

CORPORATE GOVERNANCE IN THE WAKE OF THE FINANCIAL CRISIS

Selected international views

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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

Corporate Governance in the Wake of the Financial Crisis

Selected international views



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Note

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Key Messages

The topic of corporate governance has been on UNCTAD's agenda since its tenth quadrennial conference (in Bangkok in February 2000), where member States requested UNCTAD to promote improved practices in this area. In the wake of the financial crisis, UN member States have undertaken various actions to strengthen their regulatory frameworks in this area in order to promote economic stability and investor confidence. The impact of the global financial crisis on the world economy has served to underscore the interconnectedness of the health of large global enterprises and the livelihoods of ordinary people. To be sure, the causes of the crisis are complex and the remedies that have been proposed are multifaceted. Yet corporate governance features strongly. This compilation of perspectives on the corporate governance-related causes and remedies of the global financial crisis is intended to inform ongoing reform efforts and document the work of major organisations. A number of important insights may be distilled:

- a. Multilateral and national financial reform efforts have identified specific areas of corporate governance requiring reform at financial institutions. *In particular, reform efforts should focus on: a) strengthening board oversight of management; b) positioning risk management as a key board responsibility, and; c) encouraging remuneration practices that balance risk and long-term performance criteria.*
- b. Weak shareholder rights limit the ability of shareholders to hold boards to account, while fairness and transparency in financial markets inspire investor confidence and facilitate increased investment. *Regulators can improve the mechanisms through which shareholders are able to influence corporate governance, and also encourage shareholders to take a more active role in the governance of their portfolio companies.*
- c. Governance-related reform efforts that initially focused on financial institutions have fueled reform efforts targeted also at non-financial institutions. *Policy makers can use the momentum created by the financial crisis to address corporate governance problems that prevail more generally.*
- d. There has been a recent international convergence in thinking about corporate governance problems and remedies, which to a large extent has been driven by multilateral financial reform efforts, such as those of the G20. *International standard setting bodies can promote convergence by designing principles-based guidance that is globally applicable but can be implemented in particular national and regional contexts.*
- e. While the primary targets of governance related financial reform efforts are financial institutions in developed countries, there is the recognition that the governance principles being promoted are applicable to corporations operating in emerging markets. *In tailoring reforms for their own markets, policy makers in emerging markets should take into account certain factors, such as concentrated ownership, rights of minority shareholders, problems in enforcement regimes, and the important role of the state as owner.*
- f. Several national corporate governance reform efforts are, for the first time, using the language of 'sustainability' and 'stakeholder governance'. *There is a need to transform the concept of 'sustainability' into more concrete measures of corporate performance and embed sustainability into a new model of 'stakeholder governance'.*

Preface

The global financial crisis brought the international financial system to a grinding halt: the sudden withdrawal of global liquidity led to a catastrophic downturn in the global economy, which was only arrested by the swift and coordinated intervention of governments on a giant scale. The impact of the crisis has been colossal. UNCTAD's analysis of the causes of the global financial crisis points to regulatory weaknesses at the national and international levels, but also to poor corporate governance practices as implicated in the risk management standards prevailing in many large financial institutions. It is increasingly recognized that many of these governance weaknesses also apply to other companies. Consequently, on-going corporate governance reforms in many jurisdictions apply not only to the financial sector but to other companies in general.

These reforms are critically important because the global economy relies upon the stable functioning of large corporations. When governance mechanisms such as risk management do not work properly, the impacts can be felt around the world. In nearly all countries today ordinary people continue to experience the very real impact of the financial crisis. Unemployment, lost savings, and financial insecurity: these are the experiences of people who, up to now, had little or no say in how banks were governed, yet who suffer as a consequence of corporate governance failures. The link between corporate governance and a broader range of stakeholders has never been clearer.

The financial crisis has pushed to the top of the agenda a number of questions about key functions of corporate governance, particularly in the areas of risk management and executive compensation. The G20 has recognized that one of the causes of the financial crisis was the poorly designed executive compensation packages that lead to excessive risk taking. At their summit in Pittsburgh in 2009, leaders of the G20 called for stricter rules for risk-taking, improved corporate governance mechanisms that align compensation with long-term performance, and greater transparency in corporate governance.

The relationship between governance, sustainable business, and long-term strategic considerations has been on full display in the financial crisis. Today there is a renewed call for a more stakeholder-oriented ethic in the global corporate governance debate. Indeed, some countries have already employed these very concepts. In the case of Germany, for example, management and supervisory boards are now accountable, not just to shareholders, but to stakeholders. In South Africa, to take another example, 'stakeholder relationship governance' and sustainability reporting are now responsibilities of boards of directors.

This emerging focus on a broader range of stakeholders strengthens existing trends towards a more sustainable and development friendly approach to corporate governance and international investment. UNCTAD supports these efforts to build more transparent, responsible and sustainable markets.



Supachai Panitchpakdi
Secretary-General, UNCTAD

Geneva, October 2010

Foreword

The financial crisis did not rouse corporate governance from a state of torpidity. It has loosely been said that the financial crisis was the result of a governance failure. The principles of quality governance did not fail. The failure lay in the lack of application of mind to governance principles, particularly in regard to risk management.

One of the hallmarks of the great outside director is the ability to ask intellectually naïve questions to test risk or the quality of a recommendation from a sub-committee in regard to taking risk for reward.

For example, the following questions would have changed the risk profile of the securitised mortgage packages: Are the houses on which the bonds have been registered in former red-lined areas? Do the owners of the houses and consequently the mortgagor, always pay their mortgage payments on due date? Have house prices always continued to rise, year after year? What has the rate of collection been in regard to previous packages which have been bought by the bank? Are rating agencies always correct in their opinions? The answers to these questions would have brought to the highways of the minds of board members the true risk profile of these securitised packages which they were purchasing on behalf of their banks.

The lesson to be learned in the wake of the financial crisis is that companies do not operate in a vacuum. They operate in the milieu in which they carry on business. Our forefathers in the industrial revolution believed that mechanisation was the answer to everything. This resulted in business being conducted, for 150 years, on two false assumptions. Firstly, that there were limitless resources of natural capital and secondly, that planet earth had an infinite capacity to absorb waste. In consequence, companies, individuals and governments used natural resources faster than they could be regenerated and degradation from waste polluted land, air and water.

Parallel with the financial crisis has been the climate change crisis and the ecosystem/natural resource crisis. The crisis of our ecosystems and natural resources being used beyond nature's capacity to regenerate them will continue long after the financial crisis has come to an end. It is in this milieu that companies now have to conduct their businesses. It cannot be business as usual and companies have to learn to make more with less.

There is now an appreciation that non-financial matters contribute to financial performance and *vice versa*. There is a critical interdependency between financial capital, natural capital, human capital, social capital and manufactured/technology capital. For example, a beverage manufacturer today cannot plan long-term without strategically taking account of the scarcity of potable water.

Hence, the way we steer and manage our companies, the strategic direction in which boards steer the company and management implements those directions, have become inextricably linked with the sustainability issues pertinent to the business of the company. Major shareholders today are financial institutions, representing their ultimate beneficiaries, the people in the street. These institutions have to make responsible investments and in order to do so they need to make informed assessments of the economic value of a company as opposed to its book value. They can only do so if the company reports on the basis that there is a holistic and integrated representation of the company's performance in terms of

both its finance and its sustainability. Sustainability of a company means conducting operations in a manner that meets existing needs, without compromising the ability of future generations to meet their needs and has regard to the impacts that the business operations have on the life of the community in which it operates and includes environmental, social and governance issues.

Consequently, companies have to report on how their operations have both positively and negatively impacted on a community economically, socially and environmentally and how they intend to enhance the positive aspects and eradicate or ameliorate the negative aspects. The accounting profession is ready to help companies report in this manner and more importantly, help in giving assurance as to the veracity of these integrated reports.

The boards of companies today adopt the inclusive approach to governance in their decision making by taking account of the legitimate interests and expectations of the various stakeholder groups linked to the business of the company. Accountability by way of integrated reporting creates responsibility and boards are responsible for ensuring that companies are, and are seen to be, good corporate citizens. Stakeholders, particularly financial institutions acting on behalf of their ultimate beneficiaries, need this holistic information in order to make informed assessments of the sustainability of the business and to continue to have trust and confidence in the company. But the information needs to be independently assured by the professional that is skilled to do so, namely the auditor. Stakeholders are a company's ultimate compliance officers, but they can only ensure that a company is operating in a sustainable manner on information which is furnished by the company and assured.

The time has come for constituent bodies such as IFAC and UNCTAD to collaborate with others such as the GRI and the OECD, to build an international integrated reporting model and in time, standards. It has taken 100 years to build some consistency in financial reporting. We do not have that time to build standards for integrated reporting. Meanwhile, legal paradigms should be created by the G20, so that entities within their jurisdiction are compelled to report or explain how their operations have impacted on a community economically, socially and environmentally. At the same time, they should give courts the power, by way of statutory enforcement, to apportion blame when there is a corporate failure. Experience has taught all of us that when there is a corporate failure, it can never be attributed to just one of the stakeholders, for example, the external auditors. It usually is a combination of the failure of directors to properly apply good governance principles; managers to implement the directions of the board in good faith in the interests of the company and not for any self-interest; internal auditors failing to plan on a risk-centric basis and to ensure the adequacy and effectiveness of controls which are aligned to the long-term strategic direction of the company; and even sometimes factors beyond the control of directors or managers, such as the financial crisis.

The positive outcome from the financial crisis is an appreciation that governance, strategy and sustainability have become inseparable. There is also general agreement amongst corporate leaders that conformance must not be a weapon of mass distraction, as the ultimate social and economic responsibility is to ensure performance by the company.

Furthermore, there is an appreciation that the legitimate interests and expectations of all stakeholders must be considered in decision-making and that sustainability issues pertinent to the business of the company have to be integrated into the strategy and the operation of the business.

Finally, there is the appreciation that it is quality governance and not quantity that is important. The foundation of that is intellectual honesty. The application of mind in the best interests of that incapacitated juristic person – the company.

A handwritten signature in blue ink that reads "Mervyn King". The signature is written in a cursive, flowing style.

Professor Mervyn E. King SC

Chairman, King Committee on
Corporate Governance, South Africa

Johannesburg, October 2010

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Abbreviations

AGM	Annual General Meeting
APRA	Australian Prudential Regulation Authority
ARRA	American Recovery and Reinvestment Act 2009
BIS	Bank for International Settlements
CCGG	Canadian Coalition for Good Governance
CDO	Collateralized Debt Obligations
CEBS	Committee of European Banking Supervisors
CEIOPS	European Insurance and Occupational Pensions Supervisors
CEO	Chief Executive Office
CESR	Committee of European Securities Regulators
CGCF	Global Corporate Governance Forum
CRA	Credit Rating Agency
CRO	Chief Risk Officer
ECGF	European Corporate Governance Forum
ECOFIN	Economic and Financial Affairs Council
ESFS	European System of Financial Supervisors
ESRB	European Systemic Risk Board
EU	European Union
FASB	Financial Accounting Standards Board
FEE	Fédération des Experts Comptables Européens
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSB	Financial Stability Board
FSF	Financial Stability Forum
G20	Group of 20 Nations
G8	Group of 8 Nations
GRI	Global Reporting Initiative
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
ICGN	International Corporate Governance Network
IFAC	International Federation of Accountants
IFC	International Finance Corporation
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standards
IIF	Institute of International Finance
ILO	International Labour Organization
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
ISAR	International Standards of Accounting and Reporting
MENA	Middle East and North Africa
NED	Non-Executive Director
NYSE	New York Stock Exchange
OECD	Organization for Economic Co-operation and Development
PRI	Principles for Responsible Investment
QSPE	Qualified Special Purpose Entities
RMBS	Residential Mortgage Backed Securities
SEC	United States Securities and Exchange Commission
SIV	Structured Investment Vehicle
SME	Small and Medium Enterprises
SOX	Sarbanes Oxley Act 2002
SPE	Special Purpose Entity
TARP	Troubled Assets Relief Program

Overview

The financial crisis began with the collapse of the United States subprime mortgage market in 2007 as housing prices continued to decline (after mid-2006) and default rates rose. By late 2008 the crisis had spread globally to institutions overexposed to the risks inherent in investment products that had packaged United States subprime mortgages (mortgage-backed securities).

There were some high-profile bank failures early in 2008, notably the nationalisation of Northern Rock in the United Kingdom in February 2008 and the distress sale of Bear Stearns to JP Morgan in the United States in March 2008. However, the severity of the crisis only really became apparent in September 2008, when the United States government took over Freddie Mac, Fannie Mae and AIG, and Lehman Brothers filed for bankruptcy protection. This was followed by a series of government bailouts or government engineered emergency acquisitions of a number of large financial institutions (Washington Mutual, Wachovia, Citigroup, Merrill Lynch and others). Around this time the global reach of the crisis was also becoming apparent as a number of European financial institutions (Bradford & Bingley, Dexia, Fortis, Hypo Real Estate, UBS, RBS and HBOS) were either bailed out or nationalised and the entire banking system of Iceland collapsed.

Following a number of high-profile industry analyses (reviewed in Chapters 1 and 2), inadequate risk management and inappropriate pay practices in the financial industry, in the context of regulatory failure, are being placed squarely at the centre of the financial crisis. Pay-setting and risk management take place in the context of a set of corporate governance practices and structures. The view expressed by Grant Kirkpatrick of the Organisation for Economic Co-operation and Development (OECD) in Chapter 2 that “the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements” is therefore shared by a number of key policy makers and is reflected in both national and multilateral financial regulatory reform efforts.

This compilation of perspectives from various experts on the corporate governance-related causes and remedies of the global financial crisis is intended to inform ongoing reform efforts and to document the work of some major international organisations in their respective fields of endeavour. Chapter 1, prepared by the UNCTAD Secretariat, reviews early analyses of the causes of the financial crisis and identifies the corporate governance issues considered to be implicated in the development of troubles at large financial institutions. The Chapter goes on to explore how these are addressed by various multilateral and national financial regulatory reform efforts that have since been initiated. First reviewing the various financial regulation reform efforts more generally, the authors then identify and describe the components of these reform efforts that focus on corporate governance. The chapter then develops the argument that corporate governance reform efforts aimed at financial institutions are no less applicable to, and indeed, have informed subsequent reform efforts focused on, non-financial corporate institutions. Various international corporate governance reform efforts are reviewed and direct and indirect links to responses to the financial crisis are identified in them. For instance, the International Corporate Governance Network (ICGN), the Organisation for Economic Co-operation and Development (OECD) and other organisations whose experts have contributed chapters to this publication have been prompted to review and, where necessary, update their own guidance on corporate governance in the light of governance failures highlighted in the financial crisis.

The financial crisis, through its impact on the global economy, has had a real impact on the livelihoods of people around the world. Chapter 1 closes by reviewing how the link between corporate governance and sustainability is now being articulated more concretely, giving impetus to a stakeholder-oriented model of corporate governance. This theme is returned to in the final chapter of the publication which documents the concrete efforts being made by the international accounting community to operationalise a stakeholder approach to corporate governance.

In Chapter 2 Grant Kirkpatrick of the OECD reviews the macro- and micro-economic conditions that prevailed immediately prior to the onset of the 2007/2008 financial crisis. The Chapter goes on to identify weaknesses in corporate governance arrangements at financial institutions explored in parliamentary enquiries, company investigations and national and international regulatory reports. Singling out risk management and incentive structures as two key governance factors implicated in the financial crisis, it explores these more fully in the context of the board's oversight responsibilities. Over-exposure to liquidity risk, inadequate stress-testing and scenario analysis, a failure on the part of large financial institutions to observe the intent of regulations to which they were subject, and the poor transmission of risk-related information up to board level are all identified as key weaknesses in the area of risk management. Incentive structures that failed to incorporate longer term, firm-wide performance measures and that made inadequate use of risk metrics are considered to have encouraged excessive risk taking by key decision-makers at large financial institutions. In the case of both risk management and incentive structures, the analysis presented in Chapter 2 singles out board-level oversight as a key weakness in allowing these conditions to prevail. The chapter closes by considering how the inadequacy and misuse of credit ratings and crucial gaps in accounting standards further exacerbated financial problems by allowing, and even encouraging, the misuse of a number of new and poorly regulated financial instruments.

Financial regulatory reform efforts are influencing corporate governance reform at large corporations more generally as it becomes recognised that weaknesses in risk management, board oversight and executive remuneration are not exclusive to financial institutions. In Chapter 3 Laura Ard and Alex Berg of the World Bank argue that governance issues that have been raised by the financial crisis are not only "developed country" issues. World Bank work on corporate governance has identified some of the same issues across the spectrum of developed and developing countries. Notable improvements in codes of best practice and financial and non-financial disclosures have been accomplished in emerging countries, yet weaknesses in the areas of risk governance, remuneration, board professionalism and shareholder rights and engagement are no less applicable to emerging markets than they are to large companies and financial institutions in developed markets. In fact, these may be compounded by conditions more specific to emerging markets such as concentrated ownership, conflicts of interest between managers and shareholders, and high levels of state ownership of the financial sector. Ard and Berg argue that attention to regulatory detail and improving board capacity are key areas in which improvements can be made.

In Chapter 4 Jane Diplock of the International Organization of Securities Commissions (IOSCO), describes how IOSCO's infrastructure for cross-border enforcement and the exchange of information amongst members of the international community of securities regulators positioned it for a key role in the post-crisis regulatory reform effort. This infrastructure has been articulated through its Multilateral Memorandum of

Understanding (MMOU), which it hopes will achieve the endorsement of all of its 109 members during 2010, and the through the strategic direction that it adopted in 2005, described as ‘global ideas implemented nationally’. This chapter describes contributions that IOSCO has made in this respect through the G20’s Financial Stability Board (FSB). In this forum IOSCO works closely with other national and international standard setters and prudential regulators to promote international convergence in areas it considers crucial to financial market stability, primarily the unregulated boundaries of financial markets, elsewhere referred to as the ‘shadow banking system’. Following on from IOSCO’s initial review of the sub-prime crisis, IOSCO has advanced proposals for addressing systematic risk through a series of recommendations for reigning in the unregulated financial products, market practices and entities that obscured the actual health and functioning of financial system in the years leading up to the financial crisis. It has also developed a set of ‘Principles for periodic disclosure by listed entities’ as key to investor protection and the promotion of financial market transparency, complementing efforts by the IASB and others addressing post-crisis accounting issues.

In Chapter 5, Carl Rosen of the International Corporate Governance Network (ICGN) recognises among the governance weaknesses that have been implicated in the financial crisis many of the issues that the ICGN had been highlighting prior to the onset of crisis, namely: the need for more competent and accountable boards; transparent and fair markets; independent accounting standards with sufficient narrative comment on risk; remuneration that avoids encouraging excessive risk-taking; and regulation of credit rating agencies. However, one of the ICGN’s leading concerns is the exercise of the rights and responsibilities of shareholders, particularly large institutional shareholders. Chapter 5 initially points out that the failure by institutional shareholders to hold boards of financial institutions to account, and perhaps even the implicit encouragement of short-term returns, at least exacerbated the financial crisis in the context of macroeconomic and regulatory failures. Rosen argues that multilateral reform efforts need therefore to consider how to equip shareholders with the means to exercise their rights through, for instance, a vote on how company executives are remunerated (‘say on pay’), improving the mechanics of cross-border voting, protections against dilution, and addressing share structures that obscure the link between ownership and control. In conjunction to this, reform efforts need to identify strategies for encouraging shareholders to exercise these rights. On the latter point, he identifies the *ICGN Statement of Principles on Institutional Shareholder Responsibilities* (2007) and the United Kingdom Financial Reporting Council’s recently finalized *Stewardship Code for Institutional Investors* as providing models for the type of regulatory reform that he believes will motivate institutional investors to engage with their portfolio companies on governance issues to a greater extent.

In Chapter 6 Stephen Davis, Jon Lukomnik and David Pitt-Watson of the Global Corporate Governance Forum open by expressing concern that the regulatory response to the financial crisis may fail to engender resilience in the financial system if it does not attend to “market discipline,” in its fullest sense. Constraining regulation alone, they argue, will not develop the inherent trustworthiness of the financial system. Rather, the correct mix of constraining regulation and self-regulation, given certain properties of the system itself, should be the focus of reform efforts, with the ultimate objective of making markets more accountable. Their interpretation of the events leading up to the financial crisis employs principles of social psychology: diffusion of responsibility for the risks inherent in sub-prime mortgages through their being repackaged and sold on; and the bystander effect which paralyzed the financial market as the risk models on which banks had based their

business started to appear faulty. They characterize the regulatory system that had prevailed up to the onset of the financial crisis as ‘horizontal regulation’, where a regulator has responsibility only for one type of institution. The model that they consider to be better suited to achieving ‘accountable capitalism’ they characterize as ‘vertical regulation’, where regulators and rules instead are geared towards mediating the interactions among institutions through relationships of accountability and responsibility. They offer a number of concrete regulatory measures that they argue would enhance the functioning of the market, thereby reducing the need for prescriptive regulation, many of which are components of existing regulatory reform effectors, such as advisory votes on executive remuneration, bonus ‘clawbacks’, improved disclosures around conflicts of interest by various market intermediaries, improving the quality of credit ratings, and others. They also review various market-based solutions to the problem of regulating relationships between market participants to promote responsibility and accountability. Since markets are interconnected globally, they support the co-ordination of regulatory reform through the Financial Stability Board (FSB) and encourage the local adoption of international principles endorsed by the FSB.

The theme of stakeholder governance is returned to in Chapter 7. Ian Ball of IFAC, describes three insightful studies in which IFAC explored developments and weaknesses in global corporate governance practices. Interestingly, even prior to the full onset of the financial crisis, the first two of their studies, involving interviews with investors, preparers, company management and directors, auditors, standard setters, and regulators from various international jurisdictions, had already identified some of the areas of concern that have since become the cornerstones of financial regulatory reforms in the area of corporate governance at large financial institutions. These include remuneration practices that fail to engender long-term sustainable corporate performance, narrowly focused risk and control systems, an overly compliance-based approach to governance, and a failure to incorporate sustainability and ethics in governance practices. Drawing on in-depth interviews with global thought leaders in financial regulation, corporate governance and accounting, IFAC has developed a framework for embedding stakeholder governance, sustainability and a performance approach to corporate leadership into corporate disclosure practices and governance models. This framework is articulated in Chapter 7 through a review of IFAC’s core guidance documents and key collaborative efforts through which it promotes its agenda. Echoing a theme raised in earlier chapters, one of IFAC’s central drivers is the need to integrate ‘conformance’ activities (involving compliance with applicable laws, regulations and guidance documents) and ‘performance’ (risk, strategy, value-creation and decision-making) into a unified corporate governance framework. Performance is defined more broadly as incorporating ‘social, environmental and economic organizational performance’. IFAC views the financial crisis as having provided the momentum for the promotion of this governance model. This chapter conveys an optimistic and constructive outlook, with ethics and values featuring strongly as principles for guiding global financial regulatory reform.

CHAPTER 1

Review of Regulatory Developments in the Wake of the Financial Crisis

UNCTAD Secretariat

A. Introduction

Since the onset of the financial crisis, the global debate around corporate governance and disclosure has escalated dramatically. This review highlights the connections between the broader wave of reform following the onset of the financial crisis and recent reforms focused on corporate governance and disclosure. Corporate governance failures are being reviewed at every level of regulation of the global financial market, spurring governance changes not only for financial institutions, but also for other public companies. A large number of jurisdictions have initiated sweeping reviews of corporate governance codes and regulation alongside reviews of systems of financial supervision. Regulators' appetite for stronger governance standards and a stronger shareholder voice in corporate governance in key markets has driven important developments, particularly in the area of executive remuneration and risk management, but also in the area of shareholder rights, quality of board oversight and quality of corporate governance disclosures.

A significant increase in government efforts to address corporate governance weaknesses has bolstered certain shareholder campaigns in the United States. These campaigns include: 'say-on-pay'; proxy access; elimination of broker voting in director elections; majority vote in director elections; clawback of bonuses earned under erroneous or fraudulent earnings statements; restricting golden parachutes; compensation committee independence and independent board chairperson. Some of these issues have been taken up by other jurisdictions in efforts to respond to perceived governance weaknesses. They will be referred to throughout this report, with additional explanations provided in Appendix I.

The review concludes that, while differences remain in governance practices around the world, there is nevertheless a global recognition of the importance of key governance principles, namely, strong board oversight, appropriate remuneration practices tied to performance as well as risk, and transparency. There is also an emerging focus on a broader range of stakeholders rather than only shareholders. This may strengthen existing trends towards the integration of environmental and social reporting within corporate governance reporting.

B. Background on the financial crisis

Reviews of causes of the financial crisis identify both macro- and micro-economic factors. Expansionary monetary policy with falling interest rates caused asset price booms, particularly in the U.S. housing sector. This was accompanied with a rapid expansion of

lending and a corresponding decline in underwriting standards and increase in risk, fuelled in part by the unregulated growth of the so-called ‘shadow banking system’. This side of the financial system developed between 2000 and 2008 and consists of institutions and legal entities that provide financial intermediation without taking deposits. As such, they are not subject to the same regulatory oversight as institutions that do take deposits. These institutions used short-term credit to invest heavily in subprime mortgage-backed securities, which became increasingly risky as housing prices began to fall in the US after mid-2006. In the absence of regulatory oversight, the risk inherent in these assets were not adequately rated, yet had become increasingly dispersed throughout the global financial system. Being highly leveraged and holding what became known as ‘toxic assets’, large financial institutions in the shadow banking system began to fail as default rates began to rise. Global credit markets contracted with the decline in confidence: the record high interest rates that banks used to lend to each other almost halted inter-bank lending. This caused a global liquidity crisis and a subsequent decline in world trade triggering, through various feedback loops, a recession which has impacted real economies globally.

Early in 2008, in a letter to the Chairman of the Financial Stability Forum (FSF),¹ a group of senior national financial supervisors (representing France, Germany, Switzerland, the United Kingdom and the United States) reviewed a survey of some of the largest banking and securities firms in their jurisdictions and highlighted factors that separated large institutions that, up to then, had suffered the worst losses from those that had thus far weathered the ‘recent market turbulence’. These factors included risk identification, measurement, analysis and reporting, as well as valuation practices and liquidity, credit and market risk management. “Firms that avoided such problems demonstrated a comprehensive approach to viewing firm-wide exposures and risk, sharing quantitative and qualitative information more effectively across the firm and engaging in more effective dialogue across the management team” (Senior Supervisors Group, 2008).

This analysis preceded the full onset of the global financial crisis, yet subsequent analyses² confirm that excessive risk-taking by large financial institutions was a key cause of the financial crisis. Critically, this practice of excessive risk-taking was found to be linked to the failure of board oversight at financial institutions and, more specifically, to the way in which those responsible for risk-related decisions were incentivised.

C. Reform of financial supervision

The causes of and responses to the financial crisis are being viewed by a number of member States and international organisations in terms of the global system of financial supervision.³ International policy response following the full onset of the crisis in

¹ The Financial Stability Forum was founded in 1999 by Finance Ministers and Central Bank Governors of the G7 countries. It has since evolved into the Financial Stability Board, with membership extending to all G20 countries. See <http://www.financialstabilityboard.org>

² See, for instance de Larosière, Jacques, et al.: *Report of the High-Level Group on Financial Supervision in the EU*, 25 February 2009. http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf; HM Treasury: *United Kingdom White paper on Reforming financial markets*, 8 July 2009. http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf and OECD: *Governance Lessons from the Financial Crisis*, February 2009, <http://www.oecd.org/dataoecd/32/1/42229620.pdf>

³ For UNCTAD’s view on the crisis, please see the publication *The Global Economic Crisis: Systemic Failures and Multilateral Remedies*, 2009, (E.09.II.D.4).

September 2008 has been swift, sweeping and multilateral, aimed both at financial stabilization and creating early warning mechanisms to identify and monitor systemic sources of risk in the future. Resulting regulatory reforms have implications for corporate governance and disclosure.

1. Group of 20 and creation of the FSB

International efforts to address the financial crisis were initiated with the convening of the first G20 meeting in Washington D.C. on 15 November 2008. The product of this meeting was an ‘Action Plan’ setting out ‘high priority actions to be completed prior to March 31, 2009’: “In consultation with other economies and existing bodies, drawing upon the recommendations of such eminent independent experts as they may appoint, we request our Finance Ministers to formulate additional recommendations” (Group of 20, 2008). These recommendations focus on identifying sources of systematic risk in financial systems, integrating financial supervision across markets, developing the capacity to respond to crisis and “reviewing compensation practices as they relate to incentives for risk-taking and innovation”.

A progress report on the implementation of the ‘Washington Action Plan’, presented at the London Summit of the G20 on 2 April 2009, sets out in detail the 47 Actions comprising the Plan, as well as progress that had been made up to the Summit on each Action and the next steps in implementing the Action Plan. Under Action Plan item number 25, which deals with incentive structures and compensation schemes at financial institutions, it is noted that the Financial Stability Forum (FSF) had “published Principles for Sound Compensation Practices for financial institutions to prevent incentives towards excessive risk-taking that may arise from compensation schemes” (FSF, 2009b). These principles are discussed further in Section D.2.a. More generally, the London Summit led to commitments to pursue an agenda of international cooperation on standard setting, including in the area of compensation practices at financial institutions. Also at the London Summit, the G20 agreed to expand the scope of the FSF and transform it into the Financial Stability Board (FSB) with a strengthened mandate to pursue the G20’s agenda in safeguarding global financial stability (Group of 20, 2009).

The attention on achieving global financial stability through regulatory reform following the financial crisis has cemented the role of the G20 as the permanent council for international economic cooperation, taking over from the G8 in this respect. This expanded role, announced at the Pittsburgh summit of the G20 on 25 September 2009, ensures that developing economies such as Brazil, China and India will be part of deliberations on matters impacting global economic stability (such as tax havens, oil price speculation, the role of the IMF and financial regulatory reform) (Davis, *et al.*, 2009). Also at the Pittsburgh Summit the FSB Charter took effect, formalising its mandate within the G20 with respect to “the diagnosis of regulatory, supervisory and financial policy changes needed to maintain financial stability” (see Draghi, 2005). It has a membership of regulatory authorities, central banks and finance ministries from 24 jurisdictions as well as heads of important international standard setting bodies.

One of the notable features of the design of financial services regulatory reform in some of the largest markets (Europe and North America are reviewed below) is strengthening cooperation between existing regulatory bodies. A review of reform proposals in key jurisdictions shows that this is to be achieved in part through the creation

of new structures to facilitate coordination amongst existing bodies in the execution of oversight and the identification of sources of instability in the financial system.

2. Financial supervision reform in North America and Europe

On 17 June 2009 the Department of the Treasury of the United States issued a white paper on financial regulatory reform in the United States entitled ‘Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation’ (United States Department of the Treasury, 2009). This paper sets out proposed reforms for the United States system of financial supervision and regulation, thereby laying a foundation for regulatory developments that have taken place subsequently. Reforms are based on five key goals:

- a. promote robust supervision and regulation of financial firms;
- b. establish comprehensive supervision and regulation of financial markets;
- c. protect consumers and investors from financial abuse;
- d. improve tools for managing financial crises; and
- e. raise international regulatory standards and improve international cooperation, consisting of recommendations which follow from United States commitment to the G20 process.

The proposals attached to each goal entail new standards of transparency and accountability, new authorities for the Federal Reserve and the establishment of three new oversight bodies, including:

- a. A Financial Services Oversight Council, whose function it would be to “identify emerging systemic risks and improve interagency cooperation” (which is similar in function to the European Systemic Risk Board, discussed below).
- b. A Consumer Financial Protection Agency, tasked with protecting consumers in credit, savings, and payments markets.
- c. A National Bank Supervisor, with responsibility for federally chartered depository institutions.

The thrust of these reforms would be to integrate oversight of the various sectors of the financial services industry, where fragmented oversight is named as one of the causes of the behaviours that led to the financial crisis. The report proposes international reforms that would complement reforms focused on the United States’ financial services industry, including: “strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools” (United States Department of The Treasury, 2009, p. 4.).

By November of 2009 a number of legislative initiatives had been presented to Congress, and were under consideration by either the Senate or the House of Representatives, variously implementing the proposals contained in the Treasury’s White Paper. These include, among others, The Shareholder Bill of Rights introduced in May 2009 by Sens. Charles Schumer (D-N.Y.) and Maria Cantwell (D-Wash.); the *Shareholder Empowerment Act of 2009*, introduced in June 2009 by Rep. Gary Peters (D-Mich.); the *Corporate and Financial Institution Compensation Fairness Act of 2009*, introduced in July 2009 by Rep. Barney Frank (D-Mass.); and The *Restoring American Financial Stability Act of 2009*, introduced in draft form by Senator Christopher Dodd (D-Conn.) on 10 November 2009 (Moats, et al., 2009). Comprehensive financial regulatory reform, including executive compensation, investor protection and hedge fund and credit rating

provisions, was approved by the US House of Representatives in passing the *Wall Street Reform and Consumer Protection Act of 2009* on 11 December 2009, sponsored by House Financial Services Committee Chairman Barney Frank (D-MA) (Paletta and Sidel, 2009). A similar bill, introduced by Senate Banking Committee Chairman Christopher Dodd, was passed by the Senate Banking Committee in late March 2010 (Paletta, 2010) and was passed by a vote of the full Senate on 20 May 2010. Following deliberations between the two houses, final legislation on financial services regulatory reform, entitled “Dodd-Frank Wall Street Reform and Consumer Protection Act”, was enacted on 21 July 2010.

During the financial crisis large financial institutions were provided financial assistance by the US government because it was feared that their failure could precipitate a collapse of the whole financial system. This set up a moral hazard problem which is generally referred to as ‘too big to fail’. Much of the debate around the financial reform agenda in the United States, as embodied by the House and Senate Bills, has revolved around the question of how to reign in institutions that are considered to be too big to fail. One side of the debate advocates better regulation of banking activities, in particular ‘shadow banking’.⁴ The other side of the debate advocates restrictions on the size of banking institutions.⁵ The final set of provisions contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act that address the ‘too big to fail’ dilemma comprise a mixed strategy of prohibitions on, or disincentives for, engaging in riskier activities (such as the ‘Volcker Rule’), improving capital and liquidity standards and setting limits on the size of financial institutions. Extending financial regulation to include nonbank financial companies is seen as an important step in limiting systemic risk in the financial system. In addition there are provisions that enhance the regulatory framework for the resolution of failing financial institutions that are considered systemically significant.⁶

European financial supervision reform was initiated in October 2008. A high Level Expert Group on EU Financial Supervision was set up under the chairmanship of Jacques de Larosière and mandated by European Commission President José Manuel Barroso to investigate how to create a more efficient and integrated system of financial supervision for Europe: “The Group will make recommendations to the Commission on strengthening European supervisory arrangements covering all financial sectors, with the objective of establishing a more efficient, integrated and sustainable European system of supervision and also of reinforcing cooperation between European supervisors and their international counterparts” (European Commission, 2008).

The report produced by the de Larosière group was presented to the Commission on 25 February 2009 (High Level Group on Financial Supervision in the EU, 2009). Following a period of consultation, on 27 May 2009 the European Commission adopted a Communication on Financial Supervision in Europe based on the recommendations of the de Larosière report which sets out the framework for a system of pan-European

⁴ See Section B for a brief description of the contribution of the shadow banking system to the financial crisis

⁵ See, for instance, Krugman, P., ‘Financial reform 101’, *New York Times*, 1 April 2010 for an articulation of the two sides of the ‘too big to fail’ reform debate: <http://www.nytimes.com/2010/04/02/opinion/02krugman.html>

⁶ A more detailed discussion of the provisions of the Senate Bill that address the ‘too big to fail’ dilemma is contained in the Standard & Poor’s report: *Proposed Financial Regulatory Bill Suggests Constraints On Potential Extraordinary Support For U.S. Banks*, 22 March 2010, http://www2.standardandpoors.com/spf/pdf/fixedincome/Financial_Regulatory.pdf. The Act is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf

supervision of the financial services market.⁷ The proposed reforms entail two key elements:

- European Systemic Risk Board (ESRB), to be headed up by the European Central Bank, which would assess threats to financial stability, issue warnings and monitor their application (similar in function to the US proposal for a Financial Services Oversight Council, discussed above), and
- European System of Financial Supervisors (ESFS), comprised of three existing authorities with oversight responsibility for different parts of the financial system, known as the ‘Lamfalussy level 3 Committees’, or ‘3L3 Committees’. These include the Committee of European Securities Regulators (CESR), the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Under this plan the ESFS would have a strengthened mandate for upgrading the quality and consistency of national financial supervision and providing oversight of cross-border groups (European Commission, 2009a).

This plan received the endorsement of the European Council on 19 June 2009, paving the way for its implementation in 2010. Interim stages that have been achieved on the road to the implementation of the European Commission’s reform plan include: adoption by the European Commission on 23 September 2009 of specific proposals for the creation of the ESRB and the ESFS; agreement by the Economic and Financial Affairs Council (ECOFIN) on the substance of these proposals at its October 2009 meeting; and the reaching of a general approach by the European Council on the new ESRB and ESFS structures on 2 December 2009 (European Central Bank, 2009). A final vote on the EU’s new financial supervisory structure was being debated in the European Parliament as of January 2010.

In the United Kingdom, sweeping assessments and proposals for reforming the financial system were initiated by the government. In October 2008, the Financial Services Authority (FSA)⁸, at the request of the Chancellor of the Exchequer, initiated the Turner Review of the Banking Industry led by Lord Turner, Chairman of the FSA. The Turner Review constitutes “a wide-ranging review of global banking regulation”. The United Kingdom’s approach to financial supervisory reform has been decidedly global. The country held chairmanship of the G20 in 2009 and recognises that group as the primary vehicle through which to promote changes to the global framework of financial regulation and supervision. The United Kingdom also supports the findings of the de Larosiere report which informs the development of a European-wide system of financial supervision and, early on in the process, acknowledged that “[a] key part of the new global framework [of financial regulation and supervision] will be agreed at EU level” (HM Treasury, 2009d, p. 8). The Government’s white paper on financial regulatory reform, released on 8 July 2009, represents a review of United Kingdom financial regulation and supervision and presents the government’s response to the proposals put forward in the Turner Review.

⁷ See: http://ec.europa.eu/internal_market/finances/committees/index_en.htm

⁸ The FSA is an independent body, accountable to the Treasury. The FSA regulates the financial services industry in the United Kingdom. See: <http://www.fsa.gov.uk>

Two of the key proposals put forward in the white paper including strengthening the powers of the FSA and the creation of a new Council for Financial Stability (CFS) had been taken up in the Financial Services Bill, which was introduced into Parliament on 19 November 2009. The Financial Services Act, which passed into law in April 2010, dropped the second of these proposals and assigns the task of the stability of the UK financial system to the FSA.

The new legislation assigns new powers to the FSA to nullify employment contracts in the banking industry that are deemed to encourage excessive risk-taking; it can ban individuals and firms from operating in certain markets as a disciplinary measure in cases of misconduct; and it can request information from non-regulated firms such as hedge funds and investment funds and individuals or firms that provide services to anyone regulated by the FSA (HM Treasury, 2009c).⁹

D. Governance reform targeted at financial institutions

1. Governance failures implicated in the financial crisis

One of the six areas that finance ministers of the G20 countries were tasked with at the Washington D.C. summit is reviewing private sector compensation practices related to incentives for risk-taking and innovation. The objective of this area of review is to direct member states to develop regulatory structures that encourage internal incentive structures within financial institutions that promote financial stability across the financial system, and to avoid incentive structures that encourage short-term returns or excessive risk-taking (United States White House, 2008).

Inadequate risk management and inappropriate pay practices in the financial industry are being placed squarely at the centre of the financial crisis. Pay-setting and risk management takes place in the context of a set of corporate governance practices and structures. Hence, the view of the OECD that “the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements” (Kirkpatrick, 2009, p. 2) is shared by a number of key policy makers:

Financial Stability Forum: “Compensation schemes in financial institutions encouraged disproportionate risk-taking with insufficient regard to longer-term risks. This risk-taking was not always subject to adequate checks and balances in firms’ risk management systems.” (FSF, 2008, p. 12)

United Kingdom Financial Services Authority: “There is now a consensus amongst both regulators and industry practitioners that inappropriate remuneration practices contributed to significant losses at major firms and therefore to the severity and duration of the current market turmoil” (FSA, 2009a, p. 9).

Committee of European Banking Supervisors: “The recent market turbulence has, amongst other things, highlighted the risks inherent in institutions having inadequate

⁹ The full text of the UK Financial Services Act 2010 is available at:
http://www.opsi.gov.uk/acts/acts2010/pdf/ukpga_20100028_en.pdf

remuneration policies and structures. The absence of a coherent and adequate remuneration policy generates potential risks for a financial institution that need to be adequately analysed and contained” (CEBS, 2009, p. 1)

United States Department of the Treasury: “This financial crisis had many significant causes, but executive compensation practices were a contributing factor. Incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage” (Geithner, 2009).

