Introduction to Corporate Governance

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§1 Introduction

While corporate governance has attracted a great deal of attention among the developed countries of the world it has clearly become a global issue to be addressed in some fashion by all countries regardless of their stage of economic development. Given that, it is appropriate to note the definition of corporate governance that was used by the Organisation of Economic Co-operation and Development ("OECD") in its 2004 Principles of Corporate Governance:

> "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth."[1]

While the OECD definition correctly points to the importance of corporate governance from the perspective of developing and maintaining an efficient market economy, it should not be forgotten that corporate governance plays a key role in promoting societal stability and equity, issues of particular concern to developing countries. As one noted corporate governance scholar noted: "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of these resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."[2]

Clarke has explained that while the emergence of the business corporation as the dominant form of business association around the world is a relatively recent development, societies have been creating and using various types of business

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[1] Organisation of Economic Co-operation and Development, Principles of Corporate Governance (2004), 11.
[2] A. Cadbury, World Bank, Corporate Governance: A Framework for Implementation (Foreward) (2000).

associations for centuries in an effort to "resolve problems of group relations" and establish the duties and responsibilities of stakeholders pooling their resources to carry out a common purpose or objective.[3] Governments, such as the Parliament in England, became involved in granting charters for private incorporation, and countries continued to develop increasingly sophisticated sets of rules to facilitate the separation of ownership and control so as to allow company managers to assume responsibility for the investments of others while providing the investors with appropriate tools to monitor the use of their assets and hold managers accountable for their actions. While entrepreneurs remain free to choose from a variety of incorporated and unincorporated forms of business association, subject to the legal and regulatory factors in play in their particular country, the consensus seems to be that the "public corporation business form . . . has . . . prevailed for the financing and management of large enterprises universally".[4] Cadbury and Millstein provided the following further explanation:

> "During the same period that the governance issue was gaining prominence, the corporate structure became universally accepted, with local variations in form, as the most efficient means of organising financial and human capital to produce goods and services. The corporation, with its classic attributes of perpetual life, limited liability, unrestricted purpose with transferability of ownership, has prevailed over competing systems internationally . . . as a superior method of aggregating capital. The emergence of the corporation, as the dominant form of economic organization across the world, was due to its proven competitive advantage. But in this, the focus on governance played its part."[5]

However, while the theory underlying the corporate governance model would appear to be fairly clear, events of the last two decades have highlighted a wide array of problems and remaining challenges. Using the words of Cadbury and Millstein again, "[t]he theoretical model of the publicly-quoted corporation was based on the shareholders electing the directors, the directors appointing the managers to carry out the activities of the corporation to satisfy the aims of the shareholders, and directors being held to account in the general meeting . . . [however] . . . [t]he gaps between theory and practice are all too evident, particularly in the United States."[6] Jesovar and Kirkpatrick arrived at a similar conclusion: "Experience around the world shows that although the powerful concept of a listed company has been successfully introduced in many countries, the accompanying legal and regulatory system has often lagged, leading in some cases to abuse of minority shareholders and to reduced growth prospects when financial markets lose credibility—or fail to achieve it in the first place."[7]

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[3] T. Clarke, International Corporate Governance: A Comparative Approach (2007), 3.
[4] Id. at 8.
[5] A. Cadbury and I. Millstein, The New Agenda for ICGN (2005), 8 and 10.
[6] Id. at 10.
[7] F. Jesovar and G. Kirkpatrick, "The Revised OECD Principles of Corporate Governance and their Relevance to Non-OECD Countries", Corporate Governance: An International Review, 13(2) (2005), 127, 130.

Legions of authors and regulatory agencies have documented, analyzed and critiqued the economic and financial crises and scandals that have erupted around the world beginning with the Asian financial crisis of 1997 and continuing with the collapse of Enron and the other corporate scandals in the early 2000s and the sub-prime banking crisis that eventually led to the global Great Recession beginning in 2008 that was accompanied by crippling financial losses and emotional damage to shareholders and employees. The consensus is that failures of governance played a significant role in each of these crises and scandals. What is particularly striking, however, is that globalization—the growing influence of multinational enterprises and the explosive growth and development of a truly international financial system that connects investors and markets from all over the world—has turned what might have been simply a local problem into a something that might trigger a financial collapse thousands of miles away. It is therefore not surprising that "corporations and their governance . . . have burst the boundaries of any national jurisdiction" and "[t]he realization of the profound impact of corporations on the economies and societies of all countries of the world has focused attention on the growth importance of corporate governance".[8]

Banks has noted that governance problems can send firms down an increasingly challenging path that threatens, and sometimes extinguishes, their financial and operational viability and flawed governance practices can be found everywhere in the world in both developed and developing countries.[9] The consequences of governance problems vary—as Banks pointed out there are "cases where companies have managed to survive, albeit reputationally tarnished and financially impaired to varying degrees; [companies] that have merged in radically different form; and [companies] that have actually failed".[10] For example, companies such as Waste Management in the US and Vivendi Universal in France were faced with a wide array of governance problems (e.g., lack of proper controls, misreporting of financial statements, lax board members, conflicts of interest, failure of external audits and flawed strategy) yet survived following severe financial distress, forced assets sales and management reorganization. However, the outcome was not as good for many other companies that allowed, and were thereafter unable and/or unwilling to address governance problems, and were eventually forced into bankruptcy followed by either reorganization or liquidation: Andersen Worldwide (US), Daewoo Group (Korea), Enron (US), Kirch Media (Germany), SAir Group (Swissair) (Switzerland), WorldCom (US). Banks also explained that governance crises have crippled entire sectors and industries such as external auditors, energy trading companies, investment banking/research firms and Indonesian corporate/banking groups.[11]

[8] T. Clarke, International Corporate Governance: A Comparative Approach (2007), 11. Clarke's book also includes a useful collection of Corporate Governance Websites (Appendix A) and Regional and Country Codes and Reports (Appendix B) as of the book's publication date in 2007.

[9] An extensive set of studies in flawed governance featuring companies from around the world, including the companies mentioned in this paragraph, can be found in E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 166-230.

[10] Id. at 166.

[11] Id. at 231-256.

Claessens reminds that there are reasons other than scandal and crisis for countries and international organizations to be interested in corporate governance[12]:

- Privatization of firms and industries formerly owned and controlled by national governments in a number of countries has created increased demand for good corporate governance in order to induce investors to place their capital at risk with these newly-listed companies.
- Technological progress, as well as liberalization of national laws and regulations regarding firm ownership and cross-border investment, has increased the scope and complexity of global capital markets, a phenomenon that has not only made good corporate governance more important but also made it more difficult to achieve since there are more opportunities for unethical behavior.
- The growing importance of institutional investors as delegates of funds provided by individual investors has increased the need for corporate governance practice that protect the increasing number of beneficial owners who have become more distant from day-to-day management of the businesses in which they are invested.
- Increases in cross-border trade and investment have led to the creation of more and more enterprises composed of stakeholders from different cultures and legal systems, often resulting in uneasiness and confusion about the appropriate corporate governance structures for those enterprises.
- Countries embark on new regulatory strategies and reforms on a continuous basis, resulting in an ongoing evolution and transition of the local and global financial landscape that requires constant monitoring by businesses everywhere, regardless of their size or level of involvement in global financial markets. Change also brings innovation in financial instruments as investment bankers and their clients struggle to find new ways to improve their return on investment of their assets; however, as we have seen, these innovations often are accompanied by levels of risk that have been misunderstood and underestimated even by those closest to the innovation process.

Globalization of financial markets and the seemingly closer proximity of legal and institutional norms has led many to predict that there will ultimately be a convergence that results in uniform corporate governance institutions and standards around the world; however, others have rejected this notion on the basis that "[o]wnership and control arrangements are still a part of a society's core characteristics and will remain to a considerable degree idiosyncratic".[13] What is expected, or at least hoped for, is that the increase in cross-border investment and participation of foreigners in local economies will lead to a recognition that there needs to be a better mutual understanding between overseas investors and the companies they invest in regarding the reasonable requirements of those investors regarding "transparency and . . . disclosure norms" and a recognition by those companies that they can and will derive greater value by acknowledging and respecting the interests of all of their stakeholders.[14]

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[12] S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 6-7.
[13] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 129.
[14] Id. at 129.

The importance of corporate governance for companies and countries all around the world has been succinctly summarized as follows in a United Nations publication: "In a more globalized, interconnected and competitive world, the way that environmental, social and corporate governance issues are managed is part of companies' overall management quality needed to compete successfully. Companies that perform better with regard to these issues can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets while at the same time contributing to the sustainable development of the societies in which they operate. Moreover these issues can have a strong impact on reputation and brands, an increasingly important part of company value."[15] If this statement is true, the primary push for corporate governance standards will come from individual firms, responding to market requirements and consumer perceptions of their reputation and brands, as opposed to formal rulemaking by the state.

Another important driver of the global interest in corporate governance has been the recognition that governance can and does have a substantial influence on economic development and social conditions in every country regardless of its size or level of prosperity. Globalization, and the accompanying increase in cross-border investment, coupled with the highly publicized corporate scandals in the US and elsewhere throughout the last several decades has led to a growing interest in the study of corporate governance. Scholarship in the area has become more rigorous and methodological and attracted the attention of researchers from multiple disciplines. However, while the field is often referred to as "global" corporate governance, the work has often been heavily oriented toward the institutional context found in the US and rigorous cross-national studies have been slow to emerge.[16] Fortunately, there does seems to be a growing understanding that the institutional context does matter when analyzing corporate governance in a particular country and that greater emphasis is needed on understanding how and why a particular country's governance systems are influenced by localized factors such as property rights, the financial system, inter-firm networking, the role of labor and management ideology, the political and regulatory system and societal culture. In addition, research relating to corporate governance in particular countries has expanded to cover a wider range of issues. In India, for example, articles in corporate governance journals published in India have addressed the relationship of corporate governance to performance, corporate social responsibility, governance origins and models, disclosure, regulatory mechanisms and reforms, the board of directors, investor protection mechanisms and ownership structure.[17]

This Research Paper provides an overview of the complex set of laws and regulations, including statutes and case law, pertaining to corporate governance and the procedures

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[15] Id. at 128 (citing "Who Cares Wins: Connecting Financial Markets to a Changing World", UN Global Compact, 2004, p. i).

[16] For discussion, see B. Durisin and F. Puzone, "Maturation of corporate governance research, 1993–2007: An assessment", Corporate Governance: An International Review, 17(3) (2009), 266-291.

[17] See P. Srinivasan and V. Srinivasan, "Status of Corporate Governance Research on India: An Exploratory Study", Indian Institute of Management Working Paper No. 34 (2011).

that companies should establish to comply with their duties and obligations. This Paper includes a description of the evolving basic corporate governance model and focuses on the roles of the board of directors and its various committees and the steps that should be taken to create, implement and monitor disclosure controls and codes and policies pertaining to corporate governance matters, compliance issues and business ethics. Corporate governance has been a matter of intense focus and debate for public companies over the last few years and a wide array of new statutes and regulations have been adopted that impact fiduciary obligations of directors and officers to shareholders; the composition and responsibilities of the audit and other committees of the board of directors; and the duties of professional advisor to public companies, notably accountants and lawyers. While this has created additional expense and risk for public companies it has also raised the bar for privately-held emerging companies that are now expected to set and meet higher standards with respect to internal controls and ensuring the appropriate compliance and risk management programs have been implemented and followed. Corporate governance does demand investment of significant resources, including the time and attention of senior management; however, the effort can pay substantial dividends in terms of employee morale and creating a position impression and reputation in the investment community and among the consumers of the company's products and services.

This Research Paper also surveys some of the work that has been done on cross-national research relating to corporate governance. In order to make comparative studies across borders with respect to corporate governance it is necessary to construct some form of normative framework that includes common rules and institutions under which firms in all countries are operating with the rules coming from such sources as legal systems, judicial systems, financial markets and factor (labor) markets. This Paper discusses the elements of that framework and includes specific discussions on areas such as global corporate governance standards, competing corporate governance systems (e.g., Anglo-American, Germanic, Latin and Japanese systems), methods used in different countries for managing the "agency" issues in corporate governance, the role of the State in corporate governance, the factors that influence the choice and operation of corporate governance systems in a particular country and, finally, whether the world will ultimately converge toward a preference for one of the existing models of corporate governance or settle upon some sort of hybrid model that has yet to emerge.

§2 Definitions and descriptions of corporate governance

As with almost every topic in the study of organizations, definitions of "corporate governance" vary widely and the choice of the "definition" influences how comparisons among organizations and countries are conducted and how the results and implications of those comparisons are interpreted. A relatively simple definition of corporate governance is that it is "the system by which business entities are monitored, managed and controlled".[18] This notion of a "system" focuses on the relationship, and allocation of responsibilities, between the owners of the firm, the shareholders, and the managers of

[18] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128.

the firm who are vested with the duties to oversee day-to-day firm operations. The "management group" consists of two different and important classes, both of which are represented on the firm's board of directors elected by the shareholders: the "executives", such as the chief executive officer, who are expected to work full-time on the business of the firm; and the non-executive directors, who are not serving as employees of the firm yet are chosen for the independence and expertise and ability to look out for and protect the interests of the shareholders against attempts by the executives to take advantage of their insider positions. According to Nisa and Warsi, the measure of effectiveness of this system of corporate governance is whether a firm has created an enduring structure "that encourages symbiotic relationship among shareholders, executive directors and the board of directors so that the company is managed efficiently and the rewards are equitably shared among shareholders and stakeholders".[19]

Others have suggested that while definitions of corporate governance do indeed vary widely they can usefully be sorted into two categories.[20] The first set of definitions are primarily concerned with the actual behavior of corporations as measured by indicators of performance (e.g., growth and/or efficiency), financial structure, operations of the board of directors, the relationship between executive compensation and performance, the relationship between labor policies and firm performance and the roles and treatment of shareholders and other stakeholders. This approach is suitable when studying a single country or firms within a single country. The second set of definitions, thought to be appropriate for comparative studies across national borders, are primarily concerned with the "normative framework", which has been defined as "the rules under which firms are operating—with the rules coming from such sources as the legal system, the judicial system, financial markets, and factor (labor) markets".[21]

Given the emerging interest around the world in comparing and contrasting corporate governance systems, the normative framework is of great interest as an overriding framework. Not surprisingly, however, there is debate about how broadly the framework should be defined. Among the possibilities are the following[22]:

- A relatively limited focus on the rules that have been established in the capital markets relating to investment in equity securities of publicly listed companies. This has been the area of most interest in the US over the last decade and has included an emphasis on listing requirements, insider dealing arrangements, expanding and improving disclosure requirements and accounting rules and expanding protections of minority shareholder rights (e.g., easier access to proxy mechanisms and rights to voice their opinions regarding executive compensation).

[19] Id. at 129.
[20] S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 4.
[21] Id.
[22] The discussed in the following list is adapted from S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 4-6.

- A more "finance-related" approach that focuses on "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment".[23] This approach is concerned with resolving potential conflicts of interest between various corporate claimholders, which explains the push for independent directors, and the ability of dispersed investors to act collectively to protect their mutual interests (e.g., the availability of class-action lawsuits as remedies for managerial malfeasance). Since capital suppliers also include banks and holders of debt instruments this view of the framework goes beyond corporate and securities laws to include laws relating to creditor rights, such as bankruptcy laws and rules governing collateral (secured transactions).
- Another approach is similar to the one discussed above and views corporate governance as "the system by which companies are directed and controlled".[24] This approach has been explained to be one that emphasizes analysis of the mechanisms through which firms operate when ownership is separate from day-to-day management of their activities.
- The broadest approach, and one that appears to be slowly gaining interest around the world, defines corporate governance to include "the relationship between shareholders, creditors, and corporations; between financial markets, institutions, and corporations; and between employees and corporations . . . [and] the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment".[25] When operating in this type of framework, which is discussed in more detailed below, good corporate governance means maximizing the contribution of the firm to the overall economy, including all of the relevant stakeholders mentioned above.[26]

Complicating the definition of corporate governance and the relevant framework is determining the range of rules and/or institutions that are involved. In the Anglo-American countries the emphasis has been on rules and markets while in other countries institutions such as banks, insiders (e.g., families) and the state have been emphasized as key stakeholders in the corporate governance process. The real answer is that both rules and institutions matter and taken together they can and should be viewed as mechanisms that are dynamic, evolving and susceptible to change through political processes (e.g., the Sarbanes-Oxley Act in the US).[27] Claessens has suggested that both rules and institutions can be comfortably incorporated into the study of corporate governance by defining it as "the range of institutions and policies that are involved in [specified functions] as they

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[23] A. Shleifer and R. Vishny, "A Survey of Corporate Governance", Journal of Finance, 52(2) (1997), 737-783, 737.

[24] A. Cadbury, The Report of the Committee on the Financial Aspects of Corporate Governance (London: Cadbury Committee (Committee on the Financial Aspects of Corporate Governance), 1992), Introduction.

[25] The discussed in the following list is adapted from S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 5.

[26] Others have adopted a "stakeholder" approach to analyzing corporate governance. See, e.g., M. Aoki, Information, corporate governance, and institutional diversity: Competitiveness in Japan, the USA, and the transnational economies (Oxford: Oxford University Press, 2000), 11 (corporate governance concerns "the structure of rights and responsibilities among the parties with a stake in the firm").

[27] A. Shleifer and R. Vishny, "A Survey of Corporate Governance", Journal of Finance, 52(2) (1997), 737-783, 738.

relate to corporations" and then looking at the following functions suggested by Bodie and Merton: pooling resources and subdividing shares; transferring resources across time and space; managing risk; generating and providing information; dealing with incentive problems; and resolving competing claims generated by the corporation.[28]

According to Nestor and Thompson, in the "ideal world" suggested by neoclassical economists firms operating in competitive markets would simultaneously be able to maximize the welfare of all their owners (e.g., the shareholders of a corporation), which is why they provided capital to the firms in the first place, and the welfare of their customers by choosing to price and sell their products at no more than their marginal cost of production.[29] However, the fact that this rarely, if ever, happens illustrates some of the tensions and problems that can arise with respect to corporate governance. A partial list of issues noted by Nestor and Thompson includes the following[30]:

- Creditors of the firm are not interested in profitability but only in making sure they will get repaid and thus will impose restrictions on the firm that cause it to take on less risky projects with lower rates of return that what the owners would like to see;
- Managers, even those with a small ownership interest in the firm, may be tempted to maximize their own benefits—and reduce profits for shareholders and increase prices for customers—by taking higher salaries and/or diverting company resources to their own personal advantage;
- Managers may also undermine the pursuit of optimal performance by refusing to give up their positions even when the firm performance is subpar;
- In some countries employees are allowed to be highly involved with strategic decision making, which presumably increases productivity and commitment to the firms development; however, too much labor influence makes it more difficult for the firm to quickly and efficiently redeploy its resources; and
- Even members of the ownership group may be at odds with one another, as is the case when controlling shareholders seek to maximize their returns and participation in control at the expenses of poorly protected minority shareholders.

Shareholders, creditors, managers, customers and employees, as well as suppliers and even the government, are all part of the complex network of agency relationships that are the foundation of operations for firms all around the world and it is impossible to write laws and contracts that are sufficiently detailed to cover all of the potential issues arising out of these relationships and that would ensure that the costs associated with operating the firm are fairly and predictably allocated among these stakeholders at all times. As a

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[28] The discussed in the following list is adapted from S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 6 (citing Z. Bodie and R. Merton, "A Conceptual Framework of Analyzing the Financial Environment" in D. Crane, Z. Bodie, K. Froot, A. Perold and R. Merton (Eds.), The Global Financial System: A Functional Perspective (Boston: Harvard Business School Press, 1995)).

[29] S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43, 19.

[30] Id. at 19-20.

result, the best solution is to try and create governance structures that can serve as a "mechanism for making decisions that have not been specified by contract".[31]

Rahim noted that corporate governance is an "umbrella term" and that it has both a narrow and broad meaning, each of which should be seen as being complementary.[32] In its narrowest sense, corporate governance "describes the formal system of accountability of corporate directors to the owners of companies".[33] When this concept is used, it looks a lot like the traditional argument that the purpose of the corporation is to maximize shareholder value and that the primary function of corporate governance is to make sure that investors can assure themselves of obtaining a return on their investment. In its broadest sense, the concept of corporate governance "includes the entire network of formal and informal relationships involving the corporate sector and the consequences of these relationships for society in general".[34] As Rahim explained, the broad conception of corporate governance "is no longer merely about maximizing stock value; rather, it concerns the 'relationships among the many players involved (the stakeholders) and the goals for which the corporation is governed'".[35]

As noted above, one of the most common descriptions of corporate governance has been the way in which corporations are directed, administered and controlled and the actual activities of the directors and senior executives have been referred to as steering, guiding and piloting the corporation through the challenges that arise as it pursues its goals and objectives. Jamali et al. explained that the "control" aspect of corporate governance encompassed the notions of compliance, accountability, and transparency, and how managers exert their functions through compliance with the existing laws and regulations and codes of conduct.[36] At the board level, the focus is on leadership and strategy and

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[31] Id. at 19 (citing O. Hart, "Corporate governance: some theory and implications", The Economic Journal, 105 (1995), 678-689).

[32] M. Rahim, Legal Regulation of Corporate Social Responsibility: A Meta-Regulation Approach of Law for Raising CSR in a Weak Economy (Berlin: Springer, 2013), 13, 21. Rahim provided the following list of additional resources on corporate governance: A. Shleifer and R. Vishny, "A Survey of Corporate Governance", Journal of Finance, 52(2) (1977), 737, 3; S. Turnbull, "Corporate Governance: Its Scope, Concerns and theories", Corporate Governance, 5(4) (1997), 180; O. Hart, "Corporate Governance: Some Theory and Implications", Economic Journal, 105(430) (1995), 678; M. Becht, P. Bolton and A. Roell, "Corporate Governance and Control", 1 Handbook of the Economics of Finance (2003), 1; C. Daily, D. Dalton and A. Cannella Jr, "Corporate Governance: Decades of Dialogue and Data" Academy of Management Review, 28(3) (2003), 371; L. Bebchuk, A. Cohen and A. Ferrell, "What Matters in Corporate Governance?", Review of Financial Studies, 22(2) (2009), 783.

[33] M. Rahim, Legal Regulation of Corporate Social Responsibility: A Meta-Regulation Approach of Law for Raising CSR in a Weak Economy (Berlin: Springer, 2013), 13, 21.

[34] Id. (citing M. Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century (1995) 3).

[35] Id. (citing Corporate Governance, http://en.wikipedia.org/wiki/Corporate_governance at 3 February 2011).

[36] D. Jamali, A. Safieddine and M. Rabbath, "Corporate Governance and Corporate Social Responsibility Synergies and Interrelationship", Corporate Governance, 16(5) (2008), 443, 444 (citing K. MacMillan, K. Money, S. Downing and C. Hillenbrad, "Giving your organization SPIRIT: An overview and call to action for directors on issues of corporate governance, corporate reputation and corporate responsibility", Journal of General Management, 30 (2004), 15; and A. Cadbury, "The corporate governance agenda", Journal of Corporate Governance, Practice-Based Papers, 8 (2000), 7).

directors are expected to deliberate, establish, monitor and adjust the corporation's strategy, determine and communicate the rules by which the strategy is to be implemented, and select, monitor and evaluate the members of the senior executive team who will be responsible for the day-to-day activities associated with the strategy. In addition, directors are expected to define roles and responsibilities, orient management toward a long-term vision of corporate performance, set proper resource allocation plans, contribute know-how, expertise, and external information, perform various watchdog functions, and lead the firm's executives, managers and employees in the desired direction.[37]

Setting the strategy for the corporation obviously requires consensus on the goals and objectives of the corporation's activities and the parties who are to be the primary beneficiaries of the performance of the corporation. Traditionally, directors were seen as the agents of the persons and parties that provided the capital necessary for the corporation to operate—the shareholders—and corporate governance was depicted as the framework for allocating power between the directors and the shareholders and holding the directors accountable for the stewardship of the capital provided by investors. While economists and corporate governance scholars from other disciplines recognized that the governance framework involved a variety of tools and mechanisms such as contracts, organizational designs and legislation, the primary question was how to use these tools and mechanisms in the best way to motivate and guarantee that the managers of the corporation would deliver a competitive rate of return.[38] All of this is consistent with what has been described as the "narrow view" of corporate governance, one that conceptualizes corporate governance as an enforced system of laws and of financial accounting, where socio/environmental considerations are accorded a low priority.[39]

While it has long been accepted that the principal participants in the corporate governance framework were the shareholders, management and board of directors, the scope of corporate governance began to change during the 1990s as new and different goals for corporate activities were suggested. Sir Adrian Cadbury, Chair of the UK Commission on Corporate Governance, famously offered the following description of corporate governance and the governance framework in the Commission's 1992 Report on the Financial Aspects of Corporate Governance: "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.

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[37] K. MacMillan, K. Money, S. Downing and C. Hillenbrad, "Giving your organization SPIRIT: An overview and call to action for directors on issues of corporate governance, corporate reputation and corporate responsibility", Journal of General Management, 30 (2004), 15; A. Cadbury, "The corporate governance agenda", Journal of Corporate Governance, Practice-Based Papers, 8 (2000), 7) and J. Page, Corporate Governance and Value Creation (University of Sherbrooke, Research Foundation of CFA Institute, 2005).

[38] H. Mathiesen, Managerial Ownership and Finance Performance (Dissertation presented at Copenhagen Business School, 2002).

[39] K. Saravanamuthu, "What is measured counts: Harmonized corporate reporting and sustainable economic development", Critical Perspectives on Accounting, 15 (2004), 295.

The aim is to align as nearly as possible the interests of individuals, corporations and society."

Cadbury's formulation of corporate governance brought an array of other participants, referred to as "stakeholders", into the conversation: employees, suppliers, partners, customers, creditors, auditors, government agencies, the press and the general community. As described by Goergen and Renneboog: "[a] corporate governance system is the combination of mechanisms which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business."[40] The principles of corporate governance of the Organisation for Economic Cooperation and Development clearly state that the corporate governance framework should recognize the rights of stakeholders (i.e., employees, customers, partners and the local community) as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

The focus on interested parties beyond shareholders is the hallmark of a broader view of corporate governance that emphasizes the responsibilities of business organizations to all of the different stakeholders that provide it with the necessary resources for its survival, competitiveness, and success.[41] In this conception, managers remain primarily accountable to the stockholders who have placed their wealth in the hands of those managers; however, managers, particularly the members of the board of directors, are also responsible to groups of stakeholders that have made equally significant contributions to the corporation and these stakeholder responsibilities impose additional constraints on managerial action and the primacy of shareholder rights.[42] Rahim, noting that the roles and responsibilities of directors have been described as the "board as manager", pointed out that the duties of board members have been vastly extended as CSR has moved from the margins to the center of corporate governance attention.[43]

The stakeholder approach to corporate governance arose out of a growing sense that more consideration had to be given to "the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated."[44] The impact and importance of corporate governance was emphasized by

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[40] M. Goergen and L. Renneboog, "Contractual Corporate Governance", Journal of Corporate Finance, 14(3) (June 2008), 166.

[41] K. MacMillan, K. Money, S. Downing and C. Hillenbrad, "Giving your organization SPIRIT: An overview and call to action for directors on issues of corporate governance, corporate reputation and corporate responsibility", Journal of General Management, 30 (2004), 15

[42] J. Page, Corporate Governance and Value Creation (University of Sherbrooke, Research Foundation of CFA Institute, 2005); and N. Kendall, "Good corporate governance", Accountants' Digest, 40 (1999).

