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BOARDS—THE REALITY OF CO-EXISTING DIVERSE MODELS

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Academicians have sought to examine the board structures mainly from a binary perspective – the one-tier / unitary model and the two-tier one. Many have argued the merits of one over the other as eventual points of convergence. Some comparative studies have even sought to link the models with economic outcome for the firm and for the country. This debate continues even as countries known to represent these classic models themselves seem to be borrowing from each other and elsewhere in some manner. That should not be surprising as the management world in the US and UK has seen much learning from the Japanese and the Germans in earlier decades followed by the reversal apparent during the last decade.

The Adaptations of the Classical One-tier Model:

The one-tier model which has been traditionally popular with international investing community is typified by the UK and the USA and is followed in almost all countries with common law tradition. When the Cadbury Report - which generated a slew of codes all over the world - drew attention to the need for independent directors, independent audit committee, separation of chairperson from the executive there was understandable criticism from some quarters that it was superimposing the supervisory board idea. It implied that the supervisory role and control function of the board must dominate over its more strategic management role. Further, in many of the common law countries, the Codes define corporate governance as the manner in which the company is “directed and controlled” – a supervisory function.- even as their law treats non-executive Directors also as “officers at default” along with executive directors and key managerial personnel!

Some believed, and in many countries they still do, that these changes to the one-tier board model induces bureaucracy, erodes competitiveness and imposes higher transaction costs in general. However, most felt that the opportunities provided by internationalization and capital markets required that adjustment to bring in more investor confidence and their money. Further refinements, such as the induction of lead director, and executive sessions of the independent directors reinforce abundantly this disposition towards enhanced stewardship as against managerial role.

TIDBITS:

A note (*pro bono*) was prepared by us for the benefit of SADC-DFRC, Botswana, examining the relevance of corporate governance for SMEs and proposing a structured approach to promoting the same. Subsequently, DFRC conducted a programme along with an SME workshop with support from EU agencies. This resulted in both capacity building as well as suggestions for promoting corporate governance among select clusters of SMEs in the SADC region in Africa.

The Institute of Company Secretaries of India (ICSI) has instituted a group to review the processes of its much-acclaimed corporate governance award. The group comprised of: Mr. Philip Armstrong, Head-GCGF; Dr. Grant Kirkpatrick, Head-Corporate Affairs division, OECD; Mr. Arun Balakrishnan, Ex-CMD, HPCL; Dr. Anil Khandelwal, Chairman, Baroda Pioneer AMC; Mr. Gopalakrishna Hegde, Council Member; Mr. B. Ramachandran, Company Secretary, WIPRO; Mr. N K Jain, Secretary and CEO ICSI; Mrs. Alka Kapoor, Jt. Director ICSI; with Dr. Y.R.K. Reddy as the Chair. The comments and observations of the members have since been processed by the secretariat.

INTERNATIONAL:

☉ According to CLSA - ACGA Corporate Governance Watch 2012, Singapore, Hong Kong and Thailand ranked as the top three in Asia. These three were followed by Japan / Malaysia, Taiwan, India, Korea, China, Philippines and

Simultaneously, it has become a norm for all big corporations to have a formal Management / Executive Committee comprising the senior management which in many ways mimics the Management Board in a two-tier model but without a legal status, unless provided for in the Articles of the company.

There is another manner in which the disposition of civil law countries that represent the two-tier model has possibly seeped into the one-tier system. The recent emphasis on corporate social responsibility, triple bottom-line / sustainability reporting, special statements regarding environmental compliance in respect of some types of industries and even ethics (most exemplified by the King Committee III of South Africa) reflects the shift from the share-holder model to at least recognizing the stake-holder idea. Further, despite the expected tradition of “comply / apply or explain”, some aspects have slowly started creeping into legislation, regulatory directives and prudential standards. This is exemplified by Sarbanes-Oxley in the US, the changes to listing agreements with securities exchange regulators in many countries, prudential standards relating to governance as issued by banking / financial regulators, and changing remits of statutory auditors in some countries.

One may recall that there were some in the UK that seriously argued in favour of a two-tier model during the 70's but the sore issue that stalled the move was that of providing space for labour a la Germany. Nevertheless, in many common law countries where state-owned enterprises are significant, it is not unusual to have a stake-holder representative on the board by law or on State's directive. Such representatives are often from the unions / collectives, minority shareholder or depositors in the case of banks. The State's intervention in board composition to represent public interest have also been evident intermittently in cases of major corporate failures or bailouts in these countries. This is most recently witnessed in the US and the UK once again reflecting the stakeholder assertions witnessed in the civil law countries that have two-tier boards.

