CORPORATE GOVERNANCE: NEW CHALLENGES AND OPPORTUNITIES

Alexander N. Kostyuk
Udo Braendle
Vincenzo Capizzi

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Anna Tilba

1.1.1. Overview of the UK Ownership and Control Patterns

The debates about corporate governance have a longstanding history, with the first mentioning of the phrase 'corporate governance' appearing in use in the 1980s, which was quickly adopted worldwide (Tricker, 2015). The wider debate on corporate governance and the observation that the modern corporation is characterized by a separation of ownership from control (Berle and Means, 1932), which presumes that the functions of management and ownership are typically held by separate constituents: ownership in the form of equity being dispersed among a large number of shareowners, whilst day-to-day control of the corporation is delegated to professional managers acting as executives for the corporation. Associated with this separation is a corporate governance problem, whereby managers do not share shareholders' interests. Jensen and Meckling (1976) and Fama and Jensen (1983) define this as an agency problem. Jensen and Meckling (1976) define an agency relationship as:

> *'…a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal' (p. 308).*

Within corporate governance, the agency problem arises when the same agents manage and control important decisions within a firm (Fama and Jensen, 1983). Information asymmetry, in this case, means that incumbent managers are in a position to pursue their own objectives, such as increasing corporate size, at the expense of the shareholder interests, for example, the value of the company. Agency costs are therefore incurred as a result of a need to monitor and control agents who otherwise might act in their own interests, rather than those of principals (Fama and Jensen, 1983).

Following the agency perspective, a principal concern of corporate governance is to employ governance mechanisms that resolve or minimize a conflict of interests between managers and shareholders. A significant body of theoretical and empirical literature about corporate governance exists on the principal-agent relationships, proposing several hypotheses about various governance mechanisms to minimize agency costs. One way of differentiating between governance mechanisms is to refer to them as internal (incentives and monitoring) governance mechanisms and external (monitoring and disciplinary) mechanisms. Internal mechanisms include managerial share ownership (Jensen and Meckling, 1976) and oversight by a board of directors (Fama, 1980; Fama and Jensen, 1983; Baysinger and Butler, 1985). The external mechanisms include managerial labour markets (Fama, 1980), the existence of large external shareholders (Shleifer and Vishny, 1986), mergers, buyouts and takeovers (Hirschey, 1986), as well as the market for corporate control, which acts as a mechanism of last resort (Jensen, 1986; Grossman and Hart, 1987).

The literature on the evolution of corporate ownership is voluminous[1], but one of the well-established facts about corporate ownership is that ownership of large listed companies is dispersed in the UK and US and concentrated in most other countries (Franks, Mayer and Rossi, 2005). In the UK, even in the absence of strong investor protection rights dispersed ownership has emerged rapidly in the first half of the 20th century. The separation of ownership from control and the shift to 'managerial capitalism' (Aguilera et al., 2006) encouraged ownership diversification to the point where most shareholders only held small stakes within companies. This created a more dispersed share ownership within the Anglo-Saxon system of corporate governance (Mayer, 2000). The changed pattern of share ownership in the UK and US has over the past 30 years led to a greater concentration of ownership in the hands of institutional investors such as insurance companies and pension funds (Mallin et al., 2005). According to Mallin (2008), institutional investors such as insurance companies, pension funds, banks, unit and investment trusts and other financial institutions own approximately 45% of UK equities, with overseas institutional investors owning 40% and individuals owning only 13% of UK equity. Pension funds held nearly 13% of total UK equity in 2006, exceeded only by insurance companies, which owned nearly 15% (Mallin, 2008).

By 2015, out of £6.6 trillion of assets under management in the UK, approximately £2.1 trillion were invested through pension funds, £1.2 trillion were in retail investment products and £0.4 trillion in public sector and charity investments. There is a further £1 trillion investment in insurance products and £1 trillion invested in non-mainstream asset management products, which include pension fund investments (FCA, 2016). In 2010, UK pension funds invested around 43% of their assets in UK equities, a figure that amounted to nearly £400 billion (The Purple Book, 2010).

1.1.2. Legislation, Regulation and Corporate Governance Codes

The traditional form of the limited liability company has been created in law and therefore limited liability companies depend on company law for their existence, continuity and winding up (Tricker, 2015). UK company law and particularly the

[1] For an overview see Wilson, J. F. (1995). *British Business History, 1720-1994.* Manchester University Press. For thorough surveys of historical trends influencing the development of Britain's current system of corporate governance see Cheffins, B. (2001). Law, economics and the UK's system of corporate governance: Lessons from history. *Journal of Corporate Law Studies, 71* and Cheffins, B. (2004). Mergers and the evolution of patterns of corporate ownership and control: The British experience. *Business History, 46(2),* 256-284. For a political and historical account of corporate governance see Mar Roe (2004). Institutions of corporate governance in Menard, C., & Shirley, M. eds., *Handbook for New Institutional Economics*' .Norwell MA: Kluwer Academic Publishers.

Companies Act 2006 defines the way in which the companies are incorporated, how their directors are appointed, how the company information is being disclosed and reported and how shareholder relations are being handled (Tricker, 2015). In the United Kingdom and in Commonwealth countries the corporate governance model is 'principles based', which means that the codes of good governance practice determine board responsibilities, not the rule of law. In this model, UK companies are required to report on how they have followed the best practice codes and explain why they have not – a so-called 'comply or explain' model.

Following corporate scandals such as Mirror Group/Maxwell, Polly Peck, Queen's Moat House Hotels and Ferranti, the UK produced the world's first corporate governance report in 1992, which contained a formal corporate governance code. The Committee on Financial Aspects of Corporate Governance, also known as the Cadbury Committee, was set up in May 1991 to address the increasingly voiced concerns about the conduct of UK companies and how they dealt with financial reporting, accountability and the wider implications of these issues. The Committee was sponsored by the London Stock Exchange (LSE), the Financial Reporting Council (FRC) and the accountancy profession. It produced a draft Report in May 1992 and, after further consultation, published its final Report and recommendations in December 1992. The Cadbury Report played a crucial role in influencing thinking about corporate governance around the world. The Report had identified 'corporate governance' as 'the system by which the companies are directed and controlled. Boards of directors are responsible for the governance of their companies'. Subsequently, the UK has published more corporate governance reports than any other country.

The governance reports that followed[2] focused on preventing the potential abuse of corporate power and called for greater accountability, compliance, and independence at board level, the separation of the role of chairman of the board from that of chief executive, as well as more effective participation by non-executive directors on boards. Table 1.1.1 gives a chronological summary of the key UK governance reports.

Notwithstanding the significance of the Cadbury Report, as well as the reports that followed, many critics have argued that all these reports did not go far enough to improve corporate governance practices by simply introducing a 'comply or explain' culture. For example, Tilba (2015) suggests that the narrative around Cadbury was framed mostly in terms of resolving the issues arising between shareholders and boards, excluding, for example, employees. Nordberg and McNulty (2013) and Stewart and McNulty (2015) also observe a shifting discourse in the codification within UK corporate governance away from board structures, composition and procedures in Cadbury towards 'behaviour', as the codes seek to improve board effectiveness as a mechanism of governance. The revised version of the Code now explicates that compliance is not enough; what is also important is the substance of compliance, which is context-specific and involves the behaviour of actors both in and around boards.

[2] For an overview of the development of UK corporate governance codes see Nordberg, D, & McNulty, T. (2013). Creating better boards through codification: Possibilities and limitations in UK corporate governance, 1992-2010. *Business History, 55(3),* 348-374.

Table 1.1.1. UK corporate governance reports (Part 1)

Report	***Description***
The Cadbury Report 1992	A discretionary 'comply or explain' code which called for: - the wider use of independent non-executive directors (NED) - the introduction of an audit committee of the board with a minimum of three independent NEDs - the division of responsibilities between the Board Chairman and the Chief Executive - the use of the remuneration committee within the board to oversee executive rewards - the introduction of the nomination committee with independent director to oversee the appointment of the new board members - adherence to a detailed code of best practice
The Greenbury Report 1995	Focused on the issues of director's remuneration recommending that: - the remuneration committees consisted solely of independent non-executive directors - the chairman of the remuneration committee should respond to shareholder's questions at the AGM - annual reports should include details of all director rewards – naming each director - director's contracts should run no more than 1 year to avoid excessive golden handshakes - share options schemes for directors should be linked to long-term corporate performance
The Hampel Report 1998	A review of the progress made after the first two reports. The report argued that: - good governance needs broad principles, not prescriptive rules - compliance with sound governance practices should be flexible and relevant to each company's individual circumstances - governance should not be reduced to a 'box-ticking' exercise - the unitary board structure is totally accepted and there is no interest in the alternative governance structures (e.g two tier structures) - the board is accountable to the company's shareholders (no case to include other stakeholder groups) - self-regulation is the preferred approach to corporate governance with no need for more company legislation
The UK Combined Code 1998	Consolidated previous codes and was incorporated into the London Stock Exchange's listing rules. The code set out standards of best practice on board composition, director remuneration, accountability and audit in relation to shareholders. The code was accepted on the 'comply or explain' basis for all the companies that were incorporated in the UK.
The Turnbull Report 1999/2005	Elaborated on the internal controls of the companies, including financial, operational, compliance and risk management. The report recognized that risk assessment was vital, recommending that internal controls analysis was a vital part of corporate governance process.
The Myners Report 2001	Focused on addressing the responsibilities of institutional investors. The report suggested that: 'Good governance is essential to all forms of business. It provides checks and balances that ensures that firms are run efficiently and meet the objectives of their owners, whether shareholders or the members of a life mutual. It also has limitations…risk is inherent in the conduct of business…The recommendations aim to achieve greater accountability by life mutuals to their members…This includes measures …promoting better internal scrutiny of management by firm's boards as well as the role of the Financial Services Authority (FSA), the UK's financial regulatory body.

Table 1.1.1. UK corporate governance reports (Part 2)

Report	*Description*
The Higgs Report 2003	Focused on the effectiveness of the Non-Executive Directors and sharpened the requirements in the previous codes, recommending that: - at least half of the board should comprise of independent NEDs - all members of the audit and remuneration committees and a majority of the members of the nomination committees should be independent NEDs - the role of Chairman should always be separate from the Chief Executive - director recruitment should be rigorous, formal and transparent - executive directors should not hold more than one NED role of a FTSE100 company - boards should evaluate director performance and board committees annually and have a comprehensive induction programme - boards should have a senior NED to liaise with shareholders
The Smith Report 2003	Focused on the work of the audit committees and called for: - a strengthening for the role of the audit committee - all members of the audit committee to be independent - at least one member of the committee to have significant, recent and relevant financial experience - the audit committee should recommend the selection of the external auditor - the audit committee report should be included in the annual report to shareholders - the chairman of the audit committee should attend the AGM to answer shareholder's questions
The Tyson Report 2003	Focused on recruitment and development of NEDs, calling for: - more professionalism and transparency in the recruitment of directors - the introduction of director induction and training - the use of wider catchment area for outside directors
The (revised) UK Combined Code 2003/2006	Produces a more detailed list of broad corporate governance requirements grouped under four headings: - independence - diligence - professional development - board performance evaluation
Turner Review 2009	Focused on banking sector remuneration and compensation incentives
UK Corporate Governance Code 2010/2012	Following the Financial Crisis the Financial Reporting Council (FRC) has reviewed the UK Combined Code and updated the Code to contain broad principles around: - Leadership - Effectiveness - Accountability - Remuneration - Relations with Shareholders

Note: Adapted from Tricker (2015)

The emergence of institutional investors, such as insurance companies and pension funds, as well as the arrival of non-traditional investors, such as hedge funds and investors outside the UK, have also altered the character of the codes. Greater attention is now being given to the role that institutional investors *ought* to perform in corporate governance (Mallin, 2008), highlighting the degree of disengagement currently pursued by these bodies. Following governance scandals relating to Enron in 2001 and leading up to the collapse of Lehman Brothers in 2008, a number of 'voluntary' codes have prescribed greater investor monitoring and engagement vis-à-vis investee companies. By 2006, the Combined Code on Corporate Governance was requiring institutional investors to make considered use of their votes; enter into a dialogue with investee companies based on the mutual understanding of objectives; and give due consideration to all relevant factors drawn to their attention when evaluating corporate governance arrangements of their investee companies. Similar requirements have been published by the ISC's Responsibilities of Institutional Shareholders and Agents: Statements of Principles (Institutional Shareholders' Committee, 2007). In the UK the financial crisis has served to heighten the expectations of policy-makers that institutional investors should act as stewards and engaged owners of shares (Ownership Commission, 2012; The Stewardship Code, 2010).

A year-long review by John Kay of UK equity markets (2012) was especially critical of investment short-termism and a lack of investor ownership behaviour. The Kay Review emphasized the need for a shift towards long-term and fiduciary standards, necessitating loyalty and prudence within the investment world. This also prompted the UK Law Commissions' inquiry into fiduciary duties of investment intermediaries, resulting in a report (2014) that defines stewardship activities as including the monitoring of and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration. In November 2015, the Financial Conduct Authority launched an Asset Management Market Study in order to understand whether competition within the capital market is working effectively to enable both institutional and retail investors to generate value for money when purchasing asset management services.

1.1.3. Board of Directors' Practices

Fama and Jensen (1983) consider the board of directors to be the most central governance mechanism. They argue that managerial opportunism can be countered by a board of directors exercising decision control and subsequent oversight of management. The importance and prominence afforded to boards are also visible in the development of the corporate governance reforms, starting with the Cadbury Committee (1992), continuing with the Higgs Review (2003) and most recently culminating in the revised UK Code of Corporate Governance (2012).

Within UK unitary board structure corporate directors have two fundamental duties: a duty of trust and a duty of care. A duty of trust assumes the exercise of fiduciary responsibility to the shareholders. This includes acting in good faith in the interests of the company as a whole; not acting for an improper purpose; avoiding conflicts of interest; not making an improper use of position and information; not trading wile insolvent. A duty of care assumes making decisions with reasonable care and due diligence (Tricker, 2015). Boards of Directors are thus entrusted to exercise critical evaluative judgement at the top of the corporate hierarchy. The board is usually tasked with: determining the company aims, strategic direction; establishing policies to achieve those aims; and monitoring progress in the achievement of those aims (Mallin, 2016). Table 1.1.2 summarises key roles within the UK unitary board.

Table 1.1.2. Board roles, responsibilities and subcommittees

Role	***Responsibility***
Chief Executive Officer (CEO)	Responsible for the running of the company's' business should be separate from Board Chairman to avoid power concentration in one individual
Charmin	Responsible for running the board; making sure that the board meets frequently; that all directors have access to the information they need to make an informed contribution at board meetings; and that all directors have an opportunity to speak at board meetings.
Senior Independent Director (SID)	Typically selected from the independent non-executive directors on the board. Company shareholders have the right to contact a SID if their concerns cannot be addressed by other senior members of the board.
Non-Executive Director (NED)	The counterweight to executive directors in order to ensure that the individuals or a group of individuals cannot unduly influence board decisions. Independence is also a key characteristic within this role.
Company Secretary	Responsible for facilitating board activities, for example, by providing adequate and timely information ahead of board meetings. Also, provides advice on all governance matters. Must act in good faith and avid conflicts of interest.
Audit Committee	The most important committee, which is independent of the executive and whose remit is to protect the interests of shareholders in relation to financial reporting and internal controls. Should comprise of independent non – executive directors who are in a position to ask appropriate questions and challenge where necessary.
Remuneration Committee	Responsible for making recommendations to the board on the company's framework of executive remuneration and its cost. Could determine specific remuneration packages for each of the executive directors including pensions arrangements and any compensation.
Nomination Committee	Leading a rigorous process of board appointments comprised of independent non-executive directors. Responsible for evaluating the existing balance of skills, knowledge and experience on the board, utilizing this profile when preparing a candidate profile for a new appointment. Should also be involved in succession planning.
Risk Committee	Ensuring that internal mechanisms of control and risk management systems are working effectively and efficiently.
Ethics Committee	Following collapse of Enron more companies have introduced ethics sub-committees to ensure that there is a strong organizational ethic by cascading an ethics code through the company.

Note: Adapted from Mallin (2016)

Ultimately, the board has three key functions: management, oversight, and service. The lines between these functions are fuzzy at best and overtime there has been a shift from boards having an advisory role in the 1970s to a more managerial role in the 1990s, with an increasing emphasis on the monitoring role and director independence in the context of persisting corporate scandals and failures in the 2000s (Bainbridge, 2012). In short, the focus on director independence has resulted in a culture of avoiding conflicts of interest at the expense of competence.

1.1.4. Director Remuneration and Corporate Performance

Directors' remuneration practices have always been a focus of attention for policy makers, media and academics alike. Excessive bonus packages, share options and other financial perks, which in many cases have a very weak or no link to corporate performance, as well as persisting and spectacular corporate collapses, have created conditions of mistrust, particularly within the UK's financial sector. Mallin (2016) characterizes the debate around director remuneration as long-standing and tending to focus on four key areas: the overall level of director's remuneration and the role of share-option; the suitability of performance measures linking director's remuneration with performance; the role played by the remuneration committee in the setting of director's remuneration; and the influence that shareholders can exercise on directors' pay.

Within the UK, the use of corporate share options as long-term contracts has been a common incentive device for senior executives. Other elements of directors' remuneration include base salary, bonuses, restricted share plans, pension and other benefits like cars and healthcare (Mallin, 2016). The accompanying public perception of directors' remuneration and other incentive packages being too generous and at the expense of rewarding shareholders has been ever present in those debates. It is also worth noting, however, that remuneration packages in the States have been much higher than in the UK (Mallin, 2016). Bebchuk and Fried (2004) identify serious flaws in remuneration arrangements which 'have hurt shareholders both by increasing pay levels and, even more important, by leading to practices that dilute and distort manager's incentives'. The recent financial crisis and corporate failures serve only to emphasize the inadequacy of the current reward and incentive systems in the UK which are not supported by strong corporate performance.

In the context of the UK banking crisis, the Turner Review (2009) reported that executive compensation incentives encouraged executives and traders to take on excessive investment risks. The report also highlighted the short-term nature of executive remuneration incentives which come at the expense of long-term sustainability and value for shareholders. A key recommendation that the Report made was to incorporate risk-taking within the executive and senior management remuneration packages. Mallin (2016) cites the response of the House of Commons Treasury Committee on the banking crisis, governance and pay structures in the City by stating that:

> *'Whilst the causes of the present financial crisis are numerous and diverse, it is clear that bonus-driven remuneration structures prevalent in the City of London as well as in other financial centres, especially in investment banking, led to reckless and excessive risk-taking in too many cases the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-term sustainability of banks.'*

The UK government committee was also very critical of the Financial Services Authority (presently Financial Conduct Authority) arguing that the Turner Review has downplayed the role that directors' incentives played in the banking crisis, placing more emphasis on reforming remuneration structures and the unhealthy bonus culture. The government response to the Report also suggested strengthening the links between risk, remuneration and audit committees. Within the subsequent review of the efficiency of UK equity markets, Sir David Walker (2009) also looked very closely at remuneration, recommending more disclosure, creating a code of conduct for remuneration consultants, and recommending that executive pay should be more closely aligned to corporate performance. The revised UK Corporate Governance Code 2010 did include a number of Walker's recommendations and importantly a recommendation about performance-related pay being more aligned to the long-term interests of the company and into its internal risk mechanisms. Notwithstanding progress made in executive pay codes of best practice, however, there is still great disparity between executive pay and employees of UK largest companies where CEO compensation bears little relationship to company performance and/or shareholder returns (Mallin, 2016).

While corporate performance criteria may differ between different companies and industries, broadly it can be characterised as market-based measures; accounts-based measures; and individual-based measures. Some elements of performance can include return to shareholders; profit margins; share price and earnings per share; return on capital and individual director performance indicators (Mallin, 2016). The High Pay Commission's 2011 report has examined executive compensation in relation to corporate performance and observed that bonuses are still excessive and that salary growth is not related to key corporate performance indicators such as share earnings, market capitalisation and/or corporate profit. The High Commission's Final Report (2011) on *Cheques with Balances: why tackling high pay is in the national interest* provided a comprehensive plan based on the principles of transparency, accountability, and fairness to help tackle persistent problems of the mismatch between excessive executive pay and unrelated firm performance.

The Financial Crisis of 2008 has also placed greater emphasis on institutional investor involvement in corporate governance. The subsequent UK Stewardship Code (2010) therefore encouraged instructional investors such as insurance companies, investment fund managers and pension funds to act as engaged and responsible shareowners, rather than just traders of corporate stock and be more involved in influencing governance issues such as directors' pay, board structure, and strategic initiatives.

1.1.5. Shareholder Activism

While exploring the role of legal restrictions on institutional investor behaviour, Black and Coffee (1994) argue that the UK is an ideal setting for institutional investors to monitor and intervene in company affairs because it provides more legal tools to protect shareholders' interests. The UK common law system, which is associated with higher guarantees for shareholder protection (La Porta et al., 1999; 2000) and the development of codes of good governance (Shleifer and Vishny, 1997; La Porta et al., 2000; 1999; Aguilera and Cuervo-Cazurra, 2004) is considered to have placed institutional investors in a position of power to hold corporate managers accountable. Bebchuk (2005) notes that 'the UK law gives shareholders…powers that enable them to have greater influence on the board than their US counterparts' (p. 849). For example, outside of Annual General Meetings (AGMs) shareholders in the UK can call for Extraordinary General Meetings (EGMs), starting with 10% of shareholdings and put forward proposals to remove any or all board directors if more than 50% of votes support this proposition (Becht et al., 2009). Institutional involvement is also facilitated through organizations such as the Association of British Insurers (ABI) and National Association of Pension Funds (NAPF).

All in all, the current landscape of UK ownership, and the legal and regulatory environment of shareholder protection are seen to create receptive conditions for investor involvement in corporate governance. However, despite the legal frameworks and certain shareholder activism developments, the evidence of investors behaving as stewards in the spirit of the codes appears more assumed than demonstrated as managerial decision making is still left to professionally trained managers and executives. The empirical evidence investigating this relationship is decidedly mixed (Bainbridge, 2003; Dalton et al., 2007; Tilba, 2011). Most recent academic reviews of the current state of shareholder activism literature suggest that the research on shareholder engagement offers conflicting perspectives on this topic (Goranova and Ryan, 2014; McNulty and Nordberg, 2016). On the one hand, there is much written about 'active' and engaging investors, yet on the other hand, the case is made that institutional investors tend to be 'passive' in their approach to corporations. What follows on here is a discussion of the existing evidence of shareholder activism in the context of corporate governance issues such as executive remuneration, director practices, CSR and firm performance. This is then followed by a summary of the evidence of shareholder disengagement.

Shareholder Engagement

Over the years, various studies have examined how institutional investors apply the ownership principles to establish the effectiveness of such application in different areas of corporate governance. There is evidence of investor activism both in the US and Britain. The US studies of investor activism are relevant here because the corporate landscape in the UK and the US has similar dispersed share-ownership structures (Mayer, 2000) and institutional investors in both countries have been under similar pressures to act as a mechanism of accountability between senior managers, boards, and shareholders. As a result of corporate governance scandals, the Sarbanes-Oxley Act in the US and The Combined Code on Corporate Governance in the UK, both share the philosophy of shareholder primacy (Armour et al., 2003).

Some of the well-quoted studies on investor activism explore the effects of California Public Employees Retirement System (CalPERS) activism on target firm governance structure, shareholder wealth, and performance. Smith (1996) finds that shareholder wealth increases in those targeted companies who adopt changes proposed by the active investor. The analysis of announcement reactions of CalPERS focus list firms carried out by Barber (2007) finds that CalPERS' activism has created \$ 3.1 billion in shareholder value. Focusing particularly on the effects of shareholder proposals, the often-quoted survey by Gillian and Starks (2000) reports that institutional investor proposals gain substantially more support from the companies. Gillian and Starks also note that shareholder activism has evolved to become an important characteristic of the financial market.

A considerable number of articles concentrate particularly on the relationship between institutional ownership and executive remuneration. A study into the effects of institutional ownership on executive pay over the period between 1992-1997 by Hartzell and Starks (2003) demonstrates that institutional investors actively influence executive compensation structures. Hartzell and Starks suggest that firms with higher institutional investor concentration have lower managerial compensations. The results of the Hartzell and Starks (2003) study also indicate that institutional investors serve a monitoring role in corporate governance. Relating to executive remuneration, a more recent survey by Watson Wyatt (2005) finds that 90% of institutional investors consider that corporate executives are overpaid. This may help explain the results of Hartzell and Starks (2003) and the Annual Corporate Governance Review by Georgeson Shareholder (2005) that observes an increase in the number of resolutions voted upon and higher numbers of proposals have achieved a majority of votes cast. The most significant increase in voting was associated with executive compensation and board related issues. Table 1.1.3 demonstrates that the voting on executive compensation increased from 51 proposals in 2001 to 133 in 2005. Board-related proposals jumped from 52 in 2001 to 109 in 2005.

Table 1.1.3. Corporate governance proposals, 2001-2005

Proposal Type	***2001***	***%***	***2002***	***%***	***2003***	***%***	***2004***	***%***	***2005***	***%***
Executive Compensation	51	21.2	43	15.8	179	41.9	167	40.3	133	35.5
Board Related	52	21.6	58	21.2	52	12.2	82	19.8	109	29.1
Repeal Classified Board	42	17.4	39	14.3	38	8.9	36	8.7	44	11.7
Poison Pill Rescission	21	8.7	50	18.3	76	17.8	50	12.1	23	6.1
Cumulative Voting	16	6.6	18	6.6	19	4.4	22	5.3	18	4.8
Supermajority Provision	9	3.7	10	3.7	8	1.9	7	1.7	13	3.5
Audit-Related	N/A	N/A	20	7.3	19	4.4	16	3.9	7	1.9
Other	50	20.8	35	12.8	36	8.5	34	8.2	28	7.4
Total	241	100	273	100	427	100	414	100	375	100

Source: Annual Corporate Governance Review (2005), Georgeson Shareholder

More general conclusions about the significance of the role of institutional investors in financial markets and corporate governance are drawn by Gillian and Starks (2003), who find that the growing share ownership of institutional investors enables them to play an important role and improve corporate governance.

There are also numerous UK academic articles that describe institutional investors as active in corporate governance. The articles focus on examining the outcomes of investor activism in different areas of corporate governance. In a paper that describes ownership structures among a sample of 470 UK listed firms and the consequences of ownership on firm's control and incentive factors, Leech and Leahy (1991) establish positive effects of large institutional shareholdings on corporate control and performance. While surveying the voting levels of the Top 250 UK firms, Mallin (1994) finds that the mean level of voting was 35%. That, however, changed and voting levels have gradually increased to around 65% (Mallin, 2010). Furthermore, while investigating the monitoring role of UK shareholder coalitions, Crespi and Renneboog (2010) provide evidence of voting coalitions in the UK. Crespi and Renneboog find that voting power held by financial institutions (mainly the insurance companies) is positively related to executive director turnover. Their paper shows that voting coalition of shareholders can be instrumental in bringing about change in poorly performing companies.

Besides corporate performance, there is also evidence of UK institutional investors concerning themselves with other areas of corporate governance. In a paper that explores how investment fund managers deal with information uncertainty in stock selection and asset allocation decisions, Holland (2006) suggests that UK investors concern themselves with board structure, the extent of a board's power over top management, the ability of a board to show unity of direction and purpose, the stability of senior management, succession policy, the separation of Chairman and Chief Executive roles, and the number and quality of Non-Executive directors. Holland's (2006) data set consisted of interviews with 40 investment fund managers conducted between 1997 and 2000. Furthermore, while exploring the differences between institutional investors in the UK and the US concerning corporate social responsibility (CSR), Aguilera et al. (2006) find that institutional investors in the UK show a significant increase in the level of involvement with their investee companies, concerning themselves with corporate governance issues such as corporate strategy, board effectiveness, executive remuneration and succession planning. The reasons for this are said to include the governmental pressure for active ownership, with impetus from the Myners Review (2001) and the Combined Code (2006), as well as the tendency of institutional investors in the UK to hold shares for a relatively longer period of time than in the US (Aguilera et al., 2006).

With particular reference to compensation, Dong and Ozkan (2008) empirically examine the determinants of directors' pay for a sample of listed, non-financial UK firms, focusing on institutional investor ownership. Dong and Ozkan find that long-term oriented investors restrain the level of directors' pay and strengthen the link between pay and performance. Dong and Ozkan also note that the findings of their study are consistent with their expectations that the long-horizon institutional investors are more involved in corporate governance and serve a better monitoring and disciplining role in corporate governance.

A number of UK studies also indicate that institutional investors effectively monitor their investee companies. While investigating the investment cash flow sensitivity of 985 firms listed on the London Stock Exchange (LSE) between 1992 and 1998, Pawlina and Renneboog (2005) suggest that institutional investors appear to play a part in mitigating information asymmetries between capital markets and firms by effective monitoring. In addition, in a book that examines the relations between investors and firms, Martin et al. (2007) show that institutional investors such as UK fund managers routinely analyse information concerning those companies in which they invest, vote and have meetings with company senior management. Investors also might propose resolutions, resort to calling extraordinary general meetings and intervene jointly with other shareholders. Comparative studies between UK and US on shareholder activism by Noe, (2002) suggest that within current financial market structures investors have the ability not only to monitor their companies effectively, but also profitably. Noe argues that strategic investors (those that are capable of intervening in corporate governance) can monitor and intervene in the firm's management, while investors with small holdings appear to take up investor activism more aggressively. Noe concludes by suggesting that there is no monolithic relationship between the size of shareholdings and activism. Leech (2002) echoes Noe's (2002) conclusion by arguing that the minority shareholders can be almost as powerful as the majority shareholders.

1.1.6. Corporate Social Responsibility and Shareholder Engagement

Broadly, Corporate Social Responsibility (CSR) is about corporate entities acting as good corporate citizens. However, this seemingly straightforward term CSR over time has acquired different meanings to different organisations and individuals. William C. Frederick provided one of the earlier definitions of CSR as he wrote:

> *[Social responsibilities] mean that businessmen should oversee the operation of an economic system that fulfils the expectations of the public. And this means in turn that the economy's means of production should be employed in such a way that production and distribution should enhance total socio-economic welfare. Social responsibility, in the final analysis, implies a public posture toward society's economic and human resources and a willingness to see that those resources are used for broad social ends and not simply for the narrowly circumscribed interests of private persons and firms (Frederick, 1960, p. 60).*

With the growth of institutional investment in the UK, we have also witnessed an increasing awareness of socially responsible investment (SRI), which has become an integral part of corporate governance at the individual company level, as well as at the institutional investment level. As institutional investors are becoming more aware of the importance of CSR, there is also a growing body of academic literature that highlights increasing activity of institutional investors to promote corporate, social and environmental responsibility. Armour et al. (2003) suggest that some institutional investors in the UK are beginning to redirect their investment strategies in favour of longer-term, stakeholder-inclusive practices. Another study, which assesses 1146 ethical investors and their willingness to support active ethical investment in the UK by Lewis and Mackenzie (2000), finds that institutional investors generally support ethical investment practices. Lewis and Mackenzie indicate that investors are willing to engage in a dialogue with investee companies to improve corporate practices. In addition, while discussing whether it pays to invest ethically and examining corporate social responsibility from the philosophical, moral and practical point of view, Hellsten and

Mallin (2006) acknowledge the growth of ethical investment funds in the UK. Hellsten and Mallin suggest that ethical investing has an important role to play in reinforcing corporate and social responsibility.

A UK survey on institutional socially responsible investment (SRI) carried out by Dresner (2002) indicates that 95% of fund managers become involved with the investee companies in the issues arising from SRI. Dresner also finds that investors prefer to negotiate with investee companies individually, where only 6% of activism is collaborative, namely, where groups of investors come together to influence one or more target companies. While exploring how corporate activism by socially responsible investors could enhance stakeholder accountability, McLaren (2004) argues that corporate, social and environmental abuses result from the lack of corporate accountability. Furthermore, in an empirical investigation of the patterns of UK shareholdings and its relationship with socially responsible behaviour by companies within a sample of over 500 UK firms, Cox et al. (2004) find that long-term institutional investing is positively related to corporate social performance and that long-term institutional investors reject those firms that have the worst corporate social performance indicators. In a review of the growth of the socially responsible investment in the UK and Japan, Solomon et al. (2004) indicate that SRI is more mature in the UK and that one of the reasons for this is the positive impact of the dialogue between institutional investors and corporate managers. Solomon et al. (2004) note that in 2001 institutional investors in the UK invested EUR 5910 million into socially responsible investment funds. In seeking to explain UK institutional investors' motives to care about CSR, Aguilera et al. (2006) put forward instrumental (self-driven), relational (group-oriented and legitimising) and moral (appropriate behaviour) motives, exemplifying the CSR activities of the Universities Superannuation Scheme (USS).

More recently, Hawley and Williams (2007), Thamotheram and Wildsmith (2007) Lyndenberg (2007) emphasise a growing academic interest in institutional investors playing an active role in corporate governance and SRI as 'Universal Owners' whose investment behaviour is different in that it deliberately takes account of more than market price in seeking returns on investment (Lyndenberg, 2007). In a review of the evolution of UK institutional investors' interest in climate change from 1995 to 2005, Pfeifer and Sullivan (2007) demonstrate that institutional investors, particularly pension funds, begin to concentrate not only on issues of corporate governance, but also on corporate ethical and social responsibility. Pfeifer and Sullivan conclude that 'soft' policy measures such as information disclosure and awareness-raising played an important role in encouraging institutional investors to discuss social and environmental issues with corporate managers. The introduction of 'hard' policy measures such as regulation and market-based instruments had led to investors systematically factoring issues such as climate change into their investment analysis. The latest discussion on the forms and effects of shareholder activism by Chung and Talaulicar (2010) confirms that investor engagement is on the increase.

1.1.7. Shareholder Disengagement

Paradoxically, Davis (2008) and Jackson (2008) observe that although institutional investors seem to be increasing in both size and the concentration of their stakes, this concentrated ownership is generally liquid and without commitment, focusing on generating short-term investment returns. This is reflected in the trend towards increased stock turnover and shorter average stock-holding periods (Tomorrow's Owners, 2008; Ownership Commission, 2012). For example, in the UK institutional investors' portfolio turnover reached 56% (Jackson, 2008), while the average duration of equity holding has fallen from five years in the 1960s to just over seven months in 2009 (Haldane, 2010).

The language of investor 'passivity' and disengagement goes back to Berle and Means (1932) and has been used by scholars such as Bernard Black (1990; 1992) and John Coffee (1991). More recently, it was reiterated by Paul Myners, who claimed that investors were *'too passive, just accepting the decision management make...'* (Hawthorne, 2009). Like the evidence on shareholder activism, the literature on investor passivity can be found both in the UK and the US context.

In the US, a number of studies on investor activism suggest that there is little link between activism and performance. One of the significant overviews of institutional investors and shareholder activism is carried out by Gillian and Starks (1998). In their survey of empirical and theoretical research regarding motivations and outcomes of shareholder activism, the two authors find mixed empirical evidence of shareholder activism. Although Gillian and Starks' paper finds some short-term market reaction to some forms of activism, there is little to indicate a link between activism and performance. Similarly, in a survey of empirical findings of the impact of shareholder activism on target companies, Karpoff (2001) indicates a disagreement within the literature over the extent to which shareholder activism facilitates improvement in target firms and concludes that shareholder activism has a negligible impact on share value and earnings. Furthermore, the investigation of the impact of Focus Listing by the Council of Institutional Investors on targeting poorly performing companies by Song and Szewczyk (2003) finds very little evidence of the effectiveness of coordinated shareholder activism. Song and Szewczyk analyse the holdings of banks, insurance, and investment companies, investment advisors, pension funds and university endowment funds, finding no evidence that shareholder activism via Focus List is an effective device to enhance a firm's value.

Other studies cast doubt on the significance of institutional investors in affecting corporate governance. While examining the data on the determinants of institutional ownership, Edwards and Hubbard (2000) doubt that institutional investors are likely to alter significantly the way U.S. corporations are run, despite the increase in institutional stock ownership that has occurred since 1980. Edwards and Hubbard argue that the optimism about the prospects of corporate governance revolution led by a growth of institutional investors might be premature because apart from the episodic activities of a few large pension funds, institutional investors have not taken an active role in corporate governance. Edwards and Hubbard (2000) suggest that one of the reasons for this might be that although institutional ownership increased since the 1980s, it is generally still quite low and unlikely to reach the concentration that would allow investors to have a voice in the boardroom. Investors also face significant legal and institutional constraints that deter them from accumulating large ownership stakes and use those stakes to discipline managers. Another US study that examines the nature of hedge fund activism and its effects on corporate governance and control by Kahan and Rock (2007) highlights that traditional institutional investors do not pursue activism because of their investment diversification strategies.

Within the UK, a number of studies examine investor activism in the context of voting. In an international comparison of institutional investors' voting practices, Mallin (2001) argues that although institutional investors have the potential to exert significant influence on corporations using their voting rights, the levels of institutional voting are much lower in the UK than was expected, amounting to just over 46% in 1998 for FTSE 350 companies. Mallin suggests that the existing proxy voting system in the UK is viewed as slow and over-complicated, with many players along the chain, limiting flexibility. Mallin concludes by summarising that the institutional investors' voting levels are disappointing and that there is still a long way to go to achieve the type of institutional investor envisaged in the Myners Report (2001). Similarly, in a book *Control of Corporate Europe* Goergen and Renneboog (2002) note that institutional investors are the most important category of UK shareholders. However Goergen and Renneboog argue that institutional investors tend to be passive corporate owners who often fail to exercise their voting rights. According to Goergen and Renneboog, the passive stance of investors increases the already significant power of corporate directors who represent the second most important category of investors, creating agency problems of high managerial discretion. More recently, Conyon and Sadler (2010) find that less than 10% of UK shareholders vote against the mandated Directors' Remuneration Report resolutions, which means that on average, 'say on pay' does not materially alter the subsequent level and design of CEO compensation.

When it comes to investor monitoring and intervening in poor corporate performance, Franks et al. (2001) find little relation between poor performance and concentration of institutional investor ownership. While examining a randomly selected sample of 250 companies quoted on the London Stock Exchange between 1988-1993, combined with the information on stock ownership, sales of share blocks, takeovers, board and capital structures, Franks et al. (2001) indicate that holders of large share blocks exert little disciplining influence on corporate management. Furthermore, in their analysis of CEO turnover and monetary remuneration schemes within 250 UK listed companies, Renneboog and Trojanovski (2003) reveal little evidence of outside shareholder monitoring to mitigate agency problems between managers and shareholders. Renneboog and Trojanovski find that CEOs with strong voting power successfully resist replacement, irrespective of corporate performance, concluding that powerful outside shareholders do not seem to be interested in removing CEOs even in the light of poor corporate performance. In the discussion of the problems and limitation of investor participation in corporate governance, Webb et al. (2003) utilize the academic literature on financial system design to question the viability of institutional investors assuming an active role in monitoring and disciplining managers in the UK. Webb et al. highlight that there has been, and there will remain, a dearth of solid incentives for institutional investors to involve themselves more systematically in corporate governance matters, and that fund managers may be doing their best by remaining passive. Webb et al. (2003) argues that it is inappropriate to expect institutional investors to behave like banks and have long-term relationships with companies because institutional investors have different constraints, investment time horizons and abilities.

In the empirical investigation of eight institutional investors and the overall role of investors as owners of public companies, Hellman (2005) argues that institutional investors are passive because they are not well suited to affect the way companies are managed. Hellman suggests that investors tend to simplify the information available to them regarding listed companies and rely too much on external advice, which might have negative implications for the management of the listed companies. Hellman (2005) concludes by saying that even the large institutional investors cannot assume responsibility for corporate governance processes because these organisations are not designed to develop profound knowledge about specific investee companies to have a genuine contribution to the discussions about corporate strategy with the management.

In the context of investment practices of UK pension funds, Tilba and McNulty (2013) provide further support for investor disengagement, finding the majority of pension funds to be distant and more concerned with the performance of the portfolios of their investment managers, rather than the performance of individual companies in which they hold shares. Although one might expect pension funds to act as long-term and engaged share owners because of their supposedly long-term investment horizons (Ryan and Schneider, 2002), Tilba and McNulty (2013) found that pension funds do not seek to influence their investee companies because they operate at a considerable distance from their investee corporations, with a high dependency on a chain of financial market intermediaries. Most recently Tilba and Wilson (2017) cast doubt on the willingness and ability of pension funds to change their disengaged behaviour because participants seem to decouple their view of the world from their impact on the world.

1.1.8. Conclusions

Over the past twenty-five years, we have witnessed an endless flow of corporate scandals accompanied by criticisms of financial markets and indeed the nature of 'capitalism' itself. While governance codes of best practice have been evolving since Cadbury 1992, there is still very little to show for all this activity. Arad Reisberg (2015) has rightfully described the UK Stewardship Code as 'trivial, absent of meaning and incapable of achieving its goals'. Such critique is not surprising. While the UK has long been seen as a global leader in corporate governance reform and the development of voluntary codes and guidance of best practice, we still find ourselves in a paradox of 'ownerless companies' with broken chains of accountability (Tilba and McNulty, 2013) and compliance, with the codes of best practice seemingly to be more assumed than demonstrated. It is unclear whether or not the signatories to the codes of best practice translate their commitment into action. The poor quality of explanations of non-compliance to date is indicative of the ineffectiveness of these codes (Reisberg, 2015). Although a number of scholars have argued that the so-called 'new era' of capitalism ought to be characterised by institutional investors (particularly pension funds) acting as share 'owners', the existing evidence of institutional investor distance and investment short-termism indicates that the reality of business ownership and control is more consistent with the prevalence of control by managers rather than institutional owners (Tilba and Wilson, 2017). The authors find the focus on shareholder value and the role of shareholders, with many attempts made to facilitate further engagement and stewardship between shareholders and management within academic and policy debates misconceived because trustees' accounts of their fiduciary role within the trust relationship contradict in practice the logic of engagement, as many trustees equate beneficiaries' interests to financial interests and maximizing investment returns.

The UK's policy makers and legislators continue to promote the principles of fairness, transparency, and accountability through various industry consultations and reports. The most recent year-long Asset Management Market Study (2016/2017) by the UK Financial Conduct Authority has looked into the effectiveness of the UK's asset management and financial services industry. The consultation found that the industry is not working in the consumer's best interests due to weak price competition, lack of transparency and accountability within asset management, with no clear relationship between investment charges and investment performance. The key proposed remedies included better protection for investors; a clearer understanding of what value for money looks like and how to achieve it; strengthening the duty of fund managers to act in the best interest of their clients; and better disclosure.

So far, the report has received a mixed reception within the finical services industry – some find the Report to be progressive and robust in its assessment and recommendations, yet others found it disappointing and not going far enough. Questions were asked about FCA's ability to monitor and enforce their proposed remedies, while some concerns were raised about the lack of focus on education of individual investors within the Report (Transparency Symposium, July 2017).

Notwithstanding this pessimistic perspective, it is worth concluding on a positive note. Corporate governance, corporate social responsibility, and engaged responsible investor behaviour can help strengthen the economy and improve not only the lives of corporate and investment managers, but also the lives of various stakeholders. Corporate governance reforms and the development of codes of best practice continue to grow and are unlikely to lose their public and policy attention. New challenges will no doubt emerge and the governance structures will evolve to adapt in light of these challenges. However, another important part of the solution should also lay with the individual. Accountable and responsible corporate behaviour can only be achieved by the accountable and responsible behaviour of individuals within firms. Ultimately, (over)regulation should not replace the professionalism of individuals and boards as a collective of individuals acting with integrity.

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1.2. CORPORATE GOVERNANCE IN THE USA: GLOBAL PETROLEUM INDUSTRIES

William L. Megginson
Romora E. Sitorus

1.2.1. Introduction and Overview

Corporate governance has received considerable attention in the last decades, especially after the corporate scandals involving Enron, Tyco, Adelphi, and others. In response to a series of high-profile corporate governance failures in the United States, the Sarbanes-Oxley Act in 2002 and Dodd-Frank Act in 2010 were passed by the U.S. lawmakers. Once the U.S. Congress passed the Sarbanes-Oxley Act on July 30, 2002, the Securities and Exchange Commission (SEC) was put in charge of enforcing the law with the main provision requiring that (1) a majority of board members on a single board be independent, (2) members of the compensation, audit, and nominating committees be independent, (3) separate meetings by nonemployee directors be held, and (4) specific procedures, so-called corporate chapters, be written to evaluate CEOs and select new board members. Both New York Stock Exchange and Nasdaq required listed firms to adopt these provisions after January 15, 2004, but no later than October 31, 2004. Furthermore, firms with classified boards (a board for which only a portion of the member are up for re-election in any given year) were allowed time to comply with the requirements, but only until December 31, 2005.

Additionally, the Dodd-Frank Act of 2010 mandates two key provisions, including say-on-pay and proxy access. Specifically, Dodd-Frank mandates a nonbinding advisory “say on pay” ballot allowing shareholders to vote against executive compensation plans. Say-on-pay votes must be held at least every three years. In addition, firms must have shareholders that have at least three percent ownership for three years or more to nominate one-quarter of the board on the annual proxy. This provision is referred to as proxy access or shareholder democracy. Similarly, international regulators outside the United States also created codes to improve ethical standards in the industry, such as the Cadbury Report and the Smith Report in the United Kingdom. The common idea in these guidelines is to have an independent board of directors that monitors corporate executives.

