

**OVERVIEW OF CORPORATE GOVERNANCE
GUIDELINES & CODES OF BEST PRACTICE
IN DEVELOPING & EMERGING MARKETS***

When a firm's management is separate and distinct from the providers of the firm's capital, managers have a responsibility to use assets efficiently in pursuit of the firm's objective. Ensuring that they do so is important to a firm's successful economic performance as well as to its ability to attract long-term, stable, low-cost investment capital. This is true whether the firm is publicly traded, privately held, family-controlled or state-owned. (It is only when the managers of a firm themselves own the entire firm -- and are committed to relying solely on their own capital -- that managers generally are free to apply corporate assets (as their own private property) inefficiently or for non-productive uses.) The fundamental concern of corporate governance is to ensure the means by which a firm's managers are held accountable to capital providers for the use of assets.

The responsibilities and functions of the corporate board in both developed and developing nations are receiving greater attention as a result of the increasing recognition that a firm's corporate governance affects both its economic performance and its ability to access patient, low-cost capital. After all, the board of directors -- or, in two-tier systems, the supervisory board -- is the corporate organ designed to hold managers accountable to capital providers for the use of firm assets. The past five years has witnessed a proliferation of corporate governance guidelines and codes of "best practice" designed to improve the ability of corporate directors to hold managements accountable. This global movement to emphasize that boards have responsibilities separate and apart from management -- and to describe the practices that best enable directors to carry out these responsibilities -- is a manifestation of the importance now attributed to corporate governance generally and, more particularly, to the role of the board.

Corporate governance guidelines and codes of best practice arise in the context of, and are affected by, differing national frameworks of law, regulation and stock exchange listing rules, and differing societal values. Although boards of directors provide an important internal mechanism for holding management accountable, effective corporate governance is supported by and dependent on the market for corporate control, securities regulation, company law, accounting and auditing standards, bankruptcy laws, and judicial enforcement. Therefore, to understand one nation's corporate governance practices in relation to another's, one must understand not only the "best practice" documents but also the underlying legal and enforcement framework.

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Some governance codes are linked to listing or legally mandated disclosure requirements. Others are purely voluntary in nature -- but may be designed to help forestall further government or listing body regulation. In the developing nations, governance codes are more likely to address basic principles of corporate governance that tend to be more established in developed countries through company law and securities regulation, such as the equitable treatment of shareholders, the need for reliable and timely disclosure of information concerning corporate performance and ownership, and the holding of annual general meetings of shareholders. However, in both developed and developing nations, codes focus on boards of directors and attempt to describe ways in which boards can be positioned to provide some form of guidance and oversight to management, and accountability to shareholders and society at large.

Overview

The modern trend of developing corporate governance guidelines and codes of best practice began in the early 1990's in the United Kingdom, the United States and Canada in response to problems in the corporate performance of leading companies, the perceived lack of effective board oversight that contributed to those performance problems, and pressure for change from institutional investors. The Cadbury Report in the U.K., the General Motors Board of Directors Guidelines in the U.S., and the Dey Report in Canada have each proved influential sources for other guideline and code efforts.

Over the past decade, governance guidelines and codes have issued from stock exchanges, corporations, institutional investors, and associations of directors and corporate managers. Compliance with these governance recommendations is generally not mandated by law, although the codes linked to stock exchanges may have a coercive effect. For example, listed companies on the London and Toronto Stock Exchanges need not follow the recommendations of the Cadbury Report (as amended in the Combined Code) and the Dey Report, but they must disclose whether they follow the recommendations in those documents and must provide an explanation concerning divergent practices. Such disclosure requirements exert a significant pressure for compliance. In contrast, the guidelines issued by associations of directors, corporate managers and individual companies tend to be wholly voluntary. For example, the GM Board Guidelines simply reflect an individual board's efforts to improve its own governance capacity. Such guidelines can have wide influence, however. For example, in the case of the GM Guidelines, institutional investors encouraged other companies to adopt similar guidelines.

In developing nations, both voluntary guidelines and more coercive codes of best practice have issued as well. For example, both the Code of Best Practices issued by the Brazilian Institute of Corporate Directors and the Code of Corporate Governance issued by the Corporate Governance Committee of the Mexican Business Coordinating Counsel are wholly aspirational and not linked to any listing requirements. Similarly, the Confederation of Indian Industry Code and the Stock Exchange of Thailand Code are designed to build awareness within the corporate sector of governance best practice, but are not, at this time, linked to stock exchange listing requirements. In contrast, Malaysia's Code on Corporate Governance, the Code of Best Practice issued by the Hong Kong Stock Exchange, and South Africa's King Commission Report on Corporate Governance, all contemplate mandatory disclosure concerning compliance with their recommendations.

