BREAKTHROUGH CORPORATE GOVERNANCE:
A Toolbox for Senior Managers and Directors

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# Table of Contents

INTRODUCTION ................................................................................................................................. 4

CHAPTER 1. EXECUTIVE SUMMARY .......................................................................................... 7

CHAPTER 2. THE CORPORATE GOVERNANCE DIAMOND: AN INTEGRATED APPROACH ......................................................................................................................... 14
   THE PROBLEM .............................................................................................................................. 14
   THE IMPORTANCE ....................................................................................................................... 16
   THE CORPORATE GOVERNANCE DIAMOND ............................................................................ 19

CHAPTER 3. CORPORATE PERFORMANCE: THE BOARD OF DIRECTORS .................. 25
   MANAGEMENT SUPERVISION ...................................................................................................... 25
   VALUE-ADDED SERVICES .......................................................................................................... 35
   TOP MANAGEMENT’S HUMAN RESOURCES ............................................................................ 41

CHAPTER 4. SHAREHOLDER PROTECTION ........................................................................... 54
   MARKET PROTECTION ............................................................................................................... 54
   BOARD PROTECTION .................................................................................................................. 56
   VOTING PROTECTION ................................................................................................................ 57

CHAPTER 5. CORPORATE DISCLOSURE ............................................................................... 63
   FINANCIAL DISCLOSURE .......................................................................................................... 65
   ORGANIZATIONAL DISCLOSURE ............................................................................................. 67
   CONTROL DISCLOSURE ............................................................................................................ 68

CHAPTER 6. WINNING CORPORATE GOVERNANCE STRATEGIES ...................... 75
   THE ROLE OF THE CHIEF CORPORATE GOVERNANCE OFFICER ........................................ 75
   CRAFTING CORPORATE GOVERNANCE ARCHITECTURE: BUILDING GATEWAYS FOR THE FUTURE .................................................................................................................. 75
   INTANGIBLE ASSETS ................................................................................................................ 76
   CORPORATE PERFORMANCE: THE BOARD OF DIRECTORS ............................................. 77
   SHAREHOLDER PROTECTION .................................................................................................. 81
   CORPORATE DISCLOSURE ........................................................................................................ 82

REFERENCES ................................................................................................................................. 84

ABOUT THE AUTHOR .................................................................................................................... 88
“Darwin learned that in a competitive environment an organism’s chance of survival and reproduction is not just a matter of chance. If one organism has even a tiny edge over the others, the advantage becomes amplified over time. In ‘The Origin of the Species’, Darwin noted ‘A grain in the balance will determine which individual shall be live and which shall die’. I suggest that an independent, attentive board is the grain in the balance that leads to a corporate advantage. A performing board is most likely to respond effectively to a world where the pace of change is accelerating. An inert board is more likely to produce leadership that circles the wagons” Ira M. Millstein, Senior Partner, Weil, Gotshal & Manges, LLP

“Before I served as a consultant to Kennedy, I had believed, like most academics, that the process of decision-making was largely intellectual and all one had to do was to walk into the President’s office and convince him of the correctness of one’s view. This perspective I soon realized is as dangerously immature as it is widely held” Henry Kissinger, Former Secretary of State of the United States
Introduction

Financial economics perspective. Corporate America and corporate Europe are extremely upset in the corporate governance arena. Not only there have been significant losses in the financial markets, but, what is also more important, and has been less highlighted in the media, is that there has been a misallocation of capital into real assets (e.g. telecommunication investments). Furthermore, many talented individuals that went to work for “new-economy” businesses during the stock market bubble, have lost their jobs; that is, there has been a misallocation of human capital that could have been employed for better uses.

From a financial economics point of view the main functions of a corporate governance system are to (1) ensure that financial capital flows, without friction, from investors to companies that can best use it, that is, to companies that can achieve superior risk-adjusted returns and (2) to ensure that financial capitals leaves companies that have run out of positive-NPV investments. To ensure that financial capital inflows and outflows move efficiently, investors need a certain degree of protection of their investments, otherwise the capital will not flow. However, complete protection of investors is neither feasible nor desirable. It is not feasible because financial investors do not know what information managers and employees manage, and, even in the case they knew it, uncertainty about the future will make impossible to guarantee the investment (so-called “theory of incomplete contracting”). Moreover, it is not desirable because if financial capital is perfectly protected, human capital will not flow. A corporation is a partnership, a co-investment of financial and human capital and both types of resources have to be deployed to achieve a “joint maximum efficiency”; that is, managers need to have some discretion in order to facilitate the efficiency in the financial and human capital market.

Quoting Felton (1996) “Before moving forward, most CEOs will want to be sure of the answers to a few key questions. To begin with, are major shareholders raising questions about your governance practices? If you are not under scrutiny today, how likely is it, given current trends, that you will be tomorrow? Even if your company is performing well and your shareholders seem satisfied, it may still be wise to explore whether now is the time to begin building a stronger board” and a robust corporate governance system.

Objective. The objectives of the paper are (1) to provide a primer for senior managers and directors, a way of thinking on corporate governance issues, whether those currently discussed on the market or those that will appear in the future and (2) to suggest some internal initiatives that, if made, can have a positive payoff or mitigate a negative one. I do not intend to provide the definitive answer or to cover all corporate governance topics, I just aim to provide a manageable and easy-to-read guide. The framework presented in the paper does not recommend any regulatory change but internal changes within the corporation, enforced by the General Secretary, the Chief Governance Officer and the CEO; in that sense it can be considered a modest proposal. This paper does not aim to critique or propose any legislative changes.

Gary Hamel defines, better than I, the objective of this paper: “the goal of competition for industry foresight is, at one level, simple: to build the best possible assumption about the future and thereby develop the prescience needed to proactively shape industry evolution. Competition for industry foresight is essentially competition to establish one’s company as the intellectual leader in terms of influence over the direction and shape of industry transformation. Industry foresight gives a company the potential to

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1 This section is mainly based in a speech given by Prof. S. Myers in the academic convocation of the 50th anniversary celebrations of the MIT Sloan School of Management.
get to the future first and stake out a leadership position. The trick is to see the future before it arrives.“ However, as Hamel also says “all the foresight in the world, if not matched by a capacity to execute, counts for little.” Finally, industry foresight is the product of many people’s vision and though I have gathered many well-respected corporate governance systems, other relevant corporate governance systems could have been left. However, it is important to bring a quote of The Business Roundtable reminding us that: “Good corporate governance is far more than a check-the-box list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A good corporate governance structure is a working system for principled goal-setting, effective decision making, and appropriate monitoring of compliance and performance”.

**Structure.** This paper is intended to be a primer on corporate governance for senior managers. It discusses the *integrated corporate governance framework*, (1) emphasizing the three main building blocks of a corporate governance system of a firm (*corporate governance diamond*), that is, corporate performance –board of directors, shareholder protection and corporate disclosure and (2) integrating four different perspectives (*institutional, institutional investor, corporate and market regulator*) that, combined, allow corporations to define their optimal corporate governance architecture. The paper offers a functional analysis of the design of the architecture of corporate governance systems using a wide set of illustrative situations to show best practices and it also shows how the design of corporate governance influences the overall business activities and the performance of the firm. Finally, the paper concludes with a perspective on a portfolio strategy for the design of corporate governance systems.

The paper is structured as follows. Chapter 1 provides an executive summary of the paper. Chapter 2, chapter 3 and chapter 4 provide an overview of the three components of a corporate governance system. Finally, chapter 5 discusses several corporate governance strategies to build gateways for the future. It proposes a portfolio strategy using a strategic matrix of areas to compete (corporate performance –board of directors-, shareholder protection and corporate disclosure) and strategies to use (intangible assets, big bets, real options, no-regrets moves and safety nets). Bibliography is classified by corporate governance topics at the end of the paper.

**Note.** This paper has been done part-time for the course of “The Board of Directors & Corporate Governance” at the Harvard Business School. All errors are solely from the author; he can be reached at his EFL jose.marco@sloan.mit.edu.
Chapter 1

Executive Summary
Chapter 1. Executive Summary

This paper aims to propose a set of strategies on corporate governance by (1) setting an integrated corporate governance framework, (2) analyzing the current best practices on corporate governance worldwide through four different perspectives –corporate, regulatory, institutional and investor- and (3) developing a portfolio strategy on corporate governance whether by adapting successful strategies used or recommended by other corporations and institutions or by actually creating them.

The Diamond of Corporate Governance: An Integrated Approach

This chapter begins with a simple understanding of the rationale for the existence of corporate governance systems, showing that, due to the nature of man, even the best carefully designed system can be overcome by executives. It follows a framework that relates the value drivers of firms to the quality of corporate governance systems. The rest of the chapter is devoted to outline the pillars of corporate governance architecture (corporate governance diamond) and the different perspectives that must be taken in each pillar when senior managers and directors approach the design of governance systems for their corporations.

The problem. Governance exists in corporations because decisions cannot be concentrated in one single executive that holds the complete ownership of the corporation. When corporate decisions are not made by a single person, and this person is not the only shareholder of the firm, two sources of agency costs appear: (1) costs due to poor information and (2) costs due to inconsistent objectives. To mitigate these costs corporations devise control and coordination systems. However, these systems have costs too: (1) costs of devising and writing contracts, monitoring costs, bonding costs and residual loss. The allocation of rights among executives is not where agency costs are minimized but where organization costs –including the costs of governance systems- are minimized and shareholder value maximized.

The importance. Poor corporate governance not only generates significant losses in the financial markets but also a misallocation of capital into real assets (e.g. telecommunication investments). Furthermore, many talented individuals that went to work for “new-economy” businesses during the stock market bubble have lost their jobs; that is, there has been a misallocation of human capital that could have been employed for better uses.

From a financial economics point of view the main functions of a corporate governance system are (1) to ensure that financial capital flows, without friction, from investors to companies that can best use it, that is, to companies that can achieve superior risk-adjusted returns and (2) to ensure that financial capitals leaves companies that have run out of positive-NPV investments. To ensure that financial capital inflows and outflows move efficiently, investors need a certain degree of protection of their investments, otherwise the capital will not flow. However, complete protection of investors is neither feasible nor desirable. It is not feasible because financial investors do not know what information managers and employees manage, and even in the case they knew it, uncertainty about the future will make impossible to guarantee the investment. Moreover, it is not desirable because if financial capital is perfectly protected human capital will not flow. A corporation is a partnership, a co-investment of financial and human capital, and both types of resources have to be deployed to achieve a “joint maximum efficiency”; that is, managers need to have some discretion in order to facilitate the efficiency in the financial and human capital market.
When a corporate governance system is not fixed, the efforts to put a best-in class corporate governance system do not have an immediate payoff because financial markets have memory and it takes time to recover trust lost. Not surprisingly, there is a path dependence and negative feedback that is initiated with a poor corporate governance system. The effects of poor corporate governance, through negative reinforcing feedback loops, are (exhibit 8) on (1) expected cash flows, (2) access to capital markets, (3) cost of capital, (4) profits, (5) revenues and (6) investments.

The corporate governance diamond. The design of the architecture of a corporate governance system must be made “in context”, that is, there no “one-size-fits-all” corporate governance system and no system is the best in a generic way, but “in the context” of the country, the culture, the corporation and historic time. A corporate governance system can be grouped in three building blocks forming what I call the corporate governance diamond. The three blocks are (1) corporate performance: the board of directors, (2) shareholder protection and (3) corporate disclosure (exhibit 1).

EXHIBIT 1
THE DIAMOND OF CORPORATE GOVERNANCE

The first block of the diamond, corporate performance: the board of directors, is comprised of three components: (a) management supervision, (b) value-added services and (c) top management’s human resources. I called this block corporate performance: the board of directors because it is the only block that enhances the potential performance of the corporation. The blocks of corporate disclosure and shareholder protection just ensure or facilitate that the potential performance is effectively achieved. The second block of the diamond, shareholder protection, is comprised of three components: (a) market protection, (b) voting protection and (c) board
Protection. The third block of the diamond, corporate disclosure is comprised of three components: (a) financial disclosure, (b) organizational disclosure and (c) control disclosure.

**Integrated approach to the design of corporate governance systems.** One of the most powerful ways to design the architecture of a corporate governance system is to maintain a functional, structural and process approach. *Exhibit 2* analyzes the corporate governance diamond from four different and complementary perspectives:

**EXHIBIT 2**

INTEGRATED APPROACH TO THE DESIGN OF CORPORATE GOVERNANCE SYSTEMS

These four perspectives are:

- **Institutional perspective.** The institutional perspective is based on the OCDE because this institution focuses on access to capital as the primary driver for the integration of core corporate governance practices in the international arena. As I have stated many times before I believe that the main function of a corporate governance system is to ensure efficient capital inflows and outflows of corporations and I think that, from all international institutions, OCDE reports best represent this view.

- **Corporate perspective.** The corporate perspective is based on General Motors Board Guidelines. As Holly, J. Gregory highlights, "these guidelines are viewed as a seminal expression of a board’s voluntary efforts to improve its own governance and have been widely discussed and emulated well beyond the U.S.A”.

- **Institutional investor perspective.** The institutional investor perspective is mainly inspired in the corporate governance principles of the largest and most active pension fund in corporate governance, Calpers.
• **Market regulator perspective.** The market regulator perspective is inspired in the NYSE Corporate Accountability and Listing Standards.

The paper compares, through the corporate governance diamond, each block and its components, from the four difference perspectives highlighted before. Furthermore, and given the recent release of the “Report on the framework for company law in Europe”, the report is compared to the other four perspectives in each dimension of the corporate governance diamond.

**Corporate Performance: The Board of Directors**

**Management supervision.** The Board of Directors can fulfill its management supervision function by establishing some of the following structures: separation of Chairman and CEO, lead director, mix of inside and outside directors, definition of independence, executive sessions of outside directors without senior management, board meetings and agenda, number, structure and independence of committees, assignment and rotation of committee members and outside advice. The key priorities that emerge in this area, and where senior managers and directors could focus, are: (1) ensure empowerment of independent directors, (2) develop specific rules for conflicts of interest, (3) establish a process to control potential conflicts of interest, (4) ensure board oversight of key senior managers, (5) ensure independency of board committees and (6) adjust the structure of meetings to board members’ profiles.

**Value-added services.** Board of Directors should also focus on services that can increase the value of the corporation (e.g. high-level development of corporate strategy), as opposed to only focusing on the management supervision function, where directors ensure that value is not destroyed. The key functions on which senior managers and directors could focus are: (1) refine, approve and monitor strategy, (2) ensure adequate crisis management, (3) ensure management is focused on key value creating parts of the business and (4) facilitate the development of high-performing teams.

**Top management's human resources.** Senior managers and directors focus their human resource management in (1) selecting, inviting and orienting new members of their board, (2) selecting and limiting the term and establishing the terms of mandatory retirement, (3) establishing board and top management compensation, (4) evaluating board and top management performance, especially that of the CEO and (5) planning CEO succession. The key priorities that emerge in this area for senior managers and directors are: (1) establish annual individual and board performance reviews, (2) provide understandable information for non-executive directors, (3) assure effective CEO succession planning, (4) assess the impact of executive and board compensation on performance and the overall risk profile, (5) establish annual reelectons of directors and (6) balance board members according to the geographical presence of the business.