[43] M. Rahim, Legal Regulation of Corporate Social Responsibility: A Meta-Regulation Approach of Law for Raising CSR in a Weak Economy (Berlin: Springer, 2013), 13, 22 (citing M. Eisenberg, "The Modernization of Corporate Law: An Essay for Bill Cary", University of Miami Law Review, 37 (1982), 187, 209-210).

[44] M. Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century (Washington DC: The Brookings Institute , 1995).

Gourvevitch and Shinn in the following quotes from their book on the "new global politics of corporate governance"[45]:

> "Corporate governance–the authority structure of a firm–lies at the heart of the most important issues of society"… such as "who has claim to the cash flow of the firm, who has a say in its strategy and its allocation of resources." The corporate governance framework shapes corporate efficiency, employment stability, retirement security, and the endowments of orphanages, hospitals, and universities. "It creates the temptations for cheating and the rewards for honesty, inside the firm and more generally in the body politic." It "influences social mobility, stability and fluidity… It is no wonder then, that corporate governance provokes conflict. Anything so important will be fought over… like other decisions about authority, corporate governance structures are fundamentally the result of political decisions. Shareholder value is partly about efficiency. But there are serious issues of distribution at stake – job security, income inequality, social welfare."

Jamali et al. noted that corporate governance "is also intimately concerned with honesty and transparency, which are increasingly expected of the public both in corporate dealings and disclosure".[46] They pointed out that investor confidence and market efficiency has always depended on the disclosure of accurate information about corporate performance and regulators and corporate activists have insisted that companies prepare and disseminate reports that are clear, consistent and comparable. The growing interest in CSR and the broader view of corporate governance has slowly transformed the concept of disclosure and transparency to include non-shareholder stakeholders of the corporation. For example, Jamali et al. pointed out that transparency and disclosure of information between managers and employees is essential to earning employee trust and commitment. As for external stakeholders, such as the members of the communities in which the company operates and society as a whole, transparency has become a fundamental principle underlying the notion that firms need to be "good citizens".[47] An additional byproduct of the aspiration for transparency is the creation of reporting systems that provide directors with the information necessary for them to discharge their leadership and strategic duties and ensure that the corporate governance framework works efficiently.

Jamali et al. summed up the importance of corporate governance as follows:

> "The importance of [corporate governance] lies in its quest at crafting/continuously refining the laws, regulations, and contracts that govern

[45] P. Gourvevitch and J. Shinn, Political Power and Corporate Control: The New Global Politics of Corporate Governance (Princeton NJ: Princeton University Press, 2007) (as compiled by J. McRichie at https://www.corpgov.net/library/corporate-governance-defined/)
[46] D. Jamali, A. Safieddine and M. Rabbath, "Corporate Governance and Corporate Social Responsibility Synergies and Interrelationship", Corporate Governance, 16(5) (2008), 443, 444 (citing J. Page, Corporate Governance and Value Creation (University of Sherbrooke, Research Foundation of CFA Institute, 2005)).
[47] D. Jamali, A. Safieddine and M. Rabbath, "Corporate Governance and Corporate Social Responsibility Synergies and Interrelationship", Corporate Governance, 16(5) (2008), 443, 444.

companies' operations, and ensuring that shareholder rights are safeguarded, stakeholder and manager interests are reconciled, and that a transparent environment is maintained wherein each party is able to assume its responsibilities and contribute to the corporation's growth and value creation. Governance thus sets the tone for the organization, defining how power is exerted and how decisions are reached."[48]

§3 Governance structure

Corporate governance begins with the establishment of rules and procedures for allocation of authority among groups and persons at various levels within the organizational hierarchy of the company. A person or group vested with "authority" has the legitimate power to hold the people reporting to him/her or them accountable for their actions and performance and the ability to directly influence, or control, the scope of the duties and responsibilities of such persons and the manner in which they discharge those duties and responsibilities. Authority within a company is typically described through a "chain of command," which is the system of hierarchical reporting relationships within the company's organizational structure that also identifies where people (and groups of similarly-situated people, such as shareholders) rank in relation to one another and their formal scope of authority within the company. For example, a large US corporation with multiple business units may have five levels in the organizational hierarchy ranging vertically from top to bottom as follows:

- The shareholders, who are the owners of the corporation;
- The board of directors and the various committees thereof, all of which serve as trustees of the interests of the shareholders in overseeing the activities of the managers of the corporation;
- The senior, or executive, management of the corporation including the chief executive officer ("CEO"), the president or chief operating officer ("COO"), and the various executive and senior vice presidents responsible for oversight of major functional and business units;
- The divisional managers, who perform the day-to-day management functions within each of the business units (i.e., units focusing on products or markets); and
- The functional managers, who perform the day-to-day management functions within each of the functional units (i.e., units focusing on functional activities such as research and development, manufacturing, sales and marketing or finance).

The multi-level hierarchy described above is certainly correct from an ideal perspective as well as a matter of US corporate law; however, it does not represent the typical system of reporting relationships for an operations viewpoint. For example, while the shareholders are at the top of the pyramid they are not directly involved in issuing orders to, and exercising control and authority over the day-to-day activities of, the employees of the company. Instead, the key reporting decisions that must be made relate to the

[48] D. Jamali, A. Safieddine and M. Rabbath, "Corporate Governance and Corporate Social Responsibility Synergies and Interrelationship", Corporate Governance, 16(5) (2008), 443, 444 (citing J. Page, Corporate Governance and Value Creation (University of Sherbrooke, Research Foundation of CFA Institute, 2005)).

senior executives and the divisional and functional managers. Similarly, the members of the board of directors do not expect to be able to walk into the company's facilities and give instructions to the employees. The directors look out for the interests of the shareholders and carry out their duties and responsibilities by selecting the CEO and the other members of the executive team and evaluating their performance. The relevance of this model is limited in the case of large public corporations given the large number of shareholders and the practical limitations that exist on their ability to quickly and directly influence the composition of the board of directors in spite of recent shareholder activism. However, in the case of small, but rapidly growing, "emerging" companies the outside shareholders—generally venture capitalists and other professional investors—are very involved in the designation of directors and in the selection and evaluation of each of the members of the executive team.

§4 --Board of directors

Regardless of the size of the company and any other rules to which the company may be subject due to its status as a "public company", the board of directors is the focal point for corporate governance activities and responsibilities. Each jurisdiction has its own set of statutory rules regarding the composition of the board and the method for selecting directors and these rules apply to all companies regardless of their size. However, with regard to public companies, as well as larger privately held businesses that either have a large number of outside shareholders or may be looking to become a public company in the future, notice must be taken of development such as those that have been occurring in the US, which has seen a substantially increased role and authority for independent directors; expanded responsibilities of various committees of the board of directors, notably the audit committee; and imposition of requirements relating to the financial expertise of board members, particularly those serving on the audit committee, and education and training of directors.[49]

Audit committees of the boards of directors of public companies have become the foundation of many aspects of the emerging corporate governance scheme for public companies in the US. Specific rules have been promulgated regarding the structure and composition of audit committees, and such committees have been given broad responsibilities with respect to oversight of various activities and procedures include engagement of outside auditing firms, establishment and monitoring of internal controls and creation of procedures for receipt and investigation of complaints regarding questionable accounting or auditing matters. The audit committee is also a key participant in the company's efforts to assess risks and develop and implement risk management strategies. Minimum qualifications for service on an audit committee have been promulgated by the SEC and the major exchanges and place a premium on education and experience in the accounting and finance areas and the ability to critically evaluate the recommendations and decisions of senior management and the outside auditors with respect to financial reporting issues.

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[49] For further discussion of the roles and duties of corporate directors, see "Directors' Rights, Duties and Liabilities" in "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

§5 --CEO and executive team members

While there are examples of organizations that are led by a single individual exercising what appears to be dictatorial control over day-to-day activities and long-term strategy the realities of an increasingly complex business environment, even for smaller companies, generally dictate the creation of teams of top managers to coordinate the activities of the business units that are part of the organizational structure of the company. These teams are commonly referred to as "executive teams" since they are composed of the chief executive officer of the entire company (i.e., the "CEO") and the CEOs of key functional departments—research and development, manufacturing, sales and marketing, finance and human resources—and any major business units with a non-functional focus such as divisions formed to concentration on specific products or markets. While the formal role of the members of the executive team, as officers of the company, is to act as agents for the directors and shareholders of the company, as a practical matter the executive team exerts substantial authority over the acquisition and use of the company's resources and the decisions made by the members of the executive team are the determining factors in the success or failure of the strategies pursued to increase shareholder value. Members of the executive team must have the deep experience and knowledge necessary to lead the company toward development of a core competency in their area of specialization as well as the personal skills to positively interact with other team members and the ability to think strategically on behalf of the company and all of its stakeholders.[50]

In most instances, the person with the most responsibility for, and control over, the organizational design of the company—the recognized leader of the executive team—is the CEO. While the CEO "reports" to the board of directors and the board of directors is vested with more legal authority than any officer of the company, including the CEO, it is the CEO to whom the directors turn for leadership in setting strategy and putting the assets and other resources of the company to work in order to achieve the stated goals and objectives of the company. The CEO is almost always a member of the board of directors and, until recently, the common practice among public companies in the US was for the CEO to also serve as the chairperson of the board of directors. While it is now the general rule that US public companies, as well as many larger privately-held companies, will fill a majority of the seats on the board of directors with outsiders (i.e., non-employees and persons who do not represent a large shareholder block) it is nonetheless still true that the CEO exerts significant influence over the board of directors even in those circumstances.

[50] The legal framework relating to the composition of the executive team and the duties of each of the members is laid out in applicable statutes as well as in the formation and governance documents of the particular company (e.g., the articles of incorporation and bylaws of US corporations) and in any agreements among the shareholders and/or special resolutions of the board of directors regulating the duties and powers of the officers. For further discussion of the roles and duties of each of the members of the executive team, see "The Executive Team" in "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

Every CEO has a broad, if not overwhelming, set of duties and responsibilities. Some of these duties are formal and prescribed by law and the governing documents of the company; however, most of the expectations imposed on the CEO are often vague and are left to the CEO to define and execute. A CEO is confronted with challenges in a number of different areas and from various stakeholders and he or she must be able to balance and prioritize the demands on his or her time and intellectual resources. For example, at any point in time the CEO may be focusing on the timetable for launching a new product or service and establishing and testing specifications for the product or service; evaluating and responding to unforeseen actions by competitors; responding to the concerns of key customers; reviewing the suggestions of the marketing team regarding shifts in brand strategy and image of the company; and preparing for the next board meeting and a presentation to prospective new investors.

Many of the basic duties and responsibilities of the CEO remain the same regardless of the size of the company and its stage of development; however, successfully steering an emerging company into the marketplace does not necessarily mean that the CEO will thrive as the leader of a public company nor is it always the case that a CEO of a large multi-national firm can seamlessly take over the reins of a new business. As the company grows the CEO must be able to appreciate the need for more formal planning and creation of internal controls and must be prepared to delegate authority in many areas to the members of the executive team that the CEO is responsible for recruiting and managing. In addition, the CEO of an emerging company, often a member of the founding group, must be willing to change his or her style of leadership to facilitate greater participation by other executive team members and key managers at lower levels of an increasingly taller organizational hierarchy. Finally, as the company expands the CEO will need to invest more time in building and maintaining relationships with new stakeholders including vendors, customers, investors and journalists and will need to focus on new issues such as financial reporting and accounting practices, risk management and globalization.

§6 Global corporate governance standards

The International Finance Corporation ("IFC"), part of the World Bank Group, has described corporate governance as the structures and processes for the direction and control of companies and noted that the topic concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders and other stakeholders. Like other organizations and commentators, the IFC has argued that good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. Historically, corporate governance, to the extent it has been formally regulated at all, has been the concern of national policymakers and legislators and the level of their concern and activity has accelerated in recent years as the number of public companies has increased and well-publicized incidents of corruption by high-ranking officials of those companies has triggered concerns about protecting shareholders. The result has been a plethora of laws, regulations, reports and guides of best practices in the US and in Europe, particularly in the United Kingdom, focusing on increasing the rigor and effectiveness of internal controls, expanding disclosure requirements, regulating remuneration of executive officers and directors, and imposing broader oversight requirements on independent directors and audit committees of the board.

The response to the national laws and regulations referred to above, such as the Sarbanes-Oxley Act of 2002 in the US, has been decidedly mixed, with companies complaining about the added costs and commentators questioning the effectiveness of the initiatives. In addition, many have questioned the appropriateness of a complex and diverging patchwork of national corporate governance standards for an increasingly globalizing economy in which companies often operate in multiple jurisdictions and have argued that global corporate governance standards would be a more practical and efficient solution. This line of reasoning has led to the adoption and promotion of models for global governance standards such as the Organisation for Economic Co-Operation and Development's Principles of Corporate Governance discussed below. However, there is a good deal of skepticism as to whether a global standard of corporate governance is a realistic objective in a world in which cultural values, legal structures, political and financial institutions, perceptions of shareholder participation and attitudes toward leadership behavior and style are so widely divergent. Moreover, researchers such as Bebchuk and Hamdani have criticized proposed global corporate governance standards and metrics for assessing the governance of public companies in different countries that are based on conditions in countries such as the US and the UK, noting that while most public companies in those countries do not have a controlling shareholder the situation is quite different in most other countries where a dominating single shareholder is the norm.[51] They argue, in effect, that prescriptions for governance standards that fail to take into account local ownership structures will be unworkable.

§7 --Organisation for Economic Co-Operation and Development

The Organisation for Economic Co-Operation and Development (OECD) Principles of Corporate Governance, which were originally endorsed by OECD Ministers in 1999 and revised in 2004, have become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide.[52] With respect to the responsibilities of the board of directors, the OECD Principles emphasize that the board must establish a corporate governance framework that ensures the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders. Specific guidelines include the following:

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

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[51] L. Bebchuk and A. Hamdani, "The Elusive Quest for Global Governance Standards", University of Pennsylvania Law Review, 157 (2009), 1263-1317. They argued that "governance metrics that purport to apply to companies regardless of ownership structure are bound to miss the market with respect to one or both types of firms" and challenged the adequacy of well-known and influential assessment metrics such as the Corporate Governance Quotient, the Anti-Director Rights Index and the Anti-Self-Dealing Index.
[52] See OECD Principles for Corporate Governance Part One, Sec. VI (2004).

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfill certain key functions, including:

- Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
- Monitoring the effectiveness of the company's governance practices and making changes as needed.
- Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
- Ensuring a formal and transparent board nomination and election process.
- Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.
- Overseeing the process of disclosure and communications.

E. The board should be able to exercise objective independent judgment on corporate affairs.

- Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.
- When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.
- Board members should be able to commit themselves effectively to their responsibilities.

F. In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

§8 --International Corporate Governance Network

The International Corporate Governance Network ("ICGN") was founded in 1995 and has been supported by major institutional investors interested in the development of "global corporate governance practices", including ongoing dialogue between companies and their shareholders relating to enabling shareholders to participate in the governance of corporations that they own. One of the main initiatives of the ICGN has been the development of Global Corporate Governance Principles (the "Principles") that are intended to serve as standards for high-quality corporate governance and "best practices" for companies. These Principles are obviously written from the perspective of institutional investors; however, the ICGN believes that they are also relevant to governments, legislators, regulators, operators of investment markets, audit firms and investment intermediaries. The Principles are intended to be of general application around the world, regardless of the legislative background or listing rules applicable to companies and the ICGN has stated that it expects that the Principles would be applied with flexibility and understanding of the specific circumstances of individual companies and their markets.

The most recent version of the Principles was approved and announced in 2009. The actual text is extensive and available from the ICGN and covers the following areas[53]:

- *Corporate objectives:* Creation of sustainable value
- *Corporate boards:* Directors as fiduciaries; effective board behavior; responsibilities of the board; composition and structure of the board; skills and experience; time commitment; independence; composition of board committees; role of the chair; lead independent director; company secretary; knowledge of company; appointment and election of directors; information on board nominees; board and director development and evaluation; and related party transactions and conflicts of interest
- *Corporate culture:* Culture and ethical behavior; integrity; codes of ethics and conduct; bribery and corruption; employee share dealing; compliance with laws; and whistle-blowing
- *Risk management:* Effective and appropriate risk management; dynamic management process; board oversight; and disclosure
- *Remuneration:* Alignment with long term and link to value-creation; pay for non-executive directors; transparency; share ownership; hedging; shareholder approval and dialogue; and employee remuneration
- *Audit:* Robust and independent audit; annual audits; scope and independence of audits; ethical standards; internal audit; role and composition of audit committee
- *Disclosure and transparency:* Transparent and open communication; timely disclosure; affirmation of financial statements; accounting standards and non-financial business reporting; and disclosure of ownership
- *Shareholder rights:* Accountability; corporate charter; shareholder protections (i.e., unequal voting rights, shareholder participation in governance, major decisions, pre-emption, shareholders' right to call a meeting of shareholders, shareholder

[53] See International Corporate Governance Network, ICGN Global Corporate Governance Principles: Revised (2009), https://www.icgn.org/ The Secretariat of the ICGN is based in London.

resolutions, shareholder questions and consultation among institutional shareholders); voting-related rights (i.e., shareholder ownership rights, vote execution and counting and disclosure of voting results); shareholder rights of action; record of ownership of a company's shares; and promoting shareholder rights

- *Shareholder responsibilities:* Alignment; integration into mandates; integration into investment decision-making; collaboration; active and considered voting; commitment to Principles; and internal corporate governance

§9 Corporate governance systems around the world

The elements of a framework for identifying and contrasting national differences in corporate governance systems have been hotly debated over a significant period of time and have attracted the interest of a number of researchers all around the world[54] and the consensus is that "corporate governance systems vary across nations" when comparisons are made using a variety of dimensions including ownership and board structure, managerial incentives, the role of banks and large financial institutions, the size and development of stock markets, company law, securities regulation and government involvement.[55] Corporate governance researchers have identified several different types of national systems, or models, of corporate governance that can be used for comparisons, to explain why various internal and external governance mechanisms are used and to predict the success and impact of proposed changes to governance rules and practices. While "convergence" is a widely debated topic among corporate governance experts it seems clear that while the corporate model has become a universal framework the business form and system of corporate governance used in particular instances will depend on a variety of social and economic factors such as "national regional and cultural differences; ownership structure and dispersion; the industry and market environment of the corporation; firm size and structure; lifecycle variations, including origin and development, technology and periodic crises and new directions; [and] CEO tenure, attributes and background".[56]

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[54] See, e.g., E. Gedajlovic and D. Shapiro, "Management and ownership effects: Evidence from five countries", Strategic Management Journal, 19 (1998), 533–553; M. O'Sullivan, Contests for corporate control. Corporate governance and economic performance in the United States and Germany (New York: Oxford University Press, 2000); J. Parkinson and G. Kelly, "The conceptual foundations of the firm" in J. Parkinson, A. Gamble and G. Kelly (Eds.), The political economy of the company (Oxford: Hart Publishing, 2001), 113–140; T. Pedersen and S. Thomsen, "European patterns of corporate ownership: A twelve-country study", Journal of International Business Studies, 28 (1997), 759–778; S. Prowse, "Corporate governance in an international perspective: A survey of corporate control mechanisms among large firms in the U.S., U.K. and Germany", Financial Markets, Institutions, and Instruments, 4 (1995), 1–61; A. Shleifer and R. Vishny, "A survey of corporate governance", Journal of Finance, 52 (1997), 737–783; and S. Thomsen and T. Pedersen, "Ownership structure and economic performance in the largest European companies", Strategic Management Journal, 21 (2000): 689–705.

[55] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 129.

[56] T. Clarke, International Corporate Governance: A Comparative Approach (2007), 9 (citing M. Huse, Accountability and Creating Accountability: A Framework for Exploring Behavioral Perspectives of Corporate Governance, 16(s1) British Journal of Management S65, S68 (2005)).

The most common means for comparison is to focus on the "outsider" model associated with the Anglo-American countries and the "insider" model typically associated with Europe and Japan. Clarke provided the following summary: "In the rich diversity of corporate governance forms internationally, there is a clear divergence between outsider systems found in Anglo-American countries with dispersed equity markets, separation of ownership and control and disclosure-based regulation; and the insider systems which predominates in Europe, Asia Pacific and other regions of the world, with concentrated ownership, bank finance and the representation of majority interests on the board of directors."[57] These models are often used as the launching point for the argument that all large public corporations will ultimately opt for the separation of ownership and control associated with the Anglo-American approach (i.e., the "outsider" system); however, the available evidence indicates that traditions in other countries are difficult to overcome and that the more likely outcome will be the survival of institutional diversity in developed countries and emergence of corporate governance models in developing countries that are based on unique local historical and cultural factors.[58] Another criticism of this approach was offered by Aguilera and Jackson, who argued that "this classification only partially fits Japan and other East Asian countries, the variations within Continental Europe, Eastern Europe and multinational firms.[59]

Banks, following the practice of many others, referred to the main governance models as "market", "relationship" and "hybrid" and explained: ". . . some countries have very diffuse shareholdings and rely heavily on market forces to instill governance and control discipline. Others feature concentrated shareholdings and focus primarily on long-term relationships and monitoring to enforce governance. In fact, these models have developed over a relatively long period of time (several decades at a minimum) often in

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[57] T. Clarke, International Corporate Governance: A Comparative Approach (2007), 9. For a table of the properties of insider and outsider systems of corporate governance, see Id. at 10.

[58] For further discussion, see J. Coffee, "The Rise of Dispersed Ownership: The Role of the Law in the Separation of Ownership and Control", Yale Law Journal, 111(1) (2001).

[59] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 447 (citing, with respect to Japan and other East Asian countries, R. Dore, Stock market capitalism: Welfare capitalism. Japan and Germany versus Anglo-Saxons (New York: Oxford University Press, 2000); M. Gerlach, Alliance capitalism: The social organization of Japanese business (Berkeley, CA: University of California Press, 1992); H. Khan, Corporate governance of family businesses in Asia (Tokyo: East Asian Development Bank Institute, 2001); H. Knudsen, Employee participation in Europe (London: Sage, 1995); M. Orru´, N. Biggart and G. Hamilton, The economic organization of East Asian capitalism (Thousand Oaks, CA: Sage, 1997); R. Whitley (Ed.), European business systems: Firms and markets in their national contexts (London: Sage, 1992); with respect to Continental Europe, F. Barca and M. Becht, The control of corporate Europe (New York: Oxford University Press, 2001); M. Rhodes and B. van Apeldoorn, "Capital unbound? The transformation of European corporate governance", Journal of European Public Policy, 5 (1998), 406–427; J. Weimer and J. Pape, "A taxonomy of systems of corporate governance", Corporate Governance, 7 (1999), 152-166; R. Whittington and M. Mayer, The European corporation: Strategy, structure, and social science (New York: Oxford University Press, 2000); with respect to Eastern Europe, R. Martin, Transforming management in Central and Eastern Europe (Oxford: Oxford University Press, 1999); and M. Wright, I. Filatotchev and T. Buck, "Corporate governance in Central and Eastern Europe" in K. Thompson and M. Wright (Eds.), Corporate governance: Economic, management and financial issues (Oxford: Oxford University Press, 1997), 212-232; and with respect to multinational firms, M. Fukao, Financial integration, corporate governance and the performance of multinational companies (Washington, DC: Brookings Institution Press, 1995)).

response to the specific characteristics of the national or regional marketplace. Different power and control groupings and structures thus emerge to cope with particular characteristics or inadequacies of the system (such as lack of a capital market, lack of a strong regulator, lack of a strong legal framework and lack of long-term relationships).”[60]

The “market” model is essentially the “outsider” system described above and typically associated with developed Anglo-American countries such as the US, UK, Australia and Canada and, according to Banks and others, features “very diffuse shareholdings, liquid capital markets, dynamic capital reallocation, advanced legal and regulatory frameworks, and an active market for corporate control”.[61] The shareholders are the primary stakeholders in this model and boards tend to be composed primarily of outsiders and rely on committees and internal controls to oversee the activities of company managers. For their part company management, although subject to board monitoring, exercise considerable autonomous power and, in the words of Banks, “tend to operate in a decentralized, entrepreneurial fashion . . . are often compensated handsomely . . . [and are] very focused on investments with measurable returns that seek to maximize enterprise value and the stock price, particularly over the short run”.[62] In contrast to the relationship-based model discussed below, it is probably fair to state that companies operating under market model are more interested in transactions that produce tangible short-term results as opposed to investing time and effort in relationships for which results may not be known for a long period of time.[63]

The “relationship” model is similar to the “insider” system described above and is used in other major developed countries such as Japan, Germany, Italy, the Netherlands and France and stands in somewhat stark contrast to the market model and features “greater concentrated ownership stakes and cross-shareholdings, moderately liquid capital markets, less active capital reallocation and less corporate control activity”.[64] Banks noted that while legal and regulatory frameworks and systems in these countries are generally quite strong and robust, there is a tendency among participants to supplant (or at least supplement) formal rules and procedures with informal negotiations in the context

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[60] E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 25-26. Banks noted that descriptions of the various models should only be taken as attempts to illustrate general characteristics of each model and that it should be expected that exceptions can and do exist in any specific situation. Id. at 25. Evolution of each of the governance models is a widely debated subject with some arguing for convergence on one universal model, generally thought to be close to the market model due to the influence of investors in countries using that model, and others predicting that multiple models can and should exist. Id. at 29-30.
[61] The description of the market model in this paragraph is adapted from E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 26.
[62] Id.
[63] See also the general discussion of Anglo-American Corporate Governance in T. Clarke, International Corporate Governance: A Comparative Approach (2007), 129. Clarke described the central characteristics of what he called the “market-based outsider model” as “diffuse equity ownership with institutions having very large shareholdings; shareholder interests are considered the primary focus of company law; there is an emphasis on effective minority shareholder protection in securities law and regulation; [and] there is a stringent requirement for continuous disclosure to inform the market”. Id.
[64] The description of the relationship model in this paragraph is adapted from E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 26-27.

of the long-term business relationships that arise among the primary stakeholders in these countries: banks, large company or family shareholders (as opposed to widely dispersed investment-focused shareholders in the market-based countries) and employees. Board membership in these countries typically ranges from primarily insiders, as is typically found in Japan, to mixed, as is generally the case in Germany, and is based on appointments made by the primary stakeholders mentioned above. Board committees are rare; however, internal controls do exist albeit not as strong as those found in the market-based countries. Banks argues that management style in these countries is centralized and rigid and that managers receive less compensation than their counterparts in the market-based countries and are very intensive to short-term movement of stock prices and focus on measurable returns on internal investment and longer-term goals such as building and maintaining market share, technical leadership and perpetuation of the firm.[65] Firms following the relationship model tend to focus more on cooperative relationships over a long-term horizon rather than on achieving short-term transaction-based results, which often appears to be the primary goal among firms following the market model.[66]

The “hybrid” model includes, according to Banks, “significant elements of the relationship model, but also includes dimensions of the market model and certain unique characteristics of its own” and “appears to be linked closely with some emerging nations (e.g., Indonesia, Thailand, Malaysia, Korea and Mexico)”.[67] At the macro level one finds that countries operating under the hybrid model have relatively illiquid capital markets with little or no market for corporate control and rudimentary legal and regulatory frameworks. Micro level characteristics of the hybrid model include large family ownership stakes, related conglomeration of companies, significant ownership ties between companies and banks and strong cooperative relationships between companies and governmental bodies. Controlling shareholders are generally the primary stakeholders of companies operating under the hybrid model and such companies typically have board membership dominated by insiders and little in the way of internal controls. Banks observed that “[i]n the absence of well-established regulations and/or legal foundations, business dealings are often based on trust and relationships”.[68]

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[65] Banks pointed out that making generalizations with respect to the members of the relationship model group can be misleading and noted: “For instance, Japan still features fairly diffuse shareholdings compared with Germany, Japanese boards are almost exclusively insider and most lack board committees, German boards have labor representatives and so forth. While companies in both [Japan and Germany] are interested in perpetuating the existence of their firms, German companies favor technical leadership and Japanese companies market share.” See E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 27.