One of the most recent corporate governance scandals in the U.S. energy industry is the case involving Chesapeake Energy Corp. in 2012. Behind the scenes, the chairman and CEO-founder of Chesapeake, Aubrey McClendon, had a personal business interest in conflict with the company. More specifically, McClendon borrowed as much as $1.1 billion from a company that Chesapeake was doing business with to finance his participation in the wells plan of the company[3]. Indeed, Chesapeake is the only large

[3] See Driver, A., & Grow, B. (2012). Special report: Chesapeake CEO took $1.1 billion in shrouded personal loans. Reuters. Retrieved from the World Wide Web: http://www.reuters.com/article/us-chesapeake-mcclendon-loans-idUSBRE83H0GA20120418

listed oil and gas firms to provide its CEO the opportunity to take a direct stake in wells it drills. According to Chesapeake, the well plan is arguably a unique and powerful incentive because it may align McClendon's personal interests with those of the firm's. The size and nature of the debts, however, increase concerns whether McClendon's personal financial deals could undermine his fiduciary obligation toward Chesapeake investors. Moreover, McClendon also managed a lucrative $200 million hedge fund that traded in the same commodities as did Chesapeake. Soon after McClendon was found to be taking out loans against his stakes in Chesapeake oil and gas wells, shareholders started calling for a shake-up of the board of directors and removal of McClendon from the chairmanship. The failure to disclose that the CEO engaged in unethical conduct could constitute a fraud problem. This case underlines the importance of having a board of directors who are fully aware of corporate financial transactions and who are responsive to shareholder concerns.

In the past decades, several firms have formed special purpose vehicles similar to those McClendon used to enable employees to borrow from the employer and conduct investments. For instance, the case of Worldcom's accounting scandal was started by the Worldcom chief executive Bernard Ebbers taking out a $1 billion loan secured by company shares he owned. Similarly, the Enron scandal occurred through the usage of corporate off-balance-sheet entities to hide debt from shareholders. To avoid similar frauds, regulators have revised related-party transaction rules to mandate that firms disclose when top managers use corporate stock as collateral for loans.

This study examines broad corporate governance features that the largest oil and gas firms put in place to prevent similar corporate governance scandals like Chesapeake. We pay considerable attention to governance attributes that have been shown to affect firm performance and behaviour, such as internal governance mechanisms and management incentives. For instance, financial economists have focused their attention on the function of the board of directors in internal corporate governance, to the extent of director's duty to monitor chief executive officers (CEOs) and remove non-performing managers. Since the board of directors is a key player in any corporate governance system, we examine various number board-related corporate governance attributes in oil and gas firms, such as board size, the proportion of outside director, the proportion of independent director, the proportion of each committee members on board (i.e. audit, compensation, and nominating committee) and board of directors' characteristics. Moreover, we examine other prominent corporate governance features related to CEOs, such as CEO-chairman duality, CEO succession planning, and CEO compensation structure. We discuss these variables, which will be the focus of our empirical analysis.

Our empirical framework leads to several conclusions. First, there is no general, global theory of board structure and CEO compensation. Second, individual firm corporate governance best practices are not always consistent with each other, and thus they could be subject to alternative interpretations. It should not be surprising that common or uniform best practices do not exist in the corporate governance literature. The success of each corporate governance recommendation is predicated on its external setting, the interaction of the constituents, and the execution of the governance strategy. Furthermore, internal governance in our study could be endogenously determined within the greater system of corporate governance.

The first variable of interest in our study is the board size. The empirical corporate governance literature emphasizes the importance of board size for firm performance and oversight abilities of directors. A large board often does not perform properly because of free-riding issues, diseconomies of scale and lack of decisiveness (Ravina and Sapienza, 2009). Yermack (1996) documents that smaller boards achieve greater valuation and better financial ratios and that they extend more performance-related compensation to CEOs and other officers. Additionally, Jensen (1993) shows that small boards are more effective in advising and monitoring a CEO's decisions since large boards put more emphasis on "politeness and courtesy" and could be controlled easily by the CEO. Although board size was decreasing in the 1990s, particularly for a large firm, this tendency was reversed after the implementation of Sarbanes-Oxley Act (SOX) of 2002 and the associated corporate governance changes required by the national stock exchanges.

In analysing the role of a corporate board of directors, we proceed by classifying directors into inside (corporate employee) directors, outside (nonemployee) directors, affiliated directors and independent directors. Most corporate boards have members from top management, as well as some from outside the firm. The inside directors can provide information about the firm's projects and operations, while outside directors can contribute based on their specific expertise and objectivity in monitoring and evaluating executive decisions. The outside directors have an important monitoring function on the corporate board. The outside directors can bring an external perspective that managers may not take into account because of their unconscious pride of authorship (Winter, 1977; Byrd and Hickman, 1992). The importance of corporate boards, particularly outside directors, however, has not been clear. Outside directors may be relatively adept at monitoring management decisions, but the contribution of outside directors to disciplining managers may have already been imposed by the product market, the market for corporate control, and various internal governance controls (Hart, 1983; Fama, 1980; and Manne, 1965).

The independent directors characterize the main monitoring component of the board of directors. Current regulation seems to support the notion that it is in the interest of shareholders for corporate boards to be dominated by independent directors. A direct effect of the agency view seems to support this, arguing that outside directors can effectively reduce agency problems. In contrast, an indirect effect of the agency view argues that there exists a more strategic interaction between inside and outside directors. More specifically, inside directors may not obtain full or completely accurate information when the board is controlled by outside directors (Harris and Raviv, 2008).

Affiliated directors are not full-time employees of the firm but are linked with the company to some extent. These include investment bankers, commercial bankers, and consultants. Independent directors have no affiliation with the company or any of its subsidiaries other than their directorship, including private investors, executives, and academics. One may argue that independent directors are important, not only because of their independent stance in monitoring but also for their abilities, expertise and skills. Weisbach (1988) shows that outsider-dominated boards are more likely to fire top executives due to poor performance. These beneficial effects of independent directors might be decreased in complex firms, where monitoring costs are high since independent directors have inferior information relative to insiders (Raheja, 2005; Harriz and Raviv, 2008).

In listed corporations, the duties of the board of directors are to protect and promote the interests of shareholders. The board of directors has the power to challenge and monitor managerial decisions, evaluate the performance of senior executives, and reward or penalize their performance. Commenting on board effectiveness in monitoring top executives, Jensen (1993) argues that internal corporate governance mechanisms are relatively weak for disciplining managers because of the lack of independent leadership. In particular, Jensen suggests that when a CEO holds the position of chairman of the board, internal corporate governance fails, as the board cannot conduct its main role of evaluating and dismissing CEOs. Therefore, when the board's leadership is not independent, it becomes very difficult for the board to respond effectively and immediately to problems in the company's top management team. Similarly, Fama and Jensen (1983) shows that concentration of decision management and decision control in one person (i.e., CEO-chairman duality) could limit a board's effectiveness in evaluating top management.

The quality of board monitoring also depends on the directors' incentives to oversee executives' activities. The prior literature argues that busy directors who have multiple directorships have higher incentives to perform corporate monitoring because they have had a significant investment in building their reputation as monitoring specialists (Fama and Jensen, 1983; and Ricardo-Campbell, 1983). In addition, this study also reviews the size of the board of directors' committee, including the audit, compensation, and nominating committees. The audit committee nominates the external auditors and makes sure that the financial statements are reliable, complete, and accurate. The compensation committee examines the incentive package for the top executives and the other officers. The nominating committee monitors the size and the composition of the board and nominates the new board members to be selected.

Internal succession is an important aspect of corporate governance because it affects a firm's ability to find future CEOs and incentivize current internal executives to perform well. There are several reasons for this: First, replacing current CEO with insiders, providing the signal that internal candidates are an important source of future executives (Cremers and Grinsetin, 2009). Second, selecting internal executives provide incentives for managers to invest in firm-specific skills, to have long-term tenure in the firm, and work harder to maximize shareholder value (Fama and Jensen, 1983; Acharya et al., 2011). Prior literature on stock returns around succession announcements also shows the market views the appointment of an outsider to the CEO position more favourably than an internal appointment. One of the reasons for the positive market reaction is that the new CEO from outside the firm is viewed as more likely to change firm policies that benefit shareholders. Agrawal, Knoeber, and Tsoulouhas (2006) further argue that outside Chief Executive Officers (CEOs) are handicapped, meaning they are chosen only if they are markedly better than the best inside CEO candidates. The literature on tournaments (Lazear and Rosen, 1981; Rosen, 1986; and Chan, 1996) explains that outside directors are handicapped in the market to provide an incentive for insiders to work hard.

In a similar vein, we also examine the importance of CEO compensation structure as a corporate governance tool of oil and gas firms around the world. For instance, managerial ownership of the firm's stock could create an incentive for managers to avoid unprofitable projects in order to protect their financial stake in the firm (Jensen and Meckling, 1976). In other words, managerial equity ownership should lead to a closer alignment between the interest of shareholders and managers. Holmstrom (1979) and Shavell (1979) also argue that aligning compensation with the stock's price performance better aligns both managers and shareholders' interests, reducing agency problem. Since Jensen and Murphy (1990), researchers have shown that pay-for-performance sensitivity (PPS) is important for maintaining effective corporate governance. Nevertheless, the Stulz (1988) model argues that higher levels of equity ownership may harm shareholders by allowing managers to become more entrenched and become protected from the market for corporate control. Furthermore, for a manager faced with a risky project, restricted stock tied to stock performance may decrease his wealth if the outcome of the project is negative. On the other hand, stock options could limit his downside exposure, and consequently encourage risky investment (Ryan and Wiggins, 2001).

Following standard practice in the literature, we also review CEO career concerns and horizons, using the proxy of CEO age and tenure (Gibbons and Murphy, 1992; Chevalier and Ellison, 1999a). Young CEOs have greater incentives to build their reputations than do older executives because they have longer career opportunities. Notwithstanding this, anecdotal evidence often portrays younger CEOs as risk takers. For instance, Serfling (2014) documents that when 30-year-old Michael Reger, the top executive of Northern Oil and Gas, started financing rounds to drill for oil in unexplored places; his decisions were deemed as too risky by older generations. Additionally, Murphy and Zimmerman (1993) and Weisbach (1988) also document strong relation between CEO age and CEO turnover.

Our paper extends the corporate governance literature in several ways. We add to the scholarship on corporate governance by examining the corporate governance of the largest oil and gas firms in the world, including both listed and non-listed oil and gas firms. While several studies have addressed the trend and current corporate governance of U.S. and international firms, these have usually been as a part of an overall industry analysis. Consequently, the unique characteristics of corporate governance in global oil and gas firms are still unclear. Additionally, those studies have used very specific measures to understand corporate governance, thus limiting the generalizability of overall corporate governance aspects. Our study attempts to fill this gap in the literature by providing additional evidence on the evolution of board control and CEO compensation using various corporate governance measures.

This paper proceeds as follows. We conduct empirical investigations on the trend of corporate governance attributes in our sample. First, we examine the common size of oil and gas firms' board. Second, we examine the proportion of the inside and outside directorship on board. Third, we also discuss the time-series variation of the proportion of independent and affiliated directors of the listed U.S. firms. Fourth, we present the statistics of the board committee characteristics, including "busy" (directors holding more than one board seat), international, and government directors. Fifth, we examine the CEO-chairman duality. Sixth, we study the pattern of CEO and chairman succession. Seventh, we analyse the compensation structure of the CEOs. Lastly, we review CEO age and tenure. By and large, our primary focus is to understand the trend and current corporate governance features of the largest oil and gas firms around the world during the last decade.

1.2.2. Data and Variables

We extract Director and chief executive officer information from Institutional Shareholder Services Inc. (ISS) database, the Execucomp Database (via WRDS), the Marketline database, and the S&P Capital IQ. When possible, we also hand-collect information on board composition and corporate governance from the firm's annual report. We obtain information on the listed U.S. and non-U.S. petroleum firms by combining the Platts Top 250 Global Energy Company Rankings and the Compustat S&P 1500 Super Composite Index Constituents. Additionally, we use information from The World's 25 Biggest Oil Firms ranking by Forbes to identify all other non-listed global petroleum firms.

We impose several screening criteria. First, we require that each company in the sample be included in the category of integrated oil and gas, oil and gas exploration and production, oil and gas extraction, oil and gas refining and marketing, and oil and gas refining. Second, for the listed firms, the total number of board of directors is at least one. Third, the oil and gas firms that are not operating by 2015 are excluded from the sample. The final sample consists of the 80 largest global petroleum company based on total assets in 2015 (see Appendix).

Because of the sample constraints, our main analysis consists of three parts: (i) five-year interval time-series trend of corporate governance features (2005, 2010, and 2015). We use this five-year interval data set to show the time series corporate governance trend of listed U.S. and listed non U.S. firms in Figure 1.2.1, 1.2.4, and 1.2.6; (ii) annual time-series trend of governance features over the period of 2007-2015. We utilize this annual data set to perform empirical analysis solely for listed U.S. firms group in Figure 1.2.3, 1.2.8, and 1.2.9; (iii) cross-sectional analysis on corporate governance features in 2016. We use these cross-sectional data sets to compare corporate governance features in all listing groups in our sample (non-listed U.S. firms, listed U.S. firms, listed non U.S. firms) in Figure 1.2.2, 1.2.5, and 1.2.7. Finally, all local currency variables of non-US firms are converted to U.S. dollars.

For each firm, we collect data on corporate governance features during the sample period. Board size is calculated as the number of directors on the board. Following that, we categorize boards as having CEO-Chairman duality if the CEO is also the chairman of the board. In addition, the ISS (formerly RiskMetrics) database has a variable that categorizes a director as an independent or affiliated director. ISS describes an independent director as a director who is neither affiliated nor currently an employee of the firm. An affiliated director is defined as a former employee of the firm or of a majority-owned subsidiary; provider of services to the company (for instance, legal, consulting, or financial services); a customer or supplier to the company; a significant shareholders of the company; a director who control 50% of company's voting power; a family member of an employee; or an employee who receives donation from the company. The proportion of independent directors is calculated as the number of independent directors divided by the total number of directors on the board. The proportion of affiliated directors is calculated as the number of outside directors who have a business relationship with the firm divided by total directors.

The proportion of busy directors is computed as the number of directors who serve in other firms' board. We modify Core et al. (1999) and Ferris et al. (2003) who use a three-directorship criterion as a busy director. We consider outside directors as busy if they serve on one or more boards outside the firm. This definition is consistent with the purpose of this study, which is to understand the broader market of outside directorships. The proportion of government directors is calculated as the number of directors who also work in a government organization. Internal succession is measured as 1 or 0 depending on whether the CEO or chairman is promoted from the internal organization or outside the firm. CEO tenure is measured by the number of years the CEO had held the position. Finally, we use the total incentive structure, which includes base salary, bonuses, options, and all other compensation.

1.2.3. Corporate Governance Trend in the Largest Oil and Gas Firms around the World

Based on competing theories of corporate governance, we focus on two main aspects of internal corporate governance mechanisms: the board of directors and the executive compensation structure. Both the board-of-director characteristics and the executive compensation contract are choice variables that come from maximizing firm value given the firm's operating and information environment, as well as the reservation wage of an executive with a particular quality. With this assumption, the economic determinants of the type of board of directors and compensation (e.g. total assets, current firm performance, investment opportunity) would completely describe the time-series and cross-sectional variation in the equilibrium level of board-of-director type and executive compensation (Core, Holthausen and Larcker, 1999). Following that, we calculate the descriptive statistics for key corporate governance features in our sample, as shown in Panel A and B of Table 1.2.1.

Table 1.2.1. Descriptive statistics

Panel A. Descriptive statistics of main variable measures by listing type						
Type of firms	***Number of firms***	***Firm age***	***Number of directors***	***CEO-Chairman duality***	***Outside directors***	***Total Assets***
Non-listed firms	9	55	10	0.50	0.54	549,780
Listed Non-US firms	33	55	12	0.26	0.78	2,713,311
Listed US firms	38	47	9	0.45	0.86	1,197,138
Total	80	51	10	0.38	0.80	4,460,229
Panel B. Descriptive Statistics of main variable measures by country						
Country	***Number of firms***	***Firm age***	***Number of directors***	***CEO-Chairman duality***	***Outside directors***	***Total Assets***
United States	38	47	9	0.4	0.86	1,197,138
China	4	22	12	0.3	0.65	706,967
Netherlands	1	109	11	0	0.82	340,157
Russia	6	42	11	0	0.84	304,254
United Kingdom	1	108	14	0	0.86	261,832
France	1	92	14	1	0.93	224,484
Venezuela	1	40	11	1	0.55	187,073
Canada	5	48	11	0	0.87	185,639
India	4	64	14	1	0.54	152,399
Italy	1	63	9	0	0.78	146,472
Mexico	1	78	14	0	1.00	123,036
Qatar	1	42	7	1	0.57	109,998
Norway	1	44	10	0	1.00	109,181
Algeria	1	53	1	0	0.00	84,825
Spain	1	29	16	0	0.88	68,543
Thailand	1	38	15	0	0.93	60,334
Kuwait	1	36	8	1	0.75	44,848
Colombia	1	95	8	0	1.00	38,938
Argentina	1	94	15	1	0.80	28,082
Australia	1	62	10	0	0.90	23,839
South Africa	1	66	12	0	0.75	20,856
Chile	1	82	9	-	-	19,937
Poland	1	40	14	0	0.57	12,662
Turkey	1	62	4	1	0.50	8,735
UAE	1	45	27	1	0.37	-
Saudi Arabia	1	83	9	0	0.89	-
Iraq	1	50	-	-	-	-
Iran	1	68	6	0	0.17	-

Note: The descriptive statistics variables include the average of the number of firms, firm age, the number of directors, CEO-Chairman duality, outside directors, and total assets for each listing group (Panel A) and each country group (Panel B) in the sample. Total asset is based on $ million in 2015. The descriptive statistics of other variables in the Table are measured using the data in 2016.

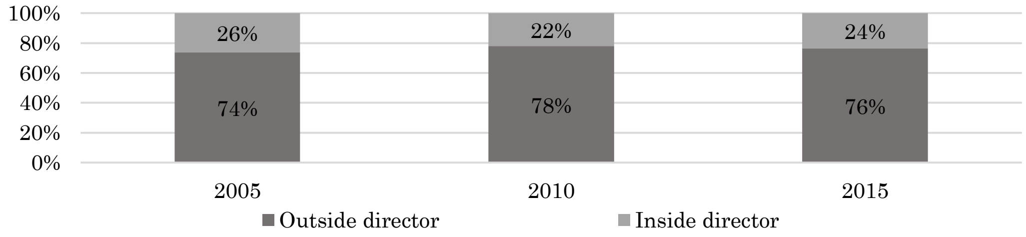
Table 1.2.1, Panel A, presents summary statistics about our sample of global oil and gas firms. We divide the sample into three groups, consisting of non-listed, listed U.S., and listed non-U.S. firms. The total assets of all firms in our sample is $4,460,229 million. More specifically, total assets of the non-listed firms are $549,780 million, while the total assets of all listed non-U.S. firms and listed U.S. firms' asset are $2,713,311 million and $1,197,138 million, respectively. On average, the number of directors in our overall sample is 10. In a more specific category, on average, non-listed firms, listed non-U.S. firms, and listed U.S. firms have 10, 12 and 9 directors per firm per year, respectively.

The result of Panel A, Table 1.2.1 tells us that 28% of the total listed non-U.S. firms sample who does not separate the title of CEO and Chairman of the board. This outcome is higher for listed U.S. firms (43%) and non-listed firms (50%). Most evidence in the corporate governance literature appears to support the notion that separating CEO and chairman should improve corporate performance. For instance, Rechner and Dalton (1991) show that firms with separate titles consistently perform better than firms with combined titles. More importantly, the common practice of combining the titles of chief executive officer (CEO) and chairman of the board (Chairman) is a main concern of regulators during the period in our sample.

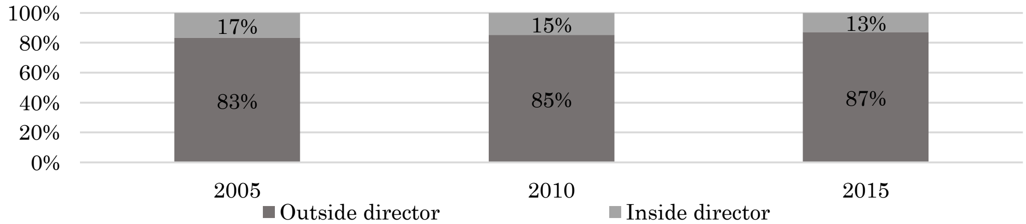
Table 1.2.1, Panel B, reports the average number of directors of oil and gas firms in each country of our sample. In the first column, the variable is the number of firms in each country sample and, in the second column, age is the number of year since of company establishment until the end of 2016. The summary statistics indicate that our sample data are predominantly located in the U.S. with an average firm age of 47 years and number of directors of 9 people. The average CEO-chairman duality is 0.4 (40%), and the average number of directors is 0.54. The next four countries with the highest number of firms in our sample are Russia (6), Canada (5), China (4) and India (4). The average number of directors in those countries are 11, 11, 12, and 11, respectively, while the average CEO-chairman duality averages are 0, 0, 0.3 and 1, respectively. The firms in those countries also have varied proportions of outside directors, which are 0.84, 0.87, 0.64, and 0.54, respectively.

Figure 1.2.1 presents the trend in the proportion of inside directors on board for listed non-U.S. and listed US firms in 2005 (pre-crisis period), 2010 (crisis period), and 2015 (post- crisis period). We find that listed non-U.S. firms have more inside directors than listed U.S. firms. More specifically, Figure 1.2.1, Part A, reports the trend in the proportion of inside (outside) directors on boards in listed non-U.S. firms increases from 74% (26%) in 2005 to 76% (24%) in 2015. Figure 1.2.1, Part B, reports the increasing trend in the proportion of inside (outside) directors on boards of listed non-U.S. firms, from 83% (17%) in 2005 to 87% (13%) in 2015.

Figure 1.2.1. The average proportion of inside and outside directors on board of the listed non-U.S. firms and listed U.S. firms over the period 2005-2015



(a) Listed Non-U.S. firms



(b) Listed U.S. firms

Figure 1.2.2 shows that the proportion of outside director across countries in 2016 is the highest for oil and gas firms in Norway (Statoil), Colombia (Ecopetrol) and Mexico (Petroleos Mexicanos). The lowest proportion of outside directors was for the company headquartered in Turkey (Tarkiye Petrol Rafinerileri A.S.), UAE (Abu Dhabi National Oil Company) and Iran (Iranian National Oil Company).

Figure 1.2.2. The average proportion of outside directors on board across countries in 2016

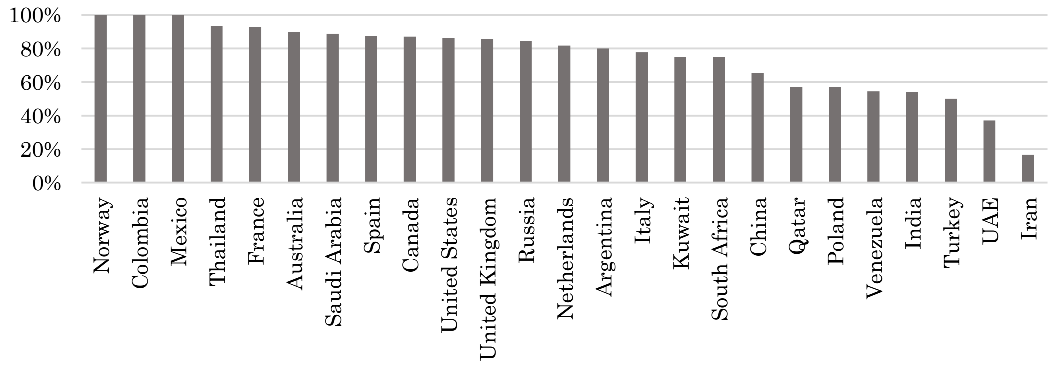


Figure 1.2.3 reports the average proportion of independent directors on board for the sample of 38 listed U.S. firms. The definition we use for director independence follows ISS requirements. We find that the proportion of independent (affiliated)

directors on the board of listed U.S. firms increases (decreases) from 79% (14%) in 2007 to 82% (15%) in 2015. The proportions of independent, affiliated, and executive board members sum to one.

Figure 1.2.3. The average proportion of independent and affiliated directors on board of listed U.S. firms between 2007 and 2015

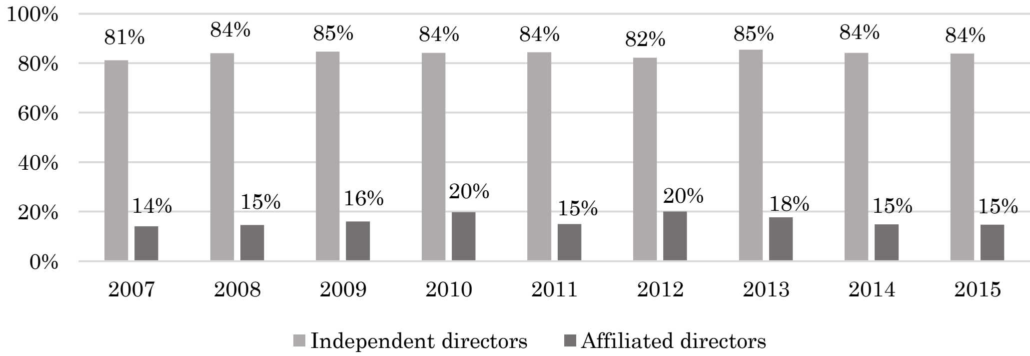
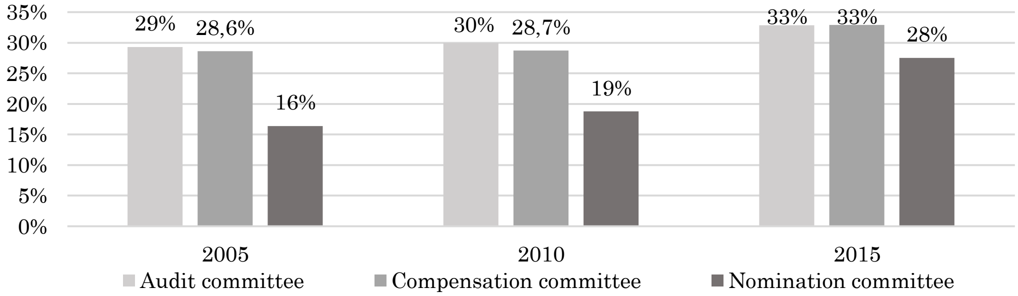
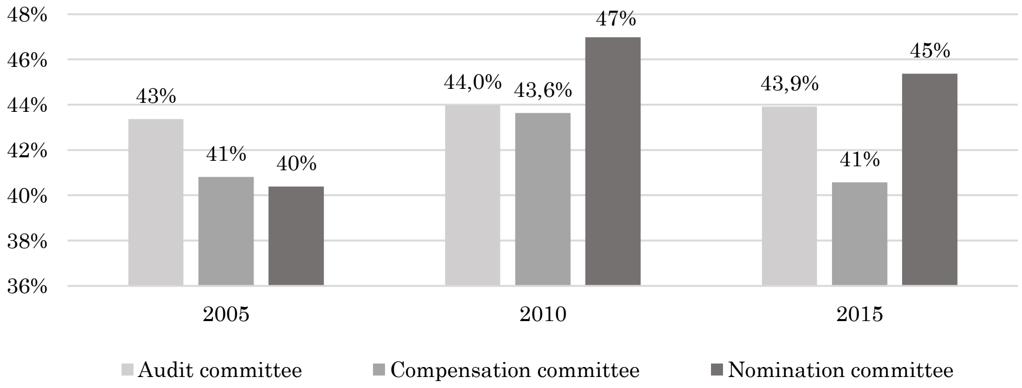


Figure 1.2.4, Part A and B, shows the trend of the average proportion of audit, compensation and nominating committee members on the board of the listed non-U.S. firms and listed U.S. firms, respectively. Figure 1.2.4, Part A shows that the proportion of audit committee members on the boards of listed non-U.S. firms has increased steadily from 2005 (29%) to 2015 (33%). The Figure also shows that the largest five-year increase in audit committee proportion occurs between the period of 2010-2015 by 4%. This is consistent with the notion that many firms began to change their board committee structure after the proposals were put forth by the regulators by the end of the global financial crisis period.

Figure 1.2.4. The average proportion of audit, compensation, and nominating committee members on board of listed non-U.S. firms and listed U.S. firms for the period 2005-2015



(a) Listed non-U.S. firms



(b) Listed U.S. firms

We observe a similar pattern in the average proportion of compensation committee members, and of nominating committee members on board. The proportion of compensation committee members on board in the listed non-U.S. firms increased from 2005 (28.6%) and 2015 (33%), and the average proportion of nominating committee members on board increases substantially between 2005 (16%) and 2015 (28%). The result consistently shows that there is an increasing trend in the proportion of each committee members on the board for listed non-U.S. firms between 2005 and 2015.

Figure 1.2.4, Part B, reports that the average proportion of audit committee members, compensation committee members, and the nominating committee members on the board of the listed U.S. firms. The graph shows that the proportion of audit committee members on the board has changed slightly from 2005 (43%) to 2015 (43.9%). In other words, on average, approximately 4 of 10 directors on the board have a responsibility to serve in audit committee. We observe a similar pattern in the average proportion of the compensation committee members on the board. The compensation committee member proportion on the board increased from 2005 (41%) to 2010 (43.6%) but decreased in 2015 (41%). In contrast, the proportion of nominating committee members on board increased considerably from 2005 (40%), 2010 (47%) to 2015 (45%).

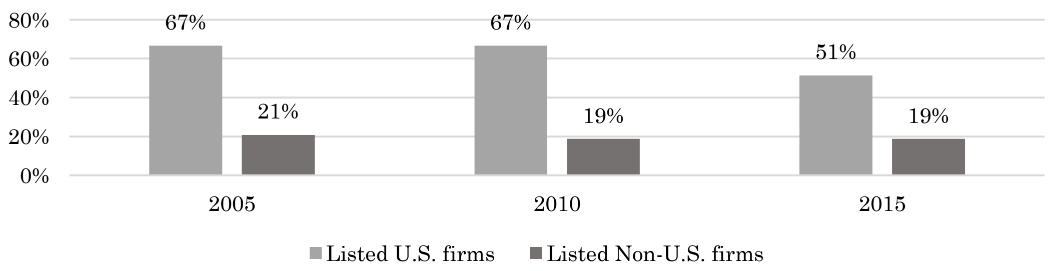
Figure 1.2.5 shows the cross-sectional variation of the proportion of directors on the board with certain characteristics (the proportion of busy directors, international directors, and government directors on the board) in the global oil and gas industry. The proportion of busy directors on board is the highest for listed-U.S. firms (0.4), followed by listed non-U.S. firms (0.31) and non-listed firms (0.22). In addition, the proportion of international directors on board is the highest for non-listed firms (0.08), followed by listed non-U.S. firms (0.01) and listed U.S. firms (0.003). Finally, the proportion of government directors on the board is the highest for non-listed firms (0.48), followed by listed non-U.S. firms (0.04) and listed U.S. firms (0.003).

Figure 1.2.5. The average proportion of busy directors, international directors, and government directors on board of non-listed firms, listed non-U.S. firms and listed U.S. firms in 2016

We interpret the results in Figure 1.2.5 as consistent with the view that serving on multiple boards could be a source of both valuable experience and reputational benefits for outside directors. Prior work on this topic is, however, inconclusive. Ferris, Jagannathan and Pritchard (2003), for instance, argue that busy boards have equally effective monitoring as non-busy boards. Moreover, Fama and Jensen (1983) point out that the market for outside directorships could incentivize outside directors to develop a reputation as a monitoring specialist. In contrast, Core, Holthausen and Larcker (1999) show that busy directors tend to set relatively high CEO incentive packages, which in turn adversely affect firm performance. An investor may expect that the oil and gas firms, where government directors served, to benefit from their political influence. Moreover, some of the directors may also be selected for their international issues expertise, which might have been developed while he/she worked at international organizations such as the International Monetary Fund or the World Bank.

Figure 1.2.6 shows that in 2005 and 2010, the average CEO-Chairman duality (CEOs are also chairman of the board) is 67% in the listed U.S. firms. However, the average CEO-Chairman duality in this sample decreased substantially to 51% in 2015. On the other hand, CEO-chairman duality in listed non-U.S. firms decreased only slightly from 21% in 2005 to 19% in 2015.

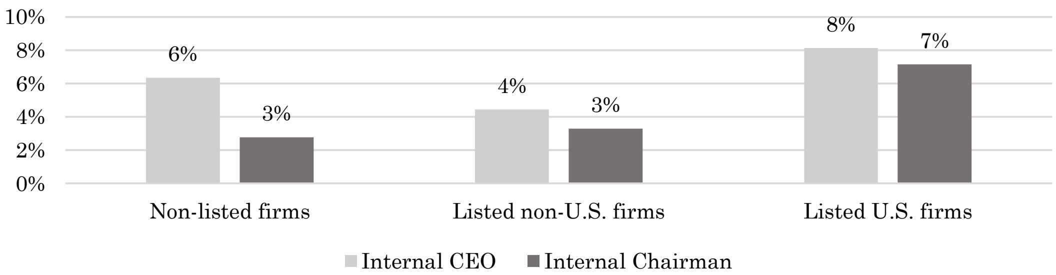
Figure 1.2.6. The average CEO-Chairman duality in listed U.S. firms and listed Non-U.S. firms for the period 2005-2015



The CEO-chairman duality governance structure focuses the power in the CEO's position, leading to more top management discretion in the firm. The dual office composition allows the CEO to manage information available to other board member and thus could restrict board monitoring (Jensen, 1993). The CEO who is vested with the title of Chairman may not be able to monitor top management effectively, and this may consequently create more severe agency problems.

Figure 1.2.7 shows that the trend of CEO and Chairman internal succession among different type of oil and gas firms. The CEO internal succession is, on average, the highest in listed U.S. firms (8%), followed by non-listed firms (6%), and listed non-U.S. firms (4%). In contrast, the average Chairman internal succession is the highest in listed U.S. firms (7%), followed by listed non-U.S. firms (3.3%), and non-listed firms (2.8%).

Figure 1.2.7. The average internal succession of CEO and Chairman of the Board in the non-listed firms, listed non-U.S. firms, and listed U.S. firms in 2016



When the board of directors need to select somebody for the CEO position from internal promotion or the appointment of an outside CEO, it faces the choice between top management who is more qualified to implement a firm's existing policies and another who is more prepared to implement new policies. It is widely known that inside candidates have had the experience to implement firm current policies as managers at lower levels. On the other hand, outsider CEOs, by virtue of their external experience, have broader insights and experience to run a firm with an alternative way to manage the firm. Thus, deeper managerial depth makes it more likely that a suitable executive will be selected from inside the firm, and a more complex control structure hinders an outsider's ability to manage and control a large firm.

Figure 1.2.8 reports that, based on 36 of the listed U.S. firms, the average CEO's age ranges from 57 years to 60 years during the period between 2007 and 2015. In addition to that, the trend of average CEO tenure is decreasing from 8 years (2007) to 6 years (2015). Before the financial crisis, there is a slightly increasing trend of CEO tenure to 10 years (2008 and 2009), followed by declining trend after the crisis. The decreasing trend of CEO age and tenure is consistent with the argument that limitation of CEO age and tenure in the firm is used as a means of breaking with CEO entrenchment.

Figure 1.2.8. The average CEO age and tenure in the listed U.S. firms over the period of 2007-2015

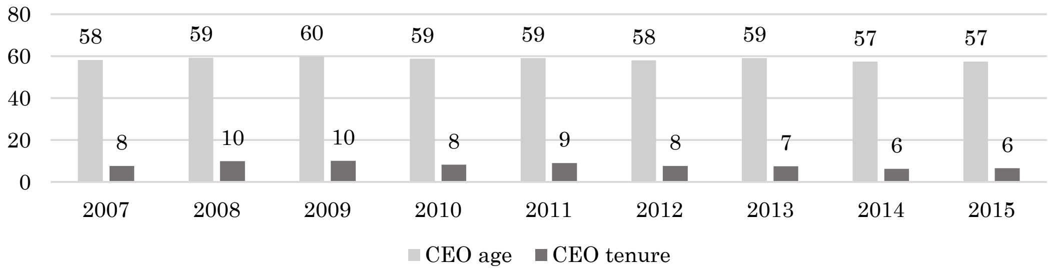
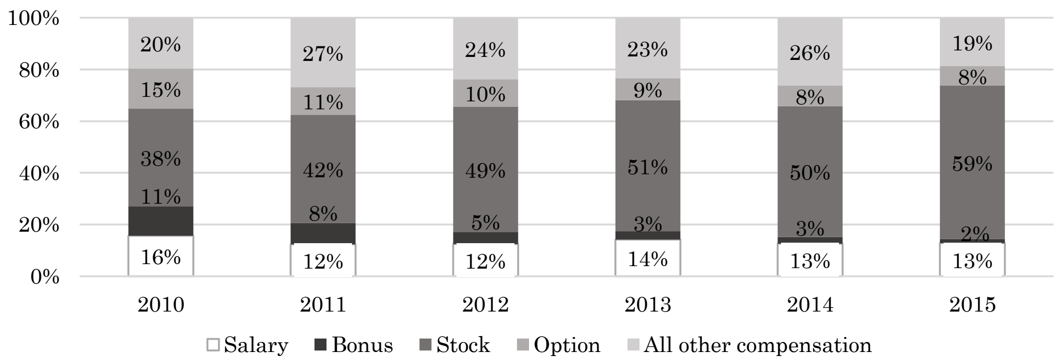


Figure 1.2.9 shows that the average proportion of salary of total compensation for CEOs decreased from 16% (2010) to 13% (2015). Similarly, the average proportion of CEO's bonuses decreases drastically from 11% (2010) to 12% (2015). Interestingly, the average proportion of CEO's stock award increases significantly from 38% (2010) to 59% (2015). Moreover, another type of equity-based compensation, option awards, also decreases from an average of 15% in 2010 to 8% in 2015. Therefore, on average, the total equity-based compensation (sum of the stock and option award) has increased substantially from 53% in 2010 to 67% in 2015.

Figure 1.2.9. The average CEO compensation structure of the listed U.S. firms over the period 2010-2015



Overall, the average of the total proportion of all other compensation for CEOs (i.e., non-equity award, pension, other compensation) decreases slightly from 20% in 2010 to 19% in 2015. This result suggests that most of the change in CEO compensation structure is driven by the increase in equity compensation (stock and option award) and the drop in non-equity compensation (base salary and bonuses). The declining usage of options as part of CEO compensation structure could also be caused by the new requirement by FASB (FAS 123R) to expense options. It is possible that firms with noncompliant boards would react to this option expensing rule.

Prior literature also shows that total CEO compensation (including cash, stock, options, benefits, and perks) is relatively higher for U.S. executive than their counterparts in Europe and Asia (Boyd, 1994). Moreover, stock options are widely used in compensation plans of listed firms. A common option grant provides C-suite executives the right to purchase a certain number of stocks at a fixed price, which is typically the share price at the time of the grant, up to an expiration day. Chance, Kumar and Todd (2000) argue that most of the executive stock options are a mix of American- and European style and have ten-year time to expiration on the grant date. Although the stock option is useful to keep managerial talent, firms may not provide stock options for several reasons. First, it is possible that executives are too entrenched and thus they can convince the board of directors that the firm's problem is market- or industry-driven. Second, the board of directors may choose to reduce the manager's incentive to take on high-risk projects. Third, favourable tax laws may allow management to qualify for favourable tax treatment on exercise.

In most of the publicly-traded firms, compensation decisions are decided by a board of directors, which represents the common stock shareholders. Fama (1980) and Fama and Jensen (1983) argues that compensation decisions should be made by outside directors since outsiders are more likely to make an unbiased judgement about CEO quality and hence efficient compensation, recruiting, and firing decisions. However, Bebchuk and Fried (2003) and (2004) argue that often in the listed U.S. firms, CEOs have a great influence over the board's agenda, causing a significant effect on compensation policies and it may lead to suboptimal compensation arrangements, for instance, overcompensation. Thus, the Dodd-Frank Act of 2010 has been introduced to allow compensation policies to be voted on by the shareholders to avoid director biases.

1.2.4. Summary and Conclusions

Overall, the results of our empirical investigation indicate that, on average, corporate governance features in the largest oil and gas companies around the world have changed considerably in the wake of the landmark case of Enron and the 2008 global financial crisis. First, both listed non-U.S. firms and listed U.S. oil and gas firms have increased the proportion of outside directors on the board and have reduced CEO-Chairman duality over the period 2000-2015. This decreasing CEO-Chairman duality trend for listed U.S. firms is more pronounced after 2010 than before, possibly reflecting greater sensitivity toward the role of CEO-Chairman in corporate governance issues. Interestingly, on average, listed U.S. firms have higher proportions of outside directors on the board than do other categories of firms, but are less likely to have CEO-chairman duality relative to non-listed U.S. firms. However, the relatively more stable trend of CEO-Chairman duality in listed non-U.S. firms may imply that the corporate governance trend in the listed U.S. firms may not be followed closely by listed non-U.S. firms.

This study further emphasizes that corporate governance outcomes vary depending on the location of the headquarters and the listing groups. For instance, the proportion of directors who sit on the audit committee, compensation committee, and nominating committee of corporate boards is higher for listed U.S. firms than listed non-

U.S. firms. Our study also shows that most of the boards in our sample firms are dominated by independent directors (listed U.S. firms) and outside directors (in both listed U.S. firms and listed non-U.S. firms). Prior studies have already shown that firm with high growth opportunities, high R&D capacities, and greater stock return volatility tend to have smaller and less independent boards, while larger firms have greater and more independent boards.

Furthermore, using a cross-sectional analysis, we show that the average proportion of busy directors on the board of listed U.S. firms is higher than that of the non-listed U.S. firms and listed non-U.S. firms. Besides that, the average proportions of international directors and government directors on boards are higher in non-listed firms than listed U.S. firms and listed non-U.S. firms. It is also more likely for the CEO and Chairman of the board to be promoted internally, with the highest occurrence of internal succession is for listed U.S. firms. In addition, the trend of CEO age is stable for the listed U.S. firms, while CEO tenure tends to decline over time. Finally, we document a trend of increasing proportion of stock awards and a declining proportion of salary and option awards in the CEO compensation structure of listed U.S firms during the post-crisis period.

Our results suggest several avenues for future research. While we have documented internal control mechanisms in global oil and gas firms, including the board of director attributes and CEO compensation structures, the trend in external corporate governance in global oil and gas firms remains an open question. Fama and Jensen (1983) argue that there exist two types of control mechanisms, internal and external, to reduce agency problems in the firms by separating responsibilities between management decision and management control. Future studies may investigate external corporate governance mechanisms which include market-based measures such as takeover attempts, failure of the firm, and hedge fund activism. Another potential area of research is to determine whether both internal and external corporate governance mechanisms differ across oil and gas firms with different national culture and law, and to examine how the interaction among those different governance features affect large global oil and gas firms' performance.