Following the ‘acute phase’ of the financial crisis around September 2008 and the subsequent emergence of a strong international consensus about the role of pay practices in creating counter-productive incentives and excessive risk-taking, a number of jurisdictions responded rapidly by putting in place restrictions on executive compensation at financial institutions that were being rescued by government-sponsored bail-out plans. A Wall Street Journal article from 21 October 2008 notes that “At least six countries now have curbed pay, or are poised to do so” and lists Germany, Sweden and the United States as amongst these (Lublin and Esterl, 2008). The various plans for reform of systems of financial supervision that have evolved since the initial restrictions associated with bail-out plans place special emphasis on reforming remuneration practices at large financial institutions.

Government-led commissions of inquiry into the causes of the financial crisis have since been launched in a number of jurisdictions, beginning with the United Kingdom, in November 2008, and more recently, in January 2010, the Netherlands, Ireland, and the United States. Each of these reserves space for consideration of corporate governance and pay practices implicated in the financial crisis. They also call upon heads of large banks to give information or testimony. The outcome of the United Kingdom’s inquiry provides a scathing overview of the governance failures implicated in the financial crisis (House of Commons Treasury Committee, 2009).

In fact, Britain introduced a one-off tax of 50 per cent on 2009 bonuses of over £25,000 paid to executives at all UK banks, including subsidiaries of foreign banks, whether or not they received government funds during the financial crisis. In December 2009, France followed suit, imposing a 50 per cent tax on bonuses over €27,000. A proposal for a fee on bonuses paid to executives of US banks that were recipients of funds issued under the government’s Troubled Assets Relief Program (TARP) was issued by the Obama Administration in January 2010 (Landon, 2009). These measures may be viewed as an exasperated attempt to curb ongoing pay practices at large banking institutions.

2. Strengthening of corporate governance in financial institutions

a. International responses

In an effort to restore confidence early on in the ‘market turmoil’, the Institute of International Finance (IIF), a global association of financial institutions, established a Committee on Market Best Practices in October 2007 with the mandate of developing “practical ways to address market weaknesses and rebuild confidence via actionable best practice recommendations based on core principles”. An interim report was prepared in April 2008 (IIF, 2008b) and the final report was issued in July 2008 (IIF, 2008a). Recommendations are presented in six sections, one of which is devoted to compensation

policies. Seven principles of conduct for compensation policies are articulated and together emphasise linking incentive compensation with risk-adjusted performance metrics that reflect the risk appetite and risk time-horizons of the firm. The principles also call for strong, independent oversight and measurement of compensation metrics and transparency in the compensation setting process (see pp. 49-51 of the report). The seven principles are:

- a. Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital.
- b. Compensation incentives should not induce risk-taking in excess of the firm's risk appetite.
- c. Payout of compensation incentives should be based on risk-adjusted and cost of capital-adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit.
- d. Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organization as a whole.
- e. Incentive compensation should have a component reflecting the firm's overall results and achievements of risk-management and other general goals.
- f. Severance pay should take into account realized performance for shareholders over time.
- g. The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

This self-regulatory response from the financial industry came too late, however, and the full impact of the financial crisis was felt shortly after the IIF published its industry guidance. The need for reform of systems of financial supervision was announced in November 2008 at the Washington G20 summit in the Action Plan and the London Summit of the G20 on 2 April 2009 endorsed the 'Principles for Sound Compensation Practices' set out by the Financial Stability Forum. Nine principles are organised around three themes and are addressed to national regulators. The three themes are:

- a. Effective governance of compensation, emphasising the role of the board in designing and monitoring effective compensation systems, with a special role for independent input from risk management specialists within the institution.
- b. Effective alignment of compensation with prudent risk-taking, where a combination of cash, equity and other forms of compensation payout should be linked to all types of risk outcomes and risk time horizons.
- c. Effective regulatory supervisory oversight of compensation practices at firms, facilitated by clear, comprehensive and timely disclosures to stakeholders, including supervisors of the financial system (FSF, 2009a).

These principles have been followed by a set of Implementation Standards (FSB, 2009a), released by the FSB on 25 September 2009 at the G20 Pittsburgh Summit, which provide more specific guidance on compensation governance, structure and disclosure consistent with the Principles. Among the 19 Implementation Standards organised into five categories, the FSB notes that areas requiring particular focus early on are:

- a. "independent and effective board oversight of compensation policies and practices;

- b. linkages of the total variable compensation pool to the overall performance of the firm and the need to maintain a sound capital base;
- c. compensation structure and risk alignment, including deferral, vesting and clawback arrangements;
- d. limitations on guaranteed bonuses;
- e. enhanced public disclosure and transparency of compensation; and
- f. enhanced supervisory oversight of compensation, including corrective measures if necessary” (FSB, 2009b).

The Implementation Standards were endorsed by G20 leaders at the Pittsburgh Summit and apply to any employee with the power to have a significant impact on the balance sheet of a bank. A more general impact of the implementation standards with respect to governance rulemaking in national jurisdictions is to bring compensation into national regulation.

Corporate governance rules applicable to internationally active banks are also being reviewed at the level of the Group of Ten (G10) by the Basel Committee on Banking Supervision. Created by the G10 central bank governors in 1974, the Basel Committee on Banking Supervision provides a forum for regular cooperation among the central bank governors of 27 member states on matters of banking supervision (Basel Committee on Banking Supervision, 2009a). In an effort to respond to weaknesses in the regulation and supervision of internationally active banks as revealed through the global financial crisis, in November 2008 the Basel Committee on Banking Supervision initiated a consultation process to enhance the Basel II Framework. The Basel II Framework is a set of recommendations for banking laws and regulations on risk and capital management that regulators can incorporate in their respective jurisdictions. The Framework consists of three Pillars. Proposed enhancements were announced in January 2009 (Basel Committee on Banking Supervision, 2009c) and finalized in July 2009 (Basel Committee on Banking Supervision, 2009b). Two areas of enhancements to Pillar 2 (the ‘supervisory review process’) focus on firm-level governance issues. Under ‘firm-wide risk oversight’ clear expectations for boards and senior management with respect to risk assessment and risk control are set out. Under ‘sound compensation practices’ the Framework endorses the FSF’s ‘Principles for Sound Compensation Practices’. Reciprocally, in a communiqué ahead of the Pittsburgh Summit the G20 endorsed the “consistent and coordinated implementation of international standards, including Basel II” (G20, 2009a).

At the EU level, in late 2008 the CEBS formed a task force to develop principles for sound remuneration on behalf of all three European 3L3 committees (CEBS, CEIOPS and CESR). Following a consultation period, the final draft of these principles was released on 20 April 2009 (Committee of European Banking Supervisors, 2009), with implementation by European financial institutions required by the close of Q3 2009. The principles are addressed both to banks and to regulating authorities within the EU. The areas of remuneration policy that these principles focus on are:

- a. alignment of company and individual objectives;
- b. transparency towards internal and external stakeholders;
- c. governance with respect to oversight and decision-making;
- d. performance measurement; and
- e. form, or structure, of remuneration.

On 29 April 2009 the European Commission announced that it will issue two draft laws on executive compensation, which will take the form of recommendations for member states to incorporate into national laws.¹⁰ One law relates to financial institutions (European Commission 2009b) and the other relates to all listed companies (European Commission, 2009c) (for discussion of the latter see section 5.2. below).

Rules relating to financial institutions are organized according to five themes:¹¹

- a. structure of remuneration policy;
- b. performance measurement;
- c. governance of the pay-setting process and internal oversight over pay awards;
- d. enhanced disclosures of the pay-setting process and remuneration policy, including details of performance criteria; and
- e. regulatory oversight.

Following a consultation period from April to May 2009, in June 2009 the European Commission released proposals for updating the Capital Requirements Directive (CRD), which will apply to all EU credit institutions and investment firms.¹² The proposed revisions will give effect to the CEBS's principles on sound remuneration policies as well as the Commission's recommendations on remuneration policies in the financial services sector:

“The more detailed principles set out in the Commission Recommendation, along with the CEBS guidelines, will be relevant to compliance with the obligation under the CRD. They should provide further guidance as to how the obligation might be met, and a framework for regulators when assessing firms' remuneration structures.” (p. 9)

The proposal imposes sanctions, including as a last resort, stricter capital requirements ('capital add-ons') on institutions that fail to measure up to the specified standards. Remuneration standards would apply to “staff whose activities have material impact on the risk profile of the financial institution”.¹³

b. National responses

In the United States, specific rules restricting compensation and governing the compensation setting process apply to executives and certain other employees of institutions that have received financial assistance under the Government's Troubled Assets Relief Program (TARP) or may receive such assistance in the future. The Interim

¹⁰ See: European Commission: New Initiatives in Response to the Financial Crisis – Recommendations, 29 April 2009. http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm

¹¹ The United States' counterpart to these five themes are the provisions aimed at financial institutions participating in the United States government's Troubled Assets Relief Program discussed below.

¹² See: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm and Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies: http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf

¹³ See: Capital Requirements Directive - Frequently Asked Questions. <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/335&format=HTML&aged=0&language=EN&guiLanguage=en>

Final Rule on TARP Standards for Compensation and Corporate Governance, announced by the Treasury on 10 June 2009 and published in the Federal Register on 15 June 2009 implement executive compensation rules enacted under the American Recovery and Reinvestment Act (ARRA) of 2009. The Interim Final Rule sets out specifics for establishing compensation committee independence, conducting risk assessments of compensation plans, developing ‘clawback’ policies, restricting golden parachute payments and payments of bonuses, retention awards, and other incentive compensation. The Interim Final Rule requires that a narrative disclosure of each compensation plan be provided to shareholders in proxy materials at least once a year with reference to how the plan discourages unnecessary risk-taking and earnings manipulation. It also sets out additional disclosure requirements around compensation consultants and perquisites. By way of implementing the requirement that TARP companies permit shareholders an advisory vote on executive compensation, the Interim Final Rule directs TARP recipient companies to comply with any rules or guidance on ‘say-on-pay’ promulgated by the SEC (Shearman & Sterling, LLP, 2009; Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, 2009). The SEC’s guidance in this respect was forthcoming on 1 July 2009 (and is discussed further in section F.7 below) (United States Securities and Exchange Commission, 2009a).

On 17 July 2009 Rep. Barney Frank, chairman of the House Financial Services Committee released a discussion draft of legislation, entitled the “Corporate and Financial Institution Compensation Fairness Act of 2009”¹⁴ that incorporated the Treasury’s recommendations on an advisory vote and compensation committee independence (see section V.F for more discussion of Treasury’s announcement). This bill was passed by the United States House of Representatives on 31 July 2009 and was then incorporated into the *Wall Street Reform and Consumer Protection Act of 2009*, which was passed by the House of Representatives on 11 December 2009. It required annual ‘say on pay’ votes at all United States companies as well as specific disclosures of (and separate investor votes on) ‘golden parachute’ payments. It also imposed stricter independence standards on compensation committees and new disclosures on compensation consultants’ independence. These two sets of requirements would be encoded and enforced by the SEC. Further, the Bill required enhanced reporting of compensation structures by financial institutions with more than \$1 billion in assets, requiring institutions to disclose the structure of executives’ compensation packages in sufficient detail to allow the applicable regulator to evaluate how well the package links pay to performance, accounts for time horizon of risks, is aligned with sound risk management and does not promote undue risk-taking or foster perverse incentives. The fourth main requirement of the legislation was that the Government Accountability Office (GAO) conduct a study of the connection between executive compensation structure and excessive risk-taking (Carleen and Ross, 2009).

Financial regulatory reform proposals, called ‘*Restoring American Financial Stability Act of 2010*’, were passed by the Senate Banking Committee on 22 March 2010 and by the Senate on 20 May 2010. The final combined legislation, entitled “Dodd-Frank Wall Street Reform and Consumer Protection Act”, was cleared by the House on June 30,

¹⁴ See: “A BILL To amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation and to prevent perverse incentives in the compensation practices of financial institutions”, (2009). 111TH CONGRESS, 1ST SESSION, 17 June. Available at http://www.house.gov/apps/list/press/financialsvcs_dem/comp_001_xml.pdf

2010 and by the Senate on July 15, 2010 and was signed into law by President Barack Obama on July 21, 2010. It contains most, but not all, of the key governance provisions discussed in this Chapter as components of earlier bills. These include rules directed specifically at certain bank and non-bank financial institutions, including strengthened oversight by federal regulators of compensation practices at financial institutions and the establishment of risk committees. They also include rules applicable to all public companies, including the authorization of the SEC to grant shareholders access to companies' proxy materials to nominate directors, the requirement for an annual 'say on pay' vote at US public companies and the introduction of stricter independence standards for directors serving on compensation committees. It also includes provisions for 'clawback' of bonuses, but drops the requirement that directors be elected under a 'majority vote' system (as opposed to a 'plurality vote'). The corporate governance-related measures set out in the new legislation reflect some of the key campaigns that corporate governance advocates in the United States have been advancing in recent years (see Appendix 1.1 for more detail of these campaigns and section F.7 for a more detailed overview of the corporate governance and compensation provisions of the new legislation).

In the United Kingdom, the report of the 'Turner Review of Banking Regulation' was published on 18 March 2009. One of the 28 recommendations put forward in the report is that: "Remuneration policies should be designed to avoid incentives for undue risk-taking; risk management considerations should be closely integrated into remuneration decisions. This should be achieved through the development and enforcement of United Kingdom and global codes" (FSA, 2009c).

This makes clear the message that a key component of the United Kingdom's financial supervision reform is corporate governance reform, as communicated in a report by HM Treasury to the Parliament in July 2009: "It is also clear that there must be major changes to the way that bank boards function. Improved risk management at board level, changes to the balance of skills, experience and independence, and a better approach to audit, risk and remuneration are required. Institutional shareholders need to be more actively engaged in monitoring the board of the bank in which they have invested." (HM Treasury, 2009e, p. 7)

Following a consultation period on the Turner Review, implementation of the final recommendations is planned for November 2009. In the mean time, the government has responded to the initial recommendations regarding remuneration indicating that it is pursuing international action on remuneration policies through the G20 and the FSB, and will require the FSA to produce an annual assessment of compliance with its new remuneration code across the banking industry: "The FSA will present to the first meeting of the new Council for Financial Stability (CFS) on its new Code, and remuneration practices by firms, and will provide an annual report on remuneration practices and the risks they pose to financial stability" (HM Treasury, 2009e, p. 71).

On 18 March 2009 the FSA published the second draft of a remuneration code first published on 26 February 2009, which sets out remuneration principles that would apply to certain financial firms regulated by the FSA and that would be incorporated into the FSA's Handbook.¹⁵ "The Remuneration Code covers all aspects of remuneration that

¹⁵ Rules set out in the FSA's Handbook are legally binding on covered financial institutions.

could have a bearing on effective risk management including wages, bonus, long term-incentive plans, options, hiring bonuses, severance packages and pension arrangements” (FSA, 2009d, p. 2). A consultation paper on how the Remuneration Code would be incorporated into the FSA’s Handbook and to which FSA-regulated institutions it should be applied was published likewise on 18 March 2009 by the FSA (FSA, 2009b). This paper also reports on the findings of a review of remuneration practices at United Kingdom-incorporated banks and building societies conducted between November 2008 and January 2009. The consultation period on the implementation of the remuneration code ran to 18 May 2009 with the final Code – the ‘Remuneration Code of Practice’ - published on 12 August 2009 and brought into force on 1 January 2010 (FSA, 2009a). Linking the Remuneration Code with general governance practices, the report on the consultation process leading to the final version of the Code notes that recommendations are consistent with the recommendations of the Walker Review of Banking Governance.

In light of the corporate governance failures that contributed to the financial crisis, in February 2009 the Chancellor of the Exchequer, the Secretary of State for Business, Enterprise and Regulatory Reform and the Financial Services Secretary to the Treasury initiated a review of corporate governance practices at banks in the United Kingdom. With close links to a review process considering updates to the Combined Code on Corporate Governance, the Walker Review has implications for corporate governance practices at financial institutions as well as at other public companies in the United Kingdom and is discussed further in section F.6 below.

Similarly, in Australia, the Government has undertaken a review of governance standards applying to regulated financial institutions, referencing the FSB’s *Principles of Sound Compensation Practices*. On 28 May 2009 the Australian Prudential Regulation Authority (APRA), the regulator of the Australia’s financial services industry, released draft extensions to existing governance standards (APRA, 2009b). This document notes that: “APRA’s governance standards set out the minimum requirements that a regulated institution must satisfy in the interests of promoting strong and effective governance. Remuneration is a key aspect of any governance framework and needs to be properly considered in order to mitigate the risks that may arise from poorly designed remuneration arrangements.” APRA’s existing practice guide covers:

- a. Board Remuneration Committee - setting out the responsibilities of the committee in relation to remuneration policy setting, review and documentation, as well as expertise and experience required of the committee; and
- b. Remuneration Policy - identifying which personnel the remuneration policy covers, how to adjust remuneration for risk, criteria for performance measurement and consideration of equity related components of pay, signing on and termination payments, perquisites and fringe benefits, and prohibiting an executive or director from hedging their equity exposure in the regulated institution (APRA, 2009c).

APRA’s discussion paper issued on 28 May 2009 (ARPA, 2009d) notes extensions to this guidance, including:

- a. Board Remuneration Committee of regulated institutions should consist only of independent directors, and

- b. Specific measures that would ensure that remuneration is aligned with prudent risk-taking, taking into account all types of risk, risk time horizons and risk outcomes.

APRA's final revisions were announced on 30 November 2009 and came into effect on 1 April 2010, by which time regulated institutions are required to have established a Board Remuneration Committee, with appropriate composition and charter (or terms of reference) and will have a written Remuneration Policy that complies with the new governance standards (APRA, 2009a).

Expert Comment 1.1 **Recriminations, Reviews and Reflections**

**Vanessa Jones, Head of Corporate Governance,
Institute for Chartered Accountants in England and Wales (ICAEW)**

Corporate governance and its perceived shortcomings came under severe scrutiny in 2009. It was a year of recriminations, reviews and reflections on governance with many reviews initiated as governments sought (and still seek) to find ways to improve regulation and the governance of companies.

Here are what I consider to have been the key governance issues arising out of the events in 2008 and 2009.

Role of institutional shareholders

Institutional investors have come under the spotlight to a considerable degree with criticism that they have not exercised their ownership duties diligently during the credit crisis. As part of the review in the United Kingdom (UK) by Sir David Walker the remit of the Financial Reporting Council (FRC) looks likely to be extended to cover the development and encouragement of adherence to principles of best practice in stewardship (a Stewardship Code) by institutional investors and fund managers. This will be a welcome development but whether it will lead to real change remains to be seen. Can a voluntary code bring about the changes in behaviours that are needed? Many believe that it can. It will be interesting to follow the progress of the Stewardship Code in the UK: there is much to gain if a Stewardship Code can positively influence behaviours.

Risk

Risk management procedures designed for boom times may not be suitable for recessionary periods and vice versa: differing economic conditions require different management responses. It has become clear that in some institutions risk oversight has become technical and fragmented: managed more on a product or a division basis and not on an enterprise basis. As a consequence in some organisations risk management had little effect on board decisions. Risk managers were often separated from management and strategy. This needs to change and new ways of thinking about risk at board level needs to be developed.

It is important to understand that there is a conceptual difference between internal control, which is historical in outlook, and risk management which is forward looking. The skills required to cover both are very different and this may be one reason to have separate audit and risk committees. There is no right or wrong model and it has to be for each company to decide how best, given its unique circumstances, to handle board delegation in these critical areas.

Role of the non-executive director (NED)

The role of the NED in ensuring good corporate governance came under sharp focus during 2009. Certain areas require further review:

- Understanding corporate culture: Understanding the culture within a company is critical for NEDs as executive directors will operate with a host of unspoken assumptions: the culture within a company will impact the company's risk profile. It is important that NEDs endeavour to understand the cultural context of each company that they are associated with.
- Challenging data sources: NEDs are increasingly being asked to cope with independent data sources in areas such as risk management and compensation. There is a growing market expectation that NEDs will question whether existing board information sources are sufficiently varied and objective. This may lead to changes in how NEDs work and what support they need.
- Inspiring investor confidence: Investors and analysts see NEDs as a critical control mechanism. Investors are more than ever looking for increased and better quality of communication with boards and are expecting to see more proactive, broader and more meaningful communication with companies. Investors will increasingly look to NEDs to influence the whole board to communicate and address emerging concerns as well as to act as an important filter to check communications prior to market disclosure.

Remuneration

Executive remuneration is always contentious but is particularly so in periods when a company's performance weakens in line with market conditions. This area of governance came under scrutiny from various quarters:

- In the UK the Treasury Select Committee inquiry into City pay and remuneration practices made uncomfortable viewing, and produced a damning report on existing practices.^a
- The European Union's European Commission proceeded to set out a number of significant changes regarding the detailed structure and determination of directors' pay.^b
- In the United States proposed legislation now includes the provision for shareholders to have a 'say on pay'.^c

Even though there has been much focus on remuneration more needs to be done. There needs to be fresh and innovative thinking to look at ways market participants seek to incentivise boards, managers and each other to act in the interests of those that they are meant to serve. There are some fundamental areas that need to be reviewed:

- Why are certain types of incentives failing?
- What new mechanisms are needed to link pay to value creation?
- How can pay and human capital be properly governed (incorporating considerations relating to the capabilities of people, the internal governance of company structures,

and ensuring that appropriate remuneration incentives are in place to support those structures)?

These fundamental areas of review call into question the effectiveness of pay structures and incentives. Systems that either “reward failure” or that “fail to reward” can be equally as damaging in human capital terms.

We need to be ambitious for corporate governance but at the same time remain realistic about what might be achieved by corporate governance. Corporate governance, after all, remains about dealing with people and any system will reflect their strengths and weaknesses.

^a House of Commons Treasury Committee: Banking Crisis: Reforming Corporate Governance and Pay in the City, Ninth Report of Session 2008–09, 12 May 2009.

<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf>

^b See: Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies:

http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf

^c See, for instance, the ‘Wall Street Reform and Consumer Protection Act of 2009’, approved by the U.S. House of Representatives on 11 December 2009, <http://www.opencongress.org/bill/111-h4173/show>, and United States Securities and Exchange Commission (SEC): Proxy Disclosure Enhancements, <http://www.sec.gov/rules/final/2010/34-61335.pdf>

E. Multilateral guidance and rule-making on corporate governance and disclosure

This section reviews new rules and guidance on corporate governance and disclosure emerging from multilateral processes. The corporate governance standards of international bodies are evolving rapidly as a result of the financial crisis. While the initial focus was on the governance failures in financial institutions, standards applicable to all public companies have evolved alongside standards specifically aimed at the financial services industry as it has become recognised that “[t]he general policy needs are similar for financial and non-financial companies” (OECD, 2009, p. 12).

Standard setting has been focused on several inter-related issues including: executive pay and its link to performance and long-term risk; disclosure and transparency in the area of executive pay; board oversight capacity and independence of the compensation setting process; risk management and its integration into corporate governance and corporate strategy at the board-level; greater shareholder engagement and stronger shareholder rights.

1. Organisation for Economic Cooperation and Development

As part of the OECD’s ‘Strategic Response to the Financial Crisis’ the OECD Steering Group on Corporate Governance undertook to “understand the market situation that confronted financial institutions” in its first report, ‘Governance Lessons from the Financial Crisis’ (Kirkpatrick, 2009). The report links the financial crisis to “failures and weaknesses in corporate governance arrangements” and recommends a re-examination of the adequacy of the OECD’s corporate governance principles in key areas, namely, qualified board oversight, risk management, remuneration of boards and senior

management and the exercise of shareholder rights. In each of these areas it highlights important weaknesses in firm (or board) level governance that apply generally, not only to financial institutions. The report identifies gaps in disclosure and accounting standards, in particular, the need for generally accepted risk management accounting principles and readable risk disclosures. It also identifies the fair valuation of assets and the misuse of off-balance sheet entities as problem areas in disclosure. Further weaknesses in governance systems that the report considers are the quality of analysis of complex investment vehicles by credit ratings agencies and how ratings were used and the need for stronger supervision and enforcement in member jurisdictions.

After a period of consultation involving a stakeholder meeting in Paris on 18 March 2009, followed by an online public consultation ending on 30 April 2009, a second report, issued in June 2009 (OECD, 2009), examines in more depth the four key issues identified in the first report as areas of governance failure. It goes on to consider implementation of the OECD principles as a way of addressing governance shortcomings, with general application to all public companies, and with particular reference to financial institutions. The report concludes that there is no immediate need to overhaul its Principles of Corporate Governance, although it recognises the need for better guidance and stronger efforts at implementation (OECD, 2004). One of the report's recommendations on remuneration practices is that "[f]inancial institutions are advised to follow the Principles for Sound Compensation Practices issued by the Financial Stability Forum...that can be seen as further elaboration of the OECD Principles" (OECD, 2009, p. 8).

2. European Commission

On 23 March 2009 the European Corporate Governance Forum (ECGF), which is an advisory body of the European Commission, published its new Executive Pay Code containing recommendations for best practice in executive remuneration for EU member states following the financial crisis (ECGF, 2009). The Forum calls for improvements in three areas: the disclosure of directors' remuneration; the process whereby remuneration is set (including the role of remuneration consultants); and the substance of directors' remuneration. The ECGF recommends incorporating the proposals into national governance codes of EU member States and implementing a legally binding directive to require companies to disclose pay policies and individual directors' pay. Across Europe, disclosure of individual directors' pay has, up until now, been inconsistent. Companies in many European states provide only aggregated pay numbers, making it impossible to judge how each director or manager has been remunerated. Disclosure of pay policies and of individual directors' pay would go a long way to making pay practices more transparent across Europe.

Along with recommendations on the remuneration of executives of financial institutions (referred to in section D.2.a), in April 2009 the European Commission also published recommended rules applicable to all listed companies of EU member States (European Commission, 2009c). Four recommendations on the structure of directors' remuneration focus on severance pay, achieving a balance between fixed and variable pay and linking pay to performance. A further four recommendations focus on the process of pay setting, including the role of the remuneration committee, new disclosures on directors' remuneration, a prohibition on the use of stock options and the role of institutional investors in voting on directors' remuneration. The recommendations of the

European Commission are non-binding on EU member States, but member States are invited to have implemented the recommendations by 31 December 2009, and an EU-wide ‘scorecard’ of how member states fare against the recommendations is to be kept. Key features include:¹⁶

- a. no severance pay in cases of failure;
- b. a balance between fixed pay and bonuses, with clear and measurable targets;
- c. a pay claw-back if financial information has been misstated;
- d. tougher remuneration committees; and
- e. greater shareholder influence over pay decisions.

Expert Comment 1.2

Providing Assurance on Corporate Governance Statements

Federation of European Accountants (FEE)

The financial crisis has demonstrated that robust, transparent governance practices need to be embedded in all organisations, along with a re-evaluation of remuneration structures; board level expertise and training; and risk management. This needs to go beyond respecting and complying with relevant corporate governance codes. Corporate governance statements, providing increased transparency for investors and other stakeholders, have gained in importance in the aftermath of the crisis. Assurance by independent qualified accountants enhances the credibility of information. The FEE Discussion Paper on the Auditor’s Role Regarding Providing Assurance on Corporate Governance Statements^a discusses how and to what extent assurance can be provided on corporate governance statements. The survey was conducted in 2007, prior to the onset of the financial crisis, yet the recommendations and conclusions in the Discussion Paper remain extremely relevant in the current economic climate.

FEE Discussion Paper for Auditor’s Role Regarding Providing Assurance on Corporate Governance Statements

Background

In recent years, many countries have introduced mandatory requirements and voluntary codes of corporate governance. In some countries developments have been limited to implementation of the most recent requirements of European law which require listed companies to disclose certain information around their governance practices and to have an audit committee. In other countries governance requirements have gone considerably further, often based on, or exceeding, the principles of the OECD Principles of Corporate Governance.

Sound corporate governance is particularly important in financial reporting as it is a key factor in ensuring confidence in capital markets through the provision of financial and other information of the highest quality.

Good corporate governance highlights the importance of non-executive directors, the audit committee function and their structures and relationships with the board(s). It also focuses on internal controls, internal audit, external audit and disclosures about

¹⁶ The United States counterpart to these are the ‘Principles’ announced by United States Treasury Secretary on June 10, 2009 (see section F.7).

corporate governance. In particular, it considers the fundamental relationships and obligations between boards, auditors and shareholders. The external auditor can add value by reporting on his independent assessment of whether certain aspects of the corporate governance statement comply with defined reporting standards.

Such measures will undoubtedly strengthen the corporate governance practices within individual companies. The disclosures of these practices is certainly a key element as it allows investors, stakeholders and others to form their own view as to the way a company is governed. Again, some countries have implemented the requirements of European law, and others have gone further.

The final step in this process is the involvement by an independent and suitably qualified practitioner, whether the statutory auditor or another practitioner, to perform work on these governance disclosures. European law lays down certain things that the statutory auditor must do; some countries have required auditors to do more, and in other countries the auditor or others are engaged voluntarily by a company to do more work.

Key conclusions

1) Elements of corporate governance and corporate governance statements

During the period from 2007-2008, FEE carried out a survey of their Member Bodies asking questions about corporate governance in their countries. Responses to these questions indicated that, despite the range of legal systems, institutional frameworks and traditions, there is considerable convergence across Europe in the elements of national corporate governance codes. Most of these codes are closely related to the OECD's Principles of Corporate Governance – either by making explicit reference, or by incorporating the principles within the national code, supplemented by local rules and guidance.

Countries have also implemented key requirements of European law including:

- The requirements of the amended Fourth and Seventh directives which require disclosures of certain corporate governance practices in a mandatory corporate governance statement to be produced by each listed company;
- The requirements of the Statutory Audit Directive for public interest companies to have an audit committee;
- The requirements of the Shareholder Rights Directive which, unsurprisingly, deals with the exercise of rights by shareholders.

These three pieces of legislation interact – the audit committee has a role to play in monitoring and oversight of certain governance practices; the company then has to disclose these practices; this provides shareholders with information on governance which will inform the decisions they take when exercising their rights.

Additional disclosures, over and above the minimum requirements of European law as stipulated above, are common. Typically these might include information on remuneration, more detail on the operation of the board and its committees, and further detail on risk management and internal control.

2) Auditor involvement in corporate governance statements

The involvement of a suitably qualified independent auditor (whether the auditor appointed to audit the company's financial statements or another independent and suitably qualified practitioner) can increase the degree of confidence of users of corporate governance information. There is a range of practice across Europe:

- The EU directives require certain matters to be considered including the consistency of certain corporate governance information with the financial statements and whether certain other corporate governance information has been produced or included in a statement;
- Some countries have gone further and require mandatory reporting by the statutory auditor regarding other governance practices. This reporting is sometimes of factual findings, and sometimes is an assurance engagement. An assurance engagement requires the expression of an opinion by a practitioner about the outcome of the evaluation or measurement of a subject matter against suitable criteria. An assurance engagement may be a reasonable assurance engagement, resulting in a positive form of conclusion (i.e. "In our opinion... is so.") or a limited assurance engagement resulting in a negative form of conclusion (i.e. "Based on our work, we are not aware of anything that suggests that ... is not so.").

FEE also considered the potential for increased involvement by auditors with corporate governance information, considering the range of subject matters which the FEE survey of governance reporting identified as being common across Europe. We concluded that there was not one "right answer" as to the desirable level of involvement by an auditor. Some information may be suitable only for factual verification because it is subjective in nature – auditors can check underlying facts regarding remuneration of directors but will not be able to form an opinion as to whether a company's remuneration policy will lead to the directors achieving the company's stated strategy. Other information may be the subject of an assurance engagement, but the level of cost and benefit varies significantly. For example, providing assurance regarding a description of internal control may be relatively low cost, whereas forming an opinion as to its effectiveness is significantly higher. FEE's view as to the potential maximum level of auditor involvement in key areas of corporate governance is also included.

FEE has also developed some examples of what corporate governance reporting by auditors might look like. Further details can be obtained from the publication on FEE's website: www.fee.be.

FEE has contributed its views and experience to the debate on the crisis and the ways to mitigate its effects and to speed-up recovery through a special series of policy statements addressing the crisis from different perspectives. Six papers have been issued between December 2008 and January 2010, one presenting background information and analysis on the crisis, a second paper on the matters of specific relevance for statutory auditors during the financial crisis (and the 2008 year-end closing), a third paper containing views of specific relevance to Small and Medium-sized Entities,^b a fourth paper on dynamic provisioning,^c a fifth paper on the financial crisis and sustainability^d and a sixth paper on issues that may require specific attention in the 2009 year-end reporting.^e

^a Federation of European Accountants (FEE): “Discussion Paper for Auditor's Role Regarding Providing Assurance on Corporate Governance Statements”, November 2009.

^b http://www.fee.be/publications/default.asp?library_ref=4&content_ref=943

^c http://www.fee.be/publications/default.asp?library_ref=4&content_ref=992

^d http://www.fee.be/publications/default.asp?library_ref=4&content_ref=1081

^e http://www.fee.be/publications/default.asp?library_ref=4&content_ref=1196

3. Group of 8

Addressing the challenge of integrating financial supervision at the global level, at a summit held in Lecce, Italy, on 13 June 2009, finance ministers from G8 countries (namely, Canada, France, Germany, Italy, Japan, the Russian Federation, the United Kingdom, and the United States) committed to developing a global framework for regulation of financial institutions worldwide. The framework would consist of a set of standards to address “a number of fundamental weaknesses in the global economy related to propriety, integrity and transparency” highlighted by the financial crisis. This is being referred to as the ‘Lecce Framework’ and is intended constitute a set of “common principles and standards governing the conduct of international business and finance” (G8, 2009). Represented in this call for a new set of international standards are a number of international organizations at least two of which have themselves issued recommendations in the area of corporate governance, including the OECD and the FSB. The statement also commits the G8 effort to integrating with efforts of ‘broader fora’ including the G20. At the time of writing this report, no news of the development of the standards had been published.

4. International Organization of Securities Commissions

On 3 July 2009 the Technical Committee of the IOSCO published for public comment a consultation document containing a proposed set of ‘Principles for Periodic Disclosure by Listed Entities (IOSCO, 2009a). The public consultation period ended on 31 August 2009. These high-level principles set out what issues should be considered by securities regulators in developing or reviewing their periodic disclosure requirements for public listed companies. The principles call attention to measures for assuring the relevance and timeliness of periodic reports and ensuring public access to reports, as well as to the quality of information contained within the reports. A key recommendation is that reports contain a description of certain corporate governance practices by the issuer. Further, the recommendations call for a description of the internal controls over financial reporting by the issuer as well as the identification of persons responsible for financial reports. The principles also call for filing of reports with the relevant regulator. This consultation document does not make reference to the financial crisis. The proposed principles are seen as a complement to IOSCO’s existing disclosure principles and these are discussed more fully in Chapter 4 (IOSCO, 2009b).

5. International Corporate Governance Network

The ICGN, a global membership organisation primarily composed of institutional investors “with a mission to raise standards of corporate governance worldwide”, has not undertaken a formal review of its various corporate governance best practice guidelines in

response to the financial crisis. However, it did issue a statement on corporate governance and the financial crisis in December 2008, following its Annual conference in Seoul, Republic of Korea and in advance of the G20 Washington D.C. Summit. According to this statement, two areas in which it believes the most change is required is a global regulatory response (much of which has evolved subsequent to the ICGN's announcement and is outlined in this report) as well as greater shareholder empowerment and the exercise of ownership rights by institutional shareholders. In its statement, the ICGN commits to actively engage in policy debate in the areas of strengthening shareholder rights, strengthening boards, promoting fair and transparent markets, promoting clearer accounting standards on fair value and off balance sheet business, promoting remuneration arrangements more closely linked to risk management and with claw-back provisions, and promoting healthy competition in the credit ratings industry (ICGN, 2008). The ICGN subsequently issued a second statement on 23 March 2009 in which it reiterates its emphasis on the need for change in the area of regulation and shareholder empowerment and its commitment to the six core policy areas identified in its earlier statement (ICGN, 2009).

F. National rule-making on corporate governance and disclosure

This section reviews national initiatives focused on the reform of corporate governance and disclosure practices.

1. Australia

On 18 March 2009 the Australian Government announced that it had tasked the Productivity Commission to undertake a review of the regulatory framework under the Corporations Act 2001 that applies to executive and director remuneration practices in Australia. To elaborate on the terms of reference, the Commission released an issues paper on 7 April 2009 and a consultation period ensued up to 29 May 2009 (Australian Government Productivity Commission, 2009b).

As in other jurisdictions undertaking similar executive pay reviews, the context for the Australian review is the global financial crisis and the perceived centrality of pay practices. The review also considered provisions of the Act relating to other governance practices including shareholder voting as well as disclosure and reporting practices. Referencing the work being done by the G20, the FSB and the governments of the United Kingdom and United States in response to the global financial crisis, the terms of the review extended to an examination of “the international trends and responses to the problems of excessive risk-taking and corporate greed”.¹⁷ As with reviews in the United Kingdom and United States, the range of practices constituting the “framework for the oversight, accountability and transparency of director and executive remuneration practices in Australia” extend to include more general aspects of corporate governance including shareholder rights, disclosure practices and independence of pay consultants.

¹⁷ See: The Hon Wayne Swan MP, Treasurer of the Commonwealth of Australia: Productivity Commission and Allan Fels to Examine Executive Remuneration, 18 March 2009. <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/025.htm&pageID=003&min=wms&Year=&DocType>

The terms of the review also called attention to specific aspects of equity-based pay and incentive schemes and to the role of shareholders. In particular, the question of whether the non-binding vote on boards' remuneration reports should be 'strengthened'.

The terms of reference for the Productivity Commission's review acknowledged the work already being undertaken by the Australian Prudential Regulation Authority (APRA) in relation to executive pay in financial institutions (reviewed in section C.2.b.).

Draft recommendations of the Productivity Commission were released in September 2009, and final recommendations were released on 19 December 2009. In its final report, the Commission recommended exploring options to open up boards to new, more diverse membership; improving the independent functioning of remuneration committees; a fuller disclosure of compensation performance hurdles and a 'plain English' approach to compensation reporting. While initially considering various kinds of pay caps on executives' remuneration, the final recommendation argues against setting formal pay caps. Likewise, in considering options for strengthening shareholder engagement, the Commission recommended against the use of a binding vote on the remuneration report, providing evidence of the effectiveness of the non-binding vote and offering a method of strengthening a 'no' vote of 25% or more on a non-binding resolution on the remuneration report. The commission offered concrete recommendations for changes to the Australian Corporations Act 2001 and the ASX listing rules aimed at improving boards' effectiveness and credibility. These include expanding remuneration-related disclosures including disclosure of any pay advisors used; requiring disclosure by institutional investors on how they have voted on remuneration-related matters; measures for improving board and remuneration committee structure and the independence and qualification of members; restrictions on executive management hedging equity remuneration that remains unvested or subject a holding lock; restrictions on executive management from voting their proxies on remuneration-related issues; and a requirement that all proxy holders vote directed proxies on remuneration-related issues (Australian Government Productivity Commission, 2009a).

On 18 March 2009 the Treasurer announced measures specifically aimed at termination payments to executives and directors, also known as 'golden handshakes'. The Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 was introduced into the Australian Parliament in June 2009 and enacted in November 2009. Where the threshold for shareholder approval was seven years' base salary, the 'Amendment Act' requires shareholder approval for termination payments to executives for amounts exceeding one year's base salary. It also extends the definition of a termination payment to incorporate a wider range of payouts that can be made to an executive or a director upon termination.¹⁸

2. Canada

Canada follows the 'comply or explain' model of corporate governance reporting that the United Kingdom and many European countries follow. However, following the

¹⁸ See full text of the Corporations Amendment (Improving Accountability on Termination Payments) Act 2009 at: [http://www.comlaw.gov.au/ComLaw/legislation/act1.nsf/0/6AC9DD485D711C85CA2576790020DF15/\\$file/1152009.pdf](http://www.comlaw.gov.au/ComLaw/legislation/act1.nsf/0/6AC9DD485D711C85CA2576790020DF15/$file/1152009.pdf)

onset of the global financial crisis, this model came under review, with the Canadian Securities Administrators (CSA) proposing three main changes to its governance and audit committee regimes. The consultation period began on 19 December 2008, with a call for comments on changes to National Policy 58-201 Corporate Governance Guidelines, National Instrument 58-101 Disclosure of Corporate Governance Practices, and National Instrument 52-110 Audit Committees. The changes proposed shifting the emphasis from 'comply or explain' style reporting towards a less structured approach giving companies more flexibility to report on how they operationalise principles of good governance, which proponents consider more appropriate for the large number of medium and small-sized issuers in Canada, many of which have large controlling shareholders. Submissions by public institutions during the consultation period expressed concern that replacing the 'comply or explain' model with a less prescriptive model of corporate governance disclosure would result in a deterioration of corporate governance standards in Canada.¹⁹ Finally, in November 2009, the CSA issued a statement indicating it would not be changing the corporate governance regime (Canadian Securities Administrators, 2009).

