Corporate governance issues and trends: A practitioner's perspective

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SUITE OF CORPORATE GOVERNANCE TOOLS

		Description
Legal/regulatory	Fiduciary duty	• Management is required to observe duty of loyalty and care
	Shareholder rights	• Rights of action enabling shareholders to remove underperforming directors and managers
	Transparency/ disclosure	• Timely and comprehensive disclosure on key matters (e.g., operations, governance structures, executive compensation)
Intermediaries	Board of directors	• Group of overseers to monitor management
	Significant shareholders	• Significant shareholders will have greater incentive to monitor
	Gatekeepers	• Lawyers, accountants, investment bankers, ratings agencies, etc. to vouch for integrity of management/company
Financial/economic	Compensation	• Performance-based compensation (including in the form of shares) to align management-shareholder interests
	Debt	• Requirement to make periodic debt payments will instill discipline and reduce discretion
	Product market competition	• Competitive intensity will ensure that management stays focused
	Takeover market	• Fear of being taken over will instill discipline on management

CORPORATE GOVERNANCE TOOLS EXAMINED

1. Improving ***transparency*** through greater disclosure in such areas as annual accounts, executive compensation, and conflicts of interest

2. Enhancing ***independent monitoring*** of management by the board of directors

3. Strengthening ***economic alignment*** between principals and agents through performance-based compensation and other financial incentives

4. Bolstering ***shareholder rights*** through such mechanisms as cumulative voting, board nomination rights, and vote on executive remuneration

5. Imposing ***financial liability*** on corporate officers and directors, external auditors, investment bankers, and other intermediaries to ensure diligence, loyalty, and honesty

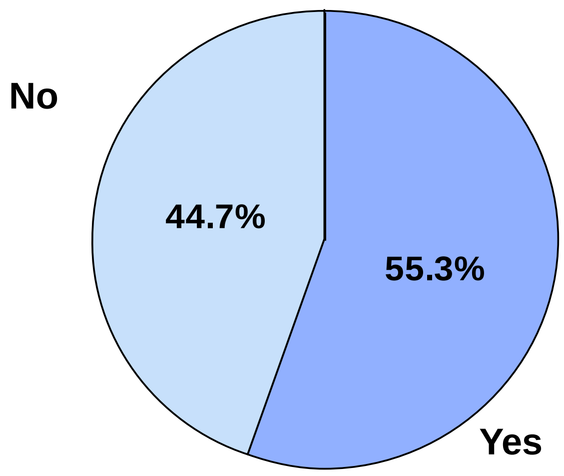
SOME TRANSPARENCY REQUIREMENTS HAVE BROUGHT ABOUT ADVERSE CONSEQUENCES

> "If I miss the [consensus earnings] target, I'm out of a job."
> - US executive

- While greater transparency has been on the whole highly positive, some disclosure requirements have brought about deleterious repercussions
- Quarterly reporting, for example, has led to company management focusing excessively on short-term performance

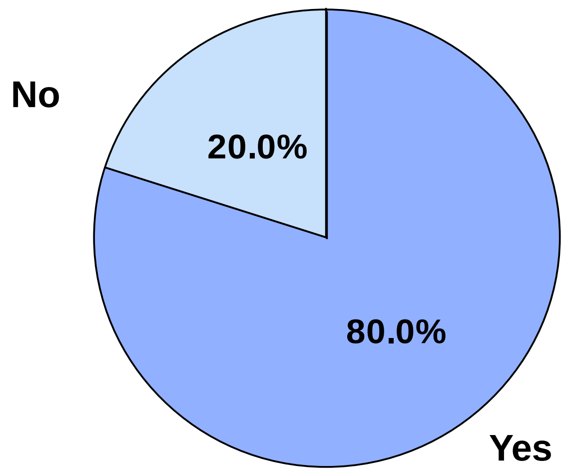
Question: To meet earnings target, would you be willing to delay starting a new project even if this entails a small sacrifice in value?

N = 401



Question: To meet earnings target, would you be willing to decrease discretionary spending (e.g. R&D, advertising, maintenance)?

N = 401



Source: Graham, Harvey and Rajgopal (2006)

OECD PRINCIPLES OF CORPORATE GOVERNANCE – BOARD TASKS

The board shall ...