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Appendix (Part 1)

Panel A. The largest non-listed oil and gas firms around the world			
Firm	***Country***	***Year established***	***Total assets***
Saudi Aramco	Saudi Arabia	1933	-
National Iranian Oil Company	Iran	1948	-
Petroleos Mexicanos	Mexico	1938	123,036
Kuwait Petroleum	Kuwait	1980	44,848
Abu Dhabi National Oil Company	UAE	1971	-
Qatar Petroleum	Qatar	1974	109,998
Sonatrach	Algeria	1963	84,825
Iraq Ministry of Oil	Iraq	1966	-
PDVSA	Venezuela	1976	187,073
Panel B. The largest listed oil and gas firms around the world			
Firm	***Country***	***Year established***	***Total assets***
PetroChina Co Ltd.	China	1999	368,555
Shell	Netherlands	1907	340,157
Exxon Mobil	United States	1999	336,758
Chevron	United States	1879	266,103
BP p.l.c.	United Kingdom	1908	261,832
TOTAL S.A.	France	1924	224,484
China Petroleum & Chemical Corp.	China	2000	222,183
Eni S.p.A.	Italy	1953	146,472
OJSC Rosneft Oil Co.	Russia	1993	131,166
Statoil ASA	Norway	1972	109,181
CNOOC Ltd	China	1982	102,285
ConocoPhillips	United States	1875	97,484
Suncor Energy Inc	Canada	1919	77,527
Reliance Industries Ltd.	India	1966	76,205
Repsol S.A.	Spain	1987	68,543
OJSC LUKOIL Oil Co.	Russia	1991	68,327
PTT Plc	Thailand	1978	60,334
OJSC Surgutneftegas	Russia	1977	55,142
Phillips 66	United States	1917	48,580
Valero Energy Corp.	United States	1980	44,343
Occidental Petroleum Corp.	United States	1920	43,437
Marathon Petroleum Corp.	United States	2005	43,115
Canadian Natural Resources Ltd.	Canada	1973	42,806

Appendix (Part 2)

Firm	*Country*	*Year established*	*Total assets*
Ecopetrol S.A.	Colombia	1921	38,938
Indian Oil Corp Ltd.	India	1959	34,230
Hess Corp.	United States	1919	34,195
OJSC Gazprom	Russia	1989	33,825
Marathon Oil Corp.	United States	1887	32,311
Oil & Natural Gas Corp Ltd.	India	1956	31,431
Devon Energy Corp.	United States	1971	29,532
YPF S.A.	Argentina	1922	28,082
EOG Resources, Inc.	United States	1999	26,975
Cenovus Energy Inc.	Canada	2009	25,791
Noble Energy, Inc.	United States	1932	24,196
Husky Energy Inc.	Canada	1938	23,872
Woodside Petroleum Ltd.	Australia	1954	23,839
Sasol Ltd.	South Africa	1950	20,856
Empresas Copec S.A.	Chile	1934	19,937
Chesapeake Energy Corp.	United States	1989	17,357
Tesoro Corp.	United States	1968	16,332
Encana Corp.	Canada	2002	15,644
Pioneer Natural Resources Co.	United States	1997	15,154
Continental Resources, Inc.	United States	1967	14,920
Kunlun Energy Co Ltd.	China	1994	13,944
PGNiG	Poland	1976	12,662
Murphy Oil Corp.	United States	1950	11,494
Bharat Petroleum Corp Ltd.	India	1928	10,533
Tarkiye Petrol Rafinerileri A.S.	Turkey	1954	8,735
OAO Tatneft	Russia	1950	8,715
Qep Resources Inc.	United States	1922	8,426
Hollyfrontier Corp.	United States	1947	8,388
Wpx Energy Inc.	United States	2011	8,350
Southwestern Energy Co.	United States	1929	8,110
JSOC Bashneft	Russia	1946	7,078
California Resources Corp.	United States	2014	7,053
Range Resources Corp.	United States	1976	6,900
Denbury Resources Inc.	United States	1999	5,920
Western Refining Inc.	United States	1997	5,833
SM Energy Co.	United States	1908	5,622
Cabot Oil & Gas Corp.	United States	1989	5,262
Cimarex Energy Co.	United States	2002	5,243
Newfield Exploration Co.	United States	1988	4,768
Gulfport Energy Corp.	United States	1997	3,335
Unit Corp.	United States	1986	2,809
Pdc Energy Inc.	United States	1969	2,371
Carrizo Oil & Gas Inc.	United States	2010	2,027
Bill Barrett Corp.	United States	2002	1,515
Rex Energy Corp.	United States	2007	1,099
Northern Oil & Gas Inc.	United States	2006	734
Synergy Resources Corp.	United States	2008	673
Contango Oil & Gas Co.	United States	1986	417

**Total assets is based on $ million in 2015*

1.3. CORPORATE GOVERNANCE IN CANADA: THE CANADIAN LEGAL AND PRACTICAL LANDSCAPE

Raef Gouiaa

1.3.1. Introduction

Corporate governance is the mechanisms, processes and relations by which corporations are controlled and directed (Shailer, 2004). Many great Canadian and international organizations can, without hesitation, relate their success to their effective governance practices. Over the past decades, the world has learned a lot from different economic leaders, scandals and outstanding profitable or crisis situations. With the incredible growth in different markets around the globe, governments now occupy a major role in refereeing the way public organizations conduct their affairs. When enacting legislation or regulations, due to globalization, countries can no longer operate on a national basis only. Legislators have the responsibility to consider numerous international factors. The laws, policies and principles that structure corporate governance today are continuously evolving achievements. They ensure transparency for shareholders, reasonable gratification for governance leaders and attempt to align these to the interests of stakeholders.

Like many markets, Canadian markets are highly influenced by American ones. The description of Canada`s corporate governance situation isn't complete if we ignore the United States early 21st-century scandals. These scandals directly impact the Canadian way of regulating governance today. In 2005, 175 corporations listed in the Toronto Stock Exchange (TSX) that represented 61% of the total capital of its market were also listed in American markets (Bédard, 2005). Naturally, after the Enron scandals, Canadian investors rapidly demonstrated anxiety. Compared to a reactive approach implementing the Sarbanes-Oxley law as in the United States, Canada decided to proactively reform the way it dealt with corporate governance. More precisely, Canada's changes were principally in the communication of financial information, audit committees, regulations towards auditors and sanctions (Bédard, 2005). This reform primarily changed how governance, that used to be based on principles that called upon a practitioner's professional judgment, has changed to our current situation consisting of multiple regulations. Boards of directors and audit committees were the ones to garner most of the criticism after the scandals. This is why the Canadian Securities Administrators (CSA) published their first edition of regulations 58-201 *Corporate Governance Guidelines* and 58-101 *Disclosure of Corporate Governance Practices,* both in April of 2005.

In Canada, even though a set of developed common law principles regarding corporate law exists, it is a fact well-known to practitioners that the securities commissions occupy a major role in establishing Canadian corporate governance practices (Liao, 2014). Legislators lack pertinent corporate experience and frequently avoid changing corporate legislation. Corporate law in Canada operates on a jurisdictional basis. The 10 provinces and 3 territories of the country control securities regulations and policies. Regulators from every region have grouped to form the Canadian Securities Administrators. This team seeks to develop a harmonized approach to securities regulation across the country (CSA, 2017). Although the CSA's mission is to protect investors from unfair, improper or fraudulent practices and it has fostered fair, efficient and vibrant capital markets, over the past decade, the CSA has been involved in changing legislature enacted by the Business Corporations Act regarding Governance. Some practitioners say that the CSA is constantly overstepping its jurisdiction; others reply that at least someone is shaping the development of corporate governance standards in Canada (Liao, 2013). Evidently, with the commissions playing a major role in leading the country's governance practices, Canada is pushed towards a more shareholder-centric model of governance (Liao, 2013).

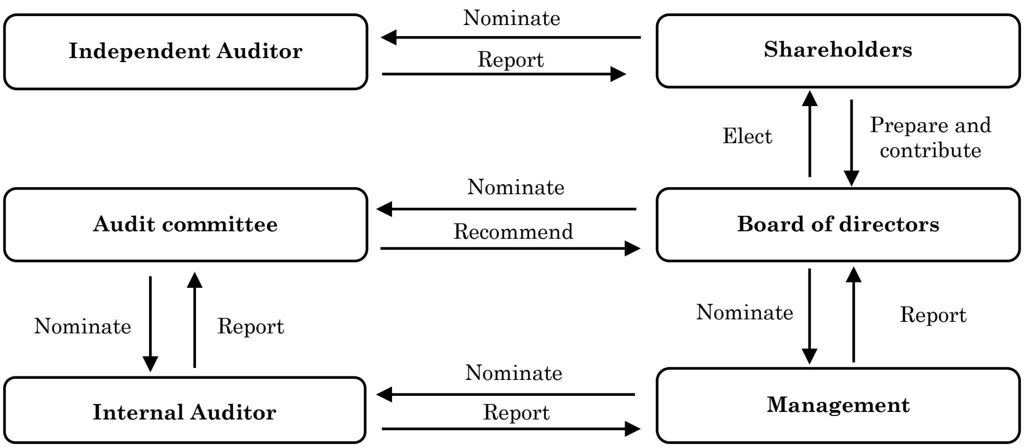
1.3.2. Shareholders' Rights Protection

When the CSA first started to come out with regulations on how governance should take place in Canadian corporations, many questioned the reasons why they were the ones bringing up issues upon this matter. Somehow, the CSA had decided to include governance in their "public interest mandate". Over the years, subjects such as having more women on boards, the independence of board members and the codes of business conduct have come to light. The CSA was involved in making many important national policies that helped increase the overall quality of corporate governance in Canada, ensuring transparency for shareholders. Three very important policies structure the governance model of the country: National Policy 58-201 on *Corporate Governance Guidelines,* National Policy 58-101 on *Disclosure of Corporate Governance Practices* and National Policy 52-110 *Respecting the Audit Committee.*

The content of these policies protects investors, dictating how boards of Canadian corporations should accomplish their mandate. They define the purpose of boards, they serve their shareholders' best interests, and also, lay out how to plan long term strategies, and ensure performance and control risks. They deal with the composition of boards, how they should be evaluated on their effectiveness as they play different precise roles. Board members should be responsible, independent and experienced individuals able to have an open dialogue with shareholders. Their compensation should depend on the outcomes they achieve and they should be elected by shareholders.

In order to ensure the representation of shareholders' interests in an organisation and to ensure that shareholders can exercise their rights, a set of Canadian statutes is in place. As previously mentioned, shareholders elect the directors who manage or supervise the management of the business and the affairs of the corporation (Hoffman & Klotz, 2013). Directors are nominated by management with the help of the nominating committee and then elected. According to Canadian legislation, a director does not have the authority to exercise fundamental changes without shareholder approval. For instance, selling a big portion of an organisation's assets would need the shareholders' approval. Another good example would be the continuance, discontinuance or expansion of the corporation into another jurisdiction. When it comes to public corporations, rules of stock exchange, such as for the TSX, can require additional approval for certain circumstances that normal legislation wouldn't impose. An example could be carrying out transactions that materially affect the control of the corporation. Procedures on how shareholders can raise issues about the corporation to management are explained under the statutes. It is indicated here that shareholders who own at least 1% of the total voting shares or have held voting shares worth a minimum fair market value of $2,000, for six months, can submit a proposal to raise a matter at a shareholders' meeting. Management has to give notice to the proposals and include brief statements in support of the proposal. A shareholder holding 5% of the voting shares of a corporation can demand a shareholders' meeting. If a shareholder feels that a corporation has violated his or her rights, a variety of actions can be undertaken, such as for instance, going to court. Minority shareholders rights are also protected. For example commissions from provinces such as Ontario and Quebec have adopted policy 61-101 *Protection of Minority Security Holders in Special Transactions*. The following figure is the ideal model of a governance structure that should be in place in Canadian Corporations. Evidently, shareholders are at the top of the hierarchy since they own corporations.

Figure 1.1.1. Model of corporate governance



Note: based on Hansell, 2003

There is a very important relationship between the external auditor, the board of directors and the shareholders. The external auditor emits an opinion on the financial information reported by the issuer. The external auditor is hired and paid by the board and has a mandate of protecting the shareholders by validating that the issuer has reported reliable information. Financial information is the most important variable when it comes to shareholders making decisions. Naturally, regulations and internal auditors must ensure that the external auditor is as independent as he or she can be. Independence ensures that the external auditor is not influenced by the issuer and gives a non-biased opinion. Under the shareholders in the diagram are the elected board members in charge of overseeing corporations' activities. In small private companies, shareholders and directors are normally the same people. This means there is no real division of power and financial information is reported for reasons other than public interest. When it comes to large public corporations, the board has more of a supervisory role with respect to executive officers at the management level. The audit committee's role is to help the board of directors fulfill their responsibility of monitoring the process of financial reporting. The internal auditor watches over management activities and reports to the audit committee regarding improper activities or controls and recommends enhancements of practices.

Financial information is not only very important for shareholders but also for many other stakeholders' decision processes. Customers, suppliers, employees, lenders and local communities have a stake in, and are affected by, a firm's success or failure (Heath & Norman, 2004). Of course, since shareholders are providers of capital, owners and finance corporations on a long term basis, management and corporate law tend to adopt a more shareholder-oriented governance way of thinking. As mentioned before, governance leaders must attempt to align the interests of all stakeholders. This practice is very beneficial in the long run; a successful corporation aims to develop strong relationships with all of its stakeholders thus contributing to its competitive advantages and ensuring its future existence. With financial information being highly important for many parties, Canada regulated the reporting of corporations with the National Policy 52-201 entitled *Disclosure Standards*. These standards are very similar to American standards and do not need to be presented in this work. A more relevant policy regarding governance in Canada is the corporate governance guidelines.

1.3.3. Board of Directors' Practices

The purpose of policy 58-201 is to provide guidance on governance practices. The following summary of the guidelines consists of addressing the primary topics of NP 58-201 which have been composed to balance out the protection of investors as well as fostering confidence, fairness and efficiency in capital markets. The policy also aims to take into consideration the development and continuous involvement of corporate governance in the United States and around the world. A reality of the Canadian corporate landscape is that there is a very large number of small companies and controlled companies that also need to follow governance regulations. This is taken into consideration in NP 58-201 since these entities do not necessarily have the same available resources as larger corporations to enable them to comply with specific policies.

Composition of the Board of Directors

The board should have a majority of independent directors; a director is independent if he or she has no direct or indirect material relationship with the issuer. According to regulation 52-110 *Respecting Audit Committees,* a "material relationship" is a relationship which could be reasonably expected to interfere with the exercise of a member's independent judgment. National Policy 58-101 elaborates that the board of directors must disclose the identity of directors who are independent as well as the ones that are not independent. The board must disclose if a director is participating in any other issuing entity. Independent directors need to disclose the frequency of their meetings without the non-independent members. It is very important to disclose whether the chair of the board is independent or not.

Meetings of Independent Directors

The independent directors should hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance (NP 58-201). National policy 58-101 indicates that an attendance record of each member for all meetings must be disclosed.

Board Mandate

A board should have a written mandate where members recognize their responsibility on managing the issuer. The mandate should explain how the board ensures the integrity of the chief executive officer (CEO) and other executives as well as how it ensures that an organizational culture of integrity is implemented by the CEO and other executive officers. The mandate must describe how the board is going to adopt and approve (at least once a year) a strategic planning process that includes an enumeration of the opportunities and risks of the organization. The written mandate should define how the board is going to illustrate the principal risks of the business and how it intends to manage risks. The board members have the responsibility of creating a detailed succession plan. The board must indicate how it intends to communicate with the issuer and what its responsibility is regarding the issuer`s internal controls and management information systems. The mandate has to explain how the board is going to develop and implement policies towards the issuer's approach on corporate governance. National Policy 58-101 states that the board of directors must disclose the text of the board's written mandate.

Position Descriptions

The board should develop clear position descriptions for the chair of the board and the chair of each board committee. In addition, the board, in collaboration with the CEO, should develop a clear position description for the CEO, which includes a layout of management's responsibilities. The board should also develop or approve the corporate goals and objectives that the CEO is responsible for meeting (NP 58-201). According to National Policy 58-101, the board must disclose if it has a written position description for the chair of the board, all of its committees and for the CEO.

Orientation and Continuing Education

The board is responsible for providing an orientation to all new directors. After an orientation, directors should understand the role of the board including its committees and the purpose of each executive officer. Of course, new directors need to comprehend the operations of the issuer's organisation. Directors should have access to continuing education opportunities. This will maintain and enhance the quality of their contribution to the business. National policy 58-101 indicates that the board must briefly describe the measures it takes to orient new directors and what measures it takes to provide them with continuing education.

Code of Business Conduct and Ethics

The board should adopt a written code of business conduct and ethics. The code should be applicable to directors, officers and employees of the issuer. The board should be responsible for monitoring compliance with the code. The code should constitute written standards that are reasonably designed to promote integrity and to deter wrongdoing. In particular, it should address conflicts of interest, protection and proper use of corporate assets, confidentiality of corporate information, compliance with laws, rules and regulations, reporting of any illegal or unethical behaviour and fair dealing with the issuer's security holders, customers, suppliers, competitors and employees (58-201). Compared to the United States, Canadian corporations are obligated to achieve a balance in meeting all stakeholders' expectations (Gendron et al., 2016). According to National Policy 58-101, the board must disclose if they have a written code and describe how it ensures that the directors exercise independent judgement in accomplishing their jobs. The board also has to explain how it promotes a culture of ethical business conduct.

Nomination of Directors

A nominating committee should be appointed by the board. The committee should only be composed of independent directors and should adopt a written charter indicating its mandate, responsibilities, and procedures on when and how to communicate with the board, also, the qualifications and authority of its members. The nominating committee is responsible for determining the competencies and skills needed in board members, the appropriate size of the board in order to facilitate decision making and identifying individuals qualified to become new board members. National Policy 58-101 indicates that the board must disclose its process in identifying potential new candidates for board nomination. If the board has a nominating committee, it has to describe all of its members and their responsibilities and authorities. National Policy 58-101 also indicates that boards must disclose director term limits and other mechanisms of board renewal.

Regular Board Assessments

The board, its committees and each individual director should be regularly assessed with regard to the effectiveness and the contribution made to the organisation by each one (NP 58-201). National Policy 58-101 indicates that a board must disclose if directors are regularly assessed regarding their effectiveness and contribution.

1.3.4. Directors' Remuneration Practices

A compensation committee should be appointed by the board of directors. The committee should only be composed of independent directors and should adopt a written charter indicating its mandate, responsibilities, and procedures on when and how to communicate the matter of compensation to the board, and also, the qualifications and authority of its members. According to National Policy 58-101, the board must disclose its procedures regarding the determination of the issuer's directors' and officers' compensations. If the board has a compensation committee, it has to describe all of its members and their responsibilities and authorities. Compensation is a subject that is frequently addressed in corporate governance since it can be used as a control lever ensuring that responsibilities delegated are accomplished, thus contributing to a corporation's long-term strategies. Since the year 2000, board members' compensation has doubled in Canada (Magnan, 2014). Although United States corporations pay higher compensation to their board members, Canadian corporations have one of the highest compensation levels in the world. Furthermore, over the 10-year period from 2001 to 2010, the average annual fees received by directors of Canadian public corporations have effectively increased substantially from $17,044 to $79,000, or an increase of 465% (Magnan, 2014). In Canada, 7 out of the 10 corporations that pay board members the most are active in the resources sector (oil, gas, oil and gas pipelines, mines); according to the survey of the 100 largest Canadian corporations conducted by Spencer Stuart, in 2011, the average compensation for board members of a resource sector varied between $180,000 to $190,000 compared to the rest of large Canadian corporations at an average of $98,000. In comparison, the compensation paid to the directors of the French company *Total*, a giant in the global oil industry, is within the range of 60,000 to 163,000 euros, with the median being about 70,000 euros (about $98,000) (Magnan, 2014). The main reason why compensation has increased so fast is simply because more is expected from board members, especially with the numerous national policies that have been enacted in the past two decades due to American scandals. Naturally, when someone's workload is increased, the salary is expected to rise proportionally as well. Does this mean that the enormous increases in compensation witnessed since 2000 for board members are reasonable? Many argue that paying board members so much affects their economic independency to the issuers which directly influences their professional judgement regarding the correct accomplishment of their duties. One of the largest institutional investors in Canada, the Ontario Teachers' Pension Plan (OTPP) stated "*...we believe there is a point at which the amount of compensation may negatively* *impact a director's ability to act independently. In determining this '"tipping point', we may consider a peer comparison and/or our assessment of decisions taken by the board and/or directors.*" The IGOPP published a policy paper on the issue in which it recommended that the debate on directors' independence should be refocused on legitimacy and credibility (Allaire, 2008). According to this policy paper, directors' independence as advanced by the regulatory authorities and pressure groups is only one facet of legitimacy, and *"While it is legitimacy that gives a board the authority to impose its will on management, it is credibility that makes a board effective and value-creating"* (Allaire, 2008). Unless we investigate every board member's personal financial situation, we cannot comment on a particular board member's economic dependency on compensation earned as a director. Legislation and regulations should focus on whether or not the compensation implemented is a control that ensures the effectiveness and contribution expected from a board member. In order to do so, we must ensure that every board member's roles and responsibilities are well defined and understood. Although Canada isn't in a crisis regarding directors' compensation, over the past decades their pay has substantially increased. In order to ensure that reasonable compensation is implemented, many principles have been developed. The following are two examples of policies relating to principles enacted by the Canadian Institute of Chartered Accountants and The Canadian Coalition for Good Governance (CCGG).

a) Seven Director Pay Principles and Goals by the Canadian Institute of Chartered Accountants (Greville & Crawford, 2004).

- Directors should be adequately compensated for their time and effort.
- There should be no distinction in pay for board members performing similar roles (time and effort).
- Distinctions should be made for board members with greater responsibilities (e.g., committee service, committee chair, board chair).
- Share ownership is a critical goal.
- The quantum of a mandatory director share investment for a particular board should be set at a level that recognizes the financial position of different board members (i.e., accommodate directors with lower economic means).
- Director tax efficiency should not be the main driver of director compensation design.
- Setting and disclosing director pay should be a deliberate and transparent process.

b) The Canadian Coalition for Good Governance suggestions towards directors' compensation.

These suggestions promote independent thinking by the directors while aligning their interests with those of the shareholders and should reflect their expertise and time commitment to their duties. They also promote shareholding by directors, aiming to make this to be the least complex and most transparent; and possibly may also be subject to shareholder approval.

1.3.5. The Representation of Women in Governance Bodies

The regulations on disclosing corporate governance practices have many policies regarding the participation of women in boards and executive officer positions. In 2007, 46% of public corporations had only one female board member and 51% had two or three (Dion, 2007). During the years 2000 to 2010, the percentage of women's representation in boards stagnated between 13% and 17% for public corporations (CIRANO, 2010). In the past two decades, Canada has made reasonable efforts in increasing opportunities for women in the governance line of work. Contrary to many countries like Norway and Spain who adopted legislation imposing targeted ratios of female presence in corporate governance positions, Canada decided to adopt a more incentive based approach (St-Onge & Magnan, 2010). National Policy 58-101 is the perfect example of a set of regulations that encourage corporations to increase governance position opportunities for women. Here are five specific topics from the national policy, related to women in industry.

a) Policies Regarding the Representation of Women on the Board.

Boards must indicate if issuers have adopted written policies regarding the identification and nomination of women directors. Indications include a summary of the policies' objectives, the measures in place to ensure the implementation of the policies, the progress in achieving the objectives of the policies and what indicators are used to evaluate the effectiveness of the policies.

b) Consideration of the Representation of Women in the Director Identification and Selection Process.

The board of directors must indicate how it or its nominating committee considers women's representation on the board during the nomination of candidates. If a certain level of female representation for election isn't considered by the issuer, the reasons why must be disclosed.

c) Consideration Given to the Representation of Women in Executive Officer Appointments.

Indications regarding the issuer's consideration of women's representation for executive officer appointments must be disclosed. If a certain level of female representation isn't considered by the issuer, the reasons why must be elaborated.

d) Issuer's Targets Regarding the Representation of Women on the Board and in Executive Officer Positions.

The issuer's targeted percentage of women's participation in boards and executive officer positions must be disclosed. Progress towards reaching its targets must be indicated and reasons, why targets aren't reached must be explained.

e) Number of Women on the Board and in Executive Officer Positions.

The percentage of board members and executive officers that are women must be disclosed.

By making corporations disclose all this information regarding a female presence in their governance practices, the CSA indirectly encourages organisations to increase female representation regarding director and executive officer positions. Since the appearance of a women policy in NP 58-101, many Canadian researchers have conducted studies on the advantages of having a balance of gender for members occupying board and executive positions. These advantages have proven to influence corporations in creating more opportunities for women in Canadian governance jobs.

Table 1.3.1. Percentage of women on the board of directors and in executive positions

	2011	*2012*	*2013*	*2014*	*2015*
% Women on the board (Canada)	0.097	0.109	0.114	0.126	0.137
No woman on the board (Canada)	0.445	0.417	0.402	0.331	0.287
% women in executive positions (Canada)	0.089	0.102	0.116	0.137	0.164

The above statistics, based on a sample of 162 Canadian companies listed on the Toronto Stock Exchange (TSX Composite), show that the percentage of women on boards of directors and in the senior executive management of Canadian companies increased from 2011 to 2015.

As with many policies related to Canadian governance, a very relevant control has been applied; the "comply or explain" policy. If Canadian corporations don't comply with regulations towards female representation in board and executive positions, they will be asked to explain why. Whether the reason is valid or not, an adapted solution will be proposed in order to correct or respect national policies in relation to women.

1.3.6. The Committees of the Board of Directors

Committees are created by board resolutions. These committees are formed in order to assign certain responsibilities to specialised administrators. These delegations do not mean that boards are no longer responsible for the tasks. Usually, three main committees are relied upon: the nominating committee, the compensation committee and, most importantly, the audit committee.

a) Nominating committee. As previously explained in NP 58-201, a nominating committee should be appointed by the board. The committee should only be composed of independent directors and should adopt a written charter indicating its mandate, responsibilities and procedures on when and how to communicate with the board, and also, the qualifications and authority of its members. The nominating committee is responsible for determining the competencies and skills needed in board members, the appropriate size of the board in order to facilitate decision making and identifying individuals qualified to become new board members.

b) Compensation committee. As previously explained in NP 58-201, a compensation committee should be appointed by the board. The committee should only be composed of independent directors and adopt a written charter indicating its mandate, responsibilities and procedures on when and how to communicate the matter of compensation with the board, also, the qualifications and authority of its members. According to National Policy 58-101, the board must disclose its procedures regarding the determination of the issuer's directors' and officers' compensations. If the board has a compensation committee, it has to describe all of its members and their responsibilities and authorities.

c) Audit Committee. The Audit committee is the only regulated committee in Canada. The first edition of regulation 52-110 *Respecting Audit Committee* was first published on March 30th, 2004. It describes that the committee's role is to help the board of directors in fulfilling their responsibility of monitoring the process of financial reporting. The committee facilitates communication between the CEOs, the board of directors and the external auditors and ensures complete independence. Of course, the Audit committee gets most of its work done by their internal auditor who has a key role in identifying and evaluating a corporation's principal risks. The internal auditor ensures the integrity of financial information and aims to enhance operational activities. According to the policy, the committee must have a written mandate explaining its responsibilities. One of its important responsibilities is to recommend an external auditor to the board as well as the auditor's compensation. The committee is directly responsible for overseeing the external auditor's work and is in charge of resolving any disagreements between the auditor and management. The audit committee is required to examine all financial statements, management reports and information regarding the financial status of the corporation. Since the regulation first came out, many modifications have been enacted to ensure that financial information is reliable.

1.3.7. Ownership Structures

Various corporate governance mechanisms are proposed to address issues of divergence of interests and to reduce agency costs associated with conflicts. Ownership structure is an important part of this and can affect significantly the value of the firm.

The Canadian corporate governance system is characterized by the presence of significant shareholders. This leads to a great dependence on the concentration of capital as a mechanism for aligning interests and controlling agency costs. Indeed, Canada has fewer widely-held firms than the United-States, with more ownership by families and financial institutions (King & Santor, 2007). Canadian firms are also more likely to use either pyramids or dual-class shares than do their American counterparts.

1.3.8. Market of Corporate Controls

Canada is considered a very bidder friendly jurisdiction. National Policy 62-202 Take-Over Bids – Defensive Tactics leaves Canadian boards with a limited number of defenses when faced with an unsolicited takeover bid (Liao, 2014). National Policy 62-202 sets out the view of the Canadian securities regulatory authorities on take-over bid defensive tactics. The Canadian securities regulatory authorities are of the view that the take-over bid provisions of Canadian securities legislation should favour neither the offeror nor the management of the target company, and should leave the shareholders of the target company free to make a fully informed decision. The Canadian securities regulatory authorities are prepared to examine target company tactics in specific cases to determine whether they are abusive of shareholder rights. If they become aware of defensive tactics that are likely to deny or severely limit the ability of shareholders to respond to a take-over bid or to a competing bid, they will take appropriate action. The National Policy also provides that prior shareholder approval of corporate action would, in appropriate cases, allay the concerns of the Canadian securities regulatory authorities.

1.3.9. Corporate Governance and Firm Performance

The recent financial crisis that hit the global economy and the scandals that affected several large companies in the world contributed to showing the importance of corporate governance. It has also increased the interest of researchers and policy-makers for thorough and detailed analyses on corporate governance and disclosure transparency. A review of the academic and professional managerial literature shows the importance of the board of directors in the corporate governance system; the board allows management to assist and control in the fulfillment of its mandate to protect the rights of shareholders and investors and consequently to improve company value (Fama & Jensen, 1983; Gouiaa & Zéghal, 2009). However, the effectiveness of this governance mechanism in fulfilling its roles and functions largely depends on its characteristics (Harris & Raviv, 2008). In a research study conducted on a sample of 192 Canadian companies in 2010, Gouiaa & Zéghal (2015) analyzed the effect of board characteristics on financing costs of Canadian corporations.

The obtained results reveal that larger boards, composed of competent and experienced directors including those where women are represented, in which the functions of the chairman and CEO are separated, which have a large, independent audit committee, and which meet more regularly, allow for a significantly improved transparency of disclosure through a broader level and with more detailed information. In addition, they show that larger boards composed of experienced and qualified directors, with greater ownership of independent directors, with larger audit committees, and in which financial institutions and women are represented can significantly reduce the financing costs by equity capital and debt as well as the average cost of capital (results presented in table 1.3.2). The results indicate that boards whose characteristics meet the requirements of good governance promote efficient control of management and the accounting and financial reporting process, and consequently allow greater disclosure transparency, leading to significantly reduced costs of financing by debt as well as by equity capital.

Table 1.3.2. Analysis of the effect of board characteristics on financing costs

Variable	***Pred. sign***	***COST_EQ***			***COST_DEBT***			***AVG_CC***		
		Coef.	***Sig.***	***VIF***	***Coef.***	***Sig.***	***VIF***	***Coef.***	***Sig.***	***VIF***
Intercept		0.016**	0.046	0.000	0.006**	0.020	0.000	0.027**	0.019	0.000
BRD_SIZE	-	-0.082*	0.061	1.645	-0.055*	0.075	1.516	-0.134*	0.072	0.762
BRD_IND	-	-0.224	0.194	2.111	-0.015	0.918	0.743	-0.181	0.182	2.277
DUAL	+	0.037	0.763	2.100	0.019	0.889	0.691	0.064	0.612	0.583
AUD_SIZE	-	-0.166**	0.027	0.740	-0.267*	0.098	1.367	-0.213	0.166	1.592
AUD_IND	-	-0.156	0.287	1.445	-0.055	0.726	2.189	-0.132	0.378	1.413
FIN_MOTIV	-	-0.059	0.196	0.891	-0.199*	0.085	0.678	-0.104	0.386	1.058
BRD_FREQ	-	-0.119	0.330	1.723	-0.079	0.154	1.359	-0.017	0.295	2.250
AC_FREQ	-	-0.078	0.150	2.219	-0.140	0.258	2.034	-0.076	0.519	1.405
BRD_TEN	-	-0.088*	0.100	1.556	-0.198**	0.015	1.839	-0.239*	0.071	2.124
FI_REP	-	-0.103**	0.042	2.078	-0.135**	0.034	1.125	-0.194*	0.088	0.796
WOM_REP	-	-0.173*	0.068	0.539	-0.072	0.589	0.740	-0.065	0.161	1.541
FRM_SIZE	-	-0.156**	0.029	1.343	-0.278*	0.083	1.739	-0.229*	0.083	1.662
ROA	-	-0.027	0.823	1.891	0.028	0.134	2.179	0.023	0.265	1.466
MB	-	-0.149	0.193	1.315	-0.065	0.160	2.006	-0.016	0.894	0.846
FIN_LEV	+	0.199*	0.092	0.679	0.026*	0.085	1.769	0.093*	0.086	0.954
VOLAT	+	0.018*	0.084	0.790	0.066	0.191	2.028	0.094**	0.042	1.324
MULT_LIST	-	-0.102*	0.085	0.792	-0.073	0.563	1.314	-0.162*	0.082	2.042
IND1	+/-	0.054	0.378	1.127	-0.173	0.216	2.016	-0.074	0.401	1.191
IND2	+/-	0.148	0.308	2.199	0.015	0.922	1.251	0.049	0.174	0.751
IND3	+/-	0.171	0.163	1.710	0.015	0.926	1.220	0.023*	0.088	1.402
IND4	+/-	-0.090	0.550	2.170	-0.163	0.314	0.499	-0.129	0.403	0.732
N = 192		Adjusted R^2 = 0.378			Adjusted R^2 = 0.289			Adjusted R^2 = 0.353		

*Note: ***, **, * indicate significance at the levels of 1%, 5%, and 10%;*

COST_EQ: *Cost of equity;* ***COST_DEBT****: Cost of debt;* ***AVG_CC****: Weighted average cost of capital;* ***BRD_SIZE****: Board size: Number of directors comprising the board of directors;* ***DUAL****: Duality or separation of CEO and chairman functions: Dummy variable that takes the value of 1 when the CEO is also the chairman of the board (duality) and 0 if otherwise (separation of functions);* ***BRD_IND****: Board independence: Percentage of independent directors on the board;* ***AUD_SIZE****: Audit committee independence: Percentage of independent directors on the audit committee;* ***AUD_IND****: Audit committee independence: Percentage of independent directors on the audit committee;* ***FIN_MOTIV****: Financial motivations of independent directors: Percentage of capital held by the independent directors;* ***BRD_TEN****: Board tenure: Average operating time of directors in the board;* ***BRD_FREQ****: Meeting frequency of the board: Number of meeting of the board of directors annually;* ***AC_FREQ****: Meeting frequency of audit committee: Number of meetings of the audit committee annually;* ***WOM_REP****: Representation of women on the board: Dummy variable that takes the value of 1 if one or more women are represented in the board and 0 if otherwise;* ***FI_REP****: Representation of financial institutions on the board: Dummy variable that takes the value of 1 when there are representatives of financial institutions on the board of the company and 0 if otherwise;* ***FRM_SIZE****: Firm size: Logarithm of the book value of total assets;* ***ROA****: Return on assets: Earnings before interest and taxes/total assets;* ***FIN_LEV****: Financial leverage: Leverage ratio based on book values = total debt/total assets;* ***MB****: Market to book: Growth opportunities measured by the ratio: Market value of equity/book value of equity;* ***MULT_LIST****: Multiple listing: Dummy variable that takes the value of 1 if the company is listed on international markets and 0 if it is listed on the Toronto Stock Exchange only;* ***VOLAT****: Volatility: Risk of the firm measured by the volatility of equity returns (standard deviation of stock returns);* ***IND****: Industry: Measured by four dichotomous variables for the four main industries: IND1 (energy), IND2 (materials), IND3 (manufactory), and IND4 (services). Each variable takes the value of 1 if the firm belongs to the specific industry and 0 otherwise.*

The results of this analysis show that the size of the board, its tenure, and size of its audit committee have a negative and statistically significant effect on the cost of equity. These results also show that boards of directors where women and financial institutions are represented allow for reducing the cost of financing. Examination of the results of the model analyzing the effect of board characteristics on the cost of debt shows that larger boards with greater ownership of independent directors, larger auditing committees and experienced and competent directors and where financial institutions are represented allow for reducing the cost of financing by debt. Finally, the review of the results of the regression model analyzing the effect of board characteristics on the average cost of capital shows that larger boards, composed of qualified and experienced directors and in which financial institutions are represented, have a negative and significant effect on the cost of funding. Moreover, these results show that larger companies listed on foreign stock-exchange markets, with lower financial leverage, lower returns volatility, and not belonging to the manufacturing sector, enjoy a lower average cost of capital.

1.3.10. Conclusion

In recent years, increasing attention has been paid to corporate governance around the world particularly after the collapse of several international companies and recurring financial crises. Therefore, corporate governance mechanisms have been constantly evaluated and reformed by policymakers and market participants to develop a framework of best governance practices that can improve firm performance and avoid such crises. Compared to a reactive approach such as that of implementing the Sarbanes-Oxley law in the United States, Canada decided to proactively reform the way it dealt with corporate governance by adopting corporate governance guidelines that promote transparency and are based on the comply or explain principle. This reform primarily changed how corporate governance, which used to be based on principles that called upon practitioners' professional judgment, has now changed to our current situation consisting of multiple regulations.

The securities commissions are now playing a major role in shaping Canadian corporate governance practices. By virtue of the fact that the securities commissions have a public interest jurisdiction to protect the capital markets, their influence has pushed Canada toward a more shareholder-centric model of governance increasing therefore shareholders' rights beyond the Canadian corporate law (Liao, 2014).

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1.4.a. CORPORATE GOVERNANCE IN AUSTRALIA

Kim Backhouse
Mark Wickham

1.4.a.1. Introduction

Corporate governance in Australia acts as an important control mechanism that links the direction of an organisation with its economic, social and environmental (i.e. Triple-Bottom Line) performance. The challenge of corporate governance in Australian corporations is similar to those faced by the majority of corporations operating internationally today (see Clark, 2006; Jensen, 2005) – but the manner in corporate governance is structured in Australia represent a strong reflection of the island continent's people, egalitarian culture, and legislative framework. This chapter will provide a summary of what the corporate governance concept means in the Australian context, before describing the legal and regulatory framework that underpins the concept in that country. Next, the chapter will provide an overview of the external market for corporate control, and the implications this has for the typical ownership structures and remuneration practices (for Boards of Directors). Lastly, this chapter will focus on specific shareholder rights and shareholder activism in Australia, and how these together influence the way Australian corporations link corporate governance practices to organisational performance and standards of corporate social responsibility.

1.4.a.2. Definition of Corporate Governance (in Australia)

To date, corporate governance in Australia has been studied from a variety of theoretical perspectives; in particular: Agency Theory; Stewardship Theory; Resource Dependency Theory; Shareholder Theory; and Stakeholder Theory. Most notably, scholars from organisational theory, strategic management (see Boyd, 1995), sociology (see Useem, 1984), finance (see Fama, 1980), economics (see Jensen and Meckling, 1976; Tirole, 2001) and law (see Richards and Stearn, 1999) have provided the basis for the majority of Australia's corporate governance research over the past three decades[4]. The myriad of approaches to the topic have resulted in many normative definitions in the Australian context (that might best be described as a set of descriptive statements about what corporate governance "may include", or "might do" etc. rather than a sound theoretical basis for promoting corporate transparency). Often the quasi-definitions appear in authoritative academic literature, where authors consider corporate governance as merely the set of methods to ensure that investors, suppliers of finance,

[4] From an international perspective on corporate governance there have been significant legislative reforms, in particular in countries such as the United Kingdom (UK) and United States of America (USA). In the UK, corporate governance standards are clearly set out in the Cadbury Committee (1992), Greenbury Committee (1995), Hampel Committee (1998), LSE (1998) to protect shareholder's interests. In the USA, the Round Table (1997) and The Sarbanes–Oxley Act of 2002 set new or enhanced standards for all U.S. public company boards to observe.

shareholders, or creditors get a return on their investment. Sir Adrian Cadbury's (2004) definition of corporate governance is widely accepted as the most fitting for the egalitarian Australian context: "… [corporate governance represents] the system by which companies are directed and controlled. Board of Directors is responsible for the governance of their companies, ensuring that they are well run" (1992). The significance of corporate governance was captured in a broader definition authored by Cadbury (2004) who noted that the governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.

1.4.a.3. Overview of the Legal Framework of Corporate Governance in Australia

In Australia, a Board of Directors is a legal requirement set out in the *Corporations Act* 2001 (Commonwealth). Boards of Directors are fundamental to corporate governance, with legislation outlining certain powers and responsibilities to be carried out for the best interests of the relevant shareholders (and indirectly to the entire market). In terms of its prime directive, the legal framework in Australia is not primarily concerned with adding value to the organisation (although it does attempt to protect shareholder rights); instead, is based on the traditional conventions of Anglo-Saxon trust law. The *Corporations Act* 2001 (Commonwealth) provides a mandatory legal requirement that all Australian companies must have directors. There are different requirements for a proprietary company which has at least one director (section 201A(1)) compared to a public company which must have a minimum of three directors (section 201A(2)). The Board of Directors according to ASX CGC Principle 2:

> *An effective board is one that facilitates the effective discharge of the duties imposed by law on the directors and adds value in a way that is appropriate to the particular company's circumstance.*

The importance of corporate governance in Australia was initially recognised in 1995, with the Australian Securities Exchange (ASX) introducing Listing Rule 3c(3)(i) requiring listed companies to include in their annual report a statement of the main corporate governance practices they had adopted (Henry, 2008). Subsequently, and in response to criticism following the aftermath of corporate collapses, the ASX Corporate Governance Council (ASX CGC) released in March 2003, the first version of the ASX Corporate Governance Principles and Guidelines (ASX Guidelines). These guidelines have been further revised are designed to provide best practice corporate governance measures for ASX listed entities. They are based around eight central principles and 29 specific recommendations published by the Australian Stock Exchange Corporate Governance Council (2009), which is an important document outlining key elements of corporate governance released in May 2014.

The Principles and recommendations of the ASX Council:

- Lay solid foundations for management and oversight;
- Structure the Board of Directors to add value;
- Act ethically and responsibly;
- Safeguard integrity in corporate reporting;

- Make timely and balanced disclosure;
- Respect the rights of security holders;
- Recognise and manage risk;
- Remunerate fairly and responsibly.

Despite that fact that the Principles and Recommendations listed above were only intended to apply to ASX listed entities (albeit not mandatorily), many other Australian entities have adopted them (as appropriate) to form part of their own governance strategies.

1.4.a.4. Market for Corporate Control

Tricker's (1994) model of corporate governance in Figure 1.4.a.1 provides a starting point to examine the role of corporate governance as an external control for Australian corporations (in both national and international markets). The typical external market control measures apparent in open market contexts (i.e. hostile take-over bids, buying controlling interests, removal of Board of Directors by shareholders etc.) operate in Australia, and manifest in the following ways: increased regulatory compliance; internal monitoring; self-regulation of individual trustees and directors, monitoring of Board of Directors' collective performance (which includes scrutiny of strategy formulation and policymaking); change in organisational strategy etc. The Board of Trustees or company directors is an important internal governance mechanism that exists to monitor external market expectations and change/adapt strategy to meet them (see the relationship described in Figure 1.4.a.2).

Monks and Minow (2004) refer to a tri-partite of participants in the corporate governance framework that must work together for mutual benefit (see Figure 1.4.a.2): shareholders, management (led by the Chief Executive Officer) and the Board of Directors. Australia is thought to be characteristic of the 'outsider system' of corporate governance, where key elements of corporate governance include: Board of Directors structure; Board of Directors process; and Board of Directors behavioural dynamics.

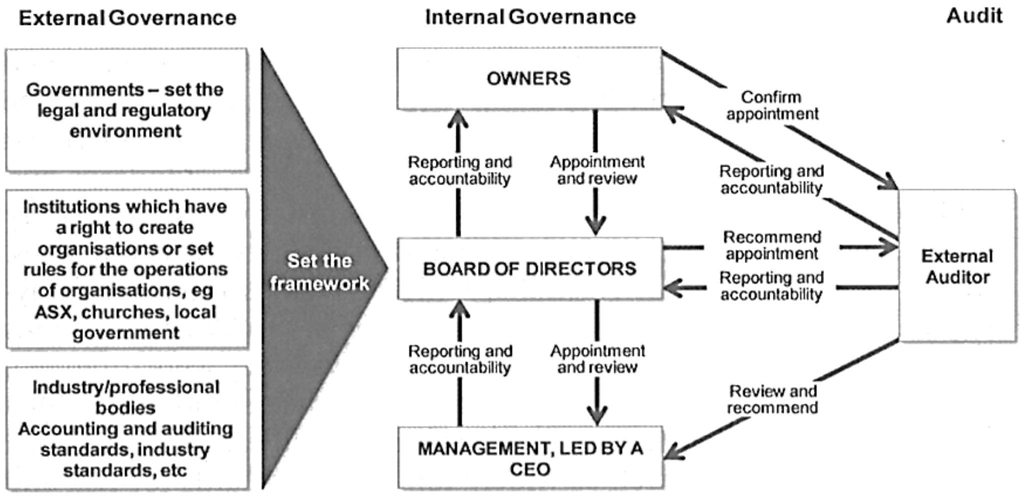
Figure 1.4.a.1. Tricker's model of corporate governance

	Compliance Roles	***Performance Roles***
External Role	Provide Accountability	Strategy Formulation
Internal Role	Monitoring and Supervising	Policy-making
	Past and Present Oriented	***Future Oriented***

Approve and work with and through the CEO

Source: Tricker (1994)

Figure 1.4.a.2. Corporate governance framework in the 21st century



Source: Keil, Nicholson, Tunny and Beck (2012).

1.4.a.5. The Role of the Board of Directors

Board of Directors Structure

Board of Directors structure concerns its size, Board of Directors composition, skill sets and is important in the effectiveness of a board determining the ability of the board members to work together (Kiel, 2012). Each of these will be discussed in turn:

1. *Size:* Clark (2004) argues that size is a hindrance on governance capacity and performance. Research by Jensen (1993) recommends a limit of eight directors as any larger number will interfere with group dynamics and inhibit Board of Directors performance and a larger board brings a greater level of bureaucracy. Dalton, Johnson and Ellstrand's (1999) viewpoint was less definitive noting that it is not the size of the Board of Directors that is critical, in relation to governance, but rather the number of outside members of the board. Notwithstanding this viewpoint, Keil (2012) notes that the key consideration should be around whether there are enough directors to provide the skills that the Board of Directors needs at the boardroom table. All the above researchers raise valid points and it is recommended in the Australian context that like that regardless of whether it is a commercial Board of Directors, superannuation Board of Directors of not-for-profit Board of Directors, that the Board of Directors size should not exceed eight or nine board members with the pre-requisite skills and experience that should be expected around a boardroom table.

2. *Board composition:* Research suggests that Board of Directors composition does matter. Dalton, Daily, Ellstrand and Johnson (1998) note that the board's composition and leadership structure can influence a variety of organisational outcomes (Beatty and Zajac, 1994; Daily and Dalton, 1992, 1993). Factors such as culture and ownership structure impact on Board of Directors composition (Kiel, et al, 2012). Related studies

on the issue of the diversity of Board of Directors, and other have identified that the large majority of directors are white males from a managerial or professional background in their fifties or sixties and that a number of observations could be made about their personalities, including a personality profile to be much less risk averse a diverse board (CAMAC Report, 2009).

3. Trustee or director skill set: Trustee competence is gained from experience, skills, attitudes and knowledge (Kiel, et al, 2012). Behavioural competencies also influence the relationships around the boardroom table, in particular, between the Board of Directors and management and between trustees or directors (Kiel, et al, 2012). The area of Board of Directors' skills and capabilities is an extremely important one in Australia and the author believes that it has not been given the attention that it currently deserves.