On 23 June 2009 the Canadian Coalition of Good Governance (CCGG) initiated consultation on revising the Corporate Governance Guidelines (CCGG, 2009a), which were last updated in November 2005 (CCGG, 2005). The comment period ran until 31 July 2009, with the final release of its best practice guidelines in March 2010 (CCGG, 2010).

New developments in the guidelines over the earlier version reflect lessons from analyses of corporate governance weaknesses implicated in the financial crisis, including an explicit emphasis on shareholder engagement and a stronger emphasis on the role of the board in developing and overseeing executive compensation plans and in overseeing risk management.

On 9 January 2009 the CCGG released for comment a set of draft principles on executive compensation. These update a set of principles first released in 2006, called '*Good Governance Guidelines for Principled Executive Compensation*'. The final version of these principles was released on 2 June 2009 (CCGG, 2009b). The introduction to the 2009 principles states that "The focus of CCGG in this summary of executive compensation principles is on 'pay for performance' and the effective implementation of risk controls suitable for the particular business by directly linking risk management with the executive compensation structure" (p. 4). Linking risk management to executive compensation and "[e]nsuring that compensation does not encourage or reward undue or unmanageable risk" (p. 4) echoes similar calls in other jurisdictions making more specific reference to the financial crisis. Besides emphasising risk management in compensation setting matched to an appropriate 'time horizon', new aspects of CCGG's most recent set of compensation guidelines recommend that companies make provision for claw-backs and in a separate principle it addresses limiting severance pay and pensions and retirement benefits. This emphasis is similar to pay setting recommendations in the United States.

Separately, the issue of 'say on pay' is receiving greater attention in Canada, with overwhelming displays of shareholder support for a resolution on this issue in 2008

¹⁹ See Comments posted on CSA's website:
http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/Comments/58-101/com_58-101_index.jsp

(O'Neill, 2009) and a recommendation by the CCGG in April 2009 that all boards provide their shareholders with a 'say on pay' opportunity (CCGG, 2009c). The final model for the wording of such a resolution was released by the CCGG on 18 January 2010, along with a model for how companies should engage with shareholders over questions raised through a shareholder advisory vote on executive compensation (CCGG, 2010). In addition, a number of large Canadian companies, mostly financial institutions, will be including a 'say on pay'²⁰ proposal on their proxy ballots (which are the materials sent to shareholders prior to the company's annual shareholder meeting) in 2010, establishing this as a mainstream practice.

3. Germany

On 18 June 2009 the German Bundestag adopted a new law on the Appropriateness of Executive Compensation (Gesetz zur Angemessenheit der Vorstandsvergütung – VorstAG) introducing a number of governance changes at German listed companies. The thrust of the law is to focus remuneration practices more on stakeholder interests, entailing a longer-term approach to the sustainability of the company. An important change is that, where previously general practice saw members of the management board retiring directly to the supervisory board, the new law requires a two-year period between retirement from the management board and appointment to a supervisory board. Another major change is that the whole supervisory board, not just the remuneration committee, will be ultimately responsible for directors' remuneration and for the appointment of the Chief Executive Officer. Further, the new law requires that stock options be held for at least four years before being exercised, it restricts the use of 'Directors and Officers Liability Insurance' and introduces a non-binding shareholder advisory vote on the executive compensation system. The supervisory board will be empowered to limit, and even retroactively reduce, executive compensation in the case of serious deterioration in company performance where, for instance, workers are laid off (German Bundestag Ministry of Justice, 2009).

Germany's Corporate Governance Code has recently undergone a change in emphasis from shareholder value creation to *sustainable* value creation. On 18 June 2009 the Government Commission of the German Corporate Governance Code changed the responsibilities of the management board to make it accountable to *stakeholders*, as well as employees and shareholders, in pursuing sustainable value. In previous versions of the Code the management board was responsible to the interests of the 'enterprise'. The section of the preamble to the code which had previously emphasised the rights of shareholders has been replaced with a new paragraph reading: "The Code clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy" (Commission of the German Corporate Governance Code, 2009, p. 2).

4. India

Developments in corporate governance rules in India have proceeded in two main areas: legislative and voluntary. Revisions to India's corporate governance rules are to be found in the Companies Bill 2009, introduced into the Indian Parliament on 3 August

²⁰ See Appendix 1.1 for a description of 'say on pay'.

2009. Key governance provisions contained in the Bill include: “basic principles for all aspects of internal governance of corporate entities [and] articulation of shareholders democracy with protection of the rights of minority stakeholders, responsible self-regulation with disclosures and accountability, substitution of government control over internal corporate processes and decisions by shareholder control” (Government of India, Press Information Bureau, 2009).

In January 2009 the Confederation of Indian Industry (CII) launched a task force to review the implications for corporate governance of the collapse of Satyam Computers. Following on from this review, in December 2009 the Ministry of Corporate Affairs launched a corporate governance code ‘Corporate Governance Voluntary Guidelines’. The new Corporate Governance Code, produced by the Ministry of Corporate Affairs, contains many of the same governance guidelines promoted by other national Codes, setting out independence standards for non-executive directors and board committees, qualifications of non-executive directors, remuneration standards for non-executive directors, the responsibilities of the board for ensuring effectiveness in areas, including risk management, independence of auditors and integrity of the audit process, and a mechanism for whistleblowing (Government of India, Ministry of Corporate Affairs, 2009).

5. South Africa

The King III Report, the third Report on Governance in South Africa, as well as the draft Code of Governance Principles for South Africa was released by The King Committee on Governance on 25 February 2009. A two-month consultation period followed, with the final version released in September 2009 (Institute of Directors Southern Africa, 2009). The review of South Africa’s Corporate Governance Code is part of a broader law reform process that will see a new Companies Act come into force in July 2010. The Code itself (King III) is based on the anticipated legislation and applies from March 2010. Up until then its predecessor, King II - published in 2002, had applied. The report distinguishes the ‘comply or explain’ style of governance regulation as embodied by the United Kingdom’s Combined Code, which is prevalent across much of Europe, as distinct from the system of rules and sanctions prevalent in the United States. Yet it notes that the ‘comply or explain’ stance of South Africa’s Governance Code has evolved into ‘apply or explain’ – a difference that it anticipates will discourage ‘tick box’ governance reporting and reflect the self-regulatory nature of corporate governance in South Africa.

The new Code sets out stronger independence requirements both for corporate boards (the same as those required by the United Kingdom’s Combined Code) and for remuneration committees, where all members of remuneration committees should be independent non-executive directors. The new code also contains a strong emphasis on risk management in corporate strategy and pay setting, consistent with revisions of governance systems in other jurisdictions. A new requirement of King III, also reflecting a general trend in governance practice elsewhere, is that boards allow shareholders an advisory vote on executive remuneration (PricewaterhouseCoopers, 2009).

King III contains a new chapter on ‘stakeholder relationship governance’, where boards are tasked with the responsibility to govern stakeholder relationships and to set up processes to promote constructive stakeholder engagement. King III requires that sustainability information be integrated with financial information in an “integrated

report” which should be prepared annually. King III requires that a formal process of assurance with regard to sustainability reporting should be established, with the audit committee ultimately responsible for the company’s assurance model and for addressing risks that arise out of it (Deloitte, 2009).

Addressing the problem of lack of involvement by institutional investors in governance affairs of public companies, the Institute of Directors in South Africa intends to release an institutional shareholder code, encouraging institutional shareholders to publish proxy voting guidelines and proxy voting records, along the lines of disclosure requirements required of mutual funds in Canada and the United States (Crotty, 2009).

6. United Kingdom

On 21 April 2009 the Walker Review on banking governance was extended to consider where the recommendations would be relevant to corporate governance in other financial institutions. The consultation document was published on 16 July 2009 (HM Treasury, 2009d). The second consultation process ended in October 2009 and final recommendations were published on 26 November 2009. The original terms of the review cover remuneration policy, board competence and independence, board effectiveness in various areas, the role of institutional shareholders in engagement and monitoring of boards, and a consideration of international best practice.²¹ The consultation document outlines 38 recommendations for corporate governance of banks and financial institutions, organised into five categories. Recommendations on ‘*board size, composition and qualification*’ push for greater independence, higher qualifications, better support and stronger risk management at board level. Recommendations on ‘*the functioning of the board and evaluation of performance*’ focus on board leadership. Under ‘*The role of institutional shareholders: communication and engagement*’ Walker proposes that the ‘Principles for Stewardship’ by institutional investors and fund managers presently contained in the Combined Code be separated out into a stand-alone code which the Financial Reporting Council (FRC) would supervise (the FRC presently has responsibility for the Combined Code). Under ‘*Governance of risk*’ the consultation document recommends the establishment of and responsibilities for a board risk committee. Finally, a set of recommendations address the scope of responsibilities of the remuneration committee and extend remuneration reporting requirements of the board. The final report, published on 26 November 2009 (HM Treasury, 2009a), sticks closely to the recommendations made in the interim report and suggests that most of the recommendations put forward would best be incorporated as provisions and guidance into the United Kingdom’s existing corporate governance code, the Combined Code. However it singles out pay disclosure provisions for statutory status through inclusion in the new Financial Services Bill presently being reviewed by the UK Parliament (see Section C.2 for more on the Financial Services Bill).

The outcome of the Walker Review is likely to have a substantial impact on the Combined Code of Corporate Governance. Initially, concurrent with the Walker Review of banking governance, the FRC undertook a review of the Combined Code on Corporate Governance, continuing a bi-annual pattern of reviews started in 2003. The consultation document for the review notes that “since [the 2007] review was concluded, there has been a significant change in the economic conditions under which companies (and in

²¹ See: http://www.hm-treasury.gov.uk/walker_review_information.htm

particular those in the financial sector) are operating... [t]he same can be said of many other regulatory regimes in the United Kingdom and internationally” (FRC, 2009c, p. 2) The terms of the Combined Code review recognised the work of the Walker Review and noted that each review, although independent, took account of the other (FRC, 2009b).

However, in early December 2009 the FRC announced a consultation process to overhaul the Combined Code, renaming it the ‘UK Corporate Governance Code’ following the publication of the final report of the Walker Review of Banking Governance in late November 2009. While the Walker Review only recommends changes to the Code with respect to the finance sector, the FRC considers the recommendations to be appropriate for all large listed companies in the UK, while noting that it is only in the financial sector that governance failures have become apparent (Stapleton, 2009).

Proposed changes to the Combined Code include: the annual election of either the board chairperson or the board as a whole or both; regular independent reviews of boards’ performance, new principles on the qualifications and independence of the board chairperson and independent directors; and new principles for how boards should handle risk, including how performance-related pay should be aligned with a company’s policy on risk (FRC, 2009a).

For the first time in the United Kingdom, and indeed the world, a code of governance best practices has been applied to audit firms. Compiled by the Institute of Chartered Accountants in England and Wales (ICAEW) for the UK’s largest eight audit firms, the Audit Firm Governance Code will be enforced on a ‘Comply or Explain’ basis, as with the present Combined Code, and incorporates many of the elements contained in the Combined Code (ICAEW, 2010).

7. United States

Efforts to address compensation shortcomings and improve board oversight at financial institutions in the United States have been incorporated into rules that now impact all US public companies. On 10 June 2009, the United States Treasury issued a press release outlining the principles that sound compensation practices should be based on in order to rectify some of the compensation practices implicated in the financial crisis (Geithner, 2009). These principles drew attention to the following issues: the link between pay and performance; the role of risk management and risk horizons in pay setting; golden parachutes and supplemental retirement packages; and compensation committee independence. The release also stated that: (a) the Treasury will support ‘say-on-pay’ legislation in Congress, “giving the SEC authority to require companies to give shareholders a non-binding vote on executive compensation packages” (accompanied by a ‘fact sheet’ on say-on-pay legislation²²) and that (b) the Treasury will “propose legislation giving the SEC the power to ensure that compensation committees are more independent, adhering to standards similar to those in place for audit committees as part of the Sarbanes-Oxley Act” (accompanied by a fact sheet on independence and competence of compensation committees²³).

²² See: http://www.treas.gov/press/releases/reports/fact_sheet_say%20on%20pay.pdf

²³ See: http://www.treas.gov/press/releases/reports/fact_sheet_indepcompcmte.pdf

On the same day the SEC Chairperson, Mary Shapiro, issued a statement that the SEC would consider additional proxy statement disclosures on how a company and its board manage risks, the overall approach to compensation, any potential conflicts of interest by compensation consultants, the experience and qualifications of director nominees to serve on the board or on particular board committees and on why a board has chosen its particular leadership structure (US SEC, 2009b).

A number of independent pieces of legislation were introduced into both the Senate and the House of Representatives over an eight month period from May 2009 incorporating, or even predating, the proposals set out by the Treasury on 10 June 2009. Incorporating many of the preceding legislative proposals, the *Wall Street Reform and Consumer Protection Act of 2009* was passed by the House of Representatives on 11 December 2009. Its counterpart, a comprehensive reform bill, “Restoring American Financial Stability Act of 2010”, was released by the Senate on 15 March 2010 after originally having been introduced by Senate Banking Committee Chairman Christopher Dodd. The final iteration of these two bills, the Dodd-Frank Wall Street Reform and Consumer Protection Act, was signed into law on July 21, 2010 by President Barack Obama (see Section D.2.b. for more discussion).

Comparing two earlier pieces of proposed legislation, one from each of the Houses of Congress, provides an overview of the main issues on the corporate governance reform agenda in the United States.

On 19 May 2009 ‘The Shareholder Bill of Rights Act of 2009’ was introduced in the Senate by Sen. Charles Schumer (D-N.Y.), addressing most of the key corporate governance issues dominating shareholder activist campaigns waged at listed companies in the United States over the past few years. On 12 June 2009, Rep. Gary Peters (R-Mich.) introduced ‘The Shareholder Empowerment Act’ into Congress, designed to address both of the issues outlined in the Treasury’s 10 June statement as well as a number of other governance issues regarded as expanding shareholder rights (Peters, 2009). Table 1.1 below, summarises and compares the measures called for by each of these bills.

The Dodd-Frank Wall Street Reform and Consumer Protection Act drops some of these requirements, namely, the requirement for a majority vote on nominees in uncontested director elections and the requirement for board declassification, and it raises the threshold requirements for shareholding by shareholders proposing nominees to the proxy ballot (proxy access). Requirements for an annual say-on-pay vote and for an advisory vote on golden parachutes remain, as do independence standards for compensation committees and their advisors, claw-back provisions. The Act directs the SEC to clarify compensation disclosure requirements: to adopt rules that would require compensation disclosures more specifically linked to certain financial performance measures. It also directs the SEC to adopt rules requiring disclosure by the board of why chairman and CEO roles are combined or separated (which the SEC has already done in 2009 amendments to its proxy rules). The Act also directs the national stock exchanges to prohibit voter discretionary voting in the election of directors (which was implemented by the NYSE in January 2010) (Hartman and Pollack, 2010; Bergman, Witdorich, Huntington and Mi, 2010; Huntington, Bergman and Hirsh, 2010; Wilson Sonsini Goodrich and Rosati, WSGR Alert, 2010).

Table 1.1 Comparison of “Schumer bill” with “Peters bill”

Provisions	The Schumer bill	The Peters bill
Executive Compensation		
Annual advisory say-on-pay vote	X	X
Advisory say-on-pay vote for "golden parachutes"	X	
Independent compensation advisor		X
Claw-back of unearned performance-based compensation		X
Severance agreements tied to performance		X
Improved disclosure of performance targets		X
Corporate Governance		
Shareholder proxy access	X	X
Majority voting for uncontested director elections	X	X
Independent board chairman	X	X
Broker discretionary voting		X
Declassified board of directors	X	
Risk management committee	X	

Source: Wilson, Sonsini, Goodrich and Rosati (2009)

On 1 July 2009 the SEC Commissioners approved a number of measures that greatly advance shareholder rights in the United States, some of which overlap with those contained in the Schumer and Peters bills (US SEC, 2009a). One key measure requires that any company that has outstanding obligations under TARP provide a separate shareholder vote on executive compensation in proxy solicitations for annual shareholder meetings. This measure was codified on 12 January 2010 when the SEC adopted it as a final rule and became effective on 18 February 2010 (US SEC, 2009d). Although directed only at certain financial institutions, this measure sets up ‘say on pay’ as a best practice corporate governance standard.

On 1 July 2009 the SEC commissioners also voted to approve the New York Stock Exchange’s (NYSE) proposed change to rule 452 of its listing rules to exclude brokers’ discretionary votes in all director elections. These are votes which brokers are able to cast on ‘routine’ matters if instructions are not received from beneficial owners of shares held in account at least 10 days before the shareholder meeting. Specifically, the NYSE proposal adds “election of directors” to the list of enumerated items for which a member generally may not give a proxy to vote without instructions from the beneficial owner. By casting director elections as ‘non-routine’ voting matter, this reform essentially eliminates a large source of support for management nominees in director elections in the United States. The rule change became effective on 1 January 2010 (Katten Muchin Rosenman LLP, 2010).

The SEC commissioners also voted to publish for comment rules to improve disclosures provided in proxy statements in the areas of executive compensation and board competence. These were adopted and take effect on 28 February 2010 (US SEC, 2009d). They include:

- a. The relationship of a company's overall compensation policies to risk as part of an expanded Compensation Discussion and Analysis (CD&A);
- b. Improved reporting of stock and option awards;
- c. More information on the qualifications of directors, executive officers and nominees as well as a consideration of board diversity in the nomination process;
- d. Any legal actions involving a company's executives, directors or nominees;
- e. More information on why a board chooses a certain leadership structure, whether combining or keeping separate the CEO and Chair roles; and
- f. More information on potential conflicts of interests of compensation consultants (fees, services and roles played within a company).

The new SEC disclosure rules also require companies to disclose the results of a shareholder vote in a form 8-K filing²⁴ within four business days after the end of the meeting at which the vote was held. Under the present system, votes are only required to be published in the quarterly report for the period following the quarter in which the meeting took place, which in practice is usually several months after the meeting took place.

In June 2009 the SEC initiated a consultation process to consider rules for allowing shareholders to nominate board candidates on the proxy ballot alongside managements' nominees (US SEC, 2009c). In January 2010 it launched a second consultation process on this issue to allow comment on data and analysis that has been submitted through the first consultation round (US, SEC, 2010b). While the SEC chairperson is a strong supporter of this reform, as are shareholder rights advocates in the United States, its finalization has been delayed due to strong opposition from industry groups, notably, the U.S. Chamber of Commerce (Westbrook, 2009).

8. Other jurisdictions

Other jurisdictions that updated their governance codes during the past year include a number of European states, all of which adhere to the 'comply or explain' model of corporate governance regulation: Austria (January 2009) (Austrian Working Group for Corporate Governance, 2009), Belgium (March 2009) (Corporate Governance Committee, 2009), Denmark (December 2008) (Danish Committee on Corporate Governance, 2008), Finland (October 2008) (Securities Market Association, 2008), France (December 2008) (Association Française des Entreprises Privées and the Mouvement des Entreprises de France, 2008), The Netherlands (December 2008) (Corporate Governance Code Monitoring Committee, 2008b) and Sweden (December 2009).²⁵ Two main themes run through these updates: greater transparency (particularly with respect to management remuneration) and a stronger supervisory board (with greater powers for overseeing remuneration policy).

The preface to the Austrian Code of Corporate Governance, written by the Chairman of the Working Group that revised the Code, notes: "The international financial crisis will not remain without impact on the Austrian capital market... The changes to the

²⁴ The 8-K filing is a regulatory disclosure called a 'Current Report Filing', to be filed with the United States SEC.

²⁵ See Swedish Corporate Governance Board website: <http://www.corporategovernanceboard.se/>

Code are designed to support the efforts to regain investor confidence. Therefore, the Code's orientation on the sustainable and long-term creation of value-added has been strengthened once again, transparency has been raised and the independence of supervisory board members broadened" (Austrian Working Group for Corporate Governance, 2009, p. 6).

On 12 March 2009, the Belgian Corporate Governance Committee published the 2009 version of the Belgian Corporate Governance Code, which replaces the previous version from 2004. The most important changes to the 2009 Code over its predecessor relate to the emphasis on executive remuneration: "The Code advocates complete transparency about remuneration and severance pay towards shareholders and the outside world. The Committee hopes to have achieved a major breakthrough in this area." (Corporate Governance Committee, 2009, p. 5) Likewise, the most recent changes to the Recommendations for Corporate Governance in Denmark are to sections dealing with transparency and the independence of the supervisory board, respectively.

At the release of the revised Dutch Corporate Governance Code, the Corporate Governance Code Monitoring Committee responsible for the revisions announced that "The main adjustments are in the areas of risk management, executive pay, shareholder responsibility, diversity in the composition of the supervisory board and corporate social responsibility." In particular, changes regarding remuneration include consideration of pay differentials within the company, the ratio of fixed and variable pay, long-term objectives, non-financial objectives and the company's risk profile, within the context of stronger oversight by the supervisory board over management board remuneration (Corporate Governance Code Monitoring Committee, 2008a).

The revised Finnish Corporate Governance Code, which replaces the Corporate Governance Recommendation from 2003 and entered into force on 1 January 2009, also emphasises increased disclosure and board independence. Amongst other updates, it calls for increased transparency with respect to the managing director and other executives, as well as changes to board composition to achieve greater independence, representation of both genders and improved levels of financial expertise (Roschier, Attorneys Ltd, 2008).

Algeria, Nigeria, the Philippines, and the United Arab Emirates are also amongst national or regional jurisdictions to have developed or updated their corporate governance rules over the past year. Algeria's first corporate governance code was launched on 11 March 2009. The code was developed with the assistance of the Global Corporate Governance Forum and the International Finance Corporation (IFC) (Bouheraoua, 2009). New corporate governance codes for listed companies have also been adopted for the first time by Qatar (Qatar Financial Markets Authority, 2009) and The Kingdom of Bahrain (Kingdom of Bahrain Ministry of Industry and Commerce and Central Bank of Bahrain, 2010). The IFC is working with the Azerbaijani government to develop a corporate governance code for that country as well (IFC, 2009).

In September 2008, the Nigerian Securities and Exchange Commission announced the formation of a Technical Committee for the Review of the Code of Corporate Governance for Public Companies in Nigeria. The new code would replace the existing code, introduced in 2003, and would rely on a combination of self-regulatory and formal regulatory enforcement (likely requiring changes to corporate governance legislation). A draft of the new code was presented to the Nigerian Securities and Exchange Commission by the Chairman of the Review Committee on 31 March 2009 and formally announced by

the Nigerian Securities and Exchange Commission on 2 April 2009 (Faith, 2009). The Revised Code focuses on six principles: “enhance[d] governance structures; greater protection of shareholders rights; improved risk management and internal audit; greater disclosure; enhanced relations with stakeholders; and enhanced sustainability appreciation” (Eboh, 2009). Important changes proposed by the draft include: a greater role for shareholders, protection of minority shareholder rights relative to those of majority shareholders, greater board independence and a stronger role for the board in risk management.

Besides a review of the existing Code of Corporate Governance, the Presidential Steering Committee on the Global Economic Crisis and the Financial Sector Regulatory Coordination Committee (FSRCC) had, in 2009, also ordered the harmonisation of the different codes of corporate governance applicable to firms operating in the financial sector in Nigeria. Questions of enforcement arise where these codes’ prescriptions conflict with each other (Alayanda, 2010).

Corporate Governance code revisions have also been adopted by the Philippines Securities and Exchange Commission (on 18 June 2009) (Republic of the Philippines Securities and Exchange Commission, 2009) and a revised draft of the corporate governance guidelines for bank directors was published by the Central Bank of the United Arab Emirates (Central Bank of the UAE, 2009).

In many jurisdictions outside the United States and Europe financial institutions were much less exposed to the risky financial products that caused the financial crisis and therefore have a less urgent need to reform systems of financial oversight. Even where financial system reform has not been undertaken, national reviews of corporate governance rules over the past year have frequently referenced the financial crisis as providing evidence of what can happen when governance oversight fails and risk is not properly integrated into incentive structures. Internationally, reform is also being driven by the need to access investment capital in markets that are now more risk averse and more convinced of the role of strong corporate governance.

There is, therefore, evidence of international convergence on at least some governance principles, particularly related to pay setting and pay disclosure, but also to the recognition of the need for strong board oversight and the integration of risk management into board deliberations.

For instance, a group of Chinese companies listed on the London Stock Exchange is looking to establish a code of corporate governance specifically tailored to Chinese companies, so as to address the perception of some critics that Chinese companies are poorly governed (“China companies seek London Code”, 2009). Likewise, stronger economic ties between China and the United States envisaged by the First United States-China Strategic and Economic Dialogue, which took place on 27 and 28 July 2009, encourages reform in both countries’ systems of financial regulation and oversight: “We pledge continued close communication and coordination to promote financial stability and will work together to expedite the financial sector reform, to improve financial regulation and supervision, and to promote greater financial market transparency, so as to make our financial sectors more robust” (United States-China Strategic and Economic Dialogue Economic Track, 2009).

The ‘Doha Declaration on Corporate Governance’ following the Third Hawkamah Regional conference on corporate governance, held in Doha on 9-10 November 2008 for business leaders and policy makers of the Middle East and North Africa (MENA) region, identified a set of eleven corporate governance issues relevant to the MENA region emerging from the financial crisis. These include, amongst others, risk management frameworks, remuneration structures, credit rating agency regulation and stronger board oversight. A number of elements reflect governance reforms elsewhere in the world: shareholder approval and scrutiny of executive remuneration; improved disclosure of executive pay; linking pay to performance and risk; board member qualifications; and board performance evaluations. This declaration serves as the Hawkamah Institute’s mandate for advancing corporate governance reform in the region (Hawkamah Institute for Corporate Governance, 2008).

G. The financial crisis and stakeholder governance

There is much debate about whether we have seen the last of the financial crisis and whether the world will emerge from recession sooner rather than later. While financial regulation reform proceeds, ordinary people in countries around the world are experiencing the very real impact of the financial crisis.

In early 2009, under alternative scenarios, the International Labour Organization (ILO) estimated that between 18 and 50 million more people were likely to be left unemployed in 2009 following the financial crisis, compared with 2007. Other measures provided in the ILO report that demonstrate the social impact of the financial crisis are substantially higher numbers in working poverty and vulnerable employment under the most likely scenarios as the world’s poor are forced to take what work is available in order to survive (ILO, 2009). The link between human rights and the financial crisis was explored in a special session of the United Nations Human Rights Council in February 2009 and described in a statement by High Commissioner for Human Rights: “while it is imperative to respond to the current crises with a thorough review of the functioning of the international financial and monetary mechanisms, a human rights approach will contribute to making solutions more durable in the medium and long run. ...A human rights framework offers the appropriate context, legal rationale and ground to guide policies and programmes countering the negative effects of the financial crisis at the national, regional and international levels” (Pillay, 2009). Citing evidence of the impact of the global economic downturn on human rights following the financial crisis, the April 2009 report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, John Ruggie, notes that “elements of the business and human rights agenda should become more closely aligned with the world’s overall economic policy agenda than in recent decades” (Ruggie, 2009, p. 6).

The proposed ‘Robin Hood Tax’ on financial transactions (or Tobin Tax, originally proposed by Nobel Laureate economist James Tobin in 1972 as a tax on currency speculation) draws the connection between the investment activities of financial institutions and public welfare. Proponents argue that this tax will both raise much needed public funds for pressing issues such as climate change and the world’s poorest as well as curb unnecessary and potentially dangerous speculative financial activity by financial

institutions.²⁶ The concept has the support of prominent leaders across Europe and on March 11, 2010 the European Parliament voted overwhelmingly in favour of developing plans for an international tax on financial transactions that would be presented to the G20 in June 2010. In his address to the World Economic Forum in Davos in February 2010 French President Nicolas Sarkozy, who will be taking Chairmanship of the G20 in 2011, stated that “...we cannot avoid the debate on a tax on speculation. Whether we wish to restrain the frenzy of financial markets, finance development aid or bring the poor countries into the fight against climate change, it all comes back to taxing financial transactions... I support without reservation the commitment of Gordon Brown, who was one of the first to defend this idea” (Sarkozy, 2010).

Unemployment, lost savings, and financial insecurity are the experiences of people who, up to now, had little or no say in how banks were governed, yet who suffer as a consequence of failed governance at large financial institutions.

The one-off tax on bank executive bonuses implemented or proposed in a number of jurisdictions (see Section D.1) links notions of social justice and bank governance more directly. There is public outrage at exorbitant bonuses paid to executives of banks that engaged in the risky investment activities that are now considered to have caused the financial crisis. Many of these financial institutions only survived as a result of taxpayer-sponsored bailout programs. This outrage has intensified both in the US and across Europe with reports of how banks that received bailout funds continue to award high compensation packages and bonuses to executives (Fletcher and Goldfarb, 2009).

Furthermore, banks in which governments were compelled to take large equity stakes are now public property and, as such, considered to be accountable to stakeholders in ways that they weren't when they remained shareholder-owned. Since it was bailed out in October 2008, RBS of the UK has been a state-owned bank. However, a recent report by a coalition of NGOs claims that RBS is the largest single funder of the controversial mining of Alberta, Canada's, bitumen deposits (PLATFORM (2010)). Together the mining projects, collectively known as 'Tar Sands' are considered at present to be the single most climate-damaging industrial project in the world. Tar Sands mining also stands accused of wreaking havoc on local ecologies and contaminating water sources that First Nations groups rely on.²⁷ A vocal coalition of groups, including Friends of the Earth, the World Development Movement, People & Planet and PLATFORM is calling on UK politicians to exercise the public's 84 per cent stake in RBS to veto financing of tar sands.

The link between corporate governance and a broader range of stakeholders is now clear. The relationship between governance, sustainable business, long-term strategic considerations and performance measures and reputational risk has played out in the financial crisis, potentially opening up the space for a more stakeholder-oriented ethic in the global corporate governance debate. Indeed, reviews of governance practices following the financial crisis have employed these very concepts. In the case of Germany, for example, management and supervisory boards are now accountable, not just to shareholders, but to 'stakeholders' (as noted in section F.3.). In South Africa 'stakeholder relationship governance' and sustainability reporting are now explicit responsibilities of

²⁶ See: <http://robinhoodtax.org.uk>

²⁷ For more information on the environmental impacts of Tar Sands mining see the Greenpeace International website: <http://www.greenpeace.org/international/campaigns/climate-change/stop-the-tar-sands>

boards of directors (as noted in section F.5.). The preamble to South Africa's new King III Report on Corporate Governance states:

“Sustainability is the primary moral and economic imperative of the 21st century. It is one of the most important sources of both opportunities and risks for businesses. Nature, society, and business are interconnected in complex ways that should be understood by decision-makers. Most importantly, current incremental changes towards sustainability are not sufficient – we need a fundamental shift in the way companies and directors act and organise themselves.”

Expert Comment 1.3

The Principles for Responsible Investment (PRI): Implications for Corporate Governance Disclosure

Meagan Thompson-Mann and Christina Zimmermann, PRI Secretariat

Launched by the UN Secretary General in 2006, the UN-backed Principles for Responsible Investment (PRI) are a set of aspirational guidelines uniting institutional investors behind the goal of integrating environmental, social and governance (ESG) issues into investment decisions and ownership practices. At the start of 2010, the PRI had more than 600 signatories worldwide who together manage over \$20 trillion in assets, making the PRI the largest global investor initiative focused on ESG issues.

Throughout the financial crisis, PRI signatories have worked to promote the understanding that improved corporate transparency will lead to greater market confidence and stability. In March 2009, the PRI Board published a statement on the financial crisis, which declared that responsible investment is an important part of the solution, and called upon investors to use the implementation tools of the PRI to this end (including the PRI Engagement Clearinghouse, the PRI Enhanced Research Portal, the Reporting and Assessment Tool and others).^a

In this statement, the Board of the PRI recognized that:

...investors can, and should, be part of the response to this crisis and that responsible investment has an important role in mitigating future such market failures. There is no doubt that better regulation (both hard and soft) is also necessary, and investors should actively participate in the debates about the type and extent of the required regulatory response. However, regulation alone cannot prescribe well-functioning markets, which are based on high levels of trust, accountability and transparency among market participants. As investors, we must take responsibility for protecting our investments and ensuring our agents act in our best interests. We believe the Principles for Responsible Investment provides a robust framework to assist investors in responding to this crisis.^b

More than one year on from this statement, and with hopes of recovery on the horizon, the message is just as relevant: active involvement by shareowners will assist companies in achieving greater transparency and accountability. The tools made available for PRI signatories can only serve to bolster the improvements that can be made at a regulatory level.

In an effort to enhance ESG disclosure and performance by companies, a number of PRI signatories are now asking how exchanges and regulators can assist them in promoting transparency and good corporate practice. On 2 November 2009 more than 100 executives from around the world met at the UN Headquarters in New York to explore how the world's exchanges can work together with investors, regulators, and companies to enhance corporate transparency and performance on ESG issues and encourage responsible long-term approaches to investment. The event, co-hosted by the PRI, UN Global Compact and UNCTAD, was the start of an ongoing multi-stakeholder discussion examining the various ways in which stock exchanges can promote sustainable business practices. Existing best practices in this area include enhanced sustainability reporting requirements for listed companies and the establishment of ESG indices.

PRI signatories are also actively engaged with regulators. Several PRI signatories, for example, are engaged in discussions with the United States Securities and Exchange Commission (SEC) through its Investor Advisory Committee, which was formed in 2009 to give investors a greater voice on the SEC.

Corporate transparency, the foundation of investor confidence, is all the more important in times of crisis and economic uncertainty. The more transparent companies are – including across a broad range of ESG issues – the more confident investors are and the more stable capital markets will be. The world has recently experienced one of the most severe financial shocks in history. Without greater attention to other critical issues, including non-financial issues such as climate change, the world will face other, potentially greater crises in the future. Responsible investors seek to avoid this and promote long term, stable, sustainable development.

^a See: <http://www.unpri.org/workstreams>

^b Full statement available at <http://www.unpri.org/files/Boardstatement.pdf>

H. Conclusions

This report has provided a review of regulatory developments in the wake of the financial crisis and the implications for corporate governance disclosure (especially in terms of disclosures related to executive compensation and risk management). Throughout this report, a range of updates on new rules impacting corporate transparency have been documented. This report has highlighted an area that is still in a state of rapid development. It is clear that there will be a broad range of new corporate governance disclosure requirements emerging as a result of these reforms.

The report notes that corporate governance failures have been implicated in almost every national and international analysis of the causes of the global financial crisis. Incentive structures that promoted short-termism and excessive risk taking within large financial institutions have been traced to poor oversight by boards and compensation committees and inadequate integration of risk management into corporate governance structures.

Globally, reform of financial markets oversight has included attention to pay setting, board oversight, risk management and the accountability of the boards of financial institutions to shareholders. Measures put in place in financial institutions through

government regulation are now established as best practice in corporate governance. These are therefore being taken up in corporate governance rules applying generally to listed companies, often following the 'comply or explain' model of enforcement.

Measures that appear to be common to many of the corporate governance reforms that were undertaken in various jurisdictions over the past year include: providing shareholders with an advisory vote on executive compensation; improving the independence of compensation committees; reviewing the status of compensation consultants; strengthening the qualifications (in particular the financial literacy) of board members; and linking pay setting to the long-term risk profile of the company.

The emerging focus on a broader range of stakeholders (rather than only shareholders) and the interconnectedness of business and the natural environment can be expected to strengthen existing trends towards the integration of environmental and social reporting within corporate governance reporting.

Policy makers may wish to use this report to take stock of the whirlwind of developments that has occurred in the wake of the financial crisis. One theme of this report has been an increased focus on international cooperation and coordination in the area of corporate governance and financial regulation. Policy makers may therefore wish to review the policies and disclosure practices in their own countries in the context of reforms taking place around the world.

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Appendix 1.1

Glossary of key United States corporate governance campaigns

Bonus Clawback – refers to the right of a board to recoup performance bonuses paid out to senior management of a company under certain specified circumstances, usually where the bonuses were based on erroneous or fraudulent financial statements.

Elimination of Broker Voting – a recent rule change by the United States SEC to NYSE rule 452 which prevents brokers from voting uninstructed client shares in director elections, where before brokers were able to vote these shares at their discretion if direction had not been received at least ten days before a scheduled shareholder meeting.

Independent Board Chairperson – a chairperson of the board of directors who is neither the CEO of the company nor one of its executive management team and who would likely be required to meet certain other independence criteria.

Independent Compensation Committees – standards of independence that apply to all or most members of a board's compensation committee members in order to ensure that the compensation-setting process is independent of the personal interests of senior management of companies.

Majority-Vote Director Elections – a rule whereby nominees for the board of directors are only elected if they achieve the affirmative vote of a majority of all votes cast in an uncontested director election (this rule is in place in various jurisdictions, including the United Kingdom, Australia, New Zealand, Germany and France and is becoming viewed as best practice in the United States following a successful shareholder campaign started in 2004).

Proxy Access – a rule change first proposed by the United States SEC in 2003 and brought into the spotlight in 2006 in the case of *AIG vs. AFSCME* whereby shareholders, under specified circumstances, be allowed to nominate one or more candidates to the ballot of director nominees put forward in the proxy statement annually by the board of directors for a shareholder vote.

Say on Pay – is a term used for a legal rule or board policy whereby a firm's shareholders have the right to vote on a resolution to ratify the remuneration of senior management of a company at annual meetings of shareholders. This rule is often also referred to as 'advisory vote on executive compensation' since, in many cases, the outcome of the vote is advisory rather than binding.

Appendix 1.2

FSF principles for sound compensation practices

Effective governance of compensation

Principle 1 The firm's board of directors must actively oversee the compensation system's design and operation.

Principle 2 The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended

Principle 3 Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

Effective alignment of compensation with prudent risk-taking

Principle 4 Compensation must be adjusted for all types of risk.

Principle 5 Compensation outcomes must be symmetric with risk outcomes.

Principle 6 Compensation payout schedules must be sensitive to the time horizon of risks.

Principle 7 The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

Effective supervisory oversight and engagement by stakeholders

Principle 8 Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.

Principle 9 Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders

Appendix 1.3

Examples of failures of major financial institutions

Continental Europe

- DEXIA – Bailed out by Belgium, France and Luxemborg to the tune of \$9bn in September 2008
- FORTIS – Partially nationalised in September 2008, with Belgian, Dutch and Luxemborg governments investing \$16bn in the bank.
- HYPO REAL ESTATE –German Government has provided capital injections to prop up HRE over a period of time since September 2008, and now owns a 90% stake.
- UBS – Bailed out by Swiss Government in October 2008.

United Kingdom

- NORTHERN ROCK – Nationalised by United Kingdom Government in February 2008.
- BRADFORD & BINGLEY – Nationalised by United Kingdom Government in September 2008.
- HBOS – Taken over by Lloyds Banking Group in January 2009.
- RBS – United Kingdom Government took majority stake in RBS in October 2008.

United States

- LEHMAN BROTHERS – Filed for bankruptcy protection on 15 September 2008.
- CITIGROUP – Massive United States Government bailout in November 2008.
- BEAR STEARNS – Distress sale to JP Morgan Chase in March 2008.
- MERRILL LYNCH – Distress sale to Bank of America in December 2008 – now Bank of America Merrill Lynch
- WACHOVIA – Bought by Wells Fargo in November 2008 after government had attempted to force a sale to Citigroup.
- AIG – Bailed out (or ‘nationalised’) by United States Government 16 September 2008 with issuance of credit liquidity facility accompanied by warrant for 79.9% of AIG shares. The credit facility was subsequently increased to over \$100bn.
- WASHINGTON MUTUAL – Taken over by the Government and distress sale to J.P. Morgan on 28 September 2008.
- FREDDIE MAC – (Government Sponsored Enterprise) Taken over (placed on ‘conservatorship’ by United States Federal Housing Finance Agency) by United States Government on 7 September 2008.
- FANNIE MAE – (Government Sponsored Enterprise) Taken over (placed on ‘conservatorship’ by United States Federal Housing Finance Agency) by United States Government on 7 September 2008.

CHAPTER 2

The Corporate Governance Lessons From the Financial Crisis

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A. Introduction

This report analyses the impact of failures and weaknesses in corporate governance on the financial crisis, including risk management systems and executive and trader remuneration. It concludes that the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies. Accounting standards and regulatory requirements have also proved insufficient in some areas. Last but not least, remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer term interests. The article also makes the case that the importance of qualified board oversight and robust risk management is not limited to financial institutions. The remuneration of boards and senior management also remains a highly controversial issue in many OECD countries.