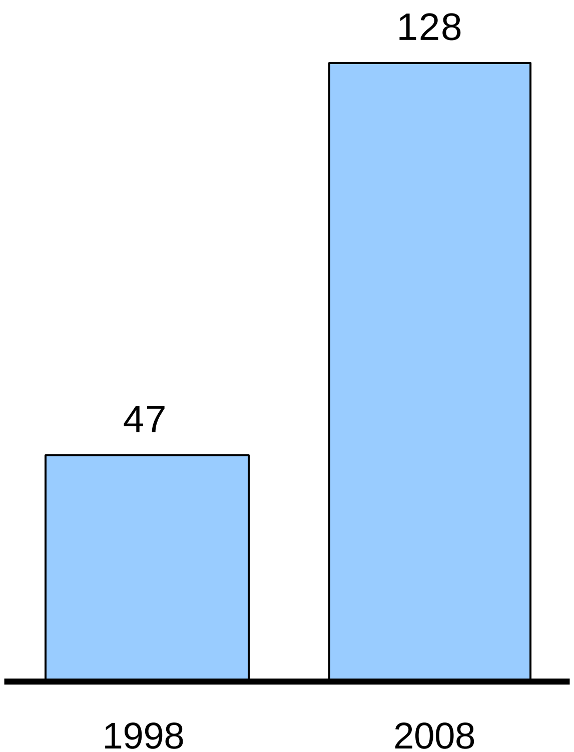
- Review and guide corporate strategy, major plans of action, risk policy, annual budgets and business plans
- Set performance objectives
- Monitor implementation and corporate performance
- Oversee major capital expenditures, acquisitions, and divestitures
- Select, compensate, monitor, and when necessary, replacing key executives
- Oversee succession planning
- Align key executive and board remuneration with the longer term interests of the company and its shareholders
- Ensure a formal and transparent board nomination and election process
- Monitor and manage potential conflicts of interest of management, board members and shareholders
- Ensure integrity of company's accounting and financial reporting, including independent audit and internal control system
- Oversee disclosure and communications

Source:OECD 2004

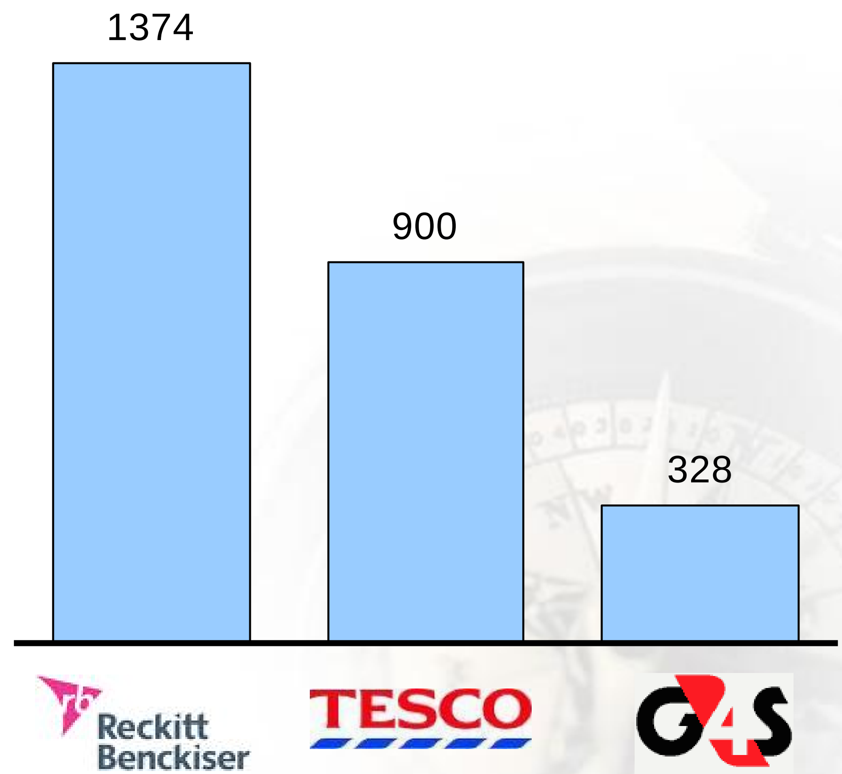
WHAT ARE THE LIMITS OF PERFORMANCE-BASED PAY?

