INVESTOR PERSPECTIVES ON CORPORATE GOVERNANCE
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ABSTRACT

[An investor is the prime entity that commits its resources and vests its financial interests in an enterprise. Their respective perspectives about governance of the enterprise are not as linear as would be expected.

Perspectives, in the given context, are defined as expectations that the governance function will protect, reasonably promote the value of investment and ensure market relevant yields and capital appreciation of investment while retaining liquidity, and market and social reputation of the investment. Perspective implies trust, but may have wider implications that the governance function will be ethical, competent, effective and consistent in the contexts in which the enterprise operates and expands.

Ever since the emergence of open market economy and global integration of financial markets, the shareholders started to protest, more significantly, to claim that Corporate Boards are not serving them as they should. Since 1993 they tried more vigorously. Leading Pension Funds like CalPERS and Herms adopted their own set of Corporate Governance principles to be followed by companies in which they invest. Over the last few years the focus of institutional investors has been on unfolding an era of corporate governance.

Governance function needs to be very clearly articulated, clear and serious that does not confuse itself with short or medium term performance of the corporate. That should be the responsibility of the executive and the management that will function within the contours of policy and guidance of the board and under governance leadership of the board. Governance may not be construed as a job that peeps over the shoulders of the CEO into corporate management, formal reporting relationships, and people training. Governance is a function much up and above; it should be oriented towards shareholders, investors and a host of varied stakeholders, regulators national and other sovereign governments. Mere financial bottom line may not be the call of the governance function; people, and planet bottom lines, ethical and moral toplines should also be the major responsibilities of the governance function. Above all, the governance function in its appropriate perspective needs to be taken seriously by all constituents' in and around the Corporate.]

INTRODUCTION

Investor is the prime entity that commits its resources and vests its financial interests in an enterprise. Retail/household investors; commercial banks; funds (mutual, pension or hedge); financial institutions; investment banks; private equity; JV Partner; and promoter are all investors listed in order of remoteness to proximity to management/control of the enterprise. Their respective perspectives about governance of the enterprise are not as linear as would be expected. Each investor's investment objectives, risk appetite, investment preferences and diversified range of investments are endlessly different. Their roles are also not exclusive but invariably superimposed. In addition to being investors they are also simultaneously consumers, employees, ordinary citizens, competitors, regulators, government, suppliers/vendors or purveyors of service to the enterprise or they are enterprise managers/controllers or those in charge of governance of the enterprise. This Paper excludes the government role as an investor and discusses corporate governance perspectives of investors qua investors.

Perspectives, in the given context, are defined as expectations that the governance function will protect, reasonably promote the value of investment and ensure market relevant yields and capital appreciation of investment while retaining liquidity, and market and social reputation of the investment. Perspective implies trust, but may have wider implications that the governance function will be ethical, competent, effective and consistent in the contexts in which the enterprise operates and expands. Expectations imply that the investors have and strive to have a reasonable right and competence to expect. It may be reasonably presumed that investors weaken or choose to erode this right to expect good from governance function if they fail to exercise the right of diligence and fail to look upon investment as an active commitment and function. As the complexity of business and enterprise grows, finance function acquires modernity and finesse, sophistication and interdependency and remoteness of the investor from the invested increases, reasonably responsible investment function demands harder striving and greater diligence from the investor. The balance between greed and fear and between fear and greed becomes subtler as well as difficult in ascendancy. An expectation, for example is that those investors who are enterprise managers/controllers or those who are in charge of governance do not use the information asymmetry between them and the other investors inequitably to their own benefit at the cost of other investors. It is also expected that there is a sincere and positive effort to reduce the degree of information asymmetry that prevails between these distinct classes of investors. But the latter class is, in the case of a publicly traded company constantly changing as shares change hands. Those investors who are in charge of management or of governance of the enterprise may like to shield some competitively sensitive information from the other investors who have not assumed such charge. Information secrecy and information transparency are thus often in conflict. When such conflict may be used to perpetrate selfish interest, even the best regulators who work against insider trading may not be able to tell. Perspective galore is often inscrutable.

Corporate governance function has also been increasing in complexity, degree of responsibility and mistaken identity [see John Carver's On Board Leadership, Jossey-Bass A Wiley Company, Nonprofit and Public Management Series, 2002]. Suffering as it does from greater expectations from different quarters along with increasing misunderstanding about what it constitutes; corporate governance function has become quintessentially paradoxical in nature and content. It is increasingly characterized by failures than by a well-researched understanding. This Paper would therefore be pontificating if it gives an air that it has understood what the contours and content of the governance function are. This Paper is thus more a feeble attempt to contribute to and promote research on corporate governance within its humble boundaries.