The development and refinement of corporate governance standards has often followed the occurrence of corporate governance failures that have highlighted areas of particular concern. The burst of the high tech bubble in the late 1990s pointed to severe conflicts of interest by brokers and analysts. The Enron/Worldcom failures pointed to issues with respect to auditor and audit committee independence and to deficiencies in accounting standards. The verdict was not that these were problems associated with energy traders or telecommunications firms, but that they were systemic. The Parmalat and Ahold cases in Europe also provided important corporate governance lessons leading to actions by international regulatory institutions such as IOSCO and by national authorities. In the above cases, corporate governance deficiencies may not have been causal in a strict sense. Rather, they facilitated or did not prevent practices that resulted in poor performance.

The recent turmoil in financial institutions starting in 2007 is often described as the most serious financial crisis since the Great Depression. It is therefore crucial for bodies such as the OECD Steering Group on Corporate Governance and others to examine the situation in the banking sector and assess the main lessons for corporate governance in general. This article points to significant failures of risk management systems in some

* Although this article is based on a report published on the responsibility of the OECD Steering Group on Corporate Governance, it does not necessarily reflect the views of the Group, the OECD or its member countries.

major financial institutions¹ made worse by incentive systems that encouraged and rewarded high levels of risk taking. Since reviewing and guiding risk policy is a key function of the board, these deficiencies point to ineffective board oversight. These concerns are also relevant for non-financial companies. In addition, disclosure and accounting standards and credit rating practices have contributed to poor corporate governance outcomes in the financial services sector. Likewise, these factors are relevant to non-financial companies, although probably to a lesser degree.

The definition of corporate governance used in this article goes beyond that focusing only on shareholder/board relations (i.e. the classic principal/agent model). Rather, it uses the approach taken by the OECD Principles of Corporate Governance: “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.” In the case of financial companies, this broader definition is crucial. Stakeholders in the form of depositors and regulators (representing the public policy interest) are likely to be risk averse, which puts them in potential conflict with shareholders. It is for corporate governance arrangements to mediate this potential clash of interests (e.g. Mülbart, 2009).

The first part of the article presents a thumbnail sketch of the macroeconomic and structural conditions that confronted banks and their corporate governance arrangements in the years leading up to 2007/2008. The second part draws together what is known from company investigations, parliamentary enquiries and international and other regulatory reports about corporate governance issues at the company level, which were closely related to how they handled the situation. It first examines shortcomings in risk management and incentive structures including remuneration and then considers the responsibility of the board and why its oversight appears to have failed in a number of cases. Other aspects of the corporate governance framework that contributed to the failures are discussed in the third section. They include credit rating agencies, accounting standards and regulatory issues.

B. Background to the present situation

By mid 2008, it was clear that the crisis in the subprime market in the US, and the associated liquidity squeeze, was having a major impact on financial institutions and banks in many countries. Bear Stearns had been taken over by JPMorgan with the support of the Federal Reserve Bank of New York, and financial institutions in both the US (e.g. Citibank, Merrill Lynch, Bank of America) and in Europe (UBS, Credit Suisse, RBS, HBOS, Barclays, Fortis, Société Générale) were continuing to raise a significant volume of additional capital to finance, *inter alia*, major realised losses on assets, diluting in a

¹ The general term "financial institutions" is used throughout the report to denote commercial and investment banks and other types of financial institutions such as specialised mortgage lenders and in some cases, insurance companies.

number of cases existing shareholders. Freddie Mac and Fanny Mae, two government sponsored enterprises that function as important intermediaries in the US secondary mortgage market, had to be taken into government conservatorship when it appeared that their capital position was weaker than expected.² In the UK, there had been a run on Northern Rock, the first in 150 years, ending in the bank being nationalised, and in the US IndyMac Bancorp and others were taken over by the deposit insurance system. In Germany, two state owned banks (IKB and Sachsenbank) had been rescued, following crises in two other state banks several years previously (Berlinerbank and WestLB). The crisis intensified in the third quarter of 2008 with a number of collapses (especially Lehman Brothers) and a generalised loss of confidence that hit all financial institutions. As a result, several banks failed in Europe and the US while others received government recapitalisation towards the end of 2008. Direct and indirect support measures in both the US and Europe continued through 2009.

The focus of this article is not the macroeconomic drivers of this situation that have been well documented elsewhere (e.g. IOSCO, 2008, Blundell-Wignall, 2007) but to understand the market situation that confronted financial institutions over the past decade and in which their business models and corporate governance arrangements had to function. There was both a macroeconomic and microeconomic dimension. From the macroeconomic perspective, monetary policy in major countries was expansive after 2000 with the result that interest rates fell, as did risk premia. Asset price booms followed in many countries, particularly in the housing sector where lending expanded rapidly. With interest rates low, investors were encouraged to search for yield to the relative neglect of risk which, it was widely believed, had been efficiently spread throughout the financial system via new financial instruments.

It is important for the following sections of this article to note that default rates on subprime mortgages in the US began to rise in 2006 when the growth of house prices started to slow and some interest rates for home owners were reset to higher levels from low initial rates (“teaser” rates). Moreover, at the end of 2006 and at the beginning of 2007, warnings about the high level of leverage and asset price bubbles were issued by a number of institutions including the Bank for International Settlements (2007), the OECD (2007) and the Bank of England (2007) with mixed reactions by financial institutions. A well known reaction to these warnings came from Chuck Prince, CEO of Citibank, who noted with respect to concerns about “froth” in the leveraged loan market in mid 2007 that “while the music is playing, you have to dance” (i.e. maintain short term market share). The directors of Northern Rock and HBOS acknowledged to the parliamentary committee of inquiry that they had read the Financial Services Authority’s (FSA) warnings in early 2007 about liquidity risk, but considered that their model of raising short term finance was sound.

In June 2007, credit spreads in some of the world’s major financial markets began to increase and the first wave of significant downgrades was announced by the major credit rating agencies. By August 2007, it was clear that at least a large part of this new risk aversion stemmed from concerns about the subprime home mortgage market in the

² Asset prices appear to have been inadequately marked to market and deferred tax assets might have been overstated. It is not the first time that the accounting practices at the two firms had come in for criticism. See “Mortgage giant overstated the size of its capital base”, New York Times, 7 September 2008.

US³ and questions about the degree to which many institutional investors were exposed to potential losses through their investments in residential mortgage backed securities (RMBS), collateralized debt obligations (CDO) and other securitized and structured finance instruments.

At the microeconomic or market environment level management and boards of financial institutions faced challenging competitive conditions but also an accommodating regulatory environment. With competition strong and non-financial companies enjoying access to other sources of finance, margins in traditional banking were compressed forcing banks to develop new sources of revenue. One way of doing this was by moving into the creation of new financial assets (such as CDO's), thereby generating fee income and proprietary trading opportunities. Some also moved increasingly into housing finance driven by exuberant markets.⁴ The regulatory framework and prevailing accounting standards (as well as strong investor demand) encouraged banks not to hold such assets on their balance sheet but to adopt an "originate to distribute" model. Under the Basel I regulatory framework, maintaining mortgages on the balance sheet would have required increased regulatory capital and a corresponding lower rate of return on shareholder funds relative to a competitor which had moved such assets off its balance sheet. Some of the financial assets were marketed through off-balance sheet entities (Blundell-Wignall, 2007) that were permitted by accounting standards, and also had the effect of economising on a bank's capital.

C. The corporate governance dimension

The post-2000 market and macroeconomic environment demanded the most out of corporate governance arrangements: boards had to be clear about the strategy and risk appetite of the company and to respond in a timely manner, requiring efficient reporting systems. At the same time, there were significant pressures from shareholders for improved returns, encouraging share buy-backs and increased leverage (i.e. more "efficient" balance sheets). They also needed to oversee risk management and remuneration systems compatible with their objectives and risk appetite. However, the evidence cited in the following section points to severe weaknesses in what were broadly considered to be sophisticated institutions. In addition to the factors just mentioned, the type of risk management that was needed is related to incentive structures in a company. There appears to have been in many cases a severe mismatch between the incentive system, risk management and internal control systems. The available evidence also suggests some potential reasons for the failures.

³ In late 2005, delinquency rates on subprime adjustable rate mortgages began rising from less than 4 per cent to over 10 per cent by September 2007. At the same time, the growth rate for such mortgages continued to expand rapidly. Due to rising house prices, actual investor losses were minimal until 2007. Between 2000 and 2006, outstanding mortgage loans increased from USD 4.8 trillion to nearly USD 9.8 trillion, a rise of 13 per cent a year. During the same period, loans to subprime borrowers tripled and at the end of 2006 accounted for 12 per cent of all mortgages (IOSCO, 2008).

⁴ For example, HSBC purchased a housing finance firm in the United States. This resulted in unexpected losses in 2005/2006 attributable to the failure to integrate the new firm into its existing risk management system. Merrill Lynch bought First Franklin in September 2006, Bear Stearns bought Encore Credit in October 2006 and Morgan Stanley bought Saxon Capital in December 2006.

1. Risk management: accepted by all, but the recent track record is poor

The focus of this section on risk management is less about the technical process and more about the behavioural or corporate governance aspect. Arguably, the risk models used by financial institutions and by investors failed due to a number of technical assumptions, including that the company in question is only a small participant in the market.⁵ The same also applies to stress testing. While the adequacy of risk modelling and stress testing are a concern for financial market regulators and for those in charge of implementing Pillar I of Basel II, these are distinct from corporate governance arrangements. Corporate governance is about how such information is used in the organization, including how it was transmitted to the board that is responsible for the oversight of risk management. Although the OECD Principles do make risk management an oversight duty of the board, the internal management issues highlighted in this section have received less explicit treatment.

Box 2.1 How a “safe” strategy incurred write downs USD 18.7bn: the case of UBS

By formal standards, the UBS strategy approved by the board appeared prudent, but by the end of 2007, the bank needed to recognise losses of USD 18.7bn and to raise new capital. What went wrong?

UBS’s growth strategy was based in large measure on a substantial expansion of the fixed income business (including asset backed securities) and by the establishment of an alternative investment business. The executive board approved the strategy in March 2006 but stressed that “the increase in highly structured illiquid commitments that could result from this growth plan would need to be carefully analysed and tightly controlled and an appropriate balance between incremental revenue and VAR/Stress Loss increase would need to be achieved to avoid undue dilution of return on risk performance”. The plan was approved by the Group board. The strategic focus for 2006-2010 was for “significant revenue increases but the Group’s risk profile was not predicted to change substantially with a moderate growth in overall risk weighted assets”. There was no specific decision by the board either to develop business in or to increase exposure to subprime markets. However, as UBS (2008) notes, “there was amongst other things, a focus on the growth of certain businesses that did, as part of their activities, invest in or increase UBS’s exposure to the US subprime sector by virtue of investments in securities referencing the sector.”

Having approved the strategy, the bank did not establish balance sheet size as a limiting metric. Top down setting of hard limits and risk weighted asset targets on each business line did not take place until Q3 and Q4 2007.

The strategy of the investment bank was to develop the fixed income business. One strategy was to acquire mortgage based assets (mainly US subprime) and then to package them for resale, holding them in the meantime (i.e. warehousing). Each transaction was frequently in excess of USD 1bn, normally requiring specific approval. In fact, approval was only ex-post. As much as 60 per cent of the CDOs were in fact retained on UBS’s own books.

⁵ For example see A, Persaud, “Why bank risk models failed”, in Felton and Reinhart (eds.), 2008 and Honohan, 2008.

In undertaking the transactions, the traders benefited from the banks' allocation of funds that did not take risk into account. There was thus an internal carry trade, but only involving returns of 20 basis points. In combination with the bonus system, traders were thus encouraged to take large positions. Yet until Q3 2007 there were no aggregate notional limits on the sum of the CDO warehouse pipeline and retained CDO positions, even though warehouse collateral had been identified as a problem in Q4 2005 and again in Q3 2006.

The strategy evolved so that the CDOs were structured into tranches with UBS retaining the Senior Super tranches. These were regarded as safe and therefore marked at nominal price. A small default of 4 per cent was assumed and this was hedged, often with monoline insurers. There was neither monitoring of counter party risk nor analysis of risks in the subprime market, the credit rating being accepted at face value. Worse, as the retained tranches were regarded as safe and fully hedged, they were netted to zero in the value at risk (VAR) calculations used by UBS for risk management. Worries about the subprime market did not penetrate higher levels of management. Moreover, with other business lines also involved in exposure to subprime it was important for the senior management and the board to know the total exposure of UBS. This was not done until Q3 2007.

Source: Shareholder Report on UBS's Write-Downs, 2008.

Attention in recent years has focused on internal controls related to financial reporting and on the need to have external checks and reporting such as along the lines of Sarbanes Oxley Section 404.⁶ It needs to be stressed, however, that internal control is at best only a subset of risk management and the broader context, which is a key concern for corporate governance, might not have received the attention that it deserved, despite the fact that enterprise risk management frameworks were already in use (for an example, the Enterprise Risk Management-Integrated Framework developed by the Committee of Sponsoring Organizations of the Treadway Commission, 2004).

Despite the importance given to risk management by regulators and corporate governance principles, the financial turmoil has revealed severe shortcomings in practices both in internal management and in the role of the board in overseeing risk management systems at a number of banks. While nearly all of the 11 major banks reviewed by the Senior Supervisors Group (2008) failed to anticipate fully the severity and nature of the post-2007 market stress, there was a marked difference in how they were affected. This was determined in great measure by their senior management structure and the nature of their risk management system, both of which should have been overseen by the boards of directors. Indeed, some major banks were able to identify the sources of significant risk as early as mid-2006 (i.e. when the housing market in the US started to correct and subprime defaults rose) and to take measures to mitigate the risk. The Senior Supervisors Group reviewed firm's practices to evaluate what worked and what did not, drawing the following conclusions:

- a. In dealing with losses through to the end of 2007, some firms made strategic decisions to retain large exposures to super senior tranches of collateralised debt

⁶ In March 2008, Credit Suisse announced write downs of USD 2.65 billion and disclosed that a SOX material weakness had existed in its internal controls over financial reporting as at 31 December, 2007 (FSA, 2008b).

obligations that far exceeded the firms' understanding of the risks inherent in such instruments, and failed to take appropriate steps to control or mitigate those risks (see Box 2.1). As noted below, in a number of cases boards were not aware of such strategic decisions and had not put control mechanisms in place to oversee their risk appetite, which is a board responsibility. In other cases, the boards might have concurred. An SEC report noted that "Bear Stearns' concentration of mortgage securities was increasing for several years and was beyond its internal limits, and that a portion of Bear Stearns' mortgage securities (e.g. adjustable rate mortgages) represented a significant concentration of mortgage risk"(SEC, 2008b, page ix). At HBOS the board was certainly aware following a warning from the FSA in 2004 that key parts of the HBOS Group were posing medium or high risks to maintaining market confidence and protecting customers (House of Commons Treasury Committee, 2008).

- b. Some firms had limited understanding and control over their potential balance sheet growth and liquidity needs. They failed to price properly the risk that exposures to certain off-balance sheet vehicles might need to be funded on the balance sheet precisely when it became difficult or expensive to raise such funds externally. Some boards had not put in place mechanisms to monitor the implementation of strategic decisions such as balance sheet growth.
- c. Firms that avoided such problems demonstrated a comprehensive approach to viewing firm-wide exposures and risk, sharing quantitative and qualitative information more efficiently across the firm and engaging in more effective dialogue across the management team. Management also relied on a wide range of risk measures to gather more information and different perspectives on the same risk exposures and employed more effective stress testing with greater use of scenario analysis. In other words, they exhibited strong governance systems since the information was also passed upwards to the board.
- d. Management of better performing firms typically enforced more active controls over the consolidated organisation's balance sheet, liquidity, and capital, often aligning treasury functions more closely with risk management processes, incorporating information from all businesses into global liquidity planning, including actual and contingent liquidity risk. This would have supported implementation of the board's duties.

The Senior Supervisors Group followed up its report in 2009 in order to check whether banks were moving to correct weaknesses. They found that self-assessments "were in aggregate too positive and that firms still had substantial work to do before they could achieve complete alignment with the recommendations and observations of" their previous study. A number of areas of weakness required further work including: the failure of some boards of directors and senior managers to establish, measure and adhere to a level of risk acceptable to the firm; compensation programs that conflicted with the control objectives of the firm; and institutional arrangements that conferred status and influence on risk takers at the expense of independent risk managers and control personnel. At the beginning of 2010, banks were under public policy pressure to reduce and restructure potentially high bonus payouts that gave the impression that it was business as usual (see below).

A marked feature of the current turmoil has been played by liquidity risk which led to the collapse of both Bear Stearns and Northern Rock.⁷ Both have argued that the risk of liquidity drying up was not foreseen and moreover that they had adequate capital. However, the warning signs were clear during the first quarter of 2007: the directors of Northern Rock acknowledged that they had read the Bank of England's Financial Stability Report (2007) and a FSA report, both of which both drew explicit attention to liquidity risks. Yet Northern Rock's management failed to put in place adequate emergency lending lines. Countrywide of the US had a similar business model but had put in place emergency credit lines at some cost to themselves (House of Commons, 2008, Vol. 1 and 2). Managing liquidity risk was not a new concept. The Institute of International Finance (IIF), representing the world's major banks, already drew attention to the need to improve liquidity risk management in March 2007 (IIF, 2007).

Stress testing and related scenario analysis is an important risk management tool that can be used by boards in their oversight of management and in reviewing and guiding strategy. However, recent experience has shown numerous deficiencies at a number of financial institutions. The Senior Supervisors Group (2008) noted that "some firms found it challenging before the recent turmoil to persuade senior management and business line management to develop and pay sufficient attention to the results of forward-looking stress scenarios that assumed large price movements" (p. 5). This is a clear corporate governance weakness since the board is responsible for reviewing and guiding corporate strategy and risk policy, and for ensuring that appropriate systems of risk management are in place.

In some cases, banks have taken on high levels of risk by following the letter rather than the intent of regulations indicating a box ticking approach. For example, credit lines extended to conduits needed to be supported by banks' capital (under Basel I) if it was for a period longer than a year. Banks therefore started writing credit lines for 364 days as opposed to 365 days thereby opening the bank to major potential risks. Whether boards were aware that capital adequacy reports to them reflected such practices is unclear although there is some indication that, in at least a few cases, they did not know.

Even if risk management systems in the technical sense are functioning, this will not benefit the company unless the information is transmitted through effective channels, a clear corporate governance issue. In this respect it is interesting to note that in "a recent survey of nearly 150 UK audit committee members and over 1000 globally, only 46 per cent were very satisfied that their company had an effective process to identify the potentially significant business risks facing the company and only 38 per cent were very satisfied with the risk reports they received from management" (KPMG, 2008). In interpreting the survey, KPMG said: "recession related risks as well as the quality of the company's risk intelligence are two of the major oversight concerns for audit committee members. But there is also concern about the culture, tone and incentives underlying the company's risk environment, with many saying that the board and/or audit committee needs to improve their effectiveness in addressing risks that may be driven by the company's incentive compensation structure" (home page).

⁷ In the second half of 2008, banks around the world that relied on wholesale financing experienced marked distress following the collapse of Lehman Brothers. Many of these banks have either merged with other banks or have been recapitalised by the government.

An example of failure to transmit information concerns is provided in Box 2.1. Although the group risk management body was alerted to potential sub-prime losses in Q1 2007, the investment bank senior management only came to appreciate the severity of the problem in late July 2007. Consequently, only on 6 August 2007, when the relevant investment bank management made a presentation to the Chairman's office and the CEO, were both given a comprehensive picture of exposures to CDO Super Senior positions (a supposedly safe strategy) and the size of the disaster became known to the board. The UBS report attributed the failure in part to a 'silo' approach to risk management.

2. Remuneration and incentive systems: strong incentives to take risk

It has often been argued that remuneration and incentive systems have played a key role in influencing not only the sensitivity of financial institutions to the macroeconomic shock occasioned by the downturn of the real estate market, but also in causing the development of unsustainable balance sheet positions in the first place. This perception has been in part responsible for the high level moves to restrain and/or tax remuneration going into 2010. The debate reflects a more general concern about incentive systems that are in operation in non-financial firms and whether they lead to excessive short-term management actions and to "rewards for failure". It has been noted, for instance, that CEO remuneration has not closely followed company performance.

One opinion is that despite political reactions, executive remuneration (as opposed to incentives at trader level) had little or no role in the crisis since executives by and large have suffered large losses on their equity holdings (see Bebhuk, 2009 and the references therein, Fahlenbrach and Stulz, 2009). On the other hand, the academic literature has always drawn attention to the danger of incentive systems that might encourage excessive risk.⁸ A more detailed examination of incentive packages suggests that they did encourage, or at least did not discourage, short term risk taking in the lead up to the crisis. This position is expanded on below.

3. Board and executive remuneration

It is important to note that executives in financial companies held a substantial level of equity in their companies in the run up to the crisis. It is usual in most companies (banks and non-banks) that the equity component in compensation (either in shares or options) increases with seniority. One study for European banks indicated that in 2006, the fixed salary accounted for 24 per cent of CEO remuneration, annual cash bonuses for 36 per cent and long term incentive awards for 40 per cent (Ladipo et al., 2008). By contrast, one study of six US financial institutions found that top executive salaries averaged only 4-6 per cent of total compensation with stock related compensation (and especially stock options in two cases) hovering at very high levels (Nestor Associates, 2009). It is interesting to note that at UBS, a company with major losses, long-term incentives accounted for some 70 per cent of CEO compensation and that the CEO is required to

⁸ The literature has emphasised the difficulty for outsiders such as investors of assessing the balance sheet of a bank with the exact nature of risk only becoming apparent over time. Incentive systems such as options maturing in the short term might encourage short term risk taking and herding behaviour by the bank that is difficult for outsiders to assess (see Chen et al, 2006).

accumulate and hold shares worth five times the amount of the last three years' average cash component of total compensation.

A number of codes emphasise that executive directors should have a meaningful shareholding in their companies in order to align incentives with those of the shareholders. Only a few European banks had such formalised policies in 2006. However, the actual amount of stock owned by the top executive in each bank was well above 100 per cent of annual fixed salary (Ladipo, p. 55). With respect to non-executive directors, it is often argued that they should acquire a meaningful shareholding but not so large as to compromise their independence. Only a few European banks disclosed such policies. UBS actively encouraged director share ownership and board fees were paid either 50 per cent in cash and 50 per cent in UBS restricted shares (which cannot be sold for four years from grant) or 100 per cent in restricted shares according to individual preference. Credit Suisse also has a similar plan. However, one study (Nestor Associates, 2009) reports that financial institutions that collapsed had CEOs with high stock holdings. These CEOs should normally have been risk averse. On the other hand, CEOs of institutions that survived had strong incentives to take risks.⁹

The fact that executives held significant levels of equity does not imply by itself that incentives were structured towards long term behaviour. This is far too simple. Executives received significant salary which would have biased their actions towards continuity of the company. However, they also received significant cash and equity based bonuses linked to yearly performance and with no obligation to repay if the performance turned out to be temporary: there was no claw back or escrow account. Moreover, many contracts contained significant golden parachutes with, for example, Citibank and Merrill Lynch paying USD 100 million and USD 161 million respectively to their CEO's who had arguably failed. Significant retirement arrangements were also offered in a number of cases (e.g. RBS).

More importantly, the mere presence of equity does not by itself establish long term incentives. Shares and options can and have been sold by executives in response to favourable short term price developments. Research in this area is, unfortunately, scarce. However, one study indicates that the top executive teams at Bear Stearns and Lehman Brothers derived cash flows of about USD 1.4 billion and USD 1 billion, respectively, from non-refundable cash bonuses and equity sales during 2000-2008 (Bebchuk, 2009). These cash flows substantially exceeded the value of executives' initial holdings at the beginning of the period. Hence, even though remaining equity in these two firms was practically written off by their collapse or sale (unless it had been hedged), the bottom line payoffs during 2000-2008 were not negative but decidedly positive. In addition, Ladipo et al. notes that only a small number of banks disclosed the proportion of annual variable pay subject to a deferral period.¹⁰ Without significant deferral, the incentive structure might favour short term risk taking.

⁹ One reason for this counter-intuitive result is that market forces did not fully determine who survived and who failed.

¹⁰ Seventy per cent of FTSE companies now defer some part of annual bonuses. For an example of such plans, Ladipo et al. note that at one bank 75 per cent of the annual bonus is delivered as cash. The remaining 25 per cent is delivered as a provisional allocation of shares which are not normally released for at least three years and are subject to potential forfeit if the individual resigns and commences employment with a competitor.

More investigation is required into actual remuneration practices at major financial companies. However it is difficult to reject the hypothesis that executive remuneration structures and arrangements might have biased decision making to the short term.

4. Incentive systems at lower levels have favoured risk taking and outsized bets

Incentive systems are wider in scope than just remuneration. At a number of banks, the lower prestige and status of risk management staff vis-à-vis traders also played an important role. Société Générale (2008) noted that there was a “lack of a systematic procedure for centralising and escalating red flags to the appropriate level in the organisation” (page 6). But soft factors were also at work. “The general environment did not encourage the development of a strong support function able to assume the full breadth of its responsibilities in terms of transaction security and operational risk management. An imbalance therefore emerged between the front office, focused on expanding its activities, and the control functions which were unable to develop the critical scrutiny necessary for their role” (Page 7). One of the goals of their action programme is to “move towards a culture of shared responsibility and mutual respect” (page 34). The inability of risk management staff to impose effective controls was also noted at Credit Suisse (FSA, 2008b).

Official as well as private reports have drawn attention also to remuneration problems at the sales and trading function level.¹¹ One central banker (Heller, 2008) has argued that the system of bonuses in investment banking provides incentives for substantial risk taking while also allowing no flexibility for banks to reduce costs when they have to: at the upper end, the size of the bonus is unlimited while at the lower end it is limited to zero. Losses are borne entirely by the bank and the shareholders and not by the employee. In support, he notes that the alleged fraud at Société Générale was undertaken by a staff member who wanted to look like an exceptional trader and achieve a higher bonus. Along the lines of Heller, the IIF (2008b), representing major banks, has proposed a set of principles to cover compensation policies that illustrate the concerns about many past practices.

The Senior Supervisors Group (2008, p. 7) noted that “an issue for a number of firms is whether compensation and other incentives have been sufficiently well designed to achieve an appropriate balance between risk appetite and risk controls, between short run and longer run performance, and between individual or local business unit goals and firm-wide objectives”. This concern is shared by the Financial Stability Board (FSB) (2009) that has established a compensation standard for important banks.

Likewise, a private sector report (IIF, 2008a) also identified compensation as a serious issue: “there is strong support for the view that the incentive compensation model should be closely related by deferrals or other means to shareholders’ interests and long-term, firm-wide profitability. Focus on the longer term implies that compensation

¹¹ Reports suggest that some banks are moving to reduce incentives for bankers to take short-term risks and out-sized bets (e.g. Merrill Lynch). Others, such as Citibank, appear to be attempting to link bonuses of senior managers and junior employees to Citibank’s overall performance. Financial Times, 30 June, page 1, European edition, “Citi set to reward co-operation with overhaul of bonus system”. UBS has also announced reforms to take effect in 2009.

programs ought as a general matter to take better into account cost of capital and not just revenues. Consideration should be given to ways through which the financial targets against which compensation is assessed can be measured on a risk-adjusted basis” (p. 12). Some banks, such as JP Morgan, already build risk weighting into employees’ performance targets to recognise the fact that their activities are putting more capital at risk, but they are the exception rather than the rule.

These issues were picked up in the UBS report, which noted that the compensation and incentive structure did not effectively differentiate between the creation of alpha return (i.e. return in excess of defined expectation) versus return from a low cost of funding. In the case of UBS, the internal cost of funds did not take account of risk so that the traders involved in sub-prime asset trading could obtain finance at a low cost. This made sub-prime an attractive asset to carry long. Super senior tranches carried low margins so that the incentive was to expand positions to achieve a given level of bonus. The report goes on to note that “day 1 P&L treatment of many of the transactions meant that employee remuneration (including bonuses) was not directly impacted by the longer term development of the positions created. The reluctance to allow variations between financial reporting and management accounting made it less likely that options to vary the revenue attributed to traders for compensation purposes would be considered (p. 42). Essentially, bonuses were measured against gross revenue after personal costs, with no formal account taken of the quality or sustainability of those earnings. Senior management, on the other hand, received a greater proportion of deferred equity.

Incentive systems at sub-executive level are also a concern for non-financial companies. For example, transactions-based compensation and promotion might lead to corrupt practices contrary to company policies and interests. Audit committees, a key component of the corporate governance structure, appear to be developing an awareness of the issues. Thus the KPMG (2008) survey noted that “while oversight of compensation plans may generally fall within the responsibility of the remuneration committee, audit committees are focusing on the risks associated with the company’s incentive compensation structure. In addition to risks associated with an emphasis on short-term earnings, audit committees want to better understand the behaviour and risks that the company’s incentive plans encourage and whether such risks are appropriate” (home page).

The Basel II capital accord contains mechanisms in pillar II enabling regulators to impose additional capital charges for incentive structures that encourage risky behaviour. Indeed, the UK’s FSA has stated that it will consider compensation structures when assessing the overall risk posed by a financial institution but that it would stop short of dictating pay levels.¹² The Basel Committee on Banking Supervision is also moving in this direction.

¹² Sants, H., “Recent market events and the FSA’s response”, speech delivered at IMA AGM Dinner, FSA, 20 May 2008.
http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0520_hs.shtml

5. Risk policy is a clear duty of the board

Deficiencies in risk management and distorted incentive systems point to poor board oversight. This applies to both banks as well as non-financial companies. Box 2.2 traces board shortcomings in companies as varied as Airbus, Boeing, Alstom, BP and Siemens. Earlier cases include Metallgesellschaft and Sumitomo Corporation. Boards of both financial and non-financial companies face a range of risk management considerations from exchange rate and interest rate risks to operational risks such as outsourcing risks, loss of intellectual property rights, and investment risks.

Box 2.2 Risk management issues in non-financial companies

In recent years there have been numerous examples that have highlighted weaknesses and failures in risk management in major non-financial companies.

BP was hit by a refinery explosion in Texas. A commissioned report (the Baker Report, 2007) suggests that the risk was well known at lower levels in the company but that it was not adequately communicated to higher levels. This is similar to what happened at Société Générale and at UBS. The refinery had been acquired as part of an M&A and it appears that risk management systems and culture had not been fully implemented at the new subsidiary, very similar to HSBC and UBS, the latter also with a new subsidiary. BP also has complex risk models including a model for corrosion used in forecasting expenditures. After major oil spills in Alaska that resulted in suspended output, it was discovered that the model significantly under-estimated corrosion, raising questions about the adequacy of risk model testing.

Airbus has invested massively in a major investment in developing the large Airbus 380 aircraft. Such projects include substantial exchange rate risk as well as significant payments to customers in the case of late delivery. Despite the substantial risks the company was taking, and which had been approved by the board, information about significant production delays came as a major surprise to the board of both Airbus and its controlling company EADS. Similar surprises were in store for boards at Citibank and UBS.

Siemens represents a case of compliance risk with respect to breaking German and other laws covering bribery of foreign officials. The supervisory board of the company appeared not to have clearly specified their expectations and to have overseen their implementation. The fact that the chairman of the board had been the CEO might not have been helpful in getting to grips with practices that had been ongoing for a number of years. Boeing also faced problems in breaching public tender rules, a serious risk for a major defence contractor. A number of banks have faced similar compliance problems in areas such as money laundering and in complying with local regulations (e.g. Citibank private bank in Japan actually lost its license).

a. However, board performance was lacking in a number of cases

Testimony by the ex-head of risk at the British bank HBOS, that had to be rescued and taken over by Lloyds TSB in late 2008, gives a picture of a bank management and board with little regard or care for risk management as it pursued its headlong rush into

expanding its mortgage business.¹³ In another case in the UK, reports suggest that the chief risk officer was prevented from appearing before the board. An SEC report about Bear Stearns also noted “a proximity of risk managers to traders suggesting a lack of independence” (SEC 2008b). The issue of “tone at the top”, clearly lacking in these cases, is a key element covered by the OECD Principles and by the Basel Committee’s corporate governance guidance that is based on the OECD Principles.

In the wake of the financial crisis many boards of financial enterprises have been quite active and a number of CEOs at problem banks have been replaced. Tellingly, both Citibank and UBS have also announced board room departures to make way for new directors with “finance and investment expertise”. UBS has gone further and is eliminating the chairman’s office that had been widely criticised by shareholders in the past and Citibank has also restructured the board, eliminating the executive committee. Shareholders have become more active, especially with respect to voting against audit committee (or equivalent) members who have been held to higher standards of accountability than other board members. The fundamental issue is, however, why boards were not effective in the years preceding the turmoil especially in view of the emphasis given in many countries in recent years to internal control more narrowly focused on financial accounts (e.g. SOX 404 certifications).

The available reports have not so far dealt in much depth with the role and performance of boards, in particular, documenting risk management failures. It is a prime responsibility of boards to ensure the integrity of the corporation’s systems for risk management, which makes this type of failure particularly unfortunate. A private sector report (IIF, 2008a) has examined board performance, concluding that “events have raised questions about the ability of certain boards properly to oversee senior managements and to understand and monitor the business itself.” This is a potentially very worrying conclusion.

The IIF (2008b) report stressed that a solid risk culture throughout the firm is essential but that there appears to be a need to re-emphasise the respective roles of the CEO and the board in the risk management process in many firms. The report goes on to make suggestions for strengthening board oversight of risk issues. Boards need to be educated on risk issues and to be given the means to understand risk appetite and the firm’s performance against it. A number of members of the risk committee (or equivalent) should be individuals with technical financial sophistication in risk disciplines, or with solid business experience giving clear perspectives on risk issues. A separation between risk and audit committees should be considered. However, form should not be confused with actual operation. At Lehman Brothers, there was a risk committee but it only met twice in both 2006 and 2007. Bear Stearns only established a full risk committee shortly before it failed. Above all, boards need to understand the firm’s business strategy from a forward looking perspective, not just review current risk issues and audit reports.

Supporting information has been presented in a survey based on interviews with European banks (Ladipo et al., 2008). All interviewed banks accepted that risk governance was a key responsibility of banks’ boards although the results of the study suggest that risk management was not deeply embedded in the organisations surveyed, which is a clear corporate governance weakness. A good example is provided in the UBS report which

¹³ See “The Moore Memo” at <http://ftalphaville.ft.com>

noted that the strategic decision to rapidly build a fixed income business (i.e. achieve significant market share) was not associated with a corresponding change to risk policy and risk appetite and a requirement for appropriate indicators. On the other hand, there are worries about the board oversight model of corporate governance: one bank noted that “risk issues are increasingly becoming too specialist for meaningful oversight by the whole board” (op. cit., p. 47).

Reports have documented that risk management information was not always available to the board or in a form corresponding to their monitoring of risk.¹⁴ The efficiency of the risk management process and its connection to board oversight has led a number of companies to establish a Chief Risk Officer (CRO) with board membership in unitary board systems.

Success in achieving a strong internal voice for risk management will depend on firm specifics such as size and complexity. It has been done successfully where the CRO reports directly to the CEO or where the CRO has a seat on the board or management committee. In many cases, the CRO will be engaged directly on a regular basis with a risk committee of the board, or when there is not one, with the audit committee. This area might need more attention in corporate governance principles that are, as yet, too narrowly focused on internal controls for financial reporting. Some banks make it a practice for the CRO to report regularly to the full board to review risk issues and exposures, as well as more frequently to the risk committee. The IIF study concluded that to have a strong, independent voice, the CRO should have a mandate to bring to the attention of both line and senior management or the board any situation that could materially violate risk-appetite guidelines. Similar arrangements have often been introduced to support the work of internal auditors.

b. Board composition and board member qualifications

As with an audit committee, the composition of any risk committee is also an important issue.¹⁵ Ladipo et al. (2008) report that in their sample of 11 European banks with risk committees, nearly half of the sample staffed their committees with non-executive directors. However, they also reported that in such cases the CEO, the CFO and the CRO were always in attendance at the committee meetings and are reported to have played a major role in the committee’s deliberations. In two cases, including UBS, non-executive directors comprised only a third of the risk committee. Whether committees comprised of non-executive directors (where officers of the company play a key role) differ from those comprised of executives is a key policy concern. Presumably, the Senior Supervisors Group has sufficient experience to make such a judgment: in at least one case they formed the judgment that there is indeed a difference. In the US, a number of financial institutions do not have a separate risk committee but rather have made it a

¹⁴ Guerra and Thal-Laresen (2008) report concerns by some market participants about the quality of information reaching the board, especially in situations where the chairman and the CEO are the same. Lack of timely information for the board due to failures in the risk management system was clearly a problem at both Citibank and UBS and possibly others. At Northern Rock by contrast, the board appeared to know the risks but decided not to hedge with back-up credit lines. Based on interviews with European banks, Ladipo reports important differences in the amount and type of information reaching the board.

¹⁵ It should be noted that only 44 per cent of their sample of banks had stand-alone risk committees, some of these had only been established in the previous five years. The average size of a risk committee is 4.4 members.

matter for the audit committee which comprises only independent directors. One survey reports that audit committees feel that their effectiveness may be hampered - or negatively impacted - by overloaded agendas and compliance activities (KPMG, 2008).

The quality of board members is a particular concern of bank supervisors who often set fit and proper person tests. However, such tests do not fully address the issue of competence in overseeing a significant business accountable to shareholders and stakeholders. The issue of board competence is addressed by OECD Principle VI.E which states that “the board should be able to exercise objective independent judgment on corporate affairs”. The annotations note that a negative list for defining when an individual should not be regarded as independent can usefully be complemented by positive examples of qualities that will increase the probability of effective independence. Principle VI.E.3 notes that “board members should be able to commit themselves effectively to their responsibilities”, the annotations noting that this may involve board training.

Board competence is extremely difficult to judge by outsiders and facts are difficult to ascertain. Nevertheless, it is often claimed that bank boards lack banking and financial experience. One study estimated that at eight major financial institutions in the United States, two thirds of directors had no banking experience (Guerra and Thal-Larsen, 2008). Moreover, many of the directors without a financial background happen to sit on highly technical board committees such as those covering audit and risk. Although now dated and based on a wider population of banks including smaller regional lenders, Moody's (2005) concluded that “too few banks have adopted the approach in other financial service sectors of appointing retired industry executives or advisors with industry experience such as accountants or consultants.”

However, banking experience is clearly not enough: Northern Rock had two board members with banking experience (one was the ex-CEO of a major UK bank) while at Bear Stearns seven out of thirteen directors had a banking background. The idea that boards are a “retirement home for the great and the good” might be an exaggeration but there is still a grain of truth to this description: at Lehman Brothers, four of the ten members of the board were over 75 years of age and only one had current financial sector knowledge. The Citigroup board in 2007 had seven serving and past chief executives – a red flag for overall board independence. Lapidio et al. (2008) reported that European banks surveyed all wanted “heavy hitters” with current experience on their boards. The survey found that 40 per cent of the non-executive directors of the 11 banks surveyed have at least one other directorship in a FTSE Eurofirst 300 company and three quarters of the banks also have at least one “high calibre” non-executive director who holds a senior executive post in a FTSE Eurofirst 300 company (Ladipo, 2008, p. 19). Two of the surveyed banks (UBS and Citibank) have since made significant changes to board membership including bringing in new members with experience in finance.

On the other hand, some banks do report difficulties in recruiting non-executive directors with recent “high level” financial expertise in order to staff their risk and audit committees. European banks report that many potential candidates are already working for a competitor. The proportion of non executive directors who have at least one other current directorship in a financial organisation varies from around 60 per cent to a low of 8 per cent at UBS (Ladipo et al., page 20). In the US, the problem appears to be magnified by listing rules and SOX rules about audit committees. One head hunter is quoted as saying that “one of the unintended consequences of Sarbox is that its emphasis on

independence rules out from board positions a lot of people who knew about this business” (Guerrera and Thal Larsen). Another head hunter is quoted as saying that “people are very nervous about joining bank boards because they feel uncertain about the extent of the sophisticated financial instruments on the balance sheet and what the values are.”