"You have to realise: if I had been paid 50 per cent more, I would not have done it better. If I had been paid 50 per cent less, then I would not have done it worse."
- Former Shell CEO Jeroen van der Veer (2009)

CEO-average employee pay ratio
UK, FTSE 100



FTSE 100 companies with highest CEO-average employee pay ratio
2008



Source: Economist (Sept 2009); Guardian (Sept 2009)

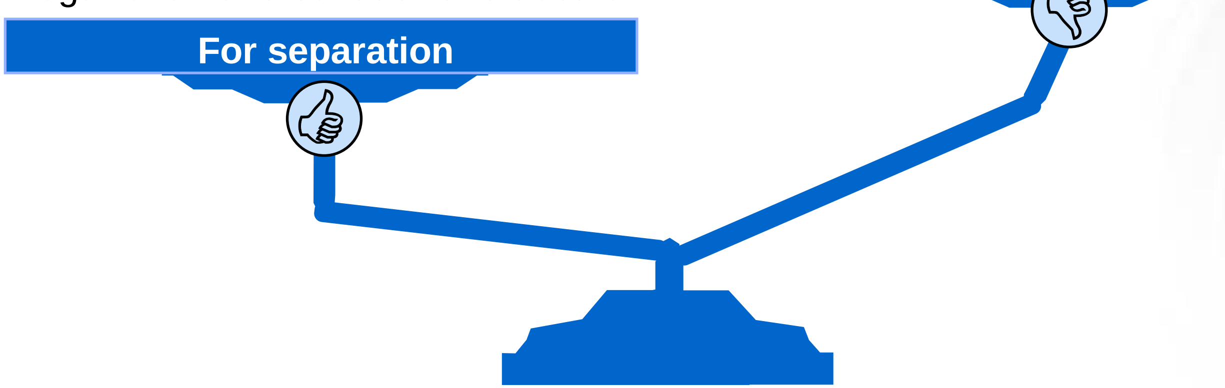
SEPARATION OF CHAIRMAN AND CEO ROLES – KEY ARGUMENTS

For separation

- Provides structure for board to act independently
- Reduces possibility of excessive concentration of authority in one person
- Clarifies roles of board and CEO, and improves board's ability to hold CEO accountable
- Ensures that board tasks are not neglected by a combined chairman-CEO due to lack of time
- Increases possibility that chairman and CEO posts will be assumed by individuals possessing the requisite skills and experience for those positions
- Creates a board environment more egalitarian and conducive to debate

Against separation

- Chairman might usurp role of CEO
- Separation of roles could result in divided spheres of influence
- Chairman might not possess adequate knowledge about the firm and its industry
- Chairman might not have sufficient time to run the board effectively
- Chairman might lose independence over time



- Risks posed by a separation of roles can be more easily resolved than the difficulties caused by a combined model
  - – Design chairman role to require 2-3 days/week commitment

GENERAL GUIDELINES ON CHAIRMAN AND CEO ROLES

Chairman roles

- Provide leadership to board
  - Plan board meeting agendas
  - Ensure board receives proper information
  - Chair all board meetings
  - Ensure directors contribute
  - Drive discussion towards consensus
- Determine structure and composition of board
- Chair shareholders meeting
- Act as firm's lead representative and explain aims/policies to outside world

CEO roles

- Develop & implement strategy reflecting long-term objectives and priorities set by board
- Assume full accountability to board for all aspects of company operations and performance
- Maintain dialogue with chairman
- Build and maintain effective executive team
- Put adequate controls in place
- Closely monitor operating and financial results
- Represent company to major customers, etc

Potentially shared roles

- External relations, including interface with shareholders and regulators
- Senior leadership development

Source: Institute of Directors (UK), Wong

THE UK STEWARDSHIP CODE

Best practice guidance for UK institutional investors* on engagement

Overall objective

To enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders and assist with the efficient exercise of governance responsibilities

