REFRESHER READING

Corporate Finance

Organizational standards, laws and regulations, customs

CORPORATE GOVERNANCE EVALUATION

5

An essential component of the analysis of a company and its risk is a review of the quality of its corporate governance system. This evaluation requires an assessment of issues relating to the board of directors, managers, and shareholders. Ultimately, the long-term performance of a company is dependent upon the quality of managers' decisions and their commitment to applying sound management practice. However, as one group concerned with the issues observes, "by analyzing the state of corporate governance for a given company, an analyst or shareholder may ascertain whether the company is governed in a manner that produces better management practices, promotes higher returns on shareholder capital, or if there is a governance and/or management problem which may impair company performance."[1]

In the following sections we provide a set of guidelines for evaluating the quality of corporate governance in a company. We reiterate that there is no single system of governance that is appropriate for all companies in all industries worldwide. However, this core set of global best practices is being applied in financial markets in Europe, Asia, and North America. They represent a standard by which corporate practices may be evaluated.

The information and corporate disclosure available in a specific jurisdiction will vary widely. However, most large financial markets and, increasingly, smaller ones require a substantial amount of information be provided about companies' governance structures and practices. In addition, a few regulatory jurisdictions will require a subset of the criteria we shall give as part of registration, exchange listing, or other requirements.

The analyst should begin by carefully reviewing the requirements in effect for the company. Information is generally available in the company's required filings with regulators. For example, in the United States, such information is provided in the 10-K report, the annual report, and the Proxy Statement (SEC Form DEF 14A). All of these are filed with the U.S. Securities and Exchange Commission (U.S. SEC), are available on the U.S. SEC website, usually are available on the company's website, and are provided by the company to current investors as well as on request. In Europe, the company's annual report provides some information. However, in an increasing number of EU

1 New York Society of Securities Analysts, *Corporate Governance Handbook*, September 22, 2003. New York City. p. 1.

Section 5 of *Corporate Governance*, by McEnally, CFA, and Kim, 2014 CFA Curriculum, Level 2, Volume 3, Reading 28. *Corporate Finance: A Practical Approach,* by Michelle R. Clayman, CFA, Martin S. Fridson, CFA, and George H. Troughton, CFA. Copyright © 2008 by CFA Institute.

countries, companies are required to provide a report on corporate governance. This report typically will provide information on board activities and decisions, whether the company has abided by its relevant national code, and explain why it departed from the code, if it has. In addition, the announcement of the company's annual general meeting should disclose the issues on the agenda that are subject to shareholder vote. The specific sources of information will differ by jurisdiction and company.

5.1 The Board of Directors

Boards of directors are a critical part of the system of checks and balances that lie at the heart of corporate governance systems. Board members, both individually and as a group, have the responsibility to:

- establish corporate values and governance structures for the company to ensure that the business is conducted in an ethical, competent, fair, and professional manner;
- ensure that all legal and regulatory requirements are met and complied with fully and in a timely fashion;
- establish long-term strategic objectives for the company with a goal of ensuring that the best interests of shareholders come first and that the company's obligations to others are met in a timely and complete manner;
- establish clear lines of responsibility and a strong system of accountability and performance measurement in all phases of a company's operations;
- hire the chief executive officer, determine the compensation package, and periodically evaluate the officer's performance;
- ensure that management has supplied the board with sufficient information for it to be fully informed and prepared to make the decisions that are its responsibility, and to be able to adequately monitor and oversee the company's management;
- meet frequently enough to adequately perform its duties, and meet in extraordinary session as required by events; and
- acquire adequate training so that members are able to adequately perform their duties.

Depending upon the nature of the company and the industries within which the company operates, these responsibilities will vary; however, these general obligations are common to all companies.

In summarizing the duties and needs of boards of directors, *The Corporate Governance of Listed Companies: A Manual for Investors*[2] states:

> Board members have a duty to make decisions based on what ultimately is best for the long-term interests of shareowners. There has been much discussion in recent years about the needs for boards and management to balance the short-term operations of a company with a long-term sustainable strategic outlook. Although shareowners with a short holding period may indeed be interested in corporate governance, long-term shareowners (those that hold shares for years) are more likely to incorporate corporate governance factors into their investment analyses. The reason is that governance aspects often affect company value over a long time frame. To act

2 *The Corporate Governance of Listed Companies: A Manual for Investors*, Second Edition, CFA Institute, 2010, p. 8.

> in the best interests of shareowners, board members need a combination of four things: independence, experience, resources, and accurate information about the company's financial and operating position.
>
> **First**, a board should be composed of at least a majority of independent board members with the autonomy to act independently from management. Rather than simply voting with management, board members should bring with them a commitment to take an unbiased approach in making decisions that will benefit the company and shareowners. **Second**, Board members who have appropriate experience and expertise relevant to the company's business are best able to evaluate what is in the best interests of shareowners. Depending on the nature of the business, specialized expertise by at least some board members may be required. **Third**, internal mechanisms are needed to support the independent work of the board. Such mechanisms include the authority to hire the external auditor and other outside consultants without management's intervention or approval. This mechanism alone provides the board with the ability to obtain expert help in specialized areas, helps it to circumvent potential areas of conflict with management, and overall, helps preserve the integrity of the board's independent oversight function. **Fourth**, Directors must have access to complete and accurate information about the financial position of the company and its underlying value drivers to enable them to steer the company in the best long-term interests of shareowners. [Emphasis added]

In the following sections we detail the attributes of the board that an investor or investment analyst must assess.

5.1.1 *Board Composition and Independence*

The board of directors of a corporation is established for the primary purpose of serving the best interests of the outside shareholders in the company. Other stakeholders including employees, creditors, and suppliers are usually in a more powerful position to oversee their interests in the company than are shareholders. The millions of outside investors cannot, individually or collectively, monitor, oversee, and approve management's strategies and policies, performance, and compensation and consumption of perquisites.

The objectives of the board are to see that company assets are used in the best long-term interests of shareholders and that management strategies, plans, policies, and practices are designed to achieve this objective. In a recent amendment to the *Investment Company Act of 1940* rules, the U.S. SEC argues that a board must be "an independent force in [company] affairs rather than a passive affiliate of management. Its independent directors must bring to the boardroom a high degree of rigor and skeptical objectivity to the evaluation of [company] managements and its plans and proposals, particularly when evaluating conflicts of interest."[3]

Similarly, the *Corporate Governance Handbook*[4] observes:

> Board independence is essential to a sound governance structure. Without independence there can be little accountability. In the words of Professor Jeffrey Sonnenfeld of Yale University, "The highest performing companies have extremely contentious boards that regard dissent as an obligation and that treat no subject as undiscussable."

3 *Amendments to Rules Governing the Investment Company Act of 1940*, 17 CFR Part 270, July 2004, p. 3.
4 *Corporate Governance Handbook*, New York Society of Securities Analysts, September 2003, p. 3.

Clearly, for members who are appointed to the board to be in a position to best perform their fiduciary responsibilities to shareholders, at a minimum a majority of the members must be independent of management. However, global best practice now recommends that *at least three-quarters* of the board members should be independent.

