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Corporate Governance and Globalisation

The Role and Responsibilities of Investors

by Kaspar Müller

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What is Corporate Governance?

Value enhancement of a company for its shareholders and all other stakeholders

Corporate Governance includes the debate on the appropriate management and control structures of a company and the rules relating to the power relations between owners, the board of directors, management, auditors and - last but not least - the stakeholders such as employees, suppliers, customers and the public at large. The aim of "Good Corporate Governance" is to enhance the long-term value of the company for its shareholders and all other partners. The enormous significance of Corporate Governance is clearly evident in this definition, which encompasses all stakeholders. Corporate Governance integrates all the participants involved in a process, which is economic, and therefore at the same time social. This definition is deliberately broader than the frequently heard narrower interpretation which only takes account of the Corporate Governance postulates aimed at shareholder interests. The reason why this broader interpretation is imperative in terms of the long-term success of a company is explained here.

Corporate Governance is a concept, rather than an individual instrument, and addresses topics such as improving the publication of important information, the protection of shareholders´ rights, the promotion of the balance of interests between managers, shareholders and other stakeholders, the independence of the board of directors, internal controls (committees of the board of directors) and the function of audits. The motives for the serious integration of Corporate Governance postulates in their dealings vary depending on the participant concerned. The focal subjects vary accordingly.

A prerequisite for the inclusion of other stakeholders is a balance between economic and social objectives and the reconciliation of the interests of the individual, the company and society. Many examples have shown the negative effects of inadequate Corporate Governance not only for shareholders and bondholders, but also for employees, suppliers and customers, as well as for society at large. Without the inclusion of other stakeholders such as employees, suppliers, customers and the public, the ability of Corporate Governance to promote productive economic development will only have a piecemeal effect.

It is only with the inclusion of other stakeholders that the difference between the Corporate Governance concept and the Shareholder Value concept becomes transparent. The long-term enhancement of the value of a company for the shareholders is not a new objective, neither is the realization that control structures are required to make managers tow the line with shareholders. These two aspects form the core postulates of the Shareholder Value philosophy. This leads to the question: Is the term Corporate Governance simply synonymous with filling old wine into new bottles? Under the heading Reflections in the

Neue Züricher Zeitung of 27 December 2001 the theory was therefore aired that "Matters which place the focus of attention on company bosses are easier to sell than matters which are intended to increase the wealth of shareholders."

Indeed: If Corporate Governance were to be understood as merely being the rules of play for the distribution of power between owners and the management, the relationship between Shareholder Value and Corporate Governance would be an extremely close one. This, however, is not the case if Corporate Governance is wider in scope and includes the interfaces between the company and other stakeholders such as employees, suppliers, customers and even the public, thereby institutionalising the balance between economic, social and individual objectives.

Corporate Governance is not a buzzword

It became apparent as far back as in the 1930s with the decline and fall of various family business dynasties that increasing division between ownership (possession of the company) and control (management of the company) produces problems (Berle and Means, 1932). At the end of the 80s Corporate Governance principles were introduced in the United States under the influence of institutional investors such as the pension funds Calpers and TIAA-CREF. This was originally a reaction to measures against take-over bids decided unilaterally by company management - often against the interests of the shareholders. At the same time the field of Corporate Governance was developing in Great Britain as a consequence of several spectacular bankruptcy cases, which aroused mistrust amongst investors. In this context the City of London instructed the Cadbury Committee to re-establish confidence in the market, improve the functioning of boards of directors and the transparency of the company accounts. Their report published in 1992 had a significant effect both in Great Britain and abroad. On the basis of this report, new guidelines were drawn up in numerous industrial countries on the initiatives of stock market supervisory authorities, shareholder associations and investment managers as well as institutions faced with the problem of responsible investment. In 1998 the OECD published its Corporate Governance principles. The objective was to assist member states to evaluate and improve the particular national framework in the member states, which governed the organisation of power relations in companies. In this way the OECD offers the stock market supervisory authorities, the investors and companies a basic concept for Best Practice guidelines[1].

The subject is by no means new. What is new, however, is the forcefulness with which it was flushed to the surface in some countries. There are a variety of different reasons for this. In

[1] Source: This paragraph is taken from an ethos publication; Codes of Best Practice for Corporate Governance; ethos, Swiss Foundation for Sustainable Development; March 2001; download in French or German at www.ethosfund.ch

Switzerland, for example, institutionalised saving (pension funds) has led to further anonymity in the ownership of shares and therefore to a widespread separation between ownership and control. This imbalance between power and control (checks and balances and incentives) has been further accentuated. As seen in a few cases, some managers have not missed the opportunity to accumulate power, which has proved to be damaging to the company and society as a whole, viewed in the long-term.