Key elements of code

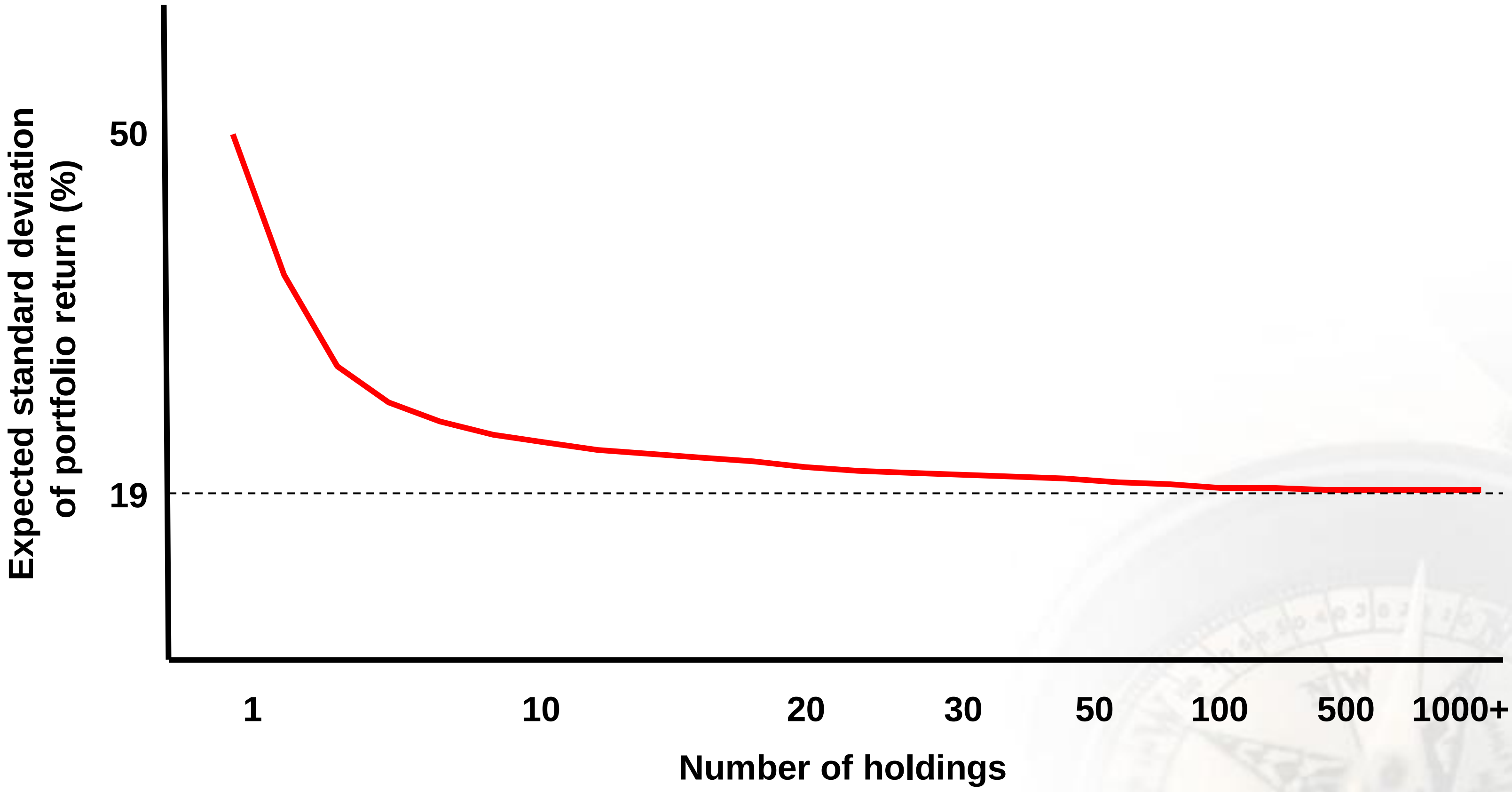
- ***Principle 1:*** Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities
- ***Principle 2:*** Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed
- ***Principle 3:*** Institutional investors should monitor their investee companies
- ***Principle 4:*** Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value
- ***Principle 5:*** Institutional investors should be willing to act collectively with other investors where appropriate
- ***Principle 6:*** Institutional investors should have a clear policy on voting and disclosure of voting activity
- ***Principle 7:*** Institutional investors should report periodically on their stewardship and voting activities

* Pension funds, insurance companies, and investment trusts and other collective investment vehicles and any agents appointed to act on their behalf.

