



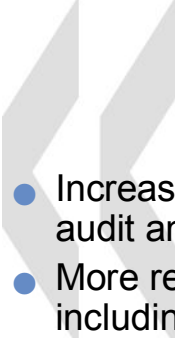
The evolution of board functions and practices in the OECD area (excl US)

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Expectations about what boards should do and how they should do it have changed markedly in recent years. Domestic developments have played a role but equally important has been the changing structure of share ownership as global capital markets have become more globalised. The share of foreign shareholders in the equity of corporations has increased around the world bringing new expectations about board performance. Multiple listings have also led to spillovers regarding the role boards are expected to fulfil. Even when foreign subsidiaries are not listed, local practices might also affect how a local board is organised. There thus appears to be some convergence in board practices, de facto if not de jure.

This paper briefly reviews the evolution of board functions and practices, paying particular attention to the non-US OECD area.



Forces changing the board

- Increased compliance duties: in part response to audit and accounting failures
- More restrictive definitions of fiduciary duties including in company groups
- Nominal board member liability has increased even if real liability remains restricted
- Increased shareholder pressure to oversee management and reporting. Board also seen as source of competitiveness
- Demographic change from owners active in management to ones operating via the board

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Since the mid 1990s there has been a tendency for the board (including the supervisory board in Germany) to be made more responsible for the operations of the company in areas such as disclosure. In the last few years boards have also been made more responsible for ensuring an independent external audit. The latter is now required in the 25 EU countries, and has long been required in Canada, Australia etc.

Countries such as Italy, Turkey and Belgium have also tightened fiduciary duties with respect to company groups. Board members now have to be more careful about overseeing intra-group transactions and ensuring reimbursement from a controlling company for any actions taken to the detriment of the group company. Korea has also tightened requirements for boards of subsidiaries. The nominal liability of board members has therefore increased, but research by Black et al (Stanford Law School, Law and Economics Working paper 71/2006) indicates that actual personal liability remains very restricted and in countries like Korea steps are already underway to limit liability. Directors and officers (D&O) insurance is widespread. A strong case can be made that actual liability should be low otherwise there is a strong disincentive for directors to join boards of bad companies where their skills are most required. However, where shareholders have little actual power to remove directors, this conclusion might want to be reconsidered.

With respect to shareholder pressure, a recent survey of 322 major institutional investors in 18

countries showed that board structure/independence/composition was regarded as the most important corporate governance issue in the near future by 26 per cent of respondents, 19 per cent thought that the key issue is executive compensation, 13 per cent cited financial reporting/auditing and 12 per cent cited company/CEO performance. As these latter issues are often handled by boards, the overall concern with board functions and operations is high. See Corporate Governance: From Compliance Obligation to Business Imperative, ISS, 2006.

Empirical work in a number of countries, including Taiwan, indicates an increased importance of boards as companies are floated and as the founder leaves the scene in favour of professional management. It should be borne in mind that in most OECD countries outside of the UK and the US, there are very often major if not controlling block holders, but that they often choose to oversee the company via the board on which they may only have some representatives.

The instruments for changing board behaviour vary across countries.

- In a number of cases, company law has been changed to more clearly specify the duties of directors and boards, e.g. the UK, EU Directive, Germany, Italy
- Company law and securities law often principles based
- In other cases securities laws have been used e.g. the US for constitutional reasons.
- Listing requirements. Usually mandatory and likely to be black-letter rules.
- With the exception of the US, most countries have opted for some form of corporate governance guidelines and codes. Not just principles based but can be prescriptive
- Usually voluntary but disclosure to the market of non-compliance often mandatory

Corporate governance codes and guidelines are often developed by the stock exchange but other methods are also observed. In Germany, Holland and Korea, there is a standing Commission to monitor and develop the codes.

In a number of countries, the comply or explain rule is anchored in law rather than by listing requirements (e.g. Germany, Holland).

As far as enforcement goes, there is also a wide range of practices. In the UK, the market is left to judge whether the corporate governance statement about the board is adequate, but in Portugal and Turkey it is reviewed by the regulator.