[66] While many scholars and commentators have found characteristics of the relationship model in European countries and in developed Asian countries such as Japan, it is common to distinguish between corporate governance regimes in Europe and the Asia-Pacific region. See, for example, the general discussion of European Corporate Governance and Asia-Pacific Corporate Governance in T. Clarke, International Corporate Governance: A Comparative Approach (2007), 170 (Europe) and 200 (Asia-Pacific).

[67] E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 27. The description of the hybrid model in this paragraph is adapted from E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 27.

[68] Id. The description of the hybrid model in this paragraph is adapted from E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 27. See also the general discussion of

Toonsi observed that a variety of descriptive labels have been assigned to corporate governance systems that appear to be favored by firms in different parts of the world, including "dispersed ownership market-based" systems preferred in the Anglo-American countries; concentrated ownership-based systems seen in parts of Europe and Asia; rules- and relationship-based systems; and, finally, market- and bank-based systems. Toonsi emphasized that one of the primary distinctions among these various systems is a "market" (or "outsider") versus "insider" orientation. Nisa and Warsi made a similar distinction in suggesting that there was evidence of three models of corporate governance in the developed and newly industrialized countries: the "outsider" model and two "insider" models, one found in Europe and the other found in East Asia.[69]

Simply put, in market-based outsider systems, of which the US and UK are primary examples, ". . . ownership is dispersed and completely separated from control, companies benefit from sophisticated capital markets and thus incur lower debt-to-equity ratios, stakeholders are rarely formally represented and do not participate in company management . . . [a] hostile takeover is the severest sanction for management misconduct . . . [and] . . . outside investors . . . are less interested in the strategic long-term goals of the company than in the short-term returns available in the market".[70] Nisa and Warsi provided their own similar list of the characteristics of "market-based systems": large and liquid stock markets, dispersed ownership, relatively high levels of minority investor protection, predominant role of institutional investors and other portfolio investors in share ownership, high product-market competition, one-tier boards and performance-sensitive executive compensation arrangements.[71]

Nestor and Thompson listed the distinguishing features of the outsider model as including dispersed equity ownership with large institutional holdings (i.e., institutional investors primarily interested in portfolio diversification and maximizing return on investment); the recognized primacy of shareholder interests in the company law; a strong emphasis on the protection of minority investors in securities law and regulation; relatively strong requirements for disclosure of information to be used for making decisions regarding whether to increase or decrease the level of investment as opposed to participating in long-term strategy decisions; and a limited role for banks (e.g., short-term financing

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Asia-Pacific Corporate Governance in T. Clarke, International Corporate Governance: A Comparative Approach (2007), 200 (noting, among other things, that "[m]ost countries of the region have corporate governance systems that are essentially based around close relationships, usually involving family control, and ongoing close relationship with creditors, suppliers, and major customers . . . [and] . . . regulators and state officials").

[69] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 130.

[70] F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full

[71] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 129.

through "arms' length" relationships).[72] Other characteristics often mentioned with respect to market-based outsider systems include a preference for equity financing, active markets for corporate control and flexible labor markets.

In contrast, the insider systems commonly found in Europe, the Middle East and Asia feature concentrated ownership that is closely associated with managerial control; closer relationships with banks, which means higher debt-to-equity ratios and a higher dependence on bank credit as a source of financing; formal participation by various stakeholders—banks, employees and other business partners—on the board of directors; a dense network of supportive relationships with related businesses; and infrequent use of takeovers to cease control.[73] Nisa and Warsi referred to these systems as "control-based" and listed the following characteristics as contrasting to the market-based system described above: lower levels of investor protection; smaller and less liquid share markets; more ownership concentration, less institutionalization of equity holdings and larger shareholdings by founding families, corporate investors (cross holdings) and governments; greater attention to employee representation on the board and higher levels of government intervention.[74]

Nestor and Thompson observed that the distinguishing feature of the insider model is, of course, the concentration of ownership and control among small, identifiable and cohesive groups of "insiders" who have long-term stable relationships with the firm and are able to communicate with each other easily both in connection with firm matters and in other non-firm relationships (i.e., banking or supply relationships).[75] Members of these insider groups include family interests, allied industrial concerns, banks and holding companies and they are generally able to operate and communicate in a regulatory environment that Nestor and Thompson described as being "more tolerant of groups of insiders who act together to control management while excluding minority investors".[76] Nestor and Thompson confirmed what has already been mentioned: "[i]nsider systems have usually been bank-centered".[77] Insider systems rely more heavily on debt financing, as opposed to financing raised by selling equity securities in capital markets, and this means that those outside shareholders that do exist generally have fewer protections than shareholders in outsider systems, particularly a much lower level of required disclosures of information.[78] Other characteristics often mentioned with respect

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[72] S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43, 23.

[73] F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full

[74] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 129.

[75] S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43, 27.

[76] Id.

[77] Id. at 28.

[78] While a large percentage of capital is provided through debt instruments, insiders do acquire controlling equity interests in their firms and maintain that control in relation to minority shareholders through a

to control-based insider systems include a preference for long-term debt financing, weak markets for corporate control and rigid labor markets.

While Nestor and Thompson followed convention by recognizing two main categories of corporate governance systems, they also mentioned a so-called "family/state model" as a sub-category of the insider system.[79] This model featured strong alliances between a small number of "founding" families of entrepreneurs who had assumed important roles in many areas of the economy (e.g., control, with their allies, over an extensive network of listed and non-listed companies) and a state that had assumed a "pervasive role" in the economy including control over large parts of heavy industry and the financial system. In countries where this model appears, such as Korea, the public capital market tends to be underdeveloped and outside financing, when needed, generally is provided by banks that are not nearly as independent as in those countries where the more traditional insider model is used. In fact, control of banks and the banking system in these countries is considered to be crucial to those in power: family companies and the state. The state also engages in other activities that are at odds with free and open competitive markets including the imposition of barriers to foreign direct investment, providing subsidies to favored firms and orchestrating soft landings for businesses that are failing. While the family/state model appears, on its face, to have a number of disadvantages and inequities, Nestor and Thompson noted that it has been beneficial in the earlier stages of economic development for many countries to the extent that it facilitates stability and long-term commitment and reinvestment of earnings to achieve continuing growth; however, the model becomes strained when it is necessary to transition to global financial and product markets and is also inherently risky in that the families do not enjoy the same level of limited liability as in other countries due to weaknesses in company laws and the excessive reliance on guarantees from the families as conditions to obtaining bank financing for their firms.[80]

Toonsi proposed a useful, and simple, framework for describing and comparing the prevailing form of corporate governance system used in different parts of the word and referred to these as Anglo-American, Germanic, Latin and Japanese systems. The Anglo-American model is, of course, the market-based outsider system. The Germanic and Latin systems are two versions of the European insider system and the Japanese system is an example of the way that the insider system manifests itself in East Asia. In fact, Toonsi's Japanese system is presented below as the "East Asian model". The features, or dimensions, in this framework included orientation, market- or network-oriented; the "prevailing concept of the firm", instrumental versus institutional; the board system, one- or two-tiered; the main stakeholders in a position to exert influence on managerial decision making (e.g., shareholders, financial institutions, the State, employee representatives, familial ownership groups and/or suppliers/customers); the importance

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variety of means sanctioned by the local legal systems: corporate structures, shareholder agreements, special rights to designate representatives to the managing board and discriminatory voting rights and procedures.

[79] S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43, 30-31.

[80] Id. at 31.

and influence of bond and stock markets; the existence of a "market for corporate control", ownership concentration; the use of performance-based compensation systems and the time horizon of economic relationships (i.e., short- versus long-term).

§10 --Anglo-American model

The corporate governance model typically associated with the Anglo-American countries (i.e., the US, UK, Canada, Australia and New Zealand) is often referred to as "market-based" since it features an active external market for corporate control and is designed to support a fluid capital market that allows participants to quickly and efficiently access the cash needed to pursue market opportunities as soon as they are identified.[81] Proponents of this model usually point to the way in which it has facilitated progress by companies in the US and UK in the development and expansion of innovative products and "new economy" industries such as electronics, software, media, and financial services. However, there has obviously been a down side to this approach given the damage that has occurred for companies and investors due to the inherent volatility of the model and the short-term orientation of executives operating in these markets due to the widespread reliance on performance (short-term)-based compensation arrangements.[82]

According to Toonsi, the Anglo-American model is based on the fundamental principal that the firm is "instrumental" and to be used as a means for collecting and deploying resources in a way that facilitates the creation of value for the owners (shareholders in the corporate context). As such, it follows that the owners (shareholders) are the main stakeholders with respect to exerting influence on managerial decision making; however, ownership concentration is low among the Anglo-American countries. In the fact, it can rightly be said that the main feature of the Anglo-American model is the separate of control of the enterprise from an ownership group that has traditionally consisted of a large number of widely dispersed individual shareholders and, more recently, institutional investors (i.e., mutual funds, pension funds and insurance companies). The Anglo-American model relies on a one-tier board system with one level of directors and no distinctions between executives ("inside" directors) and non-executives ("outside" or

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[81] The Anglo-American model has been given a number of different names including the outsider, common law, market-oriented, shareholder-centered, or liberal model. R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 447. While associating the outsider model with the Anglo-American countries is appropriate, Nestor and Thompson reminded that in some of the smaller English-speaking countries (i.e., Australia, Canada and New Zealand) there is a discernibly higher percentage of ownership concentration than in the US and the UK, particularly family-owned firms; however, they concede that the corporate governance systems in those countries clearly have characteristics similar to those in the US and the UK: strong recognition of shareholder rights, institutional ownership of wealth, the tradition of strong legal regulation of securities markets and heavy insistence on transparency in accounting. See S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43, 30.

[82] Portions of the description in this section is adapted from F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full

"independent" directors), although recent changes in the legal and regulatory framework for corporate governance in the Anglo-American countries, particularly in the US, have led to more formalized and distinguishable duties and responsibilities for non-executive members of the boards of public companies. Stock and bond markets are extremely important in the Anglo-American countries and great emphasis is placed on their efficiency and performance.

Shareholders in the Anglo-American model are heavily dependent on the actions of professional managers who have been vested with control over corporations and their assets, a situation that has led to referring to corporate governance in the Anglo-American countries as the "principal-agent" model. Clearly such a model has the potential for efficiency in light of the increasing size of firms required to attain competitive economies of scale; however, there is always the fundamental issue of how shareholders can ensure that their "agents" are acting in ways that further the interests of the shareholders and other stakeholders as opposed to simply taking advantage of their insider status and creating benefits for themselves. Not surprisingly, the Anglo-American countries have focused a good deal of attention on developing legal and regulatory frameworks that can provide protections for the shareholders.

The US and the UK share the same underlying legal system, generally referred to as the "common law", and thus the fundamental structure for governance of corporations in those two countries is quite similar.[83] Day-to-day management of the corporation is the responsibility of the members of an executive team who are charged under corporate law with fiduciary duties to act in the best interests of the shareholders who are the ultimate owners of the corporation. Shareholders are not expected to be involved in the day-to-day management of the business of the corporation; however, they exercise their control through the election of the members of the board of directors who are supposed to set the policies for the corporation and select and oversee the executive team. Boards of corporations with publicly traded securities, so-called "public companies", generally have 10 to 15 members and a majority of "outside", or "independent" directors who are not executives, officers or employees of the corporation, a structural decision designed to reduce the potential for self-dealing at the board level. For a long time, however, the outside directors were typically nominated by the chief executive officer ("CEO") and there were often serious doubts about whether outside directors could, or would, stand up to the CEO. Shareholders in the US and the UK traditionally had little input into corporate affairs other than the election of directors; however, the trend now seems to be toward giving shareholders more input into controversial issues such as executive compensation. Disclosure requirements have also been escalating in an effort to provide shareholders with an expanded view of the relationships between directors and executive officers on the one hand and the corporation on the other.

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[83] The discussion in this section is based on F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 25-26. The article also appears as F. Allen and D. Gale, "Comparative Financial Systems: A Survey" in A. Boot, S. Bhattacharya and A. Thakor (Eds.), Credit, Intermediation and the Macroeconomy (Oxford: Oxford University Press, 2004), 699-770.

§11 --Germanic European model

The system of corporate governance used in the Germanic countries—Germany, the Netherlands, Switzerland, Sweden and Austria—has been characterized as relatively oligarchic and focused on long-term industrial strategies supported by stable capital investment, robust governance procedures and enduring network relationships among key stakeholders such as shareholders, families and banks.[84] This type of system has facilitated success of German firms in industries that require long-term investment and creating and maintenance of high skill levels (e.g., luxury automobiles, precision instruments, chemicals and engineering). However, the model has been less successful in circumstances where flexibility is needed since the difficulties associated with modifying deep, long-standing relationships among different stakeholders slow the process of adjusting to changes in labor and product markets and creating or entering new businesses and industries.[85] The prevailing concept of the firm in the Germanic countries is "institutional", which means that firms are seen as autonomous economic units created and supported by strong and complex coalitions of diverse stakeholders including shareholders, managers, employees, credit providers (i.e., banks), suppliers and customers. Within this group of stakeholders the industrial banks are generally the major players and their role in providing capital tends to reduce the importance of stock and bond markets and thus the influence of outside investors. In fact, ownership concentration is moderate to high in the Germanic countries, another factor that makes it difficult for outside investor to meaningfully impact decision making, and there is no market for corporate control. Economic relationships evolve over a long-term planning horizon and the use of performance-based compensation is far less pronounced than in the Anglo-American countries.

Germany's corporate governance structure, which is based on a system referred to as "co-determination", is quite different from the structures observed in the US, the UK and Japan.[86] Germany law provides that companies with more than a specified number of employees must have two boards: a "supervisory" board and a "management" board. The supervisory board is the controlling body, much like the board of directors in the US, and designated percentages of the membership of that board are elected by the shareholders and employees, respectively. Shareholder representatives on the supervisory board are elected at the shareholders' general meeting and employee representatives are drawn both from the company's own workforce and from the trade unions involved in

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[84] The model typically associated with the Germanic countries has been described in a variety of ways including the insider, civil law, blockholder, bank-oriented, stakeholder-centered, coordinated or "Rhineland" model. R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 447.

[85] Portions of the description in this section is adapted from F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full

[86] The discussion in this section is based on F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 26-27. The article also appears as F. Allen and D. Gale, "Comparative Financial Systems: A Survey" in A. Boot, S. Bhattacharya and A. Thakor (Eds.), Credit, Intermediation and the Macroeconomy (Oxford: Oxford University Press, 2004), 699-770.

representing the interests of the company's employees. While the members of the supervisory board are elected by different constituencies, all of them are required and expected to represent the interests of the company as a whole and rules relating to voting by the supervisory board allocate tie-breaking authority to one of the directors elected by the shareholders. Supervisory boards in Germany are typically a little larger than the boards in the US and the UK but small than boards in Japan. The management board is appointed by the supervisory board and no person can be a member of both boards. As the name implies, the management board "manages" the day-to-day operations of the company under the supervision of the supervisory board. Management boards are smaller than boards in the US and the UK. Allen and Gale observed: "It is often argued that the dual board system better represents outside shareholders and ensures management must take account of their views. In addition, employees' views are also represented and their bias is presumably to ensure the long run viability of the firm."[87]

At least during the 1970s to 1990s, an interesting overlay to the German corporate governance system was the tremendous influence of German banks as large shareholders of German corporations. Germany, like Japan, has traditionally had a bank-based financial system in which banks and other financial institutions are the primary suppliers of capital to businesses and do so by collecting funds from individuals, placing them into accounts and then making those funds available to firms through loans. Aguilera and Jackson reiterated some of the well-known descriptions of bank-based systems including close relationships between banks and firms, small and underdeveloped capital markets that reinforce higher firm dependence on debt, close capital monitoring and contingent control of borrowers by banks and, finally, long-term commitment by capital providers to firms as a result of the terms upon which the capital is made available to those firms.[88]

Data from a 1978 study conducted by the German Monopoly Commission indicated that, taking into account proxies that banks obtained for shares that their customers held "on deposit" with the banks, banks at that time controlled the votes of nearly 40% of the equity of Germany's top 100 corporations and were represented on two-thirds of the supervisory boards of those corporations.[89] This so-called "hausbank" system thus included significant long-term involvement of German banks in the corporate governance of the firms to which they provided capital and provided the foundation for close ties between those banks and German industry. The high concentration of ownership of German banks in German corporations has been thought to be an effective tool in monitoring the activities of the managers of those firms to ensure they were acting to maximize shareholder value and, in fact, there is evidence that German firms with a higher proportion of equity controlled by banks have better performance.[90] In addition,

[87] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 27.

[88] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447, 453.

[89] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 35.

[90] Id. (citing J. Cable, "Capital Market Information and Industrial Performance", Economic Journal, 95 (1985), 118-132; and G. Gorton and F. Schmid, "Universal Banking and the Performance of German Firms", Journal of Financial Economics, 58 (2000), 29-80).

strong ties with their banks have allowed some German companies to avoid liquidity constraints that might undermine their strategic plans.[91]

Firm governance in Germany, at least among the larger companies, has long been dominated by reliance on "interfirm networks" that typically include both "capital ties" such as ownership and credit linkages and board representation, and non-financial links such as supplier relationships. Interfirm networks in Germany, which have long been encouraged by German competition laws, reinforce the commitment of capital to enterprises by making exit more costly and tend to reduce external influences and increase the importance of the strategic interests of business partners which are pursued through corporate governance mechanisms such as interlocking board directorates which tend to increase the propensity of partners to cooperate.[92]

The primary sources of law, regulation and practice relating to corporate governance for publicly listed companies in Switzerland are the Company Law; the Federal Stock Exchange and Securities Trading Act, which regulates exchanges, securities trading, market abuse and its sanctions, disclosure of shareholdings and public takeover offers relating to public companies; the Listing Rules of the Swiss stock exchanges, primarily the SIX Swiss Exchange AG ("SIX"), which include specific reporting and disclosure requirements designed to improve corporate transparency and governance; and the Swiss Code of Best Practice for Corporate Governance ("SCBP"), which was issued by an influential association of Swiss businesses and sets corporate governance standards in the form of non-binding recommendations in a wide range of areas including the definition of corporate governance, general shareholders' meetings, shareholders' rights to information and inspection, the composition of the board of directors and of board committees, the role of auditors and compensation for boards of directors and executive boards of public companies.[93]

While company law in Switzerland generally provides for a one-tier model, as a practical matter the responsibility for day-to-day management of Swiss companies is typically delegated from the board to senior management, thus creating a two-tier board structure. Board members are expected to represent and act in the best interests of the company, taking into account the long-term interests of the shareholders and the interests of other stakeholders such as creditors and employees of the company. Board members are also under an obligation to act in good faith and with due care to safeguard the interests of the company. By law, there are certain duties and responsibilities that the board cannot delegate or transfer. For example, regardless of any delegation of responsibilities to company executives or board committees, the entire board remains responsible for the

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[91] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 35 (citing J. Elston, Firm Ownership Structure and Investment: Theory and Evidence from German Panel Data, Unpublished Manuscript, 1993).

[92] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447, 454.

[93] Portions of the overview in this section of Swiss corporate governance laws, regulations and guidelines applicable to listed companies is adapted from L. Olgiati, Switzerland, in Corporate Governance: Board Structures and Directors' Duties in 35 Jurisdictions Worldwide (2013), 216. Another useful summary of Swiss corporate governance is P. Kunz, Swiss Corporate Governance – An Overview (2009).

ultimate management of the company and deciding upon corporate strategy and how the resources of the company should be allocated. Other responsibilities that cannot be delegated or transferred by the board include:

- Defining the fundamental organizational structure of the company;
- Establishing accounting and financial control systems, including an internal control system, and providing for financial planning as necessary for the management of the company and its businesses;
- Performing a risk assessment, the results of which should be described in the company's annual business report to its shareholders;
- Appointing and removing the management as well as granting of signing authority to the individuals authorized to act on behalf of the company;
- Ultimately monitoring the individuals entrusted with management responsibilities, in view of compliance with applicable law and regulations and the governance documents of the company;
- Preparing annual business reports to the shareholders and conducting general shareholders' meetings; and
- Notifying the bankruptcy court when the company's liabilities exceed its available assets.

Interestingly, Swiss company law does not require that Swiss companies have a minimum number of non-executive or independent directors; however, the SCBP recommends that a majority of the board should consist of non-executive members (i.e., persons who are not engaged in carrying out a line management function within the company) as a means for encouraging exchange of ideas and critical views between the board and executive management, and also provides for board positions of "lead director" and "independent director" to prevent and/or resolve potential conflicts of interest.[94] SIX, through its comprehensive "Directive on Information Relating to Corporate Governance", has imposed extensive disclosure requirements relating to the boards of SIX-listed companies including information on individual board members; the organization of the board and its committees, including the tasks and areas of responsibility of board members and their working methods; the split of responsibilities between board and executive management; information and control instruments with regard to senior management; and compensation of board members.

While Swiss company law does not include any mandatory requirements or restrictions relating to board committees, the SBCP recommends that listed companies establish audit, compensation and nomination committees and that all of the members of the audit committee and a majority of the members of the compensation committee should be non-executive, preferably independent, members. The controversial "Minder Initiative", which entered into force on January 1, 2014, implements a number of sweeping changes including requirements that the members of the compensation committee must be elected annually by the shareholders' meeting and that the shareholders be given a binding vote

[94] For further discussion of the role of independent non-executive directors in Swiss corporate governance, see B. Speck and J. Tanega, "UK and Swiss Corporate Governance: Comparing the Role of Independent Non-Executive Directors", I.C.C.L.R. (2005), 468.

at each such meeting on the aggregate compensation of the board of directors and the senior management (i.e., "say-on-pay"). Prior to the implementation of the Minder initiative, many Swiss listed companies, following non-binding SBCP recommendations, submitted "compensation reports" to their shareholders' meetings and sometimes found, to the surprise of the directors and senior managers, that shareholders, led by increasingly activist institutional investors, would reject those reports when given the opportunity through consultative votes.

§12 --Latin European model

The system of corporate governance typically seen among the "Latin countries", such as France, Italy, Spain and Belgium in Europe and Brazil and Argentina in South America, is notable for its high level of network orientation and the protective concentration of ownership among key stakeholders such as families, industrial groups and the state. The relationship among these stakeholders are strong and enduring, which leads to stability and a preference for long-term investment horizons that is well suited to specialization in industries that the state has selected for sponsorship in support. For example, aerospace, nuclear and high-tech trains are all examples of "prestige industries" that have been championed by the state in France and both France and Italy have achieved worldwide success and notoriety for their international luxury goods companies. Critics of the Latin model argue, however, that capital markets in those countries are weak and narrow since minority shareholders have little or no voice in the face of the tight relationships among the above-mentioned key stakeholders and there are few rules that force those in control to feel any accountability to outside shareholders.[95]

As is the case in the Germanic countries and in the model associated with Japan described below, the prevailing concept of the firm in the Latin countries is "institutional"; however, the composition of the main stakeholder group is a bit different and includes financial holdings, the state and families. Ownership concentration is high, stock and bond markets are relatively unimportant and there is a dearth of protections for minority investors and no market for corporate control. In general, there is a moderate relationship between compensation and performance and planning horizons tend to be long-term. The corporate governance structure typically used in France incorporates elements both the US/UK ("Anglo-American") system and the German system through the ability of companies to choose between two types of governance structures.[96] The most common types is similar to the Anglo-American system and calls for a single-tiered board structure that sets policies for the company and elects a president who is like the CEO in the US and the UK but with more power. Directors in this structure are mostly

[95] Portions of the description in this section is adapted from F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full

[96] The discussion in this section is based on F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 27-28. The article also appears as F. Allen and D. Gale, "Comparative Financial Systems: A Survey" in A. Boot, S. Bhattacharya and A. Thakor (Eds.), Credit, Intermediation and the Macroeconomy (Oxford: Oxford University Press, 2004), 699-770.

outsiders drawn from shareholders, representatives of financial institutions who have business relationships with the company and, to a larger extent than in other countries, representatives of the government. The second type of governance structure is two-tiered, as is the case in Germany; however, employees in France to not have the right to represented on the supervisory board. It should be noted, however, that a unique feature of the French governance system is that regardless of whether a single- or two-tiered structure is selected workers' representatives do have the right to attend board meetings as observers for all companies have more than a specified minimum number of employees. When the two-tiered structure is used, the senior, or "surveillance", board appoints a small "directorate" of persons who will be responsible for management and that group taps one of its members to serve as president of the directorate.

Cunningham explained that the governance and finance system traditionally used in France was the "bank/labor model", which featured substantial investment intermediation and concentration of ownership and debt holdings that tended to reduce pressure for the development of actively functioning, deep and liquid capital markets.[97] Banks were the primary capital providers to French firms and when they acted as both shareholder and debt holder the tension that normally occurs between those two classes of stakeholders disappeared and there was little need to develop any systems of checks-and-balances or strengthen disclosure systems. Cunningham also pointed out that labor was centrally involved in French corporate governance and that the deep tradition of worker protection in France had, until recently, provided workers with job security and compensation arrangements that were consider fair and reasonable in relation to senior executives. According to Cunningham, all of this could be described as a "stakeholder model of corporate governance" in which the fiduciary duties of managers ran to all of the participants in the corporation including not only shareholders, but also to the debt holders and workers.

Cunningham went on to note, however, that the French model of corporate governance has been undergoing substantial changes over the last two decades due to the influence of EC directives, privatization and globalization. For example, various EC directives have abolished, or substantially restricted, historical controls on foreign investment, thereby forcing France and other European countries to consider adopting regulations familiar to US investors to induce them to provide capital to European companies, and have also harmonized accounting rules and expanded financial disclosure requirements. Privatization in France has not only reduced the role of the state in directing the economy, but has also led to the introduction of technical governance reforms following the US model such as the creation of audit and compensation committees at the board level and greater transparency as a result of improvements in both the quantity and quality for financial and business information.

Goyer has also written about the transformation of corporate governance in France, noting at the outset that concepts such as "corporate governance" and "shareholder value" had initially been badly received in France as "generally been associated with lay-offs

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[97] L. Cunningham, Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance (1999).

and short-term thinking that privileges the next quarter's financial results over the long-term health and social responsibility of the corporation".[98] Although contempt for US-style corporate governance, and inbound investment from foreign mutual and pension funds, could be found among all of the major stakeholders of the French economy—managers, state officials, trade unionists, and the general public, Gover argued that there had nonetheless been extensive changes to France's model of corporate governance that were most evident in three areas: a transition in the ownership structure of companies from concentrated cross-shareholdings in the hands of friendly fellow domestic companies to high levels of foreign ownership; an abandonment of corporate diversification strategies in favor of concentrating on a limited set of core competencies, a development that had led to dismantling of conglomerate structures that had previously provided employees of French companies with employment protection by serving as internal labor markets and as conduits for keeping poorly performing units afloat using subsidies from faster growing units within the same conglomerate; and adoption of managerial performance incentives, including an explosion of stock option packages for senior executives. In contrast to Cunningham, Gover argued that accounting standards among French companies had lagged behind other European countries with respect to increased transparency and that minority shareholders in France still had to work harder than their counterparts in other countries to overcome ownership ceilings and the unequal voting rights.