The state-owned Landesbanken in Germany (and also IKB) have been hard hit by the financial turmoil, writing off USD 21bn by May 2008 (Bonfinger, *et al.*, 2008). It would appear that the supervisory boards of these banks have not been capable of responding to a changing business model. The banks used to have a business model based on a AAA credit rating which was due to a guarantee by the federal and state governments. Since 2005 this guarantee has been running out forcing the banks to look for higher yielding assets to boost already lagging profits. As a result, foreign denominated assets have risen rapidly as a share of the balance sheet. IKB even went as far as to set up its own structured investment vehicle (SIV), Rhineland Funding, as did Sachsen Bank (Von Balzli, *et al.*, 2008). It had to be saved in 2007 by the Kreditanstalt für Wiederaufbau, itself a state owned bank. Reports suggest that these boards, which included a number of local politicians, did not have the experience to radically change their business model and to take on new risks (Hau *et al.*, 2009).¹⁶ The same may be said of the Northern Rock board since it too had strong regional representation on its board. In the case of Sachsen Bank, the management board also failed to grasp the significance of a guarantee given to its Dublin-based subsidiary and to correct risk management weaknesses noted earlier in a special report (Von Balzli, *et al.*, 2008).

c. General implications for boards

The key issue concerns how to ensure the effectiveness of boards of large, complex companies. The evidence reviewed in this section suggests that in some instances the question of independent directors might have been pushed too far in favour of negative lists and this might have led to qualifications (i.e. a positive list) or suitability being only of secondary importance. The fact that a number of financial sector companies are now seeking to change the composition of their boards would support this hypothesis. The annotations to principle VI.E (the board should be able to exercise objective independent judgment on corporate affairs) states that a negative list defining when a board member is not independent “can usefully be complemented by “positive examples” of qualities that will increase the probability of effective independence”. The issue is not just independence and objectivity but also capabilities. The annotation to Principle VI.E.3 (board members should be able to commit themselves effectively to their responsibilities) touches on board training and notes that “this might include that board members acquire appropriate skills upon appointment, and thereafter remain abreast of relevant laws, regulations and changing risks through in-house training and external courses.”

¹⁶ A special audit report was being undertaken about events at IKB which could have shed more light on the causes of the huge unexpected loss that was announced only ten days after a board statement that the financial crisis in the United States would have no consequences. In accordance with German corporate governance practices, shareholders refused to give a discharge to the supervisory board for its work. The review was cancelled after the bank was sold to private owners. Consultancy reports covering the fiasco at Sachsen Bank are not yet available to the public.

6. Additional corporate governance issues

While the boards are primarily responsible for the weaknesses and failures of risk management and incentive systems, other aspects of the corporate governance framework have also played a role. These include credit rating agencies (CRA), and disclosure and accounting standards. In each case though, boards and companies could have used their own powers to overcome the evident weaknesses, and in some cases did just that.

a. Rating agencies: misleading but also misused by some

The quality of the work by credit rating agencies (CRA) has been a significant focus point in the current turmoil. This issue has been taken up by the International Organization of Securities Commissions (IOSCO) (2008), which recommended a strengthening of the voluntary code, as well as by the FSF (2008) and the SEC. There are serious structural problems: there is a high degree of concentration among the firms conducting the underwriting function (i.e. commissioning and paying for ratings). CRAs were therefore under considerable commercial pressure to meet the needs of their clients and to undertake ratings quickly (SEC, 2008). The FSA noted that “poor credit assessments by CRAs have contributed both to the build-up to and the unfolding of recent events. In particular, CRAs assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models. As investors realised this, they lost confidence in ratings and securitised products more generally”. More recently, the SEC (2008) has released a highly critical report about the practices of CRAs and has proposed a three-fold set of comprehensive reforms to regulate conflicts of interest, disclosures, internal policies and business practices of CRAs. The European Commission introduced wide-ranging regulation at the end of 2009 taking a prescriptive rule-based approach. Its complexity leaves, at the time of writing, many questions unanswered (Shiren and Crosignani, 2010).

In many instances, the original debt was split into varying tranches by the new financial instrument, supposedly with different risk/return characteristics. However, the CRAs were involved in advising on how to structure the instrument so as to obtain a desired rating. The principle involved here is similar to that for auditors: they should not be involved in auditing their own work, or in this case rating an instrument that they had themselves advised on how to structure. Furthermore, the originator was not only paying for ratings information but also for being assigned a specified rating – a clear conflict of interest.

While it is important to improve how ratings are made, even more important is to consider how they are used. The Senior Supervisors Group (2008) noted that some banks relied entirely on ratings and did not establish their own risk analysis of financial instruments (e.g. UBS, 2008). Such banks fared badly in the crisis. Some market participants and regulators have proposed eliminating references in regulations that establish a specific use of ratings (e.g. restricting some investors from buying securities less than investment grade) in favour of one that in principle encourages internal risk assessments and due diligence by investors, banks and others.

b. Disclosure and accounting standards: important gaps

Good corporate governance requires high standards of accounting and financial and non-financial disclosure. Research covering the major economies of the OECD suggests that the readability of the risk disclosures is difficult or very difficult and that there is generally no consistent global set of generally accepted risk management accounting principles and additional guidance available for risk disclosures in the annual report (van Manen, 2009). The Financial Stability Forum (FSF) (2008) has encouraged “financial institutions to make robust risk disclosures using the leading disclosure practices.” Leading disclosure practices were first enunciated by the Senior Supervisors Group in early 2008.

In the years after Enron, the US accounting authority, the Financial Accounting Standards Board (FASB), tightened the potential to misuse off-balance sheet entities (Special Purpose Vehicles), yet the problem has once again resurfaced in the current financial market turmoil. Prudential standards encouraged banks to engage in regulatory arbitrage by taking mortgages and other assets off the balance sheet and to finance them separately in conduits, SIVs or Qualified Special Purpose Entities (QSPE).¹⁷ This allowed them to economise on banks’ regulatory capital while booking fees from the transaction. In some cases (e.g. Citibank), the securities so created (CDOs) carried a liquidity put that allowed any buyer who ran into financing problems to sell them back at original value to Citibank. This was not disclosed to shareholders and the bank (i.e. the board) seemed unaware of the potential risk until November 2007 when USD 25 billion had to be brought back onto the balance sheet. In a number of banks, off-balance sheet CDO/conduits were brought back on to the balance sheet in order to protect the bank’s reputation. In many cases, these potential reputational risks had never been disclosed in a transparent manner and, as noted above, the risks were consequently probably not managed.

Another area where accounting standards have been put to the test concerns fair value of assets which either trade in thin markets or in no markets at all. There is a suspicion in the markets that different banks use very different valuations for the same asset contributing to market opacity and reduced integrity. The FASB has introduced a three way classification describing how assets have been valued. This system is now being used by banks reporting according to US GAAP. The FSF called on the International Account Standards Board (IASB) to strengthen its standards to achieve better disclosures about valuations, methodologies and uncertainty associated with valuations. The work is still underway at the start of 2010. In addition, the IASB has enhanced its guidance on valuing financial instruments when markets are no longer active. Both the IASB and the FASB have undertaken work on de-recognition (i.e. removing items from the balance sheet). The International Auditing and Assurance Standards Board (IAASB) is considering the lessons learned during the market turmoil and, where necessary will enhance the guidance for audits of valuations of complex or illiquid financial products and related disclosures.

¹⁷ ‘Qualified Special Purpose Entities’ is a device created in the mid-1990s to permit off-balance sheet treatment for securitisation of financial instruments. The criterion is that the off-balance sheet entity should be able to function independently from the originator.

c. The regulatory framework

Good corporate governance requires appropriate supervisory, regulatory and enforcement authorities. The experience during the financial turmoil has broadly confirmed their importance. In its review of supervision at Northern Rock, the FSA (2008) noted inadequate staff resources and training so that its risk-based system of supervision was not effective.¹⁸ They concluded that “we cannot provide assurance that the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the supervisory strategy was in line with the firms’ risk profile”. Under-resourcing was also an issue, the internal report noting shortage of expertise in some fundamental areas, notably prudential banking experience and financial data analysis. These are important deficiencies in view of the demands placed on supervisors.

D. Conclusions

This article concludes that the extent of the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements. When they were put to the test, corporate governance arrangements did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies. A number of weaknesses have been apparent. The risk management systems have failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone: information about exposures in a number of cases did not reach the board and even senior levels of management, while risk management was often activity- rather than enterprise-based. These are board responsibilities. In other cases, boards had approved strategy but then did not establish suitable metrics to monitor its implementation. Company disclosures about foreseeable risk factors and about the systems in place for monitoring and managing risk have also left a lot to be desired even though this is a key element of the OECD Principles of Corporate Governance and many national standards. Accounting standards and regulatory requirements have also proved insufficient in some areas leading the relevant standard setters to undertake reviews of these systems. Last but not least, remuneration systems have in a number of cases not been closely related to the strategy, internal controls and risk appetite of the company and its longer term interests.

The Article also argues that the importance of qualified board oversight, and robust risk management including reference to widely accepted standards is not limited to financial institutions. It is an essential, but often neglected, governance aspect in large, complex non-financial companies. Indeed, potential weaknesses in board composition and competence have been apparent for some time and widely debated. Furthermore, the remuneration of boards and executives remains a highly controversial issue in many OECD countries.

In sum, the OECD’s corporate governance principles appear to deal with many of the topical issues raised through the financial crisis but what is now required is better implementation.

¹⁸ Page 5, paragraph 27, Executive Summary.

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CHAPTER 3

the Financial Crisis: What are the Corporate Governance Lessons for Emerging Market Countries?

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A. Introduction

For many years, regulators and bankers have recognized that corporate governance plays an important role in the prudent operation of financial institutions and in the stability of the financial sector.² Principles of good governance have been a major component of international financial standards³, and many regulators view effective corporate governance as “the first line of defence” in their supervisory activities. Over the past ten years and especially since the Enron/Worldcom/Parmalat scandals of 2001–2003, significant energy and elevated attention has been placed on improving the ability of boards, managers, and owners to steer their companies through rapidly changing and volatile market conditions.

Given that background, how can the international financial community explain the events of 2007–2008? Were these failures the result of poor application of sound governance principles? Should the blame be placed solely at the feet of regulators and supervisors who some believe allowed a systemic wave to wash over otherwise well-run banks?

This chapter reviews the events of the past two years from a governance perspective and presents some preliminary lessons to guide future reform and thinking in emerging markets countries. The issues that have been raised by the financial crisis are not simply “developed country” issues. In fact, similar characteristics and issues can be seen across a spectrum of countries, as identified and highlighted through related World Bank work on corporate governance.

¹ This chapter is based on a publication *FPD Policy Brief: Corporate Governance of Banks: Lessons from the Financial Crisis*, available at <http://rru.worldbank.org/documents/CrisisResponse/Note13.pdf>

² This Chapter was written from the perspective of bank governance. However, most if not all the issues cited herein apply to all financial institutions.

³ The Organisation for Economic Co-operation and Development (OECD) *Principles of Corporate Governance*, first drafted in 1999 and revised in 2004, are the basic standard for good practice in corporate governance. The OECD Principles focus on “publicly traded companies, both financial and non-financial”, and represent an international consensus on what constitutes a good corporate governance framework. The Financial Stability Forum designated corporate governance as one of the 12 key standards for sound financial systems. Governance elements are also embedded in the Basel Core Principles (BCPs) for Effective Banking Supervision and other guidance issued by the Basel Committee on Banking Supervision (BCBS, 2006), the International Organization of Securities Commissions (IOSCO) Principles of Securities Regulation, and the International Association of Insurance Supervisors (IAIS) Principles of Insurance Regulation.

B. What is bank governance?

Corporate governance refers to the set of rules and incentives by which the management of a company is directed and controlled. Corporate governance frames the distribution of rights and responsibilities among the main corporate bodies and provides the structure through which company objectives are set, implemented and monitored. A firm committed to good corporate governance has an empowered board, a solid internal control environment, high levels of transparency and disclosure, and well-defined and protected shareholder rights.⁴

Banks have some specific corporate governance issues. Their stakeholders vary more widely than other private companies, including not only the shareholders but also, and perhaps more significantly, depositors and the general public. Banks deliberately take and position financial risk as the primary function through which to generate revenue and serve their clientele, leading to an asymmetry of information, less transparency and a greater ability to obscure existing and developing problems. They can also quickly change their risk profile, so weak internal controls can rapidly cause instability. As a result, sound internal governance for banks is essential, requiring boards to focus even more on risk assessment, management, and mitigation.

Good governance also complements financial supervision and is an integral factor to implementing effective risk-based financial oversight. The Basel II Framework requires that banks maintain strong internal governance procedures and processes. Pillar II (supervisory review) requires that banks maintain well-functioning systems of internal controls and risk measurement, management and mitigation—and adequate review processes by management and directors. Pillar III (market discipline) mandates additional risk disclosures to provide transparency and allow the market to provide discipline on poorly functioning banks that lack the risk systems to handle the institution's risk profiles.

C. Governance failures in the crisis

The central irony of the governance failures of 2007–2008 was that many took place in some of the most sophisticated banks operating in some of the most developed governance environments in the world, such as the United States (US) and the United Kingdom (UK). A variety of studies have been carried out to analyze the contribution of weak governance to bank failure and more broadly, to the financial crisis. The majority of their conclusions can be categorized into four broad areas:

- Risk governance
- Remuneration and alignment of incentive structures
- Board independence, qualifications, and composition⁵
- Shareholder engagement

⁴ For more information on the governance of financial institutions, see <http://go.worldbank.org/M0IQDL2UB0>.

⁵ This Chapter follows standard practice and uses the term “board” to refer to both the “board of directors” in a one-tier system, and the “supervisory board” in a two-tier system. Similarly, the term “CEO” (chief executive officer) refers to the senior manager in the company (managing director etc.).

A fifth area covers a separate set of governance crisis response – a new (or renewed) role for state-owned financial institutions.

1. Risk governance

A lack of effective risk governance is found at the top of the list of governance failures that led to the current crisis (OECD 2009, UBS 2008, Walker 2009). Risk governance is generally defined as board and management oversight of risk and the attendant configuration of internal risk identification, measurement, management, and reporting systems. Understanding the bank's risk composition and market position is key to the board's ability to set strategic direction and risk policy, provide management oversight, respond to developing challenges and opportunities, and effectively measure institutional performance based on the return of those risks and allocated capital. However:

- Many boards did not possess a comprehensive understanding of their institutions' risk profile and were not able to judge its appropriateness.
- Senior management failed to adopt and integrate the necessary systems to identify, manage, and report risk.
- Risk management units did not have the visibility, stature, or independence to raise and consolidate the spectre of risk to a level sufficient to prompt management and board response.

2. Remuneration and alignment of incentive structures

Good governance practice requires that boards should strive to align executive and board remuneration with the longer-term interests of the company and its shareholders. Over the past 10 to 20 years, this general goal was interpreted in the US and elsewhere to mean greatly increased use of equity-based, variable compensation, including stock options. However, the financial crisis has increased scepticism over the structure and use of incentive-based compensation. In banks (particularly failed ones), executives were seen to “reach for short-term yield” at the expense of long-term firm stability and value. This problem was compounded by the short-term nature of incentive structures, particularly those designed for the traders and business lines dealing with financial products most centrally implicated in the financial crisis. In some cases, the relatively high proportion of variable pay comprising remuneration packages required companies to issue bonuses even when the business was not profitable.

3. Board professionalism

One of the keys to aligning the interests of the company and its shareholders is to ensure board objectivity with the goal of preserving a “balance of power” or, in other words, a certain level of “productive tension” among directors. This requires ensuring effective leadership by the board chairman and the CEO, appointing experienced nonexecutive directors (NEDs), and assigning key tasks to board committees composed of a majority of NEDs. When productive tension was lost, the ability of the board to react to arising risks, address management issues, and maintain objective perspective was threatened.

4. Shareholder engagement

According to good corporate governance practice, shareholders have a number of basic rights and obligations. These include the right to appoint directors, the right to make key corporate decisions, and the right to obtain information about the company in order to inform their decision-making and prevent management from taking decisions that are contrary to their interests. On the other hand, institutional investors (who own the majority of traded shares on many markets) should play an active and informed role. They should participate in the governance process, “engage” with company management, and vote their shares responsibly.

However, basic shareholder rights are frequently violated, and institutional investors often fail to live up to good-practice expectations. In the US, dissident shareholders who put forward slates of directors for election are “confronted by substantial obstacles” and cannot frequently pass a non-binding resolution on compensation (Bebchuk and Fried 2004). At the same time, institutional investors in many countries are passive, do not vote, or have conflicts of interest with the companies in their portfolio. As a result, boards are insulated from investors, especially in the US, and shareholders are forced to rely on board independence requirements to oversee management and mitigate conflicts of interest. As noted above, board independence alone does not appear to have been able to control excessive risk taking by banks, the growth of executive compensation, and ultimately, the riskiness of the banking sector during the crisis.

5. State-owned financial institutions

In response to the credit crunch caused by the financial crisis, authorities in a number of countries have directly intervened as owners or quasi-owners in financial institutions. The best-known governance policy responses have accompanied government-provided financial support extended to financial institutions. For example, on June 10, 2009, the US government named a new official with the power to approve the compensation packages of executives at any major firms that are receiving “exceptional assistance” from the government, including AIG, Citigroup, Bank of America, Chrysler and General Motors. In Germany, banks participating in the capital support fund for capital injection / troubled asset purchases must put a cap on executive compensation, and ban dividends and bonuses. Other governments have added board representation and / or assumed the authority to change selected management.

Many countries have also taken measures to kick-start lending through the use of state financial institutions. Governments have used their state financial institutions to support lending in specific sectors, including trade finance and small and medium-size enterprise loans (Rudolf, 2010). While some governments have not provided additional funding explicitly for this purpose, others have committed such resources and have even used state financial institutions to recapitalize or provide liquidity to other troubled financial institutions (e.g. Germany).

These types of interventions appear to have reversed a long trend around the world in the reduction of the State’s involvement as owner in financial institutions. State ownership raises a host of new governance problems. Empirical evidence shows that state financial institutions around the world have been characterized by political interference,

lack of transparency, low accountability to stakeholders, inadequate prudential regulation and supervision, and lack of managerial skills and proper incentives.

D. The relevance for emerging markets

Most of the world's attention has been focused on the impact of the financial crisis on corporate governance issues in the US and the EU. However, the issues and problems identified are not only "developed country" issues. Similar concerns have been raised across a wide spectrum of countries, as identified and highlighted through World Bank work on corporate governance.⁶ In response to client demand, the World Bank has also carried out a number of specialized reviews of the corporate governance framework for financial institutions.⁷

The Bank's work suggests that a great deal has been accomplished in emerging countries to-date. Many countries have improved their corporate governance framework by adopting "codes of best practice" (guidelines that set a national standard for corporate governance) that can be implemented relatively quickly. Many financial sector supervisors have implemented regulations that attempt to bring the corporate governance of banks in line with international good practice. Financial and non-financial disclosures have also improved over time. In general, there is a much higher awareness of the importance of the role of the board of directors in most countries.

However, a number of policy issues remain in emerging countries, some of which reflect the same problems that have manifested themselves in developed countries during the crisis (see Appendix 1). The same general topics (risk governance, remuneration, board professionalism, shareholder roles and rights, and concerns about the role of the State as owner) are important in every country. However, the specific issues and their relative importance are different. This is because many of the issues that drove the financial crisis are specific to the peculiarities of US corporate governance. These are the result of the unique ownership structure in the US and the UK where ownership of large companies and financial institutions is relatively dispersed. These countries have unique corporate governance problems and concerns relating to the conflict of interest between managers and shareholders. In most other countries, such ownership is concentrated. This means that some problems present in developed markets (especially issues of executive pay) are less prominent in emerging countries.

1. Risk governance

World Bank country reviews indicate that the risk management function is nominally in place in most emerging market banks, but that it is still relatively unsophisticated. Banks have frequently established dedicated risk management units, but

⁶ Corporate governance is one of the 12 core "international best-practice standards" assessed under the Report on the Observance of Codes and Standards (ROSC) program. Each corporate governance ROSC assessment reviews the legal and regulatory framework, as well as practices and compliance of listed firms, against an internationally accepted benchmark, informing IMF surveillance, World Bank country assistance strategies, and market participants. Seventy-two assessments have been completed since 2000 in 52 countries.

⁷ Bank governance reviews are based on the principles set forth by the Basel Committee and conducted according to the World Bank's established methodology. Ten bank governance reviews have been conducted to-date.

the degrees of sophistication, autonomy, and capacity vary widely. Mechanisms to ensure broad Chief Risk Officer (CRO) autonomy and coverage have not been widely embedded. Most banks have not yet developed a board-level strategic approach to risk management, including setting risk tolerance levels. Risk-based approaches to optimizing capital allocation are not yet well established, and most banks do not yet have robust risk classification or risk pricing methodologies in place. These concerns are especially important in those countries and banks which have been growing rapidly.

2. Remuneration

High levels of equity-based remuneration are typically less of a policy concern in emerging market corporate governance. This is because there is less of a principal/agent problem between controlling shareholders / the board, and management. In fact, World Bank reviews have sometimes indicated that the opposite problem is more of a concern – shareholders are sometimes unwilling to pay for the top level talent required to manage large, rapidly growing banks. Low levels of remuneration are sometimes compensated by various indirect forms of compensation (i.e. benefits and privileges). These tend to be undisclosed and are often held to be a larger problem.

3. Board professionalism

The quality and role of boards is a major problem in most countries. In most emerging market financial institutions, ownership is concentrated. Family ownership is prevalent, leading to lack of separation of roles of ownership, board representation, and management. As a result, boards are dependent on the institutions that appoint them, and tend to be passive and insular.

Many countries have improved accountability and liability of board members. At the most basic level, this means imposing a “duty of care” and the “duty of loyalty”. However, if the results are to be judged by the number of successful legal actions taken against board members, the results have been disappointing so far: while the number of lawsuits against directors is increasing, especially in the larger markets, the absolute number remains very small.⁸

Modern board practice places great emphasis on objectivity and “independence”. However, putting “independent” boards in place is has proven to be a particular challenge. World Bank country reviews of banking sector governance indicate that objectivity at the board level is frequently compromised, because banking sector regulatory regimes have traditionally not called for independent directors. Nomination processes are still greatly influenced by banks’ ownership structures.

Board and executive capacity is also a larger concern than in markets with longer traditions of corporate governance. Most boards in most emerging markets countries have not set up formalized induction programs for new directors or ongoing professional education for current board members and senior executives to ensure that their skills stay current. Director training does not appear to be widely accepted and cultural barriers vis-à-vis continuous professional education remain and need to be overcome to further raise awareness of good corporate governance.

⁸ World Bank Bank Governance Reviews, unpublished.

Many countries now require board committees, to make the board's work more efficient and to isolate potential conflicts of interest. While in most countries committees are in place, significant additional work is required to make them work as designed.

4. Disclosure and transparency

Disclosure and transparency remains a much larger concern in emerging markets countries. While many countries have upgraded their legal and regulatory frameworks and are moving towards the adoption of International Financial Reporting Standards (IFRS), actual practice continues to lag behind the formal adoption process.

Non-financial disclosure tends to pose an even bigger problem. Very few countries meet the extensive non-financial disclosure standards required by the OECD Principles (which in some areas are more extensive than those required by international financial reporting standards). The single largest issue is the disclosure of ownership and control. Most countries have some kind of ownership disclosure requirement. However, many require only the disclosure of "direct" shareholders, not "indirect" or "ultimate" shareholders or shareholders acting in concert. Even when indirect disclosure requirements are in place, owners can use complicated ownership structures and intermediaries incorporated in offshore zones to make it nearly impossible for a shareholder (or other stakeholder) to know who really owns and controls the company. The disclosure of the real owners of publicly traded companies is a particular problem in transition economies.

5. Shareholder rights and responsibilities

Shareholders tend to have greater concerns about their basic rights in most emerging market countries. This includes basic shareholder ownership rights and protection, minority shareholder rights, and the basic governance processes and procedures. However, under most legal systems, shareholders have a variety of legal actions they can take to defend their interests, including the right to call an extraordinary shareholders meeting, appraisal rights (the right to withdraw from the company when the shareholder dissents from specific actions taken by the company), the right to appoint an outsider to inspect company records, and the ability to sue to overturn meeting decisions. Many countries have reduced the thresholds required to take action, making legal action more accessible to smaller shareholders (those with 5–10% of capital). But problems remain with the application of rules designed to protect small shareholders against expropriation, especially the review, approval, and disclosure of related party transactions.

6. State-owned financial institutions

While the nationalization of large banks in the US and UK garnered all the headlines, the State continues to play a major role as the owner of financial institutions in many emerging market countries. Although data is not yet available, the financial crisis appears (anecdotally) to have encouraged those who support the role of further state involvement in the financial sector.

Should this prediction materialize, economic growth could suffer. A significant body of literature has suggested that state financial institutions have adversely affected economic growth. Government ownership of banks is associated with slower subsequent

financial development, lower economic growth, lower productivity growth, and a higher likelihood of banking crises.⁹

E. Conclusions

One lesson from the current crisis, which is also consistent with the Asian financial crisis, which unfolded 12 years ago, is that corporate governance matters. Different financial institutions have fared differently during the crisis, depending in part on the strength of their overall governance framework and culture. Financial institutions in all markets will have to increase their efforts to build strong governance institutions and cultures.

A second lesson is that much of the existing governance regulation and framework is adequate, and should remain intact. However, the devil is in the details of implementation. A key issue (especially in emerging markets) is to increase the capacity of boards to oversee strategic risk taking and to accurately judge institutional performance. Improving board capacity will require upgrading the skill, experience and leadership of non-executive directors and rebalancing the “productive tension” that should accompany a high-performing board. Shareholders, particularly longer term institutional investors who have a stake in the performance and stability of their companies, can play a role in this respect through more responsible interaction and a focus beyond short-term returns that might compromise longer term safety and soundness.

⁹ See for example Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer. 2002. “Government Ownership of Banks.” *Journal of Finance* 57 (1): 265–301, and, Alejandro Micco, Ugo Panizza, and Monica Yañez “Bank Ownership and Performance: Does Politics Matter?” *Journal of Banking and Finance*, 2007. (1): 219–41.

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Appendix 3.1

Bank governance policy issues: developed countries compared to emerging market countries

	Developed Countries (Crisis-related findings)	Emerging Market Countries
Risk Governance	<ul style="list-style-type: none"> • Risk management systems were frequently deficient. • Boards did not understand their risk profile. • Strategies were not accompanied by a corresponding consideration of the risks involved. • Risk management functions in many banks did not have adequate visibility or stature. 	<ul style="list-style-type: none"> • Major area of concern in emerging countries. • Boards may not understand their role or set appropriate risk taking strategies. • Rapid growth in many institutions (and resulting increases in risk) not matched by improvements in risk governance. • Risk management systems are only now evolving.
Remuneration and Alignment of Incentive Structures	<ul style="list-style-type: none"> • Increased scepticism over the use of incentive-based compensation. • Executives were seen to reach for short-term yield at the expense of long term firm stability and value. • Focus on design of compensation packages and the optimal split between the fixed and variable components, and the relationship with risk, long term performance, and shareholders' interests. 	<ul style="list-style-type: none"> • Direct remuneration is less of a policy concern. • The opposite problem (low-paid executives and boards) is sometimes identified. • Lack of adequate disclosure is a major issue. • Indirect forms of compensation (i.e. benefits and privileges) may be a larger problem.
Board professionalism	<ul style="list-style-type: none"> • Studies of failed institutions suggest erosion in independent / objective oversight role of boards. • In the US, the positions of chairman and CEO were combined; the "imperial CEO" remains common practice. • Boards were less independent than they appeared. • There may have been too few executives on the board. • Technical expertise may have been inadequate. 	<ul style="list-style-type: none"> • Large problem in emerging countries, but with different characteristics. • Boards tend to be passive and insular. • Board and executive capacity is a key concern. • Family ownership prevalent, leading to lack of separation of roles of ownership, board representation, and management. • Putting "independent" boards in place is particular challenge.
Disclosure and transparency	<ul style="list-style-type: none"> • Significant financial and non-financial disclosure • Variety of problems and debates over accounting standards (e.g. market-to-market / fair value). • Concerns over disclosure of risks. 	<ul style="list-style-type: none"> • Major concern and a key problem. • Many countries moving toward adopting International Financial Reporting Standards (IFRS). • Weak enforcement mechanisms. • Ownership is often opaque.
Shareholder roles and rights	<ul style="list-style-type: none"> • Debates over shareholder engagement and passivity during run-up to crisis • In the US, shareholders are rarely able to veto board members or propose new ones in annual meetings. 	<ul style="list-style-type: none"> • Shareholder rights have also improved, but problems remain with the application of rules designed to protect small shareholders against expropriation. • The State (major owner of banks in many countries) is typically a poor owner that often plays by its own rules.

Source: World Bank

Chapter 4

Governance of Markets Matters

**Jane Diplock, Chairman of the New Zealand Securities Commission and
Chairman of the Executive Committee, International Organization of Securities
Commissions (IOSCO)**

A. Introduction

The International Organization of Securities Commissions (IOSCO) considers good corporate governance to be the key to capital market integrity and stability. A strong case can be made that the replacement of traditional, centuries-old standards of conduct with unregulated market forces was a major precipitant of the global financial crisis. John Bogle, founder and former CEO of the US corporation Vanguard Group of Mutual Funds and a member of the international Financial Crisis Advisory Group, has referred to it as a “crisis of ethic proportions” (Bogle, 2009).

The financial world is now transitioning from a time when business ethics tended to be seen more as an optional add-on than an essential operating principle: a luxury rather than a necessity. We can no longer cling to the notion that markets will sooner or later correct themselves. The challenge is to correct the poor corporate governance practices that contributed to the crisis.

Corporate governance is the codification of sound ethical standards: a set of guidelines or tools that ensure, as Bogle puts it, that self-interest does not get out of hand (Bogle, 2009). At the practical level, good governance embodies several key principles: fostering and adhering to high ethical and professional standards in every corporate decision and initiative; ensuring boards are comprised of experienced, independent, skilled, knowledgeable directors; ensuring remuneration policies are transparent, reasonable and fair; ensuring risks are clearly identified and properly managed; ensuring directors are confident of the quality and independence of auditing processes.

IOSCO’s work has always focused on addressing risks to investor protection and on the fair and efficient functioning of financial markets. A critical element in this is ensuring that the drivers of behaviour of those who control and influence market participants and markets are aligned with the interests of investors and other stakeholders. The global financial crisis revealed critical stresses and weaknesses in global financial systems. The recently published reports outlined in this chapter address various aspects of market behaviour, including conflicts of interest, due diligence practices, ownership structures and other drivers of behaviour. They also address alternative approaches regulators could take, and encourage greater transparency in markets. These reports have required an examination of the current boundaries of regulated activity and extended the reach of regulation, in some cases beyond its traditional scope.

Return on shareholder funds must never be the sole driver of corporate behaviour; good governance must be geared towards the interests of actual and potential investors and other stakeholders, allowing them to make better market choices. This is also in the interests of companies themselves, since the evidence is that good governance is also good business.¹

B. Background on IOSCO

1. IOSCO's membership

IOSCO is the global organization of securities market regulators, and the recognized standard setter for the world's securities markets. It comprises 110 ordinary members, most of whom are independently constituted government regulators, and 72 non-voting affiliate members, who include stock exchanges, various stock market industry associations, self-regulatory organizations, and international bodies with an interest in securities regulation, such as the International Monetary Fund (IMF), World Bank and the Organization for Economic Cooperation and Development (OECD).

IOSCO members regulate more than 100 jurisdictions making up more than 90 per cent of the world's securities markets.

2. IOSCO's purpose

IOSCO exists to promote global financial stability by means of agreement on, and application of, consistent standards across all the world's financial markets; and, where those standards fail to be met, to enable effective enforcement across jurisdictions.

More specifically, through its permanent structures, IOSCO members aim to cooperate in promoting high standards of regulation in order to maintain just, efficient and sound markets; exchange information on their respective experiences in order to promote development of their domestic markets; unite their efforts to establish standards and effective surveillance of international securities transactions; and assist each other in promoting the integrity of markets by rigorous application of standards and their effective enforcement.

The network of market regulators comprising IOSCO, together with central bankers who are responsible for maintaining sensible monetary policy settings and prudential regulators that oversee the soundness of financial institutions, makes IOSCO a vital part of the global financial system's regulatory architecture. It regards effective prudential regulation of institutions and effective regulation of securities markets as equally important in promoting global financial stability and in providing the essential conditions for sustainable economic growth. It works closely with prudential regulators. It also works with sister organizations responsible for standard setting in the banking and insurance sectors: the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors. Furthermore, it is a founding member of the Financial Stability Board (FSB).

¹ Investor Opinion Survey, June 2000, McKinsey & Co with Institutional Investors Inc, cited in *The King Report*, King Committee on Corporate Governance, 2002.

3. IOSCO's consensus-based, democratic model

The first decade of the 21st century has demonstrated that the pre-crisis global financial architecture needed rethinking. IOSCO's structure reflects the widely distributed and highly networked securities markets of this century.

The organization's wide membership, democratic mode of operation and consensus-based standard-setting processes are the key underpinnings of its legitimacy. IOSCO takes decisions by consensus, making recommendations for endorsement by the President's Committee. All ordinary members are represented on the committee and have an equal say, regardless of the size or development stage of their markets. The standards IOSCO sets are formulated by expert practitioners and are the result of a thorough process that incorporates public consultation. While each member jurisdiction retains its sovereign capacity to set and regulate standards as it sees fit, the consensus reached through IOSCO on what these standards should be puts the organization in a unique position. Regulators have a vested interest in implementing IOSCO recommendations because they have collaboratively developed and collectively endorsed them. This process allows IOSCO to achieve an international reach that benefits the entire global community.

The 20th century was the century of structural solutions; the 21st is likely to be that of networked solutions. IOSCO's strength lies in the understanding and practice of such solutions. Its processes entail no abrogation of individual sovereignty; rather, its strength lies in the connectedness through which it works, a model mirroring those of technology and finance markets. This is what makes IOSCO such an important 21st century organization.

4. IOSCO's 2005 strategic direction: global ideas implemented nationally

Development of IOSCO's trans-national networked regulation model was accelerated in the opening years of the 21st century by the increasing interconnectedness of the individual markets comprising the global financial system. In an international financial system characterized as much by global interdependencies as by national differences, it is clear that a workable solution for consistent regulation of international securities markets is only possible if IOSCO members agree on global ideas that each member can implement nationally. Encouraging co-operation through a network of equals became the focus of IOSCO's strategic direction in the years preceding the global financial crisis. As it turned out, this approach was the best possible one for participation in the post-crisis financial world order.

In April 2005 IOSCO formally adopted a strategic direction that required member jurisdictions to reach agreed standards of securities regulation, particularly in relation to cross-border enforcement. This strategic direction was designed to encourage and assist member jurisdictions to implement the IOSCO Principles (outlined below), and, by means of a thoroughly audited process, have every jurisdiction sign up to its Multilateral Memorandum of Understanding (MMOU) (outlined below) by a January 2010 deadline.

5. The IOSCO principles

In 1998 all 109 members of the President's Committee endorsed the *Objectives and Principles of Securities Regulation*² and a related IOSCO assessment methodology. Together these provide a global benchmark against which each jurisdiction can measure and align its own laws. The Principles recognize that securities regulation should have three objectives: the protection of investors; ensuring markets are fair, efficient and transparent; and the reduction of systemic risk. The Principles are updated regularly to keep pace with market developments and changes in regulatory thinking, and are currently being reviewed in light of the lessons of the global financial crisis. They are not an attempt to create a single international body of rules and regulations, but a set of global benchmark standards against which any jurisdiction may measure and align its laws consistent with its own priorities, traditions, market developments and legal frameworks.

In 2003 the organization endorsed a comprehensive methodology (IOSCO, 2003a) for objectively assessing the extent to which member jurisdictions have implemented the IOSCO Principles and developed feasible action plans for correcting any deficiencies.

6. The IOSCO multilateral memorandum of understanding (MMOU)

In 2002 IOSCO adopted its MMOU, designed to facilitate cross-border enforcement and the exchange of information among the international community of securities regulators (IOSCO, 2002). Three years later it endorsed the MMOU as the benchmark for international cooperation among securities regulators. At the same time, it set the goal of having all 109 IOSCO members sign on to the MMOU by 2010 (IOSCO, 2005). All but five IOSCO member jurisdictions have done so.

This has been a significant achievement in global cooperation, given the need for strict auditing before a country may sign the MMOU, the number of jurisdictions with laws needing repeal or modification before they could adopt it, and the entrenched tensions between many nations in the broader field of international affairs.

The IOSCO MMOU ushered in a new era of mutual support between national regulators, reshaping cross-border securities market enforcement and making it easier to track transgressors across markets and political borders. It is a cornerstone of the new post-crisis financial world order. It is also critical to IOSCO's pursuit of market stability by means of more effective regulation and enforcement in globalized securities markets.

C. IOSCO's place in the global financial architecture post crisis

1. IOSCO recognized by the G20

With its wide membership, democratic process, and long-standing work programme to address emerging issues and improve cooperation between jurisdictions,

² Downloadable at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>

IOSCO was ideally placed to play a leading role in the international response to the global financial crisis. As the international community sought to restore confidence in financial markets, the significance of the “global ideas implemented nationally” philosophy became more apparent.

The G20 recognized this when it included the IOSCO Principles among the standards and codes it committed to seeing implemented and peer-reviewed through the Financial Sector Assessment Programme (FSAP) (Diplock, 2009). This joint IMF-World Bank programme, often relying on IOSCO experts for its securities markets components, assesses the financial regulatory framework of countries voluntarily submitting to it. The G20 has recommended that all its members undertake an FSAP assessment and that other countries either engage in a self-assessment or an FSAP using IOSCO principles.

2. IOSCO and the financial stability board

The need for additional work to ensure global financial stability was further recognized by the G20 when it urged expansion of the Financial Stability Forum to form the new Financial Stability Board (FSB) in April 2009. The FSB brings together the leading national and international standard setters and prudential regulators of the global financial architecture – a further investment in the philosophy of “global ideas implemented nationally”. In this forum IOSCO works closely with the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors, as well as the IMF, the World Bank, the OECD and the regional development banks.

D. IOSCO’s response to the global financial crisis

The global financial crisis has been a salient reminder of the importance of market stability as a contributor – along with well-regulated institutions – to the overall health of the financial system. IOSCO’s post-crisis work programme has concentrated on market stability and systemic risk: firstly, by analyzing the underlying causes of the crisis; secondly, by a specific work programme addressing aspects of market conduct important in the crisis; thirdly, by the development of a new IOSCO principle on systemic risk.

1. IOSCO report on the sub-prime crisis

IOSCO’s post-crisis work has been informed by the work of the Task Force on the Sub-prime Crisis, established in November 2007.³ The task force was asked to identify the causes of the sub-prime crisis, analyze the implications for international capital markets, and make recommendations that addressed issues facing securities regulators. Its report, published in May 2008, recommended future IOSCO work to address issues in four areas: issuer transparency; firm risk management; prudential supervision; valuation and accounting issues (IOSCO, 2008c).

IOSCO also set up a separate task force to explore the issue of credit agency conflicts of interest. Its report, published in March 2009 (IOSCO, 2003b), significantly

³ The Sub-Prime Crisis Task Force was established by IOSCO’s Technical Committee, the organization’s standard-setting arm.

strengthened the capability of IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies to deal with the quality of ratings and conflicts of interest in the ratings process.

2. A new emphasis on identifying systemic risk

As a result of these initial reports into the causes of the sub-prime crisis, IOSCO (and organizations with which it works) has prepared a number of other reports and recommendations (detailed below). The organization has reaffirmed its focus on market stability and identification of the causes of systemic risk. It is developing strategies to help regulators more effectively identify the causes of systemic risks in markets.

IOSCO is also developing its strategic direction for 2010 onwards, and is expected to emphasize the need for greater vigilance on systemic risks. It will develop independent research capabilities, and monitor the unregulated boundaries of markets where, in otherwise well-regulated jurisdictions, destabilizing products and market practices may nevertheless appear. Two IOSCO task forces – the Task Force on Unregulated Products and Markets, and the Task Force on Unregulated Entities – are working in this area and have made preliminary recommendations on information regulators could collect to help assess systemic risk.

3. Post-crisis recommendations

This new emphasis has shaped IOSCO's recent work. Six recent IOSCO reports and one undertaken in conjunction with other organizations demonstrate its commitment to ensuring that investors are adequately protected and markets remain fair, efficient and transparent.

- a. Private Equity Conflicts of Interest, November 2009 (IOSCO, 2009a).
- b. Special Purpose Entities – Joint Forum⁴, September 2009 (Basel Committee on Banking Supervision, 2009).
- c. Elements of International Regulatory Standards on Funds of Hedge Funds Related Issues Based on Best Market Practices, September 2009 (IOSCO, 2009b).
- d. Exploration of Non-Professional Ownership Structures for Audit Firms, September 2009 (IOSCO, 2009c).
- e. Principles for Periodic Disclosure by Listed Entities, July 2009 (IOSCO 2009d).
- f. Good Practices in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments, July 2009 (IOSCO, 2009e).
- g. Hedge Funds Oversight, June 2009 (IOSCO, 2009f).

Two of these reports extend beyond the boundaries of current regulation into private equity firms and hedge funds; entities which must also be encouraged to be more transparent since they deal with parties within regulated markets.