Some experts in corporate governance have argued that all members of the board should be independent, eliminating the possibility of any senior executives serving on the board. Those who hold this position argue that the presence of managers in board deliberations may work to the detriment of the best interests of investors and other shareholders by intimidating the board or otherwise limiting debate and full discussion of important matters. Others argue that with appropriate additional safeguards, such potential problems can be overcome to the benefit of all stakeholders.

Independence is difficult to evaluate. Factors that often indicate a lack of independence include:

- former employment with the company, including founders, executives, or other employees;
- business relationships, for example, prior or current service as outside counsel, auditors, or consultants, or business interests involving contractual commitments and obligations;
- personal relationships, whether familial, friendship, or other affiliations;
- interlocking directorships, a director of another company whose independence might be impaired by the relationship with the other board or company, particularly if the director serves on interlocking compensation committees; and
- ongoing banking or other creditor relationships.

Information on the business and other relationships of board members as well as nominees for the board may be obtained from regulatory filings in most jurisdictions. For example, in the United States, such information is required to be provided in the Proxy Statement, SEC Form DEF 14A, sent to shareholders and filed with the SEC prior to shareholder meetings.

5.1.2 *Independent Chairman of the Board*

Many, if not most, corporate boards now permit a senior executive of a corporation to serve as the chairman of the board of directors. However, corporate governance experts do not regard such an arrangement to be in the best interests of the shareholders of the company. As the U.S. SEC observes:

> This practice may contribute to the [company's] ability to dominate the actions of the board of directors. The chairman of a . . . board can largely control the board's agenda, which may include matters not welcomed by the [company's management] . . . Perhaps more important, the chairman of the board can have a substantial influence on the . . . boardroom's culture. The boardroom culture can foster (or suppress) the type of meaningful dialogue between . . . management and independent directors that is critical for healthy . . . governance. It can support (or diminish) the role of the independent directors in the continuous, active engagement of . . . management necessary for them to fulfill their duties. A boardroom culture conducive to decisions favoring the long-term interest of . . . shareholders may be more likely to prevail when the chairman does not have the conflicts of interest inherent in his role as an executive of the [company]. Moreover,

> a . . . board may be more effective when negotiating with the [company] over matters such as the [compensation] if it were not at the same time led by an executive of the [company] with whom it is negotiating.[5]

Not all market participants agree with this view. Many corporate managers argue that it is essential for efficient and effective board functioning that the chairman be the senior executive in the company. They base their arguments on the proposition that only such an executive has the knowledge and experience necessary to provide needed information to the board on questions on strategy, policy, and the operational functioning of the company. Critics of this position counter that it is incumbent upon corporate management to provide all such necessary information to the board. Indeed, many argue that this obligation is the sole reason that one or more corporate managers serve as members of the board.

Whether the company has separate positions for the chief executive and chairman of the board can be determined readily from regulatory filings of the company. If the positions are not separate, an investor may doubt that the board is operating efficiently and effectively in its monitoring and oversight of corporate operations, and that decisions made are necessarily in the best interests of investors and other stakeholders.

Tradition and practice in many countries prescribe a so-called "unitary" board system, a single board of directors. However, some countries, notably Germany, have developed a formal system whose intent is to overcome such difficulties as lack of independence of board members and lack of independence of the chairman of the board from company management. The latter approach requires a tiered hierarchy of boards, a management board responsible for overseeing management's strategy, planning, and similar functions, and an independent supervisory board charged with monitoring and reviewing decisions of the management board, and making decisions in which conflicts of interest in the management board may impair their independence, for example, in determining managerial compensation.

Clearly, independence of the chairman of the board does not guarantee that the board will function properly. However, independence should be regarded as a necessary condition, even if it is not a sufficient one.

5.1.3 *Qualifications of Directors*

In addition to independence, directors need to bring sufficient skill and experience to the position to ensure that they will be able to fulfill their fiduciary responsibilities to investors and other stakeholders. Information on directors' prior business experience and other biographical material, including current and past business affiliations, can generally be found in regulatory filings.

Boards of directors require a variety of skills and experience in order to function properly. These skills will vary by industry, although such core skills as knowledge of finance, accounting, and legal matters are required by all boards. Evaluation of the members should include an assessment of whether needed skills are available among the board members. Among the qualifications and core competencies that an investor should look for in the board as a group, and in individual members or candidates for the board, are:

- independence (see factors to consider in Section 5.1.1);
- relevant expertise in the industry, including the principal technologies used in the business and in financial operations, legal matters, accounting and auditing; and managerial considerations such as the success of companies with which the director has been associated in the past;

5 *Amendments to Rules Governing the Investment Company Act of 1940*, 17 CFR Part 270, July 2004, p. 4.

- indications of ethical soundness, including public statements or writings of the director, problems in companies with which the director has been associated in the past such as legal or other regulatory violations involving ethical lapses;
- experience in strategic planning and risk management;
- other board experience with companies regarded as having sound governance practices and that are effective stewards of investors' capital as compared to serving management's interests;
- dedication and commitment to serving the board and investors' interests (board members with such qualities will not serve on more than a few boards, have an excellent record of attendance at board meetings, and will limit other business commitments that require large amounts of time); and
- commitment to the needs of investors as shown, for example, by significant personal investments in this or other companies for which he or she serves as a director, and by an absence of conflicts of interest.

Such attributes are essential to the sound functioning of a board of directors and should be carefully considered in any investment decision. Board members may be selected as much for their general stature and name recognition as for the specialized expertise they bring to their responsibilities. However, the skills, knowledge, and experience we have described are essential to effective corporate governance, oversight, and monitoring on behalf of shareholders.

5.1.4 *Annual Election of Directors*

Members of boards of directors may be elected either on an annual or a staggered basis. In annual votes, every member of the board stands for re-election every year. Such an approach ensures that shareholders are able to express their views on individual members' performance during the year, and to exercise their right to control who will represent them in corporate governance and oversight of the company. Opponents argue that subjecting members to annual re-election is disruptive to effective board oversight over the company.

Those who support election of board members on a staggered basis with re-election of only a portion of the board each year, argue that such a scheme is necessary to ensure continuity of the knowledge and experience in the company essential for good corporate governance. Critics express the view that such a practice diminishes the limited power that shareholders have to control who will serve on the board and ensure the responsiveness of board members to investor concerns, such as poor management performance and practices. They also argue that staggered boards better serve the interests of entrenched managers by making the board less responsive to the needs of shareholders, more likely to align their interests with those of managers, and more likely to resist takeover attempts that would benefit shareholders to the detriment of managers.

Corporate governance best practice generally supports the annual election of directors as being in the best interests of investors. When shareholders can express their views annually, either by casting a positive vote or by withholding their votes for poorly performing directors, directors are thought to be more likely to weigh their decisions carefully, to be better prepared and more attentive to the needs of investors, and to be more effective in their oversight of management.

Information on directors' terms and the frequency of elections may be obtained by examining the term structure of the board members in regulatory filings.

