New frontiers for corporate governance

Corporate governance is as old as trade. Whenever a principal has to rely on agents to handle his business, governance issues arise. Shakespeare understood the problem, though he did not use the phrase 'corporate governance'. His Merchant of Venice[1] agonized as he watched his ships sail away trusting his fortune to the hands of other people.

The phrase 'corporate governance' came into use about twenty-five years ago. The world's first corporate governance code, the UK's Cadbury Report, was published in 1992. This was quickly followed by codes of corporate governance principles and good practice from other countries. The first Hong Kong code was published in 1995[2]. However, to date many of the developments in corporate governance thinking have come from Europe and the United States.

Indeed, in the United States it was widely assumed that the rest of the world would gradually converge with the American corporate governance model, simply because the rest of the world, it was thought, needed access to American capital. Indeed, some American institutional investors, such as CalPers the Californian State Employees' Pension Fund, published reports advising other countries, including Germany and Japan, how to improve their corporate governance standards. How times change.

In this paper we recognize some dilemmas that face corporate governance in countries that use the Anglo-American, unitary-board model. Then we review approaches to corporate governance in China, Asia-Pacific, India and Brazil, which leads to the identification of some possible new frontiers for corporate governance.

Three dilemmas facing corporate governance in the West

The US enacted the administratively expensive Sarbanes Oxley Act (SOX) in 2002, in response to the collapses of Enron, WorldCom and big-five auditor Arthur Andersen, emphasizing the rule of law in corporate governance. Following the global financial crisis the UK proposed additions to its discretionary corporate governance code in 2009, including new principles on the leadership of the chairman, on the roles, skills and independence of non-executive directors, on the board's responsibility for risk management, and calling for external board evaluation reviews every three years.

Many commentators refer to the 'Anglo-American' approach to corporate governance. They contrast the unitary board, which has both executive and non-executive directors in the Anglo-American common law jurisdictions, with the two-tier, supervisory and executive boards of the Continental European and other civil law countries (see figure 1). But in reality, a schism has appeared between American and British concepts of corporate governance. The under-pinning of American corporate governance is now mandatory governance determined by law, including the SOX Act. In other words, follow the legal requirements or risk the

[1] The Merchant of Venice, Act 1, Scene 1
[2] Published by the Hong Kong Society of Accountants, now the Hong Kong Institute of CPAs

penalties. By contrast the basis of corporate governance in Britain and other countries[3], whose company law has been influenced over the years by UK common law, including of course Hong Kong, involves a discretioary approach to governance by principle. Listed companies need to comply with the code or, if not, explain why. The dilemma between corporate governance by rule or by principle remains unresolved.

The second dilemma concerns the actual role of the unitary board. Directors are responsible for both the performance of the enterprise and its conformance with regulation and law. In other words, the board is expected to be involved in strategy formulation and policy making, whilst also supervising management performance and ensuring accountability. It has been suggested that this means the unitary board is effectively trying to mark its own examination papers. Of course, the two-tier board structure avoids this problem by having the executive board responsible for performance and the supervisory board for conformance. Common membership between these two boards is not allowed.

To overcome the dilemma facing the unitary board, corporate governance codes call for independent outside (non-executive) directors to play a vital role. Independence is precisely defined to ensure that these directors have no interest in the company that might, or might be seen, to adversely affect genuine independent and objective judgement. The percentage of independent board members is usually specified. Audit, remuneration and nomination committees of the board must be mainly or wholly comprised of these independent, outside directors. But that leads to the third dilemma.

The definition of independence in most corporate governance codes is exhaustive. To be considered independent a director must have no relationship with any firm in the up-stream or down-stream added-value chains, must not have recently been an employee of the company, nor be a nominee for a shareholder or any other supplier of finance to the company. Indeed, the definition of independence is so strict that an independent director who has served on the board for a long period is often assumed to have become close to the company and no longer independent.