The problem has been recognised and the most effective strategy to rectify the situation is the introduction of Codes (Codes of Best Practice). In this way a remedy can be found using voluntary recommendations without having to resort to the drafting, implementing and enforcing new, frequently inflexible legislation. A large number of different Codes have already been drafted. This is a consequence of the fact that, on the one hand, the Corporate Governance debate involves many different stakeholders and, on the other hand, that each group of stakeholders champions the Code which addresses their particular concerns. The Codes deal with the entire spectrum of subjects, which are relevant within the framework of the Corporate Governance debate (cf. Paragraph 1.1).

The Codes may be divided into supranational, national or institutional codes, depending on author.

- Selected examples of supranational Codes are: OECD, ICGN (International Corporate Governance Network, CACG (Commonwealth Association for Corporate Governance);
- Selected examples of national Codes are: Viénot Report from France, the Cadbury, Greenbury and Hampel Reports and the Combined Code from the UK;
- Selected institutional Codes are: Calpers, Hermes Investment Management, Amnesty International.

A detailed list of the main codes and a description of their contents are to be found, for example, in: Codes of Best Practice for Corporate Governance[2].

[2] See Footnote 1

Corporate Governance in Practice

Two major players: Investors and Company Directors

Corporate Governance is the talk of the town. It is easy to disseminate definitions and theories on the subject, but that does not really get us anywhere. The decisive factor is the conduct of two players, the companies and the shareholders. Visible and measurable progress can only be achieved if the main participants actively apply corporate governance postulates. In doing so they can only discharge that area of responsibility, which lies within their scope of action. Even the best company cannot take over responsibility from sleepy shareholders, just as the active efforts of shareholders remain piecemeal as long as company directors fail to pull along.

What are the fields of activity for concrete and seriously intended action? First, the legislation and regulations (stock exchange) include various binding directions for action. However, effective Corporate Governance structures require additional measures (in practice these are voluntary Codes with voluntary recommendations), which often extend far beyond the minimum statutory framework.

Effective proposals for corporate action

Companies can build up a modern Corporate Governance structure on the basis of the existing Codes. The voluntary Codes are intended to guide the action of companies step by step in the desired direction. That means, for example, improvements in the publication of important information in connection with Corporate Governance postulates (e.g. level and structure of the remuneration of directors); protecting shareholders rights by facilitating rather than hindering shareholders in the exercise of their rights; taking all stakeholders seriously; the establishment of professional internal controls (committees of the board of directors), also to guarantee the independence of the board of directors; and finally the organisation of a structure which allows independent and effective audits. If, taking a long-term view, a company wishes to remain attractive for investors; it will find there is no way round up-to-date and forward-looking Corporate Governance structures.

Effective proposals for investor action

Investors: Opportunities and Trends

For shareholders, effective Corporate Governance structures have become important criteria for selecting the companies in which they wish to invest when making positive investment decisions.

Basically there are two approaches. The first focuses on the analysis of Corporate Governance structures. As investors interested in the long-term, the pension funds examine the extent to which a company has implemented the recommendations contained in the most important Codes. This analysis is the starting point for a comparison of various companies regarding "Good Corporate Governance". The test results influence investment decisions. Companies with poor structures are avoided.

The second, far more effective approach consists of acting as shareholders who actively carry out their proprietary and other rights. Shareholders have the right to demand information from the company at any time about important questions in connection with the management. However, they also have the right to participate in the shareholders´ general meeting, to propose a resolution for the agenda, to speak and, last but not least, they have the obligation to take a stand and vote accordingly.

Against this background, the Confederate Council of Switzerland, that is to say the national government, has introduced a regulation to the Swiss ordinance regulating vocational provisions (BVV2) obliging the Swiss pension funds to define whether and how they wish to exercise their shareholders´ rights as from 1 January 2002. This decision will encourage many pension institutions to exercise their shareholders´ rights, in particular their voting rights, in a systematic and responsible manner. Pension funds own about 10% of the market capitalisation of Switzerland amounting today to approximately 1,000 billion Swiss Francs. The trend is still upwards.