5.1.5 *Annual Board Self-Assessment*

Board members have a fiduciary duty to shareholders to oversee management's use of assets, to monitor and review strategies, policies and practices, and to take those actions necessary to fulfill their responsibilities to stakeholders. It is essential that a process be in place for periodically reviewing and evaluating their performance and making recommendations for improvement. Generally, this evaluation should occur at least once annually. The review should include:

- an assessment of the board's effectiveness as a whole;
- evaluations of the performance of individual board members, including assessments of the participation of each member, with regard to both attendance and the number and relevance of contributions made, and an assessment of the member's willingness to think independently of management and address challenging or controversial issues;
- a review of board committee activities;
- an assessment of the board's effectiveness in monitoring and overseeing their specific functions;
- an evaluation of the qualities the company will need in its board in the future, along with a comparison of the qualities current board members currently have; and
- a report of the board self-assessment, typically prepared by the nominations committee, and included in the proxy in the U.S. and in the corporate governance report in Europe.

The process of periodic self-assessment by directors can improve board and company performance by reminding directors of their role and responsibilities, improving their understanding of the role, improving communications between board members, and enhancing the cohesiveness of the board. Self-assessment allows directors to improve not only their own performance but to make needed changes in corporate governance structures. All of these will lead to greater efficiency and effectiveness in serving investors' and other stakeholders' interests.

The process of self-assessment should focus on board responsibilities and individual members' accountability for fulfilling these responsibilities. It should consider both substantive matters and procedural issues, for example, evaluations of the adequacy and effectiveness of the committee structure. The committees regarded as essential by corporate governance experts include the auditing, nominations, and compensation committees, all of which should be staffed by independent directors who are experts in the relevant areas. (The specific functions of these committees will be considered in later sections.)

The company, however, may need to establish additional committees. For example, for a mutual fund company, these might include a securities valuation committee responsible for setting policies for the pricing of securities, and monitoring the application of the policies by management. For a high-technology company, the committees might include one tasked with the valuation of intellectual property, or perhaps, management's success in creating new intellectual property through its investments in research and development.

In evaluating the effectiveness of the corporate governance system and specifically, the board of directors, an investment professional should consider the critical functions specific to a particular company and evaluate whether or not the board's structure and membership provides adequate oversight and control over management's strategic business decision-making and policy-making.

5.1.6 *Separate Sessions of Independent Directors*

Corporate governance best practice requires that independent directors of the board meet at least annually, and preferably quarterly, in separate sessions—that is, meetings without the presence of the management, other representatives, or interested persons (for example, retired founders of the company). The purpose of these sessions is to provide an opportunity for those entrusted with the best interests of the shareholders to engage in candid and frank discussions and debate regarding the management of the company, their strategies and policies, strengths and weaknesses, and other matters of concern. Such regular sessions would avoid the suggestion that directors are concerned with specific problems or threats to the company's well-being. Separate sessions could also enhance the board's effectiveness by improving the cooperation among board members, and their cohesiveness as a board, attributes that can strengthen the board in the fulfillment of its responsibilities to shareholders.

Regulatory filings should indicate how often boards have met, and which meetings were separate sessions of the independent directors. The investment professional should be concerned if such meetings appeared to be nonexistent, infrequent, or irregular in occurrence. These could suggest a variety of negative conclusions, including the presence of a "captive," that is, non-independent board, inattention or disinterest among board members, lack of cohesion and sense of purpose, or other conditions that can be detrimental to the interests of investors.

5.1.7 *Audit Committee and Audit Oversight*

The audit committee of the board is established to provide independent oversight of the company's financial reporting, non-financial corporate disclosure, and internal control systems. This function is essential for effective corporate governance and for seeing that their responsibilities to shareholders are fulfilled.

The primary responsibility for overseeing the design, maintenance, and continuing development of the control and compliance systems rests with this committee. At a minimum the audit committee must:

- include only independent directors;
- have sufficient expertise in financial, accounting, auditing, and legal matters to be able to adequately oversee and evaluate the control, risk management, and compliance systems, and the quality of the company's financial disclosure to shareholders and others. It is advisable for at least two members of the committee to have relevant accounting and auditing expertise;
- oversee the internal audit function; the internal audit staff should report directly and routinely to this committee of the board, and, when necessary report any concerns regarding the quality of controls or compliance issues;
- have sufficient resources to be able to properly fulfill their responsibilities;
- have full access to and the cooperation of management;
- have authority to investigate fully any matters within its purview;
- have the authority for the hiring of auditors, including the setting of contractual provisions, review of the cost-effectiveness of the audit, approving of non-audit services provided by the auditor, and assessing the auditors' independence;
- meet with auditors independently of management or other company interest parties periodically but at least once annually; and
- have the full authority to review the audit and financial statements, question auditors regarding audit findings, including the review of the system of internal controls, and to determine the quality and transparency of financial reporting choices.

Strong internal controls, risk management, and compliance systems are critical to a company's long-term success, the meeting of its business objectives, and enhancing the best interests of shareholders. Nearly all of the major corporate collapses have involved an absence of effective control systems, or the overriding of the systems by management to achieve their own interests and objectives to the detriment of those of investors.

The internal audit function should be entirely independent and separate from any of the activities being audited. Internal auditors should report directly to the chairman of the audit committee of the board of directors. The board should regularly meet with the internal audit supervisor and review the activities and address any concerns.

In evaluating the effectiveness of the board of directors, an investor should review the qualifications of the members of the audit committee, being alert to any conflicts of interest that individual members might have, for example, having previously been employed or otherwise associated with the current auditor or the company, determine the number of meetings held by the committee during the year and whether these meetings were held independent of management. A report on the activities of the audit committee, including a statement on whether the committee met independently and without the presence of management, should be included in the proxy in the U.S. and in the corporate governance report in Europe.

The audit committee should discuss in the regulatory filings the responsibilities and authority it has to evaluate and assess these functions, any findings or concerns the committee has with regard to the audit, internal control and compliance systems, and corrective action taken.

5.1.8 *Nominating Committee*

In most corporations, currently, nominations of members of the board of directors and for executive officers of the company are made by members of the board, most often at the recommendation of, or in consultation with, the management of the company. In such circumstances, the criteria for selection of nominees may favor management's best interests at the expense of the interests of shareholders. This is all the more important because in the usual case, shareholders have no authority to nominate slates of directors who might best represent them. Consequently, corporate governance best practice requires that nominees to the board be selected by a nominating committee comprising only independent directors. The responsibilities of the nominating committee are to:

- establish criteria for evaluating candidates for the board of directors;
- identify candidates for the general board and for all committees of the board;
- review the qualifications of the nominees to the board and for members of individual committees;
- establish criteria for evaluating nominees for senior management positions in the company;
- identify candidates for management positions;
- review the qualifications of the nominees for management positions; and
- document the reasons for the selection of candidates recommended to the board as a whole for consideration.

Given the pivotal role that the members of the nominating committee have in representing and protecting the interests of investors and other stakeholders, it is essential that the qualifications of these members be carefully reviewed in assessing the long-term investment prospects of a company. Particular attention should be paid

to evaluating their independence, the qualities of those selected for senior management positions, and the success of businesses with which they've been associated. This information is available in the regulatory filings of the company.