INSTITUTIONAL INVESTOR STEWARDSHIP IMPEDIMENTS

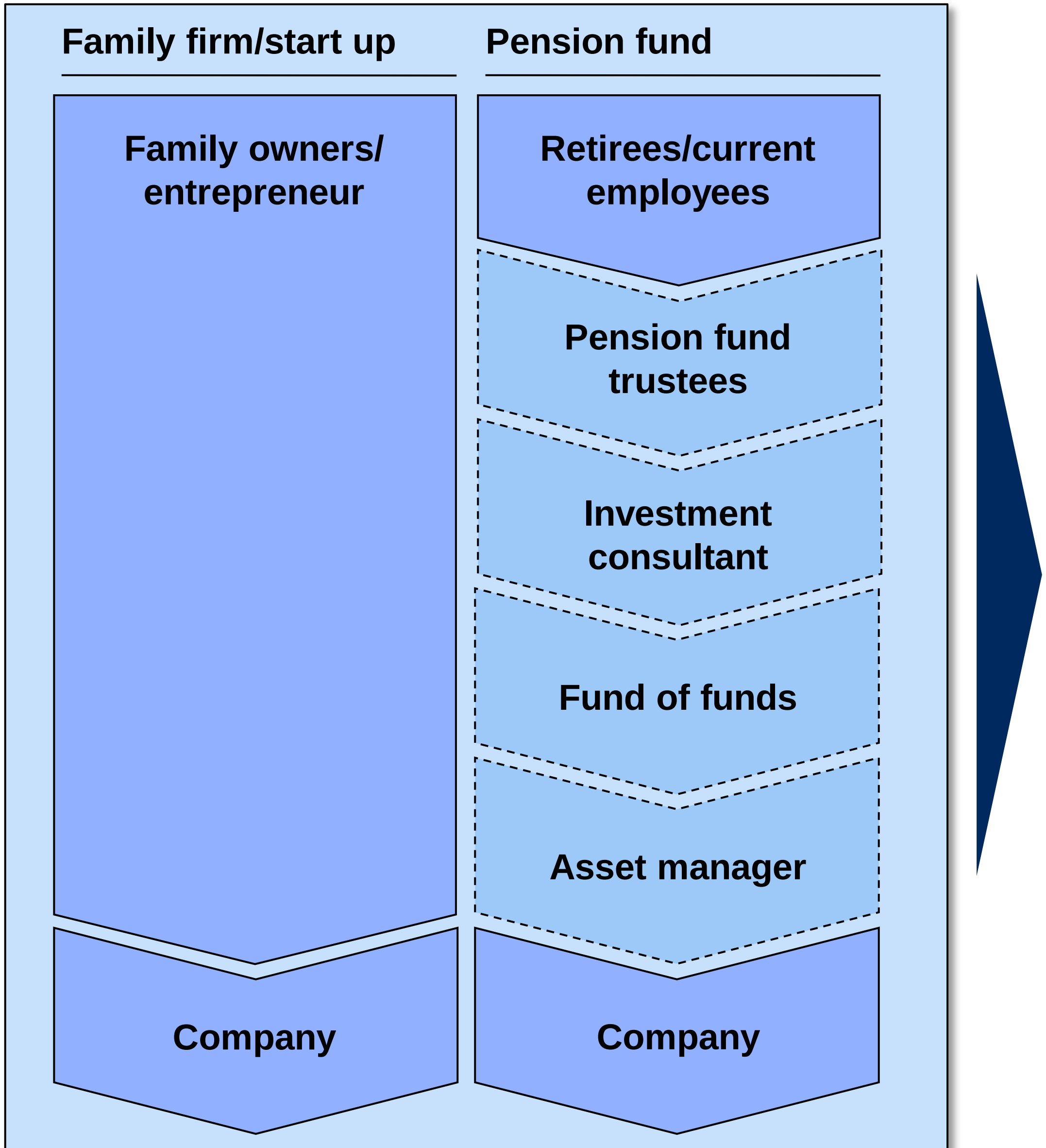
1. Inappropriate performance metrics and financial arrangements that excessively promote trading and short-term returns
2. Excessive portfolio diversification that makes monitoring difficult
3. Lengthening share ownership chain that weakens an ‘owner’ mindset
4. Flawed business model and governance approach of passive funds