There are, in some instances, alternative enforcement mechanisms. In Italy, listed firms have the option of making a public declaration to be bound by the corporate governance code, thereby becoming legally bound to comply. Few companies have done this. In the Netherlands there is a provision for the code to be enforced if the code is approved by a majority of shareholders.

Boards now seen more as the fulcrum between shareholders and professional management

- Responsible for management, accountable to company and its shareholders: duty to act in their interests
- Monitoring managerial performance
- Selecting and compensating key executives
- Guiding corporate strategy and establishing risk policy
- Setting the ethical tone and a compliance culture (incentives, feedbacks etc)
- Managing conflicts of interest
- Ensuring integrity of accounting and financial systems: internal control
- Overseeing the external audit and major accounting principles

Empirical studies indicate that probably the most important decision a board can make is in appointing and where necessary dismissing the CEO. One study for the US (Nohria et al) shows that on average the CEO accounted for about 14 per cent of a company's performance. This is almost as important as the choice of which sector to operate in. Empirical work in Europe also points to changes in management in response to financial performance but the correlation with subsequent improved performance appears to be weaker and more difficult to show econometrically. This might be due to longer lags in adjustment programmes.

Result is tendency for what is expected of boards to converge

- In unitary systems such as Australia, Canada, and the UK, move toward the board not being seen as running the company and providing business contacts but as monitoring management.
- In two tier systems, greater realisation that the board has been too separated from management and therefore could not properly supervise. Greater emphasis in countries such as Germany on information flow to the board

Incentives for directors to fulfil these duties are important

- “Good corporate governance should provide proper **incentives** for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate **effective monitoring**, thereby encouraging firms to use resources more efficiently” OECD Principles
- Some incentive structures have been perverse or inefficient
- It is about **compliance and performance**

Incentives includes more than just remuneration but also the precise structure which appears even more important. Also included are disincentives such as liability and loss of reputation. See later in presentation.

Changing role and structure of boards

- The Chair and the CEO
- Greater emphasis on “independent” directors and boards and not just non-executive directors
- Changing skill requirements of directors
- Changing size and composition of boards: more international, and broader base of recruitment
- Move to strengthen committees
- In boards with some form of audit board, critical questions are being asked and alternatives have been introduced
- Greater emphasis on more formalised appointments of management and succession planning
- Different approaches to risk



The board and the CEO

- In some countries such as the UK and Australia, most companies have now split the positions with the chair often independent. For: Focus of CEO on running company. Against. Two power bases
- In countries with two tier boards a tradition of head of management board becoming chair of upper board on retirement. For: company experience. Against: How can a chair review their own previous strategy.

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Splitting of the posts of Chair and CEO is part of the codes in these countries. Some companies such as HSBC, the large international bank, do not split the role but rather explains why they do not comply. Such companies often have nominated a senior independent director with provisions for them to meet without the chair and executive directors.

The argument for the head of the management board becoming on retirement the chair of the supervisory board is that this brings company specific knowledge to the board. The counter argument is that this person is not likely to critically review strategy, which they themselves might have developed.

Greater emphasis on “independent” directors and boards and not just non-executive directors

- Objective is “boards capable of exercising objective independent judgement”
- Duties of boards often oriented to board “independence” in action. E.g. no self serving behaviour. US view of disinterested director different
- Negative list emphasises absence of commercial relations with the firm to avoid conflict of interest
- In many countries also independence from controlling shareholders
- Special role for such directors in areas where other might have conflict of interest e.g. remuneration, audit, related party transactions
- Some codes specify number of independents

Some codes specify the proportion of independent directors such as in the UK where it is recommended to be a majority. But 13 per cent of the FTSE 100 companies have not achieved this number and choose to explain. This shows the importance of flexibility.