Table 1.4.a.1 provides insight into the sorts of expertise available by different types of directors or trustees. Notwithstanding, research by Thomas, Kidd and Fernandez-Araoz (2007) found that after investigating over 100 Boards of Directors over a five-year period, many boards lack competent members.

Table 1.4.a.1. Expertise of different type of directors or trustees

Director Category	***Areas of Resources Provided***	***Type of Director***
Insiders	• Expertise on the firm, its strategy, and direction • Specific knowledge in areas such as finance and law	• Current and former officers of the firm
Business Experts	• Expertise on competition decision-making and problem solving in large firms • Serve as 'sounding boards' for ideas • Alternative viewpoints on problems • Channels of communication between firms • Legitimacy	• Current and former senior officers of other large for-profit firms • Directors of other large for-profit firms
Support Specialists	• Specialised expertise on law, banking, insurance and public relations • Channels of communication to large and powerful suppliers or government agencies • Ease of access to vital resources, such as financial capital and legal support • Legitimacy	• Lawyers • Bankers (commercial and investment) • Insurance company representatives • Public relations experts
Community Influentials	• Non-business perspectives on issues, problems, and ideas • Influence with powerful stakeholders • Representation of interests outside competitive products or supply markets • Legitimacy	• Political leaders • University faculty • Members of clergy • Leaders of social or community organisations

Source: Hillman, Cannella and Paetzold (2000).

Demb and Neubauer (1990: 156) acknowledge that "…there is no 'perfect' structure for a board; each organisation must put a Board of Directors in place with a composition and shape – tailored to fit its legal environment, the company's size and development stage, and the personality of its Chairman and CEO." Similarly, Keil, et al. (2012: 201) acknowledges that, "… no one particular Board of Directors structure will impact corporate performance more favourably than another structure." The structure of each Board of Directors needs to be determined by the characteristics of each entity in isolation. Regardless of the country of origin, Board of Directors roles such as monitoring and ratifying role (Bosch, 2005), supervisory and management function (Demb and Neubauer, 1992) and strategic and control roles of directors identified by leading international academics remain relevant to the Australian context.

Board of Directors Process

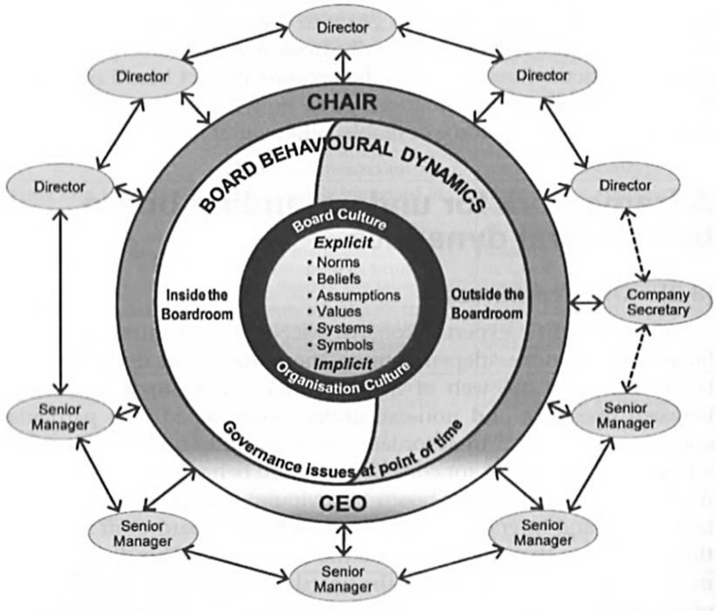
Board of Directors processes is another element that should be recognised in any corporate governance framework. Process variables include frequency and length of meetings; formality of Board of Directors proceedings; Board of Directors evaluations; professional development; Board of Directors meeting agendas, Board of Directors minutes and committees. These processes are important in the overall context of corporate governance in Australia.

Board of Directors Behavioural Dynamics

Kiel et al. (2012: 608) define Board of Directors behavioural dynamics as resulting from "… social and psychological processes occur between directors and between the Board of Directors and other groups, especially management. The individual and collective behaviours of the board and its members are dynamic as they continually change over time resulting from the changing issues facing the board at a particular point of time and the coming and going of individuals on both the board and in other groups." The effectiveness of the Board of Directors in making decisions is clearly influenced by the behavioural characteristics of the directors that make up the Board of Directors (Leblanc and Gillies, 2005).

Board of Directors' behavioural dynamics are central to effective outcomes (Kiel et al, 2012) and appropriate boardroom behaviours are an essential component of best practice corporate governance as outlined by the UK Institute of Chartered Secretaries and Administrators. Board of Directors behavioural dynamics can be an extremely difficult area for board members to address when they are dealing with individual trustees whose "… personality characteristics detract from the overall performance of the Board of Directors (Kiel et al, 2012). Another level of complexity is added in the context of the ASI, where the trustee of an ASF is a representative appointed by a class of members and retains the support of that particular class of members. Kiel et al.'s (2012) research positioned the Board of Directors behavioural dynamics at the centre of the corporate governance Practice Framework. Roberts, McNulty and Stiles (2005), acknowledge that Board of Directors effectiveness "… depends upon the behavioural dynamics of a board and how the web of interpersonal and group relationships between executive and non-executives is developed in a particular company context."

Figure 1.4.a.3. A framework for considering Board of Directors behavioural dynamics



Source: Keil et. al. (2012).

These researchers noted that there are four important drivers of Board of Directors behavioural dynamics are set out in Figure 1.4.a.3. The first driver is in relation to the governance at a particular point in time. The second is the impact of both organisational and board cultures. The third driver relates to the Chair and CEO's personalities and how they interact with each other. The fourth driver involves the personalities of the trustee/directors. These researchers acknowledge that the behaviours of trustees reflect the board culture and the wider organisational culture (Keil *et al*, 2012). Tricker (2003), acknowledges that it is often more complicated: "Board behaviour does not consist of sets of contractual relationships, but is influenced by interpersonal behaviour, group dynamics, and political intrigue". Judge (1989) further notes that board behaviour is often treated as a black "box" in these studies and researchers can only "… speculate on actual board behaviour".

Board of Directors Practices

In Governance Theory, one of the main challenges for leaders today is to maintain the Board of Director's key role in the governance system (Demb and Neubauer, 1990) and it is recognised by this researcher as a major challenge moving forward for boards in Australia. The clear ramifications for governance for Australian Boards of Directors from an agency perspective is that adequate monitoring or control mechanisms need to be established to protect the members of the fund from management's conflict of interest – the so-called 'agency costs' of modern capitalism (Fama and Jensen, 1983). This research supports the notion that in most instances, the Board of Directors in Australia is an important mechanism to alleviate agency problems in principal-agent relationships. Legally, the Board of Directors' monitors the board's functions and represents the shareholders' interests. The Board of Directors is elected by shareholders and has the ultimate decision-making and voting rights over the organisation's assets. In general, the chief executive officer reports directly to the Board of Directors.

The two most important responsibilities for the Board of Directors in this regard are: the strategic vision, setting the strategy and direction of the organisation; and the recruitment, performance management and termination (if necessary) of the CEO. In summary, the board of an Australian entity would deal with both the strategic direction and trying to maintain the sustainable competitive advantage of the organisation in an ever-changing economic landscape. Whereas, the CEO and other senior managers would deal with the operational matters of the business on a daily basis. There is considerable debate whether the board develops or ratifies the strategy of the organisation; Fama and Jensen's (1983) research, for example, outlines the different arguments pertaining to this notion. For sake of completeness, it is noteworthy that the Board of Directors in Australia can comprise of both independent and non-executive directors; the Australian Stock Exchange (2003) definition states that:

> *An independent director is a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgment.*

Boards of Directors in Australia need to consider a suitable mix of independent directors for the board composition. The ASX CGC recommends that a majority of the Board of Directors should be independent directors and that the roles of the chair and the chief executive Officers should not be exercised by the same individual. Company Law in Australia sets out Directors' general duties imposed by the *Corporations Act* on directors. They include:

- The duty to exercise their powers and duties with the care and diligence that a reasonable person would have which includes taking steps to ensure you are properly informed about the financial position of the company and ensuring the company does not trade if it is insolvent;
- The duty to exercise your powers and duties in good faith in the best interests of the company;
- The duty not to improperly use your position to gain an advantage for yourself or someone else, or to cause detriment to the company; and
- A duty not to improperly use information obtained through your position to gain an advantage for yourself or to cause detriment to the company. Directors have a positive duty to prevent your company trading if it is insolvent. The Australian Investments and Security Commission issued a Regulatory Guide (217) on the duty to prevent insolvent trading for directors.

In Australia, a director's legal duty is to the Company itself and they are not to act for any personal gain. As pointed out by Dellaportas, Thomsen and Conyon (2012), "… this differs slightly from the US, which relies on a shareholder-centric common law system, and the UK, in which a legal duty is owed to stakeholders as well as shareholders".

Board of Directors' Remuneration Practices

The Board of Directors is responsible for determining a remuneration policy and the level of compensation for both directors and senior executives in Australia. Remuneration is varied among Board of Directors in Australia. Under section 300A of the *Corporations Act 2001* (Cth), listed companies must present a remuneration report to shareholders at every annual general meeting showing the Board's policies for determining the nature and amount of remuneration paid to key management personnel (which includes any director). In 2012, the ASIC announced that companies should improve their practices with respect to the disclosure of their remuneration arrangements for directors and executives of publicly listed companies. This followed on from a review of 50 remuneration reports - drawn from 300 of Australia's biggest companies - for the year ended 30 June 2011: *'It is important for the integrity of the market and investor confidence that there is a high level of compliance with the executive remuneration laws'* (ASIC Deputy Chairman Belinda Gibson, 2011). Gibson (2011) also noted that those companies need to also provide shareholders with a better understanding of why directors have adopted the remuneration arrangements they have and provide sufficient detail on the remuneration arrangements to enable shareholders to assess the appropriateness of them in the company's circumstances.

The role of the remuneration committee was considered by the Governance Institute of Australia ('The Institute') in 2014. The Institute published a Good Governance Guide noting that the role of the remuneration committee should take account of: disclosure of remuneration policies, level and mix of remuneration; and the process for setting remuneration and assessing performance. Further, the ASX CGC noted that a Remuneration Committee may be a more efficient vehicle to focus on a remuneration policy rather than the full Board of Directors.

1.4.a.6. Ownership Structures of Companies in Australia

Australian corporations must be registered by the Australian Securities and Investment Commission (ASIC) and they legally operate under the *Corporations Act* 2001 *(Cth)*. In relation to limitation of liability of a company in Australia, there are two different types: 'Limited by guarantee' (i.e. the liability of members is restricted to an amount set out in the company constitution) and 'Limited by shares'. Contemporary literature refers primarily to two model types for corporate governance: namely, the outsider and insider models (Short, Keasey, Hull and Wright, 1998; Solomon, 2007). Solomon (2007: 181) points out that:

> *Every country exhibits a unique system of corporate governance: there are as many corporate governance systems as there are countries. The system of corporate governance presiding in any one country is determined by a wide array of internal factors including ownership structure, the state of the economy, the legal system, and government policies.*

1.4.a.7. Shareholder's Rights Protection

There are various types of shareholders in Australia ranging from small 'mum and dad investors', to wealthy private individuals, to large institutional investors (such as superannuation (i.e. pension) funds)). The *Corporations Act* 2001 (Cth) sets out the rights pertaining to all shareholders in Australia. *The Corporations Law* deals with becoming a shareholder and ceasing to be a shareholder in sections 117, 120, 601AA-601AD of the *Corporations Act* 2001 (Cth). Australian companies may have different classes of shares. The rights and restrictions attached to the shares in a class distinguish it from other classes of shares are sections 254A-254B of the Corporations Law. Section 252D which deals with the *Calling of Meetings* under the *Corporations Law* allows for members to call meetings of all shareholders or meetings of only those shareholders who hold a particular class of shares. Shareholders who hold at least 5% of the votes which may be cast at a general meeting of a company have the power to call and hold a meeting themselves or to require the directors to call and hold a meeting. Meetings may be held regularly or to resolve specific questions about the management or business of the company. The Corporations Law sets out rules dealing with shareholders' meetings. A shareholder of a company may ask the company for a copy of the record of a meeting or of a decision of shareholders taken without a meeting. Different rights to vote at meetings of shareholders may attach to different classes of shares. This is dealt with under sections 250E, 254A-254B of the Corporations Act 2001 (Cth). The buying and selling of shares in Australia is dealt with under sections 1091D-1091E of the Corporations Law. A shareholder may sell their shares but only if the sale does not breach the corporation's constitution.

1.4.a.8. Shareholder Activism

Compared to other developed financial markets, Australia's conditions favour shareholders when it comes to engaging with the companies they invest in. This is not only because of the rules in Australia's Corporations Act 2001 but also because of the large and growing pool of superannuation (i.e. pension) savings. Recent cases in Australia (such as Brickworks and Antares Energy) have attracted the public attention to the rights of shareholders in Australia. The 'two strikes rule' allows for 25% of shareholders in a publicly listed company to vote down a company's remuneration report, requiring the Board of Directors to revisit its remuneration strategy. Further, there have been recent amendments to the regulatory guidelines in Australia confirming that shareholders may communicate with each other about company's performance and act as 'voting blocs'. High profiles examples of recent activism in Australia include Mark Carnegie (from Funds Manager, Perpetual Company) in relation to the Brickworks Company demanding Board of Directors representation. The activist Janchor Partners Company had demands specific to remuneration in respect of Medibank Private Company Industry. Activist and high-profile Businessman Solomon Lew opposed the takeover terms by David Jones Company Industry; and finally, activist Lone Star Value Management demanded Board of Directors representation on Antares

Energy Company Industry Board. Approximately 50 Australian publicly listed companies have received some type of public demand from investors (Activist Insight Data, 2017) and activists have been elected to more than 100 Board seats in corporate Australia through shareholder activism.

Due to its legislative backing (and the increasing success that activism is enjoying) shareholder activism is not something that should not be ignored in the Australian context. It is important for representative Boards of Directors have a sound understanding of activism, and that they are well advised on dealing with activists' concerns in the context of the Australian culture and its legal framework.

1.4.a.9. Corporate Governance and Firm Performance

The topic of corporate governance and firm performance represents a comprehensive and growing area of research internationally. In an Australian context, as elsewhere, there is a major difficulty in determining a causal relationship between corporate governance and firm performance (especially when it comes to the more subjective indicators of social, environmental and innovative performance). The results of empirical research in Australia remains firmly divided between 'some support', 'inconclusive support' and 'no relationship' between corporate governance and organisational performance (largely depending on the independent and proxy dependent variables chosen to represent the relationship). Psaros (2009) provided a comprehensive meta-analysis on the link between corporate governance and economic performance and outlined the positive indirect relationship that corporate governance provides as a *facilitator* of economic performance. It was noted by Psaros (2009), that the "… editorial from the journal *Corporate Governance: An International Review* provides an endorsement for the economic merits of corporate governance (2002: 77):

> *There has been much discussion recently about whether corporate governance makes a difference to the bottom line, that is, does corporate governance improve shareholder value? Whilst, in my view, the evidence, both academic and practitioner, points on balance towards the view that good corporate governance helps realise value and create competitive advantage, this is more an intuitive feeling as the studies are trying to single out corporate governance variables that may affect performance and that is very difficult to do.*

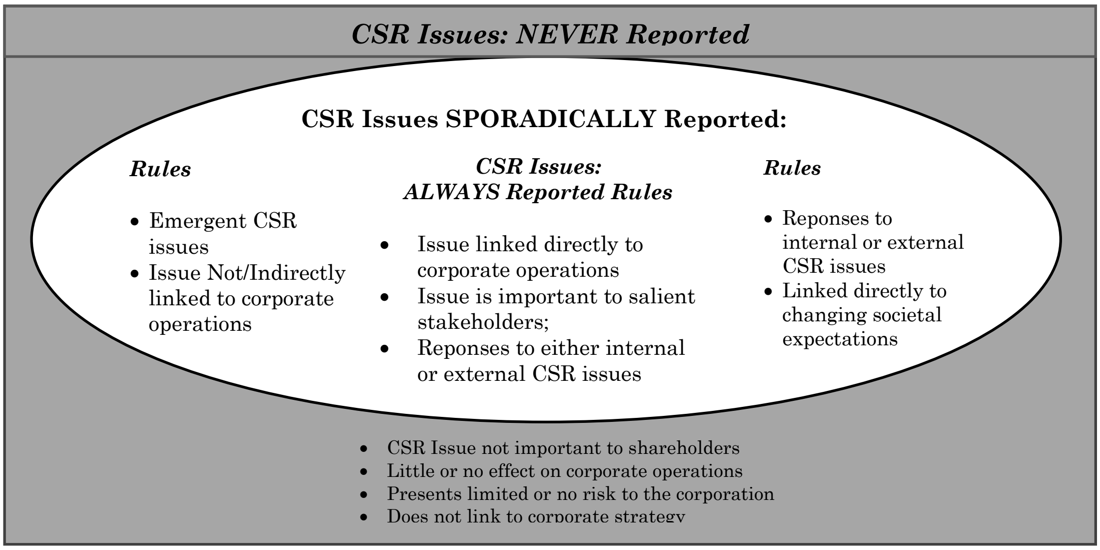
In an Australian context, Linden and Matolcsy (2004) examined whether corporate governance was directly related to firm performance and measured this by the Howarth Corporate Governance Score. Linden and Matolcsy (2004) found that there was no significant relationship between corporate governance and traditional measures of firm performance. Despite these findings, scholars, legislators, managers and investors alike remain convinced that corporate governance practices are nonetheless important measures for sustainable societal outcomes. Further research is obviously needed to form statistical or thematic relationships in this regard, as the majority of research is now somewhat dated (especially now that Australian corporations are becoming increasingly proactive with their use of Corporate Governance practices as bases for positive market differentiation).

1.4.a.9. Corporate Social Responsibility

Corporate Social Responsibility (CSR) has become a major factor in corporate governance in Australia over the past 20 years. In the practitioner sphere, the examination of CSR performance measures (specifically as a corporate governance criteria) has been researched by a range of commercial firms (c.f. Baker and McKenzie, 2007; KPMG, 2005, 2006), as well as peak and professional bodies (c.f. Business Council of Australia, 2002; Centre for Corporate Public Affairs, 2000; CPA Australia, 2005; Volunteering Australia, 2003). As a result, a variety of indices have been developed by to evaluate the CSR performance of Australian companies, most notably: the St James Ethics Centre's Corporate Responsibility Index (2003), the Reputex SR Index (2005), and the Australian CSR Standards ("AS 8003"). In support of all these indices, the Australian Institute of Social and Ethical Accountability and Models of Success and Sustainability (MOSS) have emerged to provide guidance for corporations to implement, measure and report their CSR performance measures more effectively.

Academic research conducted by Andrew, Wickham, O'Donohue, and Danzinger (2012) examined the role that CSR played in terms of corporate governance disclosures in Australia. Based on a content analysis of annual reports of the nine largest companies by market capitalisation (for the years 2005/6 to 2009/10), the results indicated that CSR impacted corporate governance reporting in three distinct ways: (i) CSR issues that were perceived as critically important by the corporations' salient stakeholders were consistently reported year-on-year; (ii) CSR issues that were important to the broader Australian community at a given point in time were sporadically reported as necessary; and (iii) CSR issues that were considered unimportant by the corporation's salient stakeholders were never reported. The findings and associated with this Australian study are summarised in Figure 1.4.a.4.

Figure 1.4.a.4. A model of CSR disclosure evident in Australian annual reports



Source: Andrew, Wickham, O'Donohue, and Danzinger (2012).

1.4.a.10. Conclusion

This chapter set out to provide a summary of corporate governance concept in the Australian context. In doing so, it has provided an overview of the legal and regulatory framework that underpins corporate governance in Australia and presented a review the typical the ownership structures, typical Board of Director roles and responsibilities (along with concomitant remuneration strategies) that exist therein. The chapter concluded with a discussion of shareholder rights and the manner in which corporate reporting practices reflect CSR and the country's egalitarian culture.

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1.4.b. CORPORATE GOVERNANCE CHALLENGES IN AUSTRALIA

Mark Rix
Anil Chandrakumara

1.4.b.1. Introduction

This chapter will investigate the challenges confronting advocates of good corporate governance in Australia's corporate sector and who seek a strengthening of the existing system of corporate governance in this country. Section 1.4.b.2 provides a brief overview of Australian company ownership structures asking whether and how these structures influence approaches to corporate governance that are adopted within company boardrooms. It also considers the available protections for minority shareholders, a significant issue arising from a company's ownership structure. This section then considers merger and acquisition activity in Australia and looks at how it affects corporate governance. Section 1.4.b.3 looks at boards of directors and their composition in the Australian corporate context and investigates the corporate governance practices and processes boards oversee with a particular emphasis on determination of director remuneration. This section will then consider the extent to which firm performance can be attributed to good corporate governance and questions whether firm (and, board) performance should be evaluated simply in terms of the financial bottom line. It will be argued that in determining directors' remuneration, important corporate social responsibility, sustainability and ethical dimensions or measures of the firm and board performance need to be given due weight. However, recognising that shareholders also have legitimate interests which boards have a responsibility to serve, attention will be given to the protections for shareholder rights that are available in Australia and to the role of shareholder activism in exercising and defending these rights. Finally, in this section, earnings management practices in Australia's corporate sector will be briefly considered including whether 'cooking the books' (understood as having both legal *and* ethical aspects) is common practice here. Section 1.4.b.4 of the chapter will examine current whistleblowing practices in corporate Australia. It will consider whether bolstering the protections for whistleblowers contained in Australia's whistleblowing legislation, along with a range of other enhancements, could help to improve corporate governance in Australian companies and bring significant benefits not only for shareholders but for a range of other stakeholders as well.

1.4.b.2. Australian Company Ownership Structures: Do They Have Any Influence on Corporate Governance?

This section is mainly concerned with understanding the influence that ownership structure has on corporate governance in the Australian corporate context. As an integral part of this inquiry, some attention will be given to the protections that are available to minority shareholders of Australian companies. The section also considers merger and acquisition (M & A) activity in this country and assesses its impact on corporate governance in Australian companies.

Firm Ownership Structures and Corporate Governance in Australia: Is the Picture Clear?

The connection between ownership structures and corporate governance in the Australian corporate context can be investigated through looking at factors such as the link between size of company (gauged by market capitalisation, perhaps a crude proxy for ownership structure), company performance measured in terms of shareholder value creation, and tenure or length of service of CEOs and Non-Executive Directors[5]. Writing recently in the Australian Institute of Company Directors *Company Directors* magazine, Paul Kerin comments that contrary to popular opinion a decision to end a CEO's tenure is more difficult than one to appoint a new CEO but boards make the latter call more often than is commonly thought. Uncited 'reported reasons' for CEO departures put the rate of these that are imposed by boards for performance reasons at about 20% but 'econometric estimates' (again uncited) suggest that the rate of involuntary, performance-related CEO departures is double this figure at roughly 40%[6]. A graph tracking shareholder value creation according to the length of CEO tenure would be 'hill-shaped' because, while incremental benefits are highest in the first few years, additional tenure generates 'diminishing incremental benefits but rising incremental costs'[7]. Evidently, size of the company does matter when it comes to ownership structure and corporate governance. For example, at the time of departure, the length of service of the CEOs of Australia's top 10 companies extended from five years to 23 years with a median term of 6.6 years. In comparison, in the marketplace more generally 'the median is about eight years' but 90% of CEOs don't last any longer than 12 years[8]. A recent study of 1244 board members, which included CEOs of 166 companies, also shows that

[5] The available academic literature on the link between ownership structure and corporate governance in Australia is pretty scant and too outdated to be of much use or relevance here. For example: Reza Monem's 'Determinants of Board Structure: Evidence of Australia' ('forthcoming in *Journal of Contemporary Accounting and Economics*') cites literature with publication dates no later than about 2011 but the vast majority much earlier than that; Maria C.A. Balatbat, Stephen L. Taylor, Terry S. Walters' 'Corporate governance, insider ownership and operating performance of Australian initial public offerings' was published in an early 2004 issue (44) of *Accounting and Finance*; Ranya Fathallah Dakhelalla's Master of Accountancy – Research Masters thesis (University of Wollongong) on "The Impact of Corporate Governance Principles on Board Characteristics: An Australian Study' was submitted in 2014 but investigates changes in board composition and structure for the period 1999 to 2009. More recent is Bronwyn J Le Grice's 'Corporate Governance in the ASX-Listed Life Sciences Sector' released in 2014 by AusBiotech, the industry association representing the Australian life sciences sector that includes companies from the therapeutics, medical technology (devices and diagnostics), food technology and agricultural, environmental and industrial sectors. However, because it concerns only life science companies it is only of limited relevance to this chapter.

[6] Paul Kerin, 'How long should CEOs stay?', *Company Director*, 1 September 2015 <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2015-back-editions/september/kerin-how-long-should-ceos-stay>.
Professor Paul Kerin is Head of the School of Economics, University of Adelaide.

[7] Kerin, 'How long should CEOs stay?'. He notes that, 'On average, share prices dive by 2.3% if a CEO's is "short" (under 9.5 years), but rise by 1.4% if it is long' with average total shareholder return (TSR) being 9.6% higher for CEOs who serve eight years than those who are shown the door after four years or fewer.

[8] Kerin, 'How long should CEOs stay?'

around 87% had more than 20 years of board work experience and that an experience range of 20 to 30 years was more prevalent than any other range of experience[9].

The size of a board can have a significant impact on shareholder value, CSR, and sustainability. For example, previous research has argued that a larger board possesses more specialised skills and is better equipped to monitor management than are available in smaller boards[10]. In contrast, smaller boards are more efficient and effective in decision-making and discharging their responsibilities[11]. The ASX Corporate Governance Council's Principles and Recommendations recommend that the size of the board should be limited so as to encourage efficient decision making[12]. Recent research findings suggest that Australian boards are more efficient than their counterparts in the US, where the mean board size is around 14 members. A 2017 study by Chandrakumara *et al*. found that the average board size of the top 166 Australian companies is 7 and, a clear trend in declining average board size is clearly evident in the recent past in Australia[13].

It is also interesting to compare the impact that CEOs have on shareholder value creation with the impact of non-executive directors (NEDs). As Paul Kerin points out, 'in contrast to their work on CEO tenure, economists generally haven't looked at the impact of individual NED tenure on shareholder value' with the reason for this apparent neglect simply being that 'individual NEDs have much less impact on shareholder value than CEOs'[14]. Nevertheless, NEDs can and do make a difference but this varies according to their length of service on a company's board, their qualifications, field of experience etc.. 'For example', notes Kerin, 'market reactions to M&A announcements are more negative if a board's average NED tenure exceeds nine years' with some evidence also indicating 'that such long-tenured boards are less willing to change direction or replace underperforming CEOs'[15]. And, average NED tenure is becoming a major factor in investment decisions:

> *Institutional investors and governance advisers are focusing more closely on average NED tenure. For example, State Street Global Advisors has stated that it may vote against a NED's re-appointment if the NED's tenure or the board's average NED tenure is "excessive" and/or it identifies that the board needs "refreshment". Likewise, the proportion of NEDs with tenure exceeding nine years now negatively affects proxy adviser ISS's [Institutional Shareholder Services Inc.] governance ratings. Australian boards, if anything, err on the short side of NED tenure. Average NED tenure for*

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[9] Anil Chandrakumara, Grace McCarthy, John Glynn, 'Exploring the Board Structures and Member Profiles of Top ASX Companies in Australia: An Industry-Level Analysis', Australian Accounting Review, Online First 1-15. DOI: 10.1111/auar.12177.

[10] R.J. Williams, P.A. Fadil and R.W. Armstrong, 'Top Management Team Tenure and Corporate Illegal Activity: the Moderating Influence of Board Size, *Journal of Managerial Issues*, 17(4), pp. 479-493.

[11] M.S. Beasley, 'An empirical analysis of the relationship between the board of director composition and financial statement fraud', *The Accounting Review*, October 1997, pp. 443-466.

[12] ASX Corporate Governance Council, Corporate Governance Principles and Recommendations (3rd ed.), 2014 <http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf>.

[13] Chandrakumara, McCarthy, Glynn, 'Exploring the Board Structures and Member Profiles of Top ASX Companies in Australia'.

[14] Paul Kerin, 'The nine-year itch', *Company Director*, 1 February 2016 <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2016-back-editions/february/kerin-the-nine-year-itch>.

[15] Kerin, Nine-year itch.

S&P/ASX [Australian Securities Exchange] 500 companies is 8.4 years. For ASX 200 companies, it's about six years, although about 20% of NEDs have served more than nine years[16].

While more will be said below about M&A activity and how it affects corporate governance in Australian companies, it is interesting to pick up on Kerin's point that market reactions to this sort activity are affected by board composition and, in particular, the average length of tenure of the NEDs who sit on the board. Because of the increasing influence of institutional investors and proxy and governance advisors, boards themselves are being compelled to monitor and maintain accurate records of the length of service of their members and have processes in place to ensure regular rotation and renewal of the membership at the same time as preserving board continuity and stability. This may be a difficult juggling act to perform effectively, but it has become a key governance responsibility: keeping investors and advisors on side helps to safeguard ongoing and sustainable shareholder value creation which in return relies heavily on boards managing their own membership renewal at the same time as maintaining continuity, consistency and a degree of stability at board level.

Naturally, not only do boards have to be attentive to their own renewal and continuity, but also to manage CEO tenure and performance simultaneously. It would seem, if the figures cited by Kerin are a guide, that boards having longer average NED tenures are less likely (or, willing) to deal effectively with extended CEO tenures and poor performance. Again, it may be a difficult juggling act but boards have to stay on the upside of the CEO-tenure hill when incremental benefits, measured in terms of shareholder value creation, outweigh incremental costs. Boards should be prepared to act decisively and proactively before they find themselves over the CEO tenure-hill, about the time additional CEO tenure begins to reverse the incremental benefits-versus-costs equation. It is a moot point as noted earlier whether CEO and board performance can or should be measured solely in terms of shareholder value creation. However, there is no doubt it is the performance metric that is the most obvious, hardest (that is, the least 'rubbery)' but easiest to calculate. And, it is a metric that certainly avoids inevitable, and perhaps intractable, disputes over the calculability, meaningfulness and actual connection with shareholder value that can arise when so-called 'soft targets' like diversity and sustainability are part of the mix of metrics used to gauge CEO and board performance[17]. Some of these issues will be investigated in a little more depth in the next section where, amongst other things, director remuneration will be considered.

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[16] Kerin, Nine-year itch. The S&P/ASX 500 and ASX 200 are two of the capitalisation weighted indices monitored by the ASX and quoted on its website http://www.asx.com.au/products/capitalisation-indices.htm.

[17] See, for example, on one such dispute at the Commonwealth Bank's 2016 shareholder annual meeting Elizabeth Knight, 'Commonwealth Bank falls foul to shareholder democracy', *The Age*, 10 November 2016. More generally on shareholder primacy, and how it links to agency theory, see Lynn A. Stout, 'The Toxic Side Effects of Shareholder Primacy', *University of Pennsylvania Law Review*, vol. 161, 2013, pp. 2003-2023 and Thomas Clarke, 'The Long Road to Reformulating the Understanding of Directors' Duties: Legalizing Team Production Theory', *Seattle University Law Review*, vol. 38, 2015, pp. 433-487.

Majority and Minority Shareholders: Does the Minority Have Any Protection?

This section considers both challenges and issues associated with protecting interests of minority shareholders and remedies outlined in the corporation act for oppressing conduct. Talk of shareholder value creation as being the implicit and unqualified goal of all shareholders can give the false and misleading impression that they share all interests in common. However, this is far from the truth and ignores the often significant and intractable divergences of opinion and interest that can arise between majority and minority shareholders (and, for that matter, between shareholders of any sort). In the Australian context, the minority shareholder is often at a distinct disadvantage in relation to majority counterparts having no right to appoint a director, little or no influence over the operation of the company or the distribution of profits, and only restricted rights to examine the company's books and records[18]. However, the Corporations Act (year) provides for 'far-reaching' remedies for minority shareholders who believe that they and their interests are being oppressed by directors to favour majority shareholders. Directors should not discriminate between different classes of shareholders and must exercise their duties in the interests of all shareholders and the company as a whole (and, of course, not in their own interests or of anyone else). When directors' conduct is believed to have caused minority shareholders a degree of commercial unfairness (no limits on the extent of unfairness are set), by for example acting contrary to the interests of all shareholders and the company or in a way that is prejudicial to the interests of a certain class of shareholders, section 232 of the Act can apply[19]. Examples abound of conduct that has been deemed by the courts to be intentionally, or unintentionally, unfairly oppressive, prejudicial or discriminatory and these include:

- The issue of shares for the dominant purpose of diluting the minority voting rights;
- Non-payment of dividends to shareholders and excessive payments to directors where these decisions are not objectively justified in the company's circumstances;
- Persistently refusing to call meetings of the company to prevent participation by minority shareholders;
- The application of company funds to benefit the interests of some shareholders, but not others; and
- Excluding a director representing a shareholder from the management of the company.

Remedies for oppressive conduct are contained in section 233 of the Corporations Act. These remedies range from a group of other shareholders being required to purchase the minority shareholders' shares at a price set by the court, through the

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[18] Ian Hillhouse, 'What are the rights of minority shareholders?', 9 July 2015 <http://www.hillhouse.com.au/legal-question/what-are-the-rights-minority-shareholders/>. Ian Hillhouse is a Managing Partner of Hillhouse Burrough McKeown Lawyers Brisbane.

[19] Mark Easton, 'Don't forget minority shareholders', *Company Director*, 1 April 2013 <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2013-back-editions/april/opinion-do-not-forget-minority-shareholders>. Mark Easton was at the time of writing this chapter a special counsel in the litigation and dispute resolution group at K&L Gates in Sydney.

company being ordered by the court to buy the shares of the minority or to appoint a receiver and manager, to having the company wound up when, for example, the majority is not able to buy the shares at the price determined by a court[20].

Merger and Acquisition (M&A) Activity: Having a Look at the Australian Picture

Similar issues and disputes to the ones that from time to time arise between minority and majority shareholders can also occur in the midst of M&A activity. In Australia, the term 'takeover' is generally used to refer to the acquisition of a controlling share of a publicly-listed company's voting shares. While this usually means taking control of at least 50% of the target company's shares, sometimes control can be gained through owning less than a half of the voting shares, for example, when a shareholder or group of shareholders is able to exert some influence over the membership of the company's board[21]. With regard to mergers, the situation in Australia is different from that which prevails in other jurisdictions like the United States because, 'there is no practice in Australia to effect control transactions via a true merger [an agreed acquisition of one company by another] which results in the target company being subsumed into the bidder company and the target company ceasing to exist'[22]. In spite of this gap in Australia's M&A legislative and regulatory regime, the country has a reasonably well developed framework covering this sort of activity. On the legislative front, the Corporations Act – specifically Part 5.1 concerning takeovers through schemes of arrangement proposed by a target company to its shareholders[23] and Chapter 6 takeovers whose title requires no further commentary – is the relevant piece of legislation(a bit of clarity). Chapter 6 covers such matters as the 20% acquisition limit (more will be said about this below), market and off-market bids, the timetable for providing relevant information to shareholders in market and off-market bids, the circumstances under which a bidder can compulsorily acquire any remaining shares in a company, and substantial holder notices dealing with the disclosure obligations of parties no longer having a substantial holding (5% or more) in a listed company[24]. The Listing Rules of the Australian Securities Exchange (ASX) also form part of the Australian regulatory framework governing M&A activity[25].

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[20] Easton, 'Don't forget minority shareholders'.

[21] Allens Linklaters, The Allens Handbook on takeovers in Australia, 27 April 2017, p. 11. <https://www.allens.com.au/pubs/pdf/ma/takeovers-handbook.pdf>.

[22] Allens Handbook on takeovers, p. 11.

[23] The whys and wherefores of schemes of arrangement for companies which can be used only in friendly acquisitions are briefly outlined and explained in Richard Graham, 'Takeovers by way of schemes of arrangement', n.d. <http://lexisweb.lexisnexis.com.au/Practical-Guidance-Topic.aspx?tid=2374>. See also Ch. 8 Schemes of arrangement (for companies), Handbook on takeovers, pp. 38-44.

[24] Takeovers Panel, Summary of Takeover Provisions in Australia, n.d. <http://www.takeovers.gov.au/content/DisplayDoc.aspx?doc=panel_process/summary_of_takeover_provisions_in_australia.htm>. According to the Takeovers Panel's website, 'The Takeovers Panel is the primary forum for resolving disputes about a takeover bid until the bid period has ended' and focuses primarily on commercial and policy issues. Section 171 of the Australian Securities and Investments Commission (ASIC) Act is the relevant piece of enabling legislation but the Panel's powers are provided in Part 6.10 of the Corporations Act. ASIC is the Australian companies' regulator.

[25] The ASX is Australia's leading financial market exchange and its Listing Rules, dealing with such matters as continuous and periodic disclosure, changes in capital and new issues, meetings, requirements for documentation and the like, are far too lengthy and complex to be dealt with sensibly here but can be found at <http://www.asx.com.au/regulation/rules/asx-listing-rules.htm>.

Perhaps, at least as significant from an M&A and corporate governance point of view as the Listing Rules are the ASX Corporate Governance Council's Principles and Recommendations which introduce and outline the corporate governance policies and practices that the council recommends (or, hopes) listed entities adopt to achieve 'good governance outcomes' and meet the 'reasonable expectations' of investors and other stakeholders (if we can re state this using short sentence?). The principles and recommendations are not mandatory but instead are based on the 'if not, why not' approach: when a listed entity decides that a certain principle or principles are not relevant to its circumstances and accordingly decides not to adopt it or them the entity must explain why it hasn't done so[26]. The Principles 'seek to promote 8 central principles' as follows.

- Lay solid foundations for management and oversight;
- Structure the board to add value;
- Act ethically and responsibly;
- Safeguard integrity in corporate reporting;
- Make time and balanced disclosure;
- Respect the rights of security holders;
- Recognise and manage risk;
- Remunerate fairly and responsibly.

It is clear that all of the Principles are important in M&A activity. These principles are all likely to be enlivened when a merger or acquisition is in play with sometimes significant disagreements among the contending parties as to their relevance and application.

There are a number of other pieces of legislation which make up Australia's M&A regulatory framework. The Australian Competition and Consumer Commission administers the Competition and Consumer Act 2010 (Commonwealth), specifically, the Act's anti-trust rules which can come into effect during mergers or acquisitions. The Foreign Acquisitions and Takeovers Act 1975 (Commonwealth) includes foreign investment rules that have supplementary regulations which can come into play when prospective acquisitions are examined by the Foreign Investment Review Board (FIRB) pending approval or rejection. A number of industries, including banking, aviation, broadcasting and media, and gaming, also have specific rules governing M & A[27]. which can be the subject of intense political, media and public scrutiny.

As noted above, Chapter 6 of the Corporations Act deals with takeovers and includes a 20% acquisitions limit. Put simply, this rule limits a person to acquiring a maximum of 20% of the voting shares of a publicly-listed company with the person being permitted to go beyond that level only by successfully invoking a so-called 'specified exception'. The rule only applies in circumstances where a person's voting power exceeds

[26] ASX Corporate Governance Council, Corporate Governance Principles and Recommendations (3rd ed.), 2014. An explanation of how the Principles and Recommendations link to the Listing Rules is provided at p. 5.

[27] Handbook on takeovers, p. 11. A number of the issues that are raised during M&A activity, and the relevant pieces of legislation, specifically involving private equity transactions are considered by Rachael Bassil, Peter Cook and Peter Feros, Transactions: Australia in Casey Cogut and William Curbow (contributing eds.), *Getting the Deal Through: Private Equity in 29 Jurisdictions Worldwide* (10th ed.), Law Business Research Ltd., London, 2014, pp. 145-152. In the same volume, Adam Laura, Deborah Johns and Peter Feros look at Fund Formation in Australia, pp. 6-12.

20% meaning that it is not unlawful for a person to form an association [where the person becomes part of a single security-bloc rather than having a so-called 'relevant interest' in voting shares] that increases the person's voting power to more than 20%[28]. There are several 'specified exceptions' permitting a person to exceed the 20% threshold. A couple of the more important of these exceptions are an acquisition that comes about as a result of the acceptance of a takeover bid under rules set out in Chapter 6 of the Corporations Act, the security-holders of the target entity approve the acquisition by passing an 'ordinary resolution' in favour or where acquisitions in increments of 3% every 6 months are made from a starting point of more than 19%[29]. The latter is referred to as 'creeping acquisitions' and are controversial because they are believed (by some at least) to circumvent the Corporation Act's purpose of ensuring that takeover activity occurs in market conditions that are transparent, informed and not skewed[30].

1.4.b.3. Boards of Directors, Firm Performance, and Corporate Governance

This section looks at boards of directors and their composition in Australia and also considers the corporate governance practices and processes boards oversee with a particular emphasis on determination of director remuneration. It argues whether firm (and, board) performance can or should be assessed simply in terms of the financial bottom line and proposes that corporate social responsibility, sustainability and ethical are factors that should be taken into account in determining directors' remuneration. The weight that should be given to such factors is also considered acknowledging that shareholders have legitimate interests, especially shareholder value creation, which boards have a responsibility to serve. Some attention will be given to the protections for shareholder rights that are available in Australia and the part that shareholder activism plays in allowing shareholders to enjoy and defend these rights. Earnings management practices in Australia, including 'cooking the books', are then briefly considered.

Australian Boards of Directors: Composition, and Roles and Responsibilities

In Australia, a public company, that is one that is publicly-listed, is required to have at least three directors, excluding alternate directors, and at least two of these must reside in Australia. A public company is also required to have a company secretary who must also reside in Australia. If a company has fewer than three directors it will be in breach of the Corporations Act and face financial penalties or prosecution[31]. The Corporations Act broadly also prescribes a number of responsibilities and duties that company

[28] Handbook on takeovers, p. 14. The Hand book points out that there is often a 'fine line' between 'relevant interest' and 'association' and explains these and other aspects of the 20% rule at greater length and in more technical language than can be usefully included here; the precise, technical meaning of 'association' and of 'relevant interest' is explained in the Handbook at pp. 14-15 and p. 16 respectively.
[29] Handbook on takeovers, p. 18 where are all the specified exceptions are explained.
[30] See on 'creeping acquisitions', for example, Raymond aa Silva Rosa, Michael Kingsbury and David Yermack, 'Evaluating Creeping Acquisitions', *Sydney Law Review*, vol. 37, 2015, pp. 37-67. Based on a review of creeping acquisitions in the ten-year period April 2003-April 2013, the authors concluded that there are few equity or efficiency grounds for tightening existing regulations dealing with creeping acquisitions and argue that in any event such acquisitions improve the 'liquidity of shares'.
[31] ASIC, Minimum Officeholders, 2014 <http://asic.gov.au/for-business/starting-a-company/minimum-officeholders/#propietary>.

officeholders (directors and company secretaries) have an obligation to discharge such as keeping up-to-date and accurate records, including financial records, and passing resolutions affirming that the company is solvent[32]. Directors also have a personal responsibility to be 'honest and careful', to know what the company is doing, to ensure that the company pays its debts in a timely fashion and keeps up-to-date and accurate financial records, to act in the best interests of the company, and to use any information obtained as a result of being a director of the company in the company's best interests. Directors, in addition, have a duty to disclose at a directors' meeting any personal interests or conflicts of interest that could compromise, or be seen to compromise, their ability to act in the best interests of the company. Certain conditions preclude a person from serving as a company director and these include being an undischarged bankrupt, being subject to a personal insolvency agreement under the Bankruptcy Act 1966, or having a conviction for an offence such as fraud or a company law offence like insolvent trading[33].

The ASX Corporate Governance Council's Corporate Governance Principles and Recommendations go considerably further than these bare minimum requirements. Three of the eight principles are of particular relevance here: Principle 1 Lay solid foundations for management and oversight; Principle 2 Structure the board to add value; and, Principle 8 Remunerate fairly and responsibly. It should be noted that in addition to the Principles themselves there are 29 specific recommendations, and accompanying explanatory commentary, that are 'intended to give effect to [each of] these general principles'[34].

In accordance with Principle 1, a company should clearly disclose and differentiate between the roles and responsibilities of its board and of its management including how the performance of each is to be monitored and evaluated. Principle 2 is similarly broad in compass and recommends that a company should have a board with an appropriate number of members who have the requisite skills, experience and diligence enabling the board to carry out its duties effectively the primary one of which is shareholder value creation. This also suggests that a company should appraise the performance of its board (and, management) against this key indicator. It is clear shareholder value creation also underpins Principle 8 recommending as it does that a company design its remuneration packages for directors and executives with a view to attracting and retaining (and for management, motivating) candidates of the highest calibre. The remuneration packages should also seek to align (to the extent possible) the interests of directors and management with the interests of shareholders by focusing on 'creation of [shareholder] value'.

An important aspect of board composition is the presence of non-executive directors (NEDs). The principles of good corporate governance published by the ASX's

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[32] ASIC, Company officeholder duties, 2014 <http://asic.gov.au/for-business/running-a-company/company-officeholder-duties/>.