Herein lays the independence dilemma. The more independent a director is, the less he or she knows about the company and its industry. The more a non-executive director knows a company's business, organization, strategies, markets, competitors, and technologies, the less independent he or she may become. Yet such people are exactly what top management needs to contribute to its strategy, policy making and enterprise risk assessment.

The New York Stock Exchange (NYSE) sponsored a Commission that has recently published 10 core principles of corporate governance[4]. Whilst the Commission supported the NYSE's listing requirements, which call for a majority of independent

[3] Including Australia, Canada, New Zealand, Hong Kong, India, Malaysia, South Africa, and Singapore.

[4] New York Stock Exchange – sponsored Commission on corporate governance, 10 Core Principles of Corporate Governance, October 2010. A commission representing investors, issuers, broker-dealers, and governance experts

outside directors, it also pointed out that companies can have additional non-independent directors so that there is an appropriate range and mix of expertise, diversity and knowledge. The Commission pointed out that while independence is an important attribute for board members, the NYSE's Listing Standards do not limit a board to just one non-independent director and boards should seek an appropriate balance between independent and non-independent directors.

Turning now to corporate governance practices in China, Asia Pacific, India and Brazil[5], the crucial question is: can Anglo-American practices learn anything from these countries?

Contemporary corporate governance in China

Business enterprises in China can be classified into:

- state-owned enterprises (SOEs), many of which have been corporatized, and partly privatized through listings in Shanghai, Shenzen, Hong Kong or overseas stock markets
- collectively-owned enterprises, including rural township and village entities
- privately-owned organizations

In this paper we are interested in the governance of listed SOEs. China has created a unique form of corporate governance structure, building on the practices of other countries around the world and developing some unique approaches of its own.

A vital aspect of the governance of China's SOEs is the role played by the state. The CSRC (China Securities Regulatory Commission) has succeeded in taking ideas from the western unitary and two-tier board models, and adapting them to the cultural and political situation in China, to create a regulatory model for supervising China's listed companies.

This comprises a management board of directors, with at least a third independent outside directors, and a board of supervisors, with both worker representatives and other members - thus combining elements of both the German-style two-tier board model and the unitary board with independent outside directors, as well as recognizing China's traditional concept of employees being masters of enterprises. (see diagram 1). However, unlike the German model, which calls for an equal number of shareholder and employee representatives, reflecting German co-determination law, Chinese company law does not specify the proportion of shareholders' representatives and employees' representatives on boards of supervisors, other than requiring at least a third to be worker representatives. Moreover, the supervisory board in China lacks the power to hire and fire directors and has no direct responsibility to the shareholders as in the Germany model. Consequently, the formal power of the Chinese supervisory board is relatively weak and it has to act through influence.

The State-owned Assets Supervision and Administration Commission (SASAC) is the state's shareholder, effectively an institutional investor and, as such, the largest

[5] Despite the undoubted economic significance of the 'BRIC' nations (Brazil, Russia, India and China), Russia has not been included because corporate governance there is still in a state of flux.

institutional investor in the world. However, SASAC plays a significant role in the governance of companies, including the appointment and removal of CEOs, involvement in major investments and funding, and strategic developments that are seen as affecting the interests of the people, represented by the Party and, therefore, the State. Both SASAC and CSRC are tied to the State Council and ultimately the National People's Congress through links with government bodies, as shown in diagram 2.

The involvement of the state in company matters and the activities of CSRC and SASAC provide an interesting model for other countries, particularly where they have had to nationalize or take part ownership of some of their financial institutions and manufacturing companies.