**Shareholder Protection**

**Market protection.** Market protection is necessary to ensure that managers and directors maximize shareholder value. If those agents cannot internally organize to achieve this purpose, other external agents in the market (e.g. corporate raiders) should be allowed to take control of the corporation. Regulators must achieve an efficient market for corporate control, meaning that (1) efficient changes of control are promoted; these changes include those on which some shareholders do not receive control premium and that (2) abusive changes of control are not allowed; even though minority shareholders receive a control premium.
**Board protection.** Boards represent the first line of defense to ensure that senior managers focus on maximizing shareholder value. Financial incentives have limits to motivate senior managers (e.g. compensation of a senior manager is not only cash or equity but also his social networks) and therefore, it could happen that even though the stock price is depressed, hence the market value of the CEO compensation, total CEO compensation (e.g. including the value of influence and social network) has not changed significantly. In these cases the board should have enough power to remove the CEO and the management team, if necessary. Boards should manage takeover defenses to the benefit of shareholder value and considered the rest of defenses for elimination; among those defenses are: board insulation, voting right distortions, authorized capital, repurchase of own shares and targeted stock placement.

**Voting protection.** When the first line of defense (board of directors) does not work, that is, when the board does not have enough power to remove an under-performing CEO and management team, capital markets, through corporate shareholders, and potential acquirors, if necessary, become the second line of defense and replace the CEO. However, an active market for corporate control has also disadvantages. As Hall\(^2\) states, “hostile takeovers can create major economic disruptions since they are often followed by dramatic changes in company management and strategic direction”. Moreover, there is the argument that corporate raiders make senior managers to focus on short-term results, so-called *Anglo-saxon short-termism*. Finally, takeover bids can be coercive due to two-tier bidding strategies that force shareholders to accept bids at low prices. With this rationale, it is admissible that boards and CEOs raise takeover defenses to get the highest possible price for the company’s shareholders. The protection of shareholders with the right to vote in a takeover is a mechanism that allows that efficient changes in control in partial offers can occur.

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**Corporate Disclosure**

**Financial disclosure.** Investors need to have accurate information of assets and liabilities to estimate their true values. If the price of the assets do not include all public information and, what is more important, if the price of the assets include misguided information, buy and sell decisions will not efficiently allocate resources. In the corporate governance crisis of the 1980’s, corporations were underperforming due to a lack of sustainable strategies developed by senior managers and directors. However, in the 1980’s information was sufficiently accurate to allow corporate raiders to estimate bidding offers and increase the performance of corporations. Today’s crisis is different in the sense that the trust of investors on market prices is low and then, it is even more difficult to identify under-performing managers, that is why, governments and institutions are setting minimum disclosure rules that minimize the incentives to provide misguided information to markets.

**Organizational disclosure.** Disclosing information about the organizational structure is uncommon and distinctive because it shows investors the capabilities that the organization has put in place to execute on the strategy. Jensen, M, and Meckling, W. highlight the following organizational systems that can influence organizational effectiveness and on which the firm could provide information: (1) system for *defining divisions in the organization*: sub-units for planning, decision making and reporting purposes, (2) system for *selecting people* for particular positions in the organization, (3) system for creating and maintaining *information channels* and (4) system for *defining the organization’s general strategy* and communicating it to decision-makers.

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\(^{2}\) Hall, B. (2002)
Control disclosure. Control disclosure is the disclosure of information related to the control systems that the corporation has put in place to ensure that the information released is right. Control disclosure is relevant because it provides the market with a perceived credibility that implicitly ensures that the disclosure of information made is accurate and hence that market agents can make their relevant decisions. Among the information included in control disclosure is (1) the disclosure related to compensation and director assessment and (2) the disclosure regarding corporate governance.

Winning Corporate Governance Strategies

As corporations are forced by capital markets to improve their corporate governance systems, they have to dedicate specific resources to develop state-of-the-art governance systems. For that purpose, corporations should give the day-to-day responsibility to an specific group led by the so-called Chief Corporate Governance Officer (CGO). Though the CGO should facilitate the creation of structures within the corporation to foster the right governance, his focus should be more of a functional approach with an emphasis on three major tasks: (1) ensure that directors and senior managers have the system to perform, (2) ensure shareholder protection and (3) ensure disclosure to allow efficient resource allocation.

The strategic architecture for the design of corporate governance systems is presented as a portfolio strategy (exhibit 3). It defines a strategic matrix of areas to compete (corporate performance –board of directors-, corporate control and corporate disclosure) and strategies to use (intangible assets, big bets, real options and no-regrets moves) across the corporate governance diamond. The portfolio of strategies is structured in three building blocks: big bets, real options and no-regrets moves. Big bets are major commitments to a course of action that may payoff handsomely in some situations but produce dismal results in others. Real options are investments that are made to learn more or create flexibility. Finally, no-regrets moves make sense no matter what eventually happens. The strategic architecture is not a detailed plan but it identifies the major capabilities to build.

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**EXHIBIT 3**

**CORPORATE GOVERNANCE PORTFOLIO STRATEGY**

<table>
<thead>
<tr>
<th>Intangible Assets</th>
<th>Corporate Performance –Board of Directors-</th>
<th>Corporate Control</th>
<th>Corporate Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethical Talent / Reputation / Stakeholder network</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Big Bet**

<table>
<thead>
<tr>
<th>Facilitate the development of high performing teams – top management and directors-</th>
<th>Respect one-share one-vote, one dividend principle</th>
<th>Disclose organizational structure and control systems</th>
</tr>
</thead>
</table>

**Real Options**

<table>
<thead>
<tr>
<th>Create &quot;ad hoc&quot; flexible governance structures</th>
<th>Gradually increase shareholding voting powers</th>
<th>Gradually disclose compensation and its process</th>
</tr>
</thead>
</table>

**No Regrets Moves**

<table>
<thead>
<tr>
<th>Develop specific rules for conflicts of interest</th>
<th>Keep law spirit of fostering only efficient transfers of control</th>
<th>Ensure accuracy of liability disclosure</th>
</tr>
</thead>
</table>

Source: Author.
Chapter 2

The Corporate Governance Diamond: an Integrated Approach
Chapter 2. The Corporate Governance Diamond: an Integrated Approach

This chapter begins with a simple understanding of the rationale for the existence of corporate governance systems, showing that, due to the nature of man, even the best carefully designed system can be overcome by executives. It follows a framework to reflect on the importance of corporate governance in shareholder value. The rest of the chapter is devoted to outline the pillars of corporate governance architecture (corporate governance diamond) and the different perspectives that must be taken in each pillar when senior managers and directors approach the design of governance systems for their corporations.

The Problem

The agency problem: sources of agency costs. Corporate governance exists in corporations because decisions cannot be concentrated in one single executive that holds the complete ownership of the corporation. Due to the fact that corporate decisions are not made by a single person and that this person is not the only shareholder of the firm, two sources of agency costs appear:

- **Costs due to poor information.** These costs increase as the distance between the decision maker and the person that holds the information expands. There are two ways to minimize these costs, depending on the type of knowledge that the decision maker needs. On the one hand, if the type of knowledge is general (low transfer costs and high value per unit), it makes sense to transfer the knowledge to the decision maker as transfer costs are low. On the other hand, if the type of knowledge to make a decision is specific (high transfer costs and high value per unit), then it makes sense to allocate the decision right close the source of specific knowledge. In decision rights on the owner of the knowledge. Then, the costs of making bad decisions as a consequence of poor information provide the incentive for decentralization.

- **Costs due to inconsistent objectives.** As Jensen, M. and Meckling, W. (1999) say, “the control problem results from self-interested behavior and the delegation of decision rights to make use of specific knowledge. Because individuals are self-interested, delegation of decision authority generates a control problem associated with the tendency of individuals to use the decision rights to make themselves better off”.

Components of agency costs. Corporations devise control and coordination systems to minimize agency costs. However, the design of control and coordination systems carry some costs. These costs are:

- **Costs of devising and writing contracts:** costs of devising the “rules of the game”. The “rules of the game” mainly include (1) the performance measurement and evaluation system, (2) the reward system, tied to performance and (3) the system for allocation of decision rights throughout the organization.

- **Monitoring costs:** expenditures by the principal (e.g. shareholder) to encourage proper decisions of the agent (e.g. senior management and board of directors).

- **Bonding costs:** expenditures by the agent to help assure the principal that he or she will not behave inappropriately.

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• *Residual loss*: costs due to the fact that contracts are seldom perfectly enforced and thus a reduction in the welfare of the principal (e.g., excess control could lead to less initiative and risk-taking).

In the current corporate governance reform, I believe that, in general, regulators and corporations are devising a significant number of rules and coordination systems that significantly increase agency costs, specially the residual loss cost: an excess of rules could lead senior managers to re-consider every action and to be less risk-taker, a required attribute to generate above-average returns.

The location at which the decision right is optimal is determined by the point at which the total organization costs are minimized (exhibit 4). This framework can be used to allocate rights to different levels of the organization. First, the board of directors can decide the rights that can be allocated to senior managers. Second, senior managers can decide the rights that can be allocated to middle managers.

**EXHIBIT 4**

**THE TRADEOFF BETWEEN COSTS DUE TO INCONSISTENT OBJECTIVES (AGENCY COSTS) AND COSTS DUE TO POOR INFORMATION AS A DECISION RIGHT IS MOVED FARTHER THE CEO’S OFFICE IN THE HIERARCHY**

Moreover, to ensure that there is a control over the decision made in a corporation, managers that initiate and implement decisions cannot have control rights over those decisions as their judgment would be biased (exhibit 5). One, or more, structures need to have control rights over management rights to (1) ratify proposal and (2) monitor implementation.

**The nature of man.** Corporate governance tries to devise solutions to the problems and costs outlined above. However, corporate governance problems exists and will continue to exist due to human's resourcefulness: managers use their resourcefulness to create new ways to reduce the effectiveness of the constraints, that is, they will find new ways to overcome the design of corporate governance systems.
EXHIBIT 5
THE DECISION PROCESS

<table>
<thead>
<tr>
<th>Management rights</th>
<th>Control rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. INITIATION: generation of proposals for resource utilization and structuring of contracts</td>
<td>2. RATIFICATION: veto power over implementation of decision initiatives</td>
</tr>
<tr>
<td>3. IMPLEMENTATION: execution of ratified decisions</td>
<td>4. MONITORING: performance measurement and implementation of rewards</td>
</tr>
</tbody>
</table>

Source: Fama, E. and Jensen, M. (1976)

The REMM\(^5\) (*Resourceful, Evaluative, Maximizing Model*) has proved to be one of the best models to describe the behavior of man and managers. It states that individuals evaluate their options, preferring more than less, maximize their opportunities to obtain more and always find resources to cope with rules. When senior managers and directors design the corporate governance system of a corporation they should be aware that the nature of man is very close to the model described above and that, many times, no rule or structure could stop a senior manager or director from achieving his objectives. That is why corporate governance is more than a set of structures and processes at the top of the corporation. Corporate governance is a state of mind that leads to ethically serve the interests of the shareholders. As an illustration, exhibit 6 shows some principles, not structures nor processes, on which a board of directors can be based\(^6\). However, *a principled-based corporate governance system is not enough* given (1) the importance of corporate governance to the performance of the firm, (2) the need to signal external and internal stakeholders that the system is well conceived so that the stock price is not unfairly punished due to asymmetric information and that, in the end, (3) people, even senior managers and directors, need some guidance through structure and process definition.

The Importance

In the introduction I highlighted the relevance of a corporate governance system from a financial economics point of view: ensure the efficient flow of capital in and out of corporations, inflows to firms with positive NPVs projects and outflows from firms with negative NPVs. When the corporate governance system that ensures these flows is not enough, trust is broken and investors will set a discount on the stock price to the corporations that do not have a system that sufficiently protects their investments. It is important to highlight that it is equally pervasive a system with many regulations as those will decrease the flow of human capital to the corporation and then, the firm will have less positive NPV projects.

Exhibit 7 shows the value levers that a corporate governance system influences and the stakeholders affected. Many attempts have been tried to quantify the discount at which corporations trade due to poor corporate governance systems. It is not the objective of this paper to summarize them but just to show a conceptual way of thinking on the potential impact of a corporate governance system. The quantitative assessment should be done “in


\(^6\) Note that, as it will be developed in this paper, a corporate governance system includes more than the structure of the board of directors
context”, not just within a specific country but within a specific corporation and time, and with an analysis of the profile of the investors’s base of the corporation.

**EXHIBIT 6**
**BUILDING AN EFFECTIVE BOARD**

<table>
<thead>
<tr>
<th>Principle</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Create a climate of trust and</td>
<td>• Share important information on time</td>
</tr>
<tr>
<td>candor</td>
<td>• Rotate to foster objectivity, full-knowledge and relationships</td>
</tr>
<tr>
<td>Foster a culture of open dissent</td>
<td>• Make sure that silent board members dissent</td>
</tr>
<tr>
<td>Utilize a fluid portfolio of roles</td>
<td>• Challenge thinking, decisions and assumptions</td>
</tr>
<tr>
<td>Ensure individual accountability</td>
<td>• Give directors tasks that require them to inform the board and leverage company resources and employees</td>
</tr>
<tr>
<td>Evaluate the board’s performance</td>
<td>• Some criteria to use on board’s evaluation:</td>
</tr>
<tr>
<td></td>
<td>➢ Board level: directors’ confidence in the integrity of the enterprise, quality of discussions, credibility of reports, use of constructive professional conflict, level of interpersonal cohesion with other board members and degree of knowledge</td>
</tr>
<tr>
<td></td>
<td>➢ Director level: roles, participation and energy level shown through level of preparedness and initiative</td>
</tr>
</tbody>
</table>

Source: Sonnenfeld, J. (2002) and author.