The recent devastating experience of investor community [the Great Recession that commenced in late 2007] gives the author of this Paper an unenviable background of disturbance and troubled times and nervous vortex of expectations from corporate governance. The Bank for International Settlements quantifies the loss in value of investor money by the horrific difference between notional (balance sheet) value of investment in asset backed securities of US$592 trillion and their market value of (only) US$34 trillion [refer A Report by the Investors Working Group sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, July 2009]. Governance and corporate governance have both come under severe disrepute in the vary lands in which they have been pontificated about. How to upgrade corporate governance for investors in those markets that defy transparency, glorify greed, and liquefy trust? The market for unregulated financial innovation—OTC derivatives, asset-backed securities, Credit Default Swaps, mortgage backed securities and so on and so forth; how does it self-regulate or subject itself to legal regulation? One wonders whether it is governance or mis-governance; under-regulation or overregulation; non-regulation or non-regulation under the garb of regulation! The doubts appear endless; the trust appears beginning less. The tendency to under-regulate is followed by the tendency to over-regulate and vice versa. Expectations are passed on to others; expectations of others from the self are conveniently forgotten. Perspectives rise; perspectives deepen. They attract sympathy; they spring confusion. The effort is endless and successes effervescent. This Paper therefore gives up its own expectations but continues the effort, by adding its own humble effort, a drop in the ocean.

Shareholder loss

The class action litigation filed by World Com shareholders resulted in a US$ 6 Billion payout, shareholders of Enron got a pay out of US$ 7 Billion and even the Indian IT Company Satyam misgovernance has over dozen loss action law suits filed by American depository receipts holders pending against it in United States.

Ever since the emergence of open market economy and global integration of financial markets, the shareholders started to protest, more significantly, to claim that Corporate Boards are not serving them as they should. In 1993 they tried as never before.

Corporate Governance: Watching the Boss, an article published in Economist January 29, 1994 highlights the intensity of Investor Activism, in following words: "Everywhere shareholders are re-examining their relationships with company bosses — what is known as their system of 'corporate governance.' Every country has its own distinct brand of corporate governance, reflecting its legal, regulatory and tax regimes… The problem of how to make bosses accountable has been around ever since the public limited company was invented in the 19th century, for the first time separating the owners of firms from the managers who run them… "

The California Public Employees' Retirement System (CalPERS), the largest U.S. public pension fund, with assets totaling $165 billion spanning domestic and international markets as of March 13, 2009, turned its focus, in the year 1993, towards companies considered poor performers by virtually every parameter, to demonstrate very specific and tangible results to those who question the value of Corporate Governance. In 1996, CalPERS published a statement of *Global Corporate Governance Principles* as the minimum standard that markets throughout the world should meet to attract CalPERS funds. CalPERS also published separate market-specific principles for the UK and France in 1997, principles for Germany and Japan in the year 1998 and also published a revised statement on *Corporate Governance Core Principles & Guidelines* in April 1998 recognising that good corporate governance – that is, **accountable governance** – means the difference between wallowing for long periods in the depths of the performance cycle, and responding quickly to correct the corporate course.

The Global Principles of Accountable Corporate Governance ("Principles") create the framework by which CalPERS executes its proxy voting responsibilities. In addition, the Principles provide a foundation for supporting its corporate engagement and governance initiatives to achieve long-term sustainable risk adjusted investment returns. As a shareowner, CalPERS implements its proxy voting responsibility and corporate governance initiatives in a manner that is consistent with the Principles unless such action may result in long-term harm to the company that outweighs all reasonably likely long-term benefit; or such a vote is contrary to the interests of the beneficiaries of CalPERS system.

For companies in the United States or listed on U.S. stock exchanges, CalPERS advocates the expansion of the Core Principles into the Domestic Principles of Accountable Corporate Governance. For companies outside the United States or listed on non-U.S. stock exchanges, it advocates the expansion of the Core Principles into the International Principles of Accountable Corporate Governance. In emerging capital markets, it advocates the expansion of the Core Principles into the Emerging Markets Principles of Accountable Corporate Governance in order to promote sustainable economic, environmental, and social development while striving to establish a governance framework that is consistent with International Principles.

Hermes Investment Management Limited (Hermes), another pension fund manager based in London stresses that companies should be run in the long term interest of shareholders. It believes that companies adhering to this principle will not only benefit their shareholders but the wider economy in which the company and its shareholders participants.

Hermes' approach to engagement with investee companies, is based on the fundamental belief that companies with active, interested and involved shareholders are more likely to achieve superior long-term returns than those without. In short, it believes that good stewardship creates value. Hermes thus places great emphasis on engagement with all companies in which it invests and has been a leader in promoting better corporate governance for over a decade. The Hermes Corporate Governance Principles (HCGP) form the basis for its engagement with the companies in which it or its clients invest. These principles have been divided into two parts, the Global Principles and the Regional Principles. The former are based on the Statement on Global Corporate Governance Principles issued by the International Corporate Governance Network (ICGN) in 1999 and revised in 2005. This statement effectively represents the ICGN's interpretation of the OECD Principles of Corporate Governance published in 1998 and revised in 2004, but amplifies certain aspects of them. The Global Principles also draw on and to some extent make reference to UK corporate governance guidance.