The influence of investors and in particular of pension funds on companies will therefore continue to grow not only as a consequence of the increasing proportion of shares in the portfolios of the pension institutions, but also due to the increasingly active exercise of their rights. However, this also requires of private as well as institutional shareholders that they prepare themselves adequately for their increased responsibility. The systematic exercising of voting rights demands, for example, clear and transparent guidelines on voting rights. It may be assumed that institutional investors (e.g. pension funds) will increasingly join forces to form groupings. On the one hand this has the advantage that tasks can be efficiently executed. On the other hand a grouping brings the additional benefit that influence on the company can be further reinforced. These groupings will not remain purely national, but, as the example of the ICGN (International Corporate Governance Network) illustrates, will increasingly operate worldwide.

Good Corporate Governance as an opportunity for Companies and Investors

The long-term success of a company has to be based on a sensible measure of Good Corporate Governance. However, Good Corporate Governance also requires that all stakeholders, and especially the shareholders, actively exercise their participatory rights. Shareholders should champion their aims and exercise their voting rights as owners. In particular, the shareholders should be aware that they elect the board of directors who decide on the strategy and monitor the implementation of that strategy. Being annoyed with the board of directors because of a large loss is of little use if, when electing the board, you did not constructively address the question of whether the board of directors standing for election had the necessary qualifications, independence and sufficient time.

Boards of directors and managers should advocate structures, which meet today's needs. Good Corporate Governance is not a trap, but an opportunity to understand and enhance the value of a company taking a long-term view.

Such conduct is imperative for institutional investors (i.e. pension funds) to remain a solid base for shareholders looking to the long-term.

Corporate Governance and the Quality of Globalisation

Corporate Governance and Financial Markets

The question of which countries are interesting to investors is, in addition to the economic efficiency of a country, closely linked with the issue of whether foreign investors in a country can depend on a stable political system and a legal system, which protects property rights. For shareholders are owners of companies and, as owners, shareholders have property rights and other rights in all countries. This issue has been discussed in detail in previous chapters.

If, in the eyes of the participant, these conditions do not prevail in the financial markets of a country, they will avoid investments in that country. One result of this is a high national interest level, which in turn cripples the economic development of the country. The people of the country, which is shunted by investors, are left to pick up the tab.

The stability of the legal system and the current legislation (that includes not only the constitution and laws, but also the accounting systems or regulations governing the official listing of securities on the stock exchange) are vital preconditions affecting the attractiveness of a country. However, these alone are often insufficient to attract investors. Further generally accepted forms of conduct are needed which often extend far beyond the minimal legal

framework. Such forms of conduct are laid down in the voluntary Corporate Governance Codes of Best Practice, amongst others. Corporate Governance structures of a country are therefore a further important indicator of the credibility of the economy as a whole and of the financial market in particular.

A discussion of the criteria, which determine the competitiveness of the financial markets of a country often, ends at this point. It is said that the objective of developing countries and emerging countries should be to alter their social and political structures in such a way that the country becomes more attractive for international investors. This is the key to flourishing economic, and therefore at the same time social, development.

However, the crucial debate only commences once a country has set up the main general framework for foreign investors and once foreign investors are investing in the country. This debate has to address the issue of the role and responsibilities of the investors. The quality and future of globalisation will depend decisively on the conduct of investors in developing and emerging nations.

The Role and Responsibilities of Investors

Responsible investors are aware that their actions can have an enormous effect on many different stakeholders. A decisive factor in this is not only the distribution of the financial value created, but also how the financial value is created. Therefore, responsible investors carefully analyse the relationship of the effects of their planned investment within the framework of the investment process: is the desired and possible increase in the market value of a company linked to a severe violation of human rights? Are the rules governing occupational safety infringed? Is an ecologically unacceptable risk created, e.g. by nuclear waste? Will a health risk be created through contaminated water? Or are unfair trade relations the basis of success? And so on. In other words: investors, who actively apply their responsibility in the globalisation process, recognise and acknowledge the concerns of other stakeholders as long-term value drivers. These include employees, suppliers and in particular the population of a country. Long-term safeguarding of the value of a company for the owners is not feasible, if (transient) success is gained at the cost of other stakeholders.