5.1.9 *Compensation Committee*

Ideally, compensation should be a tool used by directors, acting on behalf of shareholders, to attract, retain, and motivate the highest quality and most experienced managers for the company. The compensation should include incentives to meet and exceed corporate *long-term* goals, rather than short-term performance targets.

Decisions regarding the amounts and types of compensation to be awarded to senior executives and directors of a company are thought by many corporate governance experts to be the most important decisions to be made by those in a position of trust. Reports abound of compensation that is excessive relative to corporate performance, awarded to executives by compliant boards. The problem has been particularly acute in the United States, but examples are found worldwide.

In recent years, a practice has developed of gauging levels of compensation awards based not upon company objectives and goals but rather by comparison to the highest levels of compensation awarded in other companies. This occurs whether the reference companies are relevant benchmarks or not, and has caused compensation packages in many cases to be unrelated to the performance of the company. Needless to say, such excessive compensation is highly detrimental to the interests of shareholders.

In one well-known case, that of the New York Stock Exchange, the compensation of the chief executive was a substantial proportion of the net earnings of the Exchange and considerably higher than the compensation awarded to senior executives of comparable companies. The facts that have come to light in the case suggest that the compensation committee of the board was not independent as measured by the usual criteria, was not expert in compensation matters and did not seek outside counsel, was not well-informed on the details of the compensation package, and acquiesced in management's proposal of its own compensation.[6] This case is currently the subject of extensive legal and regulatory action.

Several different types of compensation awards are in common use today:

- salary, generally set by contractual commitments between the company and the executive or director;
- perquisites, additional compensation in the form of benefits, such as insurance, use of company planes, cars, and apartments, services, ranging from investment advice, tax assistance, and financial planning advice to household services;
- bonus awards, normally based on performance as compared to company goals and objectives;
- stock options, options on future awards of company stock; and
- stock awards or restricted stock.

In general, shareholders would prefer that salary and perquisite awards constitute a relatively small portion of the total compensation award. That is, the fixed, non-performance-based portion of the award should be adequate, but not excessive. Because these fixed costs must be borne by shareholders regardless of corporate performance, executives should not be automatically rewarded by poor performance. Information on salaries and some perquisites can be found in regulatory filings of companies. For example, in the United States, this information is found in the Proxy Statement in

6 Landon Thomas Jr., "Saying Grasso Duped Big Board, Suit Seeks Return of $100 Million," the *New York Times*, May 25, 2004; and "Regulators Said to Be Focusing On Board's Vote For Grasso Pay," the *New York Times*, March 26, 2004.

tables and accompanying text. The investor should be alert to the fact that significant amounts of perquisites may not be fully disclosed, as has been shown to be the case in a number of corporate scandals recently in Europe and the United States.

Bonuses should be awarded based solely on exceeding expected performance. They should provide an incentive to motivate managers to achieve the highest and most stable long-term performance, rather than to reward short-term non-sustainable "growth" at the expense of the best interests of shareholders. To the extent that management controls the operations of the company as well as corporate disclosure, incentive-based awards require the most diligent monitoring by the members of the compensation committee. Directors must ascertain that management is not manipulating variables within its control, for example, accounting disclosure choices, to artificially achieve performance targets. The investor should examine the bonus awards carefully, evaluating the performance targets for reasonableness, and to make certain that the awards are consistent with the investor's best interests.

Stock options and stock awards have been argued to better align the interests of managers with those of shareholders by making a portion of the manager's compensation dependent on the value of the stock. Unfortunately, as recent events have made clear, stock options do not always result in such an alignment of interests. Indeed, until recently, the lack of appropriate accounting recognition of the expense of stock option awards has led to widespread abuse of this form of compensation. Large grants of stock options dilute shareholders' positions in the company and diminish the value of their holdings.

Appropriate accounting for stock options, that is, expensing in the income statement with assumed conversion to stock in the earnings-per-share calculation, has come to be seen as a litmus test for high-quality financial reporting and transparency.[7] Nevertheless, abusive practices involving information manipulation related to stock option grants and option exercise still occur.

In theory, grants of stock options to executives and other employees should be subject to shareholder approval. As a practical matter, however, there are loopholes that permit managers and directors to by-pass such approval, although some jurisdictions have closed some of these loopholes recently.

Stock options' potential dilutive effect on shareholders can be assessed by a measure known as the "share overhang." The overhang is simply the number of shares represented by the options, relative to the total amount of stock outstanding. Both of these numbers are readily available in company regulatory filings in most jurisdictions.

In addition, investors should be alert to any provisions permitting the so-called "repricing" of stock options. Repricing means that the company can, with approval of the board of directors, adjust the exercise price of outstanding option grants downward to the current price of the stock. This is done by some companies when the price of the stock has declined significantly and the options are **out-of-the-money**. As is readily apparent, such repricing is inconsistent with the argument that options should serve the interests of managers and shareholders and provide an incentive for managers to strive for excellent long-term corporate performance. The managers may have **at-the-money** options following repricing, but investors cannot recoup their losses so easily. Abuse in this area has been stemmed somewhat by accounting rule changes that now require that such repriced options be expensed in the income statement, although companies can still cancel the options and reissue them later at a time consistent with the rules, usually six months.

---

7 In 2003, the International Accounting Standards Board (IASB) issued a standard requiring the fair value expensing of stock options for all companies that use IASB standards. Some ninety countries worldwide adhere to IASB standards.

Stock grants by companies to executives can be an effective means of motivating them to achieve sustainable, long-term performance objectives. Restricted stock grants, that is, stock awards that cannot be sold or otherwise disposed of for a period of time, or that are contingent upon reaching certain performance goals, can be subject to the same abusive practices as stock option awards, depending upon the terms of the awards. Well-designed restricted stock awards are increasingly used by companies to reward executives for their performance as well as to remunerate lower-level employees. Most jurisdictions require companies to disclose such grants in regulatory filings.

5.1.10 *Board's Independent Legal and Expert Counsel*

The board of directors should have the ability and sufficient resources to hire such legal and other expert counsel as they require to fulfill their fiduciary duties. In most companies, for example, the corporate counsel also has the responsibility to advise the board of directors. Because the board of directors is charged with overseeing management on behalf of the shareholders, this represents a direct conflict of interest. That is, the corporate counsel cannot be wholly independent with regard to the advice provided to the directors if it also serves, and is paid by, corporate management.

Legal counsel will be needed to help the board assess the company's compliance with legal and regulatory requirements. Outside counsel becomes increasingly important for companies with global operations. Similarly, for example, in high-technology companies, the members of the board will likely require the assistance of experts in the particular specialized technologies employed or developed by the company. However, all boards, regardless of the industry, are likely to require additional counsel and should be able to obtain such services when they require it.

The investor should review regulatory filings carefully to determine if the board makes use of independent outside counsel. If the filings are silent on the issue, the analyst or investor should specifically inquire about the board's use of independent counsel. If satisfactory answers are not forthcoming, this should reflect negatively on the board's independence as well as its ability to perform its fiduciary duties.