Hermes principles stress the fact that companies should facilitate and protect the exercise of shareholders’ rights, including those of minority and foreign investors. Fundamental shareholder rights include the right to obtain adequate information on the company on a timely and regular basis, to participate and vote in general shareholder meetings and to share in the company’s profits. Companies should disclose adequate, accurate and timely information concerning their business, complying with requirements under relevant accounting rules and market guidelines, so as to allow investors to make informed decisions about the acquisition, ownership obligations and rights, and sale of shares.

Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes, such as amendments to constitutional documents, authorization of additional shares, major acquisitions or dispositions, and closure of businesses. It also requires companies to ensure effective shareholder participation in key corporate governance decisions, such as the nomination, election and removal of members of the board as well as external auditors and give shareholders the opportunity to express their views on remuneration policies for top managers and board members.

KPMG Poll

"The State of Corporate Governance in India: 2008" a poll conducted at the initiative of KPMG during November 2008 to early January 2009, involved over 90 respondents comprising CEOs, CFOs, independent directors and similar leaders, predominantly belonging to private equity firms, financial services and the manufacturing sector. The findings of the poll pointed towards investor perspective on corporate governance are as under:

- Good corporate governance helps an organization achieve several objectives and some of the more important ones include:
- Developing appropriate strategies that result in the achievement of stakeholder objectives
- Attracting, motivating and retaining talent
- Creating a secure and prosperous operating environment and improving operational performance
- Managing and mitigating risk and protecting and enhancing the company's reputation
- Two-thirds believe that exclusive sessions of independent directors are essential
- 47 percent feel that the effectiveness of corporate governance should be monitored through audits by corporate governance specialists.

Over the last few years, the focus of institutional investors has been on unfolding an era of corporate governance in the United States. In the wake of scandals and corporate failures, it was perhaps inevitable to focus on the reform process initiated by passing of Sarbanes-Oxley Act and proposals for modifying listing rules of New York Stock Exchange (NYSE) and NASDAQ including changes in the way the fund management groups, stock analysts and investment bankers render their responsibilities.

Having said that it appears to be important to recognize that governance reform is a worldwide phenomenon addressing different challenges in different regions. In continental Europe, for example, the critical governance issue is the prevalence of controlling shareholder blocs. The existence of such blocs often creates significant vulnerabilities for investors outside the dominant group, and in these markets protection of minority or 'outsider' shareholder rights remains the central governance challenge. Elsewhere, in many emerging markets, in addition to controlling shareholders, the risk facing investors is not simply inadequate governance at the corporate level, but major uncertainties in terms of country-level governance standards. In these situations, the foundations of good governance from an investor perspective lie in such basic ingredients as secure property rights, an independent judiciary, reliable enforcement procedures and acceptance of the rule of law. Where these are deficient, investment is a speculative, high-risk venture.

McKinsey Surveys

In recent years McKinsey conducted both global and country-level surveys of institutional investor opinion which underscore following three conclusions:

1. Corporate governance does matter, with 70 to 80 per cent of investors saying that they are willing to pay a premium for a well- governed company;
2. Governance is of at least equal importance to reported financial performance for foreign investors in many regions, because of misgivings about the quality of corporate reporting.

3. Several dimensions of governance influence investors' decision making - not only corporate factors, such as shareholder rights and reporting transparency, but also capital market and country-level factors such as accounting standards, property rights and level of corruption. Around 60 per cent of investors say they will avoid certain corporations altogether because of such concerns.

Against this backdrop, it will be in the fitness of things to assume that ‘one size fits all’ approach to corporate governance does not suit to all investors. The risk profiles of different markets being diverge too much, certain common overarching governance themes of importance to investors have been identified. From a global perspective, six themes appear to be important:

- Rapid extension of governance codes worldwide;
- Increased focus on board professionalism;
- Selective redesign of corporate leadership roles;
- Re-assessment of corporate reporting needs;
- More intensive external scrutiny of governance; and
- Increased attention to corporations’ impact on society.

As far as these themes are concerned, there are divergent views. Yet it is clear that institutional investor activism is in its early stages and an established protocol for engagement has not emerged at the global level, although progress has been made in markets like United Kingdom. At the global level, initiatives such as the International Corporate Governance Network's code of practice in relation to investors' governance responsibilities are beginning to change the climate. In particular, the governance debate, which until recently focused entirely on corporations and their boards, is now beginning to focus more intensively on how fund managers themselves discharge their fiduciary responsibilities on behalf of their clients, and on how pension fund trustees hold themselves accountable to their beneficiaries.

CORPORATE GOVERNANCE IN INDIA

Historically, India has had an active equity market**.** There are approximately 10,000 listed companies and over 40 million people invest in shares and mutual funds in the country. Total market capitalization of India's stock markets in 2009 is $966 billion. The Securities and Exchange Board of India (SEBI), the independent capital markets regulator, has made significant efforts to keep up with changing corporate governance practices in leading equity markets.

