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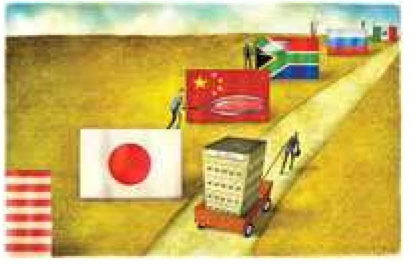
Governance Reform Goes Global

Reformers are pressuring companies around the globe to be more accountable. but no two countries are alike in their approach.

by Jill Andresky Fraser



After the scandalous collapses of Enron, Worldcom, and Parmalat, the reform of corporate governance has been seared into the social agendas of many countries and companies. Yet this trend, which has the potential to transform corporations wherever they do business, is not being driven by scandal alone.

The globalization of business and capital markets has created incentives and pressures that support or spur a range of reforms. In the United States, for example, corporate officers and boards of directors are struggling to decide the best way to make boards of directors more accountable and more effective in their oversight.

These concerns are not confined to the United States, however. The reform movement that has spawned these struggles is having a similar effect on businesspeople, investors, and creditors all over the world. The governance debate crosses many borders: of nations and regions; of industries; and of regimes of business ownership. Businesspeople everywhere are realizing that they must change the way they operate or risk becoming a casualty of the governance reform movement.

But there’s no simple or single road map showing the path to “good governance.” Each country’s culture, regulatory history, and business traditions affect its approach.That can complicate matters for businesspeople and investors who may participate in the global economy, but not understand completely the costs, risks, and other exposures that result from changing attitudes toward corporate governance.

Of course, there’s much to be gained from governance reform. One of the key benefits is that it will lower the cost of capital for companies. This will improve returns to investors. “But that can only take place if [investors are] confident that companies are being run in the long-term interests of shareholders,” says Alastair Ross Goobey, chairman of the International Corporate Governance Network (ICGN), an international organization that promotes governance best practices.

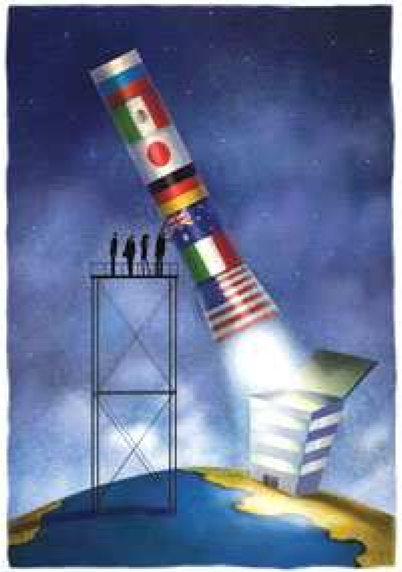
Sophisticated executive teams are increasingly recognizing this and are taking steps to meet, or even exceed, governance norms within their industries and nations. Increasing compliance can create a host of additional challenges, however. For example, notes Christopher Hamilton, a senior vice president at BearingPoint in New York City, not only do companies need to confront more obvious concerns, such as the role of outside directors and the question of who votes for them, they must also account for the fact that improving transparency can compromise customer confidentiality. In addition, he says, companies should pay close attention to their internal cultures, since this affects compensation, and ultimately, governance. Long-term planning and good governance go hand in hand. “Large companies know they can be taken down by one individual or one freak event,” says Hamilton, so creating the conditions for longevity is crucial.

Governance issues can be especially thorny for international companies. “Cross-border political risk and regulatory arbitrage are also important issues,” says Hamilton. “Operating in multiple countries is complicated. It comes back to the issue of centralized versus decentralized. If you have your headquarters in the U.S. and operate in Europe, for example, do the European regulators align their rules to those of the U.S.? Determining which laws and regulations apply is a very complex process. Regulators need to clarify what the rules are in different countries. At the same time, companies should have both decent local coverage and corporate coverage. But that’s hard to balance. It’s often the little countries that cause problems. So companies may, in certain instances, want to reevaluate what countries they want to operate in.”