When a corporate governance system is not fixed, the efforts to put a best-in class corporate governance system do not have an immediate payoff because financial markets have memory and it takes time to recover trust lost. **Exhibit 8** shows a simplified model of the impact of a poor corporate governance system in the stock price. Not surprisingly, there is a path dependence and negative feedback that is initiated with a poor corporate governance system. Several reflections can be highlighted:

- Good corporate governance does not necessarily influence shareholder returns in a positive way. Good corporate governance protects the firm against decreases in market value.
- Corporate governance is a stock variable and, as that, to compensate a decrease in the reputational stock on corporate governance, good corporate governance measures must be created; but because stocks have inertia, there will be significant delays to recover the reputation and trust lost from financial markets.
- Bad corporate governance creates many negative, reinforcing feedback loops:
  - i. Effect of poor corporate governance on expected cash flows
  - ii. Effect of poor corporate governance on access to capital markets
  - iii. Effect of poor corporate governance on cost of capital
  - iv. Effect of cost of capital increase on profits
  - v. Effect of cost of capital increase on sales
  - vi. Effect of cost of capital increase on investment levels

---

7 Not shown for simplification purposes.
### EXHIBIT 7

#### INFLUENCE OF CORPORATE GOVERNANCE ON STAKEHOLDER RETURNS

<table>
<thead>
<tr>
<th>Levers</th>
<th>Variables</th>
<th>Stakeholders affected</th>
<th>Influence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected cash flows</td>
<td>• Revenues</td>
<td>• Customers and shareholders</td>
<td>• Lack of confidence on the way a corporation is managed and controlled</td>
</tr>
<tr>
<td>Opportunity cost of capital</td>
<td>• Costs</td>
<td>• Suppliers and shareholders</td>
<td></td>
</tr>
<tr>
<td>Access to capital markets</td>
<td>• Probability of entering into financial distress and bankruptcy costs</td>
<td>• All(1)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Cost of equity: beta</td>
<td>• Shareholders and bondholders</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Cost of debt: spread over risk-free rate</td>
<td>• Shareholders</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Tax shields</td>
<td>• All(1)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• NPV of projects / acquisitions that the firm cannot take</td>
<td>• Shareholders</td>
<td></td>
</tr>
</tbody>
</table>

(1) Shareholders, suppliers, customers, government, bondholders and society

**Source:** Author.

### EXHIBIT 8

#### POOR CORPORATE GOVERNANCE DECREASES STAKEHOLDER RETURNS, DIFFICULTING FURTHER GROWTH

**Note:** boxes represent stocks variables and arrows represent flows. Source: Author.
The Corporate Governance Diamond

Designing “in context”. The design of the architecture of a corporate governance system must be made “in context”, that is, there no “one-size-fits-all” corporate governance system and no system is the best in a generic way, but “in the context” of the country, the culture, the corporation and historic time. For instance, there are at least three factors that influence the design of the working style of outside directors: (1) confidence that directors have in the CEO, (2) company’s performance, and (3) complexity of decisions facing managers and directors. These factors influence the number and length of meetings, control mechanisms for the CEO, degree of director exposure to managers...

The corporate governance diamond. A corporate governance system can be grouped in three building blocks that form what I call the corporate governance diamond. The three blocks are: (1) corporate performance: the board of directors, (2) shareholder protection and (3) corporate disclosure (exhibit 9).

EXHIBIT 9
THE CORPORATE GOVERNANCE DIAMOND

Source: Author.

The first block of the diamond, corporate performance: the board of directors, is comprised of three components (exhibit 10): (a) management supervision, (b) value-added services and (c) top management’s human resources. I called this block corporate performance: the board of directors because it is the only block that enhances the potential performance of the corporation. The blocks of corporate disclosure and shareholder protection just ensure, or facilitate, that the potential performance is effectively achieved.

---

The second block of the diamond, shareholder protection, is comprised of three components (exhibit 11): (a) market protection, (b) voting protection and (c) board protection.

The third block of the diamond, corporate disclosure is comprised of three components (exhibit 12): (a) financial disclosure, (b) organizational disclosure and (c) control disclosure.
**Methodology: an integrated approach to the design of corporate governance systems.**

One of the most powerful ways to design the architecture of a corporate governance system is to maintain a functional, structural and process approach. **Exhibit 13** analyzes the corporate governance diamond from four different and complementary perspectives that will be used throughout the paper. These four perspectives are:

- **Institutional perspective.** The institutional perspective is based on the OCDE because this institution focuses on access to capital as the primary driver for the integration of core corporate governance practices in the international arena. As I have stated many times before I believe that the main function of a corporate governance system is to ensure efficient capital inflows and outflows of corporations and I think that, from all international institutions, the OCDE reports best represent this view.

- **Corporate perspective.** The corporate perspective is based on General Motors Board Guidelines. As Holly, J. Gregory highlights, “these guidelines are viewed as a seminal expression of a board’s voluntary efforts to improve its own governance and have been widely discussed and emulated well beyond the U.S.A”.

- **Institutional investor perspective.** The institutional investor perspective is mainly inspired in the corporate governance principles of the largest and most active pension fund in corporate governance, Calpers.

- **Market regulator perspective.** The market regulator perspective is inspired in the NYSE Corporate Accountability and Listing Standards.

The rest of the paper will go through the corporate governance diamond, each block and its components, from the four difference perspectives highlighted before. Furthermore, and given
the recent release of the “Report on the framework for company law in Europe”, it is compared to the other four perspectives in each dimension of the corporate governance diamond.

EXHIBIT 12
CORPORATE DISCLOSURE

Source: Author.
EXHIBIT 13
INTEGRATED APPROACH TO THE DESIGN OF A CORPORATE GOVERNANCE SYSTEM

Corporate Performance: The Board of Directors

Corporate Disclosure

Shareholder Protection

Institutional Investor

Corporate

Market Regulator

Source: Author.
Chapter 3

Corporate Performance: The Board of Directors
Chapter 3. Corporate Performance: The Board of Directors

The first block (exhibit 14) of the diamond, corporate performance: the board of directors, is comprised of three sub-blocks: (a) management supervision, (b) value-added services and (c) top management’s human resources. The structure of this chapter is as follows. Each component is analyzed from the four different perspectives outlined before, then the “Report on the framework for company law in Europe” is compared and the current status of the firms in the EUROSTOXX-50 is shown. Finally, some recommendations are shown on the basis of an identified “corporate governance gap” between the four perspectives, the EUROSTOXX-50 corporate governance status and the EU report.

EXHIBIT 14
CORPORATE PERFORMANCE: THE BOARD OF DIRECTORS

Source: Author.

Management Supervision

The Board of Directors can fulfill one of its primary duties (management supervision) establishing the following structures: separation of Chairman and CEO, lead director, mix of inside and outside directors, definition of independence, executive sessions of outside directors without senior management, board meetings and agenda, number, structure and independence of committees, assignment and rotation of committee members and outside advice.
<table>
<thead>
<tr>
<th><strong>Institutional Investor Perspective (Calpers)</strong></th>
<th><strong>Corporate Perspective (GM)</strong></th>
<th><strong>Institutional Perspective (OECD)</strong></th>
<th><strong>Market Regulator Perspective (NYSE)</strong></th>
<th><strong>Report on framework for Company Law in Europe</strong></th>
<th><strong>Comments on the four perspectives with a focus on EU firms</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Separation of Chairman and CEO</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Firms could offer specific counterweights: lead director, right to change the agenda by outside directors…</td>
</tr>
<tr>
<td>When selecting a new CEO, boards should reexamine the traditional combination of the CEO and chairman positions.</td>
<td>The Board should be free to make this choice.</td>
<td>The separation is often proposed to ensure balance of power, accountability and independent decision making.</td>
<td>Not covered.</td>
<td>Not covered.</td>
<td></td>
</tr>
<tr>
<td><strong>2. Lead Director</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Chairman or CEO could give the leadership of maintaining a good corporate governance system to an independent director.</td>
</tr>
<tr>
<td>When the Chair of the Board also serves as the company’s CEO, the board designates an independent director who acts in a lead capacity to coordinate the other independent directors.</td>
<td>The Chairman of the Committee on Director Affairs is an independent director. He also develops the agendas for those regular sessions and also reviews the Board’s governance procedures.</td>
<td>No designation of a “lead director” is intended. Companies have some flexibility in how they provide for conduct of the executive sessions.</td>
<td>Not covered.</td>
<td>Not covered.</td>
<td></td>
</tr>
<tr>
<td><strong>3. Mix of Inside and Outside Directors</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Corporate governance code could recommend that the Board accept corporate governance proposals made by outside directors.</td>
</tr>
<tr>
<td>A substantial majority of the board consists of directors who are independent.</td>
<td>There should be a majority of independent directors.</td>
<td>Boards should consider assigning a sufficient number of non-executive directors.</td>
<td>Listed companies must have a majority of independent directors.</td>
<td>Group does not express views on composition of the full (supervisory) board but promotes role of non-executive / supervisory directors.</td>
<td></td>
</tr>
<tr>
<td>The Board allows managers to regularly attend meetings.</td>
<td>The Board accepts corporate governance proposals made by independent directors.</td>
<td>Recognizes that corporate governance is not a “one-size-fits-all” proposition.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

26
### 4. Definition of Independence

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Each corporation should publish in its proxy statement the definition of independence.</td>
<td>The Board believes there is no current relationship between any independent Director and GM that would be construed in any way to compromise any Board member being designated independent.</td>
<td>The variety of board structures and practices in different countries will require different approaches to the issue of independent board members.</td>
<td>(a) No director qualifies as “independent” unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations. (b) criteria for former employees, interlocking directorships and family members.</td>
<td>A minimum list should include: - Former employees (5 years) - Advisors - Performance related pay - Interlocking directorships - Controlling shareholder (&gt; 30%)</td>
<td>Corporate governance codes could enforce to publish: a) A definition of independence b) Principles of corporate governance of the corporation In the EU, firms should consider control shareholders when setting the role of independent board members.</td>
</tr>
</tbody>
</table>

Concrete definition of independence:
- Not employed by the company during the last 5 years
- Not affiliated nor as an adviser, nor customer nor supplier nor family related nor employed by another company on which an executive of the former company is a director

### 5. Executive Sessions of Outside Directors

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent directors meet periodically (at least once a year) along, without the CEO or other non-independent directors.</td>
<td>The independent Directors of the Board will meet in Executive Session two or three times each year. The format of these meetings will include a discussion with the Chairman and CEO.</td>
<td>Not covered.</td>
<td>To empower non-management directors to serve as an effective check on management, the non-management directors of each company must meet at regularly scheduled executive sessions without management.</td>
<td>Not covered.</td>
<td>Chairman of the Board and / or lead directorCould facilitate periodic meetings of outside directors.</td>
</tr>
</tbody>
</table>
### 6. Board Meetings & Agenda

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Lead Independent Director will:</td>
<td>The Chairman of the Board will establish an agenda for each board meeting. They will issue a schedule agenda subjects to be discussed for the ensuing year.</td>
<td>Not covered.</td>
<td>Not covered.</td>
<td>Not covered.</td>
<td>If there is no separation between the Chairman and the CEO, should recommend that an outsider has the right to modify an agenda and add additional information to send to directors.</td>
</tr>
<tr>
<td>- Advise the Chair as to an appropriate schedule of Board meetings, seeking to ensure that the independent directors can perform their duties responsibly while not interfering with the flow of company operations</td>
<td>- Provide input as to the preparation of the agendas</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institutional Investor Perspective (Calpers)</td>
<td>Corporate Perspective (GM)</td>
<td>Institutional Perspective (OECD)</td>
<td>Market Regulator Perspective (NYSE)</td>
<td>Report on framework for Company Law in Europe</td>
<td>Comments on the four perspectives with a focus on EU firms</td>
</tr>
<tr>
<td>---------------------------------------------</td>
<td>---------------------------</td>
<td>---------------------------------</td>
<td>------------------------------------</td>
<td>-----------------------------------------------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>Certain board committees consist entirely of independent directors:</td>
<td>The Board can change the number of committees. The current six committees are:</td>
<td>Boards may consider establishing specific committees which may require a minimum number, or be composed entirely of non-executive members.</td>
<td>Listed companies must have a nominating/corporate governance committee, compensation committee and audit committee composed entirely of independent directors.</td>
<td>Listed companies should be required to ensure that the nomination and remuneration of directors and the audit of the accounting for the company’s performance within the board are decided upon by exclusively non-executive or supervisory directors who are in majority independent.</td>
<td>Chairman or lead director could recommend the ad-hoc creation of committees for important issues of the corporation (e.g. evaluation of a breakthrough acquisition, technology investments, research and development…) or partial involvement on risk management committees.</td>
</tr>
<tr>
<td>- Audit</td>
<td>Audit, Capital Stock, Director Affairs, Executive Compensation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Director Nomination</td>
<td>Compensation, Investment Funds and Public Policy. Except for the Investment Funds Committee, committee membership will consist only of independent Directors.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Board Evaluation &amp; Governance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- CEO Evaluation and Management</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Compensation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Compliance and Ethics</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### 8. Assignment and Rotation of Committee Members

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Lead Independent Director will recommend to the Chair the membership of the various Board Committees.</td>
<td>The Committee on Director Affairs is responsible, after consultation with the Chairman of the Board and with consideration of the desires of individual board members, for the assignment of Board members to various Committees.</td>
<td>Not covered.</td>
<td>The nominating/corporate governance committee must have a written charter that addresses: (i) the committee’s purpose – which, at minimum, must be to: identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation. (ii) the committee’s goals and responsibilities – which must reflect, at minimum, the board’s criteria for selecting new directors, and oversight of the evaluation of the board and management. (iii) an annual performance evaluation of the committee.</td>
<td>Not covered.</td>
<td>Appropriate committees could provide a rationale for the assignment of committee members to each committee with criteria such as: skills, independency and interests.</td>
</tr>
</tbody>
</table>

5-year rotation; however it is not recommended as a policy.
## 9. Outside Advice

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>The independent directors have access to advisers (on performance and compensation criteria for the CEO) who are independent of management.</td>
<td>Not covered.</td>
<td>An annual audit should be conducted.</td>
<td>Disallowed compensation for an audit committee member includes fees paid directly or indirectly for services as a consultant or a legal or financial advisor, regardless of the amount.</td>
<td>Not covered.</td>
<td>Firms should disclose enough information to make clear that outside services received are independent.</td>
</tr>
<tr>
<td>The Lead Independent Director will recommend to the Chair the retention of consultants who report directly to the Board.</td>
<td></td>
<td>Other proposals include: limitations on the percentage of non-audit income that the auditor can receive from a particular client. Disclosure of the level of fees paid to auditors for non-audit services. Limitations on the total percentage of auditor income that can come from one client. Mandatory rotation of auditors.</td>
<td>Disallowed compensation also includes compensation paid to such a director’s firm for such consulting or advisory services even if the director is not the actual service provider. Disallowed compensation is not intended to include ordinary compensation paid in another customer or supplier or other business relationship that the board has already determined to be immaterial for purposes of its basic director independence analysis. To eliminate any confusion, note that this requirement pertains only to audit committee qualification and not to the independence determinations that the board must make for other directors.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The corporate governance guidelines should address the director access to appropriate, independent advisors.
Key priorities

There are five major obstacles that limit board effectiveness and that have to be addressed in the design of the board of directors:

- Lack of time and board size
- Complexity of information
- Lack of cohesiveness
- Power of top management
- Confused accountabilities

The next pages propose some ways, through the design of processes and structures, in which these obstacles can be counterbalanced (exhibit 15).

---

**EXHIBIT 15**

**KEY PRIORITIES FOR CORPORATE PERFORMANCE - THE BOARD OF DIRECTORS: MANAGEMENT SUPERVISION**

<table>
<thead>
<tr>
<th>Action</th>
<th>Process / structure</th>
</tr>
</thead>
</table>
| Ensure empowerment of independent directors | • Provide directors with access to senior managers  
• Establish a formal training for directors  
• Provide, if needed, a well business-educated staff for each director  
• Recruit directors with complementary spikes  
• Let a lead director modify the agenda |
| Develop specific rules for conflicts of interest | • Develop a code of conduct and communicate to stakeholders |
| Establish a process to control potential conflicts of interest | • Let independent directors lead the control process of conflicts of interest  
• Consider the creation of a sub-committee on conflicts of interest. |
| Ensure board oversight of key senior managers | • Establish annual oversight / review of key senior managers  
• Establish a committee to understand business risks and to oversee the chief risk officer |
| Ensure independency on board committees | • Appoint an independent Chairman (at least not the CEO) for Board Committees |
| Adjust the structure of meetings to board members’ profiles | • Establish few meetings but longer, when the board is populated by CEOs |

Source: Author.