Corporate governance related listing requirements in India are largely based on recommendations of the Cadbury and Higgs Reports and the Sarbanes-Oxley Act. SEBI has been proactive in keeping India's corporate governance rules and regulations in line with best practices around the world. In 1999, SEBI appointed the Kumaramangalam Birla Committee to recommend improvements to the corporate governance framework. In 2000, SEBI incorporated Clause 49, which has mandatory and non-mandatory corporate governance provisions in the Listing Agreements to be entered by the Companies with the Stock exchagnes. These listing requirements were again revised to incorporate some best practices laid out in the Sarbanes-Oxley Act. All listed companies are required to be in compliance with Clause 49 of Listing Agreement. As regards shareholders' rights, Clause 49, essentially provides for various disclosures with regard to accounting treatment, related party transaction, risk management, remuneration of directors and a management discussion & analysis report which should among other issues report on the risks & concerns, internal control system and their adequacy, discussion on financial performance with respect to operational performance, etc. In addition, Clause 49 mandates the constitution of Shareholders' Grievance Committee under the Chairmanship of a non-executive director to specifically look into the redressal of shareholder & investor complaints.

Shareholder activism in India is practically non-existent. There are several explanations for the lack of shareholder activism in the Indian equity market:

- **Large number of tightly controlled companies**: In India promoters typically retain control of companies by owning a small, yet significant, ownership stake in companies. Shares not owned or controlled by the promoter and his family and friends are widely dispersed, making it difficult for minority shareholders to voice their concerns.

- **Lack of institutional share ownership**: Although FII's increasingly own a large number of shares in Indian companies, in general, no single minority shareholder owns enough shares to significantly influence change. Therefore, even though there are laws that empower shareholders controlling 10 percent of equity, the dispersed nature of ownership of shares makes it difficult for minority shareholders to benefit from the low threshold levels that allow for taking a more active role in the management of the company.

- **Limited investment scope for pension/insurance companies**: Pension and insurance companies in India are owned largely by the government and constitute a large part of the PSU sector. The Indian government has allowed private sector companies to engage in these activities. The government strictly regulates the instruments in which pension funds can invest. Some companies like LIC and UTI have significant stakes in Indian companies but are not activist shareholders. As a result in India there is no large institutional shareholder engaged in shareholder activism through its investment decisions like CalPERS in the United States.

THE UK MODEL OF CORPORATE GOVERNANCE

The current system of corporate governance in the UK has its origins in a series of corporate scandals in the late-1980s and early-1990s, including the collapse of BCCI bank, Polly Peck, and the Robert Maxwell pension fund. The UK business community recognized a clear need to improve the robustness of its governance. This led to the establishment, in 1991, of the Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, which issued a series of recommendations in 1992 popularly known as Cadbury Report.

The Cadbury Report addressed a number of issues of corporate governance. The key policy innovation following this report was to introduce a requirement – within the Listing Rules of the London Stock Exchange - that companies should report whether they had followed Cadbury's recommendations, or explain why they had not done so (the so-called "comply or explain" principle). It was then up to shareholders – not regulators - to determine if this deviation was appropriate, and subsequently engage with company boards.

The recommendations in the Cadbury Report have been reviewed and refined at regular intervals since 1992. In 1995 the Greenbury Report set out recommendations on the remuneration of directors. In 1998 the Cadbury and Greenbury reports were brought together and updated in the form of the Combined Code. In 1999 the Turnbull guidance was issued to provide directors with guidance on how to develop an effective system of internal control.

Following the Enron and WorldCom scandals in the US, the Combined Code was updated (in 2003) to incorporate recommendations from reports on the role of non-executive directors (the Higgs Report) and the role of the audit committee (the Smith Report). In the same year, the UK Government announced that the Financial Reporting Council (FRC) was to assume responsibility for publishing and maintaining the Code. The FRC made further changes to the combined Code in 2006 and 2008. The UK approach to “best practice” in corporate governance therefore, points out that the governance should promote both accountability to shareholders and the board's ability to manage the company effectively.

A key component of UK model of Corporate Governance is a constructive dialogue between companies and shareholders. This is also reflected in the recommendations of the Combined Code which says that “The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place” (Section 1, D.1). The Code also states that “institutional shareholders should enter into a dialogue with companies based on the mutual understanding of objectives” (Section 2, E.1).

The late Jonathan Charkham, a leading authority on corporate governance, once famously described UK institutional investors as “supine”, reflecting their lack of engagement with the companies that they owned. In response to this criticism, institutional investors have made some progress in increasing their active ownership capabilities.

The assessment of another prominent analyst of corporate governance is that “the relationship between shareholders and the board is often neglected and often unsatisfactory”. An obstacle to dialogue between shareholder/board relations is the relatively small ownership stakes taken by institutional investors in individual companies (often less than 3%). Furthermore, non-passive institutional money is typically turned-over on a relatively short-term time horizon (e.g. of 1 year or less). Consequently, the incentive for individual shareholders to engage with company boards – and *vice versa* - is often inadequate. The preferred response of many active investors to disagreements over company strategy is simply to sell the shares, i.e. “exit” rather than “voice”.