The Changes to the Classical Two-Tier Board:

Though the Dutch had a 400 year history of a two-tier Board, it is the German variety that has come to represent the model. According to the German law, all public companies (*Aktiengesellschaften*) are required to have a management board (*Vorstand*) and supervisory board (*Aufsichtsrat*). The members of the Supervisory Board are normally representatives of shareholders and labour. By a separate labour related law on codetermination, companies with more than 500 employees are required to have employee representatives (which could be up to 50% of the Board in case of more than 2000 employees), elected through a highly structured process. By law, the Labour Director on the management board also may be required to be elected by the workers. The duties of the Supervisory Board are distinct from those of the management – and are mainly in respect of hiring and disciplining Management Board, monitoring their performance, providing control, approving accounts etc. The Articles of the corporation may also supplement the defined duties with possibilities of delegation, approval procedures and appellate process in case of disputes between the two. Though the division of duties and responsibilities appear to be clear and the management board acts independently, it is observed by some that the supervisory board has tended to be more hands-on in recent years compared to the past. This is especially so as the German Code enjoins the supervisory board to “advise regularly”

Indonesia. The top 50 companies, among the 864 listed corporations analysed, only five Indian companies figure. These are Infosys, HUL, Wipro, Titan industries and YES bank.

- ❶ Sadok Lel Ghoul, who was part of a group of researchers, presented interesting findings on review of politically connected firms in 31 countries. Such politically connected companies in these countries are more likely to hold greater cash than non connected firms. It is possible, as per this study, that this money is used as a resource for the firms' political friends.
- ❷ The Manhattan Institute Centre for Legal Policy reviewed the shareholders' proposals from Fortune-200 companies which revealed that almost all shareholder proposals are being sponsored by a small number of investors. These investors are mostly from labour union pension funds and social / religious sectors. Their proposals seem to be deviating from the shareholder value at large, raising concerns if the proposals and voting processes would tend to benefit more a subset of shareholders than all.
- ❸ Some believe that the death of 44 people and the spate of violence at Lowman plc's Marikana mine and others that followed in South Africa could have been avoided if the companies had embraced the ESG standards with commitment. Some believe that there were warning signals that were ignored to the detriment of not merely a few mines but the South African economy and its standing.
- ❹ According to a study by PWC, the changes in corporate governance are impacting board dynamics in the US. Being in the spotlight as never before, corporate directors are having to spend time more time on board work and change their approach to oversight. The PWC conducted a survey of 860 public company directors in the summer of 2012. Key findings include concerns over board composition and behaviour; IT oversight; executive compensation; strategy oversight and risk management.
- ❺ The ASEAN Corporate Governance Scorecard, which is a project funded by Asian Development Bank, seems to have attracted the attention of Philippines. Philippine companies had been using the scorecard system of the Institute of Corporate Directors and will now migrate to the ASEAN system which is reportedly

and be involved in decisions “of fundamental importance to the enterprise”. The monitoring and disciplining role of the Supervisory Board is further enhanced in countries like Germany where it is not uncommon to have concentration of ownership and where the markets for control may not be very active.

It is indeed mentioned by some that the adoption of a Code on a “comply or explain” basis in Germany is indicative of the influence of the common law countries that have one-tier boards – it is said that German corporations are more accustomed to following law, regulations and directives than self-regulatory Codes of best practice as introduced prominently by the UK and followed by many others.

The EU Experiment:

Many countries in Europe seem to have adapted themselves to providing alternatives to companies (mostly by way of shareholder resolutions or articles of incorporation) to follow either one-tier or two-tier Boards. Netherlands, France, Italy and Portugal are prominent examples in this respect. Some like Denmark reportedly have an even more distinguishing system of a compulsory Executive Board with an option of a Board of Directors or Supervisory Board. The diversity in Board structures and their key requirements in EU are striking despite the many observed forces of convergence.

The EU meandered through a tough patch of evolving a harmonized model first tilting to the German model and then to the British and eventually to an optional system of European Companies. The *Societas Europaea* (SE) that was evolved after 30 years of consideration was finally put into effect in 2004. A survey of these in 2009 indicated that there were 369 SE registered; of which nearly 38% were shell / shelf entities and mostly in Czech Republic; that 10 countries had no SE; and of the remaining, apart from Czech Republic (137), Germany (91), Netherlands (22) UK (16) France (15) had notable numbers; and that most were in services sector. A noteworthy feature is that SEs seem to be concentrated in countries where the two-tier system is compulsory with employee involvement. Most have opted for the single-tier board in these territories. It is apparent that the attempts at standardization / harmonization of company structures in EU have had limited success and there are notable hurdles and gaps in meeting the initial objectives – these are particularly related to law and regulation as also other socio-political considerations. As some believe, convergence even in form is a far cry leave alone in spirit. Such diversity may not be undesirable at all especially as there is no conclusive proof that one model is superior to the others. The result thus is beneficial as companies seem to have a range of alternatives within their national territories as also outside.