Research shows that many directors classified as independent may not in fact be free of conflict of interest. In Italy, only 5 out of the 284 directors declared as independent by Italian blue chip companies met all independence standards (Santella, Paone and Drago, How independent are independent directors? The case of Italy, 2005. In Japan many independent directors come from other keiretsu companies and would therefore not be regarded as independent according to widely accepted standards. See Gilson and Millhaupt, “Choice as regulatory reform: The case of Japanese corporate governance”, ECGI Law, Working Paper, 22/2004

Empirical work on whether the composition of the board matters is very difficult due to data problems and the issue of causality: do good companies have more outsider oriented boards, or do outsider boards have an independent effect on performance. One often quoted study by Bhagat and Black argues that more independent boards do not affect performance. However, less often quoted is their observation that one size does not fit all. More sophisticated work by Hermalin and Weisbach, 2001, finds more complex effects of board composition on performance including executive remuneration and company performance, and also that the quality of outside directors is

also important. Some studies are reviewed in *Corporate Governance: A survey of OECD countries*, OECD, 2004, Box 3.5. It should be noted that despite their titles, the studies do not refer to independent directors but to outside directors.

A more recent study for Korea shows strong evidence that outside directors, whether the requirement is imposed by law or is voluntary, leads to a significant increase in the value of a company. See Black et al, *Does corporate governance predict firm's market values? Evidence from Korea*, SSRN, Abstract 311275, 2005

Changing skill requirements of directors

- In many countries, companies encouraged to offer newly appointed board members orientation courses about the specificities of the business.
- A number of jurisdictions recommend continuing training and the development of training programmes for board members.
- Some recommendations about the qualities of independent directors include a list of positive attributes
- Greater importance of intellectual assets demands different skills of directors

Interest in improving the quality of directors was underpinned by the Higgs Report in the UK (Review of the role and effectiveness of non-executive directors, DTI, 2003) which found that many non-executive directors were unsure of their exact duties and felt that more induction opportunities were warranted.

In Australia, Canada, Netherlands, Spain, Switzerland and the UK, companies are encouraged to offer newly appointed board members orientation courses about the company. The need for orientation of directors was also underlined in the Worldcom report.

In addition to a list of attributes that might disqualify a director from being classified as independent, the UK has also specified a positive list in the form of non-binding recommendations: recognised professional prestige; can contribute experience and knowledge to the governance of the company, integrity and high ethical standards, sound judgement and inquiring mind; question in a constructive way the strategy of the company and contribute to its implementation.

The increasing importance of intellectual assets for companies requires that directors understand the implications for the business model and for business strategy. For example, selling a patent might be a significant strategic move for the company which needs to be understood. There might also be implications for risk management e.g. Blackberry, Pfizer.

Changing size and composition of boards

- General move to smaller boards with some notable exceptions and great differences between countries. No clear optimal size.1.
- Boards in Europe more domestic than the companies themselves. 30 per cent have no foreign directors at all.
- The proportion of non-national directors is 16 per cent.
- 46 per cent have no women on boards but UK and Sweden are markedly different
- UK, Sweden and Spain have policies or guidance to increase the number of women on boards and or policies to widen the recruitment base.2.

In Europe the average number of directors declined from 13.5 members in 1999 to 12.5 in 2005. The UK and the Netherlands have the lowest average of around 8 directors while Germany has the largest boards with around 18 members. Many in Germany see the number as too high. The large number is due to the presence of worker representatives who in large companies have 50 per cent of the positions. In reality, half the board meet separately to discuss strategy and operations then meet later with the employee representatives. Nevertheless, news of strategic decisions leaks quite regularly. Source. Heidrick and Struggles, Corporate governance in Europe, 2005 Study

Companies are also widening their recruitment due to the increasing refusal of companies to let their CEOs serve on other boards due to time pressures and sometimes the need to avoid conflicts of interest.

Move to strengthen committees

- On average there are now 2.9 board committees compared with 1.6 in 1999. Indicative of increased professionalism in European boards
- Wide variation between countries
- Audit committee in 94 per cent of companies and meets 5.2 times per year
- Composed of $\frac{3}{4}$ independent non-executive directors but 42 per cent have fully independent committee
- Committees do not take away collective responsibility of the board.
- Other committees less widespread but developing

Of the other committees, the remuneration committee is the most widespread now being found in 94 per cent of European companies, against 39 per cent in 1999. On average they are composed of 66 per cent independent directors, and are fully independent in 37 per cent of companies. This development reflects increasing complaints about executive pay.

Nomination committees are increasingly important. In the US they serve the role of balancing the “imperial CEO” and are important in a system where shareholders have little say due to plurality voting. In other countries this is not true so that nomination committees are less developed and play a different role, adding to transparency. 70 per cent of European companies now have nomination committees but these are overwhelmingly in the UK.