5.1.11 *Statement of Governance Policies*

Companies that have a strong commitment to corporate governance frequently supply a statement of their corporate governance policies, variously in their regulatory filings, on their websites, or as part other investor information packets. Investors and investment analysts should assess the following elements of a statement of corporate governance policies:

- codes of ethics;
- statements of the oversight, monitoring, and review responsibilities of directors, including internal control, risk management, audit and accounting and disclosure policy, compliance assessment, nominations, compensation awards, and other responsibilities;
- statements of management's responsibilities to provide complete and timely information to the board members prior to board meetings, and to provide directors with free and unfettered access to control and compliance functions within the company;
- reports of directors' examinations, evaluations, and findings in their oversight and review function;
- board and committee performance self-assessments;
- management performance assessments; and
- training provided to directors prior to joining the board and periodically thereafter.

Obviously, one cannot rely solely on the corporate governance statement for assurance that the company has a sound corporate governance structure. Nevertheless, such disclosures provide investors with a comparison for evaluating company and director performance over time. For example, such disclosures should not be "boilerplate" statements that do not change over time and that provide no real content or information.

5.1.12 *Disclosure and Transparency*

The purpose of accounting and disclosure is to tell the company's economic story as it is, not as some might want it to be in order to achieve some personal objective. Investors depend critically on the quality, clarity, timeliness, and completeness of financial information in valuing securities and assessing risk. Attempts to hide or otherwise obfuscate essential information can result in the mispricing of securities and the misallocation of capital, reducing the efficiency and effectiveness of markets.

It is worth observing that nearly all of the major corporate collapses in recent years have involved equally massive attempts to hide, obfuscate, or falsify information that could have alerted investors to the seriousness of the financial problems and the impending implosions. Enron attempted to hide its massive and growing debt by moving it off the balance sheet and into "partnerships," run by insiders, for which no information was available. Tyco failed to report billions in "loans" to insiders. WorldCom not only hid $11 billion in operating expenses by recording them as assets in the balance sheet, but also failed to disclose hundreds of millions of dollars in loans to the chief executive. Parmalat staved off collapse for some time by reporting falsely that the company had nearly $5 billion in a corporate account with a major international financial institution.

The crisis of the loss of confidence and trust in the broad financial markets globally, rather than just the companies involved, signals the depths of the concern that investors have had about the quality and completeness of the disclosure they are receiving. Not surprisingly, the response has been a major overhaul of legislative, regulatory, and related criminal code provisions in countries in North America and Europe, as well as elsewhere. Such provisions as the requirements in the United States that the chief executive officer and chief financial officer certify the accuracy of financial statements and develop rigorous new systems of internal controls, backed up by new audit attestation requirements and stiffer criminal penalties, make clear the seriousness of the offenses and the public's response to such malfeasance.

However, such changes do not guarantee that those in a position of trust will not again willingly mislead and misinform their investors and others, particularly when they are faced with serious financial difficulties. Consequently, an evaluation of the quality and extent of financial information provided to investors is a crucial element in evaluating the corporate governance structure of a company and the risk borne by an investor in the company's securities. In assessing the quality of disclosure, some indicators of good quality financial reporting are:[8]

- conservative assumptions used for employee benefit plans;
- adequate provisions for lawsuits and other loss contingencies;
- minimal use of off-balance sheet financing techniques and full disclosure of assets, liabilities, revenues, and expenses associated with such activities;
- absence of nonrecurring gains;
- absence of noncash earnings;
- clear and adequate disclosure;

8 White, Gerald I., Ashwinpaul C. Sondhi, and Dov Fried, *The Analysis and Use of Financial Statements*, Third Edition, 2003, Wiley, p. 637 ff.

- conservative revenue and expense recognition methods;
- use of LIFO inventory accounting (during periods of generally rising prices);
- bad-debt reserves that are high relative to receivables and past credit losses;
- use of accelerated depreciation methods and short lives;
- rapid write-off of acquisition-related intangible assets;
- minimal capitalization of interest and overhead;
- minimal capitalization of computer software costs;
- expensing of startup costs of new operations; and
- use of the completed contract method of accounting for contracts.

One area of concern in recent years is the reporting by companies of so-called "pro forma" earnings numbers, earnings before non-cash or "non-recurring" charges. Pro forma earnings have occasionally been dubbed "earnings-before-the-bad-stuff." Such misleading disclosures have been widely used by companies with poor performance and poor prospects. Unfortunately, some analysts and investors have been willing to accept the deception as reflective of economic reality, frequently to their regret. To survive and flourish long-term, companies must be able to cover all of their costs.

In addition to high-quality financial disclosure, the company should make readily available in its regulatory filings clear and complete information on such items as:

- governance policies and procedures;
- reporting lines and organizational structure;
- corporate strategy, goals, and objectives;
- competitive threats and other risks and contingencies faced by the company and the potential effect of these on the company's operations;
- insider transactions involving executives or other senior employees, and directors;
- compensation policies and amounts of compensation awarded, including perquisites, for key executives and directors; and
- changes to governance structures, including the corporate charter and by-laws.

The investor should be alert particularly to references to off-balance sheet or insider transactions that are not accompanied by full disclosure of the effects of the items on the company. The investor should also consider the implications of a lack of disclosure. For example, many large companies maintain fleets of corporate jets for the use of executives and other employees. They routinely make such planes available to executives for their private use on holidays. A failure to mention such perquisites should raise questions, not only about this item but about other possible compensation that has not been disclosed.

5.1.13 *Insider or Related-Party Transactions*

The corporate collapse cases cited above involve egregious insider transactions by senior executives, frequently with the acquiescence of a compliant board of directors. The executives' objective was self-aggrandizement at the expense of shareholders and other stakeholders in the company. This is not a new problem. Indeed, audit standards have required for decades that auditors investigate such items and flag them for users of the statements. However, both the frequency and extent of the theft and fraud, and the losses incurred by investors, employees, and others recently have dismayed even the most seasoned professionals in the financial markets.

The analyst should assess the company's policies concerning related-party transactions, whether the company has entered into any such transactions, and, if so, what the effects are on the company's financial statements. Any related-party transaction

should require the prior approval of the board of directors and a statement that such transactions are consistent with company policy. Financial disclosures and related notes in regulatory filings are a source for analysts in researching such transactions.

5.1.14 *Responsiveness of Board of Directors to Shareholder Proxy Votes*

A clear indicator of the extent to which directors and executives take seriously their fiduciary responsibility to shareholders is the response of the company to shareholder votes on proxy matters. A recent example involves the issue of expensing stock options, which has been put to proxy vote in a sizable number of companies. Shareholders in many of the companies have voted in the majority that the company begin expensing stock options. Very few company managers and directors have responded positively to the votes.

Directors cannot be expected to respond to trivial or frivolous shareholder initiatives, but few such issues carry a large portion of the vote of shareholders. However, when matters related to governance, executive compensation, mergers and acquisitions, or other matters of great importance to investors are put to a vote of the shareholders, and the results of the vote are ignored, the implications are abundantly clear: management and the board are not concerned for or motivated by the best interests of the company's shareholders. An analyst should review all such proxies put to the shareholders, determine the shareholders' consensus as reflected in the relative size of the affirmative vote, and determine the directors' response to the vote as reflected in the actions taken by the board and management. The responsiveness is a clear signal of the board's willingness to act in the best interests of the owners of the company.