DECLINING BENEFIT OF DIVERSIFICATION IN TERMS OF REDUCING VOLATILITY OF RETURNS



Source: Elton and Gruber; Statman

HAZARDS OF INCREASING INTERMEDIATION OF OWNERSHIP

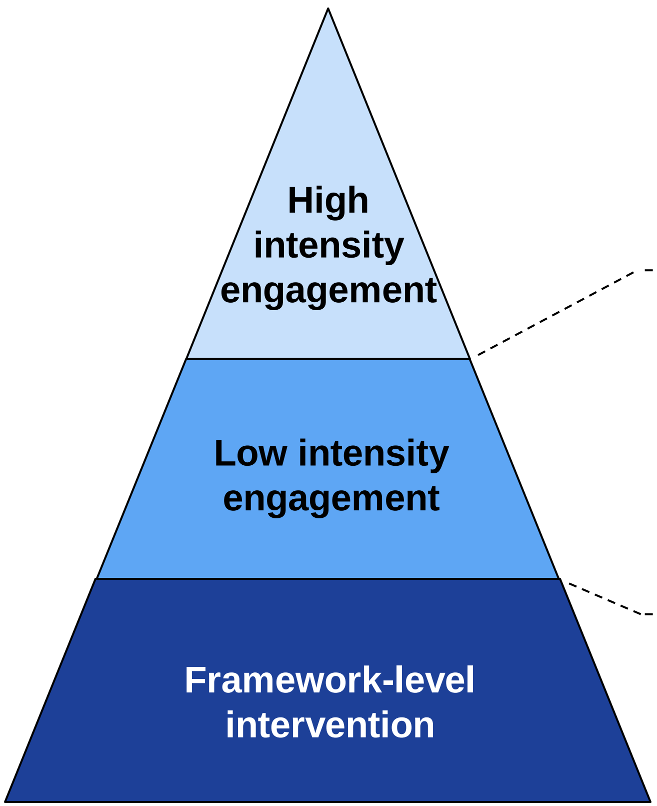


Key concerns

- Existence of intermediaries in the ownership chain means that metrics must be devised to measure their performance
- At present, short-term (e.g., quarterly) and relative measures are typically employed, giving rise to
  - Misalignment in time-horizon
  - Reduced sense of “ownership”
  - Increasing portfolio turnover (trader mentality)
  - Corresponding pressure exerted on companies to focus short-term
- Some intermediaries (e.g., pension fund trustees) possess neither requisite skills nor sufficient incentives to be effective stewards

Source: Wong, Why stewardship is proving elusive for institutional investors, 2010 (http://ssrn.com/abstract=1635662)

SYSTEM SHOULD ACCOMMODATE DIFFERENT STEWARDSHIP APPROACHES OF INSTITUTIONAL INVESTORS



Description of activity	Principal participants/rationale
• Engagements focused on changing core strategy, capital structure and/or operations at poorly performing companies	• Focus funds – small number of holdings, low turnover and relatively high fees mean substantial resources can be deployed to researching and engaging on fundamental business issues
• Regular (annual/semi-annual) meetings with chairmen and CEOs to discuss general strategy, performance and governance • Engagements in response to crisis/scandal (e.g., safety issues, bribery allegations)	• Mainstream institutional investors – interventions of this type do not require deep firm-specific knowledge and, hence, can be applied across many portfolio companies at relatively low cost
• Develop best practice guidelines (e.g., dilution limits, remuneration) • Influence policy-making (e.g., responding to consultation exercises)	• Mainstream institutional investors – with their large portfolios, framework-level interventions are efficient as the need to intervene at individual firms would decrease

Source: Wong - LSE lecture (March 2010)

Thank you.

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