---

**Ensure empowerment of independent directors.** This is justified by the fact that 75% of S&P companies have a single person serving as both chairman and CEO. The only relationship of independent directors should be a relatively high ownership of company stock, and even this stock ownership should be managed with care because then, the director’s standard of living can be somewhat dependent on his board membership. Moreover, independent directors should put

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their reputation at risk in the sense that if they do not show ethical behavior, their future career could be destroyed. However, not only is necessary to have independent directors but directors that have real power. The sources of power of independent directors come from:

- **Knowledge.** Directors should have access to senior managers, and the office of the CEO should have a primer on the company and the industry where it operates. Furthermore, each director should be allowed to have a well, business-educated staff assistant to prepare and explain any additional information.

- **Expertise.** Each director should have a clear spike in one business area (e.g., finance, marketing, industry, government relations) so that the sum of expertise of all directors can counterbalance the expertise, time and knowledge of the CEO. This is a criteria that the nomination committee should have in mind.

- **Time.** A lead director should be able to prepare, or, at least, modify, the agenda for board meetings. In this way, the CEO will not be able to spend much time of the meeting just reviewing the financials. Furthermore, relevant information should be sent in advance just to give directors enough time to prepare for the meeting.

**Develop specific rules for conflicts of interest.** According to Deminor, only 45% of the firms in the EuroSTOXX 50 have developed specific rules for conflicts of interest (**exhibit 16**) and 52% have developed a code of conduct for the board. The minimum initiative that a large European company can pursue in corporate governance is to achieve excellence in “perceived corporate governance”, that is, develop rules and guidelines to ensure that is able to respond to conflicts or ethical dilemmas. It is important to remember that Enron had both codes, that is, it had “perceived corporate governance” but the internal procedures failed to enforce these rules.

**Establish a process to control potential conflicts of interest.** By establishing rules for conflict of interest companies achieve a perceived excellence on corporate governance; however, in the long-term firms have to deliver on their “perceived corporate governance”. For that, they have to develop processes to control that senior managers and board members do not have conflicts of interest. It is in this process where Enron internal controls failed. To avoid control failures, this process should be led by independent directors; in fact, the board could consider the creation of a sub-committee of conflicts of interest.

**EXHIBIT 16**

**CORPORATE PERFORMANCE: THE BOARD OF DIRECTORS**

![Graph showing corporate performance of the board of directors](source: Deminor.)
**Ensure board oversight of key senior managers.** Directors must oversight not only the CEO but other key senior managers. As a human being, the CEO has a limited capacity in terms of detailed functional and business unit knowledge, that is why the board has to establish processes to ensure that other senior managers are reasonably supervised. *Exhibit 17* shows that 70% of the directors interviewed were very satisfied with the oversight of the CEO. However, this figure decreases dramatically to 14% and 32% when the senior manager oversight is the chief risk officer or the external legal counsel respectively. It would be wise to create a *committee to allow directors to understand business risks and to oversight the chief risk officer.*

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**EXHIBIT 17**

**BOARD OVERSIGHT OF KEY SENIOR MANAGERS**

<table>
<thead>
<tr>
<th>Percentage of responses</th>
<th>CEO</th>
<th>CFO</th>
<th>External legal counsel</th>
<th>Internal auditor</th>
<th>Chief legal counsel</th>
<th>Owner director</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very satisfied</td>
<td>14</td>
<td>32</td>
<td>34</td>
<td>41</td>
<td>48</td>
<td>55</td>
</tr>
<tr>
<td>Somewhat satisfied</td>
<td>26</td>
<td>43</td>
<td>27</td>
<td>31</td>
<td>35</td>
<td>40</td>
</tr>
<tr>
<td>Very dissatisfied</td>
<td>60</td>
<td>25</td>
<td>39</td>
<td>28</td>
<td>17</td>
<td>5</td>
</tr>
</tbody>
</table>

*Source: McKinsey.*

---

**Ensure independency on board committees.** It can seem obvious that board committees should be served by an independent chairman; however, several large Spanish corporations had, until some months ago, the CEO chairing many of the committees. The CEO should not serve on any of the Committees. Shivdansani¹¹ states that "*when the CEO serves on the nominating committee or no nominating committee exists, firms appoint fewer independent outside directors and more gray outsiders with conflicts of interest. Stock price reactions to independent director appointments are significantly lower when the CEO is involved in director selection, and independent appointees are more likely to serve on large numbers of other boards, a practice disfavored by investor activists.*"

**Adjust the structure of meetings to board members’ profiles.** The design of the structure of board meetings (e.g. length, number of meetings per year) should take into consideration directors’ profiles. If the board is populated by CEOs from other companies, they will usually travel last minute and during the meeting they will be thinking, if not leaving the room, in the firms they are running and in the next flight they have to catch. It is a challenge to capture the attention of CEOs. In these types of boards I believe that it is better to have a *limited number of*

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¹¹ Shivdansani, A. et al. (1999).
board meetings during the year but of longer duration -one or two days- so that the CEO can get immersed in board discussions.

Value-Added Services

The Board of Directors, as well as supervising the senior managers of the corporation, should be able to provide corporations with value added services. By value-added services I mean services that can increase the value of the corporation (e.g. high-level development of corporate strategy). As opposed to the management supervision function, where directors ensure that value is not destroyed, in this function, directors increase the value of the firm by providing services that the CEO and the management team could not provide alone. Some of these activities are discussion and approval of corporate strategy and risk management strategy. To ensure that directors can do these activities, some procedures, such as the design of the structure of board meetings, required information previous to those meetings and access to senior managers, have to be put in place.
<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Commitment / Changes in Job Responsibility</strong></td>
<td>When the Chairman / CEO resigns, he should submit his resignation from the Board at the same time.</td>
<td>Board members should devote sufficient time to their responsibilities.</td>
<td>Because of the audit committee’s demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment.</td>
<td>Not covered.</td>
<td>Corporate governance codes could be more explicit on:</td>
</tr>
<tr>
<td>Not covered.</td>
<td>A former Chairman / CEO should not be considered an independent director.</td>
<td>Some countries have limited the number of board positions that can be held.</td>
<td></td>
<td></td>
<td>- When Chairman/CEO resigns, he should leave the Board and if not, he will not be considered independent director.</td>
</tr>
<tr>
<td>Directors that change responsibility should submit a letter of resignation to the Board (opportunity to review the continued appropriateness of membership).</td>
<td>Independent Board members are encouraged to limit the number of other boards on which they serve considering board attendance, participation and effectiveness.</td>
<td>Directors should advise the Chairman in advance of accepting an invitation to serve on another board.</td>
<td></td>
<td></td>
<td>- Independent directors should limit the number of board memberships.</td>
</tr>
<tr>
<td></td>
<td>If an audit committee member simultaneously serves on the audit committee of more than three public companies, and the NYSE-listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company’s audit committee and disclose such determination in the annual proxy statement.</td>
<td></td>
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<td></td>
<td>- When Directors retire or change their position they should submit his resignation to the board.</td>
</tr>
<tr>
<td>Institutional Investor Perspective (Calpers)</td>
<td>Corporate Perspective (GM)</td>
<td>Institutional Perspective (OECD)</td>
<td>Market Regulator Perspective (NYSE)</td>
<td>Report on framework for Company Law in Europe</td>
<td>Comments on the four perspectives with a focus on EU firms</td>
</tr>
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</tr>
<tr>
<td>2. Attendance of Non-Directors at Board Meetings / Board Access to Senior Management</td>
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</tr>
<tr>
<td>All directors should have access to senior managers. However the CEO, chair, or independent lead director may be designated as liaison between management and directors.</td>
<td>The Board welcomes the regular attendance at each board meeting of non-Board members who are in the most senior Management positions of the Company.</td>
<td>Board members should have access to accurate, relevant and timely information.</td>
<td>The corporate governance guidelines should address the director access to management.</td>
<td>Not covered.</td>
<td>The CEO, Chairman or other director could suggest the invitation of high performing managers that are close to senior positions to attend specific board meetings and dinners previous to the meetings.</td>
</tr>
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<td></td>
<td></td>
<td>The contributions of non-executive board members can be enhanced by providing access to certain key managers within the company.</td>
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<tr>
<td></td>
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<td>Board members have complete access to GM’s Management.</td>
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<tr>
<td>3. Board Materials and Presentations</td>
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</tr>
<tr>
<td>Although Company Management is responsible for the preparation of materials for the Board, the Lead Independent Director may specifically request the inclusion of certain material.</td>
<td>Information should be distributed before Board meetings.</td>
<td>Not covered directly.</td>
<td>The corporate governance guidelines should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.</td>
<td>Not covered.</td>
<td>Corporate governance codes could recommend that the lead director include any additional information that he considers relevant.</td>
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<tr>
<td>4. Committee Meeting Frequency, Length and Agenda</td>
<td></td>
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<tr>
<td>The Lead Independent Director will provide the chair with input as to the preparation of the agendas for the Board and Committee meetings.</td>
<td>The Committee Chairman, in consultation with the members, will determine the frequency, the length of the meetings and the agenda.</td>
<td>Not covered directly.</td>
<td>Not covered.</td>
<td>Not covered.</td>
<td>The Chairman of the Board could offer the opportunity of feedback on next meeting’s agenda to all board members.</td>
</tr>
</tbody>
</table>
Key priorities

**EXHIBIT 18**

**KEY PRIORITIES FOR CORPORATE PERFORMANCE - THE BOARD OF DIRECTORS-: VALUE-ADDED SERVICES**

<table>
<thead>
<tr>
<th>Action</th>
<th>Process / structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refine, approve and monitor corporate strategy</td>
<td>Involve some directors in the development of corporate strategy or acquisitions through the development of ad-hoc, temporal committees (e.g. committee for an specific acquisition)</td>
</tr>
<tr>
<td>Ensure adequate crisis management</td>
<td>Develop specific crisis management plans according to the source of the crisis (internal vs. external, sudden vs. gradual)</td>
</tr>
<tr>
<td>Ensure management is focused on key value creating parts of the business</td>
<td>Provide information to allow directors understand value levers</td>
</tr>
<tr>
<td>Facilitate the development of high-performing teams</td>
<td>• Increase the length of time dedicated to discuss ideas in meetings, and not the meeting itself</td>
</tr>
<tr>
<td></td>
<td>• Organize off-site events and small meetings to foster mutual knowledge</td>
</tr>
<tr>
<td></td>
<td>• Facilitate open sessions to discuss how to improve the performance of the board</td>
</tr>
</tbody>
</table>

*Source: Author.*

**Refine, approve and monitor corporate strategy.** Directors should not only focus on overseeing the CEO, the management and preparing CEO succession, but they should also focus on approving the strategy. In fact, before overseeing the CEO, they should be able to understand the firm business, approve the strategy and oversee its implementation; only then directors would be ready to adequately oversee CEO activities. Moreover, the board should be active and flexible enough to set temporal committees to face challenges or opportunities ahead; among those to be considered can be an acquisition committee (e.g. when the firm considers a merger or an acquisition that changes its portfolio of businesses). For instance, Lukens Inc. established a board committee to evaluate a potential acquisition\(^\text{12}\) (e.g. Washington Steel Corporation).

**Ensure adequate crisis management.** The Board should have a crisis management plan to response to unplanned events. Plans should be different depending on the source of crisis, that is, if the crisis is external or internal, and if it is sudden or gradual (exhibit 19).

\(^\text{12}\) HBS Case n.9-493-070.
EXHIBIT 19

SOURCES OF CRISIS

<table>
<thead>
<tr>
<th>External</th>
<th>Sudden</th>
<th>Gradual</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Unfriendly takeover</td>
<td>Industry decline</td>
</tr>
<tr>
<td></td>
<td>Friendly merger</td>
<td>Rise of new competition</td>
</tr>
<tr>
<td></td>
<td>Environmental lawsuit</td>
<td></td>
</tr>
<tr>
<td>Internal</td>
<td>Death or illness of CEO</td>
<td>Failure of CEO and top management</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dissension among managers</td>
</tr>
</tbody>
</table>


Ensure management is focused on key value creating parts of the business. The rationale of management oversight is to ensure that senior managers behave in the firm’s interests and not in their own interest. However, this oversight could be called “weak supervision” because the only thing that ensures is that senior managers do not profit from the company. The “strong supervision” is the one that focuses on ensuring that senior managers maximize shareholder value, that is, that they focus on the businesses that create most value. For that purpose, directors should receive information that provides an understating of the sources of value creation. Furthermore, directors, whether with help of external consultants or not, should define metrics to measure short- and long-term value creation. A McKinsey survey estimated that only 56% of directors know the parts of the business where value is created (exhibit 20).

Facilitate the development of high-performing teams. The way boards are currently structured, large size, limited time spent together and populated by very busy business people, does not foster the development of high-performing teams. The CEO should see the board as a group on which he can rely to get help and discuss ideas, and not only as a group that tries to monitor him. To ensure that directors communicate effectively and provide valuable ideas, the CEO and the lead director should design the board in a way that fosters it. Some changes that could be made in the design of the structure of the boards are (1) increase the length of time dedicated to discuss ideas in meetings (2) organize off-site events and small meetings (executive and non-executive directors) to foster mutual knowledge and (3) facilitate sessions to discuss how to improve the performance of the board.
EXHIBIT 20
BOARD UNDERSTANDING OF THEIR FIRM’S BUSINESS

Percentage of responses

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Does your board understand:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full understanding</td>
<td>How the chosen management compensation policy aligns with the chosen strategy and risk profile?</td>
</tr>
<tr>
<td></td>
<td>Which elements of the business create most value?</td>
</tr>
<tr>
<td></td>
<td>The major risks facing the company (e.g., financial, political, interest rate, industry or competitive changes, etc.)?</td>
</tr>
<tr>
<td></td>
<td>The potential conflicts of interest between management/directors and the company (e.g., where direct business relations exist)?</td>
</tr>
<tr>
<td></td>
<td>How well the company is performing against stated objectives?</td>
</tr>
<tr>
<td>Some understanding</td>
<td>49</td>
</tr>
<tr>
<td>Not at all/not sure</td>
<td>56</td>
</tr>
<tr>
<td></td>
<td>64</td>
</tr>
<tr>
<td></td>
<td>70</td>
</tr>
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<td></td>
<td>77</td>
</tr>
</tbody>
</table>

Source: McKinsey.
Top Management’s Human Resources

One of the main functions of the board of directors is to manage the human resources of the top management of the corporation. Directors focus their human resource management in:

1. Selecting, inviting and orienting new members of their board,
2. Selecting and limiting the term and establishing the terms of mandatory retirement,
3. Establishing board and top management compensation,
4. Evaluating board and top management performance, especially that of the CEO and
5. Planning CEO succession
## 1. Board Membership Criteria