One obvious solution to the problem of insufficient dialogue between investors and companies is that institutional investors could nominate their own non-executive board members. However, this option has not been embraced by the investment community, as it reduces their flexibility in buying and selling a company’s shares (and exposes them to insider dealing legislation). There is therefore, arguably a need for a code of responsibilities for institutional investors to match the Combined Code that relates to companies.

In nutshell, a strong dialogue between boards and shareholders is essential for the UK model of corporate governance. The success of the UK model is based on the consent and participation of shareholders. If that is no longer present, it could encourage a shift towards a more legislative approach.

Other Countries

Unscrupulous managers expropriating shareholders by paying themselves fantastic salaries is a universal corporate governance problem. “One reason for inefficient compensation contracts may be that manager-dominated boards decide about key elements of the contract between the principals (shareholders) and the agents (managers). The evidence suggests that – in the face of weak boards – shareholders themselves may decide about proposals on compensation packages in general meetings”. Klaus Gugler [Corporate Governance and Economic performance, 2001, Oxford University Press] prescribes better transparency regarding the level and structure of compensation contracts, especially in **Continental Europe.** Large shareholders can improve the supervision of management and thereby improve the corporate performance. However, large block holders, by virtue of their increased scope of influence over the company may also have detrimental effects. Morck, Shleifer and Visny (1988) define managerial entrenchment as “a manager who controls a substantial fraction of the firm’s equity may have enough voting power or influence more generally to guarantee his employment at an attractive salary. Moreover, expropriation ex post can lead to suboptimal investment ex ante by stakeholders such as minority shareholders and employees.

In the context of **Continental Europe**, the identity of large and controlling equity owners matters. But Gugler agrees that in the absence of adequate studies so far, any such observations are necessarily preliminary. “While the effects of close bank-firm relationships and shareholding of institutional investors on firm profitability are ambiguous, the evidence concerning state ownership is on the negative side. Some studies confirm beneficial effects of bank involvement concerning other dimensions of performance, e.g. financial constraints or distress”. *Cable* (1985) finds for 48 large German firms in 1970 that all three bank variables employed—bank debt, representation on the supervisory board, and the bank voting power—are positively and statistically significantly related to profitability. He concludes that the findings are consistent with an efficiency-improving role of banks in corporate governance. “It is bank control as well as bank lending which raises profitability.’ In a critique of Cable’s (1985) study, *Edwards and Fischer* (1994) identify a possible simultaneity bias: If banks are better able to screen good risks than other lenders, a positive coefficient for bank debt may reflect the greater ability of banks relative to other suppliers of capital to identify firms with greater creditworthiness and a larger volume of profitable investment projects. This reverse causality implies that companies with higher profitability are able to borrow more from banks, not that banks have superior monitoring capabilities. Other studies that find positive effects of bank involvement in corporate governance on profitability include *Gordon and Schmid* (1996) and *Lichtenberg and Pushner* (1992). “Contingent governance' system of **Japan** is an evidence on this point. In Japan banks are particularly dominant. The evidence regarding incentives of institutional investors points out theoretical ambiguities. "In view of the rapidly increasing importance of institutional holdings, the lack of established empirical evidence is particularly worrying".

Institutional investors can provide part of the answer to the policy dilemma Gugler points out. While the key to more efficient corporate governance is to have private savings channeled to stock exchanges yet, at the same time, it is necessary not to lose control and give rise to managerial discretion. However, prudent regulation must provide efficient control and governance in the institutional investors themselves. "As the problem seems to be that institutional investors are not too active but too passive, restrictions of their holdings in individual companies must be questioned". In the UK, the Hampel Committee considered the introduction of compulsory voting for institutional shareholders as is the case in the USA, "Generally, excessively stringent restrictions of holdings in individual firms provide only insufficient incentives to fund managers to participate in active monitoring and to exert the 'Voice' rather than the 'exit' option. Reconsideration of overtly restrictive legislation in this field is warranted. Good corporate governance needs the right incentives, concentrated holdings of residual claims provides them".

The issue of raising the company performance through proper design and structuring the board is also important. There is also the question as to whether board structure has an effect on company performance. The board of directors or the supervisory board plays a potentially very important role. "If the CEO is also the chairman of the supervisory board, no effective monitoring or disciplining is expected. *Franks, Mayor and Renneboog* (1998) find for 250 UK companies for the 1988 to 1993 period that the separation of CEO and chairman leads to greater CEO replacement when performance is poor".

Similarly, since board members are mostly also agents, the right incentives need to be given. In **France**, the CEO/Chairman has to own shares in the company. "In the **Netherlands**, there is evidence that the structured regime, which implies a transfer of control rights from shareholders to board members, has a negative effect on firm performance. Although the economic effects of co-determination are still largely unexplored, workers on the supervisory board may have the incentive to exert a considerable monitoring function as is the case in **Germany and Austria**". Co-determination may also have detrimental effects for efficient governance. *Pistor* (1998) and *Roe* (1998) have published studies on plausible effects of co-determination.