[33] ASIC, Your company and the law, 2014 <http://asic.gov.au/for-business/running-a-company/company-officeholder-duties/your-company-and-the-law/>. See also Patrick Gallagher and Nonna Martinov-Bennie, Who should be a Director?, CPA Australia, 2015 <https://www.cpaaustralia.com.au/~/media/corporate/allfiles/document/professional-resources/sustainability/who-should-be-a-director.pdf?la=en>.

[34] ASX Corporate Governance Council, Principles and Recommendations, p. 4. The recommendations and explanatory commentary can be found at pp. 8-34.

Corporate Governance Council (2014) recommend that the board of a listed company has a majority of independent NEDs so that the board can appropriately discharge its responsibilities and duties. The representation of NEDs on corporate boards in the top 166 companies in Australia meets the requirements of the ASX recommendations as it ranges from 62% to 74% of the composition of boards across the different industry categories[35].

In 2011, the Corporations Act 2001 was amended by passage through the Australian (Commonwealth) Parliament of the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act. As the title suggests the purpose of this Act, which includes a 'two-strikes' rule, is to improve the accountability of directors and boards for how company directors and senior executives are remunerated and rewarded[36]. A 'first strike' happens when at a company's Annual General Meeting (AGM) of shareholders, 25% vote to reject the company's remuneration report which should disclose the salary and any bonuses received by each director and senior executive. If on introducing the subsequent remuneration report at the next AGM at least 25% again vote to reject the report a 'second strike' occurs and a 'spill resolution' can be put to the meeting which if supported by 50% or more requires all directors and senior executives to stand for re-election with the 'spill meeting' to be held within 90 days.

The 'two-strikes rule' raises several significant questions about the remuneration of company directors and senior executives. The most obvious of these is whether creation of shareholder value should be the only or most important indicator used in appraising director and executive performance and designing their remuneration packages. It also raises concerns about whether linking director and executive remuneration provides incentives for boards and senior executives to engage in earnings management (what is commonly called 'cooking the books'). If so, it would also raise questions regarding the viability of agency theory and shareholder primacy as a mode of corporate governance. There is no scope here to investigate the scale and frequency of earnings management in corporate Australia but it can be said with some confidence that, as in other jurisdictions, Australia corporations (and, markets) are vulnerable to this sort of manipulation[37].

Writing at about the same time as Sir Adrian Cadbury (cited above), Brian Cheffins, SJ Berwin Professor of Corporate Law at Cambridge University, observed that the discipline or subject of corporate governance 'draws from a variety of fields other than law, including economics, ethics, accounting and finance' and that understanding the issues involves, therefore, requires students (and practitioners) to acquire 'some familiarity with the concepts, assumptions, and vocabulary of these various

[35] Chandrakumara, McCarthy, Glynn, 'Exploring the Board Structures and Member Profiles of Top ASX Companies in Australia'.
[36] See Governance Institute of Australia, Guidelines for managing the requirements of a second strike, December 2014. Also very helpful and informative is Georgia Wilkins, 'What is the 'two-strikes' rule?, *The Sydney Morning Herald*, 8 October 2012.
[37] On earnings management in Australia see, for example, Fang Hu, Majella Percy, Daifei Yao, 'Asset revaluations and Earnings Management: Evidence from Australian Companies', *Corporate Ownership and Control*, 13(1), 2015, pp. 930-939 and Lan Sun, Subhrendu Rath, 'Pre Managed Earnings Benchmarks and Earnings Management of Australian Firms, *Australian Accounting, Business and Finance Journal*, 6(1), 2012, pp. 29-56.

disciplines'[38]. Studying, and indeed practising, corporate governance should accordingly be based on an awareness and understanding of the economic, political, social and cultural context within which publicly-listed companies operate. And, in an early intervention in the continuing debate about whether shareholder value or stakeholder interests should take precedence in corporate governance regimes, including director and executive remuneration, Cheffins also noted that 'whereas some prefer to confine discussion by focusing on ways to improve the return shareholders receive, others treat all corporate stakeholders, including employees, suppliers, customers and even society at large, as being part of the corporate governance equation'[39].

It is clear from the comments of Cheffins (and Cadbury) that what has become variously known as the stakeholder model, theory or philosophy of corporate governance has had a long and significant influence on the development of the subject or discipline of governance and on the practice of governance. This enduring influence has helped to ensure that corporate social and environmental responsibility and ethical business practice evolved as key principles and aspects of both governance theory and corporate governance practice. Advocates of stakeholder theory contend as Cheffins suggested that directors and the corporations they oversee are responsible and accountable to a range of stakeholders other than shareholders, namely, the many other groups and individuals affected by their decisions, behaviour and operations. Responsibility and accountability are or should be 'the price society demands for the privilege of incorporation, granting shareholders limited liability for the company's debts'[40]. One of the main difficulties encountered by advocates of stakeholder theory is in deciding how to balance the often competing interests of different stakeholder groups when it is almost always impossible to maximise or at least adequately satisfy all stakeholder interests at the same time[41]. A key question emerges from this difficulty focusing on director and management accountability: in seeking to serve the interests of different stakeholders, whose interests should be given priority and how can directors and managers be held accountable for favouring certain stakeholder interests over others? This also leaves unanswered a similarly awkward question about how director and management performance should be evaluated and rewarded. As Bob Tricker has suggested, enlightened shareholder theory (what could be called enlightened shareholder value) – a sort of hybrid of stewardship theory and stakeholder theory – can go some of the way in resolving these dilemmas. The theory acknowledges that over the longer term shareholder value can be increased or sustained only by satisfying the interests of key stakeholders in addition to those of shareholders[42].

Some of the surrounding issues and controversies were highlighted at the Commonwealth Bank of Australia's 2016 Annual General Meeting where it became the first major Australian bank to suffer the 'public relations embarrassment' of scoring a 'first strike' from shareholders after putting its remuneration report to a vote. The

[38] BR Cheffins 'Teaching Corporate Governance', *Legal Studies*, vol. 19, 1999, p. 520.
[39] Cheffins, Teaching Corporate Governance, pp. 524-525.
[40] B Tricker, *Corporate Governance: Principles, Policies and Practices* (2nd ed), Oxford University Press, 2012, p 70.
[41] Christine A Mallin, *Corporate Governance* (4th ed), Oxford University Press, 2013, p 20.
[42] B Tricker, *Corporate Governance*, p 70.

bank's shareholders were evidently unhappy with CEO Ian Narev's remuneration package that included a 'soft or so-called culture bonus' allowing him to 'earn additional financial rewards based on "diversity, inclusion, sustainability and culture"' with accordingly less of his bonus appraised on performance against '"hard" and more measurable criteria of total shareholder returns'[43]. In similar vein, Peter Fleming considers the 'horrible treatment of customers' during the chaos caused by British Airway's recent computer collapse. According to Fleming, BA's treatment of its customers 'epitomises shareholder capitalism, which corporate Britain [and, it could be added, Australia] has embraced so ardently' where 'everything a firm does is geared towards upping its share price' even though 'what's good for the share price is often not good for the long-term viability of the company, including customer value for money or employ wellbeing'[44]. As has been noted above, earnings management ('cooking the books') can become a concern when the books are manipulated to maintain a high share price and with it unreasonable director and executive remuneration.

While it can only be considered briefly here, the Commonwealth Bank and British Airways cases call attention to the growing influence of shareholder activism in corporate governance here in Australia as in overseas jurisdictions. Indeed, reports Sol Dolor reporting the view of international law firm Herbert Smith Freehills, shareholder activism is likely to become an increasingly important feature of Australia's corporate and governance landscape. An important reason for this is that Australia's legal and regulatory framework is 'conducive to activism': shareholders with only a 5% stake in a company can demand that an Emergency General Meeting of shareholders be called; shareholders with a 20% stake can call for a spill of the board; and, as seen above, the 'two-strikes rule' means that there can be pressure on companies to negotiate with shareholders over their demands[45]. Other factors contributing to this trend include recently amended 'regulatory guidelines clarifying that shareholders can communicate with each other about company performance', the increasing prominence and influence of institutional shareholders (generally large superannuation funds), and the effects of intense media scrutiny on corporate credibility and reputation[46].

1.4.b.4. Whistleblowing and Corporate Governance in Australia: A Snapshot of the Current Situation

Writing in the business section of *The Sydney Morning Herald* in December 2016 Adele Ferguson reported that Jeff Morris, who blew the whistle on systemic misconduct in the financial planning division of Commonwealth Bank, one of Australia's big four banks, is contacted at a rate of roughly once a month by employees who want to know how to go

[43] Elizabeth Knight, 'Commonwealth bank falls foul to shareholder democracy', *The Sydney Morning Herald*, 10 November 2016.
[44] Peter Fleming, 'BA's woeful conduct? It's the new normal', *The Guardian*, 31 May 2017.
[45] Sol Dolor, 'Get ready for more shareholder activism in Australia, says top firm', *Australian Lawyer*, 26 April 2017 <https://www.australasianlawyer.com.au/news/get-ready-for-more-shareholder-activism-in-australia-says-top-firm-235545.aspx>.
[46] Jeremy Leibler, 'Activism is here' in *Shareholder Activism in Australia: A review of trends in activism investing*, Activist Insight in association with Arnold Bloch Leibler, 2016, p. 3.

about disclosing misconduct in the companies they work for. She quotes Morris who grimly observes that "When I explain the potential cost to them: the loss of not just their job but also their career, due to vindictive back channel smear campaigns; the lack of any effective protection or compensation, let alone rewards; most walk away". Many of those wishing to blow the whistle justify their unwillingness or refusal to do so by saying they simply couldn't put their families through the trauma that would almost inevitably result. This sad reality reflects both the completely inadequate protections for disclosers of corporate misconduct currently contained in Australia's whistleblowing legislation and the failure by corporate leaders and company boards to understand just how important whistleblowing, and strong whistleblower protection, is to sound and effective corporate governance.

For Sir Adrian Cadbury, a pioneer of corporate governance both as a set of fundamental and complementary principles and as a field of practice, disclosure is the foundation of any system of corporate governance because it is this which is the 'basis of public confidence in the corporate system'. Cadbury also believed that equally important to corporate governance are the principles of transparency, accountability, fairness and responsibility which in his view all have universal validity[47]. While Cadbury did not refer specifically to the important role of whistleblowers in ensuring that companies are run well, it is clear that he would have regarded them as essential. Through their disclosures corporate leaders are held accountable and can be forced to take responsibility for any misconduct that takes place under their watch or they are guilty of themselves, outcomes likely to justify whatever confidence the public still has in the 'corporate system'. This is precisely why Cadbury regarded disclosure as being fundamental to corporate governance.

Along with several factors such as a conducive, legal, and regulatory framework, institutional shareholders and media scrutiny contributing to the growing influence of shareholder activism on corporate governance in Australia, more robust corporate whistleblower laws including better whistleblowing protections could have the same effect. Currently, however, Australia's private sector whistle-blowing laws, and protections are weak and feckless compared with those in other comparable jurisdictions, in particular, the United States. As far as the Corporations Act is concerned, for example, 'the scope of wrongdoing covered is ill-defined, anonymous complaints are not protected, there are no requirements for internal company procedures, compensation rights are ill-defined, and there is no oversight agency responsible for whistleblower protection'[48]. Similarly, weak and inadequate whistle-blowing provisions and protections are contained in the Banking Act 1959, Life Insurance Act 1995, Superannuation Industry (Supervision) Act 1993 and the Insurance

[47] Sir Adrian Cadbury, Foreword, MR Iskander & N Chamlou, *Corporate Governance: A Framework for Implementation*, World Bank Group, Washington DC, 2000, p v. Sir Cadbury, formerly chairman of the famous chocolate family's firm and later managing director then chairman of Cadbury Schweppes, had long been a strong advocate of the importance of corporate governance and of meaningful corporate governance reform. In 1991, he was appointed Chair of the UK Committee on the Financial Aspects of Corporate Governance which in 1992 produced the Cadbury Report and Code of Best Practice. Cadbury died in September 2015. See Martin Adeney, 'Sir Adrian Cadbury obituary', *The Guardian*, 7 September 2015.
[48] Wolfe, Worth, Dreyfus, Brown, 'Whistleblowing laws in G20 countries', p. 25.

Act 1973. Australia has nothing comparable to the US Securities and Exchange Commission's Whistleblower Program administered by the Office of the Whistleblower.

The Program, which covers employees of publicly-listed companies, was established in July 2010 when Congress inserted Section 922 (Whistleblower Protection} into the Dodd-Frank Wall Street Reform and Consumer Protection Act (the SEC website at times refers to Section 922 as the SEC Whistleblower Act)[49]. The Program commenced in August the following year when the Final Rules became effective authorising 'substantial cash rewards to whistleblowers who provide the Securities and Exchange Commission with information relating to corporate and securities fraud'[50]. The Program also includes anti-retaliatory protections for whistle-blowers[51]. Of particular relevance here is that the SEC Whistleblower Program offers rewards to individuals reporting violations of the Foreign Corrupt Practices Act who can receive between 10% and 30% of any penalty imposed by the SEC[52]. In similar fashion, the Internal Revenue Service (the US tax office) has a Whistleblower Service which pays rewards to individuals who provide information about people who fail to pay their tax or illegally avoid paying tax[53].

In a Consultation Paper released in December 2016, Kelly O'Dwyer, Federal Minister for Revenue and Financial Services, pointed out that the 2016-17 Federal Budget included 'arrangements to better protect tax whistleblowers as part of its [the Government's] commitment to tackling tax misconduct.' These measures were in addition to the Open Government National Action Plan where the Government 'committed to ensuring appropriate protections are in place for people who report corruption, fraud, tax evasion or avoidance, and misconduct within the corporate sector'[54]. Minister O'Dwyer also noted that the Government supported the 'development and implementation' of better whistleblower protections covering the corporate, public and not-for-profit sectors; a Parliamentary inquiry into whistleblower protections in these sectors is currently under way. Improved and strengthened whistleblower protections are urgently required because data recently collected by Professors A.J. Brown and Sandra Lawrence have shown that 'the corporate and not-for-profit sectors are lagging behind the public sector in terms of whistleblower protection policies'[55].

Towards the end of June 2017, *The Sydney Morning Herald* reported that Minister O'Dwyer had announced that the Federal Government 'wants to introduce measures to tighten legislation to give compensation to whistleblowers, and is also considering a bounty-style reward for those who blow the whistle on corporate

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[49] SEC Office of the Whistleblower, Resources <https://www.sec.gov/about/offices/owb/owb-resources.shtml#P11_518>.

[50] SEC, The SEC Whistleblower Program <http://www.secwhistleblowerprogram.org/>.

[51] SEC, Whistleblower Protection under the SEC Whistleblower Program, Whistleblower Blog, 10 January 2011 <http://www.secwhistleblowerprogram.org/sec-whistleblower-blog/bid/54296/whistleblower-protection-under-the-sec-whistleblower-program>.

[52] SEC, How the SEC Whistleblower Act Enforces the Foreign Corrupt Practices Act <http://www.secwhistleblowerprogram.org/whistleblower-fraud/foreign-corrupt-practices-ac>.

[53] IRS, Whistleblower – Informant Award <https://www.irs.gov/uac/Whistleblower-Informant-Award>.

[54] Kelly O'Dwyer, 'Review of tax and corporate whistleblower protections in Australia, 20 December 2016, p. 1. As part of the consultation process, submissions were open until 10 February 2017.

[55] Georgie Wilkins, 'Corporate, not-for-profit sectors lagging on whistleblower protections policies', *The Sydney Morning Herald*, 3 May 2017. See also A.J. Brown, Nerisa Dozo, Peter Roberts, 'Whistleblowing Processes and Procedures – An Australian and New Zealand Snapshort. Preliminary Results: *Whistling while they Work 2* Survery or Organisational Processes and Procedures 2016, November 2016, Griffith University.

corruption or unethical behaviour'[56]. However, it was reported in the same article that John Price, Commissioner of the Australian Securities and Investments Commission thought that while Australia should 'consider a bounty-style reward system' some time 'down the track', in his view much more pressing was the need for better compensation for whistleblowers and stronger anti-reprisal laws. He also pointed out that companies needed more robust processes to support and protect whistleblowers because 'in an era where the reputation of companies is everything, boards could not afford to push whistleblowers aside.'

1.4.b.5. Conclusion

This chapter has considered the significant challenges facing those in Australia who advocate for a strengthening of the legislative and regulatory regime of corporate governance in this country. While Australia has a reasonably robust regime for ensuring sound corporate governance practices are followed by publicly-listed companies, there are areas of weakness and vulnerability that require urgent strengthening and repair. A number of these weaknesses and vulnerabilities could be addressed through adopting more robust whistleblower laws and protections. However, even the adoption of such laws could not begin to deal with the many issues that arise from that sway that shareholder primacy, and its accompanying assumption that maximising shareholder value is or should be the primary objective of boards and company executives, holds over corporate governance in Australia. Unfortunately, wholesale cultural change at the corporate, and wider social, level is required before shareholder primacy is knocked off its perch. This suggests that there are significant challenges remaining for those who want to see a more enlightened approach to corporate governance gain significant ground in this country.

References

[56] Nassem Khadem, 'Australia not yet ready for US-style whistleblower bounty rewards, says ASIC's John Price', *The Sydney Morning Herald*, 24 June 2017.

1.5. CORPORATE GOVERNANCE IN NEW ZEALAND

Helen Roberts
Michelle Li

1.5.1. CEO Board Involvement in New Zealand

A chief executive officer (CEO) of a company has the executive responsibility for carrying out the company's business. The principal responsibilities of a typical New Zealand (NZ) listed company's board of directors, among others, include reviewing the performance of the company and senior executives against objectives and key performance indicators established by the board. The chairman of the board is often selected by the board members. The chairman's responsibilities include ensuring that all essential matters are on the board meeting agenda for discussion; presiding over board meetings; ensuring that directors receive accurate, timely and clear information to enable them to make sound decisions; and leading the board discussion to consensus based upon board members' different points of view. As is typical of most countries with legislated public listing and governance requirements, the board of directors in New Zealand is seen as an important internal mechanism in disciplining CEO behavior. The board has a fiduciary responsibility to the shareholders to oversee and monitor managerial decisions. However, CEO board involvement can compromise these relationships due to conflicts of interest between the CEO and the directors, potentially affecting board performance and firm value. The costs and benefits of CEO board involvement are not always identifiable or easily quantified.

For example, although CEO duality, a case in which the CEO also chairs the board, has some obvious benefits, such as information transfer efficiency, Jensen (1993, p. 866) proposes the costs of a dual CEO chairman as:

"The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO. Clearly, the CEO cannot perform this function apart from his or her personal interest. Without the direction of an independent leader, it is much more difficult for the board to perform its critical function. Therefore, for the board to be effective, it is important to separate the CEO and chairman positions".

Consistent with this view, the appendix of the NZ listing rule 2.1 explicitly states: "A Director should not simultaneously hold the positions of Chief Executive and chairman of the Board of the same Issuer".

In the NZ Stock Exchange's (NZX) Corporate Governance Code of Best Practice that came into effect in 2004, it was recommended that "A Director may not simultaneously hold the positions of Chief Executive of an Issuer and Chairman of the Board of the same Issuer"[57].

[57] The updated NZX Corporate Governance Code, which will apply to all NZX main board issuers for the reporting period ending 31 December 2017, re-enforces this recommendation and states that the chair and the CEO should be different people.

Complying with these recommendations, CEO duality is now very rare in New Zealand. In contrast, between 1991 and 1995, approximately one-third of all listed firms reported having a dual CEO chairman on the board of directors (Prevost et al., 2002a). This ratio changed substantially following the NZX Corporate Governance Regime, which alongside new compulsory compliance requirements for listed firms also introduced the Best Practice Code in 2004. By 2010, virtually no NZ listed company CEOs were jointly appointed to the role of board chair (Boyle and Ji, 2013). The separation of the CEO and board chair roles for NZ boards is in stark contrast with most other countries. For example, 89% of the listed firms in the United States (US) adopted a combined position of CEO and chairman from 1980 to 1983, 80% in 1989, 76% in 2000, 71% in 2004[58]. Although there is a decreasing trend of dual CEO chairman roles for US listed company boards of directors, CEO duality reported for listed company boards is still significantly higher than for non-dual firms.

1.5.2. CEO Board Membership in New Zealand

While NZ CEOs of listed companies no longer chair the board, the literature has examined the variation in CEO presence on the board of directors. Given the NZ unitary board system, it may be beneficial for the firm to exclude the CEO from the board altogether. This option carries with it the cost of information asymmetry because the CEO is no longer present to address questions and add to the discussion at board meetings. Interestingly, CEO board membership is quite common in other countries where the unitary board system is predominant. For example, Leblanc and Gillies (2010, p. 92) explain that "It is almost unheard of for the Chief Executive Officer (CEO) of the corporation not to be a member of the board of directors. Indeed, in many companies, particularly in the US, it is not unusual for the role of the board and the CEO to be combined". Due to the lack of variation in whether CEOs are on or off the board, the discussion around CEO board membership is very limited. However, Boyle and Ji (2013) report only 67.9% of NZ CEOs served on their company board in 1995 and 66.7% in 2010. The discretionary involvement of CEOs on their boards in the NZ context is still an under-researched phenomenon. The research is still not clear as to why about one-third of NZ CEOs do not sit on their boards at all and how their possession of information is transferred to the board of directors in such a setting.

1.5.3. Ownership and Shareholder Rights Protection

In 2001, the mean proportion of stock held by the top 20 shareholders in New Zealand was 73% (Hossain, Prevost, & Rao, 2001)[59]. Between 2001 and 2005, NZ listed firms reported a Herfindahl index level of 0.1764, which is close to the threshold of 0.18, a definition of high concentration by the US Department of Justice. From 2007 to 2011, this measure decreased to 46.73%, implying that firm ownership concentration had

[58] Statistics are taken from Kesner et al. (1986), Brickley et al. (1997) and Grinstein and Valles Arellano (2008).
[59] From a report by the NZ Institute of Chartered Accountants (NZICA) in 2003.

become moderate (Fauzi and Locke, 2012). While companies in New Zealand have higher institutional and concentrated shareholdings, their monitoring effectiveness is poor. This may be because of the geographical separation of large institutional investors from the companies that they hold shares in. Healy (2001) notes that foreign institutions and blockholders jointly held 54% of NZ equities, while local institutions held a meagre 15%. Further evidence of the lack of effective ownership came from the report by the Capital Market Development (CMD) Taskforce Secretariat, noting that offshore owners control a large share of the largest firms in New Zealand. In addition, the combination of concentrated institutional shareholdings and geographical dispersion of ownership does not easily lend itself to effective collaboration and monitoring. Bhabra (2007) notes the lack of shareholder activism in New Zealand and the associated criticism by the popular press. In an examination of the relationship between ownership structure and firm performance, Bhabra (2007) reports a significant non-linear relationship. Insider ownership and firm value are positively related for ownership levels below 14% (market discipline) and above 40% (convergence of interests) and inversely related at intermediate levels of ownership (entrenchment). The combination of concentrated ownership, higher shareholder litigation costs, weaker enforcement of law, and less minority shareholder protection compared with other OECD (Organization for Economic Cooperation and Development) countries (Hossain, Prevost and Rao, 2001) suggests weaker shareholder rights protection. This is further substantiated by Frijns, Gilbert and Tourani-Rad (2007), who report little effect for private enforcement. New Zealand has lower-than-average levels of public enforcement with respect to insider trading laws. Although New Zealand is a common law country, McMillan (2004) argues that ownership concentration in New Zealand and the small share market capitalization as a proportion of GDP are reflections of weak investor protection. Weaker governance caused by the ineffective monitoring of large, entrenched shareholders results in insufficient minority shareholder protection and less stringent litigation[60].

1.5.4. Corporate Governance and Firm Performance

The evidence of whether there is a link between corporate governance and firm performance in New Zealand is limited primarily due to the lack of quality data on corporate governance measures. In this section, we discuss the relationship between corporate governance and firm performance based on earlier much-quoted studies in New Zealand.

Strong governance is believed to lead to a lower cost of capital and higher company valuations. Unlike other markets where corporate governance is measured by various aggregates of governance attributes, such as the G-index (Gompers et al., 2003) and the E-index (Bebchuk et al., 2009), the NZ studies on the relationship between corporate governance and firm performance usually focus on one or more specific measures of corporate governance in New Zealand, such as the composition of the board of directors and ownership structure.

[60] Jiang, H., Habib, A., & Smallman, C. (2009). The effect of ownership concentration on CEO compensation–firm performance relationship in New Zealand. Pacific Accounting Review, 21(2), 104-131.

1.5.5. Board Independence and Firm Performance

In New Zealand, three sets of regulatory changes shape the composition of the board of directors. (i) The Companies Act 1993, which came into effect on July 1, 1994, codifies and expands the duties and liabilities of directors. The underlying rationale of this legislation is that directors, especially outside directors, should take on more fiduciary responsibilities. Accordingly, Cahan and Wilkinson (1999) find that the representation of outside directors on the board increased by about 5% after the enactment of the legislation. The proportion of outside directors was also higher in firms with higher growth opportunities because the monitoring of these outside directors was more important in these firms (Hossain et al., 2000). (ii) The introduction of the NZ Corporate Governance Best Practice Code (the Code) in October 2003. The Code required the identification and disclosure of independent directors on boards and a minimum of two independent directors, or one-third of the total board members (to be rounded to the nearest number), whichever is greater. (iii) NZX's revised Corporate Governance Code recently published on May 10, 2017, is the first substantial update of the code since 2003. As a part of the revision, recommendations were made in relation to board composition and performance, board committees, remuneration, reporting, and disclosure. For example, firms are required to disclose their diversity policy, including the number of men and women on the board, at the senior management level, and across the entire origination. In recognizing that a recommendation in the code may not be appropriate because it does not fit the issuer's circumstances, the issuer has the flexibility not to adopt it. If the issuer has not followed a recommendation for any part of the reporting period, it must disclose any material difference and explain what (if any) corporate governance arrangements it has adopted and why it has chosen not to follow the recommendation. This is the basis of the "comply or explain" approach.

Studies on the Company Act 1993 (Hossain et al., 2001; Prevost et al., 2002b) and the Code 2003 (Koerniadi and Tourani-Rad, 2012) find the intended consequence of these two legislations, that is, increased outside director representation and mandated board independence, does not, in fact, increase firm performance. The evidence shows that independent directors only create value when they are in the minority. The evidence suggests that requiring a minimum level of board independence is not necessarily optimal so that the cost of compliance may exceed any benefit realized by the shareholder.

1.5.6. Ownership and Firm Performance

Historically, the NZ equity market has experienced high levels of ownership concentration. Indeed, the average percentage of shares held by the largest shareholder ranges between 27% and 30% during the period 2002 and 2007, with maximum values exceeding 80%. The cumulative percentage of shares held by shareholders with equity interests of at least 5% during the period from 2004 to 2006 is approximately 45%[61].

[61] Data are taken from Jiang et al. (2011), Boone et al. (2011), Koerniadi and Tourani-Rad (2012).

Two competing theories exist in the corporate governance literature concerning the effect of ownership on firm value. Jensen and Meckling (1976), who build on the earlier work of Berle and Means (1932), propose the "interest alignment" hypothesis. Demsetz (1983) and Fama and Jensen (1983) propose the "entrenchment" hypothesis. Although companies in New Zealand have relatively higher concentrated shareholdings, the empirical evidence testing their monitoring effectiveness is mixed. For example, Boone et al. (2011) report a positive association between concentrated ownership and firm performance. The positive relationship also holds when financial institutions are the largest blockholder. Chen et al. (2008) find total institutional ownership in a firm increases firm values (consistent with the interest alignment with other shareholders), whereas institutions with the highest share ratio are reported to have a lower firm value (consistent with the entrenchment of the top institutional shareholder) using a sample of NZ listed non-financial firms. Bhabra (2007) finds that director ownership is positively associated with firm value at low levels (14%) of insider ownership (market discipline), inversely related to firm value over intermediate (14% to 40%) levels (entrenchment) and increases firm value when ownership exceeds 40% (interest alignment).

1.5.7. CEO Compensation and Director Compensation

Empirical studies examining the association between CEO pay and firm performance using NZ data report a misalignment between corporate performance and managerial compensation. An examination of the cross-sectional variation in NZ CEO compensation during the first year of public disclosure (1997) shows that CEO pay depends primarily on firm size[62]. The study finds that a significant number of NZ firms took advantage of the lack of required compensation disclosure as a way of separating pay from performance. Post 1997, these firms sought to remedy the disassociation between pay and performance by improving the efficiency of their compensation structures. However, empirical studies have been somewhat limited by the compensation disclosure requirements for CEOs. Only firms whose CEOs are board members are required to document clearly the amount and nature of the CEO remuneration contract[63]. Jiang et al. (2009) suggest that concentrated ownership may explain the lack of association between CEO pay and firm performance. Elayan, Meyer, and Lau (2003) also find no evidence of a relationship between either the level of CEO pay or the adoption of compensation incentives and firm performance. However, Gunasekaragea and Wilkinson (2002) report a positive association between total CEO compensation and firm performance when the change in the value of CEO shareholdings is added to cash compensation. The inclusion of the change in the value of CEO share holdings showed that the short term, long-term and future firm performances were significant determinants of the total compensation package for CEOs. Evidence reported by Roberts

[62] Andjelkovic, Boyle and McNoe (2001).
[63] Under the revised Companies Act (1993), all firms were required to disclose the number of executive employees whose total remuneration (cash and noncash) lay in each $10,000 band above $100,000. That is, firms had to list the number of executives whose compensation lay between $100,000 and $110,000, between $110,000 and $120,000, and so on. In addition, each firm had to disclose the exact amount of compensation received by each director.

(2007) measures the change in real CEO pay for the period 1997 to 2002. Real median CEO cash compensation grew by 29.7% (5.3% per annum) over the six-year period, while real worker income achieved growth of 1.5% (0.3% per annum). Using a fixed-effects model, the study documents a positive association between growth in CEO pay, contemporaneous and lagged performance, board size, compensation risk and director share ownership. Jiang et al. (2009) add to this literature by reporting that CEO compensation is negatively (positively) related to firm performance in firms with high (low) concentrated ownership structure, respectively. High ownership concentration levels are associated with CEO compensation that is detached from firm performance. However, CEO compensation demonstrates a positive association with firm performance for lower levels of ownership concentration. Using a large panel data set, Boyle and Roberts (2012) report that NZ firms where the CEO is also a compensation committee member experience lower annual increments in pay. This contradicts the popular rent extraction view of self-serving executives. Cahan, Chua, and Nyamori (2005) examine a sample of 80 public sector companies and find that board size, whether the CEO sits on the board, and director quality is related to CEO pay. They also find boards with low turnover pay excessive CEO compensation, suggesting that managerial entrenchment rather than efficient contracting is driving the results.

Academic studies examining the role of directors and boards in New Zealand have been largely concerned with governance implications. However, there is one study by Boyle and Ji (2013) that reports stylised facts of NZ corporate boards for the period 1995 to 2010. The findings show that while average board size fell, real per-person chair and director fees increased by more than 60%, which is a much faster rate than the corresponding increase in wages and salaries[64]. NZ director remuneration is still quite low compared with countries such as Australia and the United States (Jiang et al., 2009). Median chair and director fees in 2010 were $83,592 and $48,787, respectively. Directors are typically paid fees for their services. Some have an ownership interest in the firm, and executive directors are rewarded separately for their management role in the decision-making process. A separate study of the compensation and corporate governance practices of publicly listed companies in New Zealand for the period 2005–2010 finds that firms where the CEO is a director pay, CEOs more compared with firms where the CEO does not sit on the board[65]. The result suggests that CEOs on boards have the power to influence board decisions and therefore boards become less effective in monitoring CEO compensation in the NZ context. Companies that pay their directors more tend to reward their CEOs more as well, thus supporting the managerial entrenchment hypothesis.

Overall, the evidence points to a need for careful monitoring of the impact of ownership concentration on firm performance, governance and compensation plans for NZ listed companies. It may be the case that restricting ownership concentration to a certain level will constrain large shareholders and management from expropriating a firm's resources[66]. Evidence concerning CEO compensation and firm performance is

[64] The corresponding change in the all-sector labour cost index over the same period was 1.5%.
[65] Reddy, Abidin and You (2015).
[66] Jiang, Habib, and Smallman (2009).

mixed. While shareholders and regulators may monitor CEO pay levels, the lack of disclosure, especially for those CEOs who are not directors, limits transparency and impedes management accountability. Future research needs to address issues associated with large, controlling shareholder interests that fail to adequately watch and question the relationship between CEO compensation and firm performance so as to build market confidence and improve managerial responsibility.

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1.6. CORPORATE GOVERNANCE IN IRELAND

Fadi Alkaraan

1.6.1. Introduction

Corporate governance is defined as the system, principles, and process by which organisations are directed and controlled. The principles underlying corporate governance are based on conducting the business with integrity and fairness, being transparent with regard to all transactions, making all the necessary disclosures and decisions and complying with all the laws of the land. It is broadly concerned with the relationships between company boards and the company's shareholders, accountability, and responsibility towards the stakeholders. Corporate governance refers to the processes in place to ensure that board members have the ability to effectively assess management and corporate performance. Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholders value over the longer term.

The EU Member States exhibit a rich diversity in corporate governance practices, structures, and participants, reflecting differences in culture, traditional financing options and corporate ownership concentration patterns, and legal origins and frameworks. This rich diversity complicates corporate governance comparisons between nations. Nonetheless, the codes that have been issued in the Member States in the last decade express significant similarities: they reveal that as reliance on equity financing increases and shareholdings broaden in Europe, a common understanding is emerging of the role that corporate governance plays in the modern European corporation.

Corporate governance is viewed increasingly as a means of ensuring that the exercise of economic power by the corporate sector is grounded in accountability. Different EU Member States tend to articulate the purpose of corporate governance in different ways: some emphasise broad stakeholder interests and others emphasise ownership rights of shareholders. Although the comparative corporate governance literature and popular discussion tend to emphasise "fundamental" differences between stakeholder and shareholder interests, the extent to which these interests are different can be debated. The majority of the codes expressly recognise that corporate success, shareholder profit, employee security and well-being, and the interests of other stakeholders are intertwined and co-dependent.

1.6.2. Overview of the Legal Framework of Corporate Governance in Ireland

A growing academic literature focuses on the impact of culture on corporate governance systems. Some EU Member States emphasise co-operative relationships and consensus and other Member States emphasise competition and market processes in their corporate governance frameworks. However, the objective of the corporate governance Code remains the same, to provide a framework for the application of best practice in corporate governance by both commercial and non-commercial state bodies. These standards of corporate governance have, perhaps not surprisingly, evolved since the publication of the previous Code in 2009. This is reflected in the requirements within the Code. State bodies are expected to demonstrate their commitment to achieving the highest possible standards of corporate governance. The revised Code leverages corporate governance best practice in the wider public and private sectors in Ireland and internationally, such as the FRC's UK Code (2016), CIPFA and IFAC's "International Framework: Good Governance in the Public Sector" (2014) and OECD's.

The Irish Stock Exchange (ISE) recognises that the UK Corporate Governance Code (formerly the Combined Code) has set the standard for corporate governance internationally. It is regarded as being the pre-eminent corporate governance code and is widely emulated. Since the1995 ISE Act, the listing rules of the ISE have required every company listed on the main securities market to state in its annual report how the principles of the combined code have been applied and whether the company has complied with all relevant provisions. Where a company has not complied with all relevant provisions of the UK Corporate Governance Code (the 'UK Code') it is required to set out the nature, extent and reasons for non-compliance. Although it is more for the market to comment on the adequacy of the disclosures that companies make, as noted in the report commissioned by the ISE and IAIM in early 2010, companies could do more to enhance the quality and meaningfulness of the corporate governance disclosures in the annual reports.

The ISE is conscious of the work that has been undertaken by companies to apply the provisions of the combined code and believes that dispensing with the provisions of the UK Code in order to implement an Irish code would not serve the market or shareholders well at this time. The ISE accepts that it is both appropriate and desirable to retain the provisions of the UK Code going forward. However, given the particular focus on corporate governance in the Irish market, the ISE also believes that the recommendations arising from the report commissioned by the ISE and IAIM in early 2010 provide a valuable addition to the corporate governance regime in Ireland. The Irish Corporate Governance Annex (the 'Irish Annex') is addressed to companies with a primary equity listing on the main securities market of the ISE. The Irish Annex implements the nine recommendations arising from the report commissioned by the ISE and IAIM in early 2010. The Irish Annex also includes interpretative provisions for companies that are of an equivalent size to companies that are included in the FTSE 100 and FTSE 350 indices. The ISE will regard a company as being a "smaller company" where its market capitalisation is less than €750 million at the start of the company's financial year. The ISE will regard a company as being of an equivalent size to a company included in the FTSE 350 index where at the start of the company's financial year it is admitted to trading on the main securities market and has a market capitalisation of €750 million or above. The ISE will regard a company as being of an equivalent size to a company included in the FTSE 100 Index where at the start of the company's financial year it is admitted to trading on the main securities market and it has a market capitalisation of €2 billion or above. Where companies diverge from the provisions of the UK Code or the Irish Annex, the ISE expects companies to include explanations that more clearly reflect the environment within which they operate and provide a rationale for the divergence. Where a company does not comply with a provision of the UK Code or the Irish Annex but actively intends to do so in the future, it should as part of its explanation provide an indication of how and when it will comply. Where a company has decided not to implement a particular provision it should clearly outline its rationale. Companies should provide meaningful descriptions of how they apply the provisions of the UK Code and the Irish Annex. Companies should move away from the practice of recycling descriptions that replicate the wording of the UK Code or Irish Annex's provisions and provide informative disclosures that will provide shareholders with greater insight into the company and the environment in which it operates. Companies should also avoid the practice of copying wording contained in the corporate governance disclosures year on year as this practice does not reflect compliance with the spirit of the UK Code or the Irish Annex. This should not be interpreted as imposing an obligation on companies to change the wording of their corporate governance disclosures simply for the sake of change. However, companies should always have considered whether the circumstances have remained sufficiently constant that no wording changes are required.

1.6.3. Specific Provisions

Board Composition

Companies should in the annual report:

- Outline the rationale for the current board size and structure, explaining why the company believes it to be appropriate and provide details of any planned or anticipated changes to the board size or structure;
- Where the requirements of provision B.1.2 of the UK Code have been met, explain why the company regards the number of non-executive directors appointed to the board as sufficient;
- Set out how the specific skills, expertise, and experience of the board are harnessed to best effect in addressing the major challenges for the company;
- Where a company has diverged from the requirements of provision B.1.2 of the UK Code, give a reasoned explanation for the departure;
- The section of the Annual Report including the Directors' biographies should include:
- The date of appointment of each director, the length of service of each director as a director and, where applicable, the length of service of each director on a board committee;
- A detailed description of the skills, expertise, and experience that each of the directors brings to the board;
- Where a company has directors who have been nominated by shareholders or government, a reasoned explanation for such appointments including a description of the skills and expertise these directors bring to the board as provided by the shareholders or government (as applicable) or a statement that no such description has been provided to the company.

Board Appointments

In order that shareholders can assess the effectiveness of the nomination committee, companies should include an explanation, for each new appointee, of the process followed by the nomination committee in identifying a pool of candidates and selecting and recommending the candidate. Where the company has used external search agencies and advertising to identify candidates this fact should be made clear in the Annual Report or issuers should provide an appropriate negative statement.

Board Evaluation

Companies should in the Annual Report:

- State the objective and scope of the evaluation review, the methodology applied and the rationale for this methodology;
- Within the statement made under paragraph 3.1, make a distinction between the evaluation of the board process, of individual directors and of the collective board strength. The statement should also specify when the most recent externally facilitated performance evaluation was undertaken, if applicable, or when the board expects to engage an external facilitator;
- In circumstances where the process is one of self-evaluation, the board should include an explanation of the steps that were included in the methodology to achieve as robust and objective an approach as possible.

Board Re-election

Companies should in the Annual Report:

- State the board's general policy for board renewal;
- For those directors falling within scope of the list of circumstances set out in B.1.1 of the UK Code, set out what factors the board took into account when determining that a director should be regarded as independent.

Audit Committee

- Companies should include a meaningful description of the work carried out by the audit committee during the financial year. Issuers should not simply recycle the committee's terms of reference, which are required to be made available to investors in accordance with provision C.3.3 of the UK Code.
- The description should, in particular, explain the work done by the Committee relating to the oversight of risk management on behalf of the board1. If the board has assigned work on risk management to a specific risk committee, a meaningful description of the work carried out by that committee should also be included.

Remuneration

- Companies should provide a clear and meaningful description of their remuneration policy and not simply recycle the remuneration committee's terms of reference year on year.
- Companies should provide the information contained in paragraph 1.6 above for each member of the remuneration committee, in relation to that committee, to the extent not already provided under paragraph 1.6.
- Where the remuneration policy includes variable components of remuneration, companies should describe the components of bonus or other variable elements of remuneration and disclose what components of variable compensation are deferred and for how long.
- Companies should describe any arrangements that are designed to achieve the recovery of variable compensation awarded on the basis of assessments or data which are subsequently found to be materially inaccurate or provide an appropriate negative statement.
- In line with Schedule A of the UK Code, companies should describe the vesting periods for shares forming part of a director's remuneration (or otherwise awarded to the director in connection with or by reason of his being a director or employee) and such terms should not allow for vesting for at least three years after the award. Share options, or any other right to acquire shares or to be remunerated on the basis of share price movements, should not be exercisable for at least three years after the award.

Minister for Public Expenditure and Reform launched the revised Code of Practice for the Governance of State Bodies with substantial changes. The changes to the Code of Practice for the Governance of State Bodies ('the Code') are substantial - the volume of the Code has expanded from 36 pages to 72 pages (excluding four new supporting documents) which naturally results in increased compliance requirements.

> *"The Code is not a 'one size fits all' document, but rather acts as a framework to ensure that both commercial and non-commercial State Bodies meet the highest standards of corporate governance commensurate with their significant public roles and responsibilities" (Minister, Department of Public Expenditure and Reform).*

On 17 August 2016 the Minister for Public Expenditure and Reform launched the revised Code of Practice for the Governance of State Bodies 2016, along with four new supporting documents setting out the requirements in more detail. The Code applies to financial reporting periods beginning on or after 1st September 2016. The Code is effective from 1st September 2016. In this regard, State bodies are expected to be fully compliant in relation to financial reporting periods beginning on or after 1st September 2016. Prior to this the Code was last revised in 2009.

The Code has been updated to take account of a range of factors, such as: governance developments, public sector reform initiatives and stakeholder consultations. It also reflects relevant legislative and regulatory changes, including: the Companies Act 2014, Protected Disclosures Act 2014, Single Public Service Pension Scheme, Public Spending Code, Office of Government Procurement and the establishment of New Economy and Recovery Authority.

Structure of the Code

The revised Code is split into a suite of documents comprising the main Code, as well as more detailed guidance set out in four separate documents:

1. Business and Financial Reporting Requirements;
2. Audit and Risk Committee Guidance;
3. Remuneration and Superannuation; and
4. Board Self-Assessment Evaluation Questionnaire.

The revised Code is based on the following 4 key pillars:

1. Values: Good governance supports a culture of behaviour with integrity and ethical values;
2. Purpose: Each body should be clear about its mandate with clearly defined roles and responsibilities;
3. Performance: Defined priorities and outcomes to achieve efficient use of resources resulting in the delivery of effective public services; and
4. Developing Capacity: Appropriate balance of skills and knowledge within the organization, to be updated as required.

Effective governance is much more than complying with codes and ensuring that the right structures and processes are in place. It is about the behaviours of the individuals that comprise the Board, their collective dynamics and the positive impact they are having on the organisation. The introduction of the four key pillars should be seen as a welcome addition to the Code.

Comply or Explain

State Bodies must confirm their compliance with the Code. It is recognised that all aspects of this Code may not necessarily be appropriate for some smaller State Bodies and the Code allows for certain requirements to be applied proportionately in certain circumstances. Where compliance is not practical and the State Body wishes to adapt the requirements to their particular circumstances, this should be agreed with the Ministerial/parent Department and formally documented. Further, where exemptions have been approved these should be disclosed in the annual report, along with an explanation as to whether the requirements are to be phased in over a longer period of time or otherwise varied in some way.

The new Code also states that 'where appropriate', State Bodies should also comply in so far as it is practicable with the Irish Corporate Governance Annex that supplements the provision of the UK Code. State Bodies will have to determine if this is appropriate and if required, consider the requirements within the Annex.

1.6.4. Overview of the Key Changes per Section

A summary of the key changes which we consider to be the most significant are set out as follows:

Responsibilities of the Board

The responsibilities of the board have evolved and are more prescriptive. For example, there are new responsibilities relating to talent and culture, such as promoting the development of the capacity of the State Body, including the capability of its leadership and staff, and 'setting the tone from the top.' The Code has been updated to reflect the Companies Act 2014 and refers to compliance with relevant statutory provisions. Boards will have to review the controls and procedures to ensure compliance with statutory obligations and obtain reasonable assurance that they are adequate. Previously, they had to state that such obligations were identified and made known to them. There is now a requirement for boards to undertake annual board effectiveness reviews. These should take the form of an annual self-assessment evaluation of its own performance and that of its committees, with an external evaluation conducted every three years. The Code emphasises transparency and requires additional disclosures in annual reports, both in the front.

Role of the Board

A number of new principles and provisions in relation to the role of the board have been introduced, outlining the key functions of the Board and emphasising the expectations of the ethical standards expected of board members. While the core matters for the decision of the board remain the same, the provisions supporting this section are more prescriptive. For example, where the board previously had responsibility for compliance with all applicable statutory obligations and satisfying itself that all such obligations are identified and made known to it, they now have to review the controls and procedures to provide itself with reasonable assurance that such controls and procedures are adequate.