⁴ The Joint Forum consists of the Basel Committee on Banking Supervision, IOSCO and the International Association of Insurance Supervisors.

a. Private equity conflicts of interest

Conflicts between a manager and third-party investors arising from a firm's obligations to multiple funds were originally identified as a private equity industry risk in an IOSCO report published in May 2008 (IOSCO, 2008b). This latest report identifies the risks such conflicts pose to fund investors and to the efficient functioning of the market.

How companies raise equity privately rather than through public fundraising varies from country to country but is usually based on limited partnerships or similar legal structures with a lifespan of 10 years. The fund manager draws down committed investor capital throughout the life of the fund as investment opportunities arise. Investors entering into this kind of contractual agreement are therefore obliged to commit capital for the life of the fund, making private equity investment highly illiquid.

Private equity firms exist in many global markets. North America has by far the most, accounting for 26 per cent of the global figure. Europe accounts for 40 per cent of global investment activity. While the Asia-Pacific region accounts for nine per cent of funds raised, 29 per cent of global private equity investment occurs in this region.

This consultation report proposes eight principles for mitigating potential conflicts of interest in private equity firms, thereby, addressing the risks these conflicts pose to fund investors and the efficient functioning of the market.

- a. Private equity firms should manage conflicts of interest in the best interests of their fund(s), and therefore the overall best interests of fund investors.
- b. Firms should draw up and implement written policies and procedures to identify, monitor and mitigate conflicts of interest right across their whole business.
- c. Firms should ensure these policies and procedures are available to all fund investors – from when they first invest and regularly throughout the lifetime of the investment.
- d. Private equity firms should regularly review policies and procedures, and their application, to ensure these remain appropriate to new business developments.
- e. Firms should opt for the most effective mitigation techniques and those yielding the most investor clarity.
- f. Firms should draw up and implement a well-documented process for consulting investors on conflict-of-interest matters.
- g. Firms should promptly disclose to all affected investors opinions emerging from investor consultation and any actions taken (unless doing so would breach legal or regulatory requirements or duties of confidentiality).
- h. Private equity firms should ensure all investor disclosure is clear, complete, fair and not misleading.

These principles are designed to drive private equity firm governance and give industry and regulators a means of assessing controls aimed at managing potential conflicts.

b. Report on special purpose entities⁵

Special purpose entities (SPEs) have a range of uses and benefits for institutions and investors, and are likely to go on being used for financial intermediation and disintermediation. Created by a sponsoring firm, an SPE may take the form of a corporation, trust partnership or limited liability company whose operations are confined to the acquisition and financing of specific assets or liabilities. The SPE's defining feature is its bankruptcy remoteness: its assets remain inaccessible to creditors of the sponsoring firm should it go into bankruptcy.

Poor understanding of SPE risk and its management can, however, lead to failures. Market participants have suggested that the degree of due diligence carried out by firms originating SPEs depends on whether they intend retaining related risks on their own balance sheet or transferring them to the SPE. In some jurisdictions, most SPE transactions are on-balance sheet; in others they are off-balance sheet. This is a crucial factor in the degree of SPE transparency in international financial system.

The global financial crisis stress-tested SPE structures, revealing serious deficiencies in the understanding and management of the risks they pose. It highlighted some firms' incorrect estimations of the degree of risk-transfer, and that some senior managers were unaware until the crisis of their firms' linkage and obligations to SPEs. Furthermore, some investors seemed to have carried out less than adequate independent due diligence to appreciate the risk profile of SPE they were investing in.

The report's eight recommendations are aimed at regulated firms, other market participants and supervisors.

- a. Supervisors should ensure market participants assess all SPE economic risks and business purposes throughout the life of a transaction, distinguishing between risk transfer and risk transformation, and should be particularly aware of how the nature of these risks can change. Supervisors should ensure assessment is ongoing and management properly understands the risks.
- b. Market participants should be able to assess and manage factors that increase transaction complexity; for example, an SPE's particular structural features. They should include the roles of the various parties in their assessment.
- c. Firms and supervisors should ensure the SPE governance process is commensurate with the complexity of the structure and the degree of intervention and discretion required of parties participating in it.
- d. Firms should continuously monitor the quality of transferred exposures in relation to the risk profile of the firm's remaining portfolios and the impact on its balance-sheet components. Where necessary, supervisors should assess systemic implications of risk dispersion to transferees.
- e. Firms should be capable of aggregating, assessing and reporting all SPE exposure risks in conjunction with all other firm-wide risks.
- f. If, at inception or any point in the life of an SPE, there is evidence or likelihood of support by the sponsoring financial firm, including non-contractual support, then the activities of that SPE should be aggregated with

⁵ Published by the Joint Forum, which aims to enhance understanding of key supervisory issues related to financial conglomerates and other cross-sectoral issues, and improve regulation worldwide.

those of the sponsoring institution for both supervisory assessment and internal risk-management purposes.

- g. Supervisors should support market participants' efforts towards greater standardization of definitions, documentation, and disclosure requirements of SPE transactions, and communicate to investors in individual transactions any material divergence from these standards.
- h. Supervisors should regularly oversee and monitor the use of SPE activity and assess the implications for regulated firms of SPE activities. This allows them to identify developments that could lead to systemic weakness and the spread of financial troubles, or those that might exacerbate pro-cyclicality.

Several IOSCO members have recently implemented regulatory and legislative changes to address concerns raised by financial frauds. Some have adopted additional non-financial statement-disclosure requirements to solicit information on unconsolidated SPEs; others have changed relevant accounting standards to make it more likely SPEs are consolidated. Since it is too early to assess how well these measures are working, the report's authors conclude it would be premature to determine a global approach on reporting information on unconsolidated SPEs to investors. IOSCO will continue to monitor developments in off-balance sheet financing activity, including unconsolidated SPEs, and may consider whether guidance on the latter might be useful.

c. Elements of international regulatory standards on funds of hedge funds related issues based on best market practices

Hedge funds are investment companies that, due to legal exceptions, generally avoid the regulations typically applied to other types of investment company. Open to a limited number of investors, hedge funds tend to engage in a wider range of investment and trading activities – into shares, debt and commodities, for instance – than long-only funds. They generally pay managers a performance as well as a management fee, and the hedge fund manager determines the type and method of investment it will undertake.

This IOSCO report was prompted by retail investors' increasing involvement in hedge funds through funds of hedge funds. It aims to enhance regulatory protection of investors by developing proposals in two areas identified by a June 2008 report (IOSCO, 2008a): liquidity risk and due diligence. These are areas in which investors are largely unprotected. The standards the paper recommends are drawn from a larger body of IOSCO work on addressing hedge fund regulatory issues.

With regard to liquidity risk, the report recommends the fund of hedge funds' manager make reasonable enquiries to determine if the fund of hedge funds' liquidity is consistent with that of the underlying hedge funds. Before investing and during the investment's lifetime, managers should consider the liquidity of the financial instruments held by the underlying hedge funds. They should also consider whether the introduction of limited redemption arrangements is consistent with the fund's aims and objectives, and complies with proposed conditions. Before and during any investment managers should consider whether conflicts of interest might arise between any underlying hedge fund and other relevant parties.

The second key area – due diligence processes – also applies both before investment begins and continuously throughout its life. Funds of hedge funds' managers

should constantly monitor and analyze three sources of risk: the appropriateness of the legal regime and service providers, and the transparency, valuation and reporting arrangements of a specific hedge fund; the resources, procedures and organizational structures required to carry out appropriate due diligence; and the conditions for authorizing the outsourcing of due diligence.

Managers should establish, implement and regularly review due diligence procedures for investing in hedge funds, assess specific jurisdictional legal and regulatory requirements, and carry out appropriate due diligence on the underlying hedge fund whenever necessary. Resources, procedures and organizational structures should be adequate to conducting robust due diligence, with a traceable, documented procedure for selecting hedge funds as well as skilled staff with adequate technical resources. There must be resources, procedures and an organizational structure capable of taking corrective action on any anomalies that due diligence identifies. Managers should regularly assess whether selection procedures for eligible underlying hedge funds have been properly followed, and explain any deviations. If a fund of hedge funds' manager wishes to outsource any aspect of due diligence, they should ensure any conflicts of interest are adequately addressed, and see that outsourcing is consistent with the IOSCO *Principles on Outsourcing of Financial Services for Market Intermediaries* (IOSCO, 2004).

The report's standards are not intended to be comprehensive or legally binding. They do, however, reflect the common views of IOSCO members and may guide future regulation.

d. Exploration of non-professional ownership structures for audit firms

This paper was prompted by concerns raised at a June 2007 roundtable,⁶ namely: the relative transparency of audit firms and its potential effect on audit quality and the availability and delivery of audit services; the adequacy of standard audit reports; and the impact of audit firm ownership structure on concentration in the market for auditing large issuers. Since most jurisdictions require public companies to submit audited financial statements, and securities regulators and investors rely on the continued availability of quality audit services.

The European Union, Japan and the United States all restrict audit firm ownership. Yet securities regulators have long been concerned with the resulting high market concentration in audit services for large public companies. Many conduct business internationally and, accordingly, seek audit firms with international breadth and specific industry expertise. In order to extend their own global reach, several audit firms have merged. Furthermore, the criminal indictment of Arthur Andersen in 2002 prompted the firm's large public company clients to change auditor, in most cases to one of the other Big Four (Deloitte Touché Tohmatsu, Ernst & Young, KPMG, PricewaterhouseCoopers). No new entrant has emerged to challenge the market dominance of the Big Four for large public company audits.

In 2006, the Big Four audited 98 per cent of the 1,500 US public companies with annual revenues of more than \$1 billion, and 92 per cent of US public companies with

⁶ The IOSCO Roundtable on Quality of Public Company Audit from a Regulatory Perspective – Paris, June 1, 2007. <http://www.iosco.org/library/index.cfm?section=pubvids>

annual revenues of between \$500 million and \$1 billion.⁷ In 2007, global revenues of each of the Big Four ranged between EUR15 billion and 20 billion, with revenues for the next six largest audit firms ranging between EUR2 billion and 3.7 billion per year.⁸

The loss of just one of these four firms is capable of disrupting the entire market for independent audit of large companies. This would threaten investor interests along with the efficient functioning of capital markets. Yet ownership restrictions can bar motivated potential market participants. Restrictions are justified by the requirement for audit firm owners to have public interest obligations. They also aim to mitigate conflicts of interest between auditor and audit client: a publicly owned accounting firm might well have shareholders who are themselves affiliated with its audit clients.

IOSCO set out to explore audit company market concentration, the barriers preventing more firms from competing in that market, and the potential disruption to capital markets likely to result from the loss of another big firm. At the same time IOSCO is keen to preserve auditor objectivity, independence, professionalism and competence, and thus, audit quality, in which investors have an abiding interest. Audit firm regulation currently relies on principles, rules and regulations, as well as ownership restrictions to guard against threats to independence, professionalism and competence. Independence is crucial to an external audit and, historically, independence rules have been seen as one of the most important aspects of audit regulation. It may well be that these existing standards are adequate safeguards of independence, professionalism and competence even were alternative ownership arrangements to be permitted.

Additional safeguards could also, however, mitigate possible risks arising from modifying ownership restrictions. These might include requiring firms to limit non-practitioner investment to passive ownership, including non-voting shares or shares with restrictions on ownership transfer, or requiring investors to meet standards akin to ‘fit and proper requirements’. Firms could appoint independent boards and strengthen quality-control frameworks, with practitioners required to continue managing audit firms and to establish firm standards of competence, professionalism and independence.

Modifying rules for audit firm ownership, coupled with these stronger checks and Balances, would be likely to give public companies greater choice of audit firm services than they currently have. Allowing for non-practitioner ownership might enlarge the pool of human capital with appropriate technical expertise, thus improving the quality of audits and firm governance. These potential benefits, however, do not justify compromising the audit quality essential to investor protection. Auditors’ opinions are rightly expected to enhance the reliability of reported financial information, and investors should be able to expect objectivity, independence, professionalism and competence.

The report suggests that these competing elements justify further exploration of options for audit firm ownership, and that doing so could well have the potential for allowing new competitors to enter the market.

⁷ Cited in the report ‘US Government Accountability Office, Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action’, 2 January 2008, <http://www.gao.gov/new.items/d08163.pdf>

⁸ Cited in the report ‘European Commission, Directorate General for Internal Market and Services Working Paper: Consultation on Control Structures in Audit Firms and Their Consequences on the Audit Market’, 3 November 2008, http://ec.europa.eu/internal_market/auditing/docs/market/oxera_consultation_en.pdf

e. Principles for periodic disclosure by listed entities, (periodic disclosure principles)⁹

Periodic reporting is the lynchpin of both investor protection and transparent operation of financial markets. Reports should enable investors to make rational decisions by allowing them to examine a company's performance over time and compare it with that of other companies. Given that financial markets are now global, widely accepted international disclosure standards are also important in facilitating cross-border capital-raising, enabling issuers to tap quickly into global markets, and encouraging efficient, liquid markets.

Financial information is the most elemental disclosure contained in an annual report, and a basis for other reported information, such as management's assessment and analysis of the company's performance and prospects. Security holders, as well as potential investors, need a clear picture of the issuer's financial position, performance and cash flows in order to assess its liquidity and solvency and make informed decisions about their investment strategy.

This consultation report on periodic disclosure is part of IOSCO's ongoing work to develop disclosure principles for issuers of listed securities.¹⁰ It is intended to guide companies with securities listed or admitted to trading on a regulated market in which retail investors participate.

The report recommends that information in periodic reports be relevant, and to this end include independently audited financial statements covering the entire prior financial year. Financial reports should identify those responsible for producing them, and confirm that financial information is fairly presented. They should be clear, concise and understandable, and should disclose payments to the issuer's directors and senior management. Issuers should also report on their corporate governance since good practices can improve investor confidence, demonstrate that directors and executive officers are being held accountable for their actions, and ensure shareholders may exercise their rights.

Issuers' internal control over financial reporting should be regularly reviewed to ensure assets are safeguarded from unauthorized or improper use, and transactions properly recorded. Effective internal controls can improve the quality of financial reporting by minimizing financial, operational and compliance risks.

Information should be made regularly and promptly available. Periodic reports should be filed with the relevant regulator, and the information stored to facilitate public access. Information disclosed in periodic reports should be fairly presented, and not misleading or deceptive. Material information should not be omitted. Reports should be made simultaneously available to everyone in all jurisdictions in which the entity is listed or admitted to trading. Disclosing information to certain investors or other parties before it is made generally available may reduce investor confidence in the fairness of markets.

⁹ This is a consultation report as of early March 2010, with a final report to follow.

¹⁰ The report's suggested principles complement existing IOSCO disclosure principles: 'Guidance for cross-border offerings of equity securities', (1998); 'Ongoing disclosure and material development reporting', (2002); 'Management's discussion and analysis', (2003); 'Cross-border offerings of debt securities', (2007); and 'Offerings of asset-backed securities', (2009).

Prohibiting premature disclosures reduces the likelihood of insider trading or abusive use of information.

f. IOSCO Good Practices in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments (Investment Manager Due Diligence Practices)

The good due diligence practices this report recommends are aimed at helping industry and regulators understand, assess and monitor investments in structured finance instruments (SFIs) on behalf of collected investment schemes (CISs). They were developed with industry representatives following the *Report of the Task Force on the Sub-prime Crisis*, May 2008, and should inform any review, development or reconsideration of due diligence policies and procedures.

Investing in an SFI differs from investing in a more traditional instrument and therefore calls for a tailored due diligence process. Due diligence should be ongoing, beginning when initial investment in the SFI is contemplated and ending only when it matures or is divested. A buyer who cannot understand an SFI should not buy it and due diligence should never be simple box-ticking: it needs to be a three-step, iterative process.

The first step entails gaining an understanding of the SFI's underlying assets. It should never be assumed that the unique properties of its specific asset pool are identical to the broader asset category. Step two entails analyzing an SFI's structure. Managers should ensure their analysis of underlying assets is based on information relevant to that specific type. SFI structure analysis should take account of both "normal" and "stress" scenarios, and investment managers should ensure that they can access the right expertise, including legal expertise, to analyze a particular SFI. Whatever the SFI's structure, asset managers should understand how cash flows will be allocated to its various tranches. Asset managers should deploy the practices recommended in this report to decide on behalf of investors whether an SFI is valued at the right price, taking its risks into consideration. The third step entails checking that investment in the SFI on behalf of the CIS is consistent with the CIS's disclosures, mandate and internal operations.

The report also deals with the use of third parties for the due diligence process. Investment managers should understand a third party's methodology and parameters and have adequate means and expertise for challenging them. They should also understand the basis of a third-party opinion.

g. Hedge funds oversight

Although domestic regulators and standard setters publish principles and standards on hedge funds, questions continue to be asked about how effective and well-implemented such regimes are. Standards are by no means universally adopted. They vary between jurisdictions, and their enforceability by regulators or industry associations differs considerably. The hedge fund industry is international and mobile, requiring strong, globally-collective regulatory action on and application of measures and standards.

Given their various legal and business structures, hedge funds are difficult to define universally. Generally, though, they exhibit some or all of the following features: the non-application of borrowing and leverage restrictions, with many (but not all) hedge

funds using high levels of leverage; payment to managers of significant performance fees as well as an annual management fee, which may be compounded since they often invest in their own funds; investors allowed to periodically redeem their interests; use of derivatives, often speculatively, and the facility for securities to be short sold; and the involvement of diverse risks or complex underlying products.

Hedge funds can be beneficial in providing liquidity, price efficiency and risk distribution, and can contribute to global integration of financial markets as well as offer diversification opportunities. However, while the global financial crisis was not a hedge fund crisis, hedge fund activities did amplify its consequences because of their need to quickly unwind positions. This report suggests a measured approach to regulating hedge fund activity to ensure its benefits continue to accrue and its risks are mitigated. It proposes high-level principles that allow individual securities regulators to address the regulatory and systemic risks of hedge funds in their own jurisdictions on the basis of a globally consistent approach.

Hedge funds and/or their managers or advisers must be registered and subject to ongoing regulatory requirements in relation to organizational and operational standards; conflicts of interest and other conduct rules should be established; investors should be entitled to regular disclosures, and prudential regulation should be mandatory. Prime brokers and banks that fund hedge funds must also be registered, regulated and supervised, and have risk management systems and controls for monitoring their counterparty credit risk exposures to hedge funds. Hedge fund managers/advisers and prime brokers should provide regulators with information relevant to systemic risk, and regulators should encourage the development, implementation and convergence of industry good practices.

Regulators should also have the authority to co-operate and share information with other regulators. This will help mitigate risks across borders by facilitating oversight of globally active managers/advisers and/or funds and identifying risks arising from hedge fund activity or exposure.

E. IOSCO and post-crisis accounting issues

Entities' financial reporting is a hugely significant contributor to market transparency. Financial reports are the mechanism by which investors measure the economic reality of entities at any given moment. Because of this IOSCO takes a keen interest in the machinery and outcomes of global standard setting for accounting.

1. IOSCO and the process of standard setting for international financial reporting

IOSCO and its individual members maintain close interest in the standard-setting process for financial reporting, commenting on draft standards released by the International Accounting Standards Board (IASB) as exposure drafts.

Following the global financial crisis, IOSCO has been closely involved in initiatives to improve transparency by way of better quality disclosures and enhancements of the governance of international accounting standard setting. Principal among these

have been the formation of the IASB Monitoring Board. The work of the Financial Crisis Advisory Board (FCAG) has also been instrumental.

The global financial crisis highlighted a range of financial reporting issues, some commentators even going so far as to suggest that fair-value accounting either contributed to or exacerbated the causes of the crisis (Joseph-Bell, *et al.*, 2008). The FCAG has since discounted this view. However the crisis was the impetus for the two key global accounting standard setters – the IASB and its US counterpart the Financial Standards Accounting Board (FASB) – to accelerate projects to clarify and simplify a number of accounting standards. These included standards for financial instruments and loan-loss accounting. The crisis also increased the urgency of calls for the creation of globally convergent accounting standards to better serve investors in globalized capital markets.

2. Creation of the IASB Monitoring Board

The IASB is the independent body for global financial reporting that sets the International Financial Reporting Standards (IFRS) now used in more than 100 countries. The IASB's counterpart in the US is the Financial Accounting Standards Board (FASB). US adoption of IFRS is therefore seen as the critical step in convergence of global accounting standards.

In 2008 IOSCO, the European Commission, the US Securities and Exchange Commission and the Japanese Financial Services Agency established a new monitoring board to interact with the International Accounting Standards Committee Foundation (IASCF), the IASB's oversight body, in response to concerns about the governance of the IASB standard-setting process. The IASCF Monitoring Board charter was signed in April 2009.¹¹

The IASCF Monitoring Board gives securities regulators requiring or allowing the use of IFRS in their own jurisdictions a means of ensuring IFRS are being developed according to procedures and policies that protect investor interests. The monitoring board interacts exclusively with the IASCF, not the IASB, which preserves the IASB's standard-setting independence so critical to developing high-quality standards based on technical expertise. The monitoring board includes representatives of securities regulators in both developed and emerging markets, thus reflecting the widespread use of IFRS.

3. The Financial Crisis Advisory Group

FCAG was formed in late 2008 as a FASB and ISB joint initiative to investigate and advise on the implications of the global financial crisis for financial reporting. FCAG comprised 18 recognized financial market leaders, and was jointly chaired by Hans Hoogervorst, Chair of the Netherlands Authority for Financial Markets, and Harvey Goldschmid, former Commissioner of the US Securities and Exchange Commission. IOSCO was represented by the Chair of its Executive Committee.¹²

FCAG's most significant recommendation to the G20 was to push for a single global accounting standard by converging IFRS and US GAAP. The existence of two

¹¹ http://www.iosco.org/monitoring_board

¹² This paper's author, and currently Chairman of the New Zealand Securities Commission.

financial standards hinders market transparency as well as the ability to compare entities using separate standards, particularly across borders. . It requires international investors to understand both financial reporting frameworks, thereby creating an ever-present risk of significant facts being lost in translation.

In July 2009, FCAG made important recommendations to the FASB, IASB and the G20 in the form of four broad principles (IASB, 2009).

a. Effective financial reporting

FCAG emphasised how critical financial reporting is to financial market participants, including investors and regulators. It noted the limitations of current reporting standards that had been exposed by the financial crisis. It specifically recommended action on simplifying the reporting of complex financial instruments; exploring alternative standards for loan-loss provisioning; and improving standards relating to off-balance sheet issues, such as consolidation and de-recognition.

b. Limitations of financial reporting

FCAG noted that financial reporting, although critical to market transparency, has limitations. It urged financial report users against suspending their own judgment or due diligence, particularly on price transparency. It urged authorities to set up robust infrastructures to foster price transparency, particularly for structured products and derivatives. It urged financial institutions to ensure they maintain effective price verification processes in order to improve valuation of assets and liabilities that are independent of sales trading and other commercial functions.

c. Convergence of accounting standards

FCAG urged the IASB and FASB, along with national governments, financial market participants and the global business community, to make every effort to achieve a single set of globally converged financial reporting standards. It encouraged national governments to set firm timetables for implementing IFRS, and international accounting firms to take a leadership role in harmonizing accounting standard interpretations across jurisdictions.

d. Standard-setter independence and accountability

The report emphasised the importance of maintaining the independence of accounting standard setters from undue commercial or political pressure, along with the need for independence to be balanced by due process. Due process includes engaging with stakeholders and providing thorough oversight conducted in the public interest by the monitoring board. It recommended that monitoring board membership be expanded beyond the EU, USA and Japan, to include securities regulators from other IFRS-adopting jurisdictions.

F. Conclusion

The global financial crisis has been a stark reminder to the world's financial community of how important corporate governance is to global financial stability. It illustrated that markets will not always correct themselves, and that the ethical standards central to good corporate governance are not always apparent in the actions of market participants. Recent IOSCO work has focused on issues relating to the governance of market players, whether within the traditional regulatory remit or outside of it.

As the post-crisis financial architecture has emerged, global financial leaders have become more aware of the need for effective market regulation as the virtuous twin of prudential regulation. Sustainable global growth will only take place in conditions of global financial stability. This requires the structure of financial entities and the interaction between them and the markets to be equally well regulated.

IOSCO has been closely involved in post-crisis initiatives – both on its own account and in partnership with sister organizations that regulate aspects of the global financial system. Its work reflects its fundamental purpose: consistent regulatory standards across jurisdictions and in all areas of markets. The financial crisis has accelerated much of IOSCO's ongoing activity and illuminated areas requiring the most urgent attention. Among these are unregulated entities and financial instruments, conflicts of interest and convergence of global financial reporting standards.

The greater role afforded market regulators and emerging economies in the machinery of post-crisis global standard setting, such as the G20, FSB and FCAG, demonstrates that world financial leaders recognize the limitations of the system as it was, and that systemic failures were at least partly a failure of corporate governance.

The new post-crisis global financial architecture may still be under construction, but significant positive characteristics are already emerging. Decision-making in the new structures will be more inclusive and democratic. Standards will be more likely to converge in the interests of transparency and disclosure, and greater enforcement cooperation across jurisdictions will leave transgressors with fewer places to hide. IOSCO is optimistic that investors will be better served and sustainable growth better supported by markets that recognize good governance is now good business.

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Chapter 5

Corporate governance still a matter for shareholders

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The financial crisis was a regulatory failure, but corporate governance played a significant role. Better shareholder rights in the United States and stronger focus on shareholder responsibilities are two important corporate governance reforms that can restore confidence in the market.

A. Introduction

The international community is rightly engaged with discussion of the reforms needed to address the financial crisis and its consequences for the wider global economy. This chapter constitutes the International Corporate Governance Network's (ICGN) response on the subject by considering and advancing proposals for market and regulatory reform in the area of shareholder rights and corporate governance. It is intended to focus attention upon the needs of the investor community worldwide.

It is now widely agreed that corporate governance failings were not the only cause of the crisis but that they were highly significant, above all because boards failed to understand and manage risk and tolerated perverse incentives. In turn, shareholders lacked the information and, at times, the motivation, to address the gathering problems. Whilst it is clear that there were regulatory failures (for example allowing banks to operate with too little capital), it is also evident that enhanced governance practices should be integral to an overall solution aimed at restoring confidence to markets and helping to protect us from future financial crises.

The prescriptions advanced in this chapter draw upon the ICGN's international experience of exercising shareholder rights and promoting shareholder responsibility. The ICGN has some 450 members in more than 45 countries, including investors responsible for US\$9.5 trillion in assets under management. The breadth and expertise of ICGN members from investment, business, the professions and policy-making extends across capital markets. This enables the ICGN to actively engage corporations across borders to positively influence the corporate governance reform agenda, particularly in the midst of the multilateral effort to tackle the global financial crisis.

This chapter reiterates the ICGN's views on the role that corporate governance can and should play in restoring trust in global capital markets. The crisis is a collective problem with many and varied causes. This chapter, therefore, directs itself to all those charged with repairing the system: financial institutions and their boards, regulators and policy makers and, in particular, institutional shareholders. The ICGN appreciates that the reforms needed require a systemic approach, and that a technical solution alone will not be effective. Reform is as much about behaviour driven by norms and values as about behaviour driven by prescription or regulation.

B. The role of corporate governance in the development of the financial crisis

Some commentators, particularly in the United Kingdom, have criticised institutional shareholders for failing to hold boards to account. In fact, it may even be argued that shareholders at times encouraged companies, including investment banks, to ramp up short-term returns through leverage. The U.K. Treasury's 'Walker Review' notes that "...there appears to have been a widespread acquiescence by institutional investors and the market in the gearing up of banks' balance sheets as a means of boosting returns on equity... The atmosphere of at least acquiescence in high leverage on the part of shareholders will have exacerbated critical problems encountered in some instances" (UK Treasury, 2009, pp. 62-63).

Institutional investors were not always as informed as they could have been about the companies they owned. Others have been tainted by conflicts of interest. Many did not invest the time or resources necessary to provide effective oversight. In a wide range of markets shareholders do not have the rights or incentives to act as responsible owners, and much needs to be done to address this.

It is therefore vitally important for market regulators and for policy makers to consider how to ensure that fiduciary owners with long-term liabilities can be held to the standards of transparency, accountability and responsibility they expect of companies. The focus of corporate governance has rightly been on boards, and their competence and independence. More needs to be done to ensure the same of fund managers acting as intermediaries on behalf of the public's long-term savings. It is important that strong corporate governance reforms are carried through the entire investment chain.

A larger problem in the development of the global financial crisis, identified in various analyses of the causes of the financial crisis, has been macroeconomic and regulatory failure. Central banks and regulators did not respond decisively when they realised that markets were mispricing risk. They allowed banks to operate with too little capital, with excessive leverage and too little attention to liquidity risk. They failed to pick up on poor risk management by boards and on poor lending practices in the mortgage market. Important steps have been taken by the Basel committee to enhance the capital requirements for banks (Bank for International Settlements²⁰⁰⁹), but we believe this must be combined with reforms on the accountancy side. For instance the definition of fair value should be clearer.

A regulatory response with heightened international coordination and one which encourages markets to take a longer term perspective is needed. The G20 initiatives are important and it is critical that countries communicate new domestic reform initiatives to G20 members before they are being presented. A priority should be to maximise the supporting contribution of good governance and shareholder oversight. This will help avoid a knee-jerk reaction that impairs the ability of markets to innovate and allocate capital efficiently and that adds unduly to the burden of red tape or is protectionist in motivation. It is vital that regulatory reform in various jurisdictions around the world enhances corporate governance solutions and does not aggravate existing weaknesses. The proposed revision to South Korea's Commercial Law allowing domestic companies to set

up poison-pills to ward off hostile merger and acquisition activity is one such example (South Korea Considers Letting Companies Use Poison Pills, New York Times, 2009).

Empowering shareholders is an important part of this, but they also have to be willing to make the necessary effort to take a more active role. The ICGN's detailed thinking on shareholder responsibility is set out in the ICGN's 'Statement of Principles on Institutional Shareholder Responsibilities' (see Appendix 1). These principles emphasise the importance of institutional investors addressing their conflicts of interest. For instance, institutions acting as agents should disclose all known conflicts to their principals and explain how these are dealt with so as to protect their clients' interests, ensuring balance in their own governance structures, allocating proper resources to governance oversight and recognising their own accountability to their end-beneficiaries who are individual savers and pensioners. It is the job of institutional shareholders to preserve and add value on behalf of these beneficiaries over the long-term.

An important step is the proposed Stewardship Code for Institutional Investors in the United Kingdom (Financial Reporting Council, 2010). The code will be administered and surveyed by the Financial Reporting Council (FRC).

Based on the comply-or-explain principle of enforcement, the Code sets out best practice for institutional investors that choose to engage with the companies in which they invest. The Code does not constitute an obligation to micro-manage the affairs of investee companies or preclude a decision to sell a holding, where this is considered the most effective response to concerns. It therefore, provides a model for the type of regulatory reform that ICGN believes will motivate institutional investors to engage with their portfolio companies on governance issues to a greater extent.

C. Equipping shareholders as the owners of companies

The reform agenda on shareholder rights is central to strengthening corporate governance. The US debate on shareholder rights, particularly to appoint and dismiss directors (so called proxy access) should be expedited so that boards can be held to account. Weak shareholder rights limit the ability of shareholders to hold boards to account, particularly in the areas of remuneration and risk management: two areas considered key to the development of the crisis. Giving shareholders a "say on pay", which is a shareholder vote on the remuneration report of the compensation committee of the board, is an essential part of the solution. This practice was introduced as a non-binding vote in the United Kingdom in 2002 and subsequently was adopted by a large number of European countries and by Australia. In the case of The Netherlands, the shareholder vote is actually binding on the board. Shareholder efforts have more recently promoted adoption of a non-binding shareholder vote on the executive compensation report at many of the largest companies in Canada and in the U.S. Now this measure is being considered at the regulatory level in the U.S. and is already a mandatory procedure for companies receiving funds under the U.S. government's Troubled Assets Relief Program (TARP) as of mid-2009, when the SEC issued rules encoding the requirements set out in the American Recovery and Reinvestment Act (ARRA) (Hodgson, 2009). The introduction of an advisory vote on remuneration in the United States is an important step in the direction of greater shareholder voice in corporate governance.

While achieving the right to vote on issues that reflect approval, or otherwise, of board performance is one method of strengthening shareholder rights, shareholders also need the assurance that their vote actually counts. In Europe shareholders are still battling for the elimination of control-enhancing mechanisms. Shareholder agreements, multiple voting rights, pyramid structures, cross shareholdings and ownership ceilings, remain pervasive across much of Europe. These mechanisms have the effect of allowing certain classes of shareholders to control a proportion of voting rights much larger than their ownership rights and therefore undermine the ability of minority investors to be effective monitors (European Commission, 2007).

Furthermore, voting arrangements must allow shareholders to exercise their votes across borders as more and more investors are diversifying their portfolios globally. At present the international system does not function well and votes are lost, due to the complicated administrative chain that carry the vote from the investor to the AGM. This is a severe handicap in a global market. Solutions being considered within the European Union are partly technical, i.e. adopting digital options for shareholder voting, and partly regulatory, i.e. mandating a standardised regime for the identification and authorization of shareholder voting rights through a chain of intermediaries. Proposals for legislative measures addressing the latter are being considered by the European Commission.¹

Elsewhere, shareholders are dealing with unfair provisions on tenders and restructuring and pre-emption rights are under threat even in markets which have a tradition of protecting against unwilling dilution.

Globally, we need a regulatory framework that ensures fair and transparent markets which inspire confidence in financial reporting. Financial institutions should be required to make better use of narrative disclosure about their business models and how they manage the risks inherent to those models. The ICGN is planning to issue guidelines about risk disclosure later in 2010.

D. Shareholder responsibilities

Institutional shareholders must recognise their responsibility to generate long-term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working.

This would require that pension funds and those in a similar position of hiring fund managers should insist that fund managers invest sufficient resources into governance structures, processes and systems that deliver long-term value. To ensure this, pension funds should issue mandates which reward fund managers for achieving these objectives.

Institutional shareholders should take governance factors into account in assessing the riskiness of a company's business model as part of their investment decisions. Governance should not be merely a secondary, or parallel, activity. It needs to be properly integrated into investment decision making.

¹ See European Commission: Harmonisation of Securities Law.
http://ec.europa.eu/internal_market/financial-markets/securities-law/index_en.htm

Institutional shareholders should pay attention to developments in other markets, including the credit market, where these may have an impact on their investments. Important market signals can be missed if management of asset classes is too strictly divided. This could mean better integration between investment teams on the equity and fixed income sides.

Securities lending - the practice of lending of shares between two parties with the borrower providing the lender with collateral and agreeing to pay a negotiated fee or interest rate - is legal in most markets and serves a number of functions. However, the effect of securities lending is to separate the owners of securities from their voting rights – legal title over the shares is transferred from the lender to the borrower. The practice has therefore been abused in certain situations to enhance the voting rights of a particular interested party with respect to certain proxy issues (ICGN, 2009). Institutional shareholders should recognise that they lose their voting rights when they lend stock in their portfolio. Where it is important to vote, the stock should be recalled. It is also important to monitor stock lending in connection with short selling. The ICGN has developed a detailed code of practice on the issue, called the ‘ICGN Securities Lending Code of Best Practice’ (2007).²

By formally committing to the principles laid out in the ‘ICGN Statement of Principles on Institutional Shareholder Responsibilities’ (2007) institutional shareholders will be helping to establish a role for corporate governance and shareholders as well as preserving shareholder rights. Furthermore, a code of best practice for investors should be developed in major markets, on a comply-or-explain basis, to further promote transparency and accountability across the investment chain, similar to that of the FRC in the United Kingdom.

Expert Comment 5.1

Skewed Financial Incentives and the Financial Crisis

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Last year in a Wall Street Journal op-ed titled “Crazy Compensation and the Crisis: We’re all paying now because skewed financial incentives led to too many big bets” Prof. Alan Blinder summarised the problem of compensation in the financial crisis. He described the “skewed incentives” as a heads-you-win, tails-we-lose pay plan based on the “simple” notion that we “give smart people go-for-broke incentives and they will go for broke”.³ Prof. Blinder describes the past well but his most important point is that nothing has changed.

Amazingly, despite the devastating losses, these perverse pay incentives remain the rule on Wall Street today, though exceptions are growing. For now, excessive risk-taking is being held in check by rampant fear. But when fear again gives way to greed, most traders and CEOs will be faced with the same dysfunctional incentives they had before – unless the system is reformed.

² This Code may be viewed at:

http://www.icgn.org/files/icgn_main/pdfs/best_practice/sec_lending/2007_securities_lending_code_of_best_practice.pdf

Exorbitant pay not linked to the outcome of risk-related decision-making has damaged financial markets in every respect. It rewards bad choices and it fundamentally undermines the credibility of financial markets and indeed the broader economic system. As technology and globalization erode the boundaries between markets, the contest for the lowest cost of capital will be won by whichever economy has the greatest transparency and the most robust alignment of interests between the providers of capital and the people who deploy that capital. To survive in this increasingly competitive environment, financial markets must strive to become credible, accountable, and incorruptible. This requires, at its core, linking the financial rewards (of those who are taking risks with other peoples' money), with the actual, long-term outcomes of those decisions.

Blaming extraneous factors like “monetary policy” for the financial crisis ignores the logic that the financial system is supposed to respond in a sophisticated and nimble way to changes in monetary policy through the collective actions of institutions and individual decision makers within those institutions. These individual decision makers will not always be right. But when they are wrong, they should not be paid as though they were right.

Wall Street’s response to the financial meltdown has been capitalism on the upside, socialism on the downside. Good times are attributed to vision, ability, and leadership. Bad times are attributed to monetary policy. Simple logic dictates that if key risk-taking decision-makers are not willing to bet on themselves, the providers of funds with which those decisions are made should not bet on them either. As United States Special Master for TARP Executive Compensation (a.k.a. 'pay czar') Kenneth Feinberg advises, “Try to eliminate guaranteed anything.”

If financial institutions are too big to fail, then they are also too big to succeed. And that means such institutions should be regulated like a utility. If the public must be the guarantors of financial institutions because the executives at these institutions failed to manage risk, then those institutions should be under stronger public oversight.

Post-Enron reforms in the United States and other countries focused on the “supply side” of corporate governance: i.e. what directors, managers, auditors, and lawyers must do to prevent the governance failures identified as key to that well-known spate of corporate scandals. This latest and most pervasive financial crisis shows that the focus must be on the “demand side,” removing obstacles to effective oversight by shareholders. Shareholders must be both willing and able to vote against pay packages that externalise the risks of poor performance and, even more important, to vote out board members who approve those plans. Prof. Melvin Aron Eisenberg described the “limits of shareholder consent,” noting that “under current law and practice, shareholder consent to rules proposed by top managers in publicly held corporations may be either nominal, tainted by a conflict of interest, coerced, or impoverished.” This must change. Shareholders, especially large institutional shareholders, must manage their own risk by recognising that eternal vigilance is the price of economic stability.

^a Alan S. Blinder. Crazy Compensation and the Crisis: We’re all paying now because skewed financial incentives led to too many big bets. Wall Street Journal. 28 May 2009:
<http://online.wsj.com/article/SB124346974150760597.html>

E. The ICGN agenda: core issues to address

The crisis has highlighted a number of issues which are relevant to shareholders, particularly institutional shareholders, and these are areas where the ICGN will seek to engage actively in the policy debate. Below is a list of these issues and the ICGN's position on them.

1. Strengthening shareholder rights

Shareholders cannot play a useful role in monitoring and holding corporate boards to account if their rights are limited. It is crucial that they are able to appoint and dismiss boards. Likewise, shareholders must be treated fairly and be able to exercise influence in proportion to their capital at risk. Shareholders also need a disclosure framework which affords them the ability to exercise their rights in an informed way. Government intervention in financial institutions should not undermine basic shareholder rights. Corporate governance structures, including the requirement for fully independent directors, should serve to secure shareholder rights.

2. Strengthening boards

Investors need to ensure that boards have the ability to lead with integrity and that they have the skill sets necessary to oversee complex businesses and manage risk properly. Audit committees must also have a clear view of what is going on within the company and of the importance of full disclosure to the market. Competence and board dynamics must be tested through independent evaluation and the process for this should be fully disclosed to the market. As owners, suitably empowered institutional shareholders are well placed to hold boards to account on these points.

3. Promoting fair and transparent markets

Markets have become too opaque. This is especially true of certain derivatives markets. The price and volume of transactions in equity and derivatives markets must be transparent and available to everybody. Transparency is preferable to restrictions on the use of particular techniques. Short selling, for example, is a legitimate investment tool, which adds to liquidity, helps price discovery and, through opening up hedging opportunities, often reduces volatility. We do not believe that short selling should be artificially restricted, but companies and shareholders should be aware of situations when significant short positions are being created. The ICGN considers that a transparent and responsible securities lending policy by investors is a preferable solution.