Contemporary corporate governance in Overseas Chinese family companies

Successive emigration from mainland China to Hong Kong, Singapore, Malaysia, Thailand and other countries throughout Asia Pacific, has produced a unique form of business governance. Typically known as the Overseas Chinese, the governance of their family companies, even though listed on a stock exchange, can provide some interesting insights. As is well appreciated in Hong Kong, these companies are typically:

- family-centred, with close family involvement
- family- controlled, with a majority of the voting shares kept within the family
- entrepreneurial, often with a dominant entrepreneur so that decision making is centralised, with close personal links emphasizing trust and control
- paternalistic in management style, in a social fabric dependent on relationships and social harmony, avoiding confrontation and the risk of the loss of "face"
- strategically intuitive, with the business seen as more of a succession of contracts or ventures, relying on intuition, sometimes superstition and tough-minded bargaining rather than strategic plans, brand-creation or the building of business empires

With outside shareholders in the minority, the regulatory authorities tend to emphasise the importance of disclosure and the control of related party transactions. Although many corporate governance codes require independent non-executive directors, the independence of outside directors is less important to the owner than their character, trustworthiness, and overall business ability. Of course, corporate governance problems exist in Chinese and Overseas Chinese companies: corruption, insider trading, unfair treatment of minority shareholders, and domination by company leaders, to name a few. But these are unfortunate attributes of corporate governance that reflect human behaviour everywhere.

Contemporary corporate governance in India

As is so often the case, history played a part in the development of corporate governance in India. Originally a member of the British Empire ('the jewel in the crown'), India benefited from the early creation of government administrative processes. Like Hong Kong and Singapore, these included a body of company law backed by a reliable judiciary. A drawback was the accompanying bureaucracy.

Following independence India took the socialist road, with large state-owned enterprises and the public sector dominating the economy. Bureaucracy grew and inefficiency, corruption and nepotism flourished. By the 1990s, the need for India to develop its business infrastructure and attract capital was recognised. Better corporate governance and improved regulation of its stock markets was needed. In 1992, Parliament created the Securities and Exchange Board of India (SEBI).

The Indian corporate governance code, published in 1998, was exhortatory and called for 'professionally competent, independent non-executive directors to play a material role in corporate decision-making and maximising long-term shareholder value (becoming) active participants in boards, not passive advisers.' The code stated that no one should hold directorships in more than 10 listed companies. A year later India's National Code on Corporate Governance, reflecting international standards, was published by SEBI and incorporated into the stock exchange listing rules

Corporate governance standards in India's top-tier listed companies are high. But such commitment is not general. Many small and medium capital companies remain unconvinced of the value of corporate governance activities and expenditures. Moreover, many boards in India, in both the public sector and the private sector, find themselves dominated by majority shareholders. Related-party transactions are not well regulated. Shareholder meetings and proxy voting processes are frequently inefficient. Pre-emption rights for minority shareholders are sometimes ignored. Financial disclosure leaves a lot to be desired and the Indian auditing profession is fragmented. A corporate governance rating by the Asian Corporate Governance Association assessed India's corporate governance as 'fair to poor'. Corruption is entrenched, in government as well as business. Distrust of government is high, with bureaucracy and red tape sometimes stifling entrepreneurial flair. But the rapid economic growth and potential of India suggest that the next few years will see continuing changes in both attitude and practice.

Contemporary corporate governance in Brazil

Brazil’s economy is booming, despite a Byzantine tax system and endemic poverty and corruption. In Brazil, many companies are either state-owned or family-dominated. The Brazilian Institute of Corporate Governance was founded in 1995 and in 1999 produced the Brazilian Code of Best Practice of Corporate Governance, which is now in its fourth edition. Brazilian company law and the code have three unusual corporate governance features – the fiscal council, the family council, and the advisory board.

A fiscal council can be provided by the company’s constitution or established at the request of shareholders. The role of the fiscal council is to inspect the work of the board, review the activities of the company, ensure compliance with legal and statutory duties, and provide an opinion on the annual management report and on board proposals for investment projects, changes to capital, and dividend payouts. The fiscal council is required, at least quarterly, to analyze and comment on the balance sheet and other financial statements and provide an opinion to the shareholders general meeting on board proposals. Fiscal councils have the right to consult with outside professionals, and are typically recognized as adding value to the company's owners by providing independent control.