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>No director may also serve as a consultant or service provider to the company.</td>
<td>The Committee on Director Affairs is responsible for reviewing with the Board, on an annual basis, the appropriate skills required of Board members. This assessment should include issues of judgment, diversity, age, skills such as understanding of manufacturing technologies, international background, etc.</td>
<td>Not covered directly.</td>
<td>Director qualification standards. These standards should, at minimum, reflect the independence requirements set forth in subsections 1 and 2 of this Section 303A. Companies may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.</td>
<td>Listed companies should explain why individual non-executive or supervisory directors are qualified to serve on the board in their particular roles. Similar disclosures should be made in proposal for initial appointment.</td>
<td>The corporate governance code could recommend: - Criteria for selection and required skills - Timing for review (annual)</td>
</tr>
<tr>
<td>In Calpers’ view, each director should add something unique and valuable to the board as a whole.</td>
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<tr>
<td>The board has adopted guidelines that address the competing time commitments that are faced when director candidates serve on multiple boards. These guidelines are published annually in the company’s proxy statement.</td>
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<tr>
<td>The board has adopted director diversity guidelines, seeking qualified people who bring with them the benefits of different perspectives.</td>
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<td>To be re-nominated, directors must satisfactorily perform based on the established criteria. Renomination on any other basis is neither expected nor guaranteed.</td>
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<tr>
<td>The board should establish, and make available to shareowners, the skill sets which it seeks for director candidates. Minimally, these core competencies should address: accounting or finance, international markets, business or management experience, industry knowledge, customer-base experience or perspective, crisis response, or leadership or strategic planning.</td>
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</tr>
<tr>
<td><strong>Institutional Investor Perspective (Calpers)</strong></td>
<td><strong>Corporate Perspective (GM)</strong></td>
<td><strong>Institutional Perspective (OECD)</strong></td>
<td><strong>Market Regulator Perspective (NYSE)</strong></td>
<td><strong>Report on framework for Company Law in Europe</strong></td>
<td><strong>Comments on the four perspectives with a focus on EU firms</strong></td>
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</tr>
<tr>
<td>The Lead Independent Director will interview, along with the chair of the nominating committee, all Board candidates, and make recommendations to the nominating committee and the Board.</td>
<td>The Board delegates the screening process involved to the Committee on Director Affairs with the direct input from the Chairman of the Board and the CEO.</td>
<td>The Board should fulfill certain key functions, including ensuring a formal and transparent board nomination process.</td>
<td>The corporate governance guidelines should include Director orientation and continuing education.</td>
<td>Competence should be explained on appointment.</td>
<td>Board or appropriate committee could provide to shareholders the rationale for the designation of the board member; it could even propose more than one candidate.</td>
</tr>
<tr>
<td></td>
<td>The Board and the Company have a complete orientation process for new Directors that includes background material, meetings with senior management and visits to Company facilities.</td>
<td>Some companies have found useful to engage in training to new members.</td>
<td></td>
<td>Shareholders should be able to assess whether sufficient time is available through proper disclosure of number and nature of board positions held in other companies.</td>
<td></td>
</tr>
<tr>
<td><strong>2. Selecting, Inviting and Orienting New Directors</strong></td>
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<tr>
<td><strong>3. Board size</strong></td>
<td>The board should periodically review its own size, and determine the size that is most effective toward future operations.</td>
<td>It is the sense of the Board that this size is about right (15 members).</td>
<td>Not covered.</td>
<td>Not covered.</td>
<td>Justification for the board size could be provided (e.g. large board size due to the number and complexity of businesses).</td>
</tr>
</tbody>
</table>
### 4. Election Term / Term Limits / Mandatory Retirement

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Every director should be elected annually.</td>
<td>The Board does not believe it should establish term limits (new ideas vs. experience).</td>
<td>Not covered.</td>
<td>Not covered.</td>
<td>Not covered.</td>
<td>The corporate governance code could recommend an annual or bi-annual reelection just to create a market for directors and enhance board performance.</td>
</tr>
</tbody>
</table>

As an alternative to term limits, the Committee on Director Affairs, in conjunction with the CEO, will formally review each Director’s continuation on the Board every five years.

It is the sense of the Board that the current retirement age of 70 is appropriate.

### 5. Board Compensation Review

| Director compensation is a combination of cash and stock in the company. The stock component is a significant portion of the total compensation. | Report on compensation status once a year. Meaningful portion should be provided and held in common stock units. Changes in Board compensation should come at the suggestion of the Committee on Director Affairs. | The Board should fulfil certain key functions, including board remuneration. | Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). | Not covered. | The corporate governance code could establish lock-up and vesting restrictions and limits on compensation when resigning. However, establishing full transparency on compensation could be sufficient as the market will act as regulator. |
### 6. Evaluating Board Performance

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>The board establishes performance criteria, not only for itself (acting as a collecting body) but also individual behavioral expectations for its directors. Minimally, these criteria address the level of director: attendance, preparedness, participation and candor. To be renominated, directors must satisfactorily perform based on the established criteria.</td>
<td>The Committee on Director Affairs is responsible to report annually to the Board an assessment of the Board’s performance. The evaluation should be based on objective criteria including performance of the business, accomplishment of long-term strategic objectives, development of management, etc.</td>
<td>Independent board members can bring an objective view to the evaluation of the performance of the board.</td>
<td>Annual performance evaluation of the board. The board should conduct a self-evaluation, at least annually, to determine whether it and its committees are functioning effectively.</td>
<td>Competence must be assessed together with the role. Basic financial understanding is always required but other skills may be of high relevance. Competence should be explained annually against profile of board composition.</td>
<td>The firm could explicitly provide an overall and individual board evaluation.</td>
</tr>
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### 7. Board Interaction with Institutional Investors and other stakeholders

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
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<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not covered.</td>
<td>The Board believes that the Management speaks for General Motors. If comments from the Board are appropriate, they should, in most circumstances, come from the Chairman.</td>
<td>Not covered directly.</td>
<td>Not covered.</td>
<td>Not covered directly. Good governance of institutional investors requires disclosure to their beneficiaries of their investment and voting policies.</td>
<td>Investor relations or office of the Chairman should work with them to minimize trade sales due to a non-alignment with their corporate governance policy.</td>
</tr>
</tbody>
</table>
### 8. Formal Evaluation of the Chief Executive Officer

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
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</tr>
</thead>
<tbody>
<tr>
<td>The independent directors establish performance criteria and compensation incentives for the CEO, and regularly review the CEO’s performance against those criteria. Minimally, the criteria ensure that the CEO’s interests are aligned with the long-term interests of shareowners, that the CEO is evaluated against comparable peer groups, and that a significant portion of the CEO’s total compensation is at risk.</td>
<td>The full board should make this evaluation annually, and it should be communicated to the CEO by the Chairman of the Committee on Director Affairs.</td>
<td>Not covered directly.</td>
<td>The compensation committee has the responsibility of review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO’s performance in light of those goals and objectives, and set the CEO’s compensation level based on this evaluation.</td>
<td>Not covered.</td>
<td>The corporate governance code could recommend some minimum variables to include in the evaluation as well as a process (who evaluates, how evaluates, to whom it is presented, implications of the evaluation).</td>
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<tr>
<td>The Lead Independent Director will evaluate, along with members of the compensation committee / full board, the CEO’s performance and meet with the CEO to discuss the Board’s performance evaluation.</td>
<td>The evaluation should be based on objective criteria including performance of the business, accomplishment of long-term strategic objectives, development of management, etc.</td>
<td>This evaluation will be used by the Executive Compensation Committee in the course of its deliberations when considering the compensation of the CEO.</td>
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</table>

### 9. Succession Planning / Management Development

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<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>The board should have in place an effective CEO succession plan, and receive periodic reports from management on the development of other members of senior management.</td>
<td>Annual report by the CEO to the Board on succession planning and on program for management development. There should be the Chairman’s and CEO’s recommendation to a successor, should be unexpectedly disabled.</td>
<td>The board should fulfill certain key functions, including overseeing succession planning.</td>
<td>Succession planning should include policies for CEO selection and performance review, as well as for succession in an emergency or CEO retirement.</td>
<td>Not covered.</td>
<td>Annual reports on succession planning and program for management development.</td>
</tr>
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</tr>
</tbody>
</table>
10. Executive Compensation

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<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
</table>
| Not covered.                               | Not covered.                | The board should fulfill certain key functions, including key executive and board remuneration. | In determining the long-term incentive component of CEO compensation, the committee should consider the company’s performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company’s CEO in past years. | An appropriate regulatory regime at least includes the following elements:  
- Remuneration policy for directors should be annually disclosed and debated in the annual meeting  
- Individual remuneration of directors should be disclosed in detail annually to clarify the relation with company performance and to prevent potential abuses. This applies also to non-executive and supervisory directors who should not be considered to be independent if their remuneration is linked to company’s performance  
- Share incentive schemes should require a general meeting approval based on proper explanation, by remuneration committee, of the applicable rules and their likely costs.  
- An important way to prevent abuses is to require full reflection of share incentive schemes in annual accounts. The appropriate framework rule should be adopted at EU level. | The corporate governance code could follow the guidelines offered in the EU framework. |
**Key priorities**

**EXHIBIT 21**

<table>
<thead>
<tr>
<th>Action</th>
<th>Process / structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establish annual individual and board performance reviews</td>
<td>• Develop a evaluation form for the CEO, the board and each director, relating their results to compensation.</td>
</tr>
<tr>
<td>Provide understandable information for non-executive directors</td>
<td>• Test board satisfaction with the information received by mapping and evaluating board’s objectives with the information provided.</td>
</tr>
</tbody>
</table>
| Assure effective CEO succession planning<sup>13</sup> | • Establish the goals and objectives of the search  
• Select the search committee  
• Separate the roles and responsibilities of the search firm and the search committee  
• Define the candidate pool broadly  
• Analyze the multiple factors affecting company performance  
• Choose candidates on the basis of the goals and objectives of the search |
| Assess the impact of executive and board compensation on performance and the overall risk profile | • Build a quantitative and qualitative model that relates CEO and director compensation to company performance and changes in the risk profile of the firm. |
| Establish annual reelections of directors | • Formalize an annual review (with a reelection) |
| Balance board members according to the geographical presence of the business | • Elect directors with an international profile in the relevant geography and with functional and industry expertise |

*Source: Author.*

Establish annual individual and board performance reviews. Boards and directors should be evaluated on an annual basis against an agreed criteria, receive feedback and meet a minimum threshold to remain in the board. As the corporation is continuously evaluated by financial markets, boards have to create an internal market to maintain their competitiveness. This priority is justified by the fact that directors rate that 45% of their colleagues as average or low performers<sup>14</sup>.

Provide understandable information for non-executive directors. Directors have to receive enough information so that they can monitor management and approve and monitor corporate strategy. Lipton, M. and Lorsch, J. (1992) tell us that:

> “Ralph Cordiner, then CEO of General Electric, asked McKinsey and Company to develop a broader set of measures for business performance. Several different classes of measures were recommended: profitability, market position, productivity, product leadership, personnel development, employee attitudes, public responsibility and balance between short- and long-range goals”.

<sup>14</sup> McKinsey (2002).
The board, itself or through a third party, should test board satisfaction with the information received by mapping and evaluating board’s objectives with the information provided.

**Assure effective CEO succession planning.** Many corporate governance experts highlight that the most important role of the board is to choose the CEO. Currently, many CEOs are being hired externally, as compared to internal promotion, so that, apart from developing a pool of senior managers candidates for a CEO position, directors should be able to manage an outside search process. Khurana, R. (2001) identifies six pitfalls made by the board when directors look for a new CEO:

1. **Missing the chance for organizational introspection.** One main criteria to choose the CEO should be the required skills to succeed looking forward, not to succeed in the past or in the current environment.
2. **Choosing the wrong search committee.** The search committee should (1) be acknowledgeable of the company and the industry, (2) have enough time to devote to it, (3) have diverse industry and functional background and (4) be composed of members who are like to stay on.
3. **Outsourcing critical steps.** The search firm will not handle the whole process.
4. **Defining the candidate pool too narrowly.** The search committee should not assume that potential candidates need previous CEO experience and that it has to be a well-recognized business leader by market analysts or business media.
5. **Equateing candidates with their past companies.** Boards usually use the past performance of a CEO in his previous company as a predictor of future performance.
6. **Overestimating the value of insider or outsider status.** Both options, an insider or outside CEO should be considered with equal attention.
7. **Accepting false assumptions.** Do not eliminate candidates just because the board has an internal knowledge that this person will not leave his current firm. Sometimes, search firms have been able to attract candidates that the board alone has not been able to.

An effective CEO search should follow 6 steps: (1) establish the goals and objectives of the search, (2) carefully select the search committee, (3) separate the roles and responsibilities of the search firm and the search committee, (4) define the candidate pool broadly, (5) analyze the multiple factors affecting company performance and (6) choose candidates on the basis of the goals and objectives of the search.

**Assess the impact of executive and board compensation on performance and the overall risk profile.** Boards, or the compensation committee, should develop sophisticated mechanisms to align executive and board compensation to firm performance and the relationship of the compensation system to the overall risk profile. It is clear that defining a compensation program without problems is virtually impossible; however, during the endeavor, many of the problematic issues will come up and then, board members will be able to look carefully at them. Exhibit 22 highlights the process by which equity, and in general, senior management and director compensation, relates to firm performance and the potential noises that can be introduced during the process.
Hall\textsuperscript{15} highlights five challenges of equity-based pay:

- **Aligning time horizons.** Stock compensation is better than accounting-based compensation because it is forward looking; however, it has the disadvantage that can motivate earnings management to enhance share price increases in the short-term. Hall proposes the solution of setting longer vesting periods and avoiding accelerating vesting. Moreover, he encourages board members to ask themselves which the incentives are for a CEO that negotiates short-term vesting periods.

- **Aligning risk-taking incentives.** Options induce more risk-taking than stocks; however, if a CEO is non-diversified, in human and financial capital terms, then, an options package can increase his risk-aversion. Therefore, the effect cannot be predicted ex-ante as there is an opposite effect that equity is an option in itself and therefore increases its expected value in response to higher volatility. Moreover, the risk-taking elasticity of an option package changes by the value of the underlying asset, whether it is in the money or out of the money. The more in the money the options are, the lower the risk-taking elasticity and the higher the risk-aversion. These three variables, the risk-aversion of the CEO, the volatility of the stock and the value of the underlying stock related to the strike price influences the optimal compensation package.

- **Managing value-cost (in) efficiency.** As senior managers usually value equity compensation significantly lower than cash compensation (e.g. Hall’s studies show a discount between 10% and 50% to the true value of the equity grant) companies should balance this cost to the associated benefits of equity-like compensation (e.g. focus on company performance, attraction and retention incentives). An equity-like

\textsuperscript{15} Hall, B. (2002)
Breakthrough Corporate Governance: A Toolbox for Senior Managers and Directors
Jose Antonio Marco © 2002

compensation should be higher when options are in the money, senior managers are well diversified and are not very risk-averse, the volatility of the stock is low and the vesting period is short.

- Managing the leverage-fragility tradeoff. Options provide significant leverage to managers; with the same amount of money more options than stocks can be bought, however, options are very fragile (e.g. a 50% fall in the stock price decreases the value of the options by 81%).