Gover suggested that the transformation of French corporate governance described above raised issues of both process and sustainability. On the process side, Gover noted that the decisions to adopt shareholder value institutions and practices, dismantle conglomerate structures and adopt performance-based incentives had often been made by the CEOs and other senior executives of large French companies without extensive consultation with other firms, the state or internal stakeholder groups. For example, Gover pointed out that conglomerate structures were often cast aside with providing employment guarantees or other concession to employees. As a result, many French workers found themselves living in a world with substantially reduced job security and pursuing career paths that were depended more and more on the financial and business performance of their employers as opposed to a social contract. Gover also questioned the introduction of stock options, noting that many companies had limited their use to CEOs and top management and that these performance-based incentives had been deployed without greater financial transparency that would discourage those at the top of the hierarchy with options from engaging in transactions calculated to increase the short-term value of the company's stock, and thus the value of their options. In other words, Gover feared that the members of the management teams of French companies would act in their own interests rather than continuing to follow the traditional process of serving the interests of all stakeholders and mapping and pursuing sustainable long-term competitive strategies.

One of the most interesting reforms made by the French to promote innovation was the creation of a new, more flexible, type of company that facilitated that the use of a corporate governance framework that was better suited to financing risky high

[98] M. Goyer, The Transformation of Corporate Governance in France (2003).

technology start-ups.[99] The previously existing models of corporate governance in France discussed above restricted the ability of shareholders to exert control over the managers of the enterprise and it was believed that this structure would not be conducive to attracting venture capital investment, since those investors are generally unwilling to put their capital at risk unless they can have a hand in making decisions regarding the strategic path of the company. In 1999, however, legislation was enacted that authorized formation of a new form of corporation that, although it could not issue shares publicly, offered several advantages to entrepreneurs looking to raise venture capital and attract skilled technical specialists to work on risky, innovative projects. For example, these corporations could establish their own rules for management and shareholders; issue different classes of stock with different voting rights, thereby providing investors with the opportunities to direct management of the firm; issue stock options; and operate without work councils, thereby streamlining the decision making processes and providing more flexibility to management.

§13 --East Asian model

The emergence of Japan as a global, and often dominating, economic power during the 1980s and early 1990s led to extensive attention on its strongly network-oriented model of corporate governance that featured the company as the institutional center of strong, deep and long-term relationships among all of the key stakeholders including banks and other financial institutions, investors, employees, suppliers, customers and, in many instances, the state. While this model is typically associated with Japan it has also appeared in similar form in China, India and the Middle East. For the Japanese, it allowed them to make the long-term investment commitments necessary for their firms to achieve success in electronics and low-cost automobiles, continuously dominating American and European competitors in their own markets. However, the long-running economic problems of Japan that began during the mid-1990s have led many to criticize elements of its traditional corporate governance model, particularly the lack of accountability and transparency (i.e., use of secretive governance procedures) and the apparent freedom to engage in what amounts to reckless financial speculation.[100] The prevailing concept of the firm in Japan and in the other countries and regions mentioned above is institutional and firms are created and operated under the oversight of a dynamic and diverse network of stakeholders with strong and enduring relationships. Ownership concentration is actually low to moderate; however, stock and bond markets have been relatively underdeveloped due to a legal and regulatory bias against financing of enterprises through non-bank sources.

The formal corporate governance structure in Japan is similar to that found in the US due to the lingering influence of the US occupation of Japan following World War II, which

[99] J. Vela, Radical Innovation in the Transatlantic Economy: Is a Silicon Valley Possible in Europe? (2009), 34-35.
[100] Portions of the description in this section is adapted from F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full

included an intense effort to impose US legal systems and related institutions on the Japanese.[101] However, at least on paper, there are some significant differences: Japanese shareholders appear to have more rights with respect to the nomination and election of directors and also have the right to vote on and approve management compensation at general shareholders' meetings. In reality though, Japanese shareholders have little in the way of real influence for several reasons. First, the board of directors of a Japanese public company is typically much larger than in the US and the UK, which makes it difficult for the board to concentrate and focus its efforts. Second, there are usually only a handful of outside directors on the board and they have little influence in relation to the rest of the board which is composed of directors controlled by the CEO and selected from among senior members of the management team, others from inside the company who owe their careers to the CEO and the auditors of the company. The bottom line is that absent severe financial distress Japanese public companies are firmly under the control of the CEO and other insiders. Management compensation is rarely linked to performance, the time horizon of economic relationships is long-term and planning has often been driven by the choices of the state regarding which industries, markets and technologies might be most appropriate for overall economic development of the nation.

Japanese companies have also differed significantly from their counterparts in the US and the UK with respect to the composition of their shareholder groups.[102] In the US, for example, banks were, for a long time, prevented from holding equity stakes in companies except in unusual circumstances and laws and regulations governing other financial institutions such as insurance companies have generally restricted equity holdings of those entities in non-financial institutions to relatively small amounts in order to promote diversification. As a result, only a small amount of the equity of non-financial corporations is held by financial institutions in the US while in Japan, as well as in France and Germany, the average holdings were significantly higher.[103] In turn, the percentage of equity ownership of non-financial corporations in the hands of individuals and mutual and pension funds were much higher in the US than in the other countries. As for ownership of shares of non-financial corporation by other non-financial corporations, the percentage in the US has always been much lower than in Japan, Germany and France, a situation that can be attributed to significant differences in antitrust and competition laws across all of the countries.

Nisa and Warsi, who preferred to talk about a broader East Asian model rather than simply focusing on Japan, observed that "[t]he typical East Asian form of corporate governance model embodies a purer version of the insider model where 'the founding

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[101] The discussion in this section is based on F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 26. The article also appears as F. Allen and D. Gale, "Comparative Financial Systems: A Survey" in A. Boot, S. Bhattacharya and A. Thakor (Eds.), Credit, Intermediation and the Macroeconomy (Oxford: Oxford University Press, 2004), 699-770.

[102] Id. at 699.

[103] While their equity holdings in non-financial corporations are higher than in the US, banks and other financial institutions in Japan are subject to regulatory restrictions on holding shares and patterns of ownership including regulations on the proportions of the equity of firms that banks can hold. See F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 29.

family' generally holds a majority of the controlling shares, directly or through other holding companies, most of which in turn may be controlled by the founding families".[104] As such, the East Asian version of the insider model differs from the form used in Europe in the way that the relationship among the controlling stakeholders is forged: "family ties", generally unwritten, are the key in East Asia while Europe relies on complex shareholder and other commercial agreements. Regardless of how the insider relationships are created and maintained, there is a higher tolerance in both Europe and East Asia for activities that may not be fully in the interests of common shareholders. For example, assuming that Firm A and Firm B are controlled by the same group of shareholders, Firm A may provide products and other resources to Firm B on extremely favorable terms in order to assist Firm B even though the transaction is not in the best economic interests of Firm A. If the minority shareholders of Firm A do not have an interest in Firm B they are particularly disadvantaged; however, such inequities are common and expected among organizations using the insider model.

§14 Role of the state in corporate governance

National governments have a stake in, and are also important contributors to, the operation and hoped-for efficiency of corporate governance systems in their countries. Nestor and Thompson pointed out that "rising institutional and transaction costs in the realm of corporate decision-making and finance impacts on the competitiveness of economies, on the corporate investment levels and on the allocative efficiency of capital markets".[105] Accordingly, corporate governance is an important factor in national economic policies and this causes policymakers to reach into their toolboxes to attempt to develop the most effective mix of laws, institutions and regulations, all of which influence how firms make decisions and act in the market and also how firms interact with all of their key stakeholders including customers, labor, suppliers and the community at large. As they studied the various models of corporate governance discussed above, Nisa and Warsi noticed that there were several different approaches taken by governments in their relationships with industry on issues and activities relating to corporate governance. Nisa and Warsi referred to these approaches as "government as referee", "government as manager" and "government as coach", and provided summaries of their views on the salient features of each approach that are described below.[106]

§15 --Government as "referee"

According to Nisa and Warsi, governments in countries following the Anglo-American model of corporate governance (e.g., Australia, Hong Kong, New Zealand, the UK and

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[104] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 129.
[105] S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43, 20.
[106] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 131 and 135. See also J-P. Lehmann, Corporate governance in East Asia & Western Europe: Competition, confrontation and co-operation (The European Institute of Japanese Studies, Working Paper No. 24, 1996).

the US) tend to serve as a form of "referee", meaning that the government is totally impartial with respect to the market; the government "stands on the sidelines" and intervenes only if and when abuses need to be prevented or perpetrators of illegal acts need to be punished; the government emphasizes fairness, transparency and accountability in corporate governance, yet does so with minimal regulation and reliance on market forces; auditors and attorneys play an important role in corporate governance; and corruption tends to be low.

§16 --Government as "manager"

Nisa and Warsi argue that government serves as a "manager" in European countries such as France, Italy and Spain—example of the so-called "Latin European" countries—and in a wide array of Asian countries including China, India, Indonesia, Malaysia, Singapore, Thailand and Vietnam. Nisa and Warsi explained that in these countries the government neither recognizes nor respects the market and does not trust the market. Instead, the government prefers to follow policies of economic nationalism and protectionism, with large doses of bureaucratic intervention and control. Governments in these countries have been known to actively promote national corporate champions. To the extent that corporate governance systems exist in these countries, they are generally "opaque, secretive and closed" and there is little public accountability.[107]

§17 --Government as "coach"

Nisa and Warsi also identified countries where the government serves as "coach", a middle position between the two extremes of "referee" and "manager" described above. Elements of this approach were identified in non-Latin European countries such as Austria, Denmark, Finland, Germany, the Netherlands, Norway, Sweden, Switzerland (i.e., the Germanic and Scandinavian countries) and in Japan and other East Asian countries including Indonesia, Korea, Malaysia, Taiwan and Thailand. Nisa and Warsi explained that while the government works from the "sidelines" in these countries it is partial and is involved in a variety of policies and practices that organize and influence competition in the marketplace such as "administrative guidance", creation of support systems and subsidies. Nisa and Warsi described the corporate governance systems in these countries as "semi-transparent/semi-opaque . . . with limited public accountability" and noted that there was "considerable scope for corruption" in these countries.[108]

§18 Regulatory frameworks

Diversity among countries as to the type of governance model used in those countries inevitably leads to variation among countries with regard to the elements of their legal and regulatory framework for corporate governance. In the US, for example, companies are subject to state laws governing their formation, organization and operation and public companies are also highly regulated by corporate governance rules included in the federal

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[107] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 135.
[108] Id.

securities laws promulgated by the Executive Branch and Congress and administered by the Securities and Exchange Commission. The impact of both state and federal laws in the US is heavily influenced by judicial interpretation in case law that arises as disputes regarding specific laws and regulations are adjudicated. Companies operating in countries that are part of the European Union must be mindful of EU legislation relating to corporate governance matters as well as the federal and regional laws of the country in which they are operating. The content and evolution of regulatory frameworks for corporate governance in a particular country depends on political and economic factors. Corporate governance is an important factor in national economic policies and this causes policymakers to reach into their toolboxes to attempt to develop the most effective mix of laws, institutions and regulations, all of which influence how companies make decisions and act in the market and also how companies interact with all of their key stakeholders including customers, labor, suppliers and the community at large.[109] In addition, in the US and other developed countries increasingly powerful shareholder activists have lobbied legislators for changes in laws and regulations and taken their cases directly to directors and management at shareholders' meetings.

As discussed in more detail below, Standard & Poor ("S&P") developed a methodology for analyzing corporate governance practices in countries and companies and generating a corporate governance score ("CGS") that reflected S&Ps assessment of a company's corporate governance practices in general and individual components of such practices including ownership structure and influence, financial stakeholder rights and relations, financial transparency and information disclosure and board structure and process.[110] S&P did not produce CGS for individual countries and that the primary focus was on internal governance structure and processes at specific companies; however, S&P conceded that an overall assessment of the risks associated with governance practices of an individual company was not possible without some consideration of the legal, regulatory and market environment of the country in which the company was operating and S&P expected that as between "two companies with the same CGS, but domiciled in countries with contrasting legal, regulatory and market standards . . . [i]n the event of deterioration in governance standards at a particular company, investors and stakeholders are likely to receive better protection in a country with stronger and better-enforced laws and regulations".[111] S&P indicated that prior to assigning a CGS to companies in a particular country it would undertake an informal review and analysis of the corporate governance laws, regulations, and practices that were prevalent in the country and explained that the goal of this review and analysis was to "clarify what stakeholder rights exist as defined by legislation and regulatory practice . . . [and evaluate] . . . the relevance of these rights in practice".[112] According to S&P the four main areas of focus of its

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[109] For discussion of the role of the state in corporate governance, see G. Coglianese, T. Healey, E. Keating, and M. Michael, "The Role of Government in Corporate Governance," Regulatory Policy Program Report RPP-08 (Cambridge, MA: Center for Business and Government, John F. Kennedy School of Government, Harvard University, 2004).
[110] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions (July 2002).
[111] Id. at 6.
[112] Id. at 12.

country-level analysis included legal infrastructure, regulation, information infrastructure and market infrastructure.[113]

Factors that S&P would consider when analyzing a country's legal infrastructure included the following[114]:

- What are the relevant laws that address corporate governance in the country and its various jurisdictions?
- How are shareholder and other stakeholder rights defined?
- What laws exist that govern insider trading, reporting and disclosure, duties and composition of boards of directors, shareholder registry and share depository, proxy rights at shareholder meetings, voting procedures (including cumulative), minority shareholder rights and rights of foreign creditors and shareholders?
- How extensive are the laws referred to above?
- Is a shareholder registry necessary to prove ownership?
- Are outside directors required?
- Does a licensed registrar keep the shareholder registry?
- What is the nature of the judicial system in law enforcement?
- Is violation of the law a common occurrence?
- Do examples exist that point to judicial success in promoting and enforcing corporate governance?
- Are there examples of poor corporate governance where the law is not effective in principle or in practice?
- Are investor lawsuits relating to corporate governance related disputes common?
- How effective are the available legal remedies?
- What is the track record of these legal processes and what is the time frame?
- How does the legal system operate in practice?

Factors that S&P would consider when analyzing a country's regulatory environment included the following[115]:

- What regulatory bodies exist and what is their purview?
- Are there regulatory gaps or areas in which regulatory responsibility overlaps among bodies?
- Do the different regulatory bodies work in co-operation or conflict with one another?
- Do market participants view specific regulations as inappropriate?
- Do SROs play a role that is relevant from the perspective of corporate governance?
- What new legislation is on the regulatory agenda?
- What are the information and timing requirements for public disclosure?
- How effectively are securities and disclosure regulations followed and enforced?

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[113] For full discussion of each of these four main areas see Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions (July 2002), 12-16.
[114] Id. at 13-14.
[115] Id. at 14.

- Do regulators have sufficient resources and practical enforcement tools to achieve their mission?
- Is there a securities regulator and, if so, how long has it been in place?
- What is the relationship of securities and other regulators to stock exchanges?
- What are examples of regulatory successes and failures?

Factors that S&P would consider when analyzing a country's informational infrastructure included the following[116]:

- What are the number, quality and independence of public auditors?
- Is there a requirement for independent financial audit?
- How do local accounting standards compare to international accounting standards with respect to basis of consolidation, operating data in addition to financial data, financial position of subsidiaries whose health is material to the interests of the company and individual shareholders, segment data (i.e., financial performance of individual business or business units), methods of asset valuation, definitions of key financial measures (i.e., revenues, expenses, profits and losses), cash flow (i.e., sources and uses of funds), all real and contingent liabilities, evidence of transfer pricing (including hidden transfers or subsidies) and arrears with related companies?
- What is the required timing of disclosure?
- Is there ease of access to independently audited financial statements?

Factors that S&P would consider when analyzing a country's market infrastructure included the following[117]:

- What is the prevalence of listed companies or significant private ownership?
- What is the prevalence of state ownership?
- Is there ease of access to public exchanges?
- For transition economies and other countries with state-owned enterprises: what methods of privatization exist and what impact do these have on ownership structures?
- What is the importance of institutional investors (mutual funds, pension funds, insurance companies, etc.)?
- Is there a universal banking system versus separation between commercial and investment banking?
- Do banks commonly hold significant equity stakes in industrial companies?
- Are financial-industrial groups prevalent and, if so, what is the degree of transparency in their intercompany relationships?
- Do market distortions exist in the form of uncompetitive industry structures or government protection of individual companies or sectors?
- Are there signs of macroeconomic stability or stress?
- What is the nature of the political environment and is this relevant to the practice of corporate governance in the country?

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[116] Id. at 15.
[117] Id. at 15-16.

§19 Management of "agency" issues in corporate governance

While corporate governance structures differ across countries, a foundational and universal question is how to overcome the central dilemma that shareholders face when relying on management to act as their "agents" in directing the affairs of the corporation on a day-to-day basis: How can shareholders ensure that managers pursue their interests? Allen and Gale summarized the literature on several of the most commonly cited corporate governance mechanisms that are thought to be useful in forcing, or at least "encouraging", managers to act in the interests of the shareholders rather than pursuing their own interests and relying on the inability of shareholders to prevent self-dealings or even discover that it is going on. These mechanisms, and their apparent success (or lack thereof) in various countries, can be briefly summarized as follows:

§20 --Board of directors

Allen and Gale noted that the little empirical evidence available suggested that, in general, the different systems for structuring the board of directors "are equally effective (or ineffective) at disciplining management".[118] Several studies conducted on US companies have concluded that boards are weak in disciplining managers and that boards with a majority of independent directors do not perform better than firms without such boards.[119] Other researchers have found that the relationship between management turnover and various performance measures is similar in Japan, Germany and the US and that the presence of outside directors on Japanese companies appears to have no meaningful influence on the sensitivity of top of top executive turnover to either earnings or stock-price performance.[120] German companies generally did not make changes in their supervisory boards during times of poor performance although changes on management boards did occur when companies were having troubles.[121]

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[118] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 30.

[119] M. Mace, Directors, Myth and Reality (Boston, MA: Harvard Business School Press, 1971); M. Weisbach, "Outside Directors and CEO Turnover", Journal of Financial Economics, 20 (1988), 431-460; M. Jensen, "The Eclipse of the Public Corporation", Harvard Business Review, 67 (1989), 60-70; S. Bhagat and B. Black, "The Uncertain Relationship Between Board Composition and Firm Performance" in K. Hopt, M. Roe and E. Wymeersch (Eds.), Corporate Governance: The State of the Art and Emerging Research (New York: Oxford University Press, 1998). See also M. Gibson, Is Corporate Governance Ineffective in Emerging Markets? (Washington DC: Board of Governors of the Federal Reserve System, Working Paper, 1999) (finding results similar to those found in US in studies of relationship between CEO turnover and firm performance in eight emerging markets).

[120] S. Kaplan, "Top Executives, Turnover, and Firm Performance in Germany", Journal of Law, Economics, and Organization 10 (1994), 142-159; S. Kaplan, "Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States", Journal of Political Economy, 102 (1994), 510-546; and J. Kang and A. Shivdasani, "Firm Performance, Corporate Governance, and Top Executive Turnover in Japan", Journal of Financial Economics, 38 (1995), 29-58. Interestingly, however, Kang and Shivdasani found that concentrated equity ownership and ties to a main bank did appear to have a positive relationship to earnings and stock-price performance in Japan.

[121] J. Franks and C. Mayer, "Ownership, Control and the Performance of German Corporations," Working Paper, London Business School, 1997.

§21 --Executive compensation and managerial labor market

Researchers have attempted to analyze how well managers can be incentivized to act in the interests of shareholders by tying executive compensation to stock prices and/or other accounting-based measures of firm performance. Researchers have found a positive relationship between executive pay and dismissal and performance in the US, Germany and Japan.[122] Managerial labor markets also play a role in incentive strategies since a labor market that rewards high performing managers with new opportunities at other firms will obviously provide managers with additional motivations to increase shareholder value.

§22 --Market for corporate control

Markets for corporate control can operate in several different ways—proxy contests, friendly mergers and hostile takeovers—and is thought to be important for the efficient operation of capitalist economies by providing a means for "better" management teams to expand their scope of control over larger amounts of assets at the expense of inefficient managers who lose control of their assets and eventually are forced to give up their jobs.[123] In addition, the possibility of proxy contests and hostile takeovers serves as a sword over the heads of under-performing managers since they are faced with the prospect of having their firms taken over and their jobs handed to new managers by the new controlling group. Allen and Gale noted that the evidence indicates that there are differences in the number of hostile takeovers in the US and UK on the one hand and in France, Germany and Japan on the other hand, with hostile takeovers being relatively infrequent in the latter three countries, and that the standard explanation has been that the practice cross-shareholdings in the France, Germany and Japan makes it difficult for raiders to acquire the necessary number of shares to assume control.[124]

§23 --Concentrated holdings and monitoring by financial institutions

Not surprisingly, one of the most commonly recommended strategies for ensuring that managers act to maximize the value of their firms is concentrated ownership accompanied by monitoring by large shareholders.[125] In countries such as Germany and Japan, where financial institutions accumulate large blocks of shares and there is no market for corporate control, it is often anticipated that the institutions will act as the

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[122] S. Kaplan, "Top Executives, Turnover, and Firm Performance in Germany", Journal of Law, Economics, and Organization 10 (1994), 142-159; S. Kaplan, "Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States", Journal of Political Economy, 102 (1994), 510-546; and M. Jensen and K. Murphy, "Performance Pay and Top-Management Incentives", Journal of Political Economy, 98 (1990), 225-64.

[123] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 31 (citing H. Manne, "Mergers and the Market for Corporate Control", Journal of Political Economy, 73 (1965), 110-120).

[124] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 33.

[125] J. Stiglitz, "Credit Markets and the Control of Capital", Journal of Money, Credit and Banking, 17 (1985), 133-152.

"delegated monitor" of the actions of management.[126] Critics argue, however, that concentrated ownership may blunt managerial initiative[127] and that a price for monitoring must be paid in the form of reduced liquidity.[128] With specific regard to monitoring by financial institutions with large ownership positions, the evidence is mixed. Allen and Gale observed that the main bank system used in Japan appeared to be important in times of financial distress but less important when firms were doing well.[129] Allen and Gale also pointed out that "banks are themselves subject to the same agency problems as firms" given that the largest banks "essentially control themselves" due to their ability to vote substantial blocks of shares in their own elections of directors.[130] Another concern raised by Hellwig is the ability of banks to misuse private information they acquire about firms they lend to extract rents from those firms.[131] Hellwig also argued that the relationships between banks and borrowers in Germany are not intended to promote effective management but merely a means for sharing control and limiting the power of outsiders to become involved in governance of the firms.[132]

§24 --Debt

It has often been suggested that reliance on debt is an effective means for imposing discipline on managers and preventing them from squandering resources.[133] However, use of debt has been criticized as providing an incentive for manages to take risks and even accept projects that destroy firm value if significant amounts of debt are used.[134] As

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[126] See, e.g., T. Hoshi, A. Kashyap and D. Scharfstein, "Bank Monitoring and Investment: Evidence from the Changing Structure of Japanese Corporate Banking Relationships", in R. G. Hubbard (Ed.), Asymmetric Information, Corporate Finance and Investment (Chicago: Chicago University Press, 1990); T. Hoshi, A. Kashyap and D. Scharfstein, "The Role of Banks in Reducing the Costs of Financial Distress in Japan", Journal of Financial Economics, 27 (1990), 67-68; and T. Hoshi, A. Kashyap and D. Scharfstein, The Choice Between Public and Private Debt: An Analysis of Post-Deregulation Corporate Finance in Japan (Cambridge, MA: National Bureau of Economic Research Working Paper 4421, 1993) (providing evidence that the main bank system in Japan reduced agency costs).

[127] M. Burkart, D. Gromb and F. Panunzi, "Large Shareholders, Monitoring, and the Value of the Firm", Quarterly Journal of Economics, 112 (1997), 693-728.

[128] P. Bolton and E. von Thadden, "Blocks, Liquidity, and Corporate Control", Journal of Finance, 53 (1998), 1-25; P. Bolton and E. von Thadden, "Liquidity and Control: A Dynamic Theory of Corporate Ownership Structure", Journal of Institutional and Theoretical Economics, 154 (1998), 177-223.

[129] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 35.

[130] Id. (citing J. Charkham, Keeping Good Company: A Study of Corporate Governance in Five Countries (Oxford: Clarendon Press, 1994, 36).

[131] M. Hellwig, "Banking, Financial Intermediation and Corporate Finance" in A. Giovannini and C. Mayer (Eds.), European Financial Integration (New York: Cambridge University Press, 1991), 35-63.

[132] M. Hellwig, "Banks, Markets, and the Allocation of Risks in an Economy", Journal of Institutional and Theoretical Economics 54 (1998), 328-345.

[133] S. Grossman and O. Hart, "Corporate Financial Structure and Managerial Incentives" in J. McCall (Ed.), The Economics of Information and Uncertainty (Chicago: University of Chicago Press, 1982) and M. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers", American Economic Review, 76 (1986), 323-29.

[134] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 36-37 (citing M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", Journal of Financial Economics, 3 (1976), 305-60).

a practical matter, the efficacy of debt as a means for providing discipline on managers is relatively limited given that most large corporations rely on internal financing and can easily service their debt burden without having to constrain their ability to pursue operational and strategic plans.

§25 --Product market competition

An interesting alternative approach to resolving the agency problem between owners and managers focuses on the role of product market competition and proposes that managers must avoid wasting or unwisely consuming large amounts of firm resources or risk have their firms overcome by domestic and increasingly international competition that forces them out of the market and into bankruptcy.[135] When looking at the influence of competition, Allen and Gale argue that shareholders should not be so concerned about whether managers "work hard" but on whether they have the "right stuff" to avoid being pushed out of the market by competitors.[136]

§26 Influences on corporate governance systems

Predictably, there is a good deal of debate regarding the factors that influence the choice and operation of corporate governance systems in a particular country. Toonsi, for example, mentioned factors such as the legal and regulatory framework and related institutions, particularly the extent to which a country's laws protect investor and property rights and the extent to which those laws are enforced, and political decisions regarding the power and influence of various potential stakeholders such as financial institutions and/or labor organizations.[137] For example, Toonsi argues that differences in the national political climate can explain why financial institutions do not play a large direct role in the corporate governance of US firms while they are significant players in the governance systems that have traditionally driven activities in Germany and Japan. Also not to be ignored is the potential influence of societal culture on the structure and emphasis of corporate governance systems, particularly those cultural characteristics that are based on elements of trust.

Numerous other researchers have advanced their own ideas regarding the factors that determine the preferred corporate governance in a particular country, often in the context of participating in the debate described below regarding the possibility of convergence upon a single universal governance framework. Among the factors most often mentioned

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[135] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 37 (citing A. Alchian, "Uncertainty, Evolution, and Economic Theory", Journal of Political Economy, 58 (1950), 211-221; and G. Stigler, "The Economies of Scale", Journal of Law and Economics, 1 (1958), 54-71).

[136] F. Allen and D. Gale, Comparative Financial Systems: A Survey, http://www.econ.nyu.edu/user/galed/papers/paper01-04-01.pdf, 38 (citing F. Allen and D. Gale, "Corporate Governance and Competition" in X. Vives, Corporate Governance: Theoretical and Empirical Perspectives (Cambridge, UK: Cambridge University Press, 2000).