5.2 Examples of Codes of Corporate Governance

We provide examples of three codes of corporate governance, one from General Electric, one from the Monetary Authority of Singapore, and a third from an international organization, the Organization for Economic Co-Operation and Development. The first code provides an example for one of the largest globally-diversified corporations. The second addresses corporate governance issues for financial institutions, specifically commercial banks and insurers operating in Singapore. The third has a much broader scope, addressing corporate governance issues in any type of firm in any industry, operating in a variety of countries that are members of the organization. Taken together, these three codes indicate the varying approaches to corporate governance worldwide while also illustrating how the core conflicts of interest between managers and owners are addressed.

5.2.1 *General Electric:* Governance Principles

General Electric's *Governance Principles* are a particularly good example of a company code of corporate governance. GE established the code to guide not only its managers and board of directors in their activities and decision-making, but to serve as a benchmark by which their performance may be evaluated. The company publishes their *Principles* in a prominent place on their website. A review of these principles will show that many of the major governance concerns discussed above are reflected here. The principles also explicitly address issues such as the company's policy on the adoption of "poison pills" and director education.

EXAMPLE 5

General Electric's *Governance Principles*

1 Role of Board and Management

GE's business is conducted by its employees, managers and officers, under the direction of the chief executive officer (CEO) and the oversight of the board, to enhance the long-term value of the company for its shareowners. The board of directors is elected by the shareowners to oversee management and to assure that the long-term interests of the shareowners are being served. Both the board of directors and management recognize that the long-term interests of shareowners are advanced by responsibly addressing the concerns of other stakeholders and interested parties including employees, recruits, customers, suppliers, GE communities, government officials and the public at large.

2 Functions of Board

The board of directors has eight scheduled meetings a year at which it reviews and discusses reports by management on the performance of the company, its plans and prospects, as well as immediate issues facing the company. Directors are expected to attend all scheduled board and committee meetings. In addition to its general oversight of management, the board also performs a number of specific functions, including:

- selecting, evaluating and compensating the CEO and overseeing CEO succession planning;
- providing counsel and oversight on the selection, evaluation, development and compensation of senior management;
- reviewing, monitoring and, where appropriate, approving fundamental financial and business strategies and major corporate actions;
- assessing major risks facing the company—and reviewing options for their mitigation; and
- ensuring processes are in place for maintaining the integrity of the company—the integrity of the financial statements, the integrity of compliance with law and ethics, the integrity of relationships with customers and suppliers, and the integrity of relationships with other stakeholders.

3 Qualifications

Directors should possess the highest personal and professional ethics, integrity and values, and be committed to representing the long-term interests of the shareowners. They must also have an inquisitive and objective perspective, practical wisdom and mature judgment. We endeavor to have a board representing diverse experience at policymaking levels in business, government, education and technology, and in areas that are relevant to the company's global activities. Directors must be willing to devote sufficient time to carrying out their duties and responsibilities effectively, and should be committed to serve on the board for an extended period of time. Directors should offer their resignation in the event of any significant change in their personal circumstances, including a change in their principal job responsibilities.

Directors who also serve as CEOs or in equivalent positions should not serve on more than two boards of public companies in addition to the GE board, and other directors should not serve on more than four other boards of public

companies in addition to the GE board. Current positions in excess of these limits may be maintained unless the board determines that doing so would impair the director's service on the GE board.

The board does not believe that arbitrary term limits on directors' service are appropriate, nor does it believe that directors should expect to be renominated annually until they reach the mandatory retirement age. The board self-evaluation process described below will be an important determinant for board tenure. Directors will not be nominated for election to the board after their 73rd birthday, although the full board may nominate candidates over 73 for special circumstances.

4 Independence of Directors

A majority of the directors will be independent directors, as independence is determined by the board, based on the guidelines set forth below.

All future non-employee directors will be independent. GE seeks to have a minimum of ten independent directors at all times, and it is the board's goal that at least two-thirds of the directors will be independent. Directors who do not satisfy GE's independence guidelines also make valuable contributions to the board and to the company by reason of their experience and wisdom.

For a director to be considered independent, the board must determine that the director does not have any direct or indirect material relationship with GE. The board has established guidelines to assist it in determining director independence, which conform to or are more exacting than the independence requirements in the New York Stock Exchange listing requirements (NYSE rules). In addition to applying these guidelines, the board will consider all relevant facts and circumstances in making an independence determination, and not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation.

The board will make and publicly disclose its independence determination for each director when the director is first elected to the board and annually thereafter for all nominees for election as directors. If the board determines that a director who satisfies the NYSE rules is independent even though he or she does not satisfy all of GE's independence guidelines, this determination will be disclosed and explained in the next proxy statement.

In accordance with the revised NYSE rules, independence determinations under the guidelines in section (a) below will be based upon a director's relationships with GE during the 36 months preceding the determination. Similarly, independence determinations under the guidelines in section (b) below will be based upon the extent of commercial relationships during the three completed fiscal years preceding the determination.

a A director will not be independent if:

- the director is employed by GE, or an immediate family member is an executive officer of GE;
- the director receives any direct compensation from GE, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);
- an immediate family member who is a GE executive officer receives more than $100,000 per year in direct compensation from GE;
- the director is affiliated with or employed by GE's independent auditor, or an immediate family member is affiliated with or employed in a professional capacity by GE's independent auditor; or

- a GE executive officer is on the compensation committee of the board of directors of a company which employs the GE director or an immediate family member as an executive officer.

b A director will not be independent if, at the time of the independence determination, the director is an executive officer or employee, or if an immediate family member is an executive officer, of another company that does business with GE and the sales by that company to GE or purchases by that company from GE, in any single fiscal year during the evaluation period, are more than the greater of one percent of the annual revenues of that company or $1 million.

c A director will not be independent if, at the time of the independence determination, the director is an executive officer or employee, or an immediate family member is an executive officer, of another company which is indebted to GE, or to which GE is indebted, and the total amount of either company's indebtedness to the other at the end of the last completed fiscal year is more than one percent of the other company's total consolidated assets.

d A director will not be independent if, at the time of the independence determination, the director serves as an officer, director or trustee of a charitable organization, and GE's discretionary charitable contributions to the organization are more than one percent of that organization's total annual charitable receipts during its last completed fiscal year. (GE's automatic matching of employee charitable contributions will not be included in the amount of GE's contributions for this purpose.)

5 Size of Board and Selection Process

The directors are elected each year by the shareowners at the annual meeting of shareowners. Shareowners may propose nominees for consideration by the nominating and corporate governance committee by submitting the names and supporting information to: Secretary, General Electric Company, 3135 Easton Turnpike, Fairfield, CT 06828. The board proposes a slate of nominees to the shareowners for election to the board. The board also determines the number of directors on the board provided that there are at least 10. Between annual shareowner meetings, the board may elect directors to serve until the next annual meeting. The board believes that, given the size and breadth of GE and the need for diversity of board views, the size of the board should be in the range of 13 to 17 directors.