There are a number of new responsibilities relating to talent and culture, such as promoting the development of the capacity of the state body, including the capability of its leadership and staff, and 'setting the tone from the top'.

The Code also introduces a number of new provisions on the secretary of the board, setting out the high-level responsibilities of the secretary, emphasising their role in governance. The Code also now states that the board has a duty to ensure that the secretary has the required skills to discharge their duties.

Role of the Chairperson

There is a new section on the role of the chairperson of state bodies, highlighting the importance of this role. The key principles include having responsibility for the leadership of the board and setting expectations regarding culture, values, and behaviours for the State body and for the tone of discussions at board level. The provisions provide detail on the specific responsibilities, such as setting the agenda and ensuring timely and clear flows of information to the board. The existing requirement to furnish the relevant Minister with a comprehensive report is now more onerous. There are now requirements to include information such as: providing summary details of all off-balance sheet financial transactions that are not disclosed in the annual report; confirming that protected disclosures procedures are in place; and confirming that the state body has complied with its obligations under tax law. Detailed requirements are set out in the Business and Financial Reporting Guidance.

Role of Board Members

There is also a new section on the role of board members. This sets out the fiduciary duties of board members. It also references the specific fiduciary duties of directors of companies incorporated under the Companies Act 2014 (or previous Acts) and notes that bodies formed under these Acts will also have to adhere to the specific duties and obligations under the Companies Act 2014. Where a board member finds evidence of non-compliance with any statutory obligations, they must immediately bring this to the attention of their fellow board members and the chairperson should notify the relevant Minister.

Board Effectiveness

Again, there is another new section, this one specifically relating to the effectiveness of the board, the principles of which have been adapted from the UK Code. The principles are focused on ensuring the board has the right skills, information, and processes in place to support board effectiveness. One of the key changes is the requirement for boards to undertake an annual self-assessment evaluation of its own performance and that of its committees, with an external evaluation to be conducted every three years.

Principles of Corporate Governance (2015)

The expectations on corporate governance have increased considerably and without doubt, the bar has been raised. Increased accountability and transparency, particularly at board level, as well as emphasis on behaviors and organisation culture permeate the principles and provisions of the Code. For example, State Bodies now have to disclose more information on expenditure, such as termination/Severance payments which exceed €10,000; total costs incurred in relation to travel and subsistence; hospitality expenditure and cumulative consultancy fees. In relation to public procurement, State Bodies now have to maintain a database/register of all contracts or payments which exceed €25,000 and have monitoring systems in place to identify potential instances of non-compliance in procurement.

Audit and Risk Committee

There is now a requirement to establish a combined Audit and Risk Committee to give an independent view in relation to risks and risk management systems, with recognition that some larger entities may opt for separate committees. The Code recommends that the Audit and Risk Committee has external members drawn from outside the Board. The Board must confirm in the annual report that they have carried out a robust assessment of principal risks, including a description of these risks and associated mitigation measures or strategies.

The provisions relating to the Board's responsibilities for ensuring the effectiveness of the organisation's internal control are also more prescriptive, detailing what the annual review should consider and specifying the timing, namely close to the end of the financial period under review or soon after and no later than three months after the period end. The Code also notes the importance of 'on-going monitoring and review' of internal controls.

Codes of Conduct, Ethics in Public Office, Additional Disclosures of Interests by Board Members and Protected Disclosures

Although the title has changed, the substance of this section remains the same, with the exception of the inclusion of a number of new provisions relating to the Protected Disclosures Act 2014, reflecting the introduction of this legislation since the 2009 Code. Under the revised Code State Bodies must establish and maintain procedures for making and dealing with protected disclosures by workers. Further, there is a requirement to publish a report on protected disclosures in accordance with Section 22 of the Protected Disclosures Act 2014.

Business and Financial Reporting

The requirements to provide disclosure on material matters, including financial position, are now set out in a standalone section, supported with comprehensive separate guidance – Business and Financial Reporting Requirements. In line with good transparency, the new Code requires additional disclosures in annual reports, both in the front section of the report and the financial statements. Examples include a statement on how the board operates and a high level statement of matters for decision by the Board and those delegated to management; and a statement on whether the Board considers its financial statements to be a true and fair view of financial performance and financial position at year end.

The financial statements now need to disclose more information on expenditure, such as: termination/severance payments which exceed €10,000; total costs incurred in relation to travel and subsistence; hospitality expenditure (including Christmas parties, retirement parties, sports & social contributions, leaving gifts, flowers); legal costs/settlements where the cost of a case exceeds €50,000 in the calendar year; cumulative consultancy fees (legal, tax, financial advisory (excluding auditors), PR, marketing, pensions, HR, and others).

Risk Management, Internal Control, Internal Audit and Risk Committees

Further detail has been included on the principles and provisions for risk management, internal control and internal audit. The title of this section now includes 'Audit and Risk Committees', reflecting the need to establish a combined audit and risk committee to give an independent view in relation to risks and risk management systems.

In general, the audit and risk committee should be combined, however, for larger entities, the Code acknowledges there may be a requirement for a separate audit and risk committee. The revised Code sets out details of the composition, which recommends that Audit and risk committees have members drawn from outside the board. These code provisions should be read in conjunction with the supporting audit and risk committee guidance.

In addition to this change in oversight of risk management, there is now a requirement for boards to confirm in the annual report that they have carried out an assessment of the state body's principal risks, including a description of these risks, and associated mitigation measures or strategies. In line with the overarching theme of culture running throughout the revised Code, the Chief Risk Officer, or suitable management alternative, are required to promote a risk management culture in the organisation.

The revised Code emphasises the need for the board to form its own view on the effectiveness of internal control systems. The provisions relating to the board's responsibilities for ensuring the effectiveness of the organisation's internal controls are also more prescriptive, detailing what the annual review should consider and specifying the timing, namely close to the end of the financial period under review or soon after and no later than three months after the period end. The board now has to conclude on the extent to which the controls are adequate and were operating, as well as outline any actions to address any deficiencies. In addition to undertaking an annual review, the revised Code also refers to 'on-going monitoring and review' of internal controls.

Similar to the above areas, the principles and provisions relating to internal audit have also expanded. The revised Code includes a new provision on the 'Internal Audit Universe', stating that internal audit has the right to review all the management and control systems, both financial and operational, and has unrestricted access to all functional areas, records, property, and personnel in the performance of its audits.

There is also another new provision on the 'Annual Programme of Audits', whereby the head of internal audit is responsible for drawing up an annual programme of audits having regard to the state body's statement of strategy and risk management policy in consultation with the Audit and Risk Committee.

Relations with the Oireachtas, Minister, and Parent Department

In contrast to the previous version of the Code, the relations with the Oireachtas and Minister have been expanded to cover the parent department and are more outcomes-

focused. For example, one of the principles states that the procedures must define 'expected outputs and outcomes and clear procedures for monitoring performance'.
The requirement for a performance framework has evolved into two separate requirements.

Firstly, an oversight agreement which defines the terms of the state bodies relationship with the relevant minister/parent department. This is similar to the previous Performance Requirement, with the inclusion of additional criteria.

Secondly, and perhaps one of the more onerous provisions, there is a new requirement for non-commercial state bodies to have a performance delivery agreement which acts as a performance contract between the state body and parent, formalising an agreed level of performance.

Further, non-commercial State Bodies will now also be required to undertake a Periodic Critical Review ('PCR') on their organisational performance no later than every 5 years, by a working group established by the relevant government department who will report their findings to the relevant Minister.

Remuneration and Superannuation

There are limited revisions to this section of the Code. Separate remuneration and superannuation guidance have been provided which includes additional information on areas such as commercial state bodies, funded pension schemes and minimum funding standard requirements.

Quality Customer Service

While the appendix on the principles of quality customer service is largely the same, with some additional detail on complaints, the revised Code introduces principles and provisions regarding quality customer services. State bodies are expected to have a customer charter in place, displayed in a prominent place, setting out the level of service a customer can expect. This should be supported with a customer action plan, both of which should be produced simultaneously.

1.6.5. Corporate Social Responsibility

Ireland's first National Plan on CSR "Good for Business, Good for the Community" was launched in April 2014 by the Minister for Jobs, Enterprise & Innovation. The vision set out in the Plan is that:

- Ireland will be recognised as a Centre of Excellence for responsible and sustainable business practice through the adoption and implementation of best practice in CSR in enterprises and organisations as widely as possible;
- This plan sets out the general framework within which CSR operates in Ireland and outlines the key principles and objectives which underpin the Government's approach to CSR. It also seeks to communicate a common understanding of CSR by outlining the Pillars on which CSR is based in Ireland;

- The Four Pillars of CSR are: Workplace, Environment, Marketplace, and Community;
- The National Plan explains how CSR can contribute positively to a company's business and highlights practical supports which are available to organisations that want to embark on, or make improvements in, this area;
- This CSR Plan represents a milestone in raising the profile of CSR in Ireland. A CSR Stakeholder Forum was established under the objectives of the Plan. A key objective of the Forum is to raise awareness of the benefits of CSR for business and for all stakeholders in society.

1.6.6. Conclusion

The short time between the publication of the Code and the date it took effect will create challenges for state bodies to get to grips with the changes and make the necessary changes to comply with all the requirements. Each state body will have to assess how the changes will impact their governance practices and procedures and identify potential areas of non-compliance. They will need to be in a position to explain any derogations from the provisions of the Code in their oversight agreement. Boards will need to review their schedule of matters reserved and annual board calendar to ensure that they cover all responsibilities outlined in the Code, such as talent and culture. They will also need to consider the information and assurance they are receiving on these areas and whether it is sufficient to enable the board to discharge its responsibilities.

Boards that do not conduct any form of annual self-assessment of its own performance will have to establish a process. For those that have established internal practices, they will need to consider the timing of their external evaluation, which is required every three years. In addition, boards and management will also need to consider where in the annual report the new disclosure requirements will go, the governance report or financial statements. They will also need to review the impact these changes will have on the internal timetable for delivery of the annual report. Following the changes to public procurement requirements, state bodies will have to examine their procurement policies and procedures, alongside the roles and responsibilities for the monitoring and oversight of these systems. State bodies will have to review their committee structures with a view to establishing an audit and risk committee if they do not already have one in place. Those that do have one, will need to assess the composition and take into account the recommendation for an external member. The changes relating to the board's risk management and internal control responsibilities will require enhancements to processes to enable the Board 'to form its own view' and provide them with the necessary assurance to sign off the statement. Similarly, the requirement for a robust assessment of principal risks will also require state bodies to look at the processes in place to support this assessment, not just consider the wording of the statement. State bodies will have to examine the changes regarding relations with the Oireachtas and Minister/parent department, to ensure that written oversight agreements and, in the context of non-commercial state bodies, relevant performance delivery agreements are in place.

The growing interest in corporate governance codes among the EU Member States may reflect an understanding that equity investors, whether foreign or domestic, are considering the quality of corporate governance along with financial performance and other factors when deciding whether to invest in a company. The greatest distinctions between corporate governance practices in the EU Member States appear to result from differences in law company law standardisation has been achieved throughout the European Union, some commentators suggest that the remaining legal differences are the ones most deeply grounded in national attitudes, and hence, the most difficult to change. It is important to note that the codes tend to express notions of "best practice" – but the translation of best practice ideals into actual practice may take time to achieve.

Interest in both mandatory and voluntary social issue reporting is growing throughout the EU. A U.K. regulation was issued requiring investment fund companies to disclose whether they have policies on social investment. The U.K. company law review effort also recommended that boards disclose the impact of major decisions on communities, employees, and suppliers. French corporate law was recently amended to require listed companies to disclose in their annual reports how they take into account the social and environmental consequences of their activities.

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1.7. CORPORATE GOVERNANCE IN FRANCE (2008-2016)

Emilie Bonhoure
Laurent Germain

1.7.1. Overview of the French Legal Framework of Corporate Governance

On the practical side, the AFG (Association Française de la Gestion Financière) defines corporate governance as a field that «focuses on the division of powers between various stakeholders, including company's governance bodies, the board (board of directors or supervisory board) and shareholders, with the aim of ensuring a balance of power within a company. [It] encompasses the rights and obligations of corporate management with regard to the others stakeholders, as well as the mechanisms that the other stakeholders' can use to control the activities of corporate management."

The French legal framework will be detailed further in the corresponding parts, but very generally European countries have implemented reforms in the corporate governance field for the last twenty to twenty-five years for three main reasons (Enriques & Volpin, 2007):

1. To increase the attractiveness of their national markets;
2. To implement a common regulatory framework at the European level;
3. As part of a response to the many scandals of the 1990s and 2000s.

In France, these reforms have mostly focused on:

- The strengthening of internal governance mechanisms, in particular, to limit self-dealing and to improve board effectiveness.
- The increase in minority shareholders' powers.
- The increase in disclosure requirements, in particular on general corporate governance issues, along with self-dealing and insider, compensation, and financial reporting and audit issues.
- The reinforcement of public regulation and sanctions.

Regarding disclosure requirements, firms now have to disclose any corporate governance arrangements, non-routine transactions[67], the whole compensation of board members including their stock options. They also have to mention whether they comply with the national corporate governance code (we discuss below) following the *comply-or-explain* principle. Since 2002 (effective in 2006), they make their financial statements following IFRS norms.

Regarding the reinforcement of public regulation, French supervisory authorities have been merged into one single, the AMF- Autorité des Marchés Financiers (http://www.amf-france.org/en) in 2003. Criminal sanctions for market abuses have also been implemented since the 1970s in France (with a reinforcement in 1996), in addition to the Market Abuses European directive in 2003 (tightened in 2005).

More recent reforms focus on the strengthening of internal governance mechanisms in particular on the board independence and composition. For instance, a

[67] From 2001, revised in 2003 and 2005.

20%-rule (at least 20% of women on boards) by 2014, to be increased to 40% by 2017, has been set[68]. They also reinforce shareholders rights and especially shareholders' oversight over compensation. After the compensation proposal for the chairman-CEO of Renault, Carlos Ghosn, has been refused by the general meeting of shareholders (hereafter the GM) in 2016, the French Parliament included the *say-on-pay* principle into the Sapin II Act[69].

In Europe, in addition to the national laws, national sets of "soft laws" (AMF, 2016) have been implemented since the 1990s, namely the national codes of corporate governance. They are partly the expression of the wish of the European Commission to progressively come to a convergence of national corporate governance policies. Nonetheless, they also express national specificities in terms of culture or history of corporate governance.

The French code, also called the AFEP-MEDEF code[70], displays several characteristics:

- Its application is not mandatory; it is only made of recommendations. Companies can derogate thanks to the *comply-or-explain* principle: either they comply with the code recommendations, or they can explain in their releases why they do not do so. The only mandatory rule (set by a European directive) requires any firm listed on a regulated market to display which code it is submitted to and whether it has decided to comply with it or not.
- There exists another code for SMEs, the MiddleNext code, published since 2009.

The revisions of the code are not regular but rather done in specific contexts (crisis, new European directives, etc). In particular, during the last two years, some new items or issues have been added to the diversity of board and committee members, compensation issues etc.

1.7.2. Ownership Structures of Companies

Contrary to the Anglo-Saxon world, ownership in Europe is usually concentrated in large shareholder's hands that are dominant in terms of control rights (e.g. has most of the votes) but not necessarily in terms of cash-flow rights. These controlling shareholders then have "both the incentive and the power" (Enriques et al., 2007) to monitor the management. The main consequence is the emergence of a new type of agency issues between controlling (who become the agents) and minority (the principal) shareholders, instead of the usual shareholder-versus-manager conflict (Enriques et al., 2007).

The main types of concentrated ownership are (Enriques et al., 2007):

- Family control, where control is concentrated into one family's hands, most usually the founder of the company.

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[68] According to an EY (Ernst and Young) report "Panorama de la Gouvernance en 2016", the 40%-threshold represents a real challenge for French firms especially for SBF120 ones. EY indeed forecasts that less than half of them should comply with the 40%-rule by the beginning of 2017.

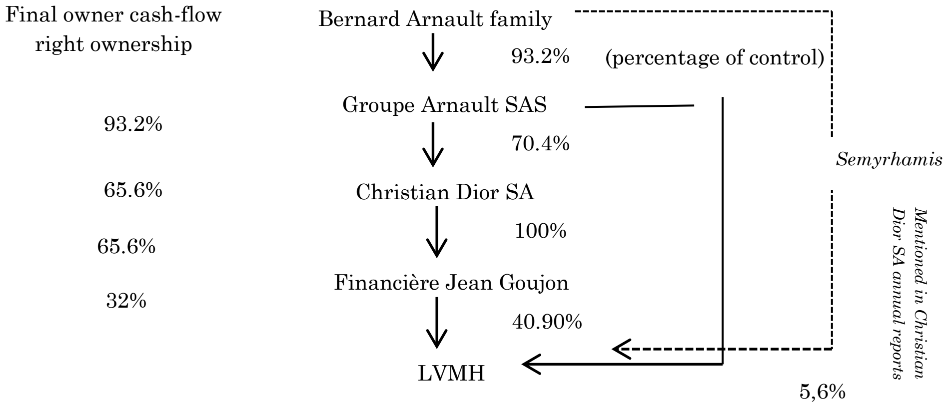
[69] AMF "Rapport 2016 sur le gouvernement d'entreprise et la rémunération des dirigeants". This new law acts as an anticipation of the revised European directive "Shareholders' rights" whose negotiation process is still pending.

[70] This code has been first released in 2004 and gathers the recommendations of different reports made in 1995, 1999, and 2002. It is written by two associations that represents issuers (namely companies): AFEP (Association Française des Entreprises Privées created in 1982) and MEDEF (Mouvement des Entreprises de France created in 1998). Since 2013, the High Committee for Corporate Governance (HCGE in French) can also make proposals of updates and impulse debates related to corporate governance. Moreover, even it is written only by issuers associations, investors and their representatives can nonetheless be consulted for the redaction. (Source: AMF 2016 report "Etude comparée : les codes de gouvernement d'entreprise dans 10 pays européens")

- Pyramidal control "in which the controlling shareholder exercises control of one company through at least one other listed company".

A good example of the pyramidal ownership structure in France is LVMH (https://www.lvmh.com). Its final owner is Bernard Arnault family who (ultimately) owns around 32.4% whereas the family controls 46.5% of LVMH thanks to the ownership of intermediary companies (such as Groupe Arnault, Christian Dior SA, etc) as Figure 1.7.1 displays[71]. Moreover, additional intermediary structures, like Semyrhamis (Forbes,2012), and specific types of shares regarding votes give even more control to the family and in particular to Groupe Arnault controlled by it[72].

Figure 1.7.1. LVMH ownership structure



Sources: Enriques, et al., 2007 and Forbes, 2012 Inside LVMH's Byzantine ownership structure.

The sole CAC40 index offers additional examples of « family businesses », namely firms controlled or ultimately controlled by the family thanks to a pyramidal structure: PSA group owned by Peugeot family through Etablissements Peugeot frères and the Société Foncière Financières et de Participations; Bouygues with the SCDM company controlled by Martin and Olivier Bouygues; L'Oréal group owned by the Bettencourt Meyers family; Kering owned by the Pinault family through the Société financière Pinault and Artémis; Sodexo in Bellon family's hands thanks to Bellon SA; and Pernod Ricard owned by the Ricard family through the Société Paul Ricard[73].

1.7.3. Market for Corporate Controls (M&A)

All takeovers are under the supervision of AMF, which applies national regulation in line with the European framework. Regarding takeovers, it especially monitors the information given to shareholders and the conformity of operations with the legal framework.

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[71] Figures are for 2012, but Groupe Arnault controlled a quite stable percentage of LVMH between 2010 and 2016 (above 46%) (Forbes, 2012). Moreover, (Enriques, et. al, 2007) 140 display a more or less similar structure in terms of ownership in their paper for 2005 (adding Semyrhamis and Financière Agache structures).

[72] According to the reference documents published by LVMH from 2010 to 2016, Groupe Arnault owned the following percentages of LVMH and of the voting rights: 47.64% (versus 63.66% of voting rights) in 2010, 46.48% (vs. 62.38%) in 2011, 46.42% (vs. 62.65%) in 2012, 46.45% (vs. 62.59%) in 2013, 46.57% (vs. 62.59%) in 2014, 46.64% (vs. 62.90%) in 2015, 46.74% (vs. 63.07%) in 2016.

[73] Information and all figures come from corporate websites as well as 2016 reference documents released by each company.

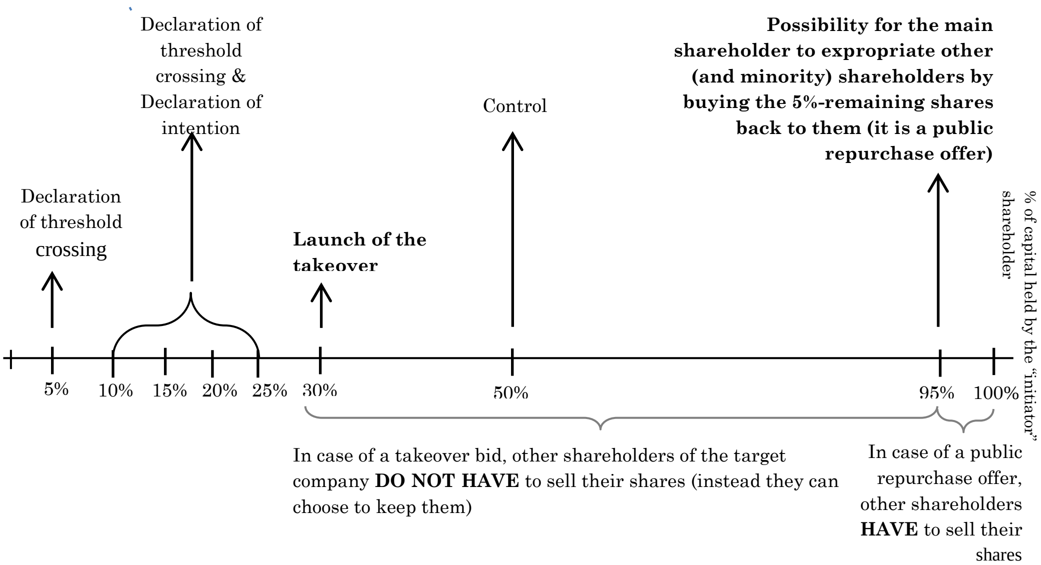
Shareholders of listed companies have to comply with specific requirements when the percentage of the capital they own goes above or below certain thresholds (see Figure 1.7.2). In particular, there exists a threshold of capital ownership above which the shareholder has to launch a takeover. In 2011, the regulator imposed shareholders to launch this mandatory takeover above 30% of capital holding (down from 33% before that). In other words, an investor who holds at least 30% of the capital of a firm has the obligation to set a takeover bid over all the other firm stocks. The purpose is to ensure minority shareholders a better protection (AMF, 2014). Furthermore, the Gallois report (2012) released a related proposal: lowering this minimal threshold of stock holding to launch a takeover from 30% down to 20% or 25% to limit even more disruptive takeovers (Gallois, 2012).

Figure 1.7.2 displays the rules implemented according to the different thresholds (AMF; www.lafinancepourtous.com).

Regarding more general assets sales or acquisitions, the mood also tends to a tightening of rules. There is actually no coercive regulation over assets sales and acquisitions: companies are not required to set a public offer/bid when they sell or purchase assets. Such operations thus legally depend on corporate law, which in France leaves much room to firms and set assets-related operations under the responsibility of managers and other management committees (with no obligation of shareholders consultation). The AFEP-MEDEF code only recommends consulting the shareholders assembly if assets sales or purchases represent a significant part of the whole corporate assets or activities (AMF, 2015).

However, a more tightened framework is considered in particular since the two big operations of SFR-Vivendi and Alstom in 2014. It may indeed ensure a better protection of shareholders and a more efficient management of their conflict of interests with firm insiders, especially thanks to a better information disclosure.

Figure 1.7.2. Takeover and disclosure thresholds



Consequently, in 2015, the AMF recommended to adopt the principle of consultation of shareholders when the company wants to sell at least a half of corporate assets[74]. More specifically, it recommends to consult shareholders when at least two out of four specific ratios reach 50% over two years (the net sales of the sold assets relative to consolidated sales, the selling price of assets relative to the corporate market capitalization, the net value of sold assets, etc). This recommendation has also been extended to significant assets acquisitions and more generally to the enhancement of information disclosure (especially on the motives of such operations) (AMF, 2015).

Mergers, as in any other country and in particular in the European community, are submitted to a much more tightened regulation, partly because of the anticompetitive effects that might threaten consumers' interests. In France, merger control has been implemented as soon as 1977, then revised several times in 1986, 2001, and 2008 (through the Modernization of the Economy act).

When the merger or any concentration project reaches certain thresholds especially in terms of total net sales, it falls under the control of either the European Commission (it is then said to be of "community dimension") or the French *Autorité de la Concurrence*[75] (then called of "national dimension"). The dimension of the concentration project depends on the thresholds. In the case of national dimension, the operation initiator has to require the *Autorité* authorization that can denies it if it expects the project to have anticompetitive effects (Autorité de la concurrence, 2015).

The examination and approval process is done in several steps (Autorité de la concurrence, 2015):

- Pre-notification, which is optional.
- Referral, either to the European Commission if the operation is of national dimension or to the *Autorité* if is of community dimension.
- Phase 1, which first consists in a formal notification. After that, the *Autorité* can authorize the merger; otherwise, the process steps to Phase 2.
- Phase 2, which ends up with the final decision, namely either the approval or the interdiction of the merger operation. One has to mention that the minister of Economy can require stepping to the phase 2, and can intervene when this step is processing.
- Appeals: all the decisions made by the *Autorité* or the minister of Economy can be appealed to the *Conseil d'Etat* (the French Administrative Supreme Court).
- Remedies: if some remedies have been required by the *Autorité* to offset expected anticompetitive effects, they are then implemented in that step.

[74] High Committee of Corporate Governance, 2016 annual report. It releases information over the period from September 2015 to August 2016. This committee has been created in 2013; its purpose is the follow-up of the application of the AFEP-MEDEF governance code along with the proposal of updates for this code. The sample of the 2016 report is made of 35 CAC40 firms and 105 SBF120 firms.

[75] Website: http://www.autoritedelaconcurrence.fr/user/index.php?lang=en. According to its 2015 annual report synthesis, the *Autorité de la concurrence* has three missions: "reviewing mergers", "punishing anticompetitive practices" (such as agreements or abuses of a dominant position), and "providing expert advice to the public authorities and economic stakeholders".

1.7.4. Board of Directors' Practices

Belot et al. (2014) provide an overview of the board structure in France and make the distinction between unitary and two-tier boards.

The former gathers in a single body the representatives of both managers and shareholders. Typically, in this case, CEO and board chairman functions are unified, but since the New Economic Regulation act in 2001, companies with a one-tier board are allowed to split both functions. Examples of such companies include LVMH or Bouygues.

By contrast, the two-tier-board structure implies the separation into two distinct boards:

- The supervisory board (the *conseil de surveillance*) is elected by shareholders and is in charge of the appointment of the CEO and other members of the management board, of their monitoring, and of the setting of the global corporate strategy.
- The management board (the *directoire*) is rather in charge of the day-to-day management.

Examples of such companies include in particular PSA group.

Belot et al.'s results show that among the founder- or family-controlled firms, the formers (unitary boards) are more likely when the CEO is part of the control group (what they call the "centralization of control"), whereas dual boards are more likely within firms with professional managers.

Table 1.7.1 summarizes the characteristics of these different types of board structures.

Table 1.7.1. Board structures – main characteristics

	Unitary boards	***Two-tier boards***	
		Supervisory board	***Management board***
Number of members	Between 3 and 18	Between 3 and 18	Up to 7
Mandate duration[76]	Max 6 years with possible renewal	Max 6 years with possible renewal	Between 2 and 6 years with possible renewal
Presence of managers	Yes in a limit of 1/3	No (not allowed)	Yes
Member independence[77]	No legal requirements	No legal requirements	NA
Committees[78]	No legal requirements except for audit committees	No legal requirements except for audit committees	NA

Belot et al. provide an empirical study of these unitary-versus-dual structures and find that the choice of the structure within French firms depends on their characteristics. In particular, when asymmetry of information is higher companies are

[76] The 2016 annual report of the High Committee for Corporate Governance displays the following figures on the mandate durations of French firms (the sample includes CAC40 and SBF120 firms): in most SBF120 companies, mandates last either 3 or 4 years (in respectively 35.2% and 61.9% of them). The trend is even clearer in CAC40 firms as mandate durations perfectly split between 3 and 4 years (resp. 34.3% and 65.7%).

[77] Even though there is no legal requirement, unitary and supervisory boards of companies typically have between a third and a half of their members regarded as independent.

[78] The missions of audit committees are determined by law. For other types of committees, there is no legal requirement, but companies most commonly have two more board committees in addition to the audit one: nomination and compensation committees.

more likely to choose a unitary board, which should be more manager-friendly and thus more likely to get information from executive officers. Conversely, when room for private benefits is greater, firms will most likely choose a dual structure, that it is shown to allow tougher monitoring, as the supervisory board (namely the monitoring part) will not look for information or any help from the management. Eventually, they find little evidence of a general effect of board structure over the firm value, meaning that dual boards (which imply stronger monitoring) do not result in a lower firm value.

An important aspect of French corporate governance (linked to board structures) is related to the separation of the CEO[79] and the chairman[80] functions, which has also been allowed in unitary boards since 2001. Indeed, in 2016 in France, only 35% of CAC40 companies distinguished both functions, versus more than 90% of the largest firms in Germany, Italy, and the UK. Power dissociation nonetheless gains momentum as the referee board member[81] and the deputy chairman[82] got more powers (Ernst and Young, 2017).

However, when it is possible, national corporate governance codes in Europe (France, Italy, and Spain) mention the possibility of appointing a referee board member to act as a counter-power of the CEO-chairman. In France, the national code does not recommend him to be chosen among the independent directors or do not even define his functions (AMF, 2016).

Another field related to board that has been very much explored in theoretical and empirical literature is its composition[83]. In particular, what are the optimal numbers of members, of employees, of women, of independent members, etc? What is the impact of its composition over firm value?

Ernst and Young provides an overview of board composition in 2016 (Ernst and Young, 2017):

- The part of women is increasing compared with 2015, to around 30% (34% for CAC40 companies, 33% for SBF120 ones, 27% for midcaps).
- The part of independent members is increasing too: 61% among CAC40 firms, 51% among SBF120 ones, 42% among midcaps.
- The part of foreigners is steady but with important gaps between larger and smaller companies: 31% and 24% for CAC40 and SBF120 (respectively) firms, versus 8% for midcaps.

Overall, EY report locates France at a good place compared with the UK, Germany, and Italy; in particular for the percentage of women (French firms of its sample have the greater percentage of women).

Employee representation in board also represents an important piece of the debate and is part of a more general question related to cultural differences between countries.

In France, employee representation begins in 1983 with an introduction in public companies (reinforced in 1986) (Bourjade, Germain, Lyon-Caen, 2016). In 2013 (via the

[79] *Directeur général*
[80] *Président du conseil d'administration*
[81] *Administrateur référent* or senior board member
[82] *Vice-président du conseil d'administration*
[83] We do not provide an exhaustive literature review on this topic here, as this is not the purpose of the book. We rather focus on the legal framework on it along with an overview of today practices.

Employment Protection act), after the release of the Gallois report, the legal obligation is extended to all large companies (5,000 employees in France or 10,000 all around the world): such firms have to allocate at least one seat for an employee representative on their board (Bourjade et al., 2016) The Rebsamen act (2015) widens the scope of companies affected by this obligation (High Committee of Corporate Governance, 2016).

Moreover, the French commercial code sets the obligation to allocate seats to representatives of employee shareholders (High Committee of Corporate Governance, 2016)[84]. The AFEP-MEDEF code also recommends the appointment of employee representatives on board committees.

To consider concrete figures, AMF reported that over the 62 firms of its sample, 16 of them had appointed in 2015 at least one representative of employee shareholders, and 29 of them had appointed a board member who was an employee but not a shareholder (AMF, 2016).

Board parity is also an important aspect of board composition. The increasing interest in this issue has led to the implementation of many new laws or recommendations all around the world. The evolution of the percentage of women on boards is homogenous across countries: while it used to be around 0% before the 1990s, in 2015, it is up to 40% of female board members within CAC40 firms, between 20% and 25% within FTSE100 and S&P500 ones (Bourjade et al., 2016).

In France, the Copé-Zimmermann act (2011) sets the legal obligation of allocating seats on boards to female members. Legal levels to be reached were 20% by 2014 and 40% by 2017 for companies (listed or not) that have more than 500 employees and whose total balance sheet or net sales are above 50 million euros (this number-of-employee threshold is to lower to 250 employees by 2020)[85]. The law followed recommendations made by the AFEP-MEDEF code one year before (AMF, 2016).

France gets the best rank in the European Union, and AMF even reports an improvement within French boards: 35.2% of women on boards of the companies in its sample by the end-2015 (against 31.5% at the end-2014 and 28% at the end-2013) (AMF, 2016).

However, there is a gap between this improvement within boards and the part of women within executive officers: only 3 over the 62 firms of the AMF sample had appointed a woman as the CEO-chairman or CEO, 2 over 62 have appointed a woman as the chairman of the board at the end-2015 (AMF, 2016)[86].

Another recently well-debated issue is the independence of the board and especially the number of independent members relatively to top management. The presence of politicians on boards (and the resulting political connections of some companies) is a good example of the accuracy of such a debate. It is indeed a common practice in Europe for former politicians to exert a function in the private sector after

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[84] The rule is that in listed companies, when employee shareholders hold more than 3% of the capital, shareholders have to appoint at least one board member who represents employee shareholders (unless one employee representative is already on the board) (Source: AMF "Rapport 2016 sur le gouvernement d'entreprise et la rémunération des dirigeants")

[85] The threshold of 20% in 2014 has been easily reached, but the 40%-level to be reached by 2017 might be more difficult to reach especially for mid-cap companies because they might lack of potential female board members (source: AMF 2016 report "Etude comparée : les codes de gouvernement d'entreprise dans 10 pays européens")

[86] According to the report, only 1.6% of its sample firms (respectively 0% of CAC40 firms) have a female CEO-chairman, 3.2% (resp. 2.8%) a female chairman, 1.6% (resp. 0%) a female CEO…

their political mandate(s); the most recent and discussed example is José Manuel Barroso, former chairman of the European Commission, who has been hired by the investment bank Goldman Sachs. It is as common in France: in 2017, for the first time, a former president, Nicolas Sarkozy, has been appointed to a board, the board of Accor hotels. In the framework of his new function, Nicolas Sarkozy will also be present at the committee for the international strategy that has been specially created. If the appointment of a former president on a board is the first time in France, other politicians have been hired by companies: Jean-Louis Borloo (beside functions at the Parliament, several times Minister in particular of the Economy and Employment) on Huawei board, Hubert Védrine (former Foreign Minister) at LVMH, Dominique Bussereau (Transport and Agriculture Minister) at CMA-CGM, Anne-Marie Idrac (Minister of State for Foreign Trade, and for Transports) at Total, Bouygues, Saint Gobain, and Aéroport de Toulouse. Even politicians' wives have been appointed too: Bernadette Chirac (former President Jacques Chirac's wife) at LVMH, Cherie Blair (former English Prime Minister Tony Blair's wife) at Renault[87].

More broadly, rules on board independence have been implemented since the 2000s and focus on the number of independent members on board, on the separation of the manager (CEO) and board chairman roles, and on the creation of specialized committees (on compensation, audit, nomination…) (Bourjade, 2016). This independence has indeed been recommended by the European Commission in 2005, which in addition sets a list of negative criteria to define it (and to be adapted according each national context). In France, such criteria are set by the corporate governance code but are not mandatory: instead, they follow the *comply-or-explain* principle[88] [89].
The AFEP-MEDEF code considers a board member to be independent when[90]:

- He is not an employee, an executive officer or a board member of the firm or of a related firm (parent company, subsidiary, cross-shareholding, cross-board mandates, customer, supplier, a bank of the firm, through any business relationship…).
- He is not a relative of an executive officer.
- He has not been an auditor of the firm during the 5 previous years.
- He has not been an administrator of the firm for more than 12 years.

In 2016, AMF reports that there are a high proportion of independent boards within French firms (61% at the end-2015). Generally, most firms comply with the recommendation over declarations of conflicts of interests (whether one of their executive officers is appointed on the board of another company, over business relationships…). Moreover, audit and compensation committees have most of their members who are independent (in a proportion greater than three quarters, which is increasing from 2014 to 2015); most of them have also an independent chairman[91].

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[87] *Challenges* "Un ex-président pantoufle à son tour" (published for March, 2th to 8th, 2017)
[88] AMF 2016 report "Etude comparée : les codes de gouvernement d'entreprise dans 10 pays européens"
[89] AMF "Rapport 2016 sur le gouvernement d'entreprise et la rémunération des dirigeants": in particular, it recommends companies to have at least 50% of independent board members when their ownership is dispersed and without controlling shareholders, and at least one third of independent members in more-concentrated-ownership firms. It also recommends that the compensation committee be chaired by an independent administrator.
[90] *Ibid*
[91] *Ibid*

Partly linked to board independence, the plurality of offices is limited[92]. The Commercial code indeed states that an individual cannot have more than five offices as a board or supervisory board member of a public corporation[93] whose head office is located in France. The Macron act (2015) tightened this rule by preventing an individual who is also a CEO or a member of the management board of a big[94] listed company from having two offices as a board member. Both financial and monetary codes include other restrictions.

The recommendations of the AFEP-MEDEF code are even more restrictive: it recommends the limitation of the number of offices at five, including in foreign companies.

Besides board composition, compensation of its members is another important issue, which, in France, is regulated. Members can only be compensated through attendance fees and potential extraordinary compensations should they complete a specific mission approved by the board and the GM (for instance within board committees) (AMF, 2016), which is in line with the recommendations of the AFEP-MEDEF code. Furthermore, the French code recommends compensation rules (both attendance fees and individual amounts) to be displayed (High Committee of Corporate Governance, 2016).

Consistently, all firms studied by the High Committee for Corporate Governance in their last report actually display information relative to attendance fees. In addition, most of them display the rules relative to the repartition rule of attendance fees and the variable part (High Committee of Corporate Governance, 2016).

Even though there is no legal requirement on board committees, many firms do implement such committees in France, in particular, three of them: audit, compensation, and nomination committees. Consequently, it may be valuable to provide a brief overview of what was in place in France by the end-2015 (High Committee of Corporate Governance, 2016).

As the audit committees is a legal obligation, all firms do have one linked to their board or supervisory board. Similarly, all firms studied by the High Committee of Corporate Governance by the end-2015 have a compensation committee[95]. Nomination (or selection and appointment) committees are often gathered with the compensation one, but in the same sample, all firms anyway have a nomination committee[96].

1.7.5. Executive officers' remuneration practices

The 2008 crisis and the many scandals that arose about directors' remuneration and termination arrangements have brought debate on this issue as well as a reputational risk for companies[97].

[92] *Ibid*
[93] *Société Anonyme (SA)*
[94] Namely that employs more than 5,000 people in France and more than 10,000 people in the world.
[95] The AFEP-MEDEF code recommends that there is no executive officer on this committee. Moreover, in 2015, 55.5% (respectively 69.6%) of SBF120 (resp. CAC40) firms had an employee representative on it.
[96] For 30.5% (resp. 54.3%) of SBF120 (resp. CAC40) companies, it was distinct from the compensation committee.
[97] This reputational risk is now less important in France. Nonetheless, it remains difficult to quantify. (Source: EY report "Panorama de la Gouvernance en 2016")

Generally, the law requires the disclosure of executive officers compensation; more specifically, the Commercial code requires the total compensation as well as any benefits in kind paid to all executive officers to be displayed (AMF, 2016).

Moreover, the consultation of shareholders relatively to executive compensation has been introduced in 2012: it is the *say-on-pay* principle. The purpose is to communicate over directors' compensation, especially whether they have been in line with the firm strategy or their objectives, and over compensation criteria (EY report, 2017).

With the Sapin II act (2016), the following has become mandatory for all firms listed in France:

- An *ex ante* annual vote of the GM to approve (or not) the principles and the criteria of the compensation of all executive officers. In other words, now changing the compensation policy requires the GM approval *ex ante*. If the new policy is not approved, the board will have to submit a new one, while the former will keep being applied.
- An *ex post* annual vote of the GM to approve (or not) compensations that have been paid for the previous year to executives, in particular, the variable part of this compensation.

The main difference is now that both votes are binding and no more consultative[98]. The High Committee of Corporate Governance even recommends the board to require an approval rate (of executive compensation) of at least 70 or 80%.

Compared with the European level, French law goes beyond the Shareholders' Rights directive, whose negotiation is still processing. In particular, the Sapin II act requires two binding votes per year.

To this legal framework, the French code of corporate governance also adds recommendations, in particular on the variable part of compensations. It indeed suggests that they are not only based on financial (or quantitative) criteria but also on non-financial (or qualitative) criteria (AMF, 2016).

Other rules have been implemented on the use of shares and stock options that are distributed to executive officers as part of their compensation. Regarding the exercise of executive stock options, the Commercial code indeed states that the board has to either decide that they will be able to exercise the options only when they are not in function anymore or fix the number of stocks that executive will have to keep after options are exercised. Since 2013, the AFEP-MEDEF code has recommended that main executive officers should be required to keep a certain number of shares (fixed by the board or the supervisory board). These retained shares can come from either option exercises or performance stocks (High Committee of Corporate Governance, 2016).

An issue that is well-debated as well as linked to termination arrangements that are the causes of many corporate scandals in the 2000s. In particular, the same code recommends the setting of maximum amounts of termination arrangements at the equivalent of two years of compensation (including both fixed and variable parts) (AMF, 2016).

[98] The binding aspect of the *say-on-pay* principle has been highlighted with negative vote of Renault and Alstom shareholders to the proposal relative to the compensation of their respective CEO-chairman.

By the end-2015, most firms studied by AMF in its annual report included a variable part in their executive compensations (93% of all firms of the sample, and 97% of the ones listed on the CAC40). Moreover, most of them complied with the recommendations in terms of termination arrangements (AMF, 2016).

Regarding the structure of the compensation within the same companies (AMF, 2016), almost all executive officer compensation included a fixed part (and almost 30% of them experienced an increase in this part). Figures on the variable part of compensation are more mixed: at the end-2015, 89% of executive officers of the sample firms earned a variable part (increasing compared with 2014), but almost all firms had at least one executive officer who earned a variable compensation (steady compared with 2014) (AMF, 2016).

The criteria that are chosen to determine the amount of the compensation are of two types (AMF, 2016):

- Quantitative criteria are used by all firms and rely on free cash-flows, operating income, ROCE (return on capital employed), growth in sales, change in EBITDA.
- Qualitative criteria are used by most of them (90%) and are related to the firm strategy, managerial quality, firm ESR (environmental and social responsibility). EY finds that the most used qualitative criteria are the decrease in the carbon footprint and in the use of energies in firm operations along with the improvement in the performance in the health and security at workplace (29% of firms), ethics (17% of them), and the innovation and the development of a series of sustainable products and services (11%) (EY report , 2016).

1.7.6. Shareholders' Rights Protection

Enriques and Volpin (2007) provide a list of shareholders' rights:

- The right to sell their shares.
- The right to sue; even though such a right depends on the easiness and the cost of suing in a given country.
- The right to say, namely to act on corporate governance issues.

In particular, to increase shareholders' voice, several measures can be (or have already been) implemented. First of all, the number of subjects to be approved by the GM may be increased especially to include any "non-routine transactions with a major shareholder" and for specific types of executive compensations[99]. Decreasing costs of voting may also participate in an increase in shareholders' rights, in particular through online vote or facilitations to vote.

In particular, minority shareholders' rights are better and better protected thanks to different measures: specific majorities are required to approve special (namely "non-routine") transactions[100], decrease in the minimum ownership threshold for minority

[99] Through the mandatory *say-on-pay* rule (see Section 1.7.5 of this chapter).
[100] The requirement of the GM approval for non-routine transactions is part of a more global trend that tends to enhance the control of all transactions made by managers and controlling shareholders.

shareholders to exert their rights (especially to call a meeting, ask for an expert…). Further improvements may limit deviations from the one-share-one-vote to prevent controlling shareholders from keeping multiple-vote shares and thus keeping control while not representing the majority on the GM. Minority shareholder representation or super-majority to approve specific topics may also be required.

Among the measures that may improve shareholders' rights protection that have not been discussed yet, the question of "non-routine" (Enriques et al., 2007) or related-party transactions has been considered by the AMF. In particular, it recommends that if the firm A is a shareholder of the firm B and the individual C a shareholder of the firm A, neither firm A nor individual C should participate in a vote of a transaction made by the firm B that may ultimately be beneficial for the individual C. In line with this recommendation, the Sapin II act (2016) requires that any regulated contract between a firm and one of its executive officers need for both board and shareholder approval (AMF, 2016).

The possibility of double voting rights has also been discussed to protect the long-term shareholders. In 2012, one of the proposals of the Gallois report (Gallois, 2012) is to allow companies to focus more on long-term perspectives. To do so, it proposed to automatically give a double voting right to shareholders after two years of stock holding: the Florange act implemented the measure in 2014.

More measures have been implemented on other issues (for instance on board-related ones) but also participate in the protection of shareholders' rights:

- The first of them relates to board independence[101]. Indeed, the more independent from top management the board is, the more it will act in shareholders' interests. In particular, if it is highly independent, it will protect better shareholders from traditional agency issues that arise from the separation of ownership and control.
- The *say-on-pay*[102] rule is also about enhancing shareholders' rights protection as it gives increasing powers to them, in particular, the possibility to influence executive compensation (allowing thus to better monitor or incentivize managers accordingly), the overall requirement to be consulted over more topics, and the possibility for them to impose their decisions.

At the European level, a directive called "Shareholders' rights" is even being discussed (discussions were still processing by the end-2016) (AMF, 2016). The main purpose is to give more power to shareholders and make interests between investors, managers, and issuers converge, especially on board member compensation and related-party transactions. So far, the following items have already been discussed: the reinforcement of shareholders' rights of access to information and of vote, transparency over and vote of executive officers compensation (a European version of the *say-on-pay* rule), a better control of related-party transactions[103].

[101] For a more detailed discussion of board independence, see Section 1.7.4 of the present chapter. Moreover, on the global issue of conflicts of interests, see the AMF "Rapport 2016 sur le gouvernement d'entreprise et la rémunération des dirigeants"
[102] For a more detailed discussion of the s*ay-on-pay* rule, see Section 1.7.5 of this chapter.
[103] The issues that are discussed in this directive negotiation process are much similar to what has already been implemented in France or is recommended by the AFEP-MEDEF code.

1.7.7. Shareholder Activism

Girard and Le Meaux (2007) define shareholder activism as "a process of contestation launched by one minority shareholder or a group of minority shareholders to improve either firm financial performance or its governance structure"[104].

In France, such a process occurs in several steps[105]: (1) informal meetings to reach an agreement, (2) other public (and more offensive) actions towards the public opinion, other shareholders or stakeholders, (3) "proxy battle" to get the majority of voting rights, and (4) share sales by initiating shareholders or legal battle. The questions addressed through this process more and more include topics such as corporate social responsibility and now overall corporate ESR (environmental and social responsibility) issues[106].

Moreover, shareholder activism also depends on cultural habits and on the legal framework. In particular, Civil law countries such as France are showed to less protect minority shareholders; for instance, because of too high minimum thresholds to exert their rights such as calling a meeting, too long share deposits to speak at GMs, impossibility to vote electronically… (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1998).

French shareholder activism has evolved since the 2000s and can now be split into two types (Girard et al., 2013): the usual shareholder activism conducted by short-term-view institutional investors, and the "shareholder commitment" which is longer-term oriented and include in its criteria non-financial and in particular ESR aspects (Girard et al., 2013)[107].

Many of the rules already implemented or recommended result from (or even participate in) shareholder activism in two ways: by guaranteeing an increasing transparency over management decisions and actions, and by increasing shareholders' decisional and coercive powers (AMF, 2007).

For instance on the transparency issue, the legal framework guarantees an increasing disclosure of all corporate governance arrangements, non-routine transactions, board compensation. Even the disclosure of financial statements has been normalized and now has to be done following IFRS so that the understanding is eased and more information is displayed. Similar rules exist on executive compensation and on takeover bids and all types of market controls[108].

The increase in decisional and coercive powers of shareholders is at least as important as the transparency issue, as it encourages them to exercise their voting rights. The *comply-or-explain* principle, for instance, participates in this insofar as it gives more voice to shareholders who, to some extent, require justifications from top

[104] Girard, C., & Le Meaux, J. (2007). De l'activisme à l'engagement actionnarial. Revue Française de Gouvernance d'Entreprise, 1, 113-132."l'activisme actionnarial se définit comme un processus de contestation […] engagé par un actionnaire ou un collectif d'actionnaires minoritaires pour améliorer soit la performance financière de l'entreprise critiquée soit son système de gouvernance"

[105] For a detailed description, see Girard, C., & Gates, S. (2013). L'Evolution de l'activisme actionnarial en France au cours des deux dernières décennies. Working paper. Retrieved from the World Wide Web : https://hal.archives-ouvertes.fr/hal-00853366

[106] For more details, see Section 1.7.9 of this chapter.

[107] a good example is that now more and more investments funds include ESR criteria in their choices of investment.

[108] For example, there exists an obligation of disclosure of threshold ownership (see Section 1.7.3 of the chapter).

management over their decisions. Similarly, the *say-on-pay* rule is also a way to reinforce shareholders' protection and consequently to enhance their potential activism as they now have a real decisional power over executive compensation. More generally, the recent legal framework has driven to a strengthening of all internal governance mechanisms[109], and a more frequent use or recommendation of the consultation of shareholders[110]; the reinforcement of minority shareholders rights and powers being a specific case of these phenomena[111].

1.7.8. Corporate Governance and Firm Performance

Many empirical researches have been conducted to examine whether corporate governance affects or not (and positively or negatively) firm performance. In particular, some studies have focused on specific issues of corporate governance linked to the board[112].

Studies of the impact of employee representation on board find that such a presence positively affects shareholders. In France, Ginglinger et al. (2011) show that if employee representation on boards does not affect firm value or profitability, employee shareholder representatives do have a positive impact over it. In their theoretical investigation, Germain and Lyon-Caen (2015) find that specific levels of employee representation on boards may increase the firm value and make it more oriented towards long-term perspectives.

However, empirical results on the parity topic (does the presence of women on boards enhance firm value?) are more mixed, in particular over the relationship between firm performance and board diversity.

As we previously discussed, board independence is more and more crucial. It is considered to help decreasing agency issues between shareholders and managers by appointing board members that are less advocated to executive officers and whose interests are more aligned with shareholders' ones[113].

Again on that topic, empirical results are mixed. On the one hand, they show that a greater independence acts more in favor of shareholders (accordingly to the decrease in agency conflicts). But on the other hand, they do not provide a clear link between independence and value for shareholders.

Bourjade et al. (2016) justify these mixed findings by several reasons. First, the independence of a board member is difficult to assess and even to define, especially if one considers crossed or multiple mandates (of board members as well as of executive officers), personal and family networks, social networks of the elite in particular in France (for instance, ENA graduates)… The second difficulty is related to the endogeneity problem: while the impact of board composition over firm performance is

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[109] A good example of this is the strengthening of board independence (see Section 1.7.4).

[110] For instance, consultation of shareholders over big corporate asset sales (see Section 1.7.3).

[111] For instance, in 2001, the lowering of minimum thresholds (from 10% down to 5%) to make a proposal to a GM, the authorization of electronical votes…

[112] In the paragraphs that present empirical results, we will mostly focus on France-related studies.

[113]Bourjade et al., provide an overview of the findings trying to correlate board independence and firm performance.

much studied, it may be interesting to ask whether this is not rather the latter that affects the former. Finally, firm performance is determined by many other factors than the single governance quality and in particular the number of independent board members.

Regarding the impact of ownership structure on firm performance, empirical studies usually show that family-controlled firms are better managed than the widely-held ones: for instance within companies from continental Europe, Barontini & Caprio (2005) observe a higher performance within family-controlled firms.

Indeed, family control may yield positive effects: shareholders' interests are more protected[114], firm strategy and shareholders' perspective are longer-term oriented. This nevertheless creates a new type of agency issues, between the family that is the controlling shareholders (equivalent to the agent) and other shareholders (equivalent to the principal) (Enriques, 2007).

On the overall ownership structure, empirical studies bring more conflicting results that well illustrate both positive and negative affects ownership type can have on firm performance[115].

Finally, regarding the overall shareholder issue, an interesting finding comes with Gompers et al.'s (2003) study. They indeed construct a "Governance index" based on shareholders' rights and find that stronger shareholders' rights imply better corporate performance.

1.7.9. Corporate Social Responsibility

Corporate social responsibility is an increasing topic of interest that was initially set by shareholders' preferences and activism (through for instance their choice of ESR-involved companies).

The main point through which a company is regarded as ESR-involved is obviously the range of products or services it offers (are they socially and environmentally sustainable?). But it is also a subject that is more and more discussed within boards (EY report, 2017) and other frameworks, and impact many other aspects of corporate lifecycle and activities. EY indeed provides clear figures to support it. According to their report:

- 55% of CAC40 boards had discussed it in 2016 (which represents an increase by 10% compared with 2015);
- Among boards that have discussed it, 26% did through a committee solely dedicated to ESR, 35% regard ESR issues as a compliance requirement, and 39% regard them as a strategic corporate issue.

ESR has even been added as a non-financial criterion to the variable part of numerous executive compensations[116]. It covers various topics as carbon, health, and

[114] Usually managers are members of the family and thus also shareholders, which reduces the traditional agency issues between shareholders and managers.

[115] Demsetz, & Villallonga, 2001 well show this possible compensation of both opposite effects, and find that ownership structure has no impact over firm performance.

[116] For more details, see Section 1.7.5 of this chapter.

safety at the workplace, ethics, innovation and sustainable offer, employees' involvement, ranking in extra-financial indexes[117].

If the increasing interest in ESR partly comes from shareholder activism, it also results from a more and more coercive legal framework on the topic. Indeed, in France, by the end-2015, several laws already regulate corporate behavior and information disclosure relative to ESR (AMF, 2016):

- The New Economic Regulations act (2001) as well as the Grenelle I act (2009) aim at regulating the disclosure of non-financial (especially social and environmental) information by listed companies.
- The Grenelle II act (2010) extends the information to be published to societal issues along with the scope of companies that have to release such information. It also makes mandatory for listed firms to display a list of 42 items linked to ESR.
- The Banking and Financial Regulation act (2010) cancels the possibility for employee and stakeholder representative institutions to discuss ESR-related information that is released.
- The Warsmann IV act (2012) implies to release two distinct lists of information and exceptions regarding subsidiary firms whose parent company already publishes a consolidated report.

After 2015, the Energy Transition for Green Growth act (2015) adds other requirements such as the report of financial risks that result from global warming and corporate actions to curb them. It also extends the information that has to be displayed in ESR reports: companies now have to include discussions about their commitment to "circular economy", and about the consequences of global warming over corporate activities and good and services firm consume. Besides, the Fight against Food Wasting act (2016) requires companies to include information on that topic in their ESR report (AMF, 2016). There also exist legal rules set at the European level such as the ESR directive (AMF, 2016).

In addition, AMF recommends to improve ESR-related information and even to explain it more in corporate ESR reports. It also makes recommendations relative to *green bond* issuance (in particular in terms of communication around their issuance), to the discussion of social and environmental risks, and to the exact definition and explanation of ESR criteria used in executive compensation (AMF, 2016).

Overall, French companies obviously comply with such requirements and even goes beyond this legal framework, as most of them set more long-term-oriented objectives, use clearer and more and more relevant ESR indicators, and release both financial and non-financial information. Consequently, even if there is room for further improvements, all French firms have increased the time and the efforts allocated to ESR (in particular in terms of time of discussion, allocated resources, development of new tools, etc.) (AMF, 2016).

[117] Such indexes are good examples of fields which corporate social responsibility covers, along with of shareholder activism. They are indeed more and more asked by investors (both institutional and individual ones). A good example is sustainable-based indexes like the DJSI (Dow Jones Sustainability Indices).

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1.8. CORPORATE GOVERNANCE IN THE NETHERLANDS: TRENDS, CHALLENGES AND OPPORTUNITIES (2008-2016)

Niels Hermes
Kees van Veen

1.8.1. Introduction

Corporate governance issues resulting from the separation of owners and managers emerged already in 1602 when the Dutch *East India Company* (in Dutch: *De Vereenigde Oostindische Compagnie*) was established. The East India Company was the first company in history to issue bonds and shares to the general public, that is, it was the first publicly traded company in history. It showed strong similarities with the modern corporation as described by Berle and Means (1932) both in terms of its governance structure, as well as with respect to the solutions it developed to solve agency problems. For instance, shareholders of the East India Company demanded that a board of executive directors dealing with the day-to-day management was installed and that this board provided the shareholders with information about the company's results, which was subsequently verified by an independent third party (Frentrop, 2002). These demands resemble the solutions to corporate governance problems advanced by agency theory (Jensen and Meckling, 1976; Fama and Jensen, 1983), one of the most prominent theories in corporate governance literature (Akkermans et al., 2009).

Since the establishment of the East India Company in the early seventeenth century, a lot has happened regarding the theory and practice of corporate governance. Discussions about its importance and impact on company decisions slowly developed since the early 1970s. These discussions became more intense when a number of corporate scandals in the UK triggered the publication of the "Report of the committee on the financial aspect of corporate governance", also known as the Cadbury Report, in 1992. This report contained a number of best practice recommendations regarding the characteristics of boards of directors and other governance mechanisms (Zattoni and Cuomo, 2007). Since then, many other countries published a corporate governance code containing best practice provisions with the aim to enhance the quality and transparency of management, which should ultimately help improving company performance and restoring investors' confidence (Von Werder et al., 2005).

Debates about corporate governance further intensified with the corporate scandals in the US and Europe during the early 2000s. Companies such as Enron, WorldCom, Parmalat and the Dutch retail company Ahold showed to have major corporate governance problems, triggering corporate misbehaviour such as falsifying financial results, inflating sales, hiding information and self-enrichment of management. The response of governments and regulating institutions to these scandals was to further strengthen rules and regulations regarding corporate governance practices. Especially in the US, this response was quite far-reaching with the establishment of mandatory rules of governance regarding the transparency and accountability of information under the Sarbanes-Oxley Act. In most other jurisdictions corporate governance codes were revised and best practices were adjusted or expanded, but compliance with these best practices remained voluntary.

The global financial crisis of 2007-2008 provided a further boost to discussions about how corporate governance problems should be addressed. This time, the governance of banks was at the center of attention and in some countries, specific codes for bank governance were established. Yet, corporate governance practices, in general, were questioned and new rules and regulations were developed, examples being say-on-pay, claw-back clauses, etc.

This chapter discusses the main developments and trends with respect to corporate governance mechanisms in the Netherlands since the wake of the global financial crisis in 2008. Special attention will be given to the Dutch legal framework, shareholders and shareholder rights, shareholder activism, the role of boards, and executive remuneration[118]. Before discussing these recent developments, we first provide a short description of the Dutch corporate governance setting and how it emerged from the late 1990s to the start of the global financial crisis.

1.8.2. The Dutch Corporate Governance System before the Global Financial Crisis

According to La Porta et al. (1999), in the 1990s ownership structure of Dutch listed companies consisted of a combination of widely dispersed ownership (30% of the largest listed companies), family controlled ownership (20%) and a mixture of ownership controlled by (foreign) pension funds, mutual funds, voting or management trust, etc. (35%). In this respect, Dutch ownership structure was rather different from many other Continental European countries, in which families (Sweden, Belgium, Portugal), the government (Austria, Italy, Finland) or financial institutions (Germany, Portugal, Sweden) had a dominant stake.

At the beginning of the 2000s, the Dutch corporate governance system was characterized by a stakeholder model, emphasizing that the interests of different stakeholders of a company should be explicitly taken into account during the board's decision-making process. Boards had a two-tier board structure with a co-option system, that is, members of the existing board decided on the selection of new board members. This led to creating an old-boys network of directors who appointed each other to board positions in different companies. Many Dutch companies also had several anti-takeover devices (such as preference and/or priority shares) in place. Because of these two characteristics, management boards had a lot of discretionary power and shareholders had only limited possibilities to influence decisions, meaning that effective checks and balances of managerial decision making were lacking.

[118] We acknowledge we do not cover important issues such as policies related to disclosure and transparency, and corporate social responsibility (CSR) in this chapter. Including discussions on these topics would have made this chapter substantially longer, however. We therefore decided to make a selection of topics related to corporate governance and decided to leave out disclosure and CSR policies.

Triggered by the corporate scandals and fraud cases that hit the corporate world in the first years of the 2000s, the Dutch government decided to change the rules of the game to increase the role of shareholders and reduce the power of the management board. Clearly, failing corporate governance was seen as one of the main causes of the corporate scandals. In particular, the Ahold accounting scandal in 2003 was a turning point. To avoid future scandals, several measures were taken. To begin with, shareholder rights were strengthened. In particular, shareholders were given the right to appoint and dismiss supervisory board members (which effectively meant the end of the co-option model), the right to approve major board decisions (such as acquisitions), the right to submit shareholder proposals (provided that the shareholder holds more than one percent of the shares), and the right to approve the management remuneration plan. Moreover, a corporate governance code was introduced in 2004. Many best practices included in this Code were directed towards reducing the discretionary power of the management board and improving the accountability towards the shareholders, for example by strengthening the duties and independence of the supervisory board members.

The changing shareholder rights and the introduction of the Code had important consequences for Dutch listed companies. In particular, after 2004 they increasingly became vulnerable to shareholder activism, especially from foreign hedge funds. This vulnerability was the result of a number of conditions that characterized ownership of Dutch companies by the time the changes were made. First, between 1995 and 2005 foreign ownership increased from 37 to 75%[119]. Most of these foreign investors were based in the US. These investors were typically focusing on shareholder value and were not familiar with the Dutch tradition of the stakeholder model.

Second, by the mid-2000s ownership structure of Dutch companies was relatively dispersed. In 2005, almost three-quarters of the large listed Dutch companies were characterized by widely dispersed ownership, which is close to the situation in the US. In Germany and France this was 60 and 50%, respectively; in Italy, it was only 20%. Moreover, the block holdings were substantially lower in the Netherlands as compared to other Continental European countries. Whereas in the Netherlands, the median largest block holder held only around 10% of shares (a percentage was similar to that of the UK and US), in France, Germany and Italy this was (much) higher (that is, 20, 57 and 55%, respectively)[120].

Third, shareholders were generally rather passive. In 2006, the average participation rates at the annual general meeting of shareholders (AGMs) of Dutch companies was less than 40%, whereas, in Germany, France and Italy participation rates were between 50 and 60% (Eumedion, 2016). These low participation rates in the Netherlands were probably related to the combination of the high foreign, the widely dispersed ownership and the absence of large block holdings. These characteristics of ownership of Dutch companies made it easier for activist shareholders to interfere with

[119] Sources: Commissie Peters (1998) and annual reports of Dutch companies listed at the AEX, 2005.
[120] Sources: Databank Eumedion (for Dutch companies, based on data from the AFM register "substantiële belangen") and Enriques and Volpin (2007) (for companies from other countries).

strategic decisions and demand changes of corporate policies. In many cases, activist shareholders used shareholder proposals to show their discontent with corporate policies.

One well-known example of this shareholder activism was the proposals made by activist shareholders Centaurus and Paulson in 2006 who demanded a radical strategic change and dismissal of the supervisory board of Stork, an industrial conglomerate with activities in digital (textile) printing technologies, poultry processing and fast food, aerospace, industrial components and technical services. Centaurus and Paulson proposed to split up the company and sell some of its divisions to be able to focus its activities on the aerospace division. The split-up of Stork was finally pulled off by making use of anti-takeover measures the company had in place. Another well-known example was the proposal made by activist hedge fund The Children's Investment Fund (TCI) in 2007 to split up Dutch bank ABN AMRO and sell parts of the bank to Royal Bank of Scotland, Fortis and Banco Santander. In this case, the activist shareholder demands were successful.

The above-described developments set the stage for the changes in the Dutch corporate governance landscape that occurred after 2008. The main developments during the period 2008-2016 will be described below.

1.8.3. The Dutch Legal Framework

In the Netherlands, the official legislation dealing with corporate governance consists of two parts. The first part is the Dutch Civil Code (DCC), which covers the general rules of civil law relating to the duties and powers of various corporate bodies, rules regarding representation, conflicts of interests, the liability of management board members, and rules with respect to financial reporting and disclosure. Compliance with the rules of the DCC may be forced through court, that is, shareholders with a specific capital interest may ask the so-called Enterprise Chamber of the Amsterdam Court of Appeal to start an inquiry into the policies and decisions taken by a company's management. The second part of official legislation refers to the Financial Supervision Act (FSA). This act specifies rules regarding the supervision of the business conduct of listed companies. More specifically, it contains rules with respect to the disclosure of major holdings, financial reporting, the prevention of market abuse, and the obligations of institutional investors. Compliance with the FSA is monitored by the Authority for Financial Markets (AFM).

Next, to official legislation, the governance of companies is also subject to a system of self-regulation. This system consists of a set of best practices with respect to various aspects of corporate governance. These best practices are described in the Dutch Corporate Governance Code (DCGC). Companies are (legally) expected to comply with these best practices. If they decide to deviate from any of these practices, an explanation is required, which should be published in the annual report. Compliance with the DCGC is monitored annually by the Monitoring Committee. The first version of the DCGC was published in 2004, which was then revised in 2008[121]. In 2016 the code was revised again. This latest revision is quite substantial.

First of all, the comply-or-explain approach of the Code has become more demanding in order to avoid the ticking-the-box behaviour. Companies are now required to explain in more detail how they deal with a number of important issues. This differs from what companies were asked to do before the latest revisions of the code. Previous versions of the Code were less demanding in terms of explaining choices and decisions regarding corporate governance.

Second, the recent changes of the Code reflect a number of discussions in the Netherlands regarding trends in corporate governance since the late 1990s. One of these discussions concerns the increasing prominence of the shareholder versus the stakeholder model. A related discussion is about whether since the early 2000s business models of Dutch companies have been focusing too much on short-term gains. The new code stipulates that in their annual report the management board should explicitly address the issue whether and to what extent it is focusing on long-term value creation, and whether and to what extent relevant stakeholder interests are taken into account.

Other discussions addressed in the newly revised code of 2016 concern responsible remuneration policies, the importance of transparency with respect to material risks the company may be confronted with in the future, and the role of corporate culture and how changing this culture may help with reducing misconduct and fraud. With respect to remuneration, an issue that has been heavily debated in the public arena revised since the early 2000s, in the revised Code the number of provisions has been substantially reduced. Instead, the Code requires companies to develop a clear and understandable remuneration policy. The Code does not stipulate any explicit requirements with regard to the level of remuneration. It does, however, address aspects that play a role in establishing and awarding remuneration and rendering account of this. A new requirement is that the supervisory board must also take into consideration the management board member's own views in determining the amount and structure of their remuneration. Another change as compared to the 2008 Code is transparency about the ratios between the average remuneration level of management board members and the average pay of the other employees of the company.

Regarding corporate culture, the Code does not prescribe what the best practices on this issue should be. Instead, the management board must develop its own view on how to create a good corporate culture and discuss this at some length in the management report. One aspect that should get special attention is the reporting of suspected misconduct and irregularities.

Finally, reporting on the risk management measures in place has been an important aspect of the Code especially since the revision of 2008. Yet, according to the new Code of 2016, the management board must also look ahead by indicating which (financial and non-financial) material risks may have an impact on the long-term viability of the company.

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[121] Before 2004, a code was established in 1997, the so-called Peters Code (Peters Commissie, 1997). This older version of the DCGC was much more restricted, however, both in terms of content as well as in terms of its scope.

Furthermore, there is a stronger focus on the role of the internal audit function. The Code prescribes companies should appoint an internal auditor and establish an internal audit department. If a company does not comply with this principle, the supervisory board is expected to assess whether adequate alternative measures have been put in place, and explain why these measures are sufficient.

Codes of conduct have also been established for specific industries. In 2010 the Banking Code was introduced (revised in 2015), followed by the introduction of the Insurance Code in 2011 (revised in 2013) and the Pension Fund Code in 2014. All these codes use a similar approach, meaning that banks, insurance companies and pension funds should comply with the best practices in the Code or explain why they decided to deviate. Moreover, as with the DCGC, the compliance with these sector-specific codes is evaluated by a separate monitoring committee[122].

1.8.4. Shareholder Rights

Some of the recent developments regarding shareholder rights that occurred between the early 2000s and 2007 were already discussed above. Here, we shortly discuss shareholder rights in more general terms.

In the Dutch corporate governance system, the AGM holds important rights, such as the right to approve of the company's annual results, amend the articles of association, appoint supervisory board members, approve of a merger, and dissolve the company. In principle, the DCC adheres to the principal of one-share-one-vote.

There are a few exceptions to this rule, however. First, companies are also allowed to issue loyalty shares, which give holders additional voting rights and/or cash flow rights as a reward for staying with the company as a long-term shareholder. Second, companies may issue preference shares as an anti-takeover device. In case a company is confronted with a hostile takeover or shareholder activism, it may issue preference shares, which are held by an independent foundation. Preference shares may be issued in two ways. One is by giving the independent foundation the right to obtain shares (that is, a call option) to an agreed upon maximum that may be enough to obtain the majority of shares of the company. The second is by giving the company the right to issue shares, which then have to be obtained by the foundation (that is, a put option). In both cases, the issued shares can be withdrawn after the threat of a takeover has been averted. The issuing of shares dilutes the voting rights of the acquiring company and/or activist shareholder. A recent example of a case in which this instrument was successfully applied is telecom company KPN. This company was confronted with a hostile takeover bid by Mexican América Móvil, owned by multi-billionaire Carlos Slim. The use of preference shares held by an independent foundation as an anti-takeover device is relatively common in the Netherlands. In 2017, almost half of the 50 largest

[122] Next to codes of conduct for private listed companies in general and for financial institutions in particular, in recent years codes were also established for organizations in the public and semi-public sector, such as health care organizations (which established a Code in 2005 and which was revised in 2010 and 2017), educational organizations (established in 2013 for organizations for higher education), housing corporations (established in 2007 and revised in 2015), etc. In this chapter, we decided to focus on the private sector and leave out discussions of the governance of organizations of the public and semi-public sector.

listed companies had this device in place (Kakebeeke and Engel, 2017).

In the framework of the Dutch corporate governance system, next to preference shares a number of other defensive anti-takeover devices have been developed against the threat of hostile takeovers and shareholder activism. One of these devices is using priority shares. In this case, the holder of these shares has specific rights, such as a binding nomination right for the appointment of board members and/or a proposal right with respect to certain resolutions at the AGM. In case these priority shares are issued a takeover becomes less attractive because the acquiring company or investor does not have a say in certain important decisions. AkzoNobel is one of the largest listed companies that has issued priority shares. With these shares, the Foundation AkzoNobel is able to determine the composition of the management board and supervisory board of the company. Another anti-takeover device is certification of shares. When a company uses certification of shares an administration office owns the shares. It hands out certificates of the shares to investors, who have the cash flow rights, but not the voting rights attached to the shares. Only a few large Dutch listed companies use priority shares or certification of shares as an anti-takeover device (Kakebeeke and Engel, 2017).

The presence of a majority shareholder can also be seen as an anti-takeover device. In the case of a takeover, the majority shareholder needs to be convinced that selling shares to the acquiring company or investor is preferred. Dutch listed companies such as Heineken (the Carvalho-Heineken family owns more than 50% of the shares) and Randstad (founder Goldschmeding holds between 30 and 40%) are well-known examples. In 2017, 18 of the 50 largest Dutch listed companies had a majority shareholder (Kakebeeke and Engel, 2017).

Recently, several Dutch companies have been confronted with takeover threats. For example, PostNL received an offer from Belgian industry peer BPost in November 2016, but after the offer was declined the number of times, the Belgium company decided to no longer pursue an acquisition of its Dutch competitor. In February 2017, Unilever, a producer of food, beverages, cleaning agents and personal care products, was approached by the significantly smaller American Kraft Heinz for a friendly takeover. The offer was declined by Unilever and was finally abandoned UK Prime Minister Theresa May had ordered a scrutiny of the deal. About the same time, AkzoNobel, a producer of paints and performance coatings and a major producer of specialty chemicals, received a friendly bid from American industry peer PPG. AkzoNobel refused, also after the bid was raised twice, and was also not willing to discuss the offer with the management board of PPG. This triggered strong opposition from a number of shareholders of AkzoNobel. In particular, American hedge fund Elliott International made clear AkzoNobel should take the offer seriously. Ultimately, the case was taken to the Dutch Enterprise Chamber of the Amsterdam Court of Appeal. As of May 2017, it is still unclear whether AkzoNobel is willing to discuss the deal with PPG and whether it will be taken over by its American competitor.

These recent developments have heated up the debate about the potential (negative) consequences of takeovers by foreign parties, especially when they appear to be driven by pursuing short-term gains. In particular, members of the Dutch government, such as Henk Kamp, Minister of Economic Affairs, have openly called for stronger protection of Dutch companies by the government by establishing stronger anti-takeover mechanisms. Kamp proposed giving the management team of a targeted company a reflection period of one year in the case of a hostile takeover bid.

Although the Dutch corporate governance system is characterized by a stakeholder model, under the Dutch law shareholders are formally allowed to give priority to their own interests. At the same time, however, the DCGC states as a best practice that: "The greater the interest which the shareholder has in a company, the greater is his responsibility to the company, fellow shareholders and other stakeholders" (Monitoring Committee Corporate Governance Code, 2016).

This call on shareholder responsibility particularly applies to institutional investors as they typically have a relatively large stake in the company. To enhance shareholder responsibility the Code includes best practices related to increasing the transparency of voting patterns. In line with this, institutional investors are required to make a statement about their voting policy on their website. Moreover, they have to report on how this policy has been carried out in the preceding year and have to inform the AGM about how they have exercised their voting rights. As an extension of these best practices laid down in the DCGC, Eumedion, an organization representing the interests of institutional investors owning shares in Dutch companies, established its own set of best practices for engaged share ownership in 2011, calling for greater transparency regarding their voting behaviour. A large majority of institutional investors comply with these best practices (Raaijmakers and Beckers, 2016).

1.8.5. Shareholder Activism

The increased shareholder activism since the mid-2000s and its consequences triggered a number of responses from the Dutch government, Dutch legislators, companies and their shareholders. First, an important judgment was given by the Dutch Supreme Court in 2010, in which it redefined the balance of power between company management and the shareholders. It established that at the AGM shareholders have the right to use their voting rights to monitor and control management; they should not interfere with company strategy, however. Moreover, the use of shareholder rights, such as making proposals at the AGM, should be based on the principle of being reasonable and fair. The Supreme Court also made clear that anti-takeover measures can be used under certain conditions, in particular when creating a level playing field between management and shareholders is required. In practice, this means that management gets more time to respond to shareholder proposals and think about potential consequences and alternatives.

Second, the government and the Parliament started to reconsider the desirability of the changes to the rules of the game that were made during the first half of the 2000s. As a consequence, a number of changes to the legal shareholder rights were made. One example that stands out was the increase of the threshold for using the right to submit shareholder proposals from one to three percent of total capital outstanding. Generally speaking, these changes made it more challenging for shareholders to actively exercise their rights. Moreover, the minimum threshold for investors to disclose shareholdings was decreased from five to three percent. The idea behind this change was to enable the management board to know the identity and intentions of shareholders at an early stage and enter into dialogue with them.

Third, the DCGC stressed that as a best practice in case a proposal that is placed on the agenda of AGM has major consequences for the strategy of the company, the management board must be given a maximum of 180 days to prepare a response. During this period the board can (and actually should) also discuss the proposal with the shareholder(s) initiating the proposal.

The examples discussed above clearly show that after a period of increased shareholder rights from the early 2000s, the trend reversed towards limiting shareholder rights (Raaijmakers and Beckers, 2016). This reversal was dictated by the view that shareholder activism led to a focus on short-term gains and a split-up and sell-out of Dutch companies to foreign competitors.

At the same time, however, since the late 2000s, there is an increasing demand for shareholder activism that is engaged in and focused on long-term value creation. One example of this trend is the discussion of creating a Stewardship Code. Such a code contains a set of principles or guidelines directed at (institutional) investors with the aim of making them more active and more engaged in the corporate governance of the companies in which they invest. It applies a comply-or-explain approach to that of corporate governance codes. The UK established a Stewardship Code in 2010 (revised in 2012). Japan (2014) and Italy (2015) have one as well. In other countries, among which is also the Netherlands, the establishment of a Stewardship Code is currently being discussed.

Another sign of an increased demand for shareholder engagement for the long-term can be found in the New EU Shareholder Rights Directive of 2016. According to this document: "Effective and sustainable shareholder engagement is one of the cornerstones of listed companies' corporate governance model, which depends on checks and balances between the different organs and different stakeholders"[123]. The EU document adds to this that the public disclosure of the engagement policy and its implementation by institutional investors could: "…facilitate the dialogue between companies and their shareholders, encourage shareholder engagement and strengthen their accountability to stakeholders and civil society"[124]. Therefore the new EU Shareholder Rights Directive 2016 proposes that institutional investors should develop and publicly disclose their engagement policy. Such a policy should entail a discussion of how they monitor companies in which they invest on relevant matters, such as strategy, financial and non-financial performance and risk, capital structure, social and environmental impact, and corporate governance. The document should also provide information on their voting behaviour.

[123] See: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52012DC0740
[124] See: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2014%3A213%3AFIN

Also, companies themselves were searching for a more stable investor base, consisting of engaged shareholders with a longer-term time horizon when it comes to their investments. One signs of this may be that recently ownership concentration is on the rise in large Dutch listed companies. In particular, whereas in 2010 some 20% of the largest companies had a large shareholder owning more than 30% of the shares, in 2015 this had increased to just over 30%. For shareholders owning between 10 and 30% of all shares, the increase was from 19 to 36% during the same period. Similar trends were observed for other (smaller) listed companies[125]. Related to this trend of concentrated ownership was the increasing representation of major shareholders on the board of companies. In some cases, major shareholders were given extra shareholder rights.

At the same time, shareholders also started to become more active at the AGMs.

Participation rates increased from 35% in 2005 to 70% in 2015. One important reason for this increase is changing legislation, which made it easier for investors to attend and actively participate in AGMs. In particular, 2011 appears to have been a watershed in this respect when legislation was established making it obligatory for company management to publish the convocation of the AGM at least 42 days before the AGM is held. Before this legislation, management could publish the convocation 15 days before the AGM was to be held. By increasing the time period shareholders have to prepare for the AGM, they are allowed to come to informed decisions on how to vote. This has contributed to shareholders' willingness to attending and be actively involved in participating in AGMs. Moreover, it has created the possibility to convene with company management to discuss their disagreement with respect to specific issues on the agenda (Hermes et al., 2016). Obviously, this may have contributed to enhanced shareholder engagement.

1.8.6. Board of Directors

The Dutch corporate governance system is characterized by a two-tier board structure, consisting of a separate management board and supervisory board. Installing a separate supervisory board is mandatory if a company has a total outstanding capital plus reserves of more than €16 million and has more than 100 employees in the Netherlands. Since 2013, when the new Management and Supervisory Act was passed, Dutch companies have the choice between a one-tier and two-tier board structure. By the end of 2016, most Dutch listed companies still opted for a two-tier structure, however.

The management board is charged with the day-to-day management of the company. The role of the supervisory board is to monitor and advise the management board. It has the right to appoint, suspend and remove management board members. Moreover, it has the right to (refuse to) approve certain strategic management board decisions, such as decisions with respect to issuing new shares, enter into a joint venture, making a major acquisition, amending the articles of association, making large divestments, or dissolving the company. In order to enable the supervisory board to carry out its duties, the management board is required to provide information on the

[125] Source: Databank Eumedion (based on data from the AFM register "substantiële belangen")

company's strategic policy, general and financial risks, and its internal control system at least once a year. The DCGC prescribes that in case the supervisory board consists of more than four members, a separate audit-, nomination and remuneration committee should be installed in which its members participate.

Members of the management board are appointed by the supervisory board for four years. After this period they can be re-appointed for a second term of four years. According to the DCGC, in case a management board member is dismissed before the contract ends he/she may be paid a maximum of one year's fixed salary. Annual evaluations of compliance with the Code show, however, that several companies did not comply with this best practice. According to the Code, members of the management board may have a maximum of two supervisory board memberships in other companies. This is to make sure they put enough time and effort into running the company on a day-to-day basis. As of January 2013, the number of supervisory board positions a management board member is allowed to hold at listed companies is limited by law.

Prospective members of the supervisory board are nominated by the supervisory board itself and appointed during the AGM. The shareholders have the right to vote against a nomination during the AGM. The DCGC contains a number of best practices aiming at increasing the effectiveness of the monitoring role of the supervisory board. In particular, the Code stresses the importance of the independence of supervisory board members, that is, they should not have family or business ties with the company. This is based on the premise that independent board members are more willing and able to ask critical questions about the decisions made by the management board. According to the Code, the best practice is that a maximum of only one supervisory member may be seen as dependent. In this sense, the Dutch Code is much more restrictive in allowing individuals with family or business ties to participate in the supervisory board than this is the case in the codes of other countries[126]. In practice, several companies deviate from this best practice. According to Spencer Stuart (2016), 60% of the supervisory board members of a sample of 50 large Dutch listed companies can be considered as being independent. At the same time, however, for the largest companies listed on the AEX, this is 84%.

Next, the Code emphasizes the importance of expertise of board members. One of the best practices mentions the importance of having a person with a financial background as a member of the audit committee. Also, the Dutch Banking Code stresses the importance of expertise. According to this Code, the members of the supervisory boards of banks are expected to have sufficient knowledge of the risks the bank may run. Moreover, since 2012 members of the management and supervisory board of banks are subject to a fit-and-proper test carried out by the AFM and the Dutch Central Bank.

Another issue related to the effectiveness of the supervisory board in its role as a monitor is multiple directorships. The general belief is that individuals having too many outside board positions may not have the time to put sufficient effort in their role as monitors of the management board. The DCGC stresses that in order to be able to

[126] In several of these countries, best practices with respect to independence of supervisory board members specify that at least more than half or two thirds of all members should be identified as independent.

effectively monitor a company a supervisory board member should have no more than five supervisory board positions in other large companies or foundations. Another reason why this limit was established is to further breakdown the old-boys network. The limitation of the number of outside board position was turned to law in 2013.

A final issue that relates to the effectiveness of boards as monitors is the diversity of its members. Diversity has many different dimensions, such as gender diversity, ethnic diversity, background diversity, nationality diversity, diversity in terms of age and experience, etc. Diversity is seen as a potentially important determinant of board effectiveness, both in terms of their roles as monitors and advisors of the management board. With more diverse supervisory boards, the capacity to provide advice is wider and discussions related to their monitoring role may be deeper and more effective. The DCGC includes a best practice in which aiming for a diversity of supervisory boards is discussed in general terms. In recent years, gender diversity has received specific attention in the Netherlands. Since January 2013 Dutch listed companies have to target a gender division of at least 30% female and 30% male members of their supervisory boards. If they do not comply with these targets, this needs to be explained. Setting targets for gender diversity in boards is in line with what has happened elsewhere although in several countries gender diversity has been pushed by setting laws, instead of targets to increase the number of female board members (see, for example, Norway, Germany and Spain). The call for increased gender diversity is also supported by the EU. In 2014 an EU directive was proposed requiring large companies to have a description of their diversity policy. This directive was implemented in the Netherlands from 2015.

Table 1.8.1 provides an overview of the main characteristics of supervisory boards of a sample of 50 Dutch listed companies as well as those of companies in other countries. The data are presented for 2016. The Table shows that Dutch boards are relatively international. First, they have a relatively high percentage of foreign members (37%) as compared to boards of companies in other countries (22% on average). Second, the diversity of board nationalities seems a bit higher than in other countries (four in the Netherlands versus three on average in the reference group of countries). The fact that Dutch supervisory boards are relatively international may be a reflection of the fact that several companies listed on the Dutch stock exchange are from the foreign origin and/or are largely foreign owned. In 2015, almost 90% of the shares of the largest Dutch listed companies were owned by foreign investors.

With respect to gender diversity, the Table shows that on average 20% of board members are female. According to Spencer Stuart (2016), only 4% of Dutch listed companies comply with the target of a minimum of 30% female board members. Spencer Stuart estimated that some 40 new female directors would have to be appointed to meet the 30% gender target.

The percentage of independent board members (60%) is in line with several other Continental European countries, such as Germany, Denmark, France and Sweden, and clearly higher than in Spain, Japan, Brazil and Turkey. It is (substantially) lower, however than in the US (84%), Canada (80%) and Switzerland (88%). Dutch boards meet relatively often, that is, on average between 11 and 12 times per year. Boards in most other countries meet between 8 and 10 times per year.

Finally, Dutch supervisory board members do not seem to have a large number of outside board positions. Whereas the average number for Dutch boards is 1.1, it is around 2 for boards in most other countries listed in Table 1.8.1. This suggests that the decision of the government in the early 2000s to change the rules of the game of the Dutch corporate governance and to break with the model of co-option has at least had some effect.

Table 1.8.1. International comparison of boards of listed companies, 2016

Country	*Board Composition*			*Diversity*			*Other*		
	Board size	*Independent directors (%)*	*Tenure of directors*	*Foreign board members (%)*	*Female board members (%)*	*Number of nationalities*	*Average number of boards per director*	*Average age*	*Average number of board meetings per year*
The Netherlands	9	60	4	36	20	4	1.1	59	11.6
Belgium	10	45	6	32	27	3	1.8	58	8.6
Brazil	9	31	-	10	7	-	-	-	-
Canada	11	80	8	26	25	-	-	-	-
Denmark	10	66	5	39	26	3	1.9	58	8.6
France	14	69	6	35	39	5	2.3	59	9
Germany	14	60	6	-	-	2	-	61	6.7
Italy	12	50	6	9	26	2	3.3	59	11.6
Japan	11	27	-	3	4	-	-	-	-
Spain	11	43	6	15	16	-	1.1	60	11.3
Sweden	10	64	6	25	36	3	2.6	58	9.2
Switzerland	11	88	7	60	21	6	2.1	61	11.1
Turkey	10	31	4	17	12	2	-	-	-
United Kingdom	10	61	5	33	24	3	1.9	58	7.7
United States	11	84	4	8	21	-	2.1	-	8.4

Source: Stuart Spencer (2016) and the Spencer Stuart interactive website "Boards around the World", available at https://www.spencerstuart.com/research-and-insight/boards-around-the-world (accessed on 28 May 2017)

Notes: "-" means not available. Country data are based on the following samples: Belgium (number of companies in the sample is 54): BeL20 plus BelMid; Brazil: BM&FBOVESPA Novo Mercado plus Nível 2 and Nível 1; Canada (100): TSX; Denmark (25): OMX Copenhagen; France (40): CAC40; Germany (67): DAX30 plus a sample of smaller caps; Italy (100): FTSE MIB plus a sample of smaller caps; Japan (225); the Netherlands (50): AEX and AMX; Spain (100): PAIN IBEX-35 plus a sample of smaller caps; Sweden (50): OMX Stockholm; Switzerland (20): SMI; UK (50): FTSE 150; US (482): S&P 500

1.8.7. Directors' Remuneration

As has been mentioned before, directors' remuneration has been a hotly debated issue in the Netherlands, especially since the early 2000s. The first version of the DCGC in 2004 contained a lot of detailed best practices regarding the structure (but not the level) of and reporting about the remuneration policies of the management board. These best practices were all pushing for remuneration policies that should promote the medium- and long-term interests of the company. Remuneration policies should not encourage management to act in their own interests and/or take unacceptable risks. They should also not be awarded when sent away after showing to have failed in their role as executives. Yet, the long list of best practices and the transparency of remuneration plans did not lead to publicly accepted pay policies. On the contrary, it contributed to continuous debates about the level of pay, the vagueness of criteria used, and the lack of a clear relationship between managerial pay and company performance.

The global financial crisis gave an additional boost to discussions about managerial remuneration. According to some the pay contracts offered to bankers was one of the main causes that had triggered the crisis. The incentives embedded in these contracts stimulated risk taking, which finally led to several banks being insolvent. These incentives, therefore, came under attack, especially with respect to the use of bonus pay to management. In first instance, from 2012 paying bonuses was no longer possible for banks that had received governmental support. Moreover, fixed salaries were frozen. Yet, criticism regarding managerial pay in the financial sector did not wane. Therefore, in 2012 the legislator adopted the best practice stipulated in the Banking Code, stipulating that the maximum variable pay to management should be no more than 100% of the fixed salary. In 2015, this was further reduced to only 20%.

At the same time, also with respect to non-financial companies, managerial pay remained fiercely discussed. Every now and then public outrage was triggered by media attention about the annual salaries of the executives of large listed companies. The Dutch government and legislator do not want to interfere in discussions about the level of remuneration[127]. They did, though, establish new legislation that should be helpful in better structuring and better monitoring of executive pay contracts. In 2014 new legislation regarding the use of a claw back clause for bonuses paid to the management board was put into force. According to the claw back clause, the bonus should be paid back once it turns out to be based on the incomplete or erroneous information. As already mentioned in section 1.8.3, the newly revised DCGC of 2016 focuses on what is called responsible remuneration policies. According to the new Code, companies are required to be more transparent and better explain the rationale behind the policy used, rather than asking for all kinds of details about the content of the policy. By making companies more responsible for explaining their choices, public outrage and discussions about excessive pay may be tempered.

1.8.8. Conclusions

In this chapter, we have discussed the main developments and trends with respect to corporate governance mechanisms in the Netherlands since the wake of the global financial crisis in 2008. We focused on describing the Dutch legal framework and discussing shareholders and shareholder rights, shareholder activism, the role of boards and executive remuneration. Our discussion made clear that after a period of increased shareholder rights from the early 2000s, from 2008 the trend reversed towards limiting shareholder rights. The improvements of shareholder rights during the early 2000s, in combination with the conditions that characterized ownership of Dutch companies by the time the changes were made, triggered an activist role of (mostly foreign) shareholders. In a number of cases, this led to strong interference with strategic

[127] The Dutch government does, however, interfere with pay levels in the non-profit sector. Here, the so-called Balkenende-norm (named after the prime-minister who introduced the norm) is adopted, which stipulates that civil servants cannot earn more than the prime-minister does.

decisions and a demand of changes in corporate policies, such as selling profit-making divisions, accepting lucrative takeover bids, etc. According to many observers, that is, the boards of companies confronted with activist shareholders, the employees of these companies, politicians and the media, this type of activism was mainly focused on short-term results.

As a consequence, the Dutch government realized that the reforms perhaps had gone too far in changing the rules of the game at the cost of the decision making the power of the management boards of Dutch listed companies. Most importantly, the fear was that the type of shareholder activism it triggered could, at least potentially, compromise the traditional Dutch stakeholder model. Reversing the trends towards limiting shareholder rights resulted into a period of less shareholder activism. At the same time, a call was made for increased shareholder engagement with a focus on the longer-term. Companies were trying to create a more stable shareholder base and were looking for so-called "cornerstone shareholders", that is, engaged shareholders who have a longer-term interest in the company and act accordingly.

Since 2016, however, shareholder activism seems to have returned again. Several Dutch listed companies were confronted with activist shareholders who proposed selling parts of the activities and/or accepting takeover bids from competitors. Recent examples are Unilever (2017), AkzoNobel (2017) and ASM International (2017). This has led to a call for stronger protection of Dutch listed companies against activist shareholders by Dutch captains of industry as well as by politicians. At the same time, investors and their representatives have made clear that Dutch listed companies are already well protected and that no further protectionist measures are needed[128]. As of May 2017, it is unclear in which direction the Dutch corporate governance system is going to evolve during the coming years.

Other topics in corporate governance that are – and are expected to remain – high on the agenda are board diversity and remuneration of the management board. In particular, gender diversity has been subject to debate as the Dutch government wants Dutch companies to make more efforts in appointing in high-level management positions. As for now, a gender division of at least 30% female and 30% male members of their supervisory boards is still a target, that is, it is not mandatory and there is no punishment if companies do not comply with the target. However, the Minister of Education, Culture and Science, Jet Bussemaker, in 2016 announced that if companies do not comply with the target soon, she will introduce gender quota similar to the ones that have been established in Norway and Germany[129].

As this chapter has made clear, a lot of changes have occurred since the wake of the global financial crisis regarding the corporate governance system in the Netherlands. Given the recent changes as described above, it seems very likely that corporate governance remains to be a hot topic in the Netherlands in the years to come.

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[128] Rients Abma, Director of Eumedion, a Foundation representing institutional investors investing in Dutch listed companies, in a recent interview made clear that Dutch companies already have several anti-takeover mechanisms, which they can use to frustrate hostile takeovers. According to him, additional protection and government interference is only justified in case of hostile takeovers of companies that are vital for Dutch society, such as telecom companies and infrastructure (Van der Heijden and Kooiman, 2017).

[129] See: http://www.ad.nl/binnenland/bussemaker-vrouwenquotum-nederland-is-optie~a86ec67f/

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1.9. CORPORATE GOVERNANCE IN ITALY: THE EVOLUTION OF CORPORATE GOVERNANCE OF ITALIAN LISTED COMPANIES DURING THE RECENT FINANCIAL TURMOIL

Doriana Cucinelli
Danilo V. Mascia

1.9.1. Introduction

Since the beginning of the financial crisis – yet unfolded ten years ago – policy makers and researchers have devoted remarkable attention to Corporate Governance (CG) and its issues. Indeed, the crisis highlighted the importance of adopting best practice policies, at the corporate level, in order to improve the efficiency of the governance structures and, thus, a company's reputation.

In particular, our chapter aims at providing the main changes that characterized the Italian CG system during the last ten years. Although small- and medium- sized enterprises (SMEs) represent the backbone of the Italian economy, we focus our study only on listed companies. We do so not only because listed firms present a more organized system of CG, but also because the main CG reforms have been especially addressed towards them.

The chapter is structured as follows: Section 1.9.2 presents the main regulatory changes that occurred in the previous years. Section 1.9.3 provides insights into ownership structures and M&As. Section 1.9.4 deeply scrutinizes the characteristics of the Board of Directors (BoD) in Italy. The remuneration system, instead, is analysed in Section 1.9.5 Section 1.9.6 provides information on shareholders' rights, while Section 1.9.7 offers details about the corporate social responsibility of Italian listed firms. Section 1.9.8 provides information on the link between CG and a company's performance. Finally, Section 1.9.9 offers the main conclusions.

1.9.2. The Evolution of the Regulation

After the significant reforms were adopted in 1998 (Draghi Law), in 2002-2004 (Vietti Law), and in 2005 (with the Savings' Law), in the course of the last ten years the Italian corporate governance system has mainly experienced a number of regulatory changes that have been adopted to comply with a series of recommendations released by the European authorities.

Before presenting details about the major amendments, it is worth mentioning that, following the Draghi Law, in 1999 Italy adopted its first version of the Corporate Governance Code (so-called Preda Code). Such Code provides listed companies with a series of the best self-regulatory practices to be spontaneously adopted. Moreover, the Code is based on the "comply or explain" principle. This means that non-compliance with the prescriptions of the Code is allowed, though it needs to be clearly motivated (see, among other, Drago et al., 2015; Brogi, 2016). Adopting the Code essentially increases a company's reputation within the market, given that investors usually pay attention to the compliance of "best-practice" policies. Nonetheless, we acknowledge that companies with low free float may be discouraged in adopting such Code because of the high costs related to its implementation. However, data issued by Assonime (the Trade Association for Italian Joint Stock Companies) show that, during the last ten years, the Code has been adopted by around 94% of the companies (this figure is significantly stable throughout the years). The remaining 6% – although non-adopting the Code – provide, in any case, information about the specific corporate governance system as required by the Draghi Law.

We offer now a brief summary of the main amendments of the Code that have been adopted in the last ten years:

- 2010: amendments concerning the remuneration policy;
- 2011: complete revision of the self-regulatory Code including, among others, the prohibition of cross directorship for chief financial officers (CFOs) and the introduction of the Nomination Committee;
- 2014: other revisions regarding the remunerations policies;
- 2015: amendments concerning the internal controls, the board functioning, and the Audit Committee.

In addition to the aforementioned regulatory changes affecting the Code, it is also worth noting that on August 1st, 2012 the Golfo-Mosca Law (also labelled as "Pink Quotas" Law) came into force in Italy. The aim of such law was to increase, with time, the proportion of females on boards. As a consequence of its implementation, in June 2016 women covered about 30.3% of seats on the boards of Italian listed companies (Consob, 2016).

1.9.3. Ownership Structure and M&A

According to the data provided in its annual report by the Italian Securities and Exchange Commission (Consob), the number of listed companies has smoothly decreased during the last years moving from a total of 270 companies in 2010 to 234 in 2015. Such decline may be motivated by a surge in M&As and in the number of delisted companies (see, in this regard, Consob, 2016).

Table 1.9.1 reports the breakdown of Italian listed companies by their control model. Here we note that the Italian market is characterized by a great ownership concentration. Indeed, as of 2015, the number of controlled firms corresponds to 84% of the total companies (i.e., 197 out of 234). More specifically, about 50% of the firms (115 out of 234) are controlled by a single shareholder that holds more than half of the ordinary shares. More than 22% (52 out of 234) of the companies, instead, are weakly controlled – namely, the single shareholder owns a stake that is lower than half of the ordinary shares. For 30 firms (representing just 13% of the companies) the control is exerted via a shareholder's agreement (so-called "*patto parasociale*"). Finally, the remaining 37 – less than 16% of the total firms – are non-controlled companies.

Table 1.9.1. Control model of Italian listed companies

Year	*Controlled companies*						*Non-controlled companies*						*Total*	
	Majority controlled		*Weakly controlled*		*Controlled by a shareholders' agreement*		*Cooperative companies*		*Widely held*		*Non-widely held*			
	no.	% mc	no.	% mc	no.	% mc	no.	% mc	no.	% mc	no.	% mc	no.	% mc
2010	128	20.6	53	43	51	12.4	8	3.4	11	20.3	19	0.3	270	100
2011	123	22.3	55	45.8	48	12	8	3.2	8	16.4	18	0.3	260	100
2012	125	22.8	49	44	42	10.1	8	3.2	10	19.2	17	0.7	251	100
2013	122	24.1	48	40.1	38	10.4	8	3.3	10	21.6	18	0.5	244	100
2014	116	25	51	36.8	32	9.6	8	4	13	24	18	0.5	238	100
2015	115	28.1	52	34.8	30	6	7	3.2	15	27.3	15	0.6	234	100

Source: Consob (2016);
Note: mc – market capitalization

However, if we read the data in terms of market capitalization, we observe that weakly controlled companies display the highest share in our sample. Indeed, although having experienced a decline through time, at the end of 2015 the companies belonging to such category accounted for about 35% of the total market capitalization (in 2010 this share was nearly 8% higher). The increasing importance of widely held companies is also quite interesting, whose weight in terms of market capitalization has moved from 20%, in 2010, to more than 27% at the end of 2015. Finally, it is also worth mentioning that the weight of the companies whose control is exerted by a coalition has almost halved during the last years.

Table 1.9.2. Identity of the 'Ultimate Controlling Agent' (UCA) in Italian listed companies by industry

	Financial		*Manufacturing*		*Services*		*Total*	
	no.	% mc	no.	% mc	no.	% mc.	no.	% mc.
Families	16	9.8	96	57.3	31	18.1	143	29.2
State and local authorities	1	4.6	6	32.7	12	66.8	19	30.4
Financial institutions	3	0.9	5	1.4	2	0.1	10	0.9
Mixed	6	6.4	5	3.1	3	0.2	14	3.6
No UCA	28	78.3	16	5.6	4	14.8	48	35.9
Total	54	100.0	128	100.0	52	100.0	234	100.0

Source: authors' elaboration from data provided by Consob (2016)
Note: mc - market capitalization

Regarding the identity of the Ultimate Controlling Agent (UCA), in Table 1.9.2 we report the latest available data (i.e., data related to 2015) by sector of activity. Here we observe that the majority of companies, corresponding to 61% (143 out of 234), are owned by families. Most of them belong to the manufacturing industry (96 companies) and account for more than 57% in terms of market capitalization (of the whole manufacturing industry). These figures corroborate the widely held view according to which the presence of "industrial families" is probably the main feature of the Italian corporate governance system. More interesting information comes from state-owned companies. Here the table displays that most of them (i.e., 12 out of 19) operate in the services industry. Although at first glance, their significance within the sector of activity might appear limited – their weight is just 23% (i.e., 12 out of 52 'services' firms) –, state-owned companies account for more than 65% of the services industry in terms of market capitalization.

1.9.4. The Board of Directors

When we talk about corporate governance, we refer to the system by which companies are directed and controlled. This system can assume, in general, one of the following structures:

- the single-tier;
- the two tier;
- the traditional model.

In particular, the first model (single-tier) is also labeled as "English model" because it came to light in the UK and is largely employed in English-speaking countries. In this case, the firm is governed by one corporate body that has both the management as well as the monitoring function.

The two-tier model is defined by the German law and, in this case, two separate bodies exist, which operate independently. In particular, there is a management body that has the management function, and the supervisory board with both administrative and monitoring functions. In this model, the components of the supervisory board are usually elected by the shareholders and the members are independent. In general, the most important role of the supervisory board is to guide and monitor the management body – namely, it has the responsibility of defining the general policy that the management board has to implement. Moreover, in the supervisory board there might also be a workers' representativeness. Nowadays, this model is the most widespread among European countries.

Finally, in the traditional model (or Italian model) two separate bodies are defined: the Board of Directors (BoD) and the Board of Auditors. The former is a collective body with management function; while the latter has the monitoring and control functions (see Table 1.9.3).

In Italy, the most widespread model is the traditional one. Table 1.9.4 shows the evolution of the Italian listed firms during the financial turmoil by corporate governance models. We can observe that effectively, in the last years, the percentage of firms that adopt the traditional model is always higher than 85%. The reason behind such huge percentage may be due to the fact that, before the implementation of the 6/2003 Legislative Decree, no alternative models were allowed.

As a result of this tradition (i.e., a CG system oriented to the adoption of the traditional model), also the Preda Code based its recommendations on the traditional model. Just in the last section, the Code underlines that if a firm decides to adopt a single or a two-tier model, the guidelines described in the previous sections can be adapted to the specific context. For this reason, in this chapter, we will talk about the board of directors, in general, as the body that plays the management function of the firm.

Table 1.9.3. The corporate governance models

Model	*Bodies*	*Bodies Election*
Single-Tier	• Shareholders meeting • Board of Directors • Internal committees	The assembly appoints the BoD which appoints its committee among its members
Two-Tier	• Shareholders meeting • Supervisory committee • Management committee	The assembly appoints the Supervisory committee, which defines the Management committee
Traditional	• Shareholders meeting • Board of Directors • Board of Auditors	The assembly decides the members both of the BoD and the Board of Auditors

Source: authors' elaboration

Table 1.9.4. Italian listed firms and the corporate governance models

Model	*2008*		*2009*		*2010*		*2011*		*2012*		*2013*		*2014*		*2015*	
	n	*%*[130]	*n*	*%*	*n*	*%*	*N*	*%*	*n*	*%*	*n*	*%*	*n*	*%*	*n*	*%*
Single-tier	44	00.1	4	0.1	3	0.1	3	0.1	2	0.1	2	0.1	2	0.1	2	0.1
Two-tier	77	112.0	7	11.7	7	8.3	7	8.1	6	7.5	5	8.6	4	10.7	4	11.3
Traditional	278	87.9	267	88.2	260	91.7	250	91.8	243	92.4	237	91.3	232	89.2	228	88.6
Total	289	100	278	100	270	100	260	100	251	100	244	100	238	100	234	100

Source: authors' elaboration on Consob data (2016)

With regard to the BoD, both executive and non-executive directors compose this body, where the latter may also be independent. In the next subparagraphs, we analyze the roles of such board members and we detect the evolution of them in the Board of Directors of Italian listed firms.

The Executive and Non-Executive Directors

In the Board of Directors, we can distinguish two main categories of members: executive (when the members have some executive role in terms of management powers or are in the executive committee) and non-executive directors. When the President of the Board of Directors is also the Chief Executive Officer (CEO), the BoD should define a Lead Independent Director (LID)[131]. The LID has the role of collaborating with the president in order to ensure the flow of information between the president and the other BoD members[132].

All members of the BoD should have suitable education, professional, managerial and experience skills with the aim of ensuring the adequate competence with regard to their duties.

[130] The percentage refers to the market capitalization: it is measured as the ratio between the market capitalization of listed firms that adopt the corporate model and the total market capitalization of the sample of listed firms.

[131] Data show that the number of cases where Chairman and CEO are the same person have decreased. Indeed, from 96 cases in 2012, in 2015 such situation appeared only in 81 companies (corresponding to 36% of the total). These numbers refer only to non-financial companies; evidence also highlights that the occurrence of these situations is inversely proportional to the firms' size (Assonime, 2016).

[132] Assonime (2016) underlines that 96 listed companies (42% of the total) elect the Lead Independent Director. The nomination of LID is more frequent when it is recommended by the Corporate Governance Code (60 cases on 81), while in the remaining cases (36) the nomination is on voluntary base.

Non-executive directors play the role of external experts that enrich boards' discussions, allowing BoD members themselves to analyze the different issues from several points of view. Furthermore, the presence of non-executive directors is crucial in subjects where executive directors and shareholders have contrasting views – among others, with regard to the remuneration of the BoD's members, as well as in terms of both the internal control and the risk appetite themes.

The average number of directors in the management body of Italian listed firms has roughly remained unchanged if we consider the BoD and the Management Board, while it has increased with regard to the Supervisory Board (from 12.4 in 2012 to 17.0 members on average in 2015). In particular, the average number of components of the BoD, after a short increase in 2010-2011, has returned to the same level shown in the first years of the crisis, while the Management Board has experienced a gradual but continuous decrease in the number of boards' members (from 7.7 in 2008 to 6.0 in 2015) (Table 1.9.5).

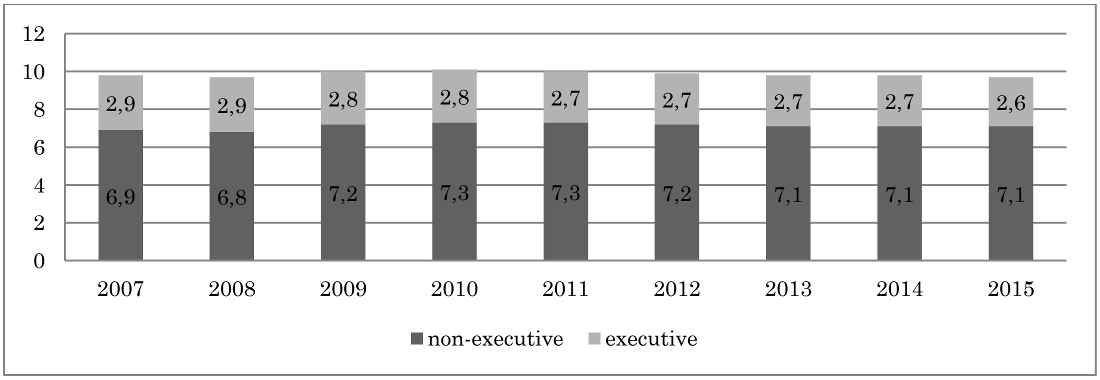
Table 1.9.5. The average number of directors among the different CG models

Year	*BoD*	*Management Board*	*Supervisory Board*	*Companies*
2008	9.9	7.7	12.4	287
2009	9.9	7.7	12.4	273
2010	10.0	7.4	13.0	262
2011	10.2	6.5	14.3	256
2012	10.0	6.3	14.2	242
2013	9.9	6.6	17.4	237
2014	9.8	6.5	17.3	225
2015	9.8	6.0	17.0	228

Source: authors' elaboration on Consob data (2016)

With regard to the specific composition of the Board of Directors, the separation between non-executive and executive directors has remained invariant during the last years. In particular, non-executive directors – who represent more than 70% of the total (Figure 1.9.1) – cover the majority of seats of Italian BoDs.

Figure 1.9.1. Executive and non-executive directors



Source: authors' elaboration on Assonime data

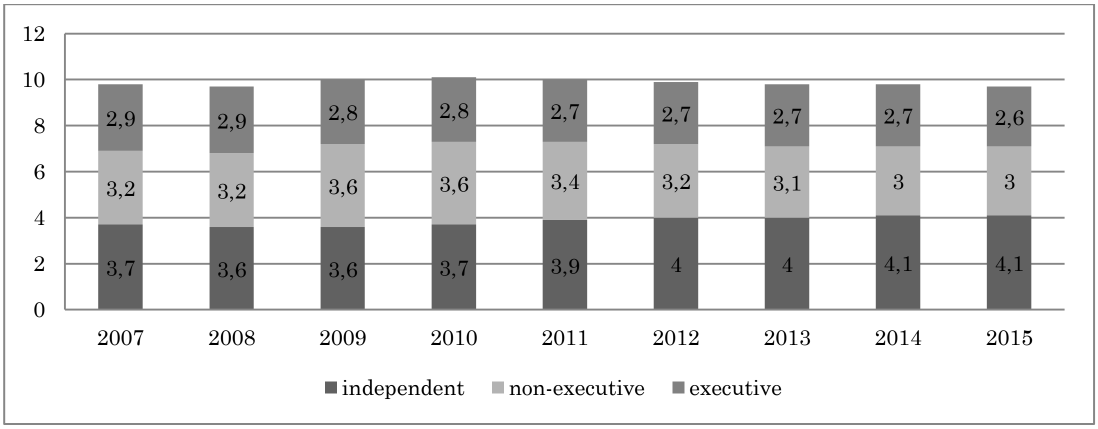
The Independent Directors

An important role is played by the independent directors, who are a particular type of non-executive directors with specific characteristics of independence from the company. The Corporate Governance Code defines the independent director as the director that has no relationship with the company or with the subjects that are linked to the company. The Code also prescribes that – with regards to the companies listed in the FTSE MIB – this type of directors should be at least equal to one-third of the total number of the BoD's directors; in any case, the minimum number of independent directors cannot be lower than two. Additionally, the number of the independent directors should allow the creation of the committees, internal to the BoD, as requested by the Code.

The presence of independent directors is most crucial when the company's ownership is fragmented. Indeed, the independent directors should control the executive directors' work and ensure the alignment between the shareholders' objectives and the executive directors' interests. However, in companies where the ownership is more concentrated – even if the problem of the alignment of executive directors and shareholders interest continues to exist – having independent directors is central to ensure that BoD's decisions are not influenced by the ownership.

The evolution in the Italian BoD composition is reported in Figure 1.9.2. During the last years, the presence of independent directors has slightly rose – from an average value of 3.7 in 2007 to 4.1 members in 2015, while the average number of total directors has almost remained constant.

Figure 1.9.2. The presence of independent directors in the BoD



Source: authors' elaboration on Assonime data

The Board Diversity

Since the beginning of the financial turmoil, authorities and researches have focused their attention on the board diversity under several aspects. In 2011, the Italian Parliament defined a new regulation on "gender quotas" in listed companies. Most of these legislative initiatives are based on the idea that the presence of women on boards could significantly affect the quality of the corporate governance system. During these years, many authors analyze the gender diversity and the relationship between the presence of women on board and both firms' performance and risk (Adams e Ferreira, 2009; Darmadi, 2011; van Ees et al. 2003; Schwizer et al., 2012; Cucinelli, 2013; Cardi and Lucarelli, 2017). Results underline that the influence of women on firms' performance is ambiguous, whereas their presence on the boards is usually associated to a lower level of risk.

Consob (2016) underlines that the presence of women on boards of directors strongly increased, broking the 30% threshold at the end of June 2016 (corresponding to a total of 683 women); before the issue of the "Pink quotas" Law, women held only 11.6% of board positions (corresponding to a total of 193 women, at the end of 2012). Additionally, before the approval of the "pink quotas" law, less than 50% of listed companies had at least one woman in their BoD. Following the adoption of such law, there has been a growing trend in terms of female presence in the BoDs. So far (data from 2016), women cover at least one seat in 99.1% of Italian listed companies' BoDs (Table 1.9.6).

Table 1.9.6. Gender diversity on boards

Year	*N. of female*	*% on total n. of directors*	*Firms with at least one woman*	*% on total n. of companies*
2008	170	5.9	126	43.8
2009	173	6.3	129	46.4
2010	182	6.8	133	49.6
2011	193	7.4	135	51.7
2012	288	11.6	169	66.8
2013	421	17.8	202	83.5
2014	521	22.7	217	91.9
2015	622	27.6	230	98.3
2016 (June)	687	30.3	228	99.1

Source: authors' elaboration on Consob data (2016)

With regard to the board diversity, other aspects could be investigated, for example, the presence of foreign directors, the age, the education and the background of directors. Several studies (Richard, 2000; Fairfax, 2005; Ruigrok et al. 2007; Masulis et al., 2012; Francis et al. 2015; Gottesman and Morey, 2015; McGuinnes et al., 2017) find that the presence of foreign directors, academic professors and, more generally, members with a higher level of education positively affects the firms' performance.

Italian listed companies experienced an increase not only in terms of women on boards, but also with regards to the number of foreign directors (from 5.0% in 2012 to 7.1% in 2015), and to the level of education of the board members (from 15.3% of members with a postgraduate degree to 20.5% in 2015); instead the average age has decreased (from 57.6 to 56.7 years, respectively, in 2012 and 2015). Finally, with regard to the professional background, the majority of directors are managers – although their representativeness has declined over the years. In contrast, the share of consultants has risen from 15.4% in 2012 to 21.2% in 2015. Academics, instead, remain roughly at the same percentage (8.0%).

These evidences differ between the two groups of male and female. In particular, women on boards are usually more educated and younger than men, and they typically work as academics or consultants/professionals. Surprisingly, the link between directors and family ownership rolled over the years. In 2012, about 25.8% of women directors show a family relationship with the controlling shareholders; whereas such percentage declines to 13.1% in 2015. In contrast, male directors experienced an increase (although modest) in such relationship, passing from 14.9% in 2012 to 16.9% in 2015, thus overcoming the female one (Table 1.9.7).

Table 1.9.7. The board diversity: by industry and by market index

Year and gender		*N. of directors*	*% f*	*Av. age*	*family*[133]	*% first degree*	*% p.d.*	*% m.*	*% consultant/ professional*	*% a.*	*% other*
'12	Directors	2,401	5.0	57.6	16.2	84.4	15.3	76.4	15.4	8.0	0.2
	F	283	5.3	50.5	25.8	82.7	20.9	68.7	17.8	13.2	0.4
	M	2,118	4.9	58.5	14.9	84.6	14.5	77.4	15.1	7.4	0.2
'13	Directors	2,332	5.7	57.3	16.3	84.9	16.5	75.0	16.4	8.2	0.5
	F	417	7.0	50.2	18.2	86.8	23.2	63.4	23.4	12.8	0.5
	M	1,915	5.4	58.9	15.9	84.5	15.0	77.5	14.9	7.2	0.5
'14	Directors	2,233	6.0	57.0	16.2	84.8	18.0	72.9	18.6	8.0	0.5
	F	507	6.3	50.7	14.8	87.2	26.0	59.4	29.0	11.0	0.6
	M	1,726	5.9	58.9	16.6	84.1	15.6	76.8	15.5	7.1	0.5
'15	Directors	2,222	7.1	56.7	15.8	85.6	20.5	70.3	21.2	8.0	0.5
	F	617	7.5	50.9	13.1	88.5	29.7	54.1	33.2	12.2	0.5
	M	1,605	7.0	58.9	16.9	84.5	16.7	76.5	16.6	6.4	0.6

Source: authors' elaboration on Consob data[134]
Note: m. – manegers; a. – academic; p.d. – postgraduate degree

The Internal Committees

In order to improve the efficiency and efficacy of the BoD, specific committees with the proposal and advisory functions can be defined. They can also have crucial roles when treating sensitive issues, thus helping the BoD in performing its duties.

The most common committees are: i) the nomination committee; ii) the remuneration committee, and iii) the internal control committee. The Corporate Governance Code regulates this topic with a series of articles that, however, leaves companies with a discrete level of freedom. In fact, the BoD may decide to define three different committees, one for each function, or, alternatively, it may create less committees and group some functions within the same committee. If the BoD decides not to form one of the three committees (and in particular the internal control committee), it must explain the reasons in a specific relation. However, among the 47 firms that did not define the three committees, only 34 of them provided an explanation in 2015. The Corporate Governance Code, in the last version of 2015, defines a new committee as dedicated to the supervision of the sustainability related to the enterprise activity and its interaction with the stakeholders.

[133] Family refers to the number of directors linked through a family connection to the controlling shareholder.
[134] Data referred to this table are available only from 2012 until 2015.

Each committee usually includes at least three members. However, if the number of directors in the BoD is less than eight, just two members may form the committees. The internal control and the remuneration committee should be formed by independent directors or, at least, be led by an independent president – according to the CG Code prescriptions.

In the last decade, the number of internal committees in the BoD of Italian listed companies has increased. Firms adopting the remuneration committee in 2008 were about 80% of the whole listed companies; such share increased to 90% in 2015. With regard to the nomination committee, the percentage has increased from 20.3% in 2011 to 53.9% in 2015. In most of the cases, the members of this committee are independent directors and the president is usually a non-executive director, in line with the Code's recommendations. Finally, referring to the internal control and risk management committee, firms adopting this committee rose from 89% in 2011 to 93% in 2015. As shown in Table 1.9.8, the internal control committee is the most widespread one.

Table 1.9.8. The committees inside the BoD of Italian listed firms

Year	*Remuneration committee*		*Nomination committee*		*Internal control committee*	
	n. of firms	*weights*	*n. of firms*	*weights*	*n. of firms*	*weights*
2008	234	80.4	-	-	-	-
2009	229	82.1	-	-	-	-
2010	229	84.2	43	15.8	240	88.2
2011	225	87.9	52	20.3	228	89.0
2012	215	88.8	95	39.2	220	90.9
2013	210	88.6	112	47.2	216	91.1
2014	200	88.8	114	50.6	206	91.5
2015	204	89.5	123	53.9	212	93.0

Source: Authors' elaboration based on Consob's data[135]

1.9.5. The Remuneration System

During the last decades, many authors have analyzed the relationship between the BoD remuneration policy and the firms' performance (inter alia, Mallin et al., 2015; Melis et al., 2015; Provasi and Riva, 2015). Empirical evidence shows the existence of a significant relationship between the two variables. Additionally, the topic related to the remuneration policy has become a crucial issue for financial authorities.

The Corporate Governance Code devotes a specific article to this theme. Setting a given level of remuneration allows the company to attract, maintain and motivate people with high professional and management skills.

With regard to the executive directors and directors with strategic role, their remuneration should be aligned to the shareholders' objectives – in order to avoid issues like conflict of interests –, in a long term perspective.

Usually, a remuneration committee composed by independent directors is defined inside the Board of Directors. The role of this committee is to propose a remuneration

[135] Data refer to nomination and internal committees are available only from 2011.

policy for the Board's members. However, it is up to the Board to define the remunerations of directors and managers with strategic roles.

The remuneration of executive directors can be formed by a fix and a variable component, where the former should be sufficient to remunerate the director in case the annual tasks are not achieved. With regard to non-executive directors, they receive a remuneration that is not linked to the economic results and they do not receive company's stocks as remuneration unless the shareholders vote in this sense and motivate the reason for such a decision.

In the last years, the average remuneration, paid to the BoD members, has increased from 235.000 to 244.000 euro. However, as shown in Table 1.9.9, the average remuneration changes on the basis of the role covered. The Chief Executive Officer receives the highest remuneration. His compensation shows a positive trend during the observed period, reaching almost one million euro. The second highest remuneration is paid to the President, when he is executive, with an average value equal to 623.000 euros in 2015.

Table 1.9.9. Remuneration policy (data in thousands of euro)

Year	*Remuneration non-equity*	*CEO*	*President (executive)*	*Executive directors*	*Non-executive directors*	*Independent directors*
2008	235	727	579	367	75	53
2009	219	672	555	340	83	51
2010	226	791	513	404	74	55
2011	233	824	596	434	79	55
2012	225	768	482	448	73	55
2013	229	846	491	499	76	54
2014	230	843	585	589	67	52
2015	244	979	623	392	67	55

Souce: Authors' elaboration based on Assonime's data.

With regard to the directors, executive, non-executive or independent, we can observe a great difference in terms of compensations. Executive directors show an increase in the average remuneration during the analyzed period – from 367.000 in 2008 to 499.000 in 2013 and then back to 392.000 in 2015 –, whereas the remuneration of non-executive and independent directors remains almost constant, around 74.000 and 55.000 euros, respectively. One of the reasons that explains the difference between the compensation of executives and non-executives is linked to the remuneration structure. Indeed, with regard to the executive directors, their compensation largely depends on performance-related elements (16%), whereas the remuneration of non-executive directors (and independent ones) is usually based on fix components only.

1.9.6. Shareholders' Rights and Corporate Governance

One of the most common problems characterizing joint-stock companies is the one concerning the agency theory, namely the conflict of interest between principal and agent (i.e., between managers and shareholders, in this specific case). In fact, managers act as the agent for the shareholders (principals) under the assumption that managers work in order to maximize the shareholders' value. However – and this is what the conflict is about – such aim is not always pursued. Therefore, monitoring the activity of managers becomes crucial for shareholders. In order to minimize the issue of the conflict of interest, a series of shareholders' rights have been defined.

Two main categories of shareholders' rights are provided:

- Patrimonial rights;
- Administrative rights.

Patrimonial rights include, among others, the right to receive dividends; the right to be attributed a proportional part of the firm's assets when the company is wound up (provided that the assets are greater than liabilities)[136]; pre-emptive rights whether the company decides to issue new stocks; and, finally, the right to withdraw from the company.

As regards the administrative rights, we can mention the right to participate and vote in general meetings, and the right to receive the information about the company and its conduction.

The administrative rights are those that allow shareholders to control the management activity.

With regard to the specific power that shareholders have against Corporate Governance, in Italy the law allows shareholders to define, modify and resolve the board of directors. The initial directors are appointed via bye-laws (Civil Code, art. 2328) and, after the first appointment, the subsequent directors are voted by the general meeting[137]. If shareholders want, they can – with just cause – remove and change directors.

However, as joint-stock companies can issue different types of stocks, the rights incorporated to the stocks may differ. Indeed, companies might attract investors by improving the patrimonial rights while reducing the administrative ones or *vice versa*. In all cases, there are some rights that cannot be eliminated, such as the right to receive the dividends. Examples of particular types of shares are privilege shares that incorporate an advantage during the distribution of dividends; shares with limited administrative rights, for instance, "saving shares" that do not offer voting rights; shares in favor of employees, for example, stock options.

Finally, the relationship between Corporate Governance and shareholders of Italian listed companies is treated also in the CG code (Art. 9). In particular, the Code asks the board of directors to increase the participation of shareholders to the general meetings and to ease the exercise of shareholders' rights. Indeed, the BoD has to do its best in order to reduce the difficulties and the costs to participate at general meetings, and has to favor as well the exercise of the right to vote (with regards, for instance, to the place, the date and the time when holding the meeting).

[136] This right has a value only if, at the time of closure of the company and after the payment of the total liabilities, some assets remain available for the division among shareholders.
[137] It is a meeting open to all shareholders of the company, where shareholders and the management discuss the company's activities and take the most important decisions.

1.9.7. Corporate Governance and Social Responsibility of Italian Listed Companies

The issue of Corporate Social Responsibility (CSR) has received particular attention by researchers and policy makers in the last decades. The CSR can be defined as the sense of responsibility that a firm has towards the community and the environment in which it operates. The European vision of CSR's is characterized by two main concepts: on one hand, the close relationship between competitiveness, social cohesion and the development of knowledge among companies and on the other hand, the belief of a strong interaction between CSR and sustainable development (ISFOL, 2013). The CSR's principles are based on the fact that a firm should achieve not only performance goals, but also social and environmental objectives. Indeed, the firm should create value not only for its shareholders, but also for all stakeholders that have a relation to it. In particular, the firm should be committed to sustaining the territory where it operates and the social context related to it.

During the last years, in Italy, the CSR has been developed more systematically and with greater attention. The Ministry of Labor and Social Policies and the Ministry of the Economic Development have worked hard to develop the Corporate Social Responsibility at the national level. Many associations (Associazione Bancaria Italiana, Italian Chambres of Commerce, Confindustria, and also many universities) have played an important role in the dissemination of the CSR principles among financial and non-financial firms.

The Annual report published by the "Osservatoio Socialis"[138] shows that 2016 has been an excellent year for the CSR in Italy. Indeed, in the last year, 80% of Italian companies declared their commitment in the CSR initiatives. This data is the highest in the last fifteen years. The Corporate Social Responsibility is transforming from an accessory tool to essential value for firms. Furthermore, starting from January 2017, firms with more than 500 employees must publish, in addition to the economic and financial results, also the performances linked to social, gender, human rights and anti-corruption policies – in line with the EU Directive 95/2014. Results of the annual survey on CSR show that the majority of companies invest in CSR initiatives, and that the two main aims pursued by companies are the improvement of the firm's reputation and the sustainable development.

Corporate Governance and Corporate Social Responsibility may, at first glance be perceived, as contrasting areas. While the former aims at maximizing the firm's profit, the latter points at boosting the benefits for the external stakeholder. The main objective of managers is to maximize the firm's value in line with the shareholders' goals. A possible increase in stakeholders' value usually occurs at the expense of shareholder value maximization. However, a sound Corporate Governance should maximize the value of both shareholders and stakeholders. The Code of CG underlines this aspect and emphasizes the importance of a sustainable development as a

[138] Osservatorio Socialis is an Italian newspaper that is specialized in Corporate Social Responsibility.

requirement for risks' minimization and firms' value creation, which are the first goals that the CG should achieve.

Italian listed firms have long since integrated the theme of CSR in their agenda. Molteni et al. (2013) analyze the CSR in the Italian listed firms. Authors underline that 70% of the observed companies offers a clear definition of CSR in its report, more than half is engaged in defining specific themes of CSR, 41, 9% verifies periodically the CSR progress in its company, about two BoD out of three are periodically updated on the social and environmental risks linked to the firms' activity, and one every four firms links part of the remuneration to the socio-environmental performance.

It is worth mentioning that researchers have identified four different type of behavior in terms of a company's attitude towards the CSR. In one case, the BoD is interested in the CSR topics and uses a collegial approach. The directors' competences are assessed and there is the CSR manager. In the second case, the BoD is interested in CSR themes, but there are specific committees that work with CSR manager. In the third group, the BoD is interested in CSR themes that refer only to the risk management, but also, in this case, there is a CSR manager. Finally, in the fourth case the BoD is engaged in CSR themes only for the strategic definition and it is not interested in the monitoring of the development of social and environmental thematic; furthermore, firms adopting such approach do not have a CSR manager. Results confirm that in the last years the CSR has become an important issue for Italian listed companies and the BoD is the body that defines the strategic guidelines and objectives regarding the social and environmental activities.

1.9.8. Corporate Governance and Performance

In this section of the chapter, we provide a brief review of the most recent papers that have investigated how corporate governance may impact on firms' performance.
The first study we examine is the one by Rossi et al. (2015). The authors explore whether the quality of corporate governance – measured via a Corporate Governance Quality Index (CGQI) – affects the performance – proxied either by a Tobin's Q or a ROE and ROA – of Italian listed companies during the financial crisis. Their study is of a cross-sectional nature and based on data from the fiscal year 2012. They observe that good Corporate Governance exerts a positive effect on the performance of firms.

Minichilli et al. (2016), instead, compare the performance (measured, alternatively, as ROA or ROE) of family and non-family listed companies in Italy. More specifically, their investigation is based on a wide dataset covering the years 2002-2012. This allows the authors to explore for differences in firms' performance during pre- and post-crisis periods. Overall, they find that family-controlled companies show better performances during the crisis.

It is also worthy of note that, following the adoption of the so-called "Pink quotas" Law, there has been a growing literature on the existence of a possible correlation between gender diversity and performance (proxied either via accounting or market measures). Among the studies that employ the formers, Di Donato et al. (2016) –

analyzing a sample of Italian listed companies, excluding firms in the financial industry, during the years 2011-2013 – find that the increase of women on boards is negatively correlated with the firm's performance (as proxied by ROA). Similarly, Cardi and Lucarelli (2017) – analyzing the boards of 83 IPOs listed on the Italian stock exchange across the years 2004-2014 – observe that higher profitability is associated to lower female participation in the Board of Directors (BoD). In contrast, considering the studies that employ the latter, we find that Gordini and Rancati (2017) – using data on Italian listed companies during the years 2011-2014 – observe a positive correlation between gender diversity and Tobin's Q.

Other studies have also investigated the effects of gender diversity on some operating performance regarding the BoD. For instance, Schwizer et al. (2012) – based on a sample of 237 listed companies throughout the years 2007-2009 – observe that the presence of women on boards is positively correlated to the monitoring activity, as well as to the frequency of the audit committee meetings.

Overall, we observe that the presence of women on boards has not a clear and precise effect on the various dimensions of the firm's performance. Hence, we are not able to definitely conclude that the Italian "Pink quotas" law has generated a positive effect on companies.

1.9.9. Conclusion

The functioning of the Corporate Governance system in Italy has attracted the interest of regulators and researchers in the last ten years – a period characterized by a long-lasting crisis. The financial turmoil, indeed, highlighted the importance of adopting best practice policies – at the corporate level – in order to improve the efficiency of the governance structures and, thus, the company's management and reputation.

Our chapter has focused on the main changes that characterized the Italian Corporate Governance system during the last ten years. Although SMEs represent the backbone of the Italian economy, we have dedicated our study only on listed companies. We mainly did so because the majority of CG reforms were especially addressed to them.

Data provided by Consob highlight that the number of listed companies has smoothly decreased in the last ten years, due to a surge in M&As and in the number of delisting.

In Italy, the most widespread CG model is the traditional one. Data provided by Consob (2016) highlight that – out of 234 listed companies – 228 employ the traditional model, 4 use the two-tier model, and only 2 adopt the single-tier design.

The members forming the Board of Directors belong to two main categories, that is executive and non-executive directors. Moreover, among the latter, there is a share of independent directors. As we observed, the average number of non-executive and independent directors has increased throughout the years, whereas executive directors have marginally decreased.

With regard to the gender diversity characterizing the BoD, thanks to the "Pink quotas" law, the number of female directors in Italian listed companies has strongly increased, namely from 5.9% in 2007 to 30.3% in 2016. Several authors believe that a greater share of women on boards generates a positive impact on the firms' performance, whereas it negatively affects the risk appetite.

Referring to the directors' compensation, data show an increase, through time, in the remuneration of all components of the BoD (both executive and non-executive). However, executive directors experienced a greater increase in their compensation compared to non-executive peers. As regards the formers, such rise is explained by an increase in both the fix component and in the performance-related elements; whereas the growth in non-executive directors' remuneration is associated with the increase in the fix component only.

Finally, concerning the attention to the social environment, 2016 was the Corporate Social Responsibility year. Indeed, at the end of 2016, 80% of Italian companies declare its commitment to CSR initiatives. This data is the highest in the last fifteen years. Indeed, there has been a change in the view of the Corporate Social Responsibility that is now felt as a value for the companies rather than a simple accessory tool.

Overall, we can conclude that Corporate Governance of Italian listed firms has notably improved throughout the crisis years. The compliance to the several guidelines and laws issued by Regulators and Authorities has also led to an enhancement in the composition of the BoD and its internal committees. Finally, the increased attention in terms of social responsibility highlights the still-growing interest of the companies towards a wider share of stakeholders and the whole environment more generally.

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1.10. CORPORATE GOVERNANCE IN SPAIN

Elena Merino
Montserrat Manzaneque

1.10.1. Overview of the Legal Framework of Corporate Governance in Spain

As in other countries, Spain has followed the European and international line, which is to establish recommendations through codes of good governance for listed companies. The content of these codes can be followed or not by companies, however, in the event that the companies do not follow the recommendations, they should explain why (the "comply or explain" approach[139]). Spanish Company Law[140] (hereafter SCL) (Art. 538) establishes that listed companies must make public an Annual Corporate Governance Report (hereafter ACGR) and disseminate it as a relevant fact, detailing the degree of fulfilment of the code of good governance recommendations, with the joint aims of monitoring the application and compliance of the internal and normative legal precepts concerning corporate governance and consolidating an essential instrument of transparency[141].

The first code of corporate governance in Spain was the Olivencia Report (1998), which was followed by the Aldama Report (2003). Afterwards, the Unified Good Governance Code of Listed Companies (Spanish Securities Markets Commission, hereafter CNMV, 2006) was approved. Subsequently there were updates to the previous text, both in 2009 and 2013. However, the amendments to the SCL (in 2014) incorporated a series of basic corporate governance precepts, which became mandatory for all companies, leading to the adoption, in 2015, of a new code called Good Governance Code of Listed Companies (hereafter CBGSC).

Thus, from 2015, the corporate governance framework for listed companies in Spain is based on:

a) The binding provisions contained in the SCL and other applicable laws and regulations.

b) The corporate governance recommendations contained in the CBGSC (2015).

The CBGSC (2015) contains 64 recommendations that are structured in different thematic areas (see Table 1.10.1). This code makes an important contribution to corporate governance in Spain when compared with the CBGC (2013) because of the addition of 23 new recommendations, 12 of which were eliminated when incorporated into the SCL and 21 of which were modified.

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[139] Spanish company legislation (Art. 540) upholds the "comply or explain" principle in requiring listed firms to specify their *"degree of compliance with corporate governance recommendations, justified any failure to comply"* in the pages of their annual corporate governance reports.

[140] Royal Legislative Decree 1/2010, of 2 July, approving the consolidated text of the corporate enterprises Act.

[141] The content of the report is mandated by the Circular 7/2015 (*https://www.boe.es/diario_boe/txt.php?id=BOE-A-2015-14289*). Additionally, the content of the report for each listed company can be consulted on the following web page: *https://www.cnmv.es/portal/Consultas/BusquedaPorEntidad.aspx*.

Table 1.10.1. Content of good governance code of listed companies (CBGSC, 2015)

General Areas	*Specific Areas*
General arrangements (5 recommendations)	Bylaw restrictions Listed companies from the same group Reporting of compliance with corporate governance recommendations Meetings and contacts with shareholders, institutional investors and proxy advisors Exercise of the delegated authority to issues shares or convertible securities without pre-emptive subscription rights
Shareholders´ general meeting (6 recommendations)	Information transparency and informed voting General meeting attendance and participation Policy on attendance payments
Board of directors (53 recommendations)	Board of directors responsibility Board of directors structure and membership Board of directors operation Board of directors organisation Corporate social responsibility Directors´ remuneration

Source: Own research from CBGSC (2015).

1.10.2. Ownership Structures of Companies in Spain

One of the main characteristics of the Spanish market is the high level of ownership concentration. In fact, while US and UK companies (commonly known as the Anglo-Saxon context) often have very dispersed ownership, European firms are characterized by a high concentration (Faccio & Lang, 2002). Spain is not an exception to the latter group and, in fact, La Porta et al. (1999) found that 85% of Spanish companies have a controlling shareholder. Also, Reyes (2002), for a sample of non-financial listed companies, in 1998, concluded that 82.98% of them had a concentrated ownership (with the level of participation of the largest shareholder being more than 10%). Recently, other authors such as De Miguel et al. (2004) have made similar observations. As can be seen in Table