4. Independent accounting standards

There must be no political interference in setting accounting standards. The fair value approach, which is to value assets as closely as possible to current market price where no market exists for that asset, has been blamed for encouraging pro-cyclicality. Investors generally support fair value pricing that delivers a picture of what is actually happening. There are some challenges to address, but abandoning this approach would damage confidence in financial reporting. Furthermore, it is important to recognise that there is a difference between fair value used for reporting and fair value used to measure

the need for regulatory capital. The ICGN takes the position that regulatory reforms being undertaken acknowledge that accounting standards also need to be extended to ensure that relevant and material off-balance sheet business should be reported. Management commentary and narrative reporting needs to be further enhanced to ensure that investors have a better picture of risk. The ICGN welcomes the intention to review the governance of accounting standards setting bodies and to ensure all interested parties have a seat at the table. This must include a stronger voice for shareholders.³

5. Remuneration setting

Shareholders need to hold boards to account for the decisions they make on executive and management remuneration. It is not the role of shareholders to take responsibility for the entire remuneration arrangements of financial institutions or other companies, but they can ensure that boards develop policies that reward sustained performance, and do not encourage employees to take excessive risks. Provided they are given a right to vote on remuneration policy shareholders should take responsibility for seeing that directors are incentivised in such a way that delivers on the agreed medium- and long-term strategy and aligns their interests with those of shareholders. It is very important not to pay rewards for failure. Institutional shareholders are likely to support regulation that underpins this principle, providing it is not overly prescriptive and provided that it is designed to deliver genuine results. They also believe it should be possible to claw back, or recoup, incentive remuneration paid on the basis of misstated performance or when relating to transactions that subsequently incur substantial losses.

6. Regulating credit rating agencies

There needs to be more competition in the credit rating market. Any regulation needs to be multilateral in approach and not set up barriers to new entrants. Credit rating agencies should not have exclusive rights to information that may be of value to all investors in making informed assessments of risk. Conversely investors should not be excessively reliant on credit ratings. Conflicts of interest in the industry will require a regulatory solution but investors must be willing to become active to support the creation of new channels of information. We welcome the G20 statement in September 2009 emphasising the need to address conflicts of interest and the need to improve disclosure by credit rating agencies in the area of practises and procedures.⁴

F. Conclusion

Corporate governance has an important role to play in overcoming the financial crisis, restoring confidence for the future and preventing regulatory overkill that would damage the entrepreneurialism needed to secure future economic growth. Global authorities should continue to work with market participants to develop enhanced

³ Under a newly finalised constitution, the enhancements to the governance of the International Accounting Standards Committee (IASC) Foundation - which oversees the International Account Standards Board (IASB), which sets the accounting standards that most countries outside the U.S. follow - include greater public accountability through regular public consultations with improved investor involvement.

⁴ See: The Pittsburgh Summit 2009. <http://www.pittsburghsummit.gov/mediacenter/129639.htm>

governance practices that will underpin other regulatory actions being taken to address the current problems.

Most importantly this involves securing and maintaining the rights of shareholders and developing the transparency needed for them to exercise these rights in a responsible, informed and considered way. Properly equipped, shareholders can play an important role in holding companies to account for the way they manage risk and incentivise board directors.

However shareholders must also recognise that they should use their share-ownership rights responsibly in the interest of creating long-term value for their beneficiaries. If they do not act responsibly their rights will be at risk and their case for strengthened rights will be undermined.

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Appendix 5.1

Relevant ICGN Best Practice Guidance

ICGN Global Corporate Governance Principles (2009)

These principles are the ICGN's overarching set of principles. Under them sit a variety of other best practise guidelines.

http://www.icgn.org/files/icgn_main/pdfs/best_practice/global_principles/icgn_global_corporate_governance_principles-revised_2009.pdf

Statement and Guidance on Anti-corruption Practices (2009)

This document presents a policy statement on why anti-corruption is an issue of concern for shareowners, and explains how corruption is ultimately detrimental to shareowner value.

[http://www.icgn.org/files/icgn_main/pdfs/best_practice/guidance_on_anti-corruption_practices/2009_anti-corruption_practices_\(march\).pdf](http://www.icgn.org/files/icgn_main/pdfs/best_practice/guidance_on_anti-corruption_practices/2009_anti-corruption_practices_(march).pdf)

Statement and Principles on Non Financial Business Reporting (2008)

These provide guidance on principles to support narrative reporting which is focused upon long-term sustainable performance.

http://www.icgn.org/files/icgn_main/pdfs/best_practice/buss_reporting/icgn_statement_&_guidance_on_non-financial_business_reporting.pdf

Statement of Principles on Institutional Shareholder Responsibilities (2007)

The statement highlights the responsibilities of investors both in their external role as owners of equity and their internal governance responsibilities to their beneficiaries.

http://www.icgn.org/files/icgn_main/pdfs/best_practice/inst_share_responsibilities/2007_principles_on_institutional_shareholder_responsibilities.pdf

Securities Lending Code of Best Practice (2007)

The code clarifies the responsibilities of all parties engaged in stock lending.

http://www.icgn.org/files/icgn_main/pdfs/best_practice/sec_lending/2007_securities_lending_code_of_best_practice.pdf

Executive Remuneration Guidelines (2006)

The guidelines focus on how companies should be structuring pay for the long-term, disclosing policies and seeking shareholder support.

http://www.icgn.org/files/icgn_main/pdfs/best_practice/exec_remun/2006_executive_remuneration.pdf

Chapter 6

Creating Responsible Financial Markets

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A. Introduction

The global financial crisis was a systemic failure. The predominant response from governments and multilateral organizations, predictably, has been a chorus of calls for systemic regulation, particularly around issues of solvency.²

That discussion is important, but incomplete. Any regulator looking at any system must first understand whether the system should be constrained because it is inherently untrustworthy or whether it is able, under the right circumstances, to police itself. So for example, in a maximum security prison the rules are tightly drawn and enforced. On the other hand, some universities take pride in their “honour code,” a peculiar institution where bad practice which could easily be policed (such as cheating in exams) is left to the individual student. The message is clear: any student who attends this university knows that cheating is beyond the pale, and will not need further sanction. They will be trustworthy.

Few systems are at one end of the spectrum or the other. Generally, however, “trustworthy” systems call for self regulation; unstable systems for more intervention. The key as to the optimal mix of regulatory response at any point in time depends critically on two elements: First, the ethos of those whom we seek to regulate (are they trustworthy or not), and, second, the architecture of the system (is it likely to encourage self-regulation and self-correction). Consequences of non-compliance may also be a factor in deciding upon regulatory approaches: A murderer breaking out of prison is a bigger problem than a student cheating on exams. So too can be internal factors, such as concentration and market share: A small bank collapsing may be allowable in trying to establish a trustworthy system even if there are localized problems, whereas the collapse of a major bank that would threaten the world’s financial system through its counterparty relationships. This results in the “too big to fail” and “moral hazard” quandary for regulators. Finally, of course, systems are dynamic over time, moving along the spectrum in response to various developments. Hence regulatory responses need to change over time.

Despite the ability to influence trustworthiness of systems, the majority of regulatory responses to the global financial crisis have been monotonal, emphasizing

¹ Davis, Lukomnik and Pitt-Watson are the authors of “The New Capitalists: How Citizen Investors Are Reshaping the Corporate Agenda,” Harvard Business School Press, 2006. Major portions of this chapter first appeared in “Towards An Accountable Capitalism,” Private Sector Opinion Issue 13, a Global Corporate Governance Forum publication.

² See, generally, Chapter 1 in this publication by Cook and Miller.

constraint. Or perhaps, to be fair, duo-tonal: They dictate either “Thou Shall” (e.g. increase capital reserves) or “Thou Shall Not” (e.g. set limits on executive compensation).

That is not to say that constraining regulation is unnecessary. But what would happen if policing were paired with regulation designed to improve the ethos of the participants and the architecture of the system, thereby enhancing its inherent trustworthiness? We believe the result would be a safer, more self-correcting system. As an analogy, imagine there has been a terrible car crash, caused by bad drivers who, though they had stayed within the regulated speed limit, were unable to stop in time when an emergency situation arose. One response would be to reduce the speed limit. An alternative response would be to retrain all drivers; to encourage them to drive responsibly. In real economic life both need to be done: Set limits *and* create an architecture which makes our financial system inherently more responsible and trustworthy. If the financial system is not trustworthy, no amount of restrictive legislation will make it stable. Unless the inherent trustworthiness of the system improves, regulators will constantly be playing “catch-up” as market participants probe the limits of regulation to find the weak spots. Constraining regulation in such situations is akin to exerting pressure on a filled balloon; the balloon won’t burst at the points of maximum constraint, but the pressure from the inside will probe for other ways out. Increasing the self-resilience of the system will serve to equalize – somewhat – the pressure.

In regulatory terms, what we propose is to increase the attention paid to “market discipline,” in its fullest sense, not just in terms of information and disclosure. This is the third -- and most chronically ignored and ill-defined -- pillar of the Basel II accord.³ Whereas the first two pillars (“minimum capital requirements” and “supervisory review”) are conventional parts of banking regulation, market discipline is often regarded as beyond regulatory reach.⁴ Yet regulation and markets coexist, each affecting the other. Making the third pillar into a real source of support for the banking system will require new thinking not only about the type of market institutions on which a successful modern financial infrastructure depends but, as importantly, on the relationship between each of these institutions. We need to clarify the principles on which any responsible market system depends, and on how these might be applied to banks. We therefore suggest various actions that participants in all markets – regulators, investors, NGOs, bankers – can take to minimize the probability and severity of future financial disasters.

As we argued in *The New Capitalists* (Davis, *et al.*, 2006) a successful economic system is like an effective political system. It has checks and balances, accountabilities and responsibilities, information flows and cultures. Of course regulation is important. But there are five central principles beyond regulation on which a successful financial system depends. These are:

- The entities in it are *responsible* for their actions.
- They will be responsible if they are *accountable*.

³ At a very basic level, the Basel II framework rests on three pillars: minimum capital requirements, supervisory review, and market discipline. See, for example, <http://www.bis.org/publ/bcbs157.htm>.

⁴ While market discipline is Pillar 3 of the Basel II framework, it is generally understood to focus on disclosure by financial institutions, rather than aligning and strengthening market mechanisms so as to encourage real market discipline, particularly in markets wherein banks are public companies or are reliant on issuing large amounts of public debt. See “International Conversion of Capital Measurement and Capital Standards”, Basel Committee on Banking Supervision, June 2006.

- Those who call them to account will need *relevant information*.
- Information must be *independently prepared*.
- Finally, just as a healthy political system hinges on the scrutiny of vigilant citizens, a successful financial system will need the oversight of *vigilant market participants*.

Attention to these principles offers a new and constructive agenda to those who wish to create a more sustainable response to the financial crisis and one which will be less expensive for us all.

B. What went wrong?

Before we offer a model for a more accountable and more stable form of capitalism, it's worth reviewing what went wrong with this one. The catalogue of culprits begins with borrowers who were overextended and could not repay their mortgages. The list extends to bankers who are blamed for lending more than was appropriate and who were caught flat-footed when depositors asked for their cash to be returned. Their culture is seen as being greedy and short term. Regulators also come in for criticism. How come they didn't see this was going to happen? After all, they knew what the banks were doing. Why didn't they put a stop to it? And what about all those eminent men and women who sat on the boards of the banks? Surely they knew – or should have known -- the risks that were being taken? What about the accountants who declared these banks to be solvent? And the credit rating agencies (CRAs) that assessed the debt as investment grade -- fit for widows and orphans – when it later turned out to be toxic? Or the investors who demanded returns above that reasonably available?

Finding a litany of miscreants misses the point. It is not one individual or institution which is to blame, it was the entire system. Each of the “players” was seeking to maximize their own interests in ways that were perfectly within the law. If they were asked if this was acceptable behaviour they would have pointed to Adam Smith, who famously observed that “it is not from the beneficence of the butcher the brewer and the baker that we expect our dinner, but from their regard to their own self interest” (Smith, 1776). Except this time, the collision of all these self-interests brought the system to its knees.

At the heart of the problem was the way banks thought about risk. They worked on the previously accepted truth of diversification: If you take many small risks you are less likely to lose all your money than if you take one big risk. So banks began to diversify their risk-taking activities. In the mortgage area, this went to an extreme, as banks and other financial institutions began to sell off parts of their mortgage loans, and to buy loans originated by others. Soon financial engineers repackaged diversified pools of mortgages into structured products, allowing instant diversification with a single purchase.⁵

Compare this to traditional practice. In the old days a local bank might hold many mortgages from people living in its home town. That would be pretty risky because if, for example, the local industry failed, the loans would all come under pressure at once. So it

⁵ The Royal Bank of Canada, for instance, cites this advantage on its website: “Diversification - Structured products allow investors to participate in a portfolio of many securities, which helps spread market risk.” See www.royalbank.com/educationcentre.

needed to monitor those loans closely, intervene to mitigate problems, and hold lots of reserves. In other words, it needed to actively manage its risk beyond the origination process. More recently, however, banks have been able to own a part share in a myriad of mortgages from literally all over the world through the use of structured products. The cost of monitoring and managing the risk of any one loan may not be worthwhile for any individual financial institution owning small pieces of thousands of loans. What this means in the aggregate is that no institution is responsible for managing the risk of any of the loans. Also, since banks diversified their loans, theoretically they had less risk in total, meaning they were able to lend more. Lend they did, with a vengeance. All this was sanctioned by banking regulators acting in accordance with the Basel agreements on banking solvency.

The result has been a huge increase in loans made on an existing capital base coupled with a decline both in the interest rates charged for the loans and in the toughness of lending standards. So for example, it was possible for purchasers to borrow more than the value of their house. This in turn forced up asset prices, such as those of houses, company shares and risky debt. Home owners and investors felt they were on a one-way bet, confident that property prices would continue to rise, so they borrowed and bought more.⁶

Why was there not more widespread criticism of these practices? Why did we not hear the whistles blowing a warning? In fact, some experts had suggested a mounting crisis.

Perhaps the market suffered from what psychologists call the “bystander effect”: Because there were so many bystanders, no-one saw it as their duty to call into question the risk models being used. Or perhaps it was the siren song of short-term profits that blinded shareholders, board members, executives and others. As Charles Prince, the deposed CEO of Citicorp infamously noted, “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing” (Nakamoto and Wighton, 2007). This was the musical chairs version of capitalism: Pray that when the music stops someone else is left without a chair, not you. What Prince and others failed to consider is that there would be no chairs left for anyone.

So the music continued and the game continued, even as the chairs were being taken away. The bank manager who issued mortgages, who was responsible for making sure they got paid back, and who was accountable they went bad, was eliminated. Instead mortgage brokers originated loans and then sold them on to be packaged with others. Bits of that one loan, and tens of thousands of others, were then sold around the system. In that way everyone took many small bets and, so they thought, reduced their risk. In fact, no one knew what risks they, or the system, were taking. Certainly no one felt it was their responsibility to manage those risks. With each institution acting the same way, spreading the risk became, itself, a systemic risk. With each institution responsible for tiny bits of thousands of mortgages, no one institution or market player was responsible or accountable for any one loan.

⁶ See Greenspan and Kennedy, “Sources and Uses of Equity Extracted From Homes,” Finance and Economic Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, DC, USA, March 2007

Enter the credit rating agencies. These organizations forecast how likely a loan is to default. When the CRAs say something is investment grade, meaning unlikely to default, companies can issue debt to investors widely and therefore less expensively. However, CRAs got it wrong on subprime mortgages. Some might argue that CRAs made an honest mistake. However, the business model of CRAs is itself suspect, because they get paid by those who are issuing debt, not by those who are investing on the basis of the ratings. So, if it wants to get paid, a CRA has the incentive to give positive credit ratings. This is obvious, and not just in hindsight.⁷ The CRAs had already got it wrong in 2001 with Enron and Worldcom. In 2006 we wrote “Credit Rating Agencies harbour a fundamental conflict: they are paid by the companies they rate, not by the investors they are supposed to protect” (Davis, *et al.*, 2006, pp. 141-143). Certainly CRAs were not producing independent information.

When the crisis broke, loans fell precipitously in value, despite those investment-grade ratings. Strong banks now had to mark down their value. When these banks started to look weak depositors began to withdraw funds and put them elsewhere. Government agencies ultimately came to the rescue, but were concerned that they couldn't be seen to save every bank. So they allowed the collapse of Lehman Brothers in September 2008. Investors became nervous. There were runs on banks as depositors took their money out. The contagion was not limited to the US (Bear Stearns, Merrill Lynch, etc.) and the UK (Northern Rock, HBOS, RBS). Around the world the list of banks receiving some type of governmental intervention continued to grow, including such high profile names as Dexia, Fortis, Hypovereinsbank (Real Estate), and, of course, much of the Icelandic banking system. Banks had no way to trust the balance sheets of other banks or even industrial companies and they wanted to conserve their own cash, so lending between banks dried up. This is the lifeblood of the financial system. Companies could no longer assume they had access to cash or credit and so cancelled investments and began to cut costs. The global financial crisis and resultant recession were upon us.

C. The requirements for accountable capitalism

Though largely unnoticed, there now is a burgeoning set of institutions that could help embed accountability into the economic system in the same way that political institutions gird democracy in “civil society”. In hundreds of initiatives, national, supranational and global; voluntary, enterprising and regulatory; people have been trying to create a “civil economy” to replace the uncivil economy of the past. All capital markets, whether equity, credit, currency or whatever, need to conform to the five principles outlined above. Each is reviewed in more detail below.

Accountability. For each player in the market, we need to be able to answer some simple questions. In whose interests do you work? To whom are you accountable? What alignments or misalignments of interests can affect your performance? The governance of each intermediary ought to assist in its alignment to both fulfil its purpose and to be accountable. This means addressing structural conflicts of interest, developing mechanisms to report to those from whom its power is derived, monitoring the functioning

⁷ The potential conflicts were recognized by the United States Securities and Exchange Commission and by various official commentators in a 2003 concept release “Rating Agencies and the use of Credit Ratings under the Federal Securities Laws” [RIN 3235-AH28]. See: <http://www.sec.gov/rules/concept/33-8236.htm>

of these mechanisms, etc. If it isn't so configured, it is a potential danger to the system and needs particular oversight.

When you look at the capital markets, particularly those in the US where the credit crisis began, there are glaring gaps in accountability. US pension plan governing boards do not include representation from the workers who are contributing to the plan. As noted earlier, credit rating agencies are paid by issuers, not the investors who rely on the ratings. The boards of most financial institutions in the US did not feature independent chairmen who could effectively oversee the CEOs. Shareowners could not easily remove directors.

Responsibility. Accountability is the tool that enforces responsibility: Each financial intermediary should actively exercise its rights to optimize the long-term value of its assets on behalf of those for whom it works. For example, institutional shareowners should not only *have* rights to oversee corporate boards and managements, they should use those rights.

In markets with dispersed share ownership (such as the US and UK), big investors, particularly pension funds, have pooled members', depositors' and individuals' savings and become the fractional owners, not only of much of the debt which has turned toxic, but of the companies that originated the debt. With such a vast amount of value at stake, one might have thought that they would have found ways to defend their interests by holding boards and managers to account, thereby protecting the interests of their savers. Yet most institutional investors prefer to try to add value by trading in and out of securities as speculators rather than investing for the long term and engaging with the companies as owners. The average American retail mutual fund turns over more than 100% of its securities every year (Bogle, 2003). Globally, even institutional accounts, supposedly invested on behalf of long-term, sophisticated investors such as pension funds, show a remarkably short-term perspective, with an average turnover of 72% per year (Investment Horizons: Do Managers Do What They Say?, 2010). Another complication is that the ultimate owners of the assets –pension funds and others – may not even realize that the asset managers that they employ are trading short term; some 65% of the accounts examined in a recent study have turnover that exceeds what the portfolio managers predicted to their clients ex-ante (Investment Horizons, 2010).

Such frequent trading is akin to Charles Prince thinking that he can find a chair even when those about him are falling onto the floor. If you always think you can trade out of the way of a disaster at the last minute, you don't put much energy into trying to prevent disasters by being a responsible owner. Lord Myners, the United Kingdom's Financial Services Secretary, noted in a criticism of pension fund executives that "disengaged investors lead to ownerless corporations and the risk of unaccountable executives and boards running amok" (Myners, 2009).

Other types of conflicts are inherent in markets with controlling shareowners, such as the practice of paying management fees to a controlling shareowner as well as other types of related party transactions. These may have the effect of enriching one particular shareowner while impoverishing others, affording that shareowner little incentive to improve the overall company or system.

Relevant Information. Disclosures should not merely be voluminous, but shaped for real use and addressed directly to value. It is an open question as to whether current accounting procedures, such as “mark-to-market”, may be inadequate.⁸ The relevance of such an accounting principle depends on the circumstances in which it is applied, and the purpose for which it is used. Certainly it is very dangerous to use such accounting for bank regulation because it is pro-cyclical: it rewards the banks when things are going well but puts a squeeze on them when things go wrong.⁹

Another concern is that there are huge areas of financial markets that are opaque, such as the “Credit Default Swap” (CDS) marketplace. A CDS is essentially an insurance policy on whether a company will default on its loan. It is a bit like a life insurance policy on a specific company and, just like a life insurance policy, it has a useful role. However, most people would be concerned if they discovered that someone had been buying a life insurance policy on their life and they didn’t know who it was. Yet many CDSs are bought and sold with no disclosure whatsoever. If you hold a CDS, it is in your interest for the company concerned to go bankrupt. Because there is little transparency about who owned how much CDS written on which companies, we don’t know how much they contributed to the credit crisis. But recent news reports do suggest that they played at least some role (Morgenson and Story, 2010). Similarly, so-called “dark pools” of liquidity mask trading in stocks by institutions. Such opaque trading platforms may help an individual institution buy and sell without disclosing positions. However, by minimizing market impact, they possibly harm the overall system by robbing the rest of us of information and by spreading liquidity from transparent exchanges to hidden computer networks.¹⁰

Independent Information. That markets move on information is well-known. For good reason auditors are now largely prevented from providing consulting services to the companies they audit) and stock analysts are prevented from being compensated for investment banking results in the US following the Enron/Worldcom scandals of the early 2000s, when puffery from investment banks (exaggerating the benefits of a particular investment) was positioned as supposedly objective investment advice, so as to gain underwriting business for those banks.¹¹ Markets need conflict-free intermediaries to serve as a reliable check on corporate information.

CRAAs are certainly conflicted, but so too are remuneration consultants (tempted to build CEO-friendly payouts in hopes of gaining other business); director search firms (leery of recommending feisty board candidates for fear of losing other search contracts); and various distribution channels which take fees from asset managers but claim to be doing due diligence on those same asset managers, as was the case in the Bernard Madoff situation. We wrote in *The New Capitalists* that if the public lost faith in the integrity of

⁸ See, for example, “Why Mark-To-Market Accounting Rules Must Die,” *Forbes*, 24 February 2009; “Reverse Leverage of Mark-To-Market Wrecks Banks,” *Bloomberg*, 13 October 2008; “Former FDIC Chair Blames SEC for Credit Crunch,” *CNBC*, 9 October 2008.

⁹ For a good primer discussion on procyclicality and other issues related to mark-to-market accounting, see, Tanya S. Beder, “Mark-To-Market Accounting: Practices and Implications,” testimony for US House of Representatives, Committee on Financial Services, Sub-Committee on Capital Markets, Insurance and Government-Sponsored Enterprises, 12 March 2009.

¹⁰ For a discussion of dark pools, see Caplan, Cohen, Lenz, and Pullano, “Dark Pools of Liquidity,” *PWC Alternatives*, Vol. 4, No. 2, 2009.

¹¹ This was accomplished through a series of United States Securities and Exchange Commission lawsuits and settlements. See <http://www.globalresearchanalystsettlement.com>.

these agents, “the capital markets would seize up” (Davis, *et al.*, 2006, p. 123). That is exactly what happened

D. Adding vertical regulation

Moving to an accountable, sustainable capitalism requires rethinking the regulation and governance, not just of banks and other entities comprising the financial system, but of the regulatory architecture encompassing them.

Each market participant is a link in many chains. A homeowner borrows to create a mortgage (link 1) from a mortgage originator such as a local bank (link 2) who sells the mortgage to an investment bank for packaging into a mortgage pool (link 3) which is rated by a credit rating agency (link 4) so that it can be sold to a pension fund or other institutional investor (link 5) and so on. That’s oversimplified, of course; there could be all manner of intermediaries, but this would be the basic structure of a mortgage securitization chain.

The cliché that a chain is only as strong as its weakest link is true. But it is also dangerous because it’s not the whole picture. Chains can fail not because there’s a weak link, but because the links don’t work smoothly with each other. If the links don’t work with each other – if they don’t fit together well or they’re rusted or frozen – then what you have is not a chain, but merely a series of elliptical pieces of metal. That’s what happened in the financial market. There was not a weak link in the chain, yet it failed. Borrowers got what they wanted: cheap and plentiful credit. Mortgage originators got what they wanted: lots of fee-generating origination. Banks got what they wanted: unprecedented numbers of individual mortgages to package and sell, reaping billions of US dollars in fees. The credit raters got what they wanted: a lucrative new product area that became their single largest profit source. Institutional investors got what they wanted: securities that yielded more than was available elsewhere in the investment grade bond market.

Economists’ term for this type of situation - wherein each individual decision seems rational but the resulting whole is problematic or illogical - is a “fallacy of composition”. The links kept on strengthening themselves – gorging on cheap credit, originating more and more mortgages, rating more and more structured products – even while systemic risk was building up, resulting, eventually, in the entire chain freezing up.

Traditional regulation – including the vast majority of the responses to the financial crisis -- tries to insure the health of each link. The theory is that by regulating each link separately, the chain will be strong. In this type of “horizontal” regulation, a regulator focuses on a particular type of institution and issues a set of commands, such as a bank needs to have a specific amount of capital in reserve. The health of the system is, mistakenly, taken for granted if the specific links are healthy.

Horizontal regulation suffers from two inevitable forces which degrade its effectiveness over time. First, markets evolve quicker than regulators can regulate (for instance, credit default swaps were a non-entity a few years ago and there is still not a full regulatory architecture to monitor and control them). Second, such command/control regulation often results in the regulated entities seeking to avoid regulation so as to gain a competitive advantage over competitors similarly regulated. So, for example, we’ve seen banks use devices which allow them to lend more by “gaming the regulator”. Gaming

strategies include, for instance, using 364-day instruments to get better risk-weighted capital treatment than 365-day instruments as well as the extensive use of off balance sheet items and various derivative transactions. Perhaps the most pervasive way credit-originating entities avoided horizontal regulation was by simply by being recognized as banks. This resulted in the rise of the non-bank financial institution in the 1990s and 2000s.

E. A new approach to regulation

We propose a new conceptualization of regulation. Regulation should enhance the robustness of the interaction between market participants, as well as the robustness of the participants themselves. It should address ethos and architecture as well as command and control type rules and regulations. We should enable the various entities within the system to be accountable to each other and to hold each other responsible. This approach might be thought of as ‘vertical regulation’ and is designed to enhance the trustworthiness and self-correcting abilities of the financial markets as a whole, as well as strengthening the individual financial institutions.

Such a regulatory philosophy implicitly recognizes the power of the marketplace, rather than the power of the regulators. Vertical regulation empowers market participants while encouraging them to be responsible and accountable, with requisite independent information and oversight. Below we outline some examples of useful vertical reforms.

- a. Enhance disclosure across the system. Transparency is a condition necessary for accountability. In the US, the focus in this area has been on equities; with the SEC requiring enhanced risk, corporate governance and compensation disclosures by corporations. Those are useful first steps. Here are a few (necessarily technical) examples of where further disclosure could be useful.
 - i. Mandate that for a financial instrument to be tradable or transferable, it must be registered. Various markets have systems for identifying tradable instruments, such as the CUSIP (Committee on Uniform Security Identification Procedures) number in the US or the SEDOL (Stock Exchange Daily Official List) identifier in the UK and Ireland. Requiring every financial instrument to be registered as a condition as a condition of being legally tradable or transferable would mean its basic characteristics are known, it is traceable, and the size of the market is calculable. This would allow the development of new instruments, yet ensure that market participants and regulators are aware of the size, shape and scope of them before they grow to a size that can affect overall financial stability, which is not the case with various derivative instruments today. (To keep this regulation manageable, it could apply only to those credit instruments which exceed a minimum size.)
 - ii. Investors, speculators and traders should have to disclose material positions in a company no matter whether those positions are held in stock, options, or contracts for differences or other derivatives, and should also disclose whether those positions are short or long. This would

mitigate disconnects between economic interests and ownership rights, such as “empty” or “over” voting in merger and acquisition situations.¹²

- iii. Ask all significant investors to make a statement of investment principles that includes a disclosure on whether they are willing to make investments that may damage the system or the real economy as a whole.
- b. Regulate power relationships between market players, not the outcomes of those relationships. In so doing, give some amount of deference to those whose capital is at risk.
 - i. Accelerate the market-by-market trend towards mandating that companies feature a UK-style advisory shareowner vote on pay, and towards allowing shareowners to nominate corporate directors more easily. These reforms do not mandate any specific outcome. They do, however, affect the balance of power between boards of directors, management and shareowners, making boards and executives more accountable.
 - ii. Insist that all the agents in the investment chain declare how they are paid. That includes fund managers, distribution channels, financial engineers, information providers, raters, etc. Encourage the development of agencies that help the ultimate investors to understand whether remuneration is appropriate and whether, over a specified time-frame, it is likely to lead the agent to work in the principle’s best interest.
- c. Focus on the functional purpose of each entity, not its legal status. If market participants are “gaming the regulator”, blow the whistle.
 - i. The requirements around the issuance of a credit instrument – the extension of credit, and, therefore, the creation of counterparty risk - should be the same if you are a bank, insurance company, hedge fund or non-bank financial institution.
 - ii. If an asset is “off balance sheet”, but is managed as though it were “on balance sheet,” it should be treated in the same way. Similarly, banking assets that are held on the banking book and trading book ought to be accounted for in the same way.
- d. Align interests across time frames as well as within and between entities. Make all compensation agreements for executive officers and anyone who can risk balance sheet assets above some minimum threshold subject to claw-backs to

¹² Empty voting refers to an investor voting shares in a company despite having no economic interest (or potentially even a negative economic interest) in that company. Over voting refers to an investor voting more shares than his economic interest would normally warrant. Both conditions are enabled by the use of derivatives such as options or contracts for differences. For more information, see Hu and Black, “The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership,” *Southern California Law Review*, Vol. 79, No. 4, 2006. See also Hu and Black, “Equity and Debt Decoupling and Empty Voting II: Importance and Extensions”, *University of Pennsylvania Law Review*, January 2008.

allow recouping of payment in the event of later restatements or financial distress after the pay period has passed.¹³

- e. Do not allow intermediaries to influence accountability between other entities if they have nothing, or too little, at risk. Often, in markets with family-controlled companies, holding companies and pyramid structures dilute the voice of shareowners with real capital at risk. While it is true that these intermediary structures have some risk, they dilute real accountability by featuring disproportionate control.
- f. Where known misalignments of interest persist, set up monitoring strategies. It will not be possible to eliminate all conflicts of interest, but where they exist, they should be under particular scrutiny.
 - i. Corporate-sponsored retirement savings schemes in some markets are nearly all controlled by the issuing company; members typically have no say in defining the nature of the plan or the choices available. This can and does allow funds to shun active engagement with portfolio companies, even where such strategies might align with the interests of beneficiaries. One key regulatory antidote would be to require each such scheme to feature member-selected trustees alongside issuer representatives in an oversight board chaired by an independent outsider.
 - ii. Credit ratings affect which instruments various institutional investors may buy. Yet the credit rating agencies are paid by the issuers of the debt, not the purchasers. As we noted in 2006, and as the world unfortunately discovered in 2007 and 2008, this creates an incentive for ratings inflation. Proposed remedies abound. As an example, Stanford Professors and Joseph Grundfest and Evgenyia Hochenberg suggest having an agency owned by institutional investors that makes parallel ratings (Grundfest and Hochenberg, 2009).

Calls for new types of regulation often lead to a discussion of whether such regulation is excessive. The question of “too much” or “too little” is not addressed in this chapter, though it is possible, and perhaps desirable, that combining vertical regulation with horizontal regulation could lead to a more resilient and self-correcting financial system, thereby allowing the elimination of some entity-level command-and-control rules. Ideally, vertical regulation will enhance the robustness of the interactions between market participants, rather than the robustness of any particular set of market participants. Regulation should strengthen the game, not determine the winners.

¹³ For a full discussion of how to ensure compensation is aligned and earnings manipulation and non-economic risk-taking discouraged, see Bebchuk and Fried, “Paying for Long-Term Performance,” Harvard Law and Economics Discussion Paper 658, December 2009. Accessible at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1535355.

F. Beyond regulation: vigilance in the capital markets

Regulation alone, however, is not sufficient. Regulation is the societal codification of the rules of the game. Many rules are subject to interpretation. Outside enforcement agencies are often the wrong entities to interpret subtleties for a number of reasons, not the least of which is that regulators often have binary options – something is or is not allowed.

Limiting the discussion to regulation would be akin to saying the only thing that matters in civil society are laws, police and courts, while ignoring the press, culture, religious institutions, the role of technology and a host of other influences. Accountable capitalism needs multiple civil economy institutions to craft the ethos of the system.

Market-based solutions can promote responsibility. For instance, the Centre for Fiduciary Excellence (CEFEX) in Canada has created a certification program to promote best practice in the investment management industry.¹⁴ More than 50 independent firms have received certifications in the two years since it was established. Two UK money managers, Hermes¹⁵ and Governance for Owners, have created services that pool institutional investor resources so as to efficiently engage with managers of corporations; another example of a market-based solution.

Multilateral institutions and NGOs can play an important role in building the civil economy, just as they do in the political arena. The Financial Markets Recovery Project of the Global Corporate Governance Forum is developing a program to build capacity to train bank directors in emerging markets, with a specific emphasis on risk management skills. This UNCTAD publication may be viewed as an initiative by a multilateral institution helping to explore the behavioural norms and desired architecture of the financial system post-global financial crisis. The Royal Society of Arts in the United Kingdom is promoting new institutions and citizen awareness of investment choices. The IRRIC Institute in New York sponsors research into issues of corporate responsibility and the informational needs of investors. The Yale School of Management's Millstein Center researches and educates corporate managements, boards of directors, shareholders, and stakeholders on how to create long-term corporate and shareholder value while at the same time meeting societal expectations.¹⁶

Industry groups can also drive change towards a more accountable capitalism. The International Corporate Governance Network (ICGN) has historically drawn its strength from institutional investors and has represented them in calling upon corporations to act responsibly. But more recently the ICGN has put increasing resources behind making sure that its members themselves act responsibly, both towards those to whom they are accountable (the individuals whose savings those institutions invest) and towards those they would seek to hold accountable (public corporations). This culminated in the ICGN's "Statement of Principles on Institutional Shareholder Responsibilities" (ICGN, 2007). The UK's Institutional Shareholder Committee devised similar guidance and the Financial

¹⁴ Jon Lukomnik serves on the CEFEX advisory board.

¹⁵ David Pitt-Watson serves as a senior advisor to Hermes Equity Owner Services and Stephen Davis as a non-executive director.

¹⁶ Pitt-Watson is an advisor to the Royal Society; Lukomnik is program director of the IRRIC Institute and lead consultant on the GCGF's financial markets recovery project; Davis is Executive Director of the Millstein Center at Yale.

Reporting Council is now conducting a consultation on those “stewardship principles” (FRC, 2010). Globally, institutes of directors and similar bodies such as the Indonesian Institute for Corporate Directorship and the Brazilian Institute of Corporate Governance, are focusing on the issues of governance and responsibility, as are banking associations such as the Union of Arab Banks and the Swiss Bankers Association, both of which attended the Global Corporate Governance Forum’s Financial Crisis Response Consultation in June 2009. This initiative helped determine the need and scope for the GCGF’s program to build capacity to train bank directors in emerging markets.

Put simply, the ethics of business are fundamental to economic success. If, when the crisis is over, all we have is a financial system constrained by command and control regulations, where market participants fail to recognize any broader responsibilities for their actions, we will not only stifle innovation, but what innovation there is will be directed at subverting the regulation we have passed. We will just have drawn the contours for the next crisis.

Expert Comment 6.1

Beyond Rules and Regulations:

Board-Level Business Ethics is Key to Better Functioning Capital Markets

Philip Armstrong, Head, Global Corporate Governance Forum

Politicians, policymakers, regulators, business leaders, and others have made considerable efforts to remedy the circumstances that led to the global financial crisis. These efforts have relied largely on the implementation of more regulations and more revisions to corporate governance standards.

Absent from the reform discussions is the role that ethics should have played in how boards reached critical decisions that had a calamitous impact on the world’s financial markets. Perhaps the closest has been the Walker Report in the United Kingdom, which explored concerns around the behavioural conduct of bank boards in its enquiry into the meltdown of the UK banking sector.

The challenge for the global business community is to seize the moment now (while institutional and investor support for reform remains strong) and build broader, more assertive adherence to corporate governance best practices.

Chief among boards’ priorities is their need to recommit to high ethical standards, especially since many were compromised over the past two decades to the point that public trust and confidence in business is very low, especially in the banking sector. Ethics should not be an issue that applies only to corporate boards, either. There is much blame to pass around for the financial crisis, including investors and regulators; they, too, should re-examine their ethical standards and decision processes.

Value systems in business have been shaken; in some instances, they appear to have collapsed, none more so than in the banking sector it would appear. In hindsight, too much effort has seemingly been spent on checking the boxes in support of compliance with rules and regulations. Too many directors sidelined ethical issues that could have better informed the fundamental business decisions they made, decisions that had a profound effect on the global economy. In some cases, difficult decisions essential to abiding by the *spirit* of codes of conduct and regulations were conveniently avoided or simply ignored.^a

The extent to which senior management, with their boards' approval, enriched themselves at the expense of their investors' long-term interests is but one example among many that underscores why the moral compass of business leaders needs to be recalibrated. Regulators, under political pressure, should well heed this point, too, as should those investors who gleefully rode the wave of superior profits to the disregard of their own stewardship responsibilities. Too many investors disregarded obvious signals that should have alerted them to problems, especially poor selection of board directors.

How can ethics be re-introduced as part of the moral compass for boards and other institutions critical to the stability and welfare of our financial markets and global economy?

First, this re-introduction surely can't be about rules alone. Boards must play a leadership role in promoting an ethical business culture, with the chairman and CEO setting the "tone at the top." This must be demonstrated – in practice and conduct – to ensure that the right decisions are made and ethical standards are rigorously observed without exception.

More time must also be devoted to board induction and director development, particularly in such complex sectors as banks and financial institutions. This effort should not only cover relevant laws, regulations and codes that govern the business; it should also include a comprehensive understanding of the financial structure of the business and such key performance issues as market environment, strategies, and major risks.

At the Global Corporate Governance Forum, we are helping to address this need by developing board instruction on bank risk governance, drawing on lessons from the financial crisis, which focuses on the special features of banks and the role of directors. This module, an extension of our globally acclaimed *Corporate Governance Board Leadership Training Resources*, follows the journey of a newly appointed bank director as he or she acquires the understanding, skills and insights required for handling the particular challenges posed by financial markets and banking, despite his or her extensive experience as a board director in industry.

Mandatory rules have a role, too, with needed reforms to ensure that boards and senior management are more closely aligned with investor and shareholder interests. Granted, there are limits to what laws and regulations can do to halt the opportunistic behaviour of individual decision-makers. A good example is the enactment of the Sarbanes-Oxley law in the United States. This put into place major reforms in securities laws that toughened audit and disclosure requirements. Yet, these laws did not avert the problems that have taken place in investment banks and other financial institutions, including excessive leverage and other reckless governance practices.

Tougher requirements can inform boards' ethical responsibilities for compensation-setting, risk management, investment strategy and accounting practices. The advent of a Stewardship Code for institutional investors in the United Kingdom shows us that governance responsibilities extend beyond companies and their boards. The various elements of our financial markets should seek to address a number of serious structural deficiencies and perverse incentives highlighted by the global financial crisis, otherwise we run the risk of simply getting back to business-as-usual all too soon and set ourselves up for another crisis in the not too distant future.

Of course, none of this will work unless the financial markets and those responsible for their effective functioning (such as policy-makers, regulators, and market participants) demonstrate that good corporate governance practices are determined by the ethical exercise of significant authority and responsibilities on which society's welfare depends.

^a Knowledge@Wharton, " 'A Race to the Bottom': Assigning Responsibility for the Financial Crisis." December 9, 2009. Available at: <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2397>

G. One world, many markets

One final dimension related to building a desirable global financial infrastructure needs to be mentioned. In our globalised economy banks operate, and securities are traded, around the globe. A large Chilean company may well be financed by a bank from Japan, or a pension fund from the Netherlands.¹⁷ Banks receive capital from sovereign wealth funds in Asia and the Gulf Region.¹⁸ Depositors around the world had their money in Icelandic banks and it is generally agreed that the precipitating cause of the global financial crisis was exposure to US sub-prime mortgages. So if a new accountable capitalism is to arise, it must do so on a global basis. If it does not, institutions based in one country could continue to practice destructive short-term strategies in another country.