In boards with some form of audit board, critical questions are being asked and alternatives have been introduced

- In both Italy and Portugal there are audit boards. Sometimes used to give minority shareholders some form of voice.
- Questions have arisen following Parmalat about their effectiveness. In Italy, companies can now adopt other corporate forms.
- In Japan, the *kansayaku* system is now optional although still used by the overwhelming majority of companies.
- In Latin America there is also concern about whether the audit boards weaken the responsibility of directors.
- Also an issue in China although the problem is more one of a very truncated supervisory board controlled often by workers/party representatives

Emphasis on more formalised appointments of management and succession planning

- Greater evidence of boards replacing management in more countries
- Succession planning for management now more widely practiced
- Gives more structure to management development

For example, in France there have been two recent cases of boards removing management and in one case (Vinci) the independent directors replaced the CEO even against the wishes of executive directors.

New emphasis on how boards are appointed:
nomination, election and recall

- Voting and nomination practices vary widely. E.g. some vote on a slate of candidates others on individuals.
- In some countries, minority shareholders have rights to nominate and elect some members of the board.
- Move to greater disclosure about candidates
- Terms of appointment and power of shareholder recall vary greatly
- Shareholding structure explains some of the variation


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In Canada, Germany, Italy, Portugal and Switzerland, lists of candidates are put before shareholders who vote on the whole list. In other jurisdictions and in many Codes there is a requirement or recommendation to vote on individual candidates.

In Portugal, Mexico and Spain there are provisions for shareholders with more than a threshold to appoint a director. This pattern reflects the importance of concentrated ownership. Cumulative voting, while permitted in a number of jurisdictions, is not a widespread practice.


An emphasis on greater board responsibility for director and executive remuneration

- In UK, Holland, Germany, Sweden, Australia and perhaps France, now a right for an advisory shareholder vote.
- Compensation statements more policy and performance based. Covers termination provisions, pension rights and details on performance based pay.
- Greater shareholder pressure on the Remuneration committee, even voting against individual members. More transparency.
- Issue of appropriate structure of directors remuneration e.g. some countries ban options and high powered incentives for directors
- Appropriate incentive structure for executives still an active debate



Performance reviews of boards

- Move toward performance review of entire board rather than of individuals
- Preference for internal process evaluation by corporate secretary or independent director
- Apparent major improvements in information process, frequency of board meetings, board agenda, interactions with management and committee's role
- Improvement expected for a more transparent selection process, more adequate director's expertise and director's training

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Performance reviews of the whole board are a part of many corporate governance codes including in the Netherlands, Germany and the UK. Formal processes are now in place in: US, 99 per cent of S&P 500 in 2005 (90 per cent in 2004); UK, 96 percent of FTSE 100, (64 per cent in 2004); Canada, 92 per cent of CSSI 100, (84 per cent in 2004); France, 37 per cent of SBF 120 in 2005 (24 per cent in 2004).

Different national approaches to internal control and risk management by boards

- In UK, France and Australia emphasis far wider than SOX 404 which focuses only on financial reporting 1.
- Research in the UK showed value of principles based approach 2.
- Less in favour of release of audit report on internal controls. Pros and cons 3.

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1.

The UK's internal control guidance defines internal controls as a system that facilitates a company's efficient operation by enabling it to respond appropriately to compliance and other risks to achieving the company's objectives. The US regulations define internal controls more narrowly in terms of controls and procedures that are designed to ensure that financial information that is required to be disclosed by an issuer is reliable.

2. See research Commissioned for Review of the Turnbull Guidance on Internal controls.


<http://www.frc.org.uk/corporate/internalcontrol.cfm>

3. Turnbull Review op cit



Future challenges

- Balancing compliance functions with promotion of risk taking
- Balancing executive and non executive board members
- How to avoid non-executive board members from becoming employees of the firm
- Board training
- Ensuring provision of material information to the board
- Incentives for the board: more actual liability? What is an appropriate incentive structure

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At the end of the day must be clear that boards are there to monitor and oversee, not to manage. There are implications for the structure of the management team.

- Thank you