Some of the key elements of governance guidelines and codes of best practice, particularly as issued in developing nations, are summarized below:

The Corporate Objective

Variations in societal values lead different nations to view the corporate objective or "mission" distinctly. Expectations of how the corporation should prioritize the interests of shareholders and stakeholders such as employees, creditors and other constituents take two primary forms. In the Anglo-Saxon nations -- Australia, Canada, the U.K., and U.S. -- maximizing the value of the owners' investment is considered the primary corporate objective. This objective is reflected in governance guidelines and codes that emphasize the duty of the board to represent shareholders' interests and maximize shareholder value. Among developing nations, the Brazilian Institute of Corporate Governance Code, the Confederation of Indian Industry Code, the Kyrgyz Republic Charter of a Shareholding Society, and the Malaysian Report on Corporate Governance, all expressly recognize that the board's mission is to protect and enhance the shareholders' investment.

The mission of the board of directors is to maximize shareholder value.
Brazilian Institute of Corporate Governance Code of Best Practice at 1.

The Board of Directors represents the shareholders of the Society, and it has a duty to act in the interests of the shareholders.
Charter of a Shareholding Society (Kyrgyz Republic) 17.1.

The single overriding objective [of] all listed companies . . . is the preservation and enhancement over time of their shareholders' investment.
Report on Corporate Governance (Malaysia), Introduction § 1, 3.3.

In other countries, more emphasis is placed on a broader range of stakeholders. However, this view is not strongly advocated in the governance guidelines and codes emanating from developing nations, although some documents recognize that stakeholder interests should be considered. (For example, the King Report from South Africa states: "Directors must act with enterprise and always strive to increase shareholders' value while having regard for the interests of all stakeholders." (Ch. 5:27.7)) This may be due to a convergence in perceptions about the corporate objective. There is a growing recognition that shareholder expectations need to be met in order to attract patient, low-cost capital. Likewise, there is growing sensitivity to the need to address stakeholder interests in order to maximize shareholder value over the long term. As the General Motors Board of Directors Mission Statement recognizes, "the board's responsibilities to shareholders as well as customers, employees, suppliers and the communities in which the corporation operates are all founded upon the successful perpetuation of the business." Simply put, shareholder and stakeholder interests in the success of the corporation are compatible in the long run.

Board Responsibilities & Job Description

Most governance guidelines and codes of best practice assert that the board assumes responsibility for the stewardship of the corporation and emphasize that board responsibilities are distinct from management responsibilities. However, the guidelines and codes differ in the level of specificity with which they explain the board's role. For example, Canada's Dey Report, France's Vienot Report, Malaysia's Report on Corporate Governance, Mexico's Code of Corporate Governance and South Africa's King Report all specify board functions such as strategic planning; risk identification and management; selection, oversight and compensation of senior management; succession planning; communication with shareholders; integrity of financial controls; and general legal compliance, as distinct board functions. The Kyrgyz Republic Charter sets out a detailed list of matters requiring board approval. Other governance guidelines and codes of best practice are far less specific. For example, the Hong Kong Stock Exchange Code simply refers to directors' obligations to ensure compliance with listing rules as well as with the "declaration and undertaking" that directors are required to execute and lodge with the Exchange. The different approaches among codes on this point likely reflect variations in the degree to which company law or listing standards specify board responsibilities, rather than any significant substantive differences.

The main functions of a board are. . . :

- *to direct the company both as to strategy and structure;*
- *to establish from time to time a strategy for the company, including a determination of the businesses that the company should be in and those that it should not be in;*
- *to ensure that the executive management implements the company's strategy as established from time to time;*
- *to ensure that the company has adequate systems of internal controls both operational and financial;*
- *to monitor the activities of the executive management;*
- *to select the chief executive, ensure succession and give guidance on the appointment of senior executives;*
- *to provide information on the activities of the company to those entitled to it;*
- *to ensure that the company operates ethically;*
- *to provide for succession of senior management;*
- *to address the adequacy of retirement and health care benefits and funding.*

The King Report (South Africa), Ch. 4:1.

Board Composition

Most governance guidelines and codes of best practice address topics related to board composition including: director qualifications/membership criteria; the director nomination process; and board independence and leadership.

Criteria. The quality, experience and independence of a board's membership directly affects board performance. Board membership criteria are described by various guidelines and codes with different levels of specificity, but tend to highlight issues such as experience, personal characteristics (including independence), core code competencies and availability.