Responsible investors not only analyse such interrelations, but also actively drive for improvements where these are due. Good Corporate Governance by investors with the inclusion of different stakeholders is an important precondition in order to permanently integrate an economy in a global setting based on fair rules. Corporate Governance permeates the economic transactions of companies and investors everywhere, extending far beyond the narrow business framework within which certain circles would like to see it limited.

Regarding the inclusion of other stakeholders, the Corporate Governance debate also addresses the issue of the distribution of power. The distribution of power is a central issue for any form

of government or economy, as well as for any company. The inclusion of other stakeholders presupposes a balance between economic and social objectives and the reconciliation of the interests of individuals, the company and society as a whole. Various examples from many countries show that failure at management level can have an enormous impact on the economy as a whole, causing significant damage not only to shareholders and bondholders, but also to the employees, suppliers, customers and society in general.

The lack of consideration for stakeholders common today and the small group of people seriously involved are expressions of a deficit. Whether this can be remedied depends on the one hand on the realisation of the "powers that be" that this circle must be expanded. On the other hand it depends greatly on the ability of stakeholders, poorly represented so far, to make use of the existing channels. Only a few investors at present face up to their responsibility as co-owners. And those who do so are often investors who place short-term financial objectives above all else. As a result of this, the quality of worldwide development is increasingly delegated to a minority of active participants in the financial markets. Hence, in a world in which countries, markets and corporations are growing closer together and trading with each other, the active participation of all investors is a major precondition for balanced, fair development, taking as many interests as possible into account. In the medium and long term, those people enjoying short-term advantages gained at the cost of others will also be made painfully aware of the consequences of the economic, ecological and, last but not least, social damage caused.

If investors are only interested in short-term success, and there are many such investors, the opening up of the financial markets of a country - whether it is a developing, an emerging, or even an industrial country - will result in the plundering of that country by investors with short-term objectives. As a consequence, the country will get bogged down with high debts, reduced credit-worthiness and accentuated social problems. Investors with short-term aims are often not aware of their responsibilities. The effects of their actions on a nation's economy and society do not count amongst their criteria. Forensic skills are not required to predict the floundering of globalisation should this scenario prevail.

Facing up to responsibility means actively participating

The two terms "stakeholders" and "the distribution of power" incorporated in the Definition of Corporate Governance contain central messages which are closely linked with the essence of SRI (Socially Responsible Investment). Investors play a central role in the further networking of the nations of the world. Without the strong quantitative and qualitative growth of SRI, globalisation will flounder. In other words: there is no such thing as a "neutral" investor. Investors are always owners too, and as such share in the responsibility. There is no escaping the active exercising of voting rights or the proposal of socially and environmentally relevant resolutions.

Appendix: A practical example – The ethos Foundation

Forming groupings has many potential advantages as the following example from ethos, the Swiss Investment Foundation for Sustainable Development shows. Founded in 1997, ethos has currently 95 pension funds throughout Switzerland amongst its members. Acting on the instructions of its members, ethos manages six investment segments in shares and bonds amounting to about 720 million Swiss Francs in accordance with the criteria of sustainable development (financial, ecological and social criteria). The main objectives are promoting those companies, which contribute to sustainable development as well as giving companies clear signals from their investors relating to the desired long-term development. Constructive dialogue with the companies plays a key role in this. The objective of ethos is also to enable its members to exercise their voting rights in a responsible manner.

In-depth analyses of the agenda of the general meetings are carried out in accordance with the detailed voting guidelines in order to enable shareholder-voting rights to be exercised in a systematic and socially responsible manner at shareholders´ general meetings of companies in which the Foundation holds shares. Voting recommendations are made to the members on this basis. It is particularly important that voting rights are exercised based on detailed voting guidelines, which are transparent and public. The ethos proxy voting guidelines[3] refer in particular to the ethos Charta (which is based on the concept of sustainable development) and to the main national and supranational Codes of Best Practice in Corporate Governance. These voting recommendations are driven by the determination to sustainably increase the company's value in the interests of its owners (shareholders) and all the company's stakeholders, such as employees, customers, suppliers, public bodies and society as a whole. Over the last years ethos has exercised its voting rights at approx. 150 general meetings of Swiss and foreign corporations. ethos has supported a variety of resolutions.

A few examples serve to illustrate this. The first describes a resolution concerning environmental and social policy: BP Amoco and oil extraction in the Arctic. The second concerns support for improvements required in connection with Corporate Governance structures, in particular the independence of the board of directors (examples CS Group and Zurich Financial Services).