"It is commonly held that supervisory boards are less effective monitors than intended by the law. *Roe* (1998) enumerates as reasons the large size of the supervisory board, infrequent board meetings, sparse information flow to the board, low incentives to actually monitor management, and co-determination, which gives shareholders and management incentives to weaken the board". Roe argues, block-holders would not get a fair price for their stock if a diffusion of ownership left firms either with labour-dominated or weak boards".

The **US and UK** corporate governance debate, Gugler points out, centres around the manager-shareholder conflict. **Continental Europe and Japanese** corporate governance is more concerned with the large shareholder-small shareholder conflict. "The former debate poses questions such as whether the takeover process is a good mechanism to constrain management, or how to efficiently design compensation packages. The latter discussion is more concerned with questions like whether minority shareholders should be better protected against large shareholders and whether the identity of owners matters. Of course all these questions are interrelated contributing to the complexity of the analysis." Gugler, therefore, suggests the following general and abstract policy guides: any corporate governance reform should be gradual, taking into account the endogenous nature of corporate governance and the national specificities of existing corporate governance arrangements.

Continental Europe features tremendous ownership and voting power concentration. Consequently, there is an important conflict of interest between large controlling shareholders and weak minority shareholders. It sometimes becomes necessary to analyse this conflict to understand corporate governance and sometimes its failures in these countries. "However, it is also equally important to recognize the growing importance of the large public corporation in **Europe**. Large scale privatization of former state-owned quasi-monopolies contribute to this development. This privatization process in **Europe (France, Germany, Austria**, not ignoring the **Eastern European countries**) makes the role of the state as entrepreneur less important, however, at the same time poses new challenges as to how to design the relationship between ownership and control. The associated conflict between management and owners will, therefore, grow in importance. Institutional investors like pension or mutual funds will play a key role in channeling private savings to productive investment as is already the case in the USA and UK. Regulation of the institutional investors will be the key to successful reform of the European capital markets".

A step in the right direction would be increased minority shareholder rights and better standards concerning company disclosure requirements. Reform in this area is surely needed. The task of prudential company legislation is to secure the benefits of large shareholders as effective monitors of management and, at the same time, to prevent them from consuming excessive private benefits from control. Stricter protection of minority shareholders is proposed. Only the prospect of a fair return will induce small and minority shareholders to invest in companies' stocks. High disclosure and accounting standards provide the necessary transparency for small shareholders to feel comfortable investing in equity markets. Disclosure requirements for pyramidal groups, the structure of ownership and voting rights, and legal separation devices should be mandatory and enforcement should be strict.

Takeovers are an incomplete mechanism to solve the basic agency problem in the large public corporation. The markets for corporate control are very active in the USA or UK, however, nearly non-existent in *Continental Europe or Japan*.

Due to concentrated ownership of shares and anti-takeover regulations, statutes, and sentiments in many countries, hostile takeovers are not possible without support by incumbent block-holders. Large shareholders and/or banks must generally be courted to support the bid for it to succeed. Large block trades and subsequent control transfers only partially substitute for an active market for corporate control. Other control devices such as direct shareholder monitoring, the dual board structure, creditor monitoring, and/or the main bank system substitute for hostile takeovers.

The question remains whether state legislation should step in to reduce the probability of (hostile) takeovers occurring. Policy recommendations should be linked to the objectives of bidder firms. Whether principals (shareholders) can cope with their agents (managers) concerning acquisition activity certainly is a function of the ownership and control structure the bidding and target firm. Certain restrictions on bidding firm managers would improve the role of the takeover process in corporate governance. Anti-takeover amendments of potential targets, however, reduce shareholder wealth. In any case, one could strengthen alternative mechanisms of control while not constraining hostile takeovers by regulation. Extreme views of either prohibiting hostile takeovers, or viewing hostile takeovers as the main control device, are too simplistic.

Particularly from a Continental European standpoint, where investor protection is lagging, takeover legislation must also be concerned with the interests of small shareholders. In Italy, Belgium, Denmark and France laws were passed that every acquisition of more than 30 per cent of the stock of one company be followed by a tender offer to all voting shares at the same price.

“Corporate Governance and Economic Performance” edited by Gugler gives the following messages including policy implications and recommendations:

Relying on one or a few tools to solve agency conflicts is not optional. Economic theory postulates that the various mechanism for solving agency problems should be employed upto the zero marginal profit condition. A central message of the book is that all constellations of ownership and control structure involve costs and benefits. Relying solely on the takeover mechanism is, for instance, not optimal. Excessive ownership concentration implies illiquid securities markets, low diversification opportunities, suboptimally risky investment projects, and possibly conflicts of interest between large and small shareholders. The right mix of direct monitoring by shareholders and board of directors, efficiently designed managerial compensation packages and competition in the managerial and product markets yield a better solution than relying excessively on one device.