6 Board Committees

The board has established the following committees to assist the board in discharging its responsibilities: i) audit; ii) management development and compensation; iii) nominating and corporate governance; and iv) public responsibilities. The current charters and key practices of these committees are published on the GE website, and will be mailed to shareowners on written request. The committee chairs report the highlights of their meetings to the full board following each meeting of the respective committees. The committees occasionally hold meetings in conjunction with the full board. For example, it is the practice of the audit committee to meet in conjunction with the full board in February so that all directors may participate in the review of the annual financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations for the prior year and financial plans for the current year.

7 Independence of Committee Members

In addition to the requirement that a majority of the board satisfy the independence standards discussed in section 4 above, members of the audit committee must also satisfy an additional NYSE independence requirement. Specifically, they may not accept directly or indirectly any consulting, advisory or other compensatory fee from GE or any of its subsidiaries other than their directors' compensation. As a matter of policy, the board will also apply a separate and heightened independence standard to members of both the management development and compensation committee and the nominating and corporate governance committee. No member of either committee may be a partner, member or principal of a law firm, accounting firm or investment banking firm that accepts consulting or advisory fees from GE or any of its subsidiaries.

8 Meetings of Non-Employee Directors

The board will have at least three regularly scheduled meetings a year for the non-employee directors without management present. The directors have determined that the chairman of the management development and compensation committee will preside at such meetings, and will serve as the presiding director in performing such other functions as the board may direct, including advising on the selection of committee chairs and advising management on the agenda for board meetings. The non-employee directors may meet without management present at such other times as determined by the presiding director.

9 Self-Evaluation

As described more fully in the key practices of the nominating and corporate governance committee, the board and each of the committees will perform an annual self-evaluation. Each November, each director will provide to an independent governance expert his or her assessment of the effectiveness of the board and its committees, as well as director performance and board dynamics. The individual assessments will be organized and summarized by this independent governance expert for discussion with the board and the committees in December.

10 Setting Board Agenda

The board shall be responsible for its agenda. At the December board meeting, the CEO and the presiding director will propose for the board's approval key issues of strategy, risk and integrity to be scheduled and discussed during the course of the next calendar year. Before that meeting, the board will be invited to offer its suggestions. As a result of this process, a schedule of major discussion items for the following year will be established. Prior to each board meeting, the CEO will discuss the other specific agenda items for the meeting with the presiding director, who shall have authority to approve the agenda for the meeting. The CEO and the presiding director, or committee chair as appropriate, shall determine the nature and extent of information that shall be provided regularly to the directors before each scheduled board or committee meeting. Directors are urged to make suggestions for agenda items, or additional pre-meeting materials, to the CEO, the presiding director, or appropriate committee chair at any time.

11 Ethics and Conflicts of Interest

The board expects GE directors, as well as officers and employees, to act ethically at all times and to acknowledge their adherence to the policies comprising GE's code of conduct set forth in the company's integrity manual, "Integrity: The Spirit and the Letter of Our Commitment." GE will not make any personal loans or extensions of credit to directors or executive officers, other than consumer loans or credit card services on terms offered to the general public. No non-employee

director may provide personal services for compensation to GE, other than in connection with serving as a GE director. The board will not permit any waiver of any ethics policy for any director or executive officer. If an actual or potential conflict of interest arises for a director, the director shall promptly inform the CEO and the presiding director. If a significant conflict exists and cannot be resolved, the director should resign. All directors will recuse themselves from any discussion or decision affecting their personal, business or professional interests. The board shall resolve any conflict of interest question involving the CEO, a vice chairman or a senior vice president, and the CEO shall resolve any conflict of interest issue involving any other officer of the company.

12 Reporting of Concerns to Non-Employee Directors or the Audit Committee

The audit committee and the non-employee directors have established the following procedures to enable anyone who has a concern about GE's conduct, or any employee who has a complaint about the company's accounting, internal accounting controls or auditing matters, to communicate that concern directly to the presiding director, to the non-employee directors or to the audit committee. Such communications may be confidential or anonymous, and may be e-mailed, submitted in writing or reported by phone to special addresses and a toll-free phone number that are published on the company's website. All such communications shall be promptly reviewed by GE's ombudsman, and any concerns relating to accounting, internal controls, auditing or officer conduct shall be sent immediately to the presiding director and to the chair of the audit committee. All concerns will be reviewed and addressed by GE's ombudsman in the same way that other concerns are addressed by the company. The status of all outstanding concerns addressed to the non-employee directors, the presiding director or the audit committee will be reported to the presiding director and the chair of the audit committee on a quarterly basis. The presiding director or the audit committee chair may direct that certain matters be presented to the audit committee or the full board and may direct special treatment, including the retention of outside advisors or counsel, for any concern addressed to them. The company's integrity manual prohibits any employee from retaliating or taking any adverse action against anyone for raising or helping to resolve an integrity concern.

13 Compensation of the Board

The nominating and corporate governance committee shall have the responsibility for recommending to the board compensation and benefits for non-employee directors. In discharging this duty, the committee shall be guided by three goals: compensation should fairly pay directors for work required in a company of GE's size and scope; compensation should align directors' interests with the long-term interests of shareowners; and the structure of the compensation should be simple, transparent and easy for shareowners to understand. As discussed more fully in the key practices of the nominating and corporate governance committee, the committee believes these goals will be served by providing 40% of non-employee director compensation in cash and 60% in deferred stock units. At the end of each year, the nominating and corporate governance committee shall review non-employee director compensation and benefits.

14 Succession Plan

The board shall approve and maintain a succession plan for the CEO and senior executives, based upon recommendations from the management development and compensation committee.

15 Annual Compensation Review of Senior Management

The management development and compensation committee shall annually approve the goals and objectives for compensating the CEO. That committee shall evaluate the CEO's performance in light of these goals before setting the CEO's salary, bonus and other incentive and equity compensation. The committee shall also annually approve the compensation structure for the company's officers, and shall evaluate the performance of the company's senior executive officers before approving their salary, bonus and other incentive and equity compensation.

16 Access to Senior Management

Non-employee directors are encouraged to contact senior managers of the company without senior corporate management present. To facilitate such contact, non-employee directors are expected to make two regularly scheduled visits to GE businesses a year without corporate management being present.

17 Access to Independent Advisors

The board and its committees shall have the right at any time to retain independent outside auditors and financial, legal or other advisors, and the company shall provide appropriate funding, as determined by the board or any committee, to compensate such independent outside auditors or advisors, as well as to cover the ordinary administrative expenses incurred by the board and its committees in carrying out their duties.

18 Director Education

The general counsel and the chief financial officer shall be responsible for providing an orientation for new directors. Each new director shall, within three months of election to the board, spend a day at corporate headquarters for personal briefing by senior management on the company's strategic plans, its financial statements, and its key policies and practices. In addition, directors shall be provided with continuing education on subjects that would assist them in discharging their duties, including regular programs on GE's financial planning and analysis, compliance and corporate governance developments; business-specific learning opportunities through site visits and Board meetings; and briefing sessions on topics that present special risks and opportunities to the company.