Since the year 2000 resolutions relating to oil drilling in the Arctic have been introduced at each shareholders´ general meeting of BP Amoco. In the year 2000 a group of shareholders presented the shareholders´ general meeting of BP Amoco with a resolution demanding that all oil drilling in the Arctic should be stopped. ethos supported this proposal, which

[3] Source: Proxy Voting Guidelines; ethos, Swiss Foundation for Sustainable Development; March 2001; download in English, French or German at www.ethosfund.ch

received a total of 13% of votes. At the shareholders´ general meeting in Spring 2002 various shareholders introduced a resolution demanding that BP Amoco periodically inform shareholders how risks of activities in environmentally and culturally sensitive regions are assessed and what precautions are being taken to avoid damage to the environment and to shareholders. This proposal was drawn up under the leadership of the WWF. Over 115 private investors in England as well as institutional investors such as the ethos Foundation, the RSPB, The Joseph Rowntree Charitable Trust, US Public Interest Research Group, Trillium Asset Management, Walden Asset Management of Boston, the Green Century Balanced Fund, Ethical Funds Inc. of Canada, Enterprise Foundation of the Rockefeller Family Fund, Clean Yield of Vermont Catholic Healthcare West and members of the Interfaith Center on Corporate Responsibility support this proposal.

The resolution obtained 10.3% of votes, which represents a stock market value of eight billion, £ (CHF 18 billion). In addition, several institutional shareholders abstained thus indicating that they do not support BP management on this issue.

Such proposals intensify the dialogue with corporations and also give corporations clear signals from groups of shareholders that environmental and social matters are to be taken just as seriously as financial aspects. The past years have shown that constructively driven resolutions in the environmental and social area gain a high proportion of votes (10% and above) at shareholders´ general meetings. This also reinforces the management position in the case of disputes with shareholders who are only concerned with short-term financial gain.[4]

At the shareholders´ general meeting of the CS Group in 2001 the proposal by the ethos investment foundation that «the board of directors implement suitable measures to guarantee its independence» was rejected by the majority of shareholders. However, the proposal initiated a discussion in Switzerland about the independence of the board of directors and also influenced the attitude of the CS Group management regarding the rules of conduct relating to Corporate Governance. The President of the board of directors resigned from the nomination and compensation committee of the board and a member of the board of directors was appointed to the post of «Senior Board Member». In particular, a Senior Board Member has the authority to convene the board of directors without its president.

At the shareholders´ general meeting of the CS Group in 2002 held on 31 May 2002 the ethos foundation presented three resolutions. All received widespread support. The most important one, aiming at the prohibition of the dual function of Chairman-CEO, received 18.6%. This has to be compared with the resolution presented in 2001, which only received 1.7% of all votes. The resolution to limit the mandates of directors to two years and for the

[4] See also: The main social and environmental shareholder resolutions; Annual General Meetings 2000; ethos, Swiss Foundation for Sustainable Development; March 2001; download in French or German at www.ethosfund.ch

individual election of directors scored 12.0%. The third resolution for the disclosure of rules of remuneration was supported by 16.2% of all votes.[5]

The three shareholder resolutions jointly submitted by ethos, Pax insurances and the Tschudi family at the annual shareholders' meeting of Zurich Financial Services on 16 May 2002 also received wide support. The resolution for a reduction of the term of office of members of the Board of Directors to two years received a support of 27.4% and the second resolution for the individual election of directors 99.1%. The most important resolution aimed at the prohibition for the Chairman of the Board to simultaneously occupy the position of CEO and received 37.3% of all votes.[6]

Such results represent a success for those who support better corporate governance. They indicate that a growing number of shareholders disapprove the accumulation of the positions of both Chairman and CEO. In this regard, the votes are a clear signal. The results are a great success for shareholder democracy. They also demonstrate that the shareholder community is increasingly aware of the fact that good corporate governance is an essential factor to ensuring a company's success.

The opportunities for active intervention are determined by the Corporate Governance structure with regard to shareholders´ rights. They can only develop full effectiveness if a fair structure for capital and voting rights exists for all investors. It is apparent that voting shares can significantly limit the sphere of action of committed investors. The same applies if shareholders are not able to vote with all their votes but only with a part-share in the vote as a result of percentage limitations.

[5] Source and details: see www.ethosfund.ch

[6] Source and details: see www.ethosfund.ch

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