addressing significant differences. The objective is the substantial equivalence of IFRS and U.S. GAAP and the elimination of the SEC's reconciliation requirement for foreign private issuers. Looking into the future (Phases III and beyond), the separate standard setters are expected to coordinate their actions and issue substantially identical standards. Longer term elements of FASB could be merged into the IASB structure to create a single, global standard setter (IASB) and accounting framework (IFRS) used worldwide.PriceWaterHouseCoopers ViewPoint (2007, April).

5. An independent, international board based in London, England, that sets standards for how certain types of transactions and other items should be noted in financial statements. In 2001, the IASB revised these standards; they are known as the International Financial Reporting Standards (IFRS).

6. A private-sector U.S. organization that sets standards for financial accounting and reporting.

Thus, global convergence does not simply imply a movement to globally uniform corporate governance norms and behaviors. Rather, it signals the adoption of principles and practices that allow investors and corporations to increasingly operate on a basis of trust across national borders. Corporations around the world also are beginning to value good corporate governance and are adopting global best practices. In the end, however, the primary force behind global convergence will be investors' demands for better governance and their willingness to value it.

11.5 Prospects for Further U.S. Governance Reform

Greater *director independence* to enhance accountability continues to be a major, if not the primary, focus of U.S. governance reform. A quick glance at the list of shareholder proposals of the most recent proxy season confirms this trend. The most popular shareholder resolutions filed concern issues, such as majority voting; access to the proxy statement; declassifying boards; "entrenchment" devices, such as classified boards, poison pills, supermajority vote requirements, and the right to call special shareholder meetings; and, of course, compensation alignment and disclosure. The latter issue, which Monks once called the "smoking gun" of U.S. corporate governance failure, is not only being targeted by shareholders but also by lawmakers.Monks (2005, March), p. 108.

Majority Voting

During the past year, many institutional shareholders have called on companies to adopt **majority voting**[7] for director elections as opposed to what has been more common, plurality voting. Under the plurality model, directors who receive the greatest number of favorable votes are elected. Shareholders cannot vote against director nominees but can only withhold or not cast their votes. Thus, most nominees are elected, even if they receive very few favorable votes and even if many votes are withheld or not cast. Under majority voting, to be elected, a nominee must get a majority of the votes cast. The states in which most U.S. public companies are incorporated make either of these models available to corporations.

Companies faced with a majority voting proposal, binding or nonbinding, should pause before adopting the traditional approach of trying to defeat this kind of shareholder proposal. Clearly, investor, and increasingly regulatory, sentiment favors this proposal, and any victory is likely to be short-lived as the proposal will almost certainly be reintroduced every year until it prevails. Moreover, fighting the proposal will be a negative in the company's "corporate governance rating" and may well lead to a new or reinvigorated campaign to withhold votes. Instead, boards would be wise to seize the corporate governance "high ground" by either adopting a modified plurality voting policy or a full-fledged majority voting regime.

Access Proposals

Another corporate governance issue that remains high on activists' lists concerns shareholder **proxy access**[8] in director elections. A few years ago, the SEC proposed rules that would have allowed certain shareholders to place the names of director nominees in the company's proxy solicitation materials and proxy card. However,

7. A type of director elections in which a nominee must get a majority of the votes cast.

8. A type of voting in which director candidates nominated by the nominating and governance boards are then voted on by shareholders on a piece of paper called a "proxy,“ which is mailed to all shareholders. Shareholders usually receive one vote for every share they own.

after reviewing the proposal, it decided against enactment. Arguments against proxy access included that, under current law, shareholders are free to utilize the proxy rules to solicit votes for their own nominees in director elections. Another argument was that proxy access might allow special interest groups to unduly influence the election process. Not all shareholders have the same interests. Arguments in favor of proxy access were that it would diversify boards and give shareholders a more prominent voice in decision making.

Elimination of "Entrenchment" Devices

Shareholders also continue to fight for the elimination of so-called classified or staggered boards, and the elimination of poison pills and related entrenchment devices. A staggered board of directors occurs when a corporation elects its directors a few at a time, with different groups of directors having overlapping multiyear terms, instead of en masse, with all directors having one-year terms. Each group of directors is put in a specified "class," for example, Class I, Class II, and so on, hence staggered boards are also known as "classified boards." In publicly held companies, staggered boards have the effect of making hostile takeover attempts more difficult because hostile bidders must win more than one proxy fight at successive shareholder meetings in order to exercise control of the target firm. Particularly in combination with a poison pill, a staggered board that cannot be dismantled or evaded is one of the most potent takeover defenses available to U.S. companies. Favole, in the *Wall Street Journal*, reported in January of 2007 that 2006 marked a key switch in the trend toward declassification or annual votes on all directors: More than half (55%) of the S&P 500 companies have declassified boards, compared with 47% in 2005.Favole (2007).

Compensation-Related Proposals

The 2008 proxy season "hot-button" issue was CEO pay, as evidenced by the large number of shareholder proposals calling for an annual advisory shareholder vote on executive pay, so-called "Say on Pay" proposals. Say on Pay is politically and emotionally appealing, attracts positive press, and, most important, is strongly supported by ISS (currently a part of RiskMetrics Group) and other proxy advisory firms. As with the issue of majority voting, given the strong national trend in favor of corporate governance activism and the obvious popular appeal of "Say on Pay," momentum is building toward a pervasive "Say on Pay" regime for U.S. public companies.

The strong momentum for "Say on Pay" is, in part, explained by its international roots. As noted earlier, the concept originated in the United Kingdom in the early 2000s and was made mandatory for LSE-listed companies by an amendment to the Companies Act in 2002. Mandatory shareholder advisory votes on executive compensation have since been legislatively adopted in Australia and Sweden. "Say on Pay" has also been implemented in the Netherlands and Norway in the form of a binding annual "vote of confidence" on executive compensation.