[137] F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full

are the legal system, political intervention, cultural differences and economic factors (i.e., variations in market size, firm size, uncertainty and industry structure).[138] Nisa and Warsi pointed to a correlation between the type of national legal system (i.e., common law versus civil law) and the methods used for addressing the apparent misalignment of interests between managers and shareholders in a system where ownership is separated from management: ". . . in common law countries this problem is resolved via the monitoring by the market for corporate control and regulation forcing managers to follow the interests of the shareholders . . . [but] civil law countries mainly rely on large shareholder, creditor or employee monitoring".[139] Nestor and Thompson summarized some of the differences between common and civil law countries and the impact those differences might have on variations between the corporate governance systems typically associated with those countries.[140] For example, they explained that firms in common law countries are often able to free themselves from legal norms through contract while in civil law countries with their rigid statutory systems offer less flexibility to their firms. They also argued that one can observe differences in how the "corporate concept" influences the relationship between managers and shareholders in common and civil law countries. In Anglo-American countries, there is a fiduciary relationship between managers and shareholders; however, in countries with a civil law tradition Nestor and Thompson claimed that "the company has an independent will, i.e. in theory, what is good for the corporation might not be good for its shareholders".[141]

Aguilera and Jackson suggested a different approach to explaining the influences on national corporate governance systems and why those influences lead to the diversity among systems seen around the world today in countries with at least a moderate level of economic development and an established "rule of law".[142] Their model focused on what they believed to be the three key stakeholder groups associated with the firm: capital, labor and management. For each of these stakeholders, Aguilera and Jackson identified two or three dimensions that they believed described the "variations in the identities and interests of each stakeholder toward the firm" and also introduced institutional domains for each of the stakeholders that they believed influenced how each of the stakeholders related to "firm decision making and control over resources".[143] Specifically, their goal was to "offer propositions that describe (1) how a country's property rights, financial system, and inter-firm networks shape the role of capital; (2) how a country's representation rights, union organization, and skill formation influence the role of labor; and (3) how a country's management ideology and career patterns affect the role of

[138] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 129.
[139] Id. at 129 and 136 (citing R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny, " Legal Determinants of External Finance", Journal of Finance, American Finance Association, 52(3) (1997), 1131-1150).
[140] S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43, 40.
[141] Id.
[142] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465.
[143] Id. at 448.

management".[144] Their assumption in creating and using this model was that the diversity of interactions among stakeholders in corporate governance that occurs in countries around the world could be explained, at least in part, by different configurations of institutions in those countries.[145] Another important player in this whole process, the "state", was not included as a stakeholder even though it is apparent in many countries that the government directly influences particular firms and industries; however, Aguilera and Jackson argued that "the state is nonetheless present in our model at the institutional level, by virtue of asserting public interest agendas and mediating conflicts among stakeholders".[146] In addition, they noted that politics played a big role in national diversity of corporate governance systems through its role in determining institutional development.[147]

§27 --Capital

Aguilera and Jackson referred to "capital" as "the stakeholder group that holds property rights, such as shareholders, or that otherwise makes financial investments in the firm, such as creditors".[148] The inclusion of creditors is significant since capital is generally viewed as the sole province of shareholders and it is assumed that their main concern is optimizing their risk-adjusted rate of return on invested capital. As noted elsewhere in this chapter, corporate governance models tend to be compared on the basis of ownership concentration, with concentrated ownership associated with stronger external influence on management and fragmented ownership resulting in more management autonomy. Aguilera and Jackson believed that it was necessary to take into account the identities, interests, time horizons and strategies of the wider range of actual capital providers including banks, pension funds, individuals, industrial companies and families. They argued that the relationship of the capital providers to the firm varied along three dimensions: "(1) whether capital pursues financial or strategic interests, (2) the degree of commitment or liquidity of capital's stakes, and (3) the exercise of control through debt or equity".[149] They also explained three institutional domains of capital that they believed influenced the characteristics of capital across countries: property rights, financial systems and inter-firm networks.

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[144] Id.

[145] Aguilera and Jackson argued that their approach addressed shortcomings in the traditional method of studying corporate governance using agency theory by doing a better job of incorporating comparative institutional analysis, specifically "actor-centered institutionalism". For further discussion, see R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 448-450. With respect to "actor-centered institutionalism", see F. Scharpf, Games real actors play: Actor-centered institutionalism in policy research (Boulder, CO: Westview, 1997).

[146] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 450.

[147] Id. (citing G. Jackson, "The origins of nonliberal corporate governance in Germany and Japan" in W. Streeck and K. Yamamura (Eds.), The origins of nonliberal capitalism: Germany and Japan compared (Ithaca, NY: Cornell University Press 2001), 121-170; and M. Roe, Strong managers, weak owners: The political roots of American corporate finance (Princeton, NJ: Princeton University Press, 1994).

[148] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 450.

[149] Id.

§28 ----Dimensions of capital

Aguilera and Jackson identified and explained three dimensions of capital, as follows[150]:

Financial versus strategic interests: Financial interests are the predominant factor when financial return on investment (i.e., maximization of market value of shares and dividend payouts) is the primary motivation or goal for investment and, not surprisingly, these interests are particularly important to individuals and institutional investors. In contract, strategic interests are the predominant factor when non-financial goals, such as control rights over key resources, drive investment. Aguilera and Jackson explained, for example, that "banks and corporations typically use ownership stakes as a means to pursue the strategic interests of their organizations: regulating competition between firms, underwriting relational contracts, securing markets, managing technological dependence, and protecting managerial autonomy from outside shareholders".[151]

Liquidity versus commitment: Liquidity speaks to the need of investors to have the ability to divest their ownership interests in the firm without suffering a substantial reduction in the value of those interests, a situation that is more likely to occur when ownership is widely distributed ("low concentration") and securities markets are robust and formalized. Investors interested in liquidity generally are more concerned about exit paths than their ability to directly control management. In contrast, "committed" investors depend on firm-specific assets to generate returns and thus are most interested in being able to exert influence over how those assets are managed. These investors typically have large ownership stakes ("high concentration") that are difficult to divest without loss of value. Banks with secured debt are another example of "committed" investment and contracts relating to secured loans typically have extensive provisions relating to management and preservation of the assets offered as collateral for the credit extended by the bank.

Debt versus equity: The distinctions between debt and equity holders are well-known: creditors bargain for fixed income from interest and a return of all of their capital on a specified date while equity holders, such as shareholders, seek larger returns tied to the growth and success of the underlying business of the firm. Creditors, generally thought to be more risk averse, have little direct rights of control until trouble occurs. Shareholders take on greater risk and are provided with more controls while the business is solvent to manage that risk; however, their control disappears if bankruptcy occurs. Capital structures often contain both equity and debt, since equity holders use debt as leverage to increase the value of their shares without have to accept the dilution that would come from raising capital by issue new equity securities.

In support of their use of three dimensions, Aguilera and Jackson observed that this allowed for a better understanding of differences between countries that are typically combined when the comparison is limited to Anglo-American versus "European" models.

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150 Id. at 449-452.
151 Id. at 451.

For example, Italy and Japan are often mentioned in the same sentence as sharing "high concentration" of ownership; however, the introduction of the notion of "strategic interests" allows for a distinction between the two countries since, as Aguilera and Jackson explain, "family ownership in Italy is less motivated by strategic interests than owners/investors in Japan".[152]

§29 ----Institutional domains of capital

Aguilera and Jackson identified and explained three institutional domains of capital, as follows[153]:

Property rights: Property rights "define mechanisms through which shareholders (capital) exert control, such as information exchange and voting rights, and how control is balanced with managerial discretion" and are established through corporate law, bankruptcy law and the contractually-determined charter documents of the firm (e.g., articles of incorporation).[154] Aguilera and Jackson noted that distinctions are often made between countries based on the relative strength or weakness of shareholders' rights in those countries; however, they believed that the most important influence of property rights on capital was the way in which those rights favored or impaired the ability of various interests to exercise control within the corporate governance framework. They offered the following illustrations of how different approaches to property rights in the Japan, Germany and US might explain the role that "capital" plays in the control of firms in those countries:

- They referred to Japanese law as an example of a "shareholder sovereignty model" in which shareholders had broad powers and voting rights based on "majority rule" but few protections for minority shareholders, weak information disclosure requirements and little in the way of "collective action" mechanisms that shareholders could use to raise and address perceived problems of corporate control. The result has been to "reduce the liquidity of capital and weaken the position of financial interests within Japanese corporations".[155]
- Germany's corporate governance system was referred to as a "constitutional model" that featured a two-tier board structure that separated the traditional exercise of "shareholders' rights" from supervisory activities. While protections for minority shareholders in Germany were characterized as "weak" large holders of shares were given seats on the supervisory board where they could exert control and closely monitor management activities and pursue their strategic interests with respect to the firm.
- The US system was referred to as the "liberal market approach" and featured the most extensive set of minority shareholder protections, both with respect to voting and

[152] Id. at 452 (citing M. Best, The new competition: Institutions of industrial restructuring (Cambridge, MA: Harvard University Press, 1990)).
[153] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 453-454.
[154] Id. at 453.
[155] Id.

disclosures, among the three countries. Aguilera and Jackson argued that this led to the creation of "incentives to pursue greater capital liquidity" and discouraged the disproportional control of the firm through blocks that is necessary in order to effectively pursue strategic interests.[156]

Aguilera and Jackson summed it all up with two propositions. First, in countries with property rights predominantly favoring large shareholders, capital tends to pursue strategic interests toward the firm and exercise control via commitment. In those countries, larger investors frequently have access to private information and can exercise control and monitoring free of concerns about smaller investors using their minority rights to intervene on control issues. However, in countries with property rights predominantly protecting minority shareholders, capital tends to pursue financial interests toward the firm and exercise control via liquidity.[157] In those countries minority investors have veto rights that they can use to limit the power of larger ownership groups and are also on a more level playing field with respect to information due to rigorous mandatory disclosure requirements.

Financial systems: Financial systems refer to the ways in which supplies of capital are made available to firms. As described elsewhere in this chapter, the two major alternatives for facilitating access by firms to capital (savings) provided by individuals are referred to as "bank-based" and "market-based".[158] In bank-based systems, such as Germany and Japan, banks and other financial institutions are the primary suppliers of capital to businesses and do so by collecting funds from individuals, placing them into accounts and then making those funds available to firms through loans. Aguilera and Jackson reiterated some of the well-known descriptions of bank-based systems including close relationships between banks and firms, small and underdeveloped capital markets that reinforce higher firm dependence on debt, close capital monitoring and contingent control of borrowers by banks and, finally, long-term commitment by capital providers to firms as a result of the terms upon which the capital is made available to those firms.[159]

Market-based financial systems are, as mentioned elsewhere in this chapter, generally associated with Anglo-American countries such as the US and the UK.[160] In these countries, individuals entrust their capital (savings) directly to firms through investments in stocks and bonds offered and available through public securities markets. The result is that capital markets are much larger and more liquid than in the bank-based countries and the primary responsibility for monitoring of the use of capital falls to institutional investors rather than banks and other similar financial institutions. In market-based

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[156] Id.
[157] Id.
[158] E. Berglo¨ f, Corporate control and capital structure: Essays on property rights and financial contracts (Stockholm: IIB Institute of International Business, 1991); and J. Zysman, Governments, markets, and growth: Financial systems and the politics of industrial change (Ithaca, NY: Cornell University Press, 1983).
[159] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 453.
[160] A. Steinherr and C. Huveneers, "On the performance of differently regulated financial institutions: Some empirical evidence", Journal of Banking and Finance, 18 (1994), 271–306.

systems investors are generally focused on the successful pursuit of their financial interests and they are prepared and likely to exit an investment when they achieve their desired rate of return and/or better investment opportunities appear elsewhere. As such, the level of commitment by investors is much lower. Investor control in market-based systems comes not so much from monitoring and large blocks of shares but from the ability of investors to retrieve their capital quickly through sales of their stocks and bonds in liquid capital markets.

Aguilera and Jackson observed that the path that countries take with regard to their preferences for financial systems is determined, in large part, by how those countries choose to regulate their financial institutions. They explained that ". . . [f]or example, banks' capacity to engage in business lending developed historically, through a variety of institutions favoring certain forms of savings (on the household side) and supporting the extension of long-term liabilities (on the bank side)".[161] They also pointed out the findings of Jackson and Vitols that the financial systems used in various countries varies based on "the mix of public versus private pensions".[162] They summed up their propositions on the relationship between financial systems and capital as follows: "In countries with predominantly bank-based financial systems, capital tends to exercise control over the firm via debt and commitment . . . [however] . . . [i]n countries with predominantly market-based financial systems, capital tends to exercise control over the firm via equity and liquidity".[163]

Interfirm networks: Another important influence on the relationship of capital to the firm is the structure of interfirm networks, which plays a key role in a firm's behavior with respect to gaining access to critical resources and information.[164] Aguilera and Jackson were particularly interested in interfirm networks that included "capital ties", such as ownership and credit linkages and board representation, along with non-financial links such as supplier relationships. They referred to this situation as "network multiplexity", cited Germany, Japan and Spain as countries with multiplex networks, and argued that "[m]ultiplex ties reinforce the commitment of capital by making exit more costly, particularly given a high degree density of relationships between firms".[165] Other byproducts of the multiplex networks include a reduction of external influences and increased importance of the strategic interests of business partners which are pursued

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[161] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 454.
[162] Id. (citing G. Jackson and S. Vitols, "Between financial commitment, market liquidity and corporate governance: Occupational pensions in Britain, Germany, Japan and the USA" in B. Ebbinghaus and P. Manow (Eds.), Comparing welfare capitalism: Social policy and political economy in Europe, Japan and the USA (London: Routledge, 2001), 171-189).
[163] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 454.
[164] Id. (citing R. Burt, Corporate profits and cooptation (New York: Academic Press, 1983); G. Davis and M. Mirzruchi, "The money center cannot hold: Commercial banks in the U.S. system of corporate governance", Administrative Science Quarterly, 44 (1999), 215–239; and P. Windolf and J. Beyer, "Cooperative capitalism: Corporate networks in Germany and Britain", British Journal of Sociology, 47 (1996), 205–231).
[165] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 454.

through corporate governance mechanisms such as interlocking board directorates which tend to increase the propensity of partners to cooperate.[166] Interfirm networks are facilitated, or discouraged, by antitrust and competition law policies and this is one of the reasons why multiplex networks are not nearly as common in the US and the UK[167], countries in which interfirm relationships are much looser and capital ties are forged, if at all, for primarily financial reasons. Aguilera and Jackson summed up their propositions on the relationship between interfirm networks and capital as follows: "In countries with a high degree of multiplexity in interfirm networks, capital tends to pursue strategic interests toward the firm and exercise control via commitment . . . [however] . . . in countries with lower degrees of multiplexity in interfirm networks, capital tends to pursue financial interests toward the firm and exercise control via liquidity".[168]

§30 --Labor

One of the most interesting elements of the model developed by Aguilera and Jackson was the explicit inclusion of "labor" (employees) as a key influence in the corporate governance structure. They explain that neglect of labor in corporate governance models could be attributed to the fact that much of the research and commentary has been generated by scholars from the US, where employee participation in governance matters is considerably weaker than in Germany and Japan.[169] Noting that there are, of course, issues embedded in the legal relationship between managers and employees relating primarily to the legitimacy of managerial authority and the degree to which employees "obey" the directives of their managers, Aguilera and Jackson focused on a specific potential role for employees in corporate governance: "their ability to influence corporate decision making and to control firms' resources".[170] They argued that there were "two critical dimensions defining employees' relationship to corporate decision making: (1) strategies of internal participation versus external control and (2) portable versus firm-specific skills" and that three sets of institutions influenced these dimensions: the representation rights given to workers; the organization of unions; and the institutions of skill formation.[171]

§31 ----Dimensions of labor

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[166] Id. (citing J. Lincoln, M. Gerlach and P. Takahashi, "Keiretsu networks in the Japanese economy: A dyad analysis of intercorporate ties", American Sociological Review, 57 (1992), 561–585; and M. Mizruchi and L. Stearns, "A longitudinal study of the formation of interlocking directorates", Administrative Science Quarterly, 33 (1988), 194–210).

[167] G. Davis and H. Greve, "Corporate elite networks and governance changes in the 1980s", American Journal of Sociology, 103 (1997), 1–37; N. Fligstein, The transformation of corporate control (Cambridge, MA: Harvard University Press, 1990).

[168] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 454.

[169] Id. (citing M. Blair and M. Roe, Employees and corporate governance (Washington, DC: Brookings Institution Press, 1999); and J. Parkinson and G. Kelly, "The conceptual foundations of the firm" in J. Parkinson, A. Gamble and G. Kelly (Eds.), The political economy of the company (Oxford: Hart Publishing, 2001), 113–140).

[170] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 455.

[171] Id.

Augilera and Jackson suggested that employees relied on one of two strategies for defining their interests in relation to corporate decision making.[172] The first strategy is referred to as "external control" and is used when decision making is the prerogative of management and labor is left to influence those decisions by external and independent collective actions such as strikes. The second strategy relies on the creation and use of internal channels of decision making that formally allows labor to democratically participate in decisions, even if the final decisions remain in the hands of management. Proponents of strategies of internal participation argue that they are to be recommended because of the role they can play in fostering consensus and cooperation and integrating the interests of employees with those of the firm.[173] The relationship of labor to corporate governance is also influenced by whether the skills of employees needed by the firm are "portable" across firms or "firm specific". Augilera and Jackson observed that "[w]hen employee skills are *portable* across firms or investments in skills are low, employees may favor exit over voice in response" while, in contrast, "when employee skills are *firm specific*, their greater dependence on the firm makes the option to exit more difficult".[174] The practical application of this observation is that when employee skills are firm-specific there is greater incentive for employees to seek ways to participate in decisions, particularly decisions about "how those skills are formed and deployed"[175], and employees are likely to have a stronger long-term vested interest in the success of the firm since that success is closely tied to their career progress and job security.

§32 ----Institutional domains of labor

Aguilera and Jackson identified and explained three institutional domains of labor, as follows[176]:

Firm-level representation rights: Collective rights to representation in firm decisions begin with the fundamental "right to organize" and can extend much further to include rights to information, consultation and co-determination**.** Representation rights vary with respect to strength, scope and source (e.g., unilateral decisions by employers to grant participation rights, collective bargaining agreements and/or direct state intervention through laws mandating employee representation) and there are also differences depending on the particular type of decision that has to be made. Aguilera and Jackson argued that when the firm-level representation rights of labor are weak, as they are in the US, employees lack internal channels for representation in decision making and thus are

[172] Id. (citing G. Bamber and R. Lansbury, International & comparative employment relations (Thousand Oaks, CA: Sage, 1998).

[173] J. Rogers and W. Streeck, "Workplace representation overseas: The works council story" in R. Freeman (Ed.), Working under different rules (New York: Sage, 1994), 97-156.

[174] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 455 (citing O. Williamson, M. Watcher and J. Harris, "Understanding the employment relation: The analysis of idiosyncratic exchange" Bell Journal of Economics, 6 (1975), 250–278).

[175] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 455.

[176] Id. at 455-457.

left to rely on external control strategies such as strikes and similar collective actions. On the other hand, in countries like Germany where representation rights are strong due to legislative mandate employees can rely on internal channels to provide them with access to information and opportunities for meaningful consultation on decisions.[177]

Union organization: Aguilera and Jackson distinguished three "ideal types" of union organizational models: (1) class-based unions, such as political and industrial unions; (2) occupation or craft-based unions, which are organized around particular sets of qualifications; and (3) enterprise-based unions, which recruit their members from specific enterprises (firms).[178] They argued that in countries with predominantly class-based and craft-based unionism, labor tends to pursue strategies of external control such as strikes which can garner the support of workers from other enterprises acting in the spirit of "employee solidarity". In contrast, labor tends to pursue strategies of internal participation in countries where enterprise-based unionism is the predominant model since those types of unions are primarily interested in long-term employment arrangements with the specific enterprise and the issues that arise for such unions tend to be related to factors associated with the long-term success of the enterprise. Aguilera and Jackson noted, for example, that "Japan's large firm sector comes close to this ideal type . . . [and] . . . Japanese enterprise unions seek to participate in firm decisions because these unions represent a relatively homogenous group of core employees within the firm whose primary interest is preserving job security within the firm's internal promotion system".[179]

Skill formation: Skill formation is concerned with the ways in which employees acquire and develop the skills necessary to perform their jobs and create and advance their careers and Aguilera and Jackson argued that the portability or firm-specific nature of investments in skill formation influence the relationship of employees with their firm and the corporate governance of the firm. Aguilera and Jackson noted that studies had identified five main skill formation institutions—(1) the state, (2) "free markets", (3) institutional companies, (4) firm networks and (5) corporatist institutions[180]—and

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[177] Id. at 456.
[178] Id.
[179] Id. (citing C. Brown, Y. Nakata and M. Reich and L. Ulman, Work and pay in the United States and Japan (New York: Oxford University Press, 1997).
[180] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 457 (citing C. Crouch, D. Finegold and M. Sako, Are skills the answer? The political economy of skill creation in advanced industrial economies. (Oxford: Oxford University Press, 1999); see also J. Brandsma, F. Kessler and J. Munch (Eds.), Continuing vocational training: Europe, Japan and the U.S. (Utrecht: Uigevrij Lemma, 1996); D. Finegold and D. Soskice, "The failure of training in Britain: Analysis and prescription", Oxford Review of Economic Policy, 4(3) (1988): 21–53; R. Locke, T. Kochan and M. Piore, Employment relations in a changing world economy. (Cambridge, MA: MIT Press, 1995); A. Sorge, "A European overview of work and vocational training" in M. Warner, W. Wobbe and P. Broedner (Eds.), New technology and manufacturing management (Chichester, UK: Wiley, 1990), 147–157). There is also substantial research on the quality of training provided by various institutions such as one researcher who found evidence of considerable gaps between the training provided by state institutions and the practical requirements of the firms where the workers would be employed. Id. (citing R. Boyer, In search of labor market flexibility (Oxford: Clarendon Press, 1988)).

observed that there is evidence of differences in national strategies regarding which institutions are primarily responsible for skill formation of human capital:

- In the US, skills for production workers are typically generated through a mix of on-the-job training and markets[181] and Freeman noted that the apparent undersupply of skills in this area is closely related to high employee turnover and the strategies used to secure control in representing employee interests.[182] With regard to professional employees, US firms tend to rely on individuals with portable skills that have been acquired outside of the firm.
- In Japan, there is great reliance on firm-specific skills generated by investments made by firms in training their own employees so that they can take advantage of rewards made available through internal promotion systems.
- In Germany, training of production workers is conducted through a collaborative system that includes employer associations, industrial unions and the state and firms also participate by supporting the efforts of employees to obtain publicly certified occupational skills and even though these skills were portable across firms, participation was deemed worthwhile because it assured high levels of training.

Aguilera and Jackson proposed that in countries with predominantly market- and state-based skill formation institutions, such as in the US, labor tended to acquire portable skills and to pursue strategies of external control. Strategies of external control in that situation could also be expected from the fact that firms relying on skills formed externally were less dependent on employees and thus less likely to accede to internal participation governance models. With regard to countries with predominantly firm-based skill formation institutions, such as Japan, Aguilera and Jackson proposed that labor tended to acquire firm-specific skills and to pursue strategies of internal participation.[183]

§33 --Management

The third key stakeholder group in the Aguilera and Jackson model was "management", which they defined as "the stakeholders occupying positions of strategic leadership in the firm and exercising control over business activities".[184] Aguilera and Jackson confined their analysis to top management and described two dimensions of managers' identities and interests in relation to the firm: autonomy versus commitment and financial versus functional orientation. As for the institutional domains of management, they selected managerial ideology and managerial career patterns.

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[181] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 457 (citing C. Brown, Y. Nakata and M. Reich and L. Ulman, Work and pay in the United States and Japan (New York: Oxford University Press, 1997).

[182] R. Freeman (Ed.), Working under different rules (New York: Sage Foundation, 1994).

[183] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 457.

[184] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 457 (citing A. Chandler and H. Daems, Managerial hierarchies: Comparative perspectives on the rise of the modern industrial enterprise (Cambridge, MA: Harvard University Press, 1980)).

§34 ----Dimensions of management

The first dimension of management that was identified by Aguilera and Jackson distinguished between autonomous managers and committed managers. They explained that "[a]utonomous managers experience a large degree of independence from specific relationships within the firm . . . [and] . . . may find it easier to 'make tough decisions' or to impose hierarchical control in the firm . . . [while] . . . [i]n contrast, committed managers are dependent on firm-specific relationships to pursue their interests".[185] The second dimension of management that they identified distinguished between financial orientation and functional orientation. Managers who conceived of managerial control from a financial perspective tended to use financial mechanisms to executive control over the firm while functionally-oriented managers paid more attention to operational functions, "either through technical specialization or through strong personal involvement and leadership".[186]

§35 ----Institutional domains of management

The first institutional domain of management identified by Aguilera and Jackson was "managerial ideology", which was described as "the major beliefs and values expressed by top managers that provide organizational members with a frame of reference for action".[187] According to Aguilera and Jackson, these ideologies influence "how managers legitimate their authority, perceive organizational problems, and justify their actions".[188] The influence of managerial ideologies on whether managers have a financial or functional orientation can be illustrated by comparing managers in the US and Germany. In the US, managers typically receive what can be characterized as a "general" management education, which usually includes a significant amount of finance courses, and Aguilera and Jackson argued that this could explain why US-educated managers tend to develop managerial ideologies that emphasize "shareholder value" and are financially oriented.[189] In contrast, German managers often pursue and achieve advanced degrees in technical fields such as engineering or chemistry and Aguilera and Jackson argued that their educational background caused German managers to adopt a managerial ideology that stressed achievement of technical excellence[190] and placed more emphasis on functional orientations than financial interests. Aguilera and Jackson also explained that "[managerial] ideologies impact the autonomy or commitment of

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[185] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 457.
[186] Id. at 458.
[187] Id. (citing I. Goll and G. Zeitz, "Conceptualizing and measuring corporate ideology", Organization Studies, 12 (1991), 191–207, 191).
[188] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 458 (citing R. Bendix, Work and authority in industry: Ideologies of management in the course of industrialization (New York: Wiley, 1956)).
[189] M. O'Sullivan, Contests for corporate control. Corporate governance and economic performance in the United States and Germany (New York: Oxford University Press, 2000).
[190] P. Lawrence, Managers and management in Germany (London: Croome Helm, 1980).

managers by shaping the degree of hierarchy or consensus in routine decision making".[191] They noted that in the US and France, for example, decision making processes tended to be hierarchical, thus reinforcing managerial autonomy. In contrast, however, decision making in Germany is based on "principles of consensus that foster managerial commitment to organizational relationships and constituencies".[192]

The second institutional domain of management identified by Aguilera and Jackson was referred to as "career patterns" and explained and analyzed by distinguishing between "closed" and "open" labor markets. Japan is an example of a closed labor market since the tendency in that country is to look to fill vacancies in managerial positions through internal promotion.[193] As a result, the career patterns of Japanese managers focus on successfully rising through the ranks of their internal labor markets, a mission that results in extensive firm knowledge rather than specialization in a particular functional area. Aguilera and Jackson observed that "Japanese managers cultivate long-term firm relationships and foster a high degree of loyalty and investment in firm-specific expertise".[194] All this was put forward as evidence for the proposition that "managers in closed managerial labor markets see their careers taking place in one firm or network of firms, thereby developing a strong attachment to the firm".[195] The contrast situation can be found in the US where external labor markets often provide candidates for filling management vacancies that may appear and the incidence of such vacancies is more frequent in Japan due to the higher risks of termination in the US. In this "open market" for managerial talent and opportunities, candidates "develop portable skills, reflecting a culture of generalist management and strong financial orientation" and also tend to be more autonomous in relation to a particular firm given that they expect to be move from firm to firm several times during their careers.[196]

§36 Country-level analysis and assessment of the governance environment

It has generally been acknowledged that there is no single model of corporate governance that will be viable and effective in all countries around the world. However, while approaches taken in various countries may differ, there are certain basic standards or principles that can and should be applied regardless of specific legal, political and economic circumstances and these have been broadly identified by the Business Sector Advisory Group on Corporate Governance to the OECD as fairness, transparency, accountability and responsibility. Standard & Poor ("S&P") used these principles as a guide in developing its methodology for analyzing corporate governance practices in

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[191] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 458.
[192] Id.
[193] R. Dore, Stock market capitalism: Welfare capitalism. Japan and Germany versus Anglo-Saxons (New York: Oxford University Press, 2000).
[194] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 459 (citing M. Wakabayashi, Management career progress in a Japanese organization (Ann Arbor: University of Michigan Press, 1980)).
[195] R. Aguilera and G. Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants", Academy of Management Review, 28(3) (2003), 447-465, 459.
[196] Id.

countries and companies and generating a corporate governance score ("CGS") that "reflects Standard and Poor's assessment of a company's corporate governance practices and policies and the extent to which these serve the interests of the company's financial stakeholders, with an emphasis on shareholders' interests".[197] S&P explained that it considered corporate governance to include "the interactions between a company's management, its board of directors, shareholders and other financial stakeholders".[198] S&P assigned a CGS on a ten-point scale ("10" being the highest and "1" the lowest) and also generated scores on four components that, taken together, contributed to the overall CGS: ownership structure and influence; financial stakeholder rights and relations; financial transparency and information disclosure; and board structure and process.[199]

S&P noted that it did not produce CGS for individual countries and that the primary focus was on internal governance structure and processes at specific companies; however, S&P conceded that an overall assessment of the risks associated with governance practices of an individual company was not possible without some consideration of the legal, regulatory and market environment of the country in which the company was operating and S&P expected that as between "two companies with the same CGS, but domiciled in countries with contrasting legal, regulatory and market standards . . . [i]n the event of deterioration in governance standards at a particular company, investors and stakeholders are likely to receive better protection in a country with stronger and better-enforced laws and regulations".[200] S&P indicated that prior to assigning a CGS to companies in a particular country it would undertake an informal review and analysis of the corporate governance laws, regulations, and practices that are prevalent in the country and explained that the goal of this review and analysis was to "clarify what stakeholder rights exist as defined by legislation and regulatory practice . . . [and evaluate] . . . the relevance of these rights in practice".[201] According to S&P the four main areas of focus of its country-level analysis included legal infrastructure, regulation, information infrastructure and market infrastructure.[202]

Factors that S&P would consider when analyzing a country's legal infrastructure included the following[203]:

- What are the relevant laws that address corporate governance in the country and its various jurisdictions?