- Managing complexity and abuse. As option valuation is not easy to understand, senior managers can get overcompensated, whether because directors do not fully understand option compensation and its relation to the stock price or because senior managers take advantage of the complexity of options to get higher compensation packages. It is well known the case of Apple CEO Steve Jobs that was given an option grant with a Black-Scholes value in excess of $500 million.

Moreover, Hall compares the advantages of stock versus options and states that:
- Stock is a more robust incentive instrument
- The value/cost ratio is generally higher for stock
- Stock is less complex and more transparent than options

More than 75% of directors in the EuroSTOXX-50 (exhibit 23) are not compensated in stock at all. One could argue that a director is dependent if he receives stock compensation; however, it is also dependent if he receives guaranteed cash compensation as long as he remains in the board. Moreover, cash compensation can favor short-term value versus long-term value because it is easier to maintain a seat in the board if decisions are visible in the short-term.

**EXHIBIT 23**

**EXECUTIVE REMUNERATION IN SHARES**

![Bar chart]

Source: DWS (2002).

**Establish annual reelections of directors.** As investors decide which stock to buy and sell, shareholders and their board, in representation, must decide if directors should remain as board members. The reelection can be a hard or an easy process, depending on the voting requirements to dismiss a director. It is the judgment of the nomination committee to decide the appropriate level of pressure on directors, balancing the potential supply of directors to serve on the firm.

---

16 Hall, B. (2002).
More than 85% of the directors interviewed by McKinsey (2002) support (1) an annual re-election process and (2) formal board review (exhibit 24).

**EXHIBIT 24**

**MECHANISMS TO TRIGGER DIRECTOR’S CONTINUED APPOINTMENT TO THE BOARD**

DIRECTORS SUPPORT VARIOUS MECHANISMS TO TRIGGER AN ASSESSMENT OF EACH INDIVIDUAL’S CONTINUED APPOINTMENT TO THE BOARD

<table>
<thead>
<tr>
<th>Percentage of responses</th>
<th>Have</th>
<th>Should have</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual re-election</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>Formal board evaluation</td>
<td>25</td>
<td>60</td>
</tr>
<tr>
<td>Review appointment if individual’s main business role changes</td>
<td>33</td>
<td>52</td>
</tr>
<tr>
<td>Formal director evaluation</td>
<td>15</td>
<td>66</td>
</tr>
<tr>
<td>Age limits, i.e., defined retirement age</td>
<td>34</td>
<td>33</td>
</tr>
<tr>
<td>Review appointment if individual takes on additional directorship</td>
<td>12</td>
<td>52</td>
</tr>
<tr>
<td>Terms limits</td>
<td>24</td>
<td>30</td>
</tr>
</tbody>
</table>

*Source: McKinsey*

**Balance board members according to the geographical presence of the business.** Boards are getting increasingly international (26% of board members are foreign nationals in 2002, up from 16% in 2001). Having a certain number of foreign directors on a company’s board contributes to the international profile and expertise of an internationally operating company. Apart from adding new perspectives to the business, it shows investors that managers and directors truly want to maximize shareholder value. It seems surprising that many European executives claim that their company is global and at the same time directors that sit on the board are mainly nationals and, sometimes, with limited international background.

**Board size and separation of CEO and Chairman.** I do not think that the corporate governance guidelines of a firm should limit the board size or the separation of the CEO and Chairman positions. Again, it depends on the specifics of the company, style of senior managers and challenges faced by the firm. Furthermore, there is no consensus on whether these two variables influence performance. A study by Dalton, Dan R. (1999) does not establish the assumed evidence that the smaller the board the better the performance. The same study does not find a relationship between performance and separation of CEO and Chairman.
Chapter 4

Shareholder Protection
Chapter 4. Shareholder Protection

The second block (exhibit 25) of the diamond, shareholder protection, is comprised of three sub-blocks: (a) market protection, (b) board protection and (c) voting protection. The structure of this chapter is as follows. Each component, if possible, is analyzed from the four different perspectives outlined before, then the “Report on the framework for company law in Europe” is compared and the current status of the firms in the EUROSTOXX-50 is shown. Finally, some recommendations are shown on the basis of an identified “corporate governance gap” between the four perspectives, the EUROSTOXX-50 corporate governance status and the EU report.

EXHIBIT 25
SHAREHOLDER PROTECTION

Market Protection

Market protection is necessary to ensure that managers and directors maximize shareholder value. If those agents cannot internally organize to achieve this purpose, other external agents in the market (e.g. corporate raiders) should be allowed to take control of the corporation. Regulators must achieve an efficient market for corporate control, meaning that:
• Efficient changes of control are promoted; those changes include some of which the shareholder does not receive the control premium
• Abusive changes of control are not allowed; even though minority shareholders receive a control premium

It is important to highlight that the problem is not in how the control premium is distributed but the rationale of the payment of the control premium (e.g. for what it is paid). If acquiror pays a control premium because it can increase the cash flows and value of the company, this transaction should happen, and, in some cases, even if minority shareholders do not receive the control premium. However, if the acquiror pays a control premium because it hopes to capture more value (e.g. it holds 40% of voting rights and will capture 60% of economic rights) without increasing the overall value of the company, this transaction should not happen.

The regulator should not only consider the benefits of a full tender offer in which minority shareholders are allowed to leave the capital and therefore, the new controlling shareholder can only take advantage of the private benefits by owning 100% of the stock, that is, bearing also the costs. However, partial offers should also be allowed in the system because, sometimes, can be efficient. One way to discriminate positive-NPV partial offers from abusive partial offers is to allow shareholders, excluding the raider, to vote in a general meeting to approve or not the partial offer.

Given that market protection must be developed by institutions outside corporations, no key priorities for firms are presented.
Board Protection

As Hall\(^\text{17}\) names it, boards represent the first line of defense to ensure that senior managers focus on maximizing shareholder value. Financial incentives have limits to motivate senior managers. This can be understood by thinking that the compensation of a senior manager is not just cash, stock and options but also its influence and social networks; therefore, it could happen that the stock price is depressed, hence the market value of the CEO compensation, but that the total compensation (e.g. including the value of influence and social network) has not changed significantly. In these cases the board should have enough power to remove the CEO, and the management team, if necessary.

Manage takeover defenses to the benefit of shareholder value. Takeover defenses have experienced little or no change in the past year (exhibit 26). Priority or golden shares still represent (26\% of companies), as well as other distortions such as multiple voting rights (34\% of companies). Institutional investors perceive that it is in shareholders’ interests that a company can be taken over, and, as a result, it can result in higher shareholder returns.

Several anti-takeover devices should be considered for elimination; among them are:

- **Board insulation.** The board insulates itself to be removed by an outside bidder, hence decreasing the probability of a takeover.
- **Voting right distortions.** The board establishes a voting right ceiling that cannot be waived in a takeover.
- **Authorised capital.** It occurs when pre-emptive rights can be waived in a takeover situation.
- **Repurchase of own shares.** The corporation is allowed to purchase its own shares during a takeover offer.
- **Targeted stock placement.** A corporation issues new shares or converts bond or warrants to increase capital and dilute the bidder.

**EXHIBIT 26**

TAKEOVER DEFENSES: VOTING RIGHTS DISTORTIONS

\[\text{Source: Deminor.}\]

\(^{17}\) Hall, B. (2002).
Voting Protection

When the first line of defense (Board of Directors) does not work, that is, when the Board does not have enough power to remove an under-performing CEO and management team, capital markets, through corporate shareholders, and potential acquirors, if necessary, become the second line of defense and replace the CEO. However, an active market for corporate control has also disadvantages. As Hall\textsuperscript{18} states, “hostile takeovers can create major economic disruptions since they are often followed by dramatic changes in company management and strategic direction”. Moreover, there is the argument that corporate raiders make senior managers to focus on short-term results, so-called Anglo-saxon short-termism. Finally, takeover bids can be coercive due to two-tier bidding strategies that force shareholders to accept bids at low prices. With this rationale, it is admissible that boards and CEOs raise takeover defenses to get the highest possible price for the company’s shareholders.

The protection of shareholders with the right to vote in a takeover is a mechanism that allows that efficient changes in control in partial offers can occur. Moreover, a corporation has to define the following items on voting rights:

- Voting practices: cumulative, confidential voting, broker non-votes, and one share/one vote
- Voting powers to obtain information, participate and vote in annual general meetings, elect the members of the board, distribute the profits of the corporation, agree on changes of control…
- Shareholder meetings / proxy proposals

\textsuperscript{18} Hall, B. (2002)
<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Shareholder Voting Practices (Cumulative &amp; Confidential Voting, Broker Non-Votes, One Share/One Vote)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Proxies should be kept confidential from the company, except at the expressed request of shareowners. | Not covered. | The corporate governance framework should protect shareholders’ rights:  
- Equitable treatment of all shareholders  
- Effective redress for violation of their rights | Not covered. | All holders of risk bearing capital (including the bidder) must be able to attend the general meeting and vote in proportion to their holding. | The corporate governance code could establish the one share/one vote principle |
| Broker non-votes should be counted for quorum purposes only. | | | | | |
| **2. Shareholder Voting Powers** |
| A majority of shareowners should be able to amend the company’s bylaws by shareowner proposal. | Not covered. | Basic shareholder rights include the right to:  
- obtain relevant information, participate and vote in general shareholder meetings (GSM), elect members of the board and share in the profits of the corporation. | Not covered. | Schemes granting shares and share options and other forms of remuneration of directors linked to the share price should require the prior approval of the shareholders meeting, on the basis of a proper explanation by the remuneration committee of the applicable rules and of their likely costs. | Shareholders could have voting powers to approve:  
- Stock related compensation  
- Director nomination |
| Any shareholder proposal that is approved by a majority of proxies cast should either be implemented by the board, or the next annual proxy statement should contain an explanation of the board’s reason for not implementing. | | | | | |
| Shareholder should have access to the director nomination process. | | | | | |
### 3. Shareholder Meetings / Proxy Proposals

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>A majority of shareowners should be able to call special meetings.</td>
<td>Not covered.</td>
<td>Recognition of information needs and rights to ask questions and modify the agenda. Equal value of voting in person or in absentia. Voting by proxy generally accepted. Moreover, firms should use of technology in voting.</td>
<td>Not covered.</td>
<td>Modern technology may offer a solution to many problems: putting meeting materials and proxy forms on the company’s website is efficient for both the company and its shareholders. Listed companies should explicitly disclose to their shareholders how they can ask questions, how and to what extent the company intends to answer questions, and how and under what conditions they can submit proposals to the shareholders meeting. With respect to the right to submit proposals for resolution by the shareholders meeting, there is a link with the squeeze-out right of a majority shareholder and sell-out right of minority shareholders. Listed companies should be required to offer facilities to vote in absentia—by way of direct vote or proxies—by electronic means, and through hard copy voting distribution or proxy forms at their request. Listed companies should be permitted, but not required, to allow absentee shareholders to participate in general meetings via electronic means.</td>
<td>Firms could provide by electronic means: proxy voting and general meetings.</td>
</tr>
</tbody>
</table>

Modern technology may offer a solution to many problems: putting meeting materials and proxy forms on the company’s website is efficient for both the company and its shareholders. Listed companies should explicitly disclose to their shareholders how they can ask questions, how and to what extent the company intends to answer questions, and how and under what conditions they can submit proposals to the shareholders meeting. With respect to the right to submit proposals for resolution by the shareholders meeting, there is a link with the squeeze-out right of a majority shareholder and sell-out right of minority shareholders. Listed companies should be required to offer facilities to vote in absentia—by way of direct vote or proxies—by electronic means, and through hard copy voting distribution or proxy forms at their request. Listed companies should be permitted, but not required, to allow absentee shareholders to participate in general meetings via electronic means.
Ensure timely and convenient timing procedures. To respect one of the basic shareholder rights, voting, the process of voting should provide

1. Enough time to make an informed decision and
2. Convenient ways to exercise this right. Three-quarters of companies in the EUROSTOXX-50 allow voting by mail. Moreover, most shareholders have had more than a month to cast an informed vote (exhibit 27).

**EXHIBIT 27**
TIME AVAILABLE TO MAKE AN INFORMED VOTE

![Graph showing time available to make an informed vote for different countries.](image)

*Source: DWS (2002).*

Respect the “one share – one vote – one dividend”. Multiple voting rights and voting rights ceilings distort the one share – one vote principle. Deminor concludes that low-ranked companies in the EuroSTOXX generally do not respect the “one share - one vote - one dividend” principle. These companies show a high percentage of non-voting shares, multiple voting shares (e.g. Danone, ING), preference or golden shares (ING, Volkswagen), voting right ceilings (Danone, Volkswagen) and ownership ceilings (ING). Moreover, nearly all of these companies have majority or core shareholders (e.g. France Telecom: 55%). Finally, company boards are not fully elected by shareholders (shareholders elect 19% of the board of France Telecom, 0% of ING, and 40% of Volkswagen, considering the two representatives of the core shareholder). Spanish corporations (exhibit 28 and exhibit 29) are aligned with the best firms of the EuroSTOXX in the ranking of “rights and duties to shareholders” and in the ranking of “absence of takeovers”; however, they are three points below the maximum (10).
**EXHIBIT 28**
RANKING OF RIGHTS AND DUTIES OF SHAREHOLDERS. EUROSTOXX 50

![Bar chart showing rankings of rights and duties of shareholders.](chart1)

*Source: Deminor.*

**EXHIBIT 29**
RANKING OF ABSENCE OF TAKEOVERS. EUROSTOXX 50

![Bar chart showing rankings of absence of takeovers.](chart2)

*Source: Deminor.*
Chapter 5

Corporate Disclosure
Chapter 5. Corporate Disclosure

The third block (exhibit 30) of the diamond, corporate disclosure, is formed by three components: (a) financial disclosure, (b) organizational disclosure and (c) control disclosure. The structure of this chapter is as follows. Each component is analyzed from the four different perspectives outlined before, then the “Report on the framework for company law in Europe” is compared and the current status of the firms in the EUROSTOXX-50 is shown. Finally, some recommendations are shown on the basis of an identified “corporate governance gap” between the four perspectives, the EUROSTOXX-50 corporate governance status and the EU report.