The Brazilian code encourages the creation of a family council in family-dominated companies. Its role is to discuss family issues and the alignment of its members' expectations with those of the other shareholders. Family councils enable boundaries to be set between family and company interests, preserve longer-term family values, and formalize succession planning for family members in both management and on the board. Family councils can also consider issues of inheritance and the transfer of property, which are inappropriate in shareholders' meetings.

The constitutions of some Brazilian companies also provide for an advisory board. The code suggests that "the existence of an advisory board, preferably made up of independent members, is good practice, particularly for organizations taking the first steps in the adoption of good practices of corporate governance. It allows independent members to contribute to the organization and gradually improve its corporate governance." The code calls for the advisory board's performance to be guided by the same principles that govern the Board of Directors.

The experience of the fiscal board, the family council, and the advisory board may provide some alternative corporate governance approaches elsewhere.

Some conclusions

Corporate governance in the Anglo/American countries is evolving. No longer can it be expected that global governance systems will converge with them. The state of the legal system, the political situation and the cultural context all affect the way corporate governance develops. Board leadership and board-level culture, in other words the way people behave, are more important than board structures and strictures, or rules and regulations.

In the 19th century, trust was at the heart of business; it was the underpinning of the idea of the original limited liability company developed in Britain. But, with the passage of time, the West seems to have replaced trust with contract and litigation. A significant message for countries relying on the Anglo/American model is the need to rediscover trust in corporate affairs.

In other countries, the importance of developing corporate governance systems that mirror the reality of the countries' situation and expectations for the future is apparent. This is particularly important in the BRIC nations (Brazil, Russia, India and China) as they develop systems relevant to their economic, legal and political situations. They may have as much to learn from each other as from Western experience. Indeed, the West may have much to learn from them.