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[197] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions (July 2002), 5.

[198] Id. S&P explained that "financial stakeholders" included both shareholders of a company and the company's creditors and that this approach was based on "the premise that the quality of a company's governance process can affect its ability both to honor contractual financial obligations to creditors and to maximize the value of a company's equity and distributions for its shareholders".

[199] Id. (includes discussion of methodology used to collect information and develop and assign components of the CGS). For further discussion of the process used by S&P to assign a CGS to individual companies, see the Part on "Introduction to Corporate Governance" in this Library.

[200] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions (July 2002), 6.

[201] Id.

[202] For full discussion of each of these four main areas see Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 12-16 (July 2002).

[203] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions (July 2002), 13-14.

- How are shareholder and other stakeholder rights defined?
- What laws exist that govern insider trading, reporting and disclosure, duties and composition of boards of directors, shareholder registry and share depository, proxy rights at shareholder meetings, voting procedures (including cumulative), minority shareholder rights and rights of foreign creditors and shareholders?
- How extensive are the laws referred to above?
- Is a shareholder registry necessary to prove ownership?
- Are outside directors required?
- Does a licensed registrar keep the shareholder registry?
- What is the nature of the judicial system in law enforcement?
- Is violation of the law a common occurrence?
- Do examples exist that point to judicial success in promoting and enforcing corporate governance?
- Are there examples of poor corporate governance where the law is not effective in principle or in practice?
- Are investor lawsuits relating to corporate governance related disputes common?
- How effective are the available legal remedies?
- What is the track record of these legal processes and what is the time frame?
- How does the legal system operate in practice?

Factors that S&P would consider when analyzing a country's regulatory environment included the following[204]:

- What regulatory bodies exist and what is their purview?
- Are there regulatory gaps or areas in which regulatory responsibility overlaps among bodies?
- Do the different regulatory bodies work in co-operation or conflict with one another?
- Do market participants view specific regulations as inappropriate?
- Do SROs play a role that is relevant from the perspective of corporate governance?
- What new legislation is on the regulatory agenda?
- What are the information and timing requirements for public disclosure?
- How effectively are securities and disclosure regulations followed and enforced?
- Do regulators have sufficient resources and practical enforcement tools to achieve their mission?
- Is there a securities regulator and, if so, how long has it been in place?
- What is the relationship of securities and other regulators to stock exchanges?
- What are examples of regulatory successes and failures?

Factors that S&P would consider when analyzing a country's informational infrastructure included the following[205]:

- What are the number, quality and independence of public auditors?

[204] Id. at 14.
[205] Id. at 15.

- Is there a requirement for independent financial audit?
- How do local accounting standards compare to international accounting standards with respect to basis of consolidation, operating data in addition to financial data, financial position of subsidiaries whose health is material to the interests of the company and individual shareholders, segment data (i.e., financial performance of individual business or business units), methods of asset valuation, definitions of key financial measures (i.e., revenues, expenses, profits and losses), cash flow (i.e., sources and uses of funds), all real and contingent liabilities, evidence of transfer pricing (including hidden transfers or subsidies) and arrears with related companies?
- What is the required timing of disclosure?
- Is there ease of access to independently audited financial statements?

Factors that S&P would consider when analyzing a country's market infrastructure included the following[206]:

- What is the prevalence of listed companies or significant private ownership?
- What is the prevalence of state ownership?
- Is there ease of access to public exchanges?
- For transition economies and other countries with state-owned enterprises: what methods of privatization exist and what impact do these have on ownership structures?
- What is the importance of institutional investors (mutual funds, pension funds, insurance companies, etc.)?
- Is there a universal banking system versus separation between commercial and investment banking?
- Do banks commonly hold significant equity stakes in industrial companies?
- Are financial-industrial groups prevalent and, if so, what is the degree of transparency in their intercompany relationships?
- Do market distortions exist in the form of uncompetitive industry structures or government protection of individual companies or sectors?
- Are there signs of macroeconomic stability or stress?
- What is the nature of the political environment and is this relevant to the practice of corporate governance in the country?

§37 Convergence

Given that it appears possible to distinguish several different types of models of corporate governance it is inevitable that comparisons will be made and speculation will occur as to whether or not the world will ultimately converge toward a preference for one of the existing models or settle upon some sort of hybrid model that has yet to emerge. While setting up the debate regarding convergence in the context of changes in Japan, Osugi addressed the threshold question of just what that means and argued that there is both

[206] Id. at 15-16.

functional and formal convergence[207] and that sub-issues include convergence of fundamental policies (i.e., shareholder supremacy versus stakeholder control and efficiency versus public good); convergence of corporate practices (e.g., separation of the roles of chairperson of the board and chief executive officer, the availability of "remedies" such as "hostile takeovers", etc.); institutional convergence (i.e., one- versus two-tier boards and reliance on independent directors versus outside auditors); and statutory convergence (i.e., "soft laws", regulations by self-regulatory organizations and statutory authorization of derivative suits and class actions).[208]

Most of the comparative work has focused on the contrasts between, and relative strengths and weaknesses of, the "outsider" system used in the Anglo-American countries that emphasizes strong and regulated financial markets and relatively high disclosure standards and the "insider" systems that have been used in countries such as Germany and Japan. Many researchers have concluded that the Anglo-American system is the "more advanced and efficient mode of corporate finance and governance" and often predict that it is "inevitable" that European and Asian countries will transition to the Anglo-American model for a variety of reasons including the increase in cross-border financial flows accompanied by a call for minimum international corporate governance standards, "Western style", dictated by institutional investors in the US and UK and the increasing influence of Anglo-American securities exchanges around the world.[209] Another indicator of convergence, at least in the minds of these researchers, is the high interest in developing and disseminating global standards that has been shown by multinational organizations such as the OECD and the World Bank.

§38 --Nestor and Thompson

Nestor and Thompson, focusing on the issue of "convergence" among corporate governance systems in OECD economies, offered their own views on the main causes of "convergence".[210] In framing their observations and arguments regarding convergence,

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[207] Osugi noted that Gilson "suggest[ed] that functional convergence, when existing governance institutions are flexible enough to respond to the demands of changed circumstances without altering the institutions' formal characteristics; formal convergence, when an effective response requires legislative action to alter the basic structure of existing governance institutions". K. Osugi, "What is Converging?: Rules on Hostile Takeovers in Japan and the Convergence Debate", Asian-Pacific Law and Policy Journal, 9(1) (2007), 143-162, 144 footnote 5 (citing R. Gilson, "Globalizing Corporate Governance: Convergence of Form or Function", American Journal of Comparative Law, 49 (2001), 329, 332).

[208] K. Osugi, "What is Converging?: Rules on Hostile Takeovers in Japan and the Convergence Debate", Asian-Pacific Law and Policy Journal, 9(1) (2007), 143-162, 145.

[209] F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full. See also S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 129-130 (discussing the impact of global economic integration ("globalization") on corporate governance reform and the pressures that it places on developing countries (and firms in those countries) to adopt standards that are acceptable and understandable to investors from industrialized countries interested in providing capital to developing countries).

[210] S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43.

Nestor and Thompson began by outlining the changing roles of the various key stakeholders in the corporate governance framework.[211] First, they noted that cross-shareholding arrangements are being unwound in a number of countries. Second, concerns about overreaching by managers are being addressed in a number of countries by enhanced transparency through disclosure systems driven by improved technology that quickly and efficiently distributes information that shareholders need to evaluate managerial performance. Managerial incentives for self-dealing are also being reduced in many countries by a gradual transition toward performance-based compensation systems that presumably align the interests of managers and financial investors. Third, banks and other financial institutions are beginning to divest their ownership stakes in borrowers in order to focus more of their time and resources on coping with the demands of international competition in their own industries. Fourth, a transition in the role of the state is evidenced by a continuous stream of privatization activities. Finally, firms transition from banks to markets as sources for their capital the relationship between firms and non-shareholder stakeholders, such as labor, may well evolve away from the co-determination models that have dominated in countries such as Germany in past years.

Proceeding to their explanation of factors driving convergence, Nestor and Thompson argued that the first factor to consider was the growing integration of financial markets driven by the recognition of investors all around the world that it is prudent for them to create and hold an internationally diversified portfolio of securities. As such, investors are seriously considering investments in various countries and firms in those countries interested in gaining access to foreign capital are looking for ways to attract that capital such as listing their securities on foreign stock exchanges and by so doing accepting new and different corporate governance standards imposed by those exchanges as a condition for listing. Institutional investors have played a particularly important role in this process by using their leverage as controllers of large amounts of investment capital to require firms to establish profit targets and "insist[ing] that companies respect international norms of governance, particularly concerning the duties of management and controlling shareholders to respect demands of minority investors concerning transparency and the procedures for exercising corporate control, especially at the shareholders meeting".[212]

A second factor, often ignored, is that firms aspiring to operate on an international scale are not only having to adapt their corporate governance practices to compete in global capital markets but are also needing to make changes in their governance frameworks in order to remain competitive in increasingly global product markets. For example, Nestor and Thompson suggested that "globalization coupled with the communications revolution allows even smaller enterprises to locate suppliers easily in remote parts of the world"[213] and that this may lead companies in Japan and elsewhere that have traditionally forged long-term relationships with their suppliers, relationships that have become embedded in their corporate governance systems, to change strategies and abandon those relationships if other types of supply arrangements can improve the "bottom line" and deliver better returns to other classes of stakeholders.

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[211] Id. at 32-36.
[212] Id. at 38.
[213] Id.

A third factor mentioned by Nestor and Thompson is the erosion of "path dependency", which effectively argues that the historical background and path of nations makes changes in institutions slow and difficult and that this makes convergence in corporate governance systems hard to imagine, at least in the near future. Nestor and Thompson point out that while national histories and cultures undoubtedly create barriers to change and "alien concepts", regarding of how efficient they might be, there is ample evidence that the people in the OECD countries "are increasingly open to foreign ideas, customs and norms" and cite as support the relative calm associated with cross-border acquisitions and the importation of American style shareholder activism, including hostile takeovers, into segments of the European corporate governance system. Nestor and Thompson also mentioned that policymakers from around the world have become more and more open to international dialogue on corporate governance issues and that regional integration initiatives such as the European Union have made it much easier to implement widespread reforms that, if effective, would lead to broader standardization of laws and regulations. Still another political factor is the need for governments to achieve "success" in their privatization efforts and this has often driven political leaders to force their former state-owned enterprises to adopt governance practices that would be acceptable to foreign investors.

Finally, Nestor and Thompson referred to several trends that they believed signaled "legal convergence" and a blurring, if not elimination, of the distinctions between common and civil law countries mentioned elsewhere in this chapter. For example, they noted the continuous expansion in the scope and coverage of securities laws, which are statutory rules that firms in both common and civil law countries cannot escape by contract. In addition, changes in corporate governance-related laws in civil law countries have recognized a changing and stronger role for shareholders and removed some of the obstacles to transparency that have been problematic for shareholders in those countries in the past (e.g., new rules regarding preparation and publication of accounts). Legal convergence also follows from the integration of financial markets since larger firms are listing their shares in foreign jurisdictions, voluntarily becoming subject to the legal regimes in those jurisdictions and, eventually, transferring the governance practices developed to comply with foreign requirements back to their home countries.

§39 --Nisa and Warsi

Nisa and Warsi summarized the neo-classical foundation for arguments that convergence is inevitable, noting that they are based on "the premise that enhanced global product and labor market competition combined with financial integration leads firms to converge on a set of 'best practices' in corporate governance".[214] This argument assumes that the "best practices" are to be found in the Anglo-American corporate governance system; however, there remains support for the various alternatives to the Anglo-American system described elsewhere in this chapter and those supporters generally argue that the alternatives, which include larger roles for key stakeholders such as labor and the state,

[214] S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 132.

provide better solutions for addressing the "misalignment of interests between managers and shareholders".[215] Other commentators argue that countries will continue to have different configuration of institutions that will trigger different responses to corporate governance issues and that therefore considerable diversity with respect to corporate governance systems is just as likely as convergence given the divergence of national cultures and national conceptions of the firm and differences among countries regarding key foundational factors of governance systems such as the role of the state in regulating property rights, the rules of cooperation and competition and the national organization of social elites.[216] Another factor working against convergence, at least in the short-term, is the resistance to changes that will likely be mounted by stakeholders with a vested interest in maintaining the status quo: managers in market-based systems will resist the formation of controlling blocks of shares and financial institutions in bank-based systems will oppose limits on their rights to own shares in the firms that they support with credit and other arrangements.[217]

Nisa and Wardi observed that the debate regarding convergence is complicated not only because there is no clear consensus regarding what system is "the best" but also because the systems that are continuously being compared are themselves changing and evolving continuously to fit within the global economic and business environment. They noted, for example, that major changes in the corporate governance system followed in the US have occurred in almost every decade since the 1980s. Specifically, ". . . [i]t (the US) used shareholder primacy, driven by hostile takeovers, to carry out much needed restructuring in the 1980s . . . [i]t insulated directors from hostile takeover allowing them to use their valuable discretion to build on their newly restructured companies during the 1990s [and] . . . [i]t increasingly utilized bank monitoring to create another efficient tool to reduce agency costs throughout this era". The 2000s brought even more legal and regulatory changes to the corporate governance system in the US and the economic problems that have broken out around the world since the turn of the century have driven policymakers everywhere to seek new solutions for how firms, and the relationships among their stakeholders, should be governed. It is reasonable to predict that the roles of two key stakeholders, financial institutions and the state, will be closely assessed along with the duties and responsibilities of institutional investors that hold funds on behalf of small individual investors who have seen their financial fortunes deteriorate in the face of what might rightly be called massive failures within corporate governance systems of all types around the world.

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[215] Id. at129.

[216] F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full. For example, antitrust laws in the US and UK have long disfavored the type of networking among actual and potential competitors that frequently is allowed to occur in European and Asian countries. In addition, the US has traditionally balked on removing restriction on share ownership in individual firms (i.e., debtors) by financial institutions.

[217] See also S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 25-28 (noting that corporate governance reforms are often inhibited by "entrenched owners and managers at the level of firms" and political economy factors at the national level, including concentrated corporate sector wealth).

§40 Corporate governance in developing countries

As discussed elsewhere in this chapter, there has been a substantial amount of debate regarding the factors that influence the choice and operation of corporate governance systems in a particular country. Among the factors that are often mentioned, which are applicable to both developing and developing countries, are the legal and regulatory framework (i.e., common law versus civil law) and related institutions, particularly the extent to which a country's laws protect investor and property rights and the extent to which those laws are enforced; political decisions regarding the power and influence of various potential stakeholders such as financial institutions and/or labor organizations; the societal culture, particularly those cultural characteristics that are based on elements of trust; economic factors (i.e., variations in market size, firm size, uncertainty and industry structure); and the role of the state as owner, manager and/or regulator of key business enterprises.[218] Developing countries face a larger context when dealing with corporate governance in that they must not only consider the issues of corporate collapse and creative accounting that have been the driving force behind corporate governance reforms in developed countries, but they must also consider the effects on economic development and globalization and must also balance a locally acceptable and relevant corporate governance strategy with the need to meet internal expectations.[219]

The situation, prospects and challenges in each of the developing countries discussed below are obviously unique; however, the Center for International Private Enterprise has suggested that the following general challenges confronting developing, emerging and transitional economies with respect to creating effective corporate governance systems in their countries include[220]:

- "Establishing a rule-based (as opposed to a relationship-based) system of governance;
- Combating vested interests;
- Dismantling pyramid ownership structures that allow insiders to control and, at times, siphon off assets from publicly owned firms based on very little direct equity ownership and thus few consequences;
- Severing links such as cross shareholdings between banks and corporations;

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[218] See F. Toonsi, "Cultures of Control: International Corporate Governance", QFinance, http://www.qfinance.com/corporate-governance-viewpoints/cultures-of-control-international-corporate-governance?full; S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 129; and S. Nestor and J. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway?" in S. Nestor and T. Yasui (Eds.), Corporate Governance in Asia: A Comparative Perspective (Paris: Organisation for Economic Co-operation and Development, 2000), 19-43, 40..

[219] D. Reed, Corporate Governance Reforms in Developing Countries, 37 Journal of Business Ethics 223-247 (2002). Although the reports and information are somewhat dated an excellent starting point for understanding corporate governance in developing countries is the governance assessments completed as part of the joint World Bank-IMF Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSC). These assessments are available through The World Bank website at http://www.worldbank.org/ifa/rosc_cg.html

[220] Center for International Private Enterprise, Instituting Corporate Governance in Developing, Emerging and Transitional Economies: A Handbook 24-25 (2002).

- Establishing property rights systems that clearly and easily identify true owners even if the state is the owner;
- De-politicizing decision-making and establishing firewalls between the government and management in corporatized companies where the state is a dominant or majority shareholder;
- Protecting and enforcing minority shareholders' rights;
- Preventing asset stripping after mass privatization;
- Finding active owners and skilled managers amid diffuse ownership structures;
- Promoting good governance within family-owned and concentrated ownership structures; and
- Cultivating technical and professional know-how."

§41 Analysis and assessment of corporate governance practices

It has generally been acknowledged that there is no single model of corporate governance that will be viable and effective in all countries around the world. However, while approaches taken in various countries may differ, there are certain basic standards or principles that can and should be applied regardless of specific legal, political and economic circumstances and these have been broadly identified by the Business Sector Advisory Group on Corporate Governance to the OECD as fairness, transparency, accountability and responsibility. Standard & Poor ("S&P") used these principles as a guide in developing its methodology for analyzing corporate governance practices in countries and companies and generating a corporate governance score ("CGS") that "reflects Standard and Poor's assessment of a company's corporate governance practices and policies and the extent to which these serve the interests of the company's financial stakeholders, with an emphasis on shareholders' interests".[221] S&P explained that it considered corporate governance to include "the interactions between a company's management, its board of directors, shareholders and other financial stakeholders".[222] S&P assigned a CGS on a ten-point scale ("10" being the highest and "1" the lowest) and also generated scores on four components that, taken together, contributed to the overall CGS: ownership structure and influence; financial stakeholder rights and relations; financial transparency and information disclosure; and board structure and process.[223]

§42 --Ownership structure and influence

S&P noted that understanding the ownership structure of a company is essential to identifying how governance works for that company and is particularly important in situations where there is a known majority shareholder (or when de facto majority ownership and control exists based on collusive shareholding arrangements) who may be

[221] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions (July 2002), 5.
[222] Id. S&P explained that "financial stakeholders" included both shareholders of a company and the company's creditors and that this approach was based on "the premise that the quality of a company's governance process can affect its ability both to honor contractual financial obligations to creditors and to maximize the value of a company's equity and distributions for its shareholders". Id.
[223] Id. at 7 (includes discussion of methodology used to collect information and develop and assign components of the CGS).

tempted to act in a manner that is not necessarily in the interests of all shareholders.[224] The first sub-category used by S&P with respect to ownership structure focused on transparency of ownership and looked at two criteria: (1) there should be adequate public information on the company's ownership structure, including, where relevant, information on beneficial ownership behind corporate nominee holdings; and (2) the company's actual ownership structure should be transparent, and should not be obscured by crossholdings, management controlled corporate holdings, nominee holdings, etc. According to S&P the key analytical issues for this sub-category included breaking down shareholdings, identification of substantial/majority holders (including indirect ownership and voting control), shareholdings of directors, evidence of indirect shareholdings and shareholdings of management.

The second sub-category used by S&P with respect to ownership structure focused on concentration and influence of ownership and looked at three criteria: (1) if large blockholders exist, these should not exert influence that is detrimental to the interests of other stakeholders and minority shareholders should be protected against loss of value or dilution of their interests (e.g., through capital increases, from which some shareholders are excluded, or through transfer pricing with connected companies); (2) concentration of economic interest and influence of controlling shareholders of the parent/holding company on independent board/management action should not occur through block holdings of key operating subsidiaries and through effective control of key customers and suppliers; and (3) shareholders should not be disadvantaged by management and insider shareholders who are shielded from accountability. According to S&P the key analytical issues for this sub-category included affiliations amongst shareholders; commercial arrangements between the company and affiliates/third parties; corporate structure, shareholding and management of key affiliates; outside holdings of major shareholders; terms of key contracts and licenses; internal financial and operational control system; management shareholding/voting control and contracts with directors/management.

§43 --Financial stakeholder rights and relations

According to S&P its assessment of financial stakeholder relations was concerned with how companies treated their financial stakeholders and, specifically, how their corporate governance practices and policies served the interests of those stakeholders.[225] The first sub-category used by S&P with respect to financial stakeholder rights and relations focused on voting and shareholder meeting procedures and looked at three criteria: (1) shareholders holding an appropriate percentage of voting rights should be able to call a special meeting and shareholders should have the opportunity to ask questions of the board during the meeting and to place items on the agenda beforehand; (2) a shareholders' assembly should be able to control appropriate decisions through processes that ensure participation by all shareholders; and (3) the processes and procedures used for advising shareholders of general meetings should provide for equal access of all shareholders and should ensure that shareholders are furnished with sufficient and timely information so that they are able to make informed voting decisions. According to S&P

[224] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions (July 2002), 8.
[225] Id. at 9-10.

the key analytical issues for this sub-category included shareholder meeting procedures, notices of meeting, documents sent to shareholders, charter provisions on the convening of meetings, arrangements for shareholders' participation at meetings, previous meeting minutes, shareholder information on voting procedures, any deposit agreement for overseas listing, proxy arrangements, charter provisions on voting thresholds and shareholder attendance records.

The second sub-category used by S&P with respect to financial stakeholder rights and relations focused on ownership rights and financial rights (including dividends) and looked at four criteria: (1) there should be secure methods of ownership of shares and full transferability of shares; (2) a company's share structure should be clear and control rights attached to shares of the same class should be uniform and easily understood; (3) a shareholders' assembly should be able to exercise decision rights in key areas, and procedures should be in place that ensure that minority shareholders are protected against dilution or other loss of value (e.g., through related party transactions on non-commercial terms); and (4) all common shareholders should receive equal financial treatment including the receipt of an equitable share of profits (i.e., dividends or other profit distributions). According to S&P the key analytical issues for this sub-category included charter provisions, arrangements with registrar, share structure – classes and rights of common and preferred shares, charter provisions – shareholder and board authorities, shareholder agreements, dividend history and examples of share repurchases and swaps.

The third sub-category used by S&P with respect to financial stakeholder rights and relations focused on takeover defenses and corporate control issues and looked at two criteria: (1) the company should maintain a level playing field for corporate control, and should be open to changes in management and ownership that provide increased shareholder value; and (2) takeover defenses are not necessarily considered to be negative governance features on their own; such defenses are analyzed against the current ownership structure to determine how virulent or benign they are in practice and how the board intends to use them to increase shareholder value. According to S&P the key analytical issues for this sub-category included effects of provisions in company charter or articles of association; arrangements as disclosed in regulatory filings or their equivalent, annual reports, records of resolution, notices of meetings and proxy materials; and interviews with Board secretary.

§44 --Financial transparency and information disclosure

According to S&P its assessment of financial transparency and information disclosure was concerned with timely disclosure of adequate information concerning a company's operating and financial performance and its corporate governance practices.[226] S&P argued that a hallmark of a well-governed company is high standards of time disclosure and transparency and that such practices "enables shareholders, creditors and directors to effectively monitor the actions of management and the operating and financial performance of the company".[227] The first sub-category used by S&P with respect to

[226] Id. at 10-11.
[227] Id. at 10.

financial transparency and information disclosure focused on the quality and content of public disclosure and looked at whether financial reporting and disclosure is being clearly articulated and completed to a high standard. According to S&P the key analytical issues for this sub-category included comprehensiveness of financial statements and reports (including data on key affiliates) disclosed to shareholders and investment community, quality of non-financial information and quality of corporate records available at the company's headquarters.

The second sub-category used by S&P with respect to financial transparency and information disclosure focused on the timing of and access to public disclosure and looked at three criteria: (1) as a result of high internal transparency standards and effective internal control policies, all publicly disclosable information should be promptly available and freely accessible to the investment community and shareholders; (2) the company's by-laws, statutes and/or articles should be clearly articulated and readily accessible to all shareholders; and (3) the company should maintain a website and make company reports, summary reports and/or other investor relevant information available in English and the local language, if applicable. According to S&P the key analytical issues for this sub-category included timeliness of filing financial and other statements with regulatory bodies, procedures for disclosure of market sensitive information, briefing materials for investment community presentations, availability of records to all shareholders at the company's headquarters, reports to shareholders and quality of website and online reporting.

The third sub-category used by S&P with respect to financial transparency and information disclosure focused on the independence and effectiveness of the audit process and looked at two criteria: (1) auditors should be independent of the board and management in all material respects and should also be reputable; and (2) there should be procedures in place to maintain the independence of the outside auditors. According to S&P the key analytical issues for this sub-category included audit contract, finance and control systems, audit committee process, charter provisions prescribing relationships with auditor and audit reports.