The costs and benefits of the various control devices depend on the kind of economic activity i.e. the industry. The question is, which assets would be better employed in an organization characterized by separation of ownership and control, and which assets are better controlled by direct large shareholder monitoring. If, for example, investment in research and development is a 'complex' and very risky undertaking, the benefits of separating the decision and control functions may overweigh the associated agency costs. Well-functioning capital and equity markets should put up the needed funds to guarantee and optimal level of investment in these activities. Investors should have opportunities to diversify their risks across a large number of stock corporations implying a rather small stake in each one. Since monitoring is a public good and dispersed shareholders have little incentive and ability to monitor management, (takeover) markets, boards, and efficient contracts should provide this service, particularly in industries characterized by complexity, uncertainty and high costs.

Corporate governance regulation and other legislation are intimately linked to each other. Anti-trust policy, competition policy, and regulations about corporate governance influence each other and must be viewed in conjunction. If competition in product markets is weak, managerial discretion over free cash flows is more likely. Accordingly, corporate governance becomes more important in monopolistic or oligopolistic environments.
The basic trade-offs encountered in corporate are similar in type across countries, although they vary in intensity.

Singapore:
Lou Lei and Mark Yuen Teen from Singapore have worked on the determinants of Corporate Governance and the link between corporate governance and performance.

Their study includes a more complete set of governance mechanisms like composite governance index as well as ownership and firm leverage. They investigate the interdependence of various governance practices, the change of governance structure and the impact on the firm value.

Their findings revealed an interesting relationship between governance and performance.. It is not the level of governance. They found that an investment strategy that buys firms with greatest improvement in governance and sells firms with largest deterioration in governance yielded 36.7 percent excess returns over the sample period (1999 to 2003), they find that investors will lose money if they buy firms ranking highest and sell firms ranking lowest.

They have used the scorecard developed by Standard and Poor's to assess the corporate governance of UK listed companies. This is used as a comprehensive measure of the extent to which a company has accepted international best practices in corporate governance, as disclosed in their corporate governance disclosure.

Studies like *Gompers et al* (2003) for the U S, *Klapper and Love* (2004) for fourteen emerging markets, *Durnev and Kim* (2002) for twenty seven countries, *Bauer et al* (2003) for the EMU and the U.K, use a broader measure of corporate governance through a composite corporate governance rating. *Lei and Teen* submit that without time series data, researchers cannot study how firms adjust their governance structure over time.

They can not analyze the causality between governance and firm performance without time series data. Lei and Teen study analyzes a number of time-varying firm-specific data. They examine the four mechanisms used in controlling agency problems – insider shareholding, block holdings, institutional shareholdings and leverage status of the firm. Their study uses a comprehensive measure of governance including a corporate governance scorecard and measures governance over a longer time period.

They find that it is the change of governance that determines performance, rather than the level of governance.

Theirs is an empirical study on whether better corporate governance leads to higher valuation through lower expected rate of return.

Some of the earlier studies on corporate governance-performance relationship were as follows:

Board Composition

That higher proportion of non-executive directors in the board helps to reduce agency cost. *Kee et al* (2003) and *Hutchison and Gul* (2003) show that higher number of non-executive directors on board weakens the negative relationship between the firm's investment opportunities and firm's performance. Some other studies like de *Jong et al* (2002) state that there is no significant relationship between non-executive directors' representation and performance. *Weir and Laing* (2000) (UK) find a negative relationship between non-executive directors' representation and performance.

Leadership Structure

The UK Combined Code regards separation of the role of CEO and Chairperson as a sign of good governance although previous empirical analyses do not support this. *Coles et al* (2001), *Weir et al* (2002), etc do not find any significant relationship between CEO duality and performance. *Brickley et al* (1997) observed that costs of separation are larger than benefits of most large US firms.

Board Ownership

US based research suggests that management is aligned at low or possibly at high levels of ownership but is entrenched at intermediate ownership levels- *Morck et al* (1988). But UK research works, *Faccio et al* (1999) and *Short and Keasey* (1999), find that management becomes entrenched at higher levels of ownership as compared to their US counterparts. *Coles et al* (2001) do not find any contribution to performance by managerial ownership.

Institutional Holdings

The UK Combined Code encourages institutions to take an active role in governance expecting a positive relationship between institutional holdings and firm performance. But empirical evidence is not supportive of this recommendation. Both *Faccio* and *Lasfer* (1999, 2000) do not find such a significant relationship for UK firms , while *de Jong et al* (2002) find that major outside and industrial shareholders negatively influence the firm value.

Composition of Committee

Canyon (1997) takes a review of the workings of remuneration committees in the UK. He finds that firms with remuneration committees pay directors less remuneration, while *Canyon* and *Mallin* (1997) observed that UK firms have been slow in adopting nomination committees, which is regarded as a symptom of failure of the corporate governance system. While the use of audit committees has been fairly widespread in the UK, *Foker* (1992) showed that the quality of disclosure is only weakly related with audit committees and non-executive directors.

Bhagat and Black (2002) find that firms suffering from slow profitability respond by increasing the independence of their board of directors. But there is no evidence that firms with more independent boards achieve improved profitability. *Vafeas* (1999) finds that the number of board meetings held in a year increases following share price declines and that operating performance improves following years of abnormal board activity.