Every non-executive director must ensure that he can give sufficient time and attention to the affairs of the issuer . . . and satisfy the Exchange that he has the character, integrity, experience and competency to serve as a director of a listed company.

The Hong Kong Stock Exchange Code, Code of Best Practice 10 and Guideline A.5.

The board should have a diversity of background, knowledge and experience.

The Brazilian Institute of Corporate Governance Code of Best Practice at 3.

[Non-executive directors should] *know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios, and have some knowledge of various company laws.*

The Confederation of Indian Industry Code, Recommendation 4.

[A] candidate should have integrity and independence of thought; the courage to express their independent thought; a grasp of the realities of business operations; an understanding of the changes taking place regionally, nationally and internationally; [and] an understanding of business and financial "language."

The King Report (South Africa), Ch.9:8.2.

Director Nomination. The process by which directors are nominated has gained attention in many guidelines and codes, which tend to emphasize a formal and transparent process for appointing new directors. The use of nominating committees is favored in the U.S. and U.K. as a means of reducing the CEO's influence in choosing the board that is charged with monitoring his or her performance. (See, in the U.S., the Report of the National Association of Corporate Directors Commission on Director Professionalism (1996), and the General Motors Board of Directors Guidelines (1994); in the U.K., the Hampel Committee Report (1998)). The Malaysian Corporate Governance Report expresses a similar view: “[T]he adoption of a formal procedure for appointments to the board, with a nomination committee making recommendations to the full board, should be recognized as good practice.” (Explanatory Note 4.) At the same time, however -- and as advocated by the King Report (South Africa) -- it is generally agreed that the board as a whole has the ultimate responsibility for nominating directors.

Mix of Inside and Outside or "Independent" Directors. Most governance guidelines and codes of best practice agree that some degree of director independence -- or the ability to exercise objective judgment of management's performance -- is important to a board's ability to exercise objective judgment concerning management performance. In the U.S., U.K., Canada and Australia, although not required by law or listing requirements, best practice recommendations generally agree that boards of publicly-traded corporations should include at least some independent directors. This viewpoint is the furthest developed in the U.S. and Canada, where best practice documents call for a "substantial" majority of the board to be comprised of independent directors. Elsewhere best practice recommendations are somewhat less stringent and seek to have a balance of executives and non-executives, with the non-executives including some truly independent directors. (Although "non-management" or "non-executive" directors may be more likely to be objective than members of management, many code documents recognize that a non-management director may still not be truly "independent" if he or she has significant financial or personal ties to management.) Nonetheless, a general consensus is developing throughout a number of countries that public company boards should include at least some non-executive members who lack significant family and business relationships with management.

The majority of the board members should be independent.
Brazilian Institute of Corporate Governance Code of Best Practice at 3.

No board should have less than two non-executive directors of sufficient calibre that their views will carry significant weight in board decisions.
The King Report (South Africa) 2.2.

[I]t is recommended that Independent Directors represent at least 20% of the total number of Board members.
Mexico Code of Corporate Governance, Principle at 6.

Definitions of “independence” vary. For example, according to the Brazilian Institute of Corporate Governance, a director is independent if he or she: has no link to the company besides board membership and share ownership and receives no compensation

from the company other than director remuneration or shareholder dividends; has never been an employee of the company (or of an affiliate or subsidiary); provides no services or products to the company (and is not employed by a firm providing major services or products); and is not a close relative of any officer, manager or controlling shareholder.

Every listed company should have independent directors, i.e., directors that are not officers of the company; who are neither related to its officers nor represent concentrated or family holdings of its shares; who, in the view of the company's board of directors, represent the interests of public shareholders, and are free of any relationship that would interfere with the exercise of independent judgment."

Malaysian Report on Corporate Governance, Explanatory Note 4.23.

In February 1998, the Korea Stock Exchange adopted a listing requirement that will mandate that outside directors soon comprise at least a quarter of the board of every listed company. Included among the list of persons who do not qualify as "outside directors" are: controlling shareholders; a spouse or family member of a director who is not an outsider; current or recent officers and employees of the corporation, its affiliates, or of corporations that have "important business relations" with the corporation; and persons who serve as outside directors on three or more listed companies.

Article 48-5 KSE Listing Regulation.

In comparison, the Cadbury Code simply refers to directors who -- apart from their fees and shareholdings -- are independent from management and free from any business or other relationship which could materially interfere with the exercise of independent judgment. And many of the best practice documents -- such as the Cadbury Report and the National Association of Corporate Directors Report on Director Professionalism (U.S.) -- view the ultimate determination of just what constitutes "independence" to be an issue for the board itself to determine.