§45 --Board structure and process

According to S&P its assessment of board structure and process was concerned with the role of the corporate board and its ability to provide independent oversight of management performance and hold management accountable to shareholders and other relevant stakeholders.[228] S&P noted: "Separation of authority at the board level is important. Boards with high accountability often include a strong base of independent outside directors that look after the interests of all shareholders—both majority and minority holders. Conversely, companies with a strong, self-interested majority shareholder—or dominated by a few such shareholders—may have boards with limited accountability to all shareholders. This may be case when the company's management is heavily represented on the corporate board."[229] Other factors relevant to assessing board

[228] Id. at 11-12.
[229] Id. at 11.

structures and processes include the procedures for determining executive remuneration and benefits and the processes for nomination and election of representatives of minority shareholders and outside directors.

The first sub-category used by S&P with respect to board structure and process focused on board structure and composition and looked at whether the board was structured in such a way as to ensure that the interests of all the shareholders could be represented fairly and objectively. According to S&P the key analytical issues for this sub-category included board size and composition, board leadership and committees and representation of constituencies. The second sub-category used by S&P with respect to board structure and process focused on the role and effectiveness of the board and looked at two criteria: (1) the board should bear overall accountability for the performance of the company; and (2) the board should be ultimately responsible for the system of internal risk control at a company. According to S&P the key analytical issues for this sub-category included definitions of board role; board-level processes for identifying, evaluating, managing and mitigating risks faced by the company; board and committee meeting's agenda and papers; and management compensation process

The third sub-category used by S&P with respect to board structure and process focused on the role and independence of "non-employed" directors and looked at two criteria: (1) an appropriate proportion of the "non-employed" directors should be truly independent and act as such and independent or outside directors should ensure that the long-term interests of all shareholders are represented by including that the interests of other stakeholders are duly taken into account; and (2) directors should be elected under a transparent system in which they are not able to participate. According to S&P the key analytical issues for this sub-category included relationships between outside board members and senior management, history of involvement of outside directors with company, terms of outside director engagement, control committee independence and activity, articulation of the specific role of outside directors and the procedures for nomination and election of directors.

The fourth sub-category used by S&P with respect to board structure and process focused on board and executive compensation, evaluation and succession policies and looked at three criteria: (1) directors and executives should be fairly remunerated and motivated to ensure the long-term success of the company; (2) appropriate incentives should be in place connecting executive pay to the performance of the company; and (3) there should be clearly articulated performance evaluation and succession policies/plans for employed directors of the company. According to S&P the key analytical issues for this sub-category included level and form of compensation, the extent to which pay is connected to financial or other performance measures, performance evaluation criteria, independence and integrity of compensation setting process and succession planning.

§46 Governance problems

For a number of reasons, corporate governance has been "front page" news all around the world over the last two decades. Unfortunately, one of those reasons has been the proliferation of scandals and crises that trace their roots to apparent shortcomings in corporate governance systems in countries dispersed widely around the world. While the range of governance-related problems and crises has been diverse it is possible to identify various general factors that frequently appear to be among the causes, such as the following list provided by Banks[230]:

- Unethical conduct among the key internal stakeholders of a company (i.e., poor judgment or behavior on the part of directors, executives and/or employees);
- Weak and ineffective boards of directors who are subject to influence and manipulation by powerful (and often charismatic) chief executives and lack the expertise necessary to actively manage company initiatives and challenge their executives;
- Inattentive directors who fail to focus on issues of importance and directors who are involved in transactions and relationships with executives that create potential and actual conflicts of interest;
- Ineffective internal controls that fail to detect or prevent problems; and
- Poor external "checks and balances" (e.g., regulators, auditors, capital markets and/or legal frameworks) that are unable to set or enforce proper governance standards.

A survey conducted by McKinsey in 2002 following numerous highly-publicized governance-related disasters around the world (e.g., Enron, Tyco, Adelphia, Daewoo etc.) provided additional data on problems in the governance area as respondents, all members of boards of directors, frequently pointed to the following shortcomings: the lack of effective mechanisms for assessing executive compensation practices or financial/operating risks; the absence of adequate succession planning for the CEO position; the absence of effective formal risk management planning; inadequacies with respect to regular formal evaluations of directors and annual re-election of directors; poor levels of director knowledge with respect to the strategies of their company, competitive conditions in their company's industries, the risks confronting their company and how their company's business creates value; and poor board oversight of the activities of the chief risk officer, internal auditors and chief legal counsel.[231] A quarter of the respondents indicated that they were seriously considering discontinuing their service as directors due to concerns about potential liability because of governance-related issues and 90% of the respondents felt that significant changes were needed to improve governance such as stronger audit committees, greater independence for directors (including designation of a lead independent director), splitting the roles of board chairman and CEO and imposing a ban on external auditor/consultant business.

Banks believed that it was possible and useful to distinguish between internal and external governance mechanisms. Internal governance mechanisms determined "corporate accountability" and were centered on the board of directors; executive management, particularly the CEO; internal control groups (e.g., finance/accounting, risk management, operations settlement, information technology, law and compliance,

[230] E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 8.
[231] E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 104 (citing McKinsey & Co., Director Opinion Survey on Corporate Governance (2002)).

internal audit and human resources) and codes of conduct and related policies.[232] External governance mechanisms determined "systemic accountability" and were centered on financial and structural governance mechanisms and forces operating outside of, or external to, the individual corporation including supervisory and regulatory oversight by agencies established by national, regional and local governments; legal/bankruptcy regimes; capital markets access; markets for corporate control and regulation/oversight of corporate control activities; block holder monitoring; activist institutional investor monitoring; external audits and credit rating agency review.[233]

Banks argued that internal, or "micro", governance problems failures could be categorized as failures of board directors and executive managers, failures of internal controls and failures of external controls.[234] Specific types of failures among board directors and executive managers include ineffective boards, CEOs with conflicts of interest, breaches of duties of care and loyalty, entrenched management and failed corporate policies. With respect to failures of internal controls key problems include a lack of technically qualified independent controls, liberal accounting policies, excessive risk-taking and inadequate internal audits. Finally, various failures of external controls follow from shortcomings in external governance mechanisms and thus could include inadequate supervisory and regulatory mechanisms, insufficient legal/bankruptcy regimes, lack of monitoring by block holders and/or activist investors, misguided/insufficient corporate control activity and unacceptable external audit practices.

Each of the systems of corporate governance discussed elsewhere in this chapter has their own unique gaps and potential shortcomings that can provide fertile ground for governance crises and problems. For example, potential issues with the hybrid model described below and commonly found among countries in the Asia-Pacific region can be illustrated by the following summary provided by Banks of some of the major governance flaws that led to the problems in Indonesia[235]:

- Government regulations and local laws permitted business groups to own cross-shareholdings in other companies without restriction. For example, family-controlled businesses often owned large, sometimes controlling, interests in local financial institutions, a situation that provided those businesses with direct, and virtually unlimited, access to credit that was available and provided without appropriate scrutiny and in amounts that frequently exceeded the financial capacity of the borrowers.
- Local regulations not only permitted large corporate ownership of local banks and other financial institutions, leading to the dubious lending practices noted above, they were also overseen by regulators who failed to enforce collateral rules, concentrated lending limited and minimum capital adequacy standards and failed to strictly review foreign currency funding and liability activities of local banks.

232 E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 23, 32-53.
233 Id. at 23-24, 54-82.
234 Id. at 103-146.
235 Id. at 255.

- Easy access to bank-supplied credit allowed companies to obtain funding without having to undergo the scrutiny that presumably exists, at least to some extent, in public capital markets and the weakness of the public markets allowed companies to get away with opaque financial disclosures and avoid compliance with accounting standards (which were themselves either non-existent or not strictly enforced). Banks noted that, as a result, "stakeholders could gain no comfort or information from the presentation of annual accounting statements".[236]
- Corruption and general disregard for ethical norms was rampant among company and government officials and Banks noted that "[c]ollusion, bribery, and corruption were the operating norm for many, and poor behavior went unnoticed or unpunished by regulatory authorities" and also that "regulators tolerated corrupt practices and widespread abuse of public interests".[237]
- Foreign banks were just as culpable as local financial institutions in their failure to perform basic credit analysis and due diligence on local companies before extending credit and their willing to rely heavily on political connections rather than credit fundamental in selecting borrowers so as not to miss out on perceived "opportunities" in a well-publicized emerging market.

Governance issues need to be discussed in a practical framework and Banks suggested that one way to do this is to focus on the impact of governance problems on corporate operations.[238] Banks noted that, of course, "[b]ad governance is not the only possible source of corporate dislocation (for example a firm might encounter difficulties as a result of a poor economic environment, client lawsuits, and regulatory restrictions, which might be completely unrelated to bad governance)"; however, he suggested that governance problems can, if not addressed quickly, draw firms into the following four stage process of continually escalating difficulties and threats to ongoing operations[239]:

- First Stage Impact – Reputational Damage: Negative press, reputational questions and temporary stock price decline
- Second Stage Impact – Early Financial Problems: Negative press, reputational questions, changing supplier/credit terms, rising borrowing costs, tightening of liquidity and more significant stock price decline
- Third Stage Impact – Growing Financial Distress: Negative market perception, reputational questions, credit downgrades, reduced financial flexibility, severe liquidity squeeze, cancellation of credit facilities, exorbitant borrowing costs and depressed stock price
- Fourth Stage Impact – Bankruptcy: Reorganization or liquidation with significant impact of key stakeholders such as shareholders, creditors, employees, suppliers, customers, professional service providers, communities, regulators and competitors

§47 Governance reforms

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[236] E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 255.
[237] Id.
[238] Id. at 147-165.
[239] Id. at 149. Banks provides extended studies of flawed governance in a number of countries around the world in Chapter 7 (pages 166-230) of the cited publication.

Building on his above-described distinction between internal and external accountabilities with respect to corporate governance Banks provided a host of suggestions for reforms. With respect to internal governance practices and activities Banks stressed that "good governance" was the actual goal and objective and that this included disciplined, fair and ethical behavior; sound, independent judgment; accountability and responsibility; and transparent operations, strategy and disclosure.[240] In order to achieve these objectives, Banks argued for the pursuit of a "micro governance reform" agenda based on strengthening the board of directors and executive management, refocusing corporate policies and enhancing internal controls. Specific recommendations for actions in each of these areas included[241]:

- Reconfiguring and, if necessary, re-staffing the board of directors so that it becomes independent, active, responsive and small; energized, dedicated and technically capable; and aligned economically with the success or failure of the company.
- Staffing the executive management team in a way that separates the roles of chairperson and CEO; creates and promotes economic alignment between the actions of executives and the success or failure of the company; and promotes cooperative behavior and willingness to share information with directors.
- Implementing specific reforms at the board level to establish active, independent and responsive boards including reducing board size; creating technically expert, independent board committees (e.g., audit (internal control), risk management, nominating and compensation committees); separating the roles of chairperson of the board and CEO and designating a lead independent director; aligning the interest of directors with those of shareholders; and increasing director accountability (and attention to his or her duties) by limiting directors' and officers' insurance coverage.
- Creating, improving or reinforcing corporate policies designed to develop rational compensation standards, create effective disclosure, support shareholders' rights, return excess capital, define and publicize strategy, establish and demonstrate a long-term perspective and engage institutional investors.
- Embarking on a program to enhance internal controls by developing and following proper accounting policies, enhancing internal audit controls, reinforcing a culture of risk identification and management, implementing crisis management programs and conducting effective "post-mortems".

Banks also argued that any of the micro reforms instituted by companies would be more effective when are conducted within a broad macro-environment based on a "systematic framework that establishes or enhances market mechanisms, promotes better standards and imposes stricter discipline" and thus "[benefits] individual companies and their stakeholders as well as broader industrial sectors and economies".[242] Some of the specific recommendations for "macro governance reforms" included Promoting changes in regulatory oversight including regulating potential conflicts of interest, promoting

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[240] E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 260.
[241] For further discussion see E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 259-290.
[242] E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 291.

uniform and meaningful accounting rules, developing proper regulatory disclosure standards, encouraging long-term investments, protecting assets and pensions and enhancing general governance mechanisms; strengthening legal frameworks and bankruptcy processes including legal guidelines relating to corporate structure and operations, capitalization, limited liability, rent and control rights and property rights; deepening capital markets and promoting corporate control activity; enhancing external audit practices; and encouraging investor activism.[243]

Perhaps the most well-known recent program of corporate governance reforms was the Sarbanes-Oxley Act of 2002 adopted in the US and discussed in detail below. However, scandals, and investigations of corporate governance practices at the highest levels of government, have not been confined to the US and there have been significant events and developments in other industrialized countries in recent years that highlight the attention being given to governance issues. For example, "bad" corporate behavior has been tapped as one of the factors leading to severe financial crises in Russia, Asia and Brazil in the late 1990s and the economic woes that have been felt by the Japanese for two decades have been blamed, at least in part, on a lack of transparency in Japan's corporate governance system and an unwillingness to integrate independence into the board rooms of Japanese corporations. The United Kingdom, watching developments in the US intently, has had a continuous stream of changes to its codes and regulations relating to corporate governance and financial markets.[244] The European Union, its members torn and beaten by financial crisis, has embarked on an effort to improve the corporate governance framework among its members with a particular focus on improving the diversity and functioning of the boards of directors and the monitoring and enforcement of existing national corporate governance codes and identifying way to enhance the engagement and participation of shareholders. In addition, the perceived need to improve corporate governance has attracted the interest of a number of global economic and political organizations such as the Organisation for Economic Co-Operation and Development, or "OECD".[245]

§48 Governance reforms: US and the Sarbanes-Oxley Act

[243] For further discussion see E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics (2004), 291-317.

[244] A number of corporate governance reports have been issued in the UK including the Cadbury Committee in 1992 (emphasized the role of the board in corporate governance and suggested best practices for board composition and creation and responsibilities of board committees to oversee audits, compensation and nominations), the Greenbury Report in 1995 (standards for director compensation and disclosure of compensation) and the Hampel Report in 1998 (emphasizing disclosure and quality of board governance). S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 134.

[245] An excellent resource for tracking developments in corporate governance in a wide range of countries is the online Global Center for Corporate Governance created, sponsored and maintained by Deloitte, which can be accessed at http://www.corpgov.deloitte.com/site/global/. A list of various corporate governance reports for different countries, including the Australia, Canada, France, India, the Netherlands, the UK and the US appears in S. Nisa and K. Warsi, "The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices", Asian Social Science, 4(9) (2008), 128-136, 134 (citing D. Norburn, "International Corporate Governance Norms", European Business Journal, 12(3) (2000), 116-133.

Corporate governance reform became a major topic of discussion in the US as it struggled to weather unprecedented turbulence in the business and financial markets during the early 2000s. Scandals and substantial losses by ordinary and institutional investors led to substantial scrutiny of corporate management and the professionals who provide advice and guidance to the chief executive and financial officers of public companies. The result was tremendous changes in the regulatory environment for governance of public companies that thrust the traditional US corporate governance scheme that had existed for years into a state of transition. Congress and the Executive Branch, through sweeping legislation such as the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act")[246], the Securities and Exchange Commission ("SEC") and the major securities exchanges developed new rules that expanded the rights of, and protections for, shareholders while imposing substantial obligations on directors, officers, outside auditors, attorneys, and investment bankers. Additional changes and reforms have been made in the US since the Sarbanes-Oxley Act came into effect and the work of Congress, the SEC and the various securities exchanges has also been supplemented by guidelines continuously issued by industry and professional groups and modifications to state corporations laws in Delaware, the preferred state of incorporation for a majority of public companies in the US, and elsewhere.[247]

The overriding purpose of the changing corporate governance scheme was to establish the shareholders as the principal beneficiaries of the fiduciary duties and management responsibilities imposed on the board of directors and the officers and managers of the corporation. Notable consequences of the regulatory changes included:

- The fiduciary obligation of the directors and officers, as well as of the professional advisors for the corporation, to the shareholders was enhanced and focused through the imposition of additional duties on directors to oversee the flow of information made available to investors;
- Directors, particularly those serving as members of audit committees of public companies, were given unprecedented authority to participate directly in day-to-day management of the corporation, at least in relation to supervision of the auditing and reporting process;
- The traditional powers of senior management in relation to directors was substantially reduced, as the board was empowered to act independently with respect to selection of directors and auditors;
- New duties were imposed on professional advisors to public companies, including serious reporting obligations on attorneys practicing on behalf of an issuer before the SEC and on the independent auditors of public companies;

[246] Pub. L. No. 107-204, 116 Stat. 745 (2002). Detailed discussion of certain of the key provisions of the Sarbanes-Oxley Act is included throughout this Library. For example, with respect to the enhanced duties and responsibilities of audit committees of the board of directors of public companies in the US, see "Board Committees" in "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[247] For example, recommendations regarding principles of "best practices" with respect to corporate governance have been announced by the American Bar Association's Task Force on Corporate Responsibility, the Business Roundtable and the American Law Institute.

- The framework relating to disclosure and accounting requirements was significantly altered by the creation of a new oversight body for accounting firms involved in the audit of public companies and the adoption of new rules regarding the use and explanation of accounting methods that diverge from generally accepted accounting principles ("GAAP");
- New rules for director and executive compensation were designed to increase the independence of directors in the course of their oversight responsibilities and reduce the incentives for executives to use non-traditional accounting and reporting strategies; and
- Increased scrutiny of internal controls established by public companies, as well as the degree of auditor independence.

The Sarbanes-Oxley Act also created criminal sanctions, and enhanced white-collar crime penalties, that apply to violations of the securities laws. Among other things, these provisions deal with alteration, destruction or concealment of corporate or audit records, including requirements relating to the maintenance of work papers by accountants; prohibitions on the ability of a debtor to use bankruptcy proceedings as a way to avoid, through discharge, liabilities incurred as a result of a violation of the securities laws; extension of the statute of limitations for private causes of action under the securities laws; evaluation and amendment of the United States Federal Sentencing Guidelines relating to crimes that involve the obstruction of justice; creating protection for "whistleblowers" in the form of civil and criminal sanctions against anyone that retaliates against persons who report potential violations of the securities laws or any other federal law that is intended to protect shareholders from fraud; and enhancement of criminal penalties under existing statutes as well as creation of new criminal statutes directed at activities that defraud the shareholders of public companies.

§49 --Shareholders

The overriding purpose of the changes to corporate governance scheme in the US implemented by the Sarbanes-Oxley Act was to establish the shareholders as the principal beneficiaries of the fiduciary duties and management responsibilities imposed on the board of directors and the officers and managers of the corporation. The notion that the fiduciary duties of directors and officers of a corporation run to the shareholders is not new. However, the Sarbanes-Oxley Act, as well as other substantial changes recently made to SEC rules and procedures, was intended to enhance the level of information and protection for investors in public companies. For example, corporate responsibility for the preparation and overall accuracy of financial reports was substantially increased by requirements for certification of the periodic reports (i.e., Forms 10-K and 10-Q) required to be filed with the SEC and publicly disclosed to investors and the establishment of disclosure controls and procedures. In addition, the breadth and scope of the information that must be included in periodic reports was enhanced by requiring mandatory disclosure of material correcting adjustments to financial statements identified by the company's auditors; off-balance-sheet transactions; reconciliation of pro-forma financial statements with GAAP; management's assessment of the company's internal controls; the existence of a code of ethics for the senior officers of the company; and the composition of the audit committee of the board, including participation by any person(s) qualifying as "financial experts."

The SEC monitors compliance with these requirements by increasing the frequency and intensity of its review of the disclosures made by certain types of issuers in their periodic reports, including issuers that have issued material restatements of financial results; experienced significant volatility in their stock price; the largest market capitalization; significant disparities in their price-to-earnings ratios; and operations that significantly affect any material sector of the economy. Enhanced information flow to shareholders has been supplemented by expanded corporate democracy in areas where directors and executive officers have sometimes engaged in excessive activities. Most notably, shareholders of listed companies must, subject to certain limited exceptions, be permitted to vote on and approve all stock option and other equity-compensation plans (and material modifications thereto).

§50 --Directors

Directors, particularly outside directors that are not involved in the day-to-day management (i.e., "outside directors"), have been asked to assume an expanded role in monitoring the business of the corporation and the actions of senior executives. The Sarbanes-Oxley Act, as well as the revised listing requirements of the major securities exchanges, relies heavily on "independence" requirements that are designed to ensure that the director group includes experienced managers who can evaluate the activities and performance of the management team without actual or apparent conflicts of interest. Outside directors are also taking on greater responsibilities through their service as members of various board committees, particularly the audit committee. In addition to the rules that relate specifically to the board of directors and its committees, directors also became subject to many of the rules and regulations that apply to senior managers of public companies.[248]

§51 --Senior management

The senior officers of a corporation, notably the president, chief executive officer ("CEO") and chief financial officer ("CFO"), are typically vested with all of the power and authority required for the day-to-day operation of the business, subject to oversight by the board of directors.[249] While this general concept survived the wave of corporate governance reforms, a number of new rules and regulations were adopted that were designed to curb the incentives for senior managers of public companies to engage in activities that might be harmful to investors. Examples include the following:

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[248] For further discussion of the roles and duties of corporate directors, see the chapter on "Directors' Rights, Duties and Liabilities" in "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[249] For further discussion of the roles and duties of the CEO, CFO and other members of the executive team, see the chapter on "Role and Importance of the Executive Team" in "Governance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

- Officers were prohibited from exerting, or attempting to exert, improper influence on the conduct of an audit, including any attempt to fraudulently influence, coerce, manipulate or mislead any public or certified accountant engaged in the audit.
- The CEO and CFO are now required to forfeit certain bonuses and profits in the event their company is required to restate its accounting results due to material non-compliance by the company, as a result of misconduct, with any financial reporting requirement imposed under the securities laws.[250]
- Any officer who violates Section 10(b) of the Exchange Act of 1934 (the "Exchange Act") or Section 17(a)(1) of the Securities Act of 1933 (the "Securities Act"), including the rules and regulations promulgated thereunder, can be barred from acting as a director or officer of a reporting company if a court determines that the person's conduct demonstrates "substantial unfitness" to serve in such capacities.
- Executive officers of reporting companies are prohibited from engaging in certain trading activities in securities of such companies during pension fund blackout periods.
- Personal loans to officers of reporting companies have essentially been prohibited.

Each of the prohibitions listed above applies with equal force to directors of public companies (including outside directors).

§52 --Outside auditors

Many of the allegations of corporate mismanagement and fraud in recent years in the US have been based on material deficiencies in the financial reports filed with the SEC and disseminated to investors. While in most cases, misstatements in such reports could be traced to active attempts by management to conceal important transactions, Congress and the SEC believed that outside audit firms could not be completely excused from the causes of poor reporting. In response, the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board ("PCAOB") to oversee the auditing of public companies subject to the securities laws. The PCAOB is responsible for the registration of public accounting firms that prepare audit reports for reporting issuers; the establishment of auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for reporting issuers; and for inspection and investigation of registered accounting firms.

In addition, the Sarbanes-Oxley Act shifted responsibility for oversight of the relationship between registered accounting firms and the public companies they audit to the audit committee of the board of directors. New rules required that the audit committee of a reporting issuer must approve, in advance, all audit and non-audit services to be provided by a registered accounting firm to the issuer. With respect to non-audit services, the

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[250] See Sarbanes-Oxley Act § 304(a), 15 U.S.C.A. § 7243(a). Both the CEO and the CFO must reimburse the company for any bonus or equity-based compensation and profits realized from the sale of the company's stock in the year following the publication of the original financials and since the Sarbanes-Oxley Act does not indicate whose misconduct will be relevant or the level of misconduct (e.g., negligent, knowing or willful) that is required in order for the penalty to apply it is possible the penalties will apply even when the CEO or CFO is not personally connected with the misconduct.

engagement must either be expressly approved by the audit committee or must be entered into pursuant to detailed prior approval policies established by the audit committee and the committee must receive timely notification of the engagement. The approval requirements were supported by new disclosure provisions that dictate that reporting companies must provide information in their periodic reports regarding fees paid to their registered accounting firms for a wide variety of services, including audit services, employee benefit audits, due diligence for acquisitions, internal control review and other consulting services relating to accounting and reporting standards.

Registered accounting firms must also deliver periodic reports to their issuer-clients disclosing all critical accounting policies and practices used by the issuer-client; any discussions with management of alternative accounting treatments of financial information within GAAP, including the ramifications of such treatments and treatment preferred by the accounting firm; and all other material written communications between the accounting firm and management of the issuer-client. Registered accounting firms are prohibited from performing audit services for an issuer-client if any key executive of the client was employed by the firm and involved in an audit of the client within a year prior to the date of the audit. An accountant is subject to censure by the SEC upon a determination by the SEC that the person does not possess the requisite qualifications to represent others; is lacking in character or integrity or has engaged in unethical or improper professional conduct; or has willfully violated or aided and abetted another to violate, any provision of the securities laws.

§53 --Attorneys

The practice of attorneys appearing and practicing before the SEC was substantially impacted by the professional standards for attorneys included in the Sarbanes-Oxley Act. In general, covered attorneys are required to report evidence of a material violation of the securities laws or breach of fiduciary duty by the company or an agent thereof to the CEO or chief legal officer of the company. In the event that the attorney does not receive an appropriate response from legal counsel or the CEO, the evidence must be reported to other recognized bodies, such as the audit committee or the entire board of directors. The failure of an attorney to comply with these standards can expose the violator to censure by the SEC in the same manner as outside auditors.[251]

It is also worth noting that the Sarbanes-Oxley Act has dramatically expanded the role of attorneys counseling public companies on corporate governance matters. Among other things, attorneys now regularly work with directors and officers on board and committee structure, composition and processes; identification and compliance with fiduciary duties; development and implementation of board committee charters, corporate governance

[251] For further information on the standards for professional conduct of attorneys included in §307 of the Sarbanes-Oxley Act, see A. Gutterman, Business Counselor's Guide to Organizational Management (Volume 1) (Eagan, MN: Thomson Reuters Westlaw, 2013), 957-968, and/or contact the founding director of the Sustainable Entrepreneurship Project (www.seproject.org), which prepared and distributed this Library.. See also 17 C.F.R. §§ 205.1 to 205.7 and SEC Release No. 33-8185, Implementation of Standard of Professional Conduct for Attorneys (January 29, 2003) ("Promulgating Release").

guidelines, codes of conduct and other compliance policies and procedures; interpreting "auditor independence" requirements; structuring and conducting board and committee self-evaluations; compliance with specific corporate governance listing requirements of the applicable securities exchange; management assessments of internal controls; executive officer and director compensation; structuring and conducting internal investigations; and indemnification, insurance and other liability protections for directors and officers.[252] In addition, the disappointing events that led to the adoption of the Sarbanes-Oxley Act have led to more and more shareholder activism and securities litigation that have required greater involvement by legal professionals, particularly outside law firms specializing in those areas.

§54 --Investment bankers

Investment bankers, those professionals that assist companies with capital-raising activities and provide other communications services to the investment community, were also substantially impacted by the corporate governance reforms. Notably, new rules and regulations were adopted to address conflicts of interest that may arise when securities analysts affiliated with an investment banking firm make recommendations regarding equity securities in research reports and public appearances.[253] Specifically, the original rules, which were incorporated into Section 15D of the Exchange Act, were designed to:

- Restrict pre-publication approval or clearance of research reports by persons employed by the broker or dealer engaged in investment banking or in other areas not directly responsible for research, other than legal or compliance staff;
- Limit the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities;
- Prohibit retaliation by investment banking personnel against any securities analyst as a result of an adverse, negative or otherwise unfavorable research report with respect to an issuer that is the subject of a potential investment banking relationship with the firm;
- Define periods during which investment banks that have participated in a public offering as underwriters or dealers are precluded from publishing research reports on the issuer; and
- Establish safeguards within investment banks to assure that securities analysts and investment bankers are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.

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[252] For further discussion of compliance-related activities and procedures, see "Compliance and Risk Management: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[253] See SEC Release No. 34-45908, Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendment No. 1 to the Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest (May 10, 2002).