Lei and Teen in their research work use the comprehensive measure of corporate governance scorecard to examine the agency problem. The scorecard has the advantage to implicitly incorporate the effect of a variety of governance practices into one study. Past research through this method analyzes either inter-country differences or inter-firm valuations within a country. *La Porta et al* (2002) investigate inter-country differences in governance standards among twenty-seven countries. They find that firms incorporated in countries with better governance standards tend to have higher valuations. Studies on inter-firm comparisons within one country appear to confirm a positive relationship between governance standards and firm value. The relationship appears to be stronger in countries with less developed standards. Examples are *Drobetz et al* (2003) for Germany; *Gompers et al* (2003) and *Marry* and *Strangeland* (2003) for the US.

Drobetz et al (2003) and *Chen et al* (2003) investigate the influence of governance scorecard on cost of equity capital for Germany and nine Asia markets respectively. Their findings show that good corporate governance practices help to reduce such costs.

Lei and Teen start their sample study from set of firms listed in Index Constituent Rankings FTSE 100 and ICR FTSE 250 from FTSE European Monthly Review, January 2001 issue.

The S&P’s corporate governance scorecard used by them is a methodology based on a synthesis of governance codes and guidelines of global best practices, as well as S & P’s own experience in reviewing individual companies.

Lei and Teen compute the corporate governance scorecard by summing up the scores under five categories of corporate governance. They are Board Matters, Nomination Matters, Remuneration Matters, Audit Matter and Communication.

The financial data employed by *Lei and Teen* are obtained from Compustat Global Industrial/ Commercial File from 1999 to 2003. Their final sample includes 206 firms with 3 to 5 years data.

They find a positive relationship between institutional shareholdings and SCORE. Institutions require firms to disclose more or they simply follow firms with a transparent disclosure history.

They also find that firms improving their corporate governance over time perform better, changes in governance are of more importance than level of governance in determining market valuation.

Conclusion

Ira M. Millstein wrote in New York Times, in 1997 that **"**Darwin learned that in a competitive environment an organism's chance of survival and reproduction is not simply a matter of chance. If one organism has even a tiny edge over the others, the advantage becomes amplified over time. In 'The Origin of the Species, 'Darwin noted, 'A grain in the balance will determine which individual shall live and which shall die.' This Paper is of the view that an independent, attentive board is the grain in the balance that leads to a corporate advantage. A performing board is most likely to respond effectively to a world where the pace of change is accelerating. An inert board is more likely to produce leadership that circles the wagons.

This Paper has already expressed the view that corporate governance is the prime responsibility of the board. It has also been observed that the role, the function and the concept of governance have been perennially misconstrued, misunderstood and widely misapplied. Corporate governance has also remained an intrinsically under-researched subject. As John Carver has noted in his work *On Board Leadership* [Introduction p xxxii] how and how far this has happened. "Typically, all workers in an organization are clearer about their jobs than is the board that governs their work. The accountant, the nurse, the janitor, the airline pilot—they know the objectives, the appropriate conduct, the reporting relationships, the required skills, and the discipline attendant to their jobs. Boards are typically confused and deficient in all these areas. It is not that board members are less intelligent or less dedicated. In fact sometimes boards are composed of just the kind of skilled, committed, experienced persons…..The problem is that the governing role is 'one of the least studied in the entire spectrum of industrial activities' [Juran and Louden, 1966, p. 7] and that boards are 'often little more than high-powered, well-intentioned people engaged in low-level activities' [Chait, Holland, and Taylor, 1996, p.1]". If research on most intricate cardiovascular problems has given exact solutions to save human life, why shouldn't there be enough research to resolve economically most vexed governance problems!

Governance job needs to be very clearly articulated, clear and serious that does not confuse itself with short or medium term performance of the corporate. That should be the responsibility of the executive and the management that will function within the contours of policy and guidance of the board and under governance leadership of the board. Governance may not be construed as a job that peeps over the shoulders of the CEO into corporate management, formal reporting relationships, and people training. Governance is a function much up and above; it should be oriented towards shareholders, investors and a host of varied stakeholders, regulators national and other sovereign governments. Mere financial bottom line may not be the call of the governance function; people, and planet bottom lines, ethical and moral toplines will also be the major responsibilities of the governance function. Above all, the governance function in its appropriate perspective needs to be taken seriously by all the *Dramatis Personae* involved in and around the corporate. Otherwise losses and accompanying travails of investors in entities like Enron, WorldCom, etc and of the order of around US dollars 550 trillion as estimated by the Bank for International Settlements in the global financial system [one trillion is equal to one followed by a dozen zeroes!] would continue to recur. Faith will tumble time and again. It is said that the Lord lives in faith; if governance is not looked upon as that high a function in the corporate sector, and this Paper suggests, it is the responsibility of all including us to do so, investors will always be left in the dark. It is our job to lead them to light and the corporate sector to consistent prosperity.

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