EXHIBIT 30
CORPORATE DISCLOSURE

Source: Author.
<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not covered.</td>
<td>Not covered.</td>
<td>Disclosure on: financial results, company objectives, major share ownership and voting rights, members of the board and remuneration, material foreseeable risk factors, governance structures and policies, capital structures and arrangements that enable certain shareholders to obtain a degree of control too disproportionate to their equity ownership and any material interest in the corporation by board members.</td>
<td>Similar to OECD. The fundamental responsibility for the company’s financial statements and disclosures rests with management and the independent auditor.</td>
<td>Member States should have effective rules in their company laws or in their national corporate governance codes, which should be enforced on a “comply or explain” basis at the minimum.</td>
<td>Firms could follow the “comply or explain” regulation. Firms should think as if information auto-regulates corporate governance, with the corresponding discounts to those that lack transparency.</td>
</tr>
</tbody>
</table>
Financial Disclosure

Investors need to have accurate information of assets and liabilities to estimate their true values. If the price of the assets do not include all public information and, what is more important, if the price of the assets include misguided information, buy and sell decisions will not efficiently allocate resources. In the corporate governance crisis of the 1980’s, corporations were underperforming due to a lack of sustainable strategies developed by senior managers and directors. However, in the 1980’s information was sufficiently accurate to allow corporate raiders to estimate bidding offers and increase the performance of corporations. Today’s crisis is different in the sense that the trust of investors on market prices is low and then, it is even more difficult to identify under-performing managers, that is why, governments and institutions are setting minimum disclosure rules that minimize the incentives to provide misguided information to markets. A PriceWaterhouse Coopers study shows that opacity, or misguided information imposes significant costs on investors, whether to individuals, institutional or corporate investors; that is, capital markets and corporations in countries where regulations do not protect about the consequences of providing misguided information to the market face a significant hidden surtax.
<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
<th>Market Regulator Perspective (NYSE)</th>
<th>Report on framework for Company Law in Europe</th>
<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not covered.</td>
<td>Not covered.</td>
<td>The corporate governance framework should ensure that timely and accurate disclosure are made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.</td>
<td>CEO’s certificate relating to the quality of financial disclosure.</td>
<td>Responsibility for the probity of financial statements should be attributed, as a matter of EU law, for all board members on a collective basis. This responsibility should extend to all statements made about the company’s financial position, as well as to all statements on key non-financial data (including the annual corporate governance statement).</td>
<td>Not internal corporate governance: comply with regulation.</td>
</tr>
</tbody>
</table>

1. Accuracy of Disclosure / Liability
Sufficient financial disclosure that allows efficient allocation of resources. Suez, graded by the corporate governance rating firm Deminor, provides extensive disclosure on financial and non-financial documents: the timing is appropriate and a website section fully dedicated to investors is easy to navigate; furthermore, it provides with a full disclosure of their capital and shareholder structure.

Adopt international accounting standards. A majority of companies already employ international accounting standards. However, as Deminor highlights (exhibit 31) 24% of the companies (mostly French) listed in the EuroSTOXX use only national accounting standards. With the EU legislation, that is expected to be implemented by 2005, IAS will be used by European companies. Some European companies now comply with US GAAP due to listing requirements, however, not many companies make their 20F report available on their websites.

**EXHIBIT 31**

ACCOUNTING STANDARDS PER COUNTRY

<table>
<thead>
<tr>
<th>Country</th>
<th>Both US GAAP and IAS</th>
<th>US-GAAP</th>
<th>IAS</th>
<th>National GAAP only</th>
</tr>
</thead>
<tbody>
<tr>
<td>SP (5)</td>
<td>100%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NL (7)</td>
<td>14%</td>
<td>86%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ITL (7)</td>
<td>29%</td>
<td>29%</td>
<td>43%</td>
<td></td>
</tr>
<tr>
<td>GER (12)</td>
<td>17%</td>
<td>50%</td>
<td>33%</td>
<td></td>
</tr>
<tr>
<td>FR (17)</td>
<td>41%</td>
<td>59%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: DWS.*

Organizational Disclosure

Disclosing information about the organizational structure is relevant because it shows investors the capabilities that the organization has put in place to execute on the strategy. Jensen, M, and Meckling, W. (1999) highlight the following organizational systems that can influence organizational effectiveness and on which the firm could provide information:

- **System for defining divisions in the organization:** sub-units for planning, decision making and reporting purposes.
- **System for selecting people** for particular positions in the organization.
- **System for creating and maintaining information channels.** Provision of facilities such as databases and processes such as committee structures and reports to facilitate the transfer and sharing of information. This communication strategy can be used to show how a company would create centers of excellence to transfer best practices across its subsidiaries or across two recently merged entities.
- **System for defining the organization’s general strategy** and communicating it to decision-makers.

Looking at the four different perspectives, there is no current reference on the possible disclosures that a firm can do on its organizational structure. This is an area in which a firm can
distinguish itself by disclosing relevant information on its strategy, coordination mechanisms and incentives.

**Control Disclosure**

Control disclosure is the disclosure of information related to the control systems that the corporation has put in place to ensure that the information released is right. Control disclosure is relevant because it provides the market with a *perceived credibility that implicitly ensures that the disclosure of information made is accurate and hence that market agents can make their relevant decisions.* Among the information included in control disclosure is (1) disclosure related to compensation and director assessment and (2) disclosure regarding corporate governance.
<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
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<th>Comments on the four perspectives with a focus on EU firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not covered.</td>
<td>Not covered.</td>
<td>Companies are expected to disclose sufficient information on the remuneration of board members and key executives for investors to properly assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to performance.</td>
<td>Not directly covered. The compensation committee must have a written charter that addresses: (i) the committee’s purpose – which, at minimum, must be to discharge the board’s responsibilities relating to the remuneration of the company’s executives, and to produce an annual report on executive compensation for inclusion in the company’s proxy statement, in accordance with applicable rules and regulations.</td>
<td>The remuneration policy for directors generally should be disclosed in the financial statements of the company, and should be an explicit item for debate on the agenda of the annual meeting.</td>
<td>Firms could provide information on the rationale for equity-linked compensation (e.g. stock, restricted stock, stock options): benefits of incentive alignment vs. firm costs due to non-diversified managers.</td>
</tr>
</tbody>
</table>

1. Disclosure Regarding Compensation and Director Assessment
### 2. Disclosure Regarding Corporate Governance

<table>
<thead>
<tr>
<th>Institutional Investor Perspective (Calpers)</th>
<th>Corporate Perspective (GM)</th>
<th>Institutional Perspective (OECD)</th>
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<tbody>
<tr>
<td>The board has adopted a written statement of its own governance principles and regularly re-evaluates them.</td>
<td>The Guidelines are published by the company and be widely available.</td>
<td>Disclosure should include, but not be limited to, material information on governance structures and policies. In particular, the division of authority between shareholders, management and board members, is important for the assessment of a company’s governance.</td>
<td>Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards.</td>
<td>Listed companies should be required to include in their annual report and accounts a coherent and descriptive statement covering the key elements of the corporate governance rules and practices they apply. This statement should also separately posted on the firm’s website. Responsibility for the annual corporate governance statement should lie with the board as a whole. Listed companies should maintain a specific section on their website where they publish all information relevant for their shareholders. This section should include all relevant materials, relating to shareholder meetings, and should offer facilities for giving proxies or voting instructions on-line or for downloading and electronic submission of proxy or instruction forms. Listed companies in all Member States are required to disclose their capital and control structures. On the basis of information about potentially defensive structures established in a company, the market would be able to react by discounts and higher costs of capital.</td>
</tr>
</tbody>
</table>
KEY PRIORITIES

**EXHIBIT 32**

KEY PRIORITIES FOR CORPORATE DISCLOSURE

<table>
<thead>
<tr>
<th>Action</th>
<th>Structure / Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Develop and publish own corporate governance guidelines</td>
<td>Chief Governance Officer / General Counsel in charge of developing and updating the guidelines</td>
</tr>
<tr>
<td></td>
<td>Put the guidelines accessible through the corporate website</td>
</tr>
<tr>
<td>Transparent communication to shareholders</td>
<td>Publish articles of association, minutes from last AGM, shareholder structure and stock option plan for employees</td>
</tr>
<tr>
<td>Publish enough information to show auditor’s independence</td>
<td>Publish initial appointment dates, audit fees and non-audit fees</td>
</tr>
</tbody>
</table>

*Source: Author.*

**Develop and publish own corporate governance guidelines.** Corporations, to ensure that they accomplish the excellence in “perceived corporate governance”, they should, first develop, and second make public their own corporate governance guidelines. Though it seems a basic step, many European corporations (*exhibit 33*) do not have these guidelines (20%) and even though others have them, they are very difficult to find. Hiding corporate governance guidelines does not provide any competitive strategy at all.

**Transparent communication to shareholders.** In the current environment companies must disclose as much non-sensitive information as possible. To understand what kind of information investors need, firms should interview them. The common characteristic of the top 5 performers in the DWS survey (2002) is a clear communication of their commitment to shareholders. Some of the information included is:

- Guidelines for conflicts of interest
- Relevant shareholder information
- Corporate governance policy
- Code of conduct for board members
- Minutes of meetings and articles of association
- Stock option plan for employees.

*Exhibit 34* shows that nearly 50% of the firms in the EUROSTOXX-50 do not have their articles of association available on the Internet and that nearly 70% do not put the minutes of the last AGM in the Internet.
EXHIBIT 33
CORPORATE GOVERNANCE DISCLOSURE

![Bar chart showing corporate governance disclosure in 2001 and 2002.]

Source: Deminor.

EXHIBIT 34
AVAILABILITY OF DOCUMENTS ON THE INTERNET

<table>
<thead>
<tr>
<th>Availability of documents on the Internet</th>
<th>2002 average</th>
<th>2001 average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual report &amp; accounts</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Articles of association</td>
<td>52%</td>
<td>24%</td>
</tr>
<tr>
<td>Agenda of the last AGM</td>
<td>90%</td>
<td>81%</td>
</tr>
<tr>
<td>Minutes of the last AGM</td>
<td>33%</td>
<td>29%</td>
</tr>
<tr>
<td>Shareholders’ newsletter</td>
<td>69%</td>
<td>57%</td>
</tr>
<tr>
<td>Half-year reports</td>
<td>90%</td>
<td>90%</td>
</tr>
<tr>
<td>Quarterly reports</td>
<td>83%</td>
<td>83%</td>
</tr>
</tbody>
</table>

Source: Deminor.

Publish enough information to show auditor’s independence. Firms should provide information to investors to show that their accounts are reviewed by independent auditors. For instance, if a firm, like nearly 80% of the EUROSTOXX (exhibit 35), decides not to publish its non-audit fees, it is not signaling investors that they strive for auditor’s independence. Furthermore, because investors have an informational asymmetry on financial information, they could penalize the stock price.
EXHIBIT 35
CORPORATE DISCLOSURE RANKING – EUROSTOXX 50

<table>
<thead>
<tr>
<th>Information on auditors</th>
<th>In 2002</th>
<th>In 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditors’ names</td>
<td>95%</td>
<td>93%</td>
</tr>
<tr>
<td>Names of the firms of auditors</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Initial appointment dates</td>
<td>74%</td>
<td>64%</td>
</tr>
<tr>
<td>Audit fees</td>
<td>31%</td>
<td>21%</td>
</tr>
<tr>
<td>Non-audit fees</td>
<td>21%</td>
<td>14%</td>
</tr>
</tbody>
</table>

Source: Deminor.

Spanish corporations are nearly the current best practice in the EuroSTOXX 50 (exhibit 36). However, to reach excellence in corporate disclosure an increase of more than 40% in the index would be required.

EXHIBIT 36
CORPORATE DISCLOSURE RANKING – EUROSTOXX 50

Source: Deminor.
Chapter 6

Winning Corporate Governance Strategies
Chapter 6. Winning Corporate Governance Strategies

"The governance of the corporation is now as important in the world economy as the government of countries."
James Wolfensohn, President, The World Bank

The Role of the Chief Corporate Governance Officer

As corporations are forced by capital markets to improve their governance systems, they have to dedicate specific resources to develop state-of-the-art governance architectures. For that purpose, corporations should give the day-to-day responsibility to a person, so-called Corporate Governance Officer (CGO). Though the CGO should facilitate the creation of structures within the corporation to foster the right governance, his focus should be more of a functional approach with an emphasis on three major functions:

1. **Ensure directors and senior managers have the system to perform (corporate performance: the board of directors).** Governance structures can change throughout times but functions such as CEO oversight, succession and compensation should be addressed regardless of times and culture. It is the role of the CGO that directors and senior managers can adequately perform their functions.

2. **Ensure shareholders are protected (shareholder protection).** The CGO should ensure that shareholders are protected by leveraging board members, monitoring anti-takeover devices and preserving basic shareholders’ rights such as that of one-share one-vote principle.

3. **Ensure disclosure to allow efficient resource allocation (corporate disclosure).** The CGO should understand the information requirements by market agents, and specially those of institutional investors, and decide whether disclosure of information is needed to ensure that agent decisions will result in an efficient allocation of resources.

Crafting Corporate Governance Architecture:
Building Gateways for the Future

To successfully design the strategic architecture of a corporate governance system, the thinking process should not focus on the strategy but on the portfolio of strategies across the building blocks of the corporate governance diamond. The portfolio of strategies is structured in three building blocks: big bets, real options and no-regrets moves. Following the McKinsey definitions, big bets are major commitments to a course of action that may payoff handsomely in some situations but produce dismal results in others. Real options are investments that are made to learn more or create flexibility. Finally, no-regrets moves make sense no matter what eventually happens. The strategic architecture is not a detailed plan but it identifies the major capabilities to be built.

This framework is used to propose a portfolio strategy for the design of corporate governance strategies in firms (exhibit 37). It defines a strategic matrix of areas to compete and strategies to use across the corporate governance diamond. A corporate governance system must compete in three areas (corporate performance, corporate control and corporate disclosure) with a different set of strategies and capabilities.
**EXHIBIT 37**

**CORPORATE GOVERNANCE PORTFOLIO STRATEGY**

<table>
<thead>
<tr>
<th>Intangible Assets</th>
<th>Corporate Performance –Board of Directors-</th>
<th>Corporate Control</th>
<th>Corporate Disclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Big Bet</strong></td>
<td>Facilitate the development of high performing teams – top management and directors-</td>
<td>Respect one-share one-vote, one dividend principle</td>
<td>Disclose organizational structure and control systems</td>
</tr>
<tr>
<td><strong>Real Options</strong></td>
<td>Create “ad hoc” flexible governance structures</td>
<td>Gradually increase shareholding voting powers</td>
<td>Gradually disclose compensation and its process</td>
</tr>
<tr>
<td><strong>No Regrets Moves</strong></td>
<td>Develop specific rules for conflicts of interest</td>
<td>Keep law spirit of fostering only efficient transfers of control</td>
<td>Ensure accuracy of liability disclosure</td>
</tr>
</tbody>
</table>

*Source: Author.*

**Intangible Assets**

**Attract and Retain Ethical Talent**

Ethical talent is one of the main ways to differentiate governance of corporations because, as stated in the beginning of the paper, executives will always find their way, if they want, to overcome rules; then attracting and retaining managers and directors with high ethical standards signal that the firm focuses not only on the “perceived corporate governance” but also on the actual delivery of corporate governance practices. How can directors and other senior managers test that the new hires have a minimum of ethical talent?: if the executive strongly pushes to shorten his vesting period of stock options or shares, then he would care about short-term increases in the share price, and probably the easiest way is to manipulate earnings through non-ethical, whether legal or not, accounting practices.

**Attract talent with a blend of skills.** Given the diverse tasks of a director’s job, the nomination committee should look for directors with complementary skills in terms of finance, strategy, operations, marketing, non-market and institutional strategies, risk and control management, industry knowledge, international experience and business and governmental networks.

