

research newsletter

Effective Boards

Introduction

This, the third edition of the ECGI Research Newsletter, focuses on the important topic of boards. Sitting at the centre of everything a company does, the board is also central to corporate governance. By their nature, however, boards are diverse in structure and conduct.

Research on this broad topic is important but difficult mainly because empirically, it is not easy to look inside the boardroom. What research can do is observe the differences in board structure and behaviour. Theorising and drawing inferences from observable differences had led to considerable debate.

Some of the themes of the research covered in this newsletter are board structure and the differences between the unitary and two tier models, the dual role of boards as advisors and monitors, and company and board performance in relation to board compensation, gender diversity and the time commitment of independent directors.

The research is given context by the views of a leading academic, a partner in a leading executive search firm and a director with both full-time and independent board experience. The featured book on corporate governance and chairmanship is by one of the founding fathers of corporate governance, Sir Adrian Cadbury.



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In this edition

• Introduction	page 1
• Research digest	pages 1-5
• An academic viewpoint	page 5
• A practitioner viewpoint	page 6
• A director's viewpoint	page 7
• Book review	page 8

Research digest

Six working papers on this topic have been published by the ECGI. The papers set out the authors' propositions in detail and supply the accompanying evidence. This Digest pulls out some of the key strands from the papers which can be downloaded from the SSRN website via the ECGI website www.ecgi.org.

Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy

Klaus Hopt, Max Planck Institute for Foreign Private and Private International Law, Hamburg & ECGI and Patrick C. Leyens, Max Planck Institute for Foreign Private and Private International Law, Hamburg (Law # 018/2005)

The core problem of corporate governance is the separation of ownership and control. In this paper the authors start by setting the scene with an historical model, the Verenigde Oostindische Compagnie (VOC) which helps to explain the later concentration of both management and control in the hands of a single board, as has been predominant in Europe since the nineteenth century.

They then move on to look at the typical two tier board which exists in Germany and then the unitary board model of the United Kingdom, comparing the two separate models and highlighting the German concept of co-determination. Companies with 2,000 workers or more must have half their supervisory board composed of labour representatives. The casting vote of the chairman gives slightly more power to shareholders but there is no doubt that this heavy level of worker participation has caused problems, not least the problem of raising finance on the

international capital markets. The effect of co-determination can be to put the company into a strait-jacket, the employee representatives are very unlikely to agree to any suggested strategy which is likely to result in job losses, therefore foreign investors are understandably reluctant to invest in a German co-determined company if global markets offer alternative investments which are not subject to co-determination.

The third part of the report sets out some reforms in France and Italy which indicate a strong movement towards organisational flexibility at board level and a clearer distinction between management and control. In France, it is already possible to have either a unitary or a two tier board structure. The majority of French companies have opted for the unitary structure but there is now a third model, introduced in 2001 in the Loi Nouvelle Régulations Economique (NRE), which still relies on the unitary structure but separates out the role of Chair and CEO, previously held by the Président Directeur Général.

In Italy, the Testo Unico of 1998 introduced specific rules for listed companies. Following the traditional structure, the company will be run by the consiglio di amministrazione. A mandatory second board, the collegio sindacale, will serve as an internal auditing device. The tasks of the collegio sindacale have been extended to include the supervision of compliance, of the organisational structure, and the accounting system. Further, the Testo Unico led to a clear distinction between internal and external auditing in that the direct auditing mandate is shifted to the external auditors.

The Report notes a striking convergence in the awareness of the distinction between management and control, a number of parallel efforts on improving internal control and a growing tendency across Europe towards the use of the audit committee regardless of the board structure typical within the individual countries.

On-Going Board Reforms: One-Size-Fits-All and Regulatory Capture

Gérard Hertig, Swiss Federal Institute of Technology (ETH Zurich) and ECGI (Law # 025/2006)

The paper is set in the context of the increase in takeover activity during the 1980s, the exponential growth in management compensation throughout the 1990s and the economic downturn and corporate scandals experienced at the turn of the century. These factors brought directors and boards under closer scrutiny than ever before, leading to a proliferation of proposals for board reforms from a variety of sources, proposals which were both legislative and self-regulatory.

The author's argument is that these reforms are often inefficient. They reflect the particular interests of the groups proposing them and they do not adequately take into account the multiple functions of the board, from

strategy setting to crisis management to monitoring. "Indeed, reformers generally battle past scandals rather than future market failures, their main purpose being the short term rebuilding of investor confidence or the soothing of voter anger prior to the next election," he says.

He presents an overview of on-going board reforms, separating them out into three broad categories. The first comprises proposals aiming at reducing board discretion by reinforcing the powers of shareholders and auditors. A second category of reforms aims at improving board independence by dealing with board structure, composition and procedure. Finally, director incentives are targeted through director compensation and liability provisions.

The author then looks at the scope of these reforms. Generally reforms are targeted at listed companies and concentrate on the Anglo Saxon model, but they are having, or can be expected to have, an impact on companies around the world regardless of their size and ownership structure. The resulting one size fits all effect is inefficient. Even with the growing trend towards globalisation, there are still significant differences in financial systems, ownership structures, legal systems and culture across jurisdictions.

He also considers that the 'best practice' promoted in many of the reforms in effect translates into 'minimum standards' and posits three possible explanations for this. "One is that board reformers are aware of the described 'one-size fits all' issues and prefer to be considered somewhat ineffective than embark into inefficient innovation. Another is that minimum standards are not as 'minimum' as they appear. Still another explanation is that the reform process has been plagued by regulatory capture. ... there is truth in all of the above and the combination results in board reforms being both inefficient and insufficient."

He concludes that board reforms have been drafted in an excessively detailed way, and that board reformers need to take a hard look at the 'minimum standards' they have enacted or are currently considering with the objective of further simplifying them. General principles should be the norm, supported by market orientated implementation mechanisms.

A Theory of Friendly Boards

by Renee Adams, Professor of Finance, UQ Business School, The University of Queensland and ECGI, and Daniel Ferreira, Lecturer in Management, London School of Economics and Political Science (LSE) and ECGI (Finance # 100/2005)

In this paper, the authors look at a fundamental dichotomy of the board which exists in its dual role as a monitor of executive performance whilst at the same time advising on strategic direction. As a result of this dual role, the CEO is faced with a dilemma with regards to the