Historically, each regulator has focused narrowly on its particular domain or jurisdiction, without having a panoramic vision of the whole system. The main regulators up to now have been the Basel Committee for Banks, the International Organization of Securities Commissions (IOSCO) for securities, the International Association of Insurance Supervisors (IAIS) for insurance, the International Forum of Independent Audit Regulators (IFIAR) for audit, and the International Accounting Standards Board (IASB) for global reporting standards. No global regulator claims jurisdiction over credit rating agencies, or over institutional investors acting as fiduciaries for others.

However, as a result of the G20 action in London, in April 2009, the newly constituted Financial Stability Board (FSB) has a clear mandate: "To maintain financial stability". Realistically, the FSB cannot become a new unified global regulator. This is both impractical and politically impossible. Around the world, regulatory structures and even the nature of the law differ.

However, an international body such as the FSB, with its overarching mandate, can agree to principles. The Organization for Economic Co-operation and Development (OECD) took that approach in its much-praised Principles of Corporate Governance, which have been widely adopted. A principles-based international entity can be rigorous, not in writing regulations, but in investigating whether internationally-agreed principles are applied in individual countries.

¹⁷ ABP, the Euro 200 billion Dutch pension fund, has invested nearly Euro 2 billion in banks which make loans in Chile and elsewhere. See: http://www.abp.nl/abp/abp/images/01%200002%2008C_top100ENG%20%28def%20versie%29_tcm108-59128.pdf

¹⁸ Some examples include multi-billion dollar infusions of capital to UBS from the Government of Singapore Investment Corp., to Citicorp from the Abu Dhabi Investment Authority and to Morgan Stanley from the China Investment Corp.

The new FSB could surely agree that:

- all actors in the financial system have responsibility for the tasks they undertake;
- they are in turn accountable, and those to whom they are accountable must be qualified and take their responsibility seriously;
- those who make them accountable need to be provided with relevant information
- information ought to be provided by independent agents;
- all banks, and other financial institutions, need to be “stress tested”, not only for solvency, but also for liquidity; and
- civil society, regulatory institutions, and central banking authorities should have powers and rights that give practical meaning to the above.

Such principles have corollaries that imply specific practices: A preference for transparency in all transactions, clear lines of authority, coordination amongst regulators, an end to opaque trading in derivatives, and a concern about OTC markets.

New institutions would be required to ensure that these practices are implemented. One possibility would be a lender of last resort, perhaps with an expanded role for the International Monetary Fund (IMF).

An inspector charged with judging whether the financial markets of the world in 2006 had met those principles would have concluded that many did not. Perhaps, had there been some such inspectorate invested with the authority of the world’s economic powers to tenaciously ensure that these principles were applied, the irresponsible and unaccountable behaviour which was allowed to thrive until 2007-8 would have been put in check.

Thankfully, the FSB has begun to act along these lines. It has already specified twelve sets of standards it believes to be crucial to global financial stability, including the OECD corporate governance standards.¹⁹ What is missing, however, is a comprehensive program to investigate whether markets have mechanisms to implement and enforce localized versions of these standards and to disclose of findings to the financial markets. Still, the FSB seems to recognize the issue, stating “It is critical that economies have in place an effective legal framework and infrastructure for enforcement.”²⁰

It is also time to realize the third of the Basle pillars – market discipline – in its fullest sense. Market discipline, the ethos and architecture of our financial markets, needs as much attention as do capital requirements and supervisory oversight. To be sure, no amount of regulation of any type can anticipate or prevent all future crises. But in this chapter, several examples of where current practice does not meet the principles of accountability have been identified. If the international regulatory focus for the next few years were to be on improving the trustworthiness of the global financial system through reforming these practices, then the stability of the financial system could be improved. That would promote the emergence of self-correcting mechanisms. That, in turn, should both mitigate the seriousness of the next crisis and allow all market participants –

¹⁹ See Financial Stability Board: 12 Key Standards for Sound Financial Systems.

http://www.financialstabilityboard.org/cos/key_standards.htm

²⁰ See <http://www.financialstabilityboard.org/cos/wasi.htm>

including regulators – to respond more quickly and more precisely. No matter what form it takes.

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Chapter 7

From Conformance to Performance: Linking Governance, Strategy and Sustainability

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A. Introduction

During the financial and economic crisis many corporate governance weaknesses have come to light – most clearly in the financial services industry – that were a causal factor in, or at least aggravated, the crisis. There is now much debate about what governance¹ actions are needed in order for organizations to move beyond this crisis and to avoid future social, environmental, and/or economic crises.

To redress the damage caused by the crisis would already be reason enough for organizations around the globe to evaluate and improve their governance, risk and control approaches. Using the momentum also to make the transition from costly compliance focused systems to more value creating, sustainable performance focused systems provides another – and more compelling – reason to look again at governance practices.

Based on various IFAC studies and publications in the areas of governance and sustainability, this article highlights a number of recommendations to further improve governance in order to create more sustainable organizational value and more sustainable economies and societies. The article describes how professional accountants and IFAC support effective governance in organizations.

B. Early evidence of governance problems

Although the current financial and economic crisis took many by surprise, in retrospect quite a number of issues that either led to the crisis, or failed to avert it, were identified well in advance of the crisis. For example, participants in two consecutive studies by IFAC identified contributing factors, even if they did not anticipate the severity of the consequences.

1. 2007 IFAC survey on governance

Prior to the financial and economic crisis, IFAC had commissioned a global survey of 341 investors, preparers, company management and directors, auditors, standard setters, and regulators to determine the extent to which governance had improved and where there was need for further improvement. In the resulting report, titled *Financial Reporting*

¹ The term “corporate governance” could give the impression that governance is relevant only for corporations when in fact it is equally important to other organizations. Therefore, the more neutral term “governance” is used throughout this article.

Supply Chain: Current Perspectives and Directions' (published in March 2008), participants provided their pre-crisis perspectives on, among other things², the state of affairs in the area of governance.

Many respondents to this 2007 IFAC survey observed progress in the area of governance, compared to five years earlier (2001/2002), which was the time of the Enron crisis and other corporate financial reporting failures around the world. Interestingly, however, well before the current financial and economic crisis developed, respondents had identified a number of persistent governance issues which are now widely seen as among the factors that contributed to the crisis, and had emphasized the importance of addressing these matters:

- *Flaws in the ethical dimension – social, cultural and personal behaviour.* From the respondents there was a widespread view that continuous attention to the behavioural and cultural aspects of governance was the most important priority. Setting the right 'tone at the top' ("leading by example") was paramount but respondents also advised that the ethical dimension – social, cultural and personal behaviour – is fundamentally important throughout the whole organization. Respondents commented that while it is desirable to improve ethical standards in accounting and auditing, banks, financial advisers and analysts, credit raters, and lawyers, as well as institutional investors, such as pension funds and equity/fund management groups, should also adhere to a code of ethics and guard against unethical practices.
- *Remuneration structures with little relation to long-term sustainable performance.* According to the survey results, executive remuneration was seen as an issue, while at the same time respondents recognized the difficulties in relating remuneration to long-term performance. Respondents felt that incentives that encouraged short-term opportunism and/or reckless risk taking, as well as rewarding failure, needed to be avoided. Alternatives to current remuneration structures should seek better alignment with longer term sustainable performance or, if that was not possible, a larger amount of pay in the form of fixed salary, and bonuses only for exceptional performance. Respondents also considered that there should be more transparency in executive compensation. In particular they identified the need to keep executive remuneration under constant review.
- *Adoption of governance in name but not in spirit, providing a false sense of security.* Many respondents felt that many governance changes had been made "in letter, but not in spirit." They shared the view that some organizations are pushed to improve their governance more by the regulatory bodies than by an inner drive "to do the right thing." In their opinion, "numerous organizations and boards of directors consider governance as yet another certification, and still think that forming committees and hiring consultants to write policies solves the problem." Organizations quickly adopt the easy-to-comply-with aspects of governance, but seem slower to adopt the more substantial measures. Respondents felt that fostering a culture of good governance is far more than a

² The other topic areas surveyed for the report were the financial reporting process, the audit of financial reports, and the usefulness of financial reports.

compliance exercise and warned that compliance in form rather than substance provides a false sense of security.

- *Regulatory overload* (especially for SMEs), *leading to legalistic compliance* (“checklist mentality”) *rather than a principles-oriented, ‘better’ practice approach*. Respondents recognized that the financial reporting failures of some years earlier “really let investors down.” Many were sceptical, however, about regulatory responses that appeared to be a knee-jerk reaction to corporate failure, and considered that resulting regulatory changes caused governance principles to be replaced by a rule-oriented and box-ticking mindset. It was felt that overregulation had created a situation where people focused too much on compliance and not enough on strategy and “building a business”. Respondents signalled a preoccupation with governance issues rather than making the company achieve and prosper over the long term. As a result, respondents anticipated that compliance activities would take too much time and attention and real risk areas and opportunities would be overlooked.
- *Reduced usefulness of financial reports due to complexity, fair value issues, focus on compliance, regulatory disclosure overload, and lack of forward looking information*. According to many respondents, financial reports have become less useful because they have become too complex for the average reader to understand. They considered the drivers behind this complexity to be regulatory disclosure overload; the greater use of fair value; and the increased fear of liability by company directors. To some, regulatory disclosure overload is such that really important information is hidden from users. At the same time, even with so much information being provided, respondents considered that there is still insufficient transparency in the most complex areas of accounting, such as derivatives or securitization. In addition, respondents were not sure whether fair value accounting was improving the fundamental understanding of the business and the accomplishments of management. Respondents also felt that preparers were too focused on compliance with reporting standards rather than on reporting the underlying economics of the business.
- *Lack of transparency in (non-financial) communications*. Respondents also took the view that contextual narrative information was becoming more important as financial reports become more difficult to understand and results more volatile. What respondents thought mattered more to users is the company’s view on market opportunities and risks, its strategy and its analysis of why that will be value creating. This disclosure could be complemented by metrics and key performance indicators that provide feedback on how a company has executed its strategies.

2. 2008 follow-up study on governance

In 2008 – just before the effects of the financial and economic crisis really hit the global economy – IFAC completed a follow-up study on the global developments in the area of governance titled, *‘Developments in the Financial Reporting Supply Chain—Results from a Global Study among IFAC Member Bodies’* (IFAC, 2009a). The study indicated that in many countries and jurisdictions, progress has been made in the area of governance, such as new or revised governance codes and standards. It also pointed out

that the legislative or regulatory framework for governance had generally improved in participants' countries or jurisdictions.

Participants also highlighted a number of additional governance issues that still needed to be addressed:

- *Risk and control systems that are too narrowly focused.* At the time of the study, participants considered that the risk and control systems of many organizations were mainly focused on financial reporting and often ignored the wider risks that they saw threatening many organizations.
- *Insufficient integration of governance and sustainability into the overarching business model.* Participants indicated that separate (“add-on”) governance and sustainability systems instead of integrated (“built-in”) ones often cost more than they deliver. Such separate systems tend to focus primarily on compliance or conformance, generating costs, while more integrated governance systems generally also focus on performance, enabling the organization to fully exploit its business model and achieve longer-term sustainable value.
- *Lack of safe harbour protection for those charged with governance.* According to the study, lack of safe harbour protection³ not only makes it more difficult to attract and retain competent individuals, but also makes boards risk averse and tends to focus them on compliance with regulations to an even greater extent, rather than on reporting the underlying economics of the business.
- *The need for more governance in public sector organizations.* Participants felt that governance principles should be applied to both private organizations (small, mid-sized and large), as well as to public sector and not-for-profit organizations. Efforts to improve governance should not be restricted to corporations only.⁴

This overview of governance issues and recommendations from the two IFAC reports that predated the global financial and economic crisis clearly shows that, at the time that the survey and the study were conducted (2007/2008), the awareness of global governance problems already existed and certain signs were clearly visible, but were ignored by many (see example in Box 7.1). The subsequent financial and economic crisis not only revealed those problems, but also showed the painful consequences of not addressing them properly and promptly.

Many of the recommendations from both reports are still highly relevant to the discussion on how to further improve corporate governance. But before we can enter that discussion we first have to determine how the 2008/2009 financial and economic crisis has changed the needs of the various governance stakeholders.

³ Provisions that reduce a party's liability, on the condition that the party performed its actions in good faith.

⁴ Especially now that so much of GDP is in public sector control in some jurisdictions as a result of the financial and economic crisis.

Box 7.1 'We're Still Dancing'

Even when the signs of the impending crisis were becoming very clear, the 'party' continued. For example, on July 10, 2007, Citigroup's then chief executive, Charles O. Prince, was quoted in a Financial Times article saying that "As long as the music is playing, you've got to get up and dance. We're still dancing." The article pointed out that Citigroup hadn't pulled back from making loans to provide funds for private equity deals, despite early concerns about the credit market and evidence of a slowing in the market for financing for leveraged buyouts. (Citigroup Chief Stays Bullish on Buyouts, July 2007)

C. After the crisis: the needs of societies, financial markets and organizations

The 2008/2009 financial and economic crisis has put many of the governance issues discussed above into the spotlight, as matters that need to be addressed if we are to achieve the creation of sustainable stakeholder value.

In addition to the two pre-crisis IFAC reports discussed above, IFAC has recently finalized a series of interviews with 25 key leaders on what next should be done to improve governance. The interviews, which are summarized below, will be published in 2010 on IFAC's website at www.ifac.org.

1. Post-crisis governance recommendations from key leaders

IFAC's recent interviews with key leaders from around the globe capture the governance recommendations from prominent preparers, directors, auditors, standard setters, regulators, and investors. The group interviewed includes Sir David Tweedie (Chairman International Accounting Standards Board, UK), Professor Mervyn King (Chairman King Committee on Corporate Governance, South Africa), Jane Diplock (Chairman IOSCO Executive Committee, New Zealand), Sam DiPiazza (former Chief Executive PwC, USA), Joe Kaeser (CFO Siemens, Germany), Euleen Goh (former CEO Standard Chartered Bank, Chairman, Accounting Standards Council, Singapore), Jim Kroeker (Chief Accountant SEC, USA), and David Webb (Investor activist, Hong Kong).

In these interviews the participants explore potential solutions for the major governance issues that emerged from the global financial and economic crisis, as well as for those issues that are only now appearing on the horizon.

Among the interviewees, there was a broad consensus on the following recommendations:

- *The primary responsibility of directors is for performance; not compliance.* To ensure the long term creation of sustainable value, both performance and compliance based perspectives are needed. The fallout from the financial and economic crisis and the uncertain path to recovery put pressure on organizations and their directors to evaluate what went wrong, to take such additional governance measures as are necessary to recover from the crisis, and to prevent such a situation happening again. However, according to the interviewees, organizations and their directors need to realize that their

stakeholders' primary interest is not in compliance, but in the performance of the organization. Therefore, in order to optimize stakeholder value organizations will need to balance their essential compliance or conformance efforts with further improvements in their performance. They will also need to consider how to use effective governance as a means to drive success.

- *Expand from shareholder perspective to stakeholder perspective.* Interviewees noted that both public and private sector organizations have an ever-growing impact on social and economic life and are of increasing significance, not only for their owners and other investors, but also for their clients, employees, suppliers, neighbours, governments, regulators, financial markets, and for societies as a whole. Moreover, individual persons now fill numerous stakeholder roles at the same time: the same person can be a client, an employee, a neighbour of, and an investor (via his or her pension fund for example) in a specific company. To accommodate these different and, at times, conflicting perspectives, organizations should adopt a wider stakeholder view.
- *Take economic as well as social and environmental performance factors into account.* Together with the expansion to the wider stakeholder concept, those interviewed tended to take the view that stakeholder value involves consideration of social, environmental and economic factors. This is not only because different stakeholders have different interests, but also because these factors are interdependent. For example, social and ecological factors can also determine or affect the economic value of an organization.⁵ Therefore, organizations need to take all these factors into account when they determine their sustainable performance objectives (see Box 7.2). In addition, long term social, environmental, and economic performance should all be taken into account to determine the remuneration of individuals or groups, preferably on the basis of what can directly be attributed to their own efforts.
- *Governance and sustainability should be better integrated in the strategy, operations, and stakeholder communications of an organization.* According to the interviewees, governance and sustainability are key elements in achieving long term social, environmental and economic performance, as well as in enhancing investor and stakeholder confidence. Put differently, the long term survival of organizations is no longer affected only by economic factors, but also by social and environmental ones. Therefore, these aspects should be better integrated in the strategy, operations, and stakeholder communications of an organization. Organizations should not produce first and think about the social and environmental consequences only as an afterthought. Sustainable organizations tackle these issues upfront instead of finding solutions after the event. With respect to business reporting, organizations mostly produce social and environmental reports completely separate from their financial report, if they report at all on those aspects. This produces at best a fragmented view of the performance of the organization. When social, environmental and economic results of an organization are in one integrated report, taking into account the

⁵ See for example the Mistra study [*The Value Relevance of Environmental and Social Performance: Evidence from Swedish SIX 300 Companies*](#) (2009) that shows that investors are willing to pay more for environmentally aware companies.

various interdependencies, interviewees believe it is then possible to see the true performance of the organization.

- *Develop and implement codes of conduct to create a values-based culture.* Interviewees recommended formulating the values to which an organization will adhere in a code of conduct, and integrating them in the operations of the organization. In addition, *investor codes of conduct* are considered to be a route to much-improved monitoring of governance (Wighton, 2009) as, according to the interviewees, shareholders have not been very pro-active in their role as owners and should actually start to take more action in this space.
- *Further improve the organization's stakeholder communications.* Drastic changes in the format of current external reporting were recommended. Otherwise they believe it will become less and less relevant to investors and other users due to their complexity and narrow focus. Financial reporting should be expanded to more integrated, connected and holistic business reporting, focused on the social, environmental, and economic fundamentals of an organization. Governance disclosures in external reporting should reflect not only the governance principles, but also the governance achievements or performance of the organization.

All these recommendations are easier said than done! The main question, therefore, is how to best enable organizations to make the transition to this next level of governance. In order to achieve the necessary governance changes, a balance is required between improved regulation, oversight and better application and integration of good practice governance principles within organizations. The key leaders that were interviewed for this IFAC project also warn that making corporate governance really work will require all stakeholders to deal in a coordinated way with the persistent challenges that seem to inhibit change, such as litigation risks and stifling regulation that leads to box-ticking.

Box 7.2 Sustainable Performance

Sustainable performance is the combination of the social, environmental and economic results of an organization that determines the overall stakeholder value and allows the organization to succeed and prosper in the longer term. Organizations' social and environmental performance is integral to their whole business and the sustainability of their company. That often requires a change in mindset at the top which then has to be communicated throughout the organization.

Sustainable performance is also strongly connected to achieving long term profit growth. This entails pursuing a governance objective of creating and optimizing sustainable stakeholder value (see IFAC's 'International Good Practice Guidance, Evaluating and Improving Governance in Organizations' (2009b)) which emphasizes the longer term interests of existing and future stakeholders rather than short term wealth maximization. Organizations can succeed and prosper in the longer term only by adapting to changing social, environmental, and economic stakeholder demands, and by integrating those demands into their strategy, operations and stakeholder communications.

2. Momentum for change

One of the positive side effects of the financial and economic crisis is that it has created momentum for change. Governance challenges and solutions are now being debated by a large number of stakeholders: governments⁶, regulators, oversight bodies, standard setters, professional bodies, as well as international agencies and organizations such as the International Organization of Securities Commissions (IOSCO), the Organisation for Economic Co-operation and Development (OECD), the United Nations Conference on Trade and Development (UNCTAD), and the World Bank. Together, these organizations will have a significant impact on determining the changes that need to be made and that can effectively work in organizations.

The accountancy profession as a whole – professional accountants who work in public practice, as well as professional accountants who work as employees, consultants and self employed owner managers or advisers in commerce, industry, financial services, the public sector, education and the not-for-profit sector, as well as their professional organizations and IFAC – are participating in making the necessary governance changes happen. They are also supporting all kinds of organizations around the globe to move to the next governance level in order to achieve more sustainable social, environmental, and economic performance.

The next section describes how professional accountants support effective governance in organizations. It is followed by a section that describes the range of IFAC activities in the areas of governance and sustainability.

D. Professional accountants supporting effective governance in organizations

This section describes professional accountants (see Box 7.3) and explores the various roles that they perform and the ways in which professional accountants should support effective governance.

Box 7.3 Professional accountants described

A professional accountant can be described as someone who:

Meets the standards of a professional, defined as having skills, knowledge and expertise tested by examination and continuously developed in a structured and monitored context; committed to the values of accuracy, honesty, integrity, objectivity, transparency and reliability; and subject to oversight by a body with disciplinary powers;

Is recognized as being an accountant, defined as belonging to a recognized accountancy body upholding professional standards and approaches in the discipline of recording, analyzing, measuring, reporting, forecasting and giving advice in support of financial, management and strategic decisions; and

⁶ Including collaboration across borders, such as the Group of Twenty Finance Ministers and Central Bank Governors which was established to bring together systemically important industrialized and developing economies to discuss key issues in the global economy.

Works in the public interest, regardless whether the professional accountant works in public practice or is employed in commerce, industry, the public sector, education, or the not-for-profit sector. Therefore, a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer.

Professional accountants, delivering professional services to organizations, support effective governance and social, environmental and economic performance in various roles, which may be classified into creators, enablers, preservers, reporters, and (external) auditors for organizations.

- *Professional accountants as creators of value.* In this role professional accountants are involved in leadership roles in governance, strategy and performance management and in overseeing the allocation of resources to ensure long-term sustainable value creation. Examples of specific roles include executive director, chief financial officer, financial director and treasury manager. As part of the organization's management, professional accountants should ensure a strong link between business strategy, governance and sustainability so that boards and managers consider these areas in an integrated rather than isolated way.
- *Professional accountants as enablers of value.* In roles such as business unit controller, business-, financial- and/or performance analyst, management or cost accountant, professional accountants influence and support those who make decisions. By providing relevant insight and analysis, and by challenging assumptions and conventional thinking, professional accountants as enablers of value will typically guide and assist sustainable strategic and operational decision making and implementation, and evaluate its ongoing relevance and success. Professional accountants should enable governance, risk management and control as a strategic activity and an integral part of an organization's management system.
- *Professional accountants as preservers of value.* Professional accountants are familiar with the national governance codes, (and other) regulatory rules and procedures in order to guarantee, as far as possible, that compliance with the applicable regulatory regimes is met. They could also ensure that organizations stay on track to achieve their sustainable strategic and operational goals by testing whether financial and non-financial information systems are working correctly and that the resulting information from these systems reflects the true sustainable performance of the organization. They are well positioned to effectively identify, prioritize, manage and control, mitigate and report strategic and operational risks and control deficiencies. Examples of such roles include risk and business assurance manager, compliance manager, and internal auditor.
- *Professional accountants as reporters of value.* Professional accountants – in roles such as group controller, head of reporting, investor relations manager and financial or management accountant – design, implement, and manage performance measurement and reporting systems. They measure social, environmental and economic performance, prepare high quality business and

financial reporting, and provide internal and external stakeholders with facts, analysis and insights on sustainable value creation.

- *Professional accountants as independent auditors.* Professional accountants serving in the role of independent auditor have as their principal service the preparation of audit reports on financial statements. In addition to financial statement audits, however, professional accountants that serve in the role of independent assurance provider can also provide assurance reports on a range of organizational information such as an organization's statement of greenhouse gas emissions. In an audit, auditors communicate with those charged with governance of an organization. This communication is not only to obtain information relevant to the audit, but also to provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibilities to oversee the organization's financial reporting process. While the independent audit serves as one of the cornerstones to effective governance, equally, good governance supports the performance of an effective and efficient audit.

Most, if not all, governance codes around the world explicitly acknowledge the important roles of professional accountants to an entity's governance (see Box 7.4).

Box 7.4 References to the role of the internal and external auditor in governance codes

Many governance codes refer to the importance of the internal or independent external auditor to an entity's governance, for example:

The Organisation for Economic Co-operation and Development (OECD) has issued the *OECD Principles of Corporate Governance (2004)* which has around 40 references to independent and internal auditors, such as:

- “An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.”
- “External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.”
- “It is an important function of the board to oversee the internal control systems covering financial reporting and the use of corporate assets and to guard against abusive related party transactions. These functions are sometimes assigned to the internal auditor which should maintain direct access to the board.”

The United Nations Conference on Trade and Development (UNCTAD) *Guidance on Good Practice in Corporate Governance Disclosure (2006)*.

- “Independent external audits should provide an objective assurance that the financial statements present a true and fair view (or are presented fairly in all material respects) of the financial condition and performance of the audited entity. Therefore, most governance codes and guidelines define procedures for enhancing the independence, objectivity and professionalism of the external audit.”

The International Organization of Securities Commissions (IOSCO) *Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence (2002)*.

- “The external auditor plays a critical role in lending independent credibility to published financial statements used by investors, creditors and other stakeholders as

a basis for making capital allocation decisions. Indeed, the public's perception of the credibility of financial reporting by listed entities is influenced significantly by the perceived effectiveness of external auditors in examining and reporting on financial statements."

The revised *Code of and Report on Governance Principles for South Africa (King III)*:

- "The board should ensure that there is an effective risk-based internal audit."
- "The board should ensure that the company has an effective and independent audit committee."
- "The audit committee should engage the external auditors to provide assurance on the summarized financial information."

International Corporate Governance Network (ICGN) *Global Corporate Governance Principles*(2005, Revised 2009):

- "Companies should aspire to robust, independent and efficient audit processes using external auditors in combination with the internal audit function."
- "The annual audit carried out on behalf of shareholders is an essential part of the checks and balances required at a company."
- "Companies should establish and maintain an effective internal audit function that has the respect, confidence and co-operation of both the board and management."

Global Corporate Governance Forum ⁷ (GCGF) *Toolkit 2: Developing Corporate Governance Codes of Best Practice* (2005):

- "Ineffective boards, weak internal controls, poor audits, lack of adequate disclosure, and lax enforcement have led to financial crises and major corporate scandals around the world in recent years."

IFAC's guidance *Evaluating and Improving Governance in Organizations* (2009):

- "Internal and external auditing can help an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of enterprise risk management, internal control, and governance processes."

Basel Committee on Banking Supervision consultative document, *Principles for Enhancing Corporate Governance* (March 2010):

- "The board should recognise and acknowledge that independent, competent and qualified internal and external auditors, as well as other internal control functions (including the compliance functions), are vital to the corporate governance process in order to achieve a number of important objectives. Senior management should also recognise the importance of the effectiveness of these functions to the long-term soundness of the bank."
- "There are also many others that can promote good corporate governance, including: external auditors - through a well-established and qualified audit profession, audit standards and communications to boards, senior management and supervisors."

⁷ The Forum was co-founded by the World Bank and the Organization for Economic Co-operation and Development (OECD) in 1999.

E. IFAC supporting effective governance in organizations

As the global organization for the accountancy profession, IFAC works in the public interest by developing high-quality international standards, promoting strong ethical values, encouraging quality practice, and supporting the development of all sectors of the profession around the world. To carry out this mission, IFAC works closely with its member bodies and regional accountancy organizations and with others, like regulators, standard setters and governments, who share IFAC's commitment to creating a sound global governance and financial architecture.

IFAC supports the required reforms to global governance discussed in this article with various initiatives, such as the publication of guidance and information papers and participation in international initiatives.

1. IFAC guidance and information on governance

On behalf of the global accountancy profession and in open communication with the various international stakeholders – for example via IFAC's due process⁸ – IFAC is developing various guidance and information papers to support professional accountants and the organizations they work for in moving to the next level in governance.

a. Evaluating and Improving Governance in Organizations

As part of its ongoing commitment to support professional accountants and the organizations they work for in enhancing governance and in improving organizational performance, IFAC has released a principles-based International Good Practice Guidance document entitled *Evaluating and Improving Governance in Organizations* (2009b). The guidance includes a framework, consisting of a series of fundamental principles, supporting guidance, and references, on how professional accountants can contribute to evaluating and improving governance in organizations (see Box 7.5).

Box 7.5 Governance framework, balancing conformance and performance

As further explained in the International Good Practice Guidance, *Evaluating and Improving Governance in Organizations*, IFAC's (2009b) governance framework is composed of two dimensions: the performance dimension and the conformance dimension, which together represent the entire value creation, resource utilization, and accountability framework of an organization.

⁸ See for example the [Preface to IFAC's International Good Practice Guidance](#).



IFAC Governance Framework

- *Performance responsibilities* (a) focus on opportunities and risks, strategy, value creation, and resource utilization, and (b) guide an organization's decision-making.
- *Conformance responsibilities* include compliance with laws and regulations, best practice governance codes, accountability, and the provision of assurances to stakeholders in general.

This International Good Practice Guidance brings together globally recognized and applicable good practice principles on effective governance (see Box 7.6) into an international benchmark for the accountancy profession. It will help professional accountants to further improve the governance structures and processes in the organizations they work for— something critical to ensuring an organization's viability and accountability.

Box 7.6 Key principles of evaluating and improving governance in organizations

IFAC guidance contains the following 12 key principles of evaluating and improving governance in organizations, which are further explained in the guidance:

- 1) The creation and optimization of sustainable stakeholder value should be the objective of governance.
- 2) Good governance should appropriately balance the interests of stakeholders.
- 3) The performance and conformance dimensions of governance are both important to optimize stakeholder value.
- 4) Good governance should be fully integrated into the organization.
- 5) The governing body should be properly constituted and structured to achieve an appropriate balance between performance and conformance.
- 6) The governing body should establish a set of fundamental values by which the organization operates. All those participating in governance should embrace these fundamental values.
- 7) The governing body should understand the organization's business model, its operating environment, and how sustainable stakeholder value is created and optimized.

- 8) The governing body should provide strategic direction and oversight in both the performance and conformance dimensions.
- 9) Effective and efficient enterprise risk management should form an integral part of an organization's governance system.
- 10) Resource utilization should align with strategic direction.
- 11) The governing body should periodically measure and evaluate the organization's strategic direction and business operations, and follow up with appropriate actions to ensure progress and continued alignment with objectives.
- 12) The governing body should ensure that reasonable demands from stakeholders for information are met, and that the information provided is relevant, understandable, and reliable.

IFAC's guidance on governance is designed to complement existing governance codes, including the OECD Principles of Corporate Governance (2004) by encouraging organizations to achieve a balance between conformance with rules and regulations and driving organizational performance. It also focuses on how to create sustainable stakeholder value in the form of good products or services, economic profitability, job security, safety, and other social and economic responsibilities.

b. Sustainability Framework

The IFAC Sustainability Framework (2009c), developed in 2009, highlights the issues that organizations must address to make sustainability an integral element in their business models. For example, it offers guidance on how to inject sustainability leadership into the management cycle, from making and executing strategic decisions to reporting on performance to stakeholders. The framework is designed from four different perspectives – business strategy, internal management, investors, and other stakeholders – to reflect the various roles performed by professional accountants (see Box 7.7).

Organizations embracing sustainable development at a senior management level and integrating it in their strategic planning typically move beyond delivering short-term results to please impatient investors and stakeholders. Such organizations tend to have more success when viewed in a wider context that attaches importance to social, environmental and economic impacts.⁹

⁹ See IFAC's Information paper, [*Why Sustainability Counts for Professional Accountants in Business*](#) (2006), which makes the business case for engaging with sustainability.

Box 7.7 Perspectives of IFAC's Sustainability Framework



IFAC's Sustainability Framework incorporates four perspectives:

- 1) *The business strategy perspective* emphasizes the importance of adopting a strategic approach, so that sustainable development is a part of strategic discussions, objectives, goals, and targets. This will help to integrate sustainable development into the strategy and operations of an organization.
- 2) *The internal management perspective* covers a range of management activities to support and improve (a) an organization's sustainability performance, and (b) its integration into management and operational activities.
- 3) *The investors' perspective* is about telling the performance story to investors. It offers advice on incorporating both environmental and other sustainability issues into financial statements in a way that supports an organization's stewardship role. It also encourages broad-based and forward-looking reporting to investors in the management commentary in the annual report.
- 4) *The stakeholders' perspective* considers achieving transparency with non-financial reporting against a broader set of stakeholder expectations. Included is advice on reporting on climate change issues and emissions in a way that demonstrates the existence of a structured system and approach to managing climate change impact and risks. This perspective also includes sustainability assurance, to help to improve credibility and trust.

c. Code of Conduct for Organizations

In 2007 IFAC issued the International Good Practice Guidance, titled *Defining and Developing an Effective Code of Conduct for Organizations (2007)*. This guidance assists professional accountants and their organizations in developing and implementing a code of conduct/ethics. It stresses the importance of a values-based organization and a values-driven code to promote a culture that encourages employees to internalize the principle of integrity, and to behave accordingly. A well-designed code of conduct can provide the context for programs targeted at improving organizational performance. Organizations that fail to establish and implement a code of conduct and to embed their organizational values could experience lower productivity, higher turnover, increased transaction and agency

costs, and increased exposure to legal action.¹⁰ Reputational advantages derived from adherence to a code of conduct are widely documented: employees generally prefer to work for organizations committed to values and ethics and consumers tend to prefer to buy from organizations with strong records of adherence to standards of good conduct and socially sensitive behaviour.¹¹ Codes also help to reassure investors and other stakeholders, in particular those looking for socially responsible investment, integrity, and a commitment to ethics.

d. Code of Ethics for Professional Accountants

The distinguishing mark of the accountancy profession is its responsibility to act in the public interest. Therefore, all professional accountants have to uphold high ethical standards in accordance with the Code of Ethics for Professional Accountants (IFAC, 2006).¹² The fundamental principles in this code are integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. The code requires accountants to encourage an ethics-based culture in an employing organization that emphasizes the importance that senior management places on ethical behaviour (paragraph 300.5 of the code), so professional accountants can support an organization's code of conduct through their own behaviour.

e. International Standards on Auditing

The International Auditing and Assurance Standards Board (IAASB)¹³ serves the public interest by setting high-quality auditing, other assurance, quality control and related services standards – such as the International Standards on Auditing (ISAs) – thereby enhancing the quality and uniformity of auditing practice throughout the world and strengthening public confidence in auditing. The ISAs and other IAASB guidance and standards support professional accountants that serve in the role of independent auditor by setting out the auditor's overall objectives in an audit, and the specific responsibilities of the auditor that help enable the auditor to meet those objectives. Over 126 jurisdictions around the world now have adopted or otherwise use the ISAs as the basis of national standards.

While the ISAs are focused on the audit of financial statements, the IAASB also recognizes the value of high quality standards for other assurance services. Emerging areas where such standards may have application include assurance on an entity's statement of governance, and, possibly, an entity's anti-bribery program. The IAASB also is developing standards on such topics as reports on greenhouse gas statements. A further example is in IFAC's own Annual Report, where assurance is provided on the statement describing the services delivered by IFAC.

¹⁰ See for example the overall conclusion in the [2009 National Business Ethics Survey](#) of the US based Ethics Resource Center (ERC) that "Executives who don't elevate culture to a priority risk long-term business problems. Ethical culture is the single biggest factor determining the amount of misconduct that will take place in a business."

¹¹ See Appendix E of IFAC's guidance for resources and references.

¹² Some jurisdictions may have requirements that differ from those contained in this code. Professional accountants need to be aware of those differences and comply with the more stringent requirements.

¹³ See <http://www.ifac.org/IAASB>

f. Governance in the public and not-for-profit sector

IFAC strongly believes that governance is of equal importance to the public and not-for-profit sectors as it is to the corporate sector. Therefore, much of what has been said in this article also applies, with necessary changes, to public sector and not-for-profit organizations. In addition, IFAC also publishes pronouncements specifically focused on the public sector. Most notable are the International Public Sector Accounting Standards (IPSASs), developed by the International Public Sector Accounting Standards Board (IPSASB).¹⁴ These public sector financial reporting standards, which are substantially converged with the International Financial Reporting Standards (IFRSs), set out the recognition, measurement, presentation, and disclosure requirements for financial statements of public sector entities. A number of years ago, IFAC also published a study on Governance in the Public Sector (2009b), which focuses on the responsibilities of a governing body of a public sector controlled entity.

2. IFAC's participation in international governance initiatives

IFAC is also participating in a number of international initiatives to further improve governance.

a. IFAC/UNCTAD collaboration on governance

Collaboration on governance between IFAC and UNCTAD dates back to 2006 when IFAC participated in the revision of UNCTAD's revised Guidance on Good Practices in Corporate Governance Disclosure (2006), designed to assist the preparers of enterprise reporting in producing disclosures on governance for investors and other stakeholders.

Furthermore, IFAC and UNCTAD are collaborating on organizing a joint conference in April 2010 addressing (a) the role of the accountancy profession in governance in the wake of the financial and economic crisis, and (b) on the next steps to take in integrating governance and sustainability into the strategy and operations of an organization.

b. OECD

When the OECD issued its revised OECD Principles of Corporate Governance in 2004 – after a consultation process involving representatives of governments, standard-setting bodies, including IFAC, as well as businesses, professional bodies, trade unions and civil society organizations – IFAC was among the first international organizations that actively welcomed and supported¹⁵ them as an extremely important element of the international financial system. IFAC agrees with the OECD's assertion that governance is a key element of improving economic efficiency and growth, and strongly supports the position that governance practices internationally should be based on the OECD principles.

¹⁴ See <http://www.ifac.org/PublicSector>

¹⁵ See <http://www.ifac.org/MediaCenter/?q=node/view/30>

IFAC also participated in the Global Consultation of the OECD on governance and the financial and economic crisis to discuss the monitoring, implementation and enforcement of governance standards and codes, as well as possible reforms and improvements.¹⁶ In light of this consultation, IFAC prepared a reconciliation of IFAC's International Good Practice Guidance, *Evaluating and Improving Governance in Organizations* (2009b), as discussed above, with the OECD corporate governance principles. In its series of recommendations to the Group of Twenty Finance Ministers and Central Bank Governors [G20](#) in 2009, IFAC explicitly expressed its continued endorsement of the OECD Principles of Corporate Governance.

c. IFAC's G20 recommendations

IFAC submitted a series of *recommendations* for the reform of the global financial system to the G20 Working Groups that met during 2009 in London, UK, and in Pittsburgh, USA (see Box 7.8). With respect to governance, IFAC recommended that G20 should call for measures to enhance governance in their respective countries and in the global marketplace as a matter of urgency.

Box 7.8 IFAC's specific governance recommendations to the G20¹⁷

IFAC urged the G20 to promote strongly and without delay the following governance actions in all countries:

- Adopt and implement (in letter and spirit) the Organization for Economic Cooperation and Development's OECD Principles of Corporate Governance as the standard framework for governance, and urge its adoption in all nations and jurisdictions.
- Complement the OECD Principles of Corporate Governance with IFAC's International Good Practice Guidance, *Evaluating and Improving Governance in Organizations*.
- Request that the OECD reconsider what constitutes appropriate governance on designing remuneration systems in light of current events. Systems of remuneration should provide incentives consistent with long-term growth and corporate performance.
- Consider how enterprise risk management systems may be reformed to support sustainable business performance.
- Establish fundamental ethical principles applicable to boards of directors which incorporate the values of integrity, objectivity, competence and due care, confidentiality, and professional behaviour.
- Stipulate that the role of an effective director, and particularly a non-executive director, requires an investment of time commensurate with the size and complexity of the company.
- Support an increased role for audit and compensation committees in executing their responsibilities by ensuring that they have appropriate (financial) expertise, by

¹⁶ See http://www.oecd.org/document/63/0,3343,en_2649_34813_42181055_1_1_1_1,00.html

¹⁷ See http://www.oecd.org/document/63/0,3343,en_2649_34813_42181055_1_1_1_1,00.html

strengthening their authority, by increasing their responsibilities, and by improving their monitoring role.

- Mandate that Chief Executive Officers and Chief Financial Officers/Finance Directors act be formal signatories to interim and annual financial statements.

F. Going forward

This article provides an overview of governance issues that need to be resolved, not only (a) as a response to the current global financial and economic crisis, but also (b) to get organizations and markets on the right track towards sustainable performance, and (c) to prepare for future social, environmental and economic crises. In order to do so a transition is required from a compliance focused approach to governance towards a more long-term performance focused approach, better integrating governance and sustainability in the strategy, operations, and stakeholder communications of organizations. The accountancy profession is prepared to act itself and support other organizations in moving to this next governance level. As described, IFAC, as the representative international organization for the global accountancy profession, is working with other stakeholders to make this happen. The UNCTAD book in which this article will appear and the associated conference on governance improvements are good examples of such international collaboration. IFAC will continue to focus on these activities in the future as governance and sustainability feature prominently in IFAC's strategy.

Together with the other stakeholders, we can turn governance and sustainability into useful catalysts for the creation, enablement, preservation, communication, and audit of improved social, environmental and economic organizational performance.

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