As a practical matter, for a U.S. company, "Say on Pay" means that its executive pay policies and procedures will have to meet ISS guidelines on executive compensation or suffer a very strong risk of ISS recommending that shareholders vote "No on Pay." Such a negative vote, if not addressed promptly by modifying executive compensation to fit ISS guidelines, will almost certainly lead to an ISS withhold-vote recommendation against the compensation committee and perhaps the entire board. The only clearly visible alternative to accepting ISS guidelines on executive compensation is for the board to negotiate exceptions with ISS based on particular facts and circumstances or with investors voting enough shares to overcome an ISS recommendation to vote "No on Pay."

Looking ahead, there are indications that shareholders activists are shifting their focus to shareholder proposals for bylaw amendments to implement corporate governance reform in place of traditional nonbinding shareholder proposals that merely recommend board action. Two major reasons for this change in focus are the continued frustration with company boards that either fail to act in response to a successful nonbinding shareholder resolution or "water down" implementation of the proposal and a concern that boards can too easily amend or rescind board adopted policies under the umbrella of fiduciary duty obligations.

The continued focus of shareholder activists on director independence, director nomination and election, and issues of disclosure and transparency described above is useful and undoubtedly has substantively contributed to improving the U.S. governance system. At the same time, we should ask why they have not adopted a broader and even somewhat bolder agenda for change, especially since it now has been clearly established that increased director independence is not a panacea that will prevent future misconduct—or even managerial inefficiency. Moreover, the evidence in support of a positive relationship between independence and performance is also weak.

As Hinsey (2006) suggests, there *are* corporate governance issues that warrant greater activists' attention. Separating the CEO and chairman positions is chief among them. In most U.S. boardrooms, the CEO continues to serve as board chair. As noted earlier, in this scenario the boardroom leadership responsible for independent directors' oversight of management is the responsibility of none other than the corporation's number one manager, a conflict of interest that is awkward at best.

The obvious solution is separating the two positions—the subject of only a handful of shareholder proposals filed in the last few years. The reason most often given against this idea is that having two leaders is confusing and does not work. The simple fact is, however, that it does work well, as demonstrated by the evidence from Great Britain. And rather than making the recently retired CEO the chairman of the board, outside directors should show their independence by filling the separate chair position with a nonexecutive boardroom leader of their own choosing.Hinsey (2006).

Another potentially productive debate concerns the issue of whether boards and shareholders should talk to each other. Most U.S. companies meet only (infrequently) with their largest shareowners and then only when threatened with resolutions or proxy contests. Resistance to increased communication between directors and investors is typically attributed to current SEC rules. It seems time, however, to test whether these regulations enhance or inhibit stronger corporate governance.

11.6 A New Compact Between Business and Society?

A third major force that has already begun to change decision making in boardrooms all around the world is the push for social responsiveness and stakeholder relations. Societal considerations increasingly force companies to rethink their approach to core strategy and business model design.This section draws heavily on Rochlin (2006). Dealing more effectively with a company's full range of stakeholders is also emerging as a strategic imperative."Pressure grows on U.S. companies to act on climate," Environmental Finance magazine, http://www.environmental-finance.com Historically, the amount of attention paid to stakeholders, other than directly affected parties, such as employees or major investors in crafting strategy, has been limited. Issues pertaining to communities, the environment, the health and happiness of employees, the human rights violations of global supply chains, and activist nongovernmental organizations (NGOs), among numerous other issues, were dealt with by the company's public relations department or its lawyers.

For example, according to Ceres, a coalition of investors and environmental groups that helps coordinate shareholder filings, investors filed a record 43 climate-related resolutions with U.S. companies during the 2007 proxy season.See "Investors and Environmentalists for Sustainable Prosperity," at http://www.ceres.org The resolutions sought greater disclosure from companies about their responses to the climate change issue, or called for companies to set greenhouse gas (GHG) reduction targets, and were filed by state and city pension funds and labor, foundation, religious, and other institutional shareholders, managing a total of more than $200 billion in assets.

Fifteen of these resolutions led to positive actions by businesses, leading to shareholders withdrawing their resolutions. Among the companies that addressed investor concerns, oil company ConocoPhillips responded to its resolution by announcing its support for an aggressive mandatory federal policy to reduce GHG emissions, committing to spend $300 million on low-carbon research, including alternative fuels, and agreeing to set a GHG reduction target.

Financial services company Wells Fargo committed to completing GHG assessments of key lending portfolios including agriculture, primary energy production, and power generation, while investment and insurance companies Hartford Insurance and Prudential Financial agreed to improve their public reporting and disclosure regarding the potential risks they face from climate change and strategies for mitigating those risks.

Seven resolutions were filed requesting that companies, including ExxonMobil, set specific GHG reduction targets from their operations and products. These resolutions received strong support, with more that 30% support at ExxonMobil, after investors raised concerns that the company is far behind competitors in addressing climate risks and investing in renewable energy. The increasing support for such resolutions shows that investors are looking for greater transparency about climate risks and information about how companies are preparing to meet the related challenges and seize the opportunities.

In this emerging environment, companies are finding that "business as usual" is no longer an option and that traditional strategies for companies to grow, cut costs, innovate, differentiate, and globalize are now subject to increased scrutiny by all stakeholders. Companies that accept, understand, and embrace this new reality will find that being a "good citizen" has significant, strategic value and does not detract but enhances business success. The late Milton Friedman might have had trouble accepting this new reality, but "good citizenship" has become "the business of business."