**Build Corporate Reputation**

Corporate reputation influences the perception of the state of its corporate governance system outside the corporation, that is, with the media, regulators and institutions. Corporations can enhance its reputation through thought leadership initiatives. Corporations that lead initiatives such as attracting ethical funds, setting up a corporate reputation forum, joining global initiatives such as that led by the ONU -so called Global Compact- position themselves as thought leaders in the corporate reputation arena with the consequent effect on media.
Mainly, corporations can position in the corporate reputation arena through three different strategies:\footnote{Baron, D. (2002).}:

- *Positioning in the space of public sentiment.* Public sentiment includes the diverse interests and viewpoints of individuals in society. A company that well-positioned itself in this space is British Petroleum, with its well-known slogan “Responsibilities Beyond Petroleum”
- *Positioning in the political space.* This is the space where the rules of the game are made, that is, where law-making and rule-making occurs.
- *Positioning in the legal space.* This space allows the company to manage its potential liabilities.

As Jack Welch commented on his first presentation as CEO of General Electric to Wall Street analysts: “My “big” message that day was intended to describe the winners of the future….As I moved into “soft” issues like reality, quality and excellence, and the “human element”, I could tell I was losing them”. It is clear that he tried to build GE reputation by positioning the firm as no other firm did it before (e.g. not just talking about the financials) and, moreover, he set himself apart from the previous CEO by developing his own strategic jargon.

A number of researchers have concluded that there is a positive relationship between corporate social performance (CSP) and corporate financial performance (CFP). That is why many firms use social responsibility as a strategy, developing the term of strategic corporate social responsibility. Consumers may pay a premium for a social responsible product and may not buy products from corporations that are not socially responsible.

**Develop a Stakeholder Network**

Corporations need to manage the non-market environment in which it plays and for that directors and senior managers have to master the creation and management of social networks in the non-market and institutional environment. Senior managers and directors should keep an open and constructive dialogue with a diverse set of external stakeholders (institutional investors, market regulators, governments, governance institutions, media, other CEOs and groups of social interest), and market intermediaries (investment banks, M&A boutiques, consulting firms and law and accounting firms).

The inclusion of all these types of networks clearly positions corporations in better shape to manage corporate governance crisis and leverage its constituencies to quickly recover, at least, the perception of good corporate governance.

**Corporate Performance: The Board of Directors**

**Facilitate the Development of High-Performing Teams at the Top (big bet)**

When CEOs, CGOs and directors think about the design of boards and, in general, of corporate governance systems, they should think out-of-the-box to develop high-performing teams at the top. Some breakthrough initiatives are:

- *Develop a web-based system for director and senior management interaction.* The design of this system could have different levels of access (e.g. one part only for independent directors).
It would provide a forum on which the CEO could communicate his actions and use board members as a “sounding board” as needed. Moreover, it would enhance the value-added service function of the board as directors would be able to post their ideas and suggestions online, providing inputs to the CEO for the structure of board agenda. However, this initiative will not work if there is no trust among board members (e.g. directors will not like seeing something written if they know that it can easily be used against them).

- **Create a position of corporate governance officer.** Beyond the tasks of the general counsel and director of institutional affairs, there are other tasks that the position of corporate governance officer can cover (e.g. Pfizer is one of the pioneer corporations).

This strategy is a bet in the sense that if some of these initiatives do not work (e.g. practices not accepted by external stakeholders, systems or CGO do not perform as expected) some well-respected directors can be lost and the reputation of the company can be damaged but if these initiatives are well-received, the corporation can position itself in developing the “next big thing” in corporate governance.

The CEO, to build a high performing team of senior managers and board of directors, has to focus on developing three dimensions of performance (exhibit 38):  

- **Quality of renewal.** As Herb, E. et al. (2001) mention, senior managers and directors have to adapt their style from their previous positions as senior managers. Mainly, they have to adapt to shorter interactions, more frequent, less prepared and aimed at a wider and more diverse audience. The major flaws in the quality of renewal made by senior managers and directors are: (1) personal dissatisfaction, (2) insularity and (3) deficient individual skills.

- **Quality of direction.** CEOs should endeavor to align his team under the same goals and values. The major flaws in the quality of direction provided by a CEO are: (1) lack of alignment, (2) lack of deep understanding and (3) lack of strategic focus.

- **Quality of interaction.** CEOs should develop a day-to-day working style that fosters open and valuable comments. The major flaws in the quality of interaction developed by a CEO are: (1) poor dialogue and (2) inability to capitalize on different viewpoints and backgrounds.
**EXHIBIT 38**

**DIMENSIONS OF HIGH PERFORMANCE FOR SENIOR MANAGERS AND DIRECTORS**

<table>
<thead>
<tr>
<th>Quality of renewal</th>
<th>Quality of interaction</th>
<th>Quality of direction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Encourage personal development and risk taking</td>
<td>Encourage critical thought through effective dialogue</td>
<td>Align priorities</td>
</tr>
<tr>
<td>Avoid insularity: utilize insight and knowledge from outside the company</td>
<td>Capitalize on diverse viewpoints</td>
<td>Focus strategically on team goals and direction, developing talent and driving growth initiatives</td>
</tr>
<tr>
<td>Provide mentoring and coaching</td>
<td>[\text{SOURCE: Herb, E. et al (2001).}]</td>
<td></td>
</tr>
</tbody>
</table>

**Create “Ad Hoc” Flexible Governance Structures (real option)**

Senior managers and directors should focus on the function of adding value to the corporation, and for that they should *modify and create new structures, if needed*. One temporal structure that value-added boards create is the so-called *acquisition committee*. The purpose of this committee is to understand relevant acquisitions for the firm at a higher depth than directors usually do. This understanding serves two purposes: (1) the CEO and senior managers make sure of their decision by asking this committee to act as an adversary of the potential acquisition and (2) the CEO gets “buy-in” from the board because some of its members have been involved and are able to support the CEO in a more confident way.

This strategy is an option in the sense that the committee is a temporal one that, depending on its success can evolve to a permanent acquisition committee (increase in time) or to a different one such as the post-merger management committee (increase in breadth). However, there are some risks associated with these types of committees, that is why it is important their temporal structure. Management can perceive that directors are exceeding on their function of monitoring the performance and approving the strategy, however, one could argue that if directors have to be acknowledgeable of what they are approving, this committee would serve this basic purpose. It is also the responsibility of the CEO to achieve the balance between board involvement without getting it in doing management tasks.
Lukens Inc, a diversified Fortune 500 company established an acquisition committee to evaluate the acquisition of Washington Steel Corporation20. The chairman of the Committee, so-called Melters’ Committee, was aware that he had to manage three areas of concern:

- **Separation of management and director function.** The chairman of the committee expressed his concerns: “you cannot have the board running the company. I don’t want the Melters’ committee experience to lead to our board always raising Washington issues that should not be discussed at the board level”.
- **Committee versus non-committee members.** The relationships developed for directors within and outside the acquisitions committee could provoke a split in the board.
- **Relationship with management.** Management could read the creation of the committee as an inroad into management decisions by the board.

**Risk management.** One area that usually does not receive sufficient attention among directors is that of risk management. A McKinsey survey shows that only 64% of directors fully understand the risks to which the firm is exposed. Furthermore, even though when directors fully understand the risks, they are not completely aware of the different approaches to risk management. Three is one approach, so-called integrated risk management that begins to show very powerful results. As Meulbroek, L. (2002) says: “because an integrated approach to risk management departs from the rigid compartmentalization of risks, and requires a thorough understanding of the firm’s operations, as well as its financial policies, risk management is the clear responsibility of senior managers. It cannot be delegated to derivatives experts, nor can management of each individual risk be delegated to separate business units”. Though it can seem simplistic, **exhibit 39** shows the steps to follow to build an integrated risk management system. The underlying idea is to build a model that incorporates all major risks of the firm so that it can be used to understand changes in firm value to changes in risk variables. Furthermore, an integrated risk management system leverages on the fact that many risks are not perfectly correlated so that by insuring a bundle of risks the premium can be lower21. One firm that began to implement this approach was Honeywell22, however, because the new risk management program started in the Treasury Department and did not receive explicit senior management support, the program did not reach that far.

**Develop Specific Rules for Conflicts of Interest (safety nets and no-regrets moves)**

A corporate governance system should have principles that guide ethics and conflict of interests at the top of the organization. Moreover, these principles should be developed into a specific set of rules and processes that ensure its enforcement. It is in this last point, enforcement of rules where corporations can fail. Rule development happens due to media pressures, but the enforcement cannot be monitored externally and it is imposed after the mismanagement happens. This strategy is a no-regret move as, no matter how the future evolves, corporations will be run by managers, and those will have different incentives from those of corporations and, therefore, rules and its enforcement will be needed to mitigate this risk.

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20 HBS 493-070
21 Technically, a put on a portfolio is cheaper than a portfolio of puts (e.g. buying a put is equivalent to buy insurance).
Shareholder protection

Respect One-Share One-Vote Principle (big bet)
One of the basic shareholder rights is to allow investors to exercise one vote per share; otherwise voting rights and economic rights (e.g. cash flow rights) would not be equal. This principle is not very well-accepted in corporate Europe but at the same time, it is probably the most important demand that active institutional investors make. An alignment with this principle would show to non-majority investors, including the powerful institutional investors, that the corporation endeavors to maximize shareholder, that is, it does not plan to capture a higher percentage of economics rights than its voting rights. If other corporations do not adopt the same principle, minority investments will flow to corporations that apply this principle. It is not a matter that the corporation that respects this principle can achieve higher cash flows but that its equal treatment of shareholders will attract more investors. Some directors and senior managers could think that if they apply this principle they give up one anti-takeover device, and that in some situations, anti-takeover devices help to maximize shareholder value, and they are right. However, there are other anti-takeover devices that can be used instead to maximize shareholder value.

Gradually Increase Shareholder Voting Powers (real option)
Board of directors could consider increasing the voting power of shareholders. Some of the areas in which voting power could be increased are: equity-linked compensation (e.g. stock options, stock, restricted stock), director nomination, absentia voting, whether by direct vote or proxies, and anti-takeover devices. However, board of directors should only give voting power to shareholders if they consider that (1) their shareholders are acknowledgeable and that (2) the information they
release for the voting does not affect the competitive advantage of the firm. For instance, to propose an approval of an equity-linked compensation plan, shareholders should be able to understand quite sophisticated analysis of the costs of issuing stock options to non-diversified investors\(^\text{23}\): on the one hand, the opportunity cost for the firm when it issues stock options is their market value; however, the value of the stock options for a non-diversified manager is less given that bears firm-specific risk for which it is not compensated. On the other hand, the only way to align management and firm incentives is to impose firm-specific risk to managers. Studies show that the private value of stock options for a non-diversified investor is between 30% and 50% less than their market value, and therefore firms, and shareholders should be able to decide whether this loss compensates for the incentive alignment. Because of these issues, shareholder qualification and confidentiality, the increase in shareholder voting powers should be seen as an option: the firm should try to increase shareholder power and understand in which areas it works so that they can institutionalize these powers.

**Keep law spirit of fostering only efficient transfers of control (safety nets and no-regrets moves)**
National, and even European law, can regulate transfer of control in a relatively high efficient way, however, it could be nearly impossible to achieve a perfect efficient framework, that is why board of directors, sometimes, would have to go beyond regulation to achieve efficient transfers of control. The incentive for corporations to go beyond regulation is that transfers of control occur many times in the life of a corporation and in a repeated game, if a firm wants to attract minority investors (e.g. retail and institutional investors) it should consider their interests in any potential transfer of control, that is, even though laws could not perfectly foster efficient transfers of control, excellent corporations that consider their potential long-term investor base will put the mechanisms in place to provide an equal treatment to minority shareholders, otherwise, institutional investors could punish them. “The Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids” offers a detailed analysis of the proposed takeover level playing field for the European Union.

**Corporate disclosure**

**Disclose organizational structure and control systems (big bet)**
The objective of organizational disclosure and control is to communicate to markets that what the firm claims to have and do regarding its strategy and control systems are true. Given the current lack of trust on corporate governance systems, corporations do not have to focus only on the disclosure of their governance practices but also on their organizational and control systems. Corporations could provide information on how they are organized and which their control systems are. Some information that could be released is:
- **Organizational structure to perform:** purpose and design of the structure.
- **Performance measurement systems:** drivers to control for evaluating strategic profit performance, design of asset allocation systems, link of performance to financial markets and management of strategic risk.

Finally, it is important to balance the advantages earned on building a reputation and trust through disclosing information and the costs involved through releasing information that could reduce the competitive advantage of the firm.

The disclosure of organizational structure and control systems is a big bet because once the firm releases part of this information, markets will expect to receive this information looking forward, and what it is more important, markets will expect to receive sound arguments for changes in the organizational structure and performance systems.

**Gradually Disclose Compensation and its Process (real option)**

Many corporations agree that disclosing compensation in detail (e.g., individualized basis, for many executives) can imply revealing competitive advantages; even the disclosure of the structure and process of the compensation system can imply giving up too much information to competitors and markets. However, at the same time, financial markets, and regulators, exert pressures on corporations to increase their transparency on compensation and, sometimes, they impose a discount to firms that do not disclose enough information on their compensation structure. For this reason, because there is a risk of losing competitive advantage by releasing information on compensation, firms could provide partial information and analyze its competitors’ response.

Firms could provide the rationale for their compensation system. For instance, by showing that their compensation system tries to sufficiently overcome the main problems of any compensation system (controllability, alignment and interdependency), markets will understand that senior managers and directors have devoted enough time to design an efficient (from the shareholder point of view) compensation system. Moreover, they could go beyond that arguing against current methods of valuing stock-option compensation (e.g. Cisco), so-called Black-Scholes valuation, and propose or implement new methods developed in the academia. For instance, when designing the proportion of stock-option compensation, they should modify the Black-Scholes valuation given that managers are not usually diversified and bear also firm-specific risk, implying that every time a firm issues stock options loses a difference compared to the market value of the options.

**Ensure accuracy of liability disclosure (safety nets and no-regrets moves)**

Corporate law endeavors to ensure that disclosure of liabilities is accurate. However, even though law enforces sufficient accuracy, there could be ways by which senior managers and directors can overcome them. No matter what, if a corporation lies the financial markets, in a repeated game scenario, markets can lose trust and apply a premium just because of firm opacity and high asymmetric informational costs. If corporate law does not cover the disclosure of relevant specific liabilities, seniors managers and directors could use disclosures as a competitive tool to attract investors as it enhances the transparency of firm’s governance. Furthermore, these corporations would be well-positioned in the social area as they would exert pressure on the rest of companies to comply with the best practice.

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24 However, it does not mean that the firm loses all the value if it does not account for that. Academic studies show that even though firms do not account for stock options, financial markets incorporate the cost into market prices.
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He is coauthor, with several professors of the Department of Finance of the Universidad Comercial de Deusto, of the book *Financial Centers in a Global Economy*, one of the most quoted Spanish books for academic research in the last year, and of several articles including *The Irruption of the Internet as a Trading Platform*, article that won a prize by Harvard-Deusto Contabilidad y Finanzas, resulting in a chapter of the book *Stock Exchange and Investment* published by Ediciones Deusto. At MIT Sloan, he is a teaching assistant of Finance Theory and he has coauthored the forthcoming paper (published by MIT press) *Financial Management and Corporate Governance in Europe* led by MIT Finance Professor S. Myers. His email forwarding for life is jose.marco@sloan.mit.edu.