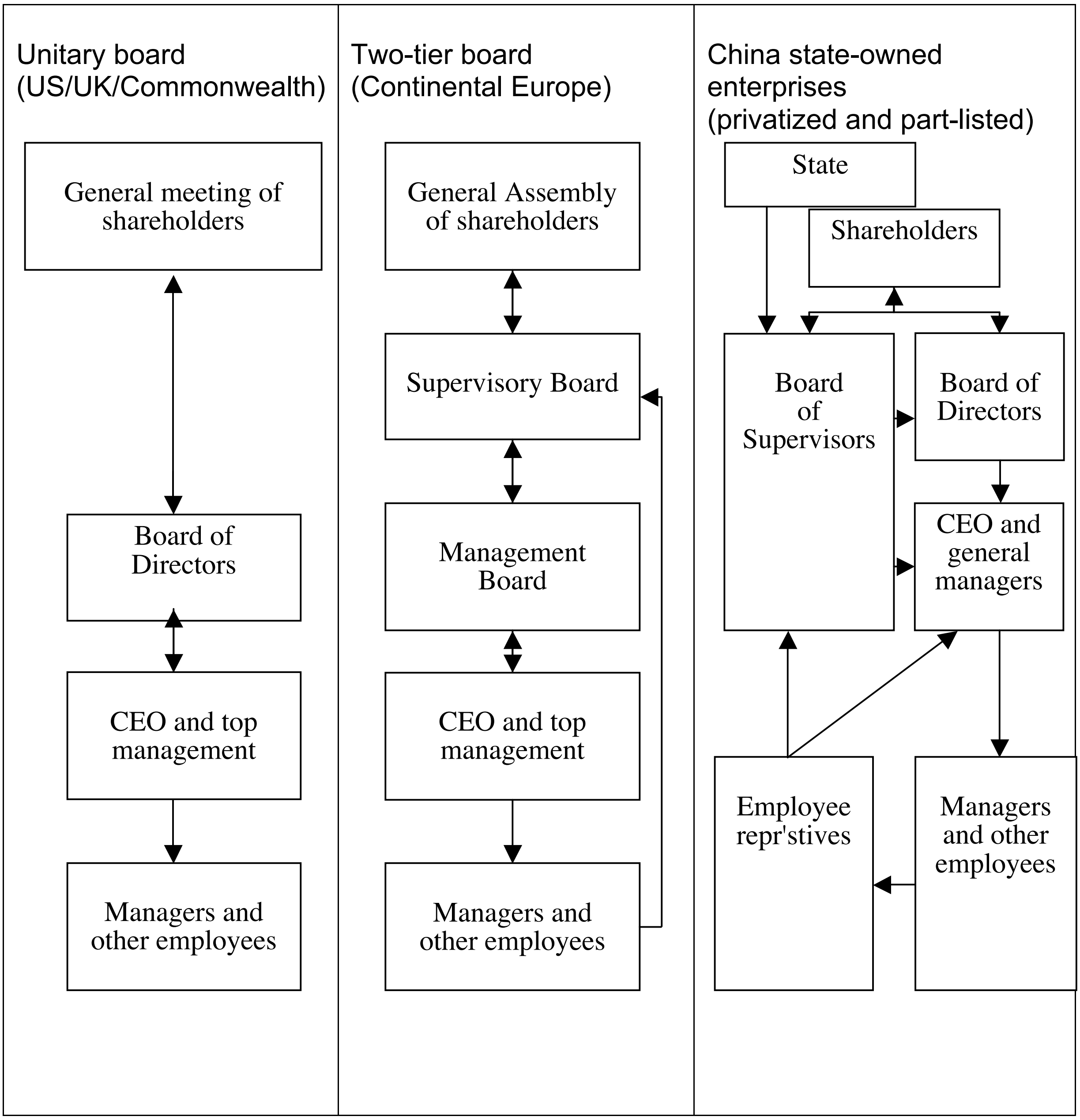
Unitary board (US/UK/Commonwealth)
General meeting of shareholders
Board of Directors
CEO and top management
Managers and other employees
Two-tier board (Continental Europe)
General Assembly of shareholders
Supervisory Board
Management Board
CEO and top management
Managers and other employees
China state-owned enterprises (privatized and part-listed)
State
Shareholders
Board of Supervisors
Board of Directors
CEO and general managers
Employee repr'stives
Managers and other employees

Diagram 1 Models of corporate governance

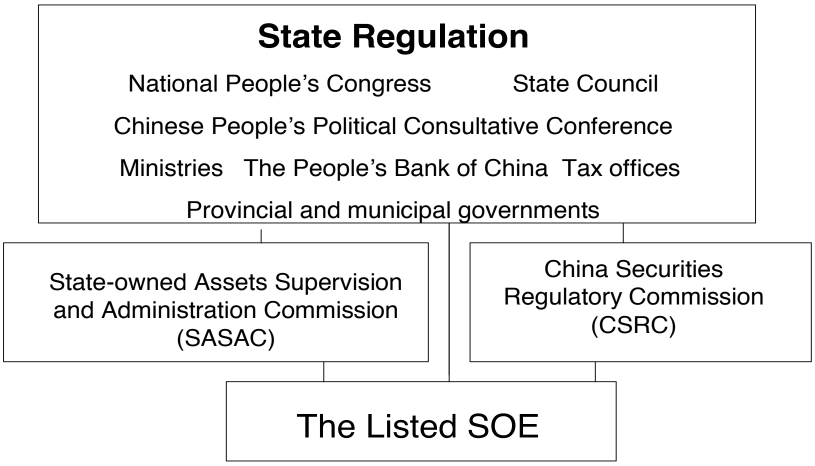
State Regulation
National People's Congress
State Council
Chinese People's Political Consultative Conference
Ministries
The People's Bank of China
Tax offices
Provincial and municipal governments
State-owned Assets Supervision and Administration Commission (SASAC)
China Securities Regulatory Commission (CSRC)
The Listed SOE

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Diagram 2 The regulation of China state-owned enterprises