Subsequently, however, the rules were liberalized with respect to initial public offerings of an "emerging growth company", as defined in the Jumpstart Our Business Startups Act ("JOBS Act") that went into law in 2012, to prevent the SEC and the securities exchanges from adopting any rule or regulation in connection with such an offering: (1) restricting, based on functional role, which associated persons of a broker, dealer, or member of a national securities association, may arrange for communications between a securities analyst and a potential investor; or (2) restricting a securities analyst from participating in any communications with the management of an emerging growth company that is also attended by any other associated person of a broker, dealer, or member of a national securities association whose functional role is other than as a securities analyst. In addition, the JOBS Act prohibits the SEC or any registered national securities association (i.e., the Financial Industry Regulatory Authority, or "FINRA") from adopting or maintaining any rules, with respect to securities of an emerging growth company, that would prohibit a broker-dealer from publishing a research report or making a public appearance within any prescribed period following the IPO or prior to the expiration of a lock-up agreement.

§55 Best practices

Several studies emphasize that no single corporate governance model is valid for every country. The model to be established should be compatible with conditions peculiar to each country. However, the concepts of equality, transparency, accountability and responsibility appear to be main (sine qua non) concepts in all international corporate governance approaches[254]:

- **Equality** means equal treatment of share and stakeholders by the management in all activities of the company and thus aims to prevent all possible conflicts of interest.
- **Transparency** aims to disclose company-related financial and non-financial information (excluding trade secrets and undisclosed information) to the public easily at low cost, and in a timely, accurate, complete, clear and construable manner.
- **Accountability** means the obligation of the board of directors to account to the company as a corporate body and to the shareholders.
- **Responsibility** defines the conformity of all operations carried out on behalf of the company with the legislation, articles of association and in-house regulations together with their audit.

Efforts to establish a framework for corporate governance around the globe continue with significant involvement by the World Bank, the OECD and Global Corporate Governance Forum (GCGF). Banks provided a comprehensive survey of global "best practice" governance reports as they existed in 2004 and preceded the survey by noting that a review of these reports leads to the identification of a core group of key global best practice governance recommendations in the following areas: the mission of the board of directors; shareholder interests; separation of the chairperson and CEO functions; inside

[254] Capital Markets Board of Turkey, Corporate Governance Principles of Turkey (June 2003), http://www.spk.gov.tr/displayfile.aspx?action=displayfile&pageid=55&fn=55.pdf.

and outside (independent) directors; independence criteria; structure of board committees; outside advice; disclosure (financial, compensation and governance); shareholder rights and voting and executive compensation.[255] Banks pointed out that "best practices" come in a variety of different forms such as voluntary, non-binding recommendations; mandatory requirements imposed by regulators, stock exchanges and other authorities; and non-binding recommendations that companies may either follow or explain to stakeholders why they have elected not to follow them.[256] Sources for recommendations are also quite broad and include supranational agencies (e.g., OECD Principles of Corporate Governance and Bank for International Settlements), regulatory authorities, government-sponsored commissions, business associations (e.g., chambers of commerce), directors' associations and investors' associations.[257]

While corporate governance "best practices" are useful guidelines for regulators and individual companies it is important to emphasize that prescriptions adopted in one country may not be effective or appropriate in other countries. Banks, after providing a lengthy discussion of key provisions of the Sarbanes-Oxley Act of 2002 ("SOXA"), which was adopted in the US in the wake of a seemingly endless stream of corporate scandals and/or bankruptcies (e.g., Adelphia Communications, Andersen, Enron, Global Crossing, Tyco, WorldCom etc.), cautioned that while SOXA was comprehensive its solutions were not necessarily unique and the breadth of coverage was necessarily customized to a set of specifically American problems.[258] Banks noted, for example, that aspects of SOXA already existed in other countries and, in fact, other countries had adopted rules that were even more stringent than those included in SOXA. Banks also conceded that many other countries that had gone through their own periods of governance crises could benefit from emulating the SOXA financial disclosure standards. Banks pointed out, however, that "certain [SOXA] requirements run contrary to corporate behavior, practice and culture in other systems" and illustrated his point by referring to the reluctance to require certification of financial statements by company executives in the UK and Germany and discomfort in engaging in business with outsiders that might make it difficult for Japanese companies to welcome "independent" directors.[259] Banks predicted that countries such as the UK would remain reluctant to adopt SOXA-type laws and regulations and would likely continue to rely primarily on "pressure", best practices guidelines and recommendations regarding minimum standards.

§56 Governance and performance

For many entrepreneurs, their first reaction to corporate governance is concern that they will be unduly restricted in their ability to take the steps they perceive as being necessary for the success of their companies. Nonetheless, while the early days of any new venture are typically chaotic and decisions are often made without regard to adherence to

[255] The survey appears at E. Banks, Corporate Governance: Financial Responsibility, Controls and Ethics 335-389 (2004).
[256] Id. at 335.
[257] Id.
[258] Id. at 315.
[259] Id. at 316.

formalistic requirements, governance is not a topic that can be ignored for long and founders and other members of the executive team need to quickly understand that paying attention to corporate governance rules and procedures really matters.

Policymakers and commentators have argued that laws and regulations mandating use of corporate governance practices not only provide protections to shareholders but also contribute to improved firm performance. The International Finance Corporation ("IFC") believes that governance can improve access for emerging market companies to global portfolio equity and lead to high market valuations for those companies. The IFC has also maintained that improved governance structures and processes help ensure quality decision-making, encourage effective succession planning for senior management and enhance the long-term prosperity of companies. Attention to corporate governance also makes firms more attractive to public financing sources such as the IFC. The IFC has made it clear that corporate governance is a priority issue when considering new investments because it presents opportunities for the IFC to manage risks and add value to clients, reduces the risk of investments by improving the governance of investee companies and reduce exposures to the reputational damage that the IFC might suffer from involvement with companies with poor governance.

Others have advocated that companies adopt good corporate governance practices to achieve other organizational benefits that will ultimately lead to better performance. For example, according to one commentator good governance can promotes better organizational strategies and plans, improved operational and process effectiveness/efficiency, improved project management and delivery, more prudent regulatory compliance, financial and risk management, improved member and stakeholder/employee engagement and communication flow and increased agility to which an organization can deliver on its purpose and goals.[260]

A substantial amount of research has been conducted on the link between the quality of corporate governance practices and the economic performance of the firms implementing those practices. One of the leading arguments for a positive link has been the work of Gompers et al., who studied the impact of corporate governance on firm performance during the 1990s and found that firms with "stronger" shareholders' rights substantially outperformed, on a risk-adjusted basis, firms with weaker shareholders' rights.[261] With respect to the adoption and maintenance of sound disclosure practices, empirical evidence has indicated that setting and meeting higher standards of disclosure can materially reduce the cost of capital for companies, primarily by convincing investors and lenders that the risk of the "unknown" is much less. In fact, rating agencies now routinely take

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[260] T. Boutros, Why Corporate Governance Matters—And How to Get It Right (March 11, 2015), https://www.linkedin.com/pulse/why-corporate-governance-matters-how-get-right-tristan-boutros [accessed April 6, 2016]

[261] P. Gompers, J. Ishii and A. Metrick, "Corporate governance and equity prices", Quarterly Journal of Economics, 118(1) (2003), 107–155. For a useful survey of research on the relationship between corporate governance and firm performance, see S. Bhagat and B. Bolton, "Corporate governance and firm performance", Journal of Corporate Finance, 14 (2008), 257–273. For their part, Bhagat and Bolton found that specific governance practices—stock ownership of board members and CEO-Chair separation--was significantly positively correlated with better contemporaneous and subsequent firm operating performance.

corporate governance procedures and disclosure controls into consideration when rendering credit opinions on companies. In addition, a reputation for reliable and complete disclosures can also positively impact the depth and quality of trading volume for the company's securities, particularly institutional investors. Studies have indicated that investors are willing to pay substantial premiums when purchasing securities of companies that have demonstrated their willingness to adopt and follow disclosure controls. Disclosure procedures also improve internal operations since reliable and timely information allows managers to make better, and more informed, decisions that ultimately lead to increased growth and profitability for the business. Finally, disclosure controls can serve as a powerful deterrent to fraud and corruption within the company and bolster employee morale.

At the national level, researchers have argued that weak and inefficient corporate governance can impinge upon economic growth by adversely impacting the development of equity markets, research and development and innovative activities, entrepreneurship and the development of an active small- and medium-sized enterprise sector.[262] The IFC has argued that improving corporate governance will also increase all other capital flows to companies in developing countries: from domestic and global capital; equity and debt; and from public securities markets and private capital sources.

It should be noted, however, that in spite of the evidence described above and the intuitive sense that better governance improves performance, it is by no means a settled issue in the research community.[263] Klein et al. observed that there is no unequivocal evidence to suggest that firm performance is enhanced by "better corporate governance" and Bradley concluded that "for many practitioners and academics in the field of corporate governance, this remains their search for the Holy Grail – the search for the link between returns and governance".[264]

§57 Influence of corporate governance on economic growth and development

There has been growing interest in the relationship between corporate governance and national economic growth and development. This has occurred for several reasons including the belief the corporate governance can influence growth and development in the following ways[265]:

[262] M. Maher and T. Andersson, Corporate Governance: Effects on Firm Performance and Economic Growth (Paris: Organization for Economic Co-Operation and Development, 1999).
[263] For a useful survey of research on the relationship between corporate governance and firm performance, see S. Bhagat and B. Bolton, "Corporate governance and firm performance", Journal of Corporate Finance, 14 (2008), 257–273. For their part, Bhagat and Bolton found that specific governance practices—stock ownership of board members and CEO-Chair separation--was significantly positively correlated with better contemporaneous and subsequent firm operating performance.
[264] P. Klein, D. Shapiro and J. Young, "Corporate Governance, Family Ownership and Firm Value: The Canadian Evidence", Corporate Governance: An International Review, 13(6) (2005), 769-784; and N. Bradley, "Corporate Governance Scoring and the Link between Corporate governance and Performance Indicators: In search of the Holy Grail", Corporate Governance: An International Review, 12(1) (2004), 8-10.
[265] S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 14.

- Increased access to external financing by firms, which presumably will lead to higher levels of investment, growth and employment;
- Lowered cost of capital that leads to higher firm valuation and investment opportunities that investors perceive to be more attractive;
- Better operational performance through better allocation of resources and better management;
- Reduced risk of financial crises, which obviously have significant economic and social costs; and
- Better relationships with all stakeholders (i.e., banks, bondholders, labor, consumers and national/local governments), which leads to improvements in the conditions of work for labor and promotion of social responsibility.

Increased access to financing through the availability of better developed financial and capital markets follows from the strengthening of the recognition and protection of property rights of shareholders and creditors. Evidence indicates that in countries where corporate governance is poor and financial and legal systems are underdeveloped and corruption is high, the negative impact on growth rates falls most heavily on smaller firms and the rate of entrepreneurship (i.e., starting new firms) is adversely affected.[266] As for the relationship between corporate governance and cost of capital, empirical evidence repeatedly shows that the cost of capital is higher and firm valuations lower in weaker property right countries and in those countries minority investors are particularly hard hit. Better operational performance by firms practicing better corporate governance comes from "more efficient management, better asset allocation, better labor policies and similar efficiency improvements".[267] High quality corporate governance systems and practices reduce the risk of financial crises by discouraging behaviors that can lead to financial distress such as withholding of information by insiders, willful misstatements with regard to financial results and condition and "corporate looting" by insiders; and there is evidence that "a well-functioning financial and legal system can help reduce financial volatility".[268] Better corporate governance is also positively related to mergers and acquisitions ("M&A") activities and the values of firms in M&A transactions.[269] Finally, a respect for corporate governance causes firms to behave "responsibly" to all stakeholders who provide input factors that are necessary for the firm to operate and survive, a strategy that ultimately increases firm value and benefits firm shareholders. It has also been argued that firms participating in social issues perform better; however, the evidence supporting this proposition is admittedly less clear.

§58 Governance and privately-held companies

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[266] Id. at 16 (citing T. Beck, A. Demirgüç-Kunt and R. Levine, "Law, Endowments and Finance", Journal of Financial Economics, 70(2) (2003), 137-181; R. Rajan and L. Zingales, "Which Capitalism? Lessons from the East Asian Crisis", Journal of Applied Corporate Finance, 11(3) (1998), 1–48).
[267] S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 17.
[268] Id. at 19.
[269] Id. at 21 (citing S. Rossi and P. Volpin, Cross-Country Determinants of Mergers and Acquisitions, London: Centre for Economic Policy Research Working Paper 3889, 2003)).

While the primary focus of the Sarbanes-Oxley Act obviously has been public companies, elective compliance with certain provisions of the Act by privately-held companies can provide them with significant advantages. In fact, many private companies are discovering that they can actually enhance the value of their businesses, and improve their operational procedures, by implementing changes in areas such as internal controls, board composition (e.g., independent directors), audit committees, and development and implementation of codes of business conduct and ethics. While public companies are treated equally in terms of regulation under the Act, regardless of their size or type of business, private companies come in all sizes and formats, and it is thus important to evaluate the stage of development of the firm and its aspirations for the future when determining what changes are necessary from a corporate compliance perspective. Specifically, the goals and objectives for various types of privately held businesses can be distinguished as follows:

- Companies contemplating an initial public offering ("IPO") or a possible acquisition by a larger firm (so-called "pre-IPO/pre-acquisition companies") can use Sarbanes-Oxley Act readiness as a means of demonstrating additional value to potential investors or acquisition suitors.
- Companies with multiple stakeholders, including outside investors, commercial lenders, strategic business partners and/or governmental customers, can follow Sarbanes-Oxley requirements to demonstrate sound business practices and build credibility with all of these interested parties.
- Closely held businesses (i.e., companies with a small number of shareholders and no immediate plans for an IPO or exit via acquisition) can nonetheless use the Sarbanes-Oxley Act as a roadmap for improving operational efficiencies and preparing for possible changes in long-term strategies in the future.
- Family-owned businesses can follow Sarbanes-Oxley Act recommendations pertaining to independent directors and internal controls as a way to establish an environment of fairness and transparency within the company.

§59 --Pre-IPO or pre–acquisition companies

Attention to Sarbanes-Oxley Act requirements is essentially mandatory for private companies interested in the possibility of an IPO or potential acquisition by a public company in the foreseeable future. Potential investors, investment bankers and acquisition partners will have little interest in a company that is not ready and able to assume the rigors of compliance with the Sarbanes-Oxley Act, and it will be important for these companies to be able to demonstrate that steps are already being taken to voluntarily prepare for the next level of regulation and scrutiny. The level and scope of compliance will depend, to some extent, on the timetable charted out for the IPO or acquisition. For example, if the company has determined that an IPO will likely occur within 12 to 18 months, it should be well along with establishing the organizational structures and procedures to achieve a smooth transition to public company status. In any case, key action items include the following:

- The experience and composition of the senior management team should be carefully reviewed and consideration should be given to bringing in new members with the requisite background and familiarity with public company governance requirements. As time moves on and the practical issues relating to Sarbanes-Oxley Act compliance are raised and resolved, private companies will be able to evaluate candidates based on their experience with the specific regulations and other requirements.
- The composition of the board of directors should be modified to comply with applicable requirements relating to independent directors and establishment of audit and other committees to take on responsibility for corporate governance matters. Private companies with support from venture capitalists will already have a strong group of outside advisors on their board; however, the venture capitalists and other professional investors should recruit completely independent board members with relevant industry experience.
- Under the direction of the newly constituted audit committee, pre-IPO or pre-acquisition companies should commission an assessment of their internal controls to identify areas that need to be strengthened or perhaps eliminated as being redundant.
- Companies with aspirations of an IPO should already be subject to an annual audit by an independent outside auditor with public company expertise; however, if that is not the case, it is important to engage a qualified auditor to assist the company in preparing for the rigors of periodic reporting.

It is well documented that gearing up for compliance with the Sarbanes-Oxley Act is not an inexpensive task. For example, it has been estimated that the "start-up" costs for compliance in the first year that a company is subject to the requirements can average $3 million for companies with $2.5 billion in revenues. Much smaller companies in terms of revenues are not, unfortunately, able to reduce the compliance costs significantly, meaning that smaller companies actually face a higher relative burden than their larger colleagues. In any case, it is important for pre-IPO candidates to budget for these items in advance and build compliance costs in as a long-term investment in the advantages of being in the public markets.

Companies seeking a public company as an acquisition partner should evaluate the risk that their operational activities and insider relationships might present to potential suitors. Among the specific issues to consider are the following:

- The CEO and CFO of the acquisition partner will need to be comfortable that consolidating the company's financial results with those of the partner will not increase the risk to those persons of providing the required certifications in periodic reports mandated under the Sarbanes-Oxley Act. Private companies should ask their independent auditors or other consultants to evaluate their financial reporting systems to be ensure that acquisition partners will be able to analyze this issue in their due diligence investigation.
- The company will need to invest in the technology and human resources necessary to ensure that its systems and procedures with respect to internal controls will be adequate to allow management of potential suitors to make the necessary discloses in the management reports required under the Sarbanes-Oxley Act. Once again, the

company's outside auditors should be asked to conduct an independent assessment of the company's internal controls in the same manner as an auditor would do with a public company.

- Private companies with actual or potential "off-balance sheet transactions" should review the scope and extent of the possible disclosure obligations that such transactions might impose on potential suitors. While such transactions are not prohibited, the disclosures may have a material impact on the acquiring company's financial statements and management's discussion and analysis. Accordingly, the company should be prepared to provide the suitor with full information on any such transaction.
- If it is anticipated that any director or executive officer of the company will assume a similar position with the acquiring company, arrangements must be made to retire any outstanding personal loan arrangement between the company and such person.

Private company acquisition candidates should anticipate that the pre-acquisition due diligence investigation will be extensive and that a premium will be placed on the ability of the company to provide all information necessary for the potential acquirer to verify that the business and financial condition of the candidate is adequate from a Sarbanes-Oxley perspective. In addition, the acquisition agreement will include specific representations and warranties on Sarbanes-Oxley Act issues, including internal controls and disclosure of off-balance sheet transactions, since the acquirer will need to be sure that the candidate will be ready and able to satisfy the stringent compliance standards to which its operations will become subject upon closing of the transaction.

§60 --Companies with multiple stakeholders

There are a number of very large private companies active in the United States, and many of these companies have a broad and diverse family of stakeholders beyond the core ownership group that is actively involved in the day-to-day management of the business. For example, private companies may have a number of outside investors, often sophisticated professionals with a healthy appetite for information regarding the operations of the company. In addition, private companies generally have to deal with the requirements imposed by their commercial lenders, and larger companies may be dealing with a loan syndicate that includes several financial institutions that have agreed to underwrite a portion of the credit facilities available to the company. Key business partners, including major vendors and customers, have a stake in the business continuity and financial strength of the company over an extended period of time. Finally, certain "special interest partners," such as government agencies that purchase goods and services from the company, may have a keen interest in the company's internal controls.

Private companies with multiple stakeholders are well advised to focus on improving their internal controls and business processes. Among the steps that can, and should, be taken are formalizing internal controls and governance policies; initiating regular formal audits of business processes; improving documentation and record retention procedures for common business transactions; developing codes of business conduct; and making sure that employees are trained in the latest cutting-edge compliance practices. These steps, when taken together, will allow the company to build and maintain credibility with all of its stakeholders. As a result, the company will likely be able to obtain better credit terms and access more business opportunities. Moreover, the directors and officers will receive richer information regarding all aspects of the business on a timely basis, thereby improving the quality of decision making within the firm.

§61 --Closely-held businesses

The potential benefits of investing in tools and processes based on the Sarbanes-Oxley Act requirements are sometimes more difficult for the owners of a closely held business to appreciate and accept. Most of these businesses have a limited set of stakeholders and no immediate thought of expanding to seek an IPO or attracting a public company as a potential acquirer. Nonetheless, owners of a closely held business are well advised to review the Sarbanes-Oxley Act standards to identify ideas that can be used to manage the risks associated with the business and increase the value of their ownership stake. The later consideration may be particularly important given that the business typically represents a substantial portion of the personal wealth of the owners. Another element to consider is the possibility that the closely held business will shift its strategy quickly at some point in the future and become one of the other types of companies described herein. For example, an attractive business opportunity in a new product or geographic market may lead to interest in obtaining capital from outside investors or a syndicate of institutional lenders. In that case, the number of stakeholders, and associated scrutiny, will increase immediately. Also, if one or more of the owners suddenly decides that he or she wants to liquidate his or her interest in the company, the owners may conclude that the best way to achieve maximum value is through a sale to a public company, which means that the firm must think and act as a "pre-acquisition" company.

Absent an immediate need for strict compliance with the requirements of the Sarbanes-Oxley Act, closely held businesses should focus on those areas where there is value in adopting "best in class" practices. One popular area of interest for closely held businesses is evaluating the documents and records used for common business transactions. By standardizing procedures in this area, the company can operate more efficiently, and management can gain better access to information about those elements of the business that are most crucial from a tracking perspective. Closely held businesses should also carefully consider adding one or more independent members to their board of directors. In many cases, the owners are also all of the directors and senior managers of the business. While this streamlines the communication process, it also can lead to insular thinking. By bringing in independent experts with industry experience and other interests, the owners can obtain the benefits of a different perspective and independent directors are often sources of new business opportunities.

§62 --Family-owned businesses

Family businesses do, of course, present special challenges, notably the need to manage family relationships at the same time as business decisions are being made. In addition, family-owned businesses face unique problems with respect to succession planning and their ability to provide attractive opportunities for managers and employees who are not family members. However, there are ways in which corporate governance principles can be woven into the management of a family-owned business, and studies appear to indicate that family-owned businesses that are successful in this attempt make better strategic decisions, grow faster and survive longer.

Some of the key success factors in integrating corporate governance into a family-owned business are as follows:

- Outside directors should be added to the board of directors and the board should be given greater authority with respect to evaluating and setting company policies and strategies. Outside directors can bring a greater degree of objectivity to the business and should be more immune from the day-to-day conflict that sometime arises among family members.
- Family members should have a clear understanding of the importance of separating family relationships from the governance and management of the company. This may be difficult; however, recruitment of key managers and other employees from outside of the family can accelerate the process and make it clear to family members that they have taken on responsibilities that extend outside of the familial group.
- The business, working through the outside directors, should establish a clear and logical organizational structure with a clear chain of command and a decision-making process that is transparent and free of opportunities for family conflicts. If family members are to be placed in management positions, they should have the authority to make decisions without reference to their "place" within the family. Moreover, decisions that may be made by outside managers and employees must be respected.
- In order to reduce strife within the family and build trust among managers and employees who are not family members, the company should establish clear policies with respect to recruitment, promotion and compensation and then follow and respect those policies.

§63 Governance and non-corporate and non-profit entities

Since the corporation has long been the dominant form of legal entity for organizations involved in business activities, particularly those organizations that are regulated by federal securities laws and the national securities exchanges in the US, governance has typically been discussed and debated under the topical umbrella of "corporate governance" and, in fact, the discussion in this chapter and throughout this Library focuses primarily on corporations with securities that are publicly traded, and thus subject to the reporting requirements of the federal securities laws (generally referred to as "public", "listed" and/or "reporting" companies), the overriding principles of corporate governance can and should be adapted to all types of organizations including non-corporate entities and non-profits. In fact, the Governance Institute's definition of corporate governance actually avoids specific reference to corporation's by emphasizing that "[g]overnance encompasses the system by which an organization is controlled and operates, and the mechanisms by which it, and its people, are held to account" and noting that important element of governance include ethics, risk management, compliance and administration.[270] In the same vein, the OECD definition of corporate governance can be adapted to apply to the relationships among senior officers, members of the managing body and the owners and other stakeholders of all types of legal business entities. For example, the board of managers of a manager-managed limited liability company in the US has duties and responsibilities similar to those of the board of directors of a corporation that flow to "members" who are the owners of the limited liability company.

§64 Issues and areas for future research

Those who have conducted extensive reviews of the literature regarding national and cross-border research on corporate governance have noted that extensive analysis has been done on the relationship between governance and access to financing, cost of capital and firm valuation and firm performance. In addition, legal and financial scholars have discussed the importance of institutional foundations for corporate governance, particularly contract and property rights and enforcement of laws and regulations by administrative agencies and courts. While most of the research relating to corporate governance conducted before and during the 1990s focused on the US, the last two decades have seen an expansion of "international comparisons", particularly on differences between legal systems in various countries and protection of public investors.[271] Work in countries outside of the US has also contributed to a greater understanding of the details of other corporate governance frameworks. With regard to the areas that appear to be the most fertile for new and additional research, Claessens offered the following list[272]:

- The corporate governance of banks, which is considered to be separate from corporations and important because of the valuable role that banks serve as providers of external financing and the direct involvement that banks in some countries have in management of the firms that they finance;
- The role and internal governance of institutional investors, who have grown significantly in recent years and now often assume extremely activist stances with respect to firm management issues;
- Improvement of enforcement, particularly in weak corporate governance environments, and the proper balance between private and public sector involvement in enforcement activities;
- The corporate governance of state-owned firms, which is becoming more important as governments allow such firms to become more involved in cooperative arrangements with privately-supported enterprises;
- Related to the previous topic is the need to examine the process of transitioning corporate governance for state-owned firms that are privatized;

[270] http://www.governanceinstitute.com.au [accessed February 3, 2015]
[271] For surveys on international comparisons of corporate governance, see R. Levine, "Law, Endowments, and Property Rights" Journal of Economic Perspectives, 19 (2005), 61–88; and R. La Porta, F. Lopez-de-Silanes and A. Shleifer, "The Economic Consequences of Legal Origin", Journal of Economic Literature, 46 (2008), 285–332.
[272] S. Claessens, Corporate Governance and Development (Washington DC: The World Bank (Global Corporate Governance Forum), 2003), 30.

- The corporate governance of family-owned firms, which continue to dominate business sectors in a number of emerging markets;
- Best practices in relation to other stakeholders, which includes empirical research on relationships between corporate governance and social corporate responsibility and which has been almost negligible outside of the developed countries;
- The relationship between better corporate governance and greater poverty alleviation, particularly how corporate governance can positively impact the small- and medium-sized enterprises that create so many new jobs in developing countries and emerging markets;
- The relationship between the institutional frameworks for corporate governance embraced by countries and various "permanent" characteristics of those countries such as culture, history and/or physical endowments; and
- The dynamic aspects of the institutional changes that must occur in order for corporate governance frameworks to advance and improve.

Other areas in which new and/or additional research might be useful include creating better measures of the "shareholder protections" and the how those protections relate to firm performance, in other words addressing some of the shortcoming in the research on the link between governance performance mentioned above; conducting cross-border comparisons of firm-level governance practices, given that much of the cross-border research to date has focused primarily on comparing and contrasting national corporate governance frameworks; and the establishment of separate standards for evaluating and comparing the corporate governance practices of firms operating under the same "model" (i.e., outsider or insider").

About the Author

Dr. Alan S. Gutterman is the Founding Director of the Sustainable Entrepreneurship Project (www.seproject.org). In addition, Alan's prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, *Business Transactions Solution*, is on online-only product available and featured on Thomson Reuters' Westlaw, the world's largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 40 books on sustainable entrepreneurship, management, business law and transactions, international law business and technology management for a number of publishers including Thomson Reuters, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, CCH and BNA. Alan has over three decades of experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Boalt Hall, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on a diverse range of topics including corporate finance, venture capital, corporate law, Japanese business law and law and economic development, He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph. D. from the University of Cambridge. For more information about Alan, his publications or the Sustainable Entrepreneurship Project, please contact him directly at alangutterman@gmail.com, and follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/).

About the Project

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