19 Policy on Poison Pills

The term "poison pill" refers to the type of shareowner rights plan that some companies adopt to make a hostile takeover of the company more difficult. GE does not have a poison pill and has no intention of adopting a poison pill because a hostile takeover of a company of our size is impractical and unrealistic. However, if GE were ever to adopt a poison pill, the board would seek prior shareowner approval unless, due to timing constraints or other reasons, a committee consisting solely of independent directors determines that it would be in the best interests of shareowners to adopt a poison pill before obtaining shareowner approval. If the GE board of directors were ever to adopt a poison pill without prior shareowner approval, the board would either submit the poison pill to shareowners for ratification, or would cause the poison pill to expire, without being renewed or replaced, within one year.

5.2.2 *Monetary Authority of Singapore:* Guidelines and Regulations on Corporate Governance

In February 2003, the Monetary Authority of Singapore (MAS) established principles of corporate governance for the banks and insurers that fall within its regulatory purview. The code, *Guidelines and Regulations on Corporate Governance*,[9] defines and explains corporate governance as:

> . . . The processes and structures by which the business and affairs of an Institution are directed, managed and controlled. [p. 6]

The MAS makes clear that the key element in an effective system of corporate governance rests with the board of directors, and that its primary duties are to shareholders and depositors, or, in the case of an insurer, the policyholders:

> The board of directors is responsible for directing the management of the Institution. Besides its obligations to the shareholders, the board of directors of an Institution has a duty to act in the best interest of the Institution and to ensure that the Institution has sufficient resources to meet its obligations to other stakeholders, in particular a bank's depositors or an insurer's policyholders.

The Monetary Authority of Singapore has the following thirteen principles to guide the banks and insurers within its regulatory authority in compliance with the corporate governance standards in its *Guidelines and Regulations on Corporate Governance*:

Principle 1 Every Institution should be headed by an effective Board.

Principle 2 There should be a strong and independent element on the Board which is able to exercise objective judgment on corporate affairs independently from management and substantial shareholders.

Principle 3 The Board should set and enforce clear lines of responsibility and accountability throughout the Institution.

Principle 4 There should be a formal and transparent process for the appointment of new directors to the Board.

Principle 5 There should be a formal assessment of the effectiveness of the Board as a whole and the contribution by each director to the effectiveness of the Board.

Principle 6 In order to fulfill their responsibilities, Board members should be provided with complete, adequate and timely information prior to board meetings and on an on-going basis by the management.

Principle 7 There should be a formal and transparent procedure for fixing the remuneration packages of individual directors. No director should be involved in deciding his own remuneration.

Principle 8 The level and composition of remuneration should be appropriate to attract, retain and motivate the directors to perform their roles and carry out their responsibilities.

Principle 9 The Board should establish an Audit Committee with a set of written terms of reference that clearly sets out its authority and duties.

Principle 10 The Board should ensure that there is an adequate risk management system and sound internal controls.

9 These guidelines expand and build upon the *Code of Corporate Governance*, issued in 2001 by the Corporate Governance Committee, established by the Ministry of Finance, the Authority and the Attorney-General's Chambers.

Principle 11 The Board should ensure that an internal audit function that is independent of the activities audited is established.

Principle 12 The Board should ensure that management formulates policies to ensure dealings with the public, the Institution's policyholders and claimants, depositors and other customers are conducted fairly, responsibly and professionally.

Principle 13 The Board should ensure that related party transactions with the Institution are made on an arm's length basis.

These principles are supported by requirements for extensive disclosures regarding companies' implementation and of the standards and their procedures for continuous monitoring of compliance. It is notable that the Monetary Authority does not require that a majority of the board members be independent, but only that one-third meet such a test.

5.2.3 *Organisation for Economic Co-Operation and Development:* OECD Principles of Corporate Governance

The Organisation for Economic Co-Operation and Development ("OECD")[10] issued its code, *OECD Principles of Corporate Governance* ("OECD Principles"), which applies to all Member countries. These countries comprise a number of different legislative, regulatory and market systems.

The OECD observes that its Principles "represent the first initiative by an inter-governmental organisation to develop the core elements of a good corporate governance regime. As such, the Principles can be used as a benchmark by governments as they evaluate and improve their laws and regulations." The Preface to the OECD Principles states:

> A good corporate governance regime helps to assure that corporations use their capital efficiently. Good corporate governance helps, too, to ensure that corporations take into account the interests of a wide range of constituencies as well as of the communities within which they operate, and that their boards are accountable to the company and the shareholders. This, in turn, helps to assure that corporations operate for the benefit of society as a whole. It helps to maintain the confidence of investors—both foreign and domestic—and to attract more "patient", long-term capital … **Common to all good corporate governance regimes, however, is a high degree of priority placed on the interests of shareholders, who place their trust in corporations to use their investment funds wisely and effectively.** [Emphasis added]

Despite the application of the OECD Principles to a wide variety of regimes, the OECD provides a special emphasis on the rights and fair treatment of shareholders. This characteristic, although considered to be a fundamental requirement for good systems of corporate governance, is not frequently found in either corporate codes or those of other business organizations. For example, the General Electric code is silent on shareholder rights, although it acknowledges in the first principle that managers and the directors have an obligation to attend to the interests of shareholders. The Monetary Authority of Singapore's code takes a similar approach.

10 Issued in 1999, and subsequently revised, the OECD Principles are intended to be adopted by each of the OECD Member countries, which include: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

EXAMPLE 6

OECD Principles of Corporate Governance

I. The Rights of Shareholders

The corporate governance framework should protect shareholders' rights.

A Basic shareholder rights include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect members of the board; and 6) share in the profits of the corporation.

B Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:

  1 Amendments to the statutes, or articles of incorporation or similar governing documents of the company;

  2 The authorisation of additional shares; and

  3 Extraordinary transactions that in effect result in the sale of the company.

C Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:

  1 Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.

  2 Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations.

  3 Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

D Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

E Markets for corporate control should be allowed to function in an efficient and transparent manner.

  1 The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

  2 Anti-take-over devices should not be used to shield management from accountability.

F Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

II. The Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A All shareholders of the same class should be treated equally.

- **1** Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote.
- **2** Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
- **3** Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

B Insider trading and abusive self-dealing should be prohibited.

C Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

III. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

B Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

C The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.

D Where stakeholders participate in the corporate governance process, they should have access to relevant information.

IV. Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A Disclosure should include, but not be limited to, material information on:

- **1** The financial and operating results of the company.
- **2** Company objectives.
- **3** Major share ownership and voting rights.
- **4** Members of the board and key executives, and their remuneration.
- **5** Material foreseeable risk factors.
- **6** Material issues regarding employees and other stakeholders.
- **7** Governance structures and policies.

B Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

C An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

D Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

V. The Responsibilities of the Board

The corporate governance framework should ensure 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.

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.

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

C The board should ensure compliance with applicable law and take into account the interests of stakeholders.

D The board should fulfill certain key functions, including:

1. 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.
2. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
3. Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.
4. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
5. 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 monitoring risk, financial control, and compliance with the law.
6. Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.
7. Overseeing the process of disclosure and communications.

E The board should be able to exercise objective judgement on corporate affairs independent, in particular, from management.

1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.
2. Board members should devote sufficient time to their responsibilities.

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

This code, and its predecessor variants, is not only among the earliest efforts to establish guidelines for good governance, but with its global reach has had wide influence on the development of other codes and regulatory frameworks.