The Reality of Diverse Models:

If one reckons the board structures particularly in Asia, one is struck by the enormous differences. There are similar differences in Board models among the BRICS that drive the global economy in good measure. Some researchers are optimistic of convergence forces that can be unleashed by institutional investors, the accounting standards & major auditing / consulting firms and the overall Anglo-American preferences. But then, one must also take into account several other forces and factors that will ensure diversity in both form and substance.

First, the economic structures of countries vary vastly especially

being adopted by Malaysia, Singapore, Thailand and Indonesia. Being a regional system it is hoped that there will be more unified approach to corporate ranking and assessment. Other ASEAN members – Vietnam, Laos, Cambodia and Myanmar – are yet to follow.

- ❖ South Africa's King-III approach to integrated reporting seems to have attracted the attention of the Harvard Business School, whose students are reportedly studying its impact on corporate behaviour and performance.
- ❖ Some observers in the Northern American region believe that there is a new-found assertiveness among shareholders that is rocking many companies considered impregnable corporate giants. The shareholder activism is going beyond the normal complaints about excessive compensation and weak corporate governance. Such activism has resulted in the departure of prominent Chief Executives both in Europe and North America. The shrunken portfolios in a long-lasting bearish market have reportedly added to the bad mood. It is reported that shareholders have also begun ignoring advice from reputed proxy advisories to support the board and management in difficult times.
- ❖ A research study has indicated slow but steady improvement in the corporate social responsibility among Chinese companies. A review of corporate sustainability index series shows a ground-swell of interest in ESG criteria both from firms as well as investors. This has been reported through Hang Seng corporate sustainability indices, which series include 30 Hong Kong listed firms and 15 mainland China listed firms.
- ❖ The Council of Microfinance Equity Funds (CMEF) has announced the release of its corporate governance manual titled *The Practice of Corporate Governance in Microfinance Institutions*. The guidelines are aimed to provide precise and practical guidance specifically tailored to MFIs and also offer practical instructions to MFI boards.

NATIONAL:

- ❖ It is reported that the Company Law Bill is likely to be presented in the winter session of the parliament.
- ❖ The MCA appointed committee headed by Mr. Adi Godrej has presented a study on

in relation to the size of capital markets, the need for foreign investment vs. domestic capital, the size and importance of the publicly traded companies in economic development, ownership structures / concentration, the extent and size of state-ownership etc. Consequently, despite meticulously stated “business case” for a unitary corporate governance framework under assumed market conditions, many countries may be slow to warming up to the idea. In this context, it is important to keep in view that the one-tier board driven corporate governance framework dominated during the last two decades particularly riding on the buoyancy of many Western economies, promise of financial flows and growth prospects of capital markets. All these have taken a severe knock in recent years following the global financial and economic crises. The appetite for market-driven policies has also been tempered around the world though none disputes the logic per se. Perhaps, there is a measured and muted pause now to understand how other types of economic policies and management have continued to be resilient - and perhaps greater appreciation of diverse approaches.

Second, many countries especially in Asia and Latin America, have diverse political structures, governance models and legal framework that are in transition in some manner or the other. They may not be mindlessly bound by legal traditions and be path dependent / persistent to the extent assumed by some writers. Board structures and corporate governance reforms are contingent on the larger changes and cannot race-ahead or be in contradiction. Many of these countries seem to favour incremental changes and regulatory forbearance / tolerance for differences in the pace of progress. This is especially so in the absence of evidence-based categorical solutions to corporate governance related issues that seems to haunt both models.

Third, international standards such as those arising from the OECD principles are themselves inclusive and accommodative of diverse board structures, ownership structures and legal forms.

Four, even if there are signs of convergence in some aspect or the other, there is a strong likelihood of variance in operations / substance that may not necessarily be undesirable. Drawing from the world of management, corporations in different countries but in the same product-market segments have similar organization designs, technological processes, accounting standards, information systems, operations, and supply and distribution chains - yet they are vastly different in the manner in which they function. They derive competitive advantage mainly out of the softer aspects in the organization. That is the reason that when comparing British, Japanese, Korean and Indian management styles, one would find overwhelming apparent similarities and yet much difference. The same should be true of Board structures, other corporate governance arrangements and their core substance that matters.

In the light of the above, it would be hard to expect convergence to any one model, divergence away from any one type or persistence with the current or the past. It would indeed continue to be a world of diverse models and practices. Instead of being frustrated over this, wise policy makers and institutional investors must welcome the prospect as it only increases the alternatives for investments depending on what works best in a given socio-cultural-political-economic-legal transitory conditions. It probably ensures different markets for different types of finance / investors, spreads the risks and promises greater value. It is already evident that even as many countries in the West with

Guiding Principles of Corporate Governance. It makes a series of suggestions for strengthening the corporate governance substance within the existing legal framework.