One buzzword when it comes to corporate governance is “convergence,” which connotes a movement toward some shared objectives and the adoption of “best practices” that meet a country’s needs.

Even if achieving convergence is possible and desirable, it can be a problematic process for many of the same reasons. A comparison of how governance reforms are playing out in different countries highlights this complexity.

Germany's governance system is relatively strong, although quite different from that of the United States. German corporations have a two-tiered board system consisting of a management board and a supervisory board. Large shareholders (who might be members of founding families, banks, or the state) and employee representatives play a significant role in governance because they are represented on the supervisory board.



The German model has many supporters. "The strength of the German governance system is in maintaining labor loyalty in low-growth or shrinking sectors," says Sigurt Vitols, a researcher at the Wissenschaftszentrum Berlin für Sozialforschung and an advisor on governance to German trade unions and the European Commission.

Despite Germany's strongly rooted governance traditions, there's a lot of debate about disclosing executive compensation. That issue became controversial when it was revealed that the directors of Mannesmann, the German telecommunications company, had approved a large severance package for then-CEO, Klaus Esser, soon after the company was taken over by Vodafone. Esser's severance led to highly publicized litigation over charges that directors breached their duty to shareholders. The directors, including Deutsche Bank CEO Josef Ackermann, were acquitted last summer. However, German executives worry that the case will encourage other types of director challenges.

Disclosure of executive compensation is "required" by Germany's Corporate Governance Code, but compliance to the Code itself is voluntary. Listed companies must disclose the extent to which they comply with the Code. According to Dr. Markus Federle, a partner in the Frankfurt office of the law firm Dewey Ballantine, about 80 percent of the 30 largest companies listed on the Frankfurtstock exchange do not disclose the compensation of individual top managers.

"There's an ongoing debate within Parliament about whether this disclosure should be mandatory or not, and this is also a debate within the European Community," says Federle.

Despite a great deal of attention to whether compensation disclosure should be mandatory, Federle says that other changes under consideration are more significant. For example, there is an initiative to facilitate shareholder lawsuits. "Shareholders need to own ten percent of a company's stock in order to file a lawsuit," says Federle. "A regulation under consideration proposes to reduce this [threshold] to one percent or, in certain circumstances, even less."

Japan is also debating the disclosure of executive compensation. But there the pressure for more disclosure is part of a much wider campaign to achieve greater transparency and other substantive corporate governance reforms in order to bring the nation's system closer to the U.S. and European models.

Cultural and historical traditions are a significant obstacle to change in Japan. "Traditions of consensus, and the existence of large, interrelated groups has meant that there has been little, if any, independence on the boards of Japanese companies," says ICGN's Ross Goobey. "Until only twenty years ago there were statutory limitations on the level of foreign ownership of most of the leading Japanese companies, so Japanese boards have not been subject to the pressures facing directors [in Europe and the United States]."

Also, individual investors are fewer and have less clout in Japan. The reliance on intra-company shareholders and cross-ownership of stock has meant that these institutional investors have dominated the market. There has been a trend to add external directors to Japanese boards, but external members just don't have the kind of authority they do in the United States.

Still, there are many positive signs of change. Because of the prolonged weakness of the Japanese economy and stock market, companies have been more willing to seek outside sources of public and private equity capital. That has led to a greater interest in American management techniques, including the use of independent board directors and separate board committees for compensation and other matters.

Alya Kayal, a senior analyst with Calvert Group, a mutual fund company specializing in socially responsible investing, applauds the leadership role SONY has taken in adopting a number of practices, including board committee structures that will separate the nominating, audit, and compensation committees. "The mind-set in Japan is changing: There is much more awareness of the role of shareholders," says Kayal. "There's also more transparency, especially when it comes to environmental issues."

A shareholder rights movement has developed in Japan, led by an organization known as Kabunushi Ombudsman (KO). The nonprofit group, founded in 1996, consists of lawyers, accountants, scholars, and individual shareholders. Its goal is to monitor and reform Japanese business practices. Since 2002, reports Professor Koji Morioka, KO's director, the group has filed shareholder proposals at a number of firms.