Independent Board Leadership. Independent board leadership is thought by some to encourage the non-executive directors' ability to work together to provide true oversight of management. As explained by the National Association of Corporate Directors (U.S.): "the purpose of creating [an independent] leader is not to add another layer of power but . . . to ensure organization of, and accountability for, the thoughtful execution of certain critical independent functions" -- such as evaluating the CEO; chairing sessions of the non-executive directors; setting the board agenda; and leading the board in responding to crisis.

Many guidelines and codes seek to institute independent leadership by recommending a clear division of responsibilities between Chairman and CEO. In this way, while the CEO can have a significant presence on the board, the non-executive directors will also have a formal independent leader to look to for authority on the board. Documents that place less emphasis on the need for a majority of independent directors seem to place more emphasis on the need for separating the role of Chairman and CEO. For example, the Indian Confederation Report expressly relates the two concepts -- recommending that if the Chairman and CEO (or managing director) are the same person, a greater percentage of non-executive directors is necessary. (Recommendation 2) The Malaysian Report on Corporate Governance similarly emphasizes that "[w]here the roles are combined there should be a strong independent element on the board." (Best Practice AA.II) This is in accord with the

Cadbury Report, which states that, where the Chairman is also the CEO "it is essential that there should be a strong and independent element on the board." (Section 1.2)

Board Committees

In developed nations, it is fairly well accepted that many board functions are carried out by board committees. For example, a *nominating committee*, an *audit committee* and a *remuneration committee* are recommended in Australia, Belgium, France, Japan, the Netherlands, Sweden, United Kingdom and the United States. While composition of these committees varies, it is generally recognized that non-executive directors have a special role.

The functioning and composition of the audit committee receives significant attention in most guideline and code documents because of the key role it plays in protecting shareholder interests and promoting investor confidence.

Special emphasis has been placed on the need for all listed company boards to establish audit committees to ensure the effective and efficient control and review of a company's administration, internal audit procedures, the preparation of financial statements and the general disclosure of material information to investors and shareholders.

President's Message, Stock Exchange of Thailand Code and Guidelines, pp. iv-v.

[There should be] a mechanism that lends support to the Board in verifying compliance of the audit function, assuring that internal and external audits are performed with the highest objectivity possible and that the financial information is useful, trustworthy and accurate.

Mexico Code of Corporate Governance, Recommendation at 12-13.

Certain countries specifically recommend the size of an audit committee. In India, the minimum size recommended is three members, as it is in Malaysia and the United Kingdom. And South Africa and India both emphasize the extra time requirements demanded of audit committee members, and the importance of written terms of reference for this committee. Malaysia also refers to the need for written terms of reference for audit and other board committees.

Disclosure Issues

Disclosure is an issue that is highly regulated under securities laws of many nations. However, there is room for voluntary disclosure by companies beyond what is mandated by law. Most countries generally agree on the need for directors to disclose their own relevant interests and to disclose financial performance in an annual report to shareholders. Generally this is required by law, but some guidelines and best practice documents address it as well. Similarly, even though directors are usually subject to legal requirements concerning the accuracy of disclosed information, a number of codes from both developed and developing nations describe the board's responsibility to disclose accurate information about the financial performance of the company, as well as information about

agenda items, prior to the annual general meeting of shareholders. (Many codes also itemize the issues reserved for shareholder decision at the AGM.) Generally, guidelines and codes of best practice place heavy emphasis on the financial reporting obligations of the board, as well as board oversight of the audit function. Again, this is because these are key to investor confidence and the integrity of markets. South Africa lays out the key points that the directors must comment on, whereas other countries do not go to this level of detail, but the distinction is not necessarily substantive since disclosure tends to be heavily regulated in many nations through securities laws.

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This brief review of the primary principles addressed by various guidelines and codes indicates that there is no single agreed upon system of "good" governance. Each country has its own corporate culture, national personality and priorities. Likewise, each company has its own history, culture, goals and business cycle maturity. All of these factors need to be taken into consideration in crafting the optimal governance structure and practices for any country or any company. However, the influence of international capital markets will likely lead to some convergence of governance practices.

As regulatory barriers between national economies fall and global competition for capital increases, investment capital will follow the path to those corporations that have adopted efficient governance standards, which include acceptable accounting and disclosure standards, satisfactory investor protections and board practices designed to provide independent, accountable oversight of managers.

Report to the OECD by the Business Sector Advisory Group on Corporate Governance (April 1998) (the Millstein Report).

This convergence is evident in the growing consensus in both developed and developing nations that board structure and practice is key to providing corporate accountability -- of the management to the board and the board to the shareholders -- in the governance paradigm.