- ❖ CII has released a report titled *Institutional Investors: Driving Force for Good Governance*. It reportedly outlines how institutional investors can enhance value to the business and economy in addition to the shareholders. The survey reveals that nearly 85% of the respondents felt that corporate governance played important role in their investment decisions. While 94.7% associated good corporate governance with high shareholder returns, only 26% have reportedly invested on the basis of high corporate governance standards. In this survey, the cluster of PSUs have been ranked the lowest by institutional investors with MNCs at the top and professionally managed companies right behind it.
- ❖ Nearly 110 central public enterprises have reportedly not submitted the self evaluation reports on corporate governance to their respective ministries for the 2010 – 11 financial year. Most of these companies are stated to be from the power sector.
- ❖ The SEBI has indicated the possibility of regulating executive compensation in listed companies with possibilities of mandatory remuneration committees headed by independent directors, disallowing stock options in the financial sector and claw-back provisions for variable pay *a la* the US etc. This has been considered an unwarranted proposal by the industry – particularly considering the proposed amendments in the Company Bill and the broad practice in the industry.
- ❖ ICSI has observed the Corporate Governance Week, the second in the series, from August 27th to 31st 2012 with several academic / professional events across the country.
- ❖ A complaint lodged by Karvy stock broking against Deccan Chronicle Holdings Limited, relating to pledging of shares has led to a series of collateral actions, which is snow-balling into yet another corporate governance scandal in the making.
- ❖ SEBI is reportedly examining the possibility of Protected Cell Companies

either of the models are tottering amidst crises, there are other countries and models that are thriving – no doubt investors are already finding great value in them.

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(This is a pre-edited version of a paper written for the special issue of CSJ, the official Journal of Hong Kong Institute of Chartered Secretaries on the occasion of the Corporate Governance Conference 2012, in which Y.R.K.Reddy is a featured speaker).

(PCC) from Mauritius, Cayman Islands and Seychelles round tripping Indian moneys into the capital market. Though SEBI had banned PCCs, it is now believed that some are being structured as PCCs, but using other routes like venture capital funds to facilitate round tripping. It was particularly reported that foreign banks were found hard selling such schemes to high net-worth individuals assuring them protection of identities and segregating the risks and returns.

PHOTO GALLERY



SADC-DFRC organized a Corporate Governance Programme for its DFI members with the assistance of African Development Bank. In this photo Y.R.K.Reddy the lead resource person is seen handing over the certificate to a participant along with Dr.Lassaad Lachaal of ADB and Mr. Stuart Kufeni, CEO, DFRC, while Ms.Bonita Freeman, ADB is announcing. The programme was held at Cape Town from 9th-12th July.



Group Photograph of participants and resource persons attending the DFRC's Corporate Governance Programme along with SME workshop conducted with the assistance of EU funds at Pretoria from 29th May - 7th June with Y.R.K.Reddy as the lead resource (as seen lecturing below).



ACTIVITIES – 2011.

1. Address on *Social Cost of Global Financial Crisis* by Founder Trustee, organised by HMA - FACCI – ISTD – NIPM, Hyderabad, 25th February 2011.
2. Assistance by Founder Trustee as moderator for breakout session on *India Asian Corporate Governance – The Future Steps* at the ICGN's mid-year conference at Kaulalampur 28th Feb. to 2nd March 2011.
3. Presentations and discussions by Founder Trustee in the GCGF-DFRC project on *Promoting on Policy Environment for Corporate Governance in the SADC Region*, Johannesburg, from 24th to 28th May 2011.
4. Assistance by Founder Trustee to the Royal Monetary Authority in *Corporate Governance Training*, in a project supported by ADB, Thimpu, Bhutan, 30th May to 4th June 2011.
5. ACG – SCOPE's *VII Programme on Corporate Governance* for CEOs and Directors, Hyderabad 28th - 29th June 2011.
6. Address by Founder Trustee on *Corporate Governance Practices in Emerging Market Economies: Trends and Implications* at the first International Conference of CSIA, Shanghai, 22nd – 23rd September 2011.
7. Facilitation by the Founder Trustee in the DFRC–IOD, Zambia *Programme on Corporate Governance relating to SOEs*, Lusaka, on 3rd to 5th October 2011.
8. Participation by the Founder Trustee as member of the Jury for *ICSI's Excellence in Corporate Governance Awards*, 12th November at New Delhi.
- 9 ACG – SCOPE's *VIII Programme on Corporate Governance* for CEOs and Directors, New Delhi, 14th to 15th December 2011.
10. Chairing / moderating the panel discussion on the eve of the Award Function of ICSI, on *CSR & Diversity in Boards*, 23rd December 2011 at Hyderabad.