One of KO's proposals asks boards of directors to amend their articles of incorporation so that salaries and retirement bonuses of individual directors are made public. Among SONY's shareholders, support for the proposal has grown from about 27 percent of the votes in 2002 to 31 percent this past year.

Substantive governance reform is likely in Japan for another key reason. U.S. and European private equity firms are increasingly expected to cast their weight behind a movement toward international best practices.

Corporate governance reform has become an even more pressing issue in emerging markets, where demand for growth capital is the driving force. “Investors will pay more for a well-governed company, and the premium they are willing to pay goes up by quite a bit in developing countries,” says Holly Gregory, a partner in the corporate governance group at the law firm Weil, Gotshal & Manges, who has organized corporate governance programs for the OECD, the World Bank, and the Global Corporate Governance Forum, among others. “What that says is that you will be rewarded if you embrace a best practice and then communicate this to the outside world.”

Brazil has earned high marks for its recent steps in this direction. Despite resistance from many of the founding families that control the country’s publicly traded companies, the government launched a sustained effort in the late 1990s to reform corporate governance practices.

Güler Manisali Darman, an international corporate governance expert based in Turkey and author of *Corporate Governance Worldwide* (ICC Books, 2004), cites Novo Mercado as an important step in the direction of reform. This is an exchange founded several years ago in Brazil for companies that voluntarily abide by governance practices and disclosure requirements over and above those that are required by Brazilian law.

Novo Mercado’s requirements, which include the disclosure of insider trading by controlling shareholders or senior managers, all serve to increase transparency, says Manisali Darman. Companies on Novo Mercado also must report balance sheet information in accordance with U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

In order to encourage more companies to move in the direction of higher governance standards, Brazil has set up two intermediary listings, known as Levels 1 and 2. These consist of about three-dozen publicly traded companies listed on one of the so-called special segments of the Brazilian stock exchange. Some studies suggest that the shares of these firms have traded at values higher than those of the shares of Brazilian peers.

Foreign investors, lenders, and potential joint-venture partners may want to negotiate for governance concessions that approximate those required by one or more of Brazil’s special exchanges or confine their activities only to companies listed on them. Other companies in the country still lag far behind on governance matters.

In Russia it may be too early to determine whether reforms have been substantive and effective enough to help companies compete globally for capital. Neil Getnick, a managing partner at New York City law firm Getnick & Getnick, has worked with the Russian Union of Industrialists and Entrepreneurs to increase awareness that, he says, “Raising standards will help companies gain access to capital, win preferred rates, get listed on foreign exchanges, and encourage joint ventures.”

Yet there are cultural and historical obstacles in Russia that may take more time to overcome.

“Whistle-blowers are viewed favorably in the United States,” Getnick points out. “In Russia there’s a very different history and set of connotations [associated with whistle-blowing], particularly from the Soviet period. You can’t just impose U.S. mores on such a different culture.”

Some governance experts have adopted a wait-and-see approach. “Corporate governance is still in its infancy here,” says Kayal of Calvert. “[But] it’s time for the country to deal with this issue more seriously.”

Getnick believes that Russia’s newer, entrepreneurial companies will take the lead in adopting international best governance practices. Indeed, this trend may replicate itself in one emerging nation after another. In developing countries, the growth-oriented companies may adopt global best practices more willingly and rapidly than the longer-established firms.

The challenges of corporate governance don’t have easy answers. But with pressure for change coming from many directions—regulators, investors, and the global business community—one thing is clear: Despite the growing high-level attention devoted to better corporate governance, there remains much tactical work to do, such as aligning technology with increasing demands for transparency. Companies need to review their compliance architectures and strategies for enterprise content management as carefully as they look at who is sitting on their boards. Risks abound, but companies that can harmonize their internal processes, systems, and cultures with broader global governance imperatives will have the advantage.

Jill Andresky Fraser has written for Inc., Institutional Investor, Smart Money, and Worth. She is a former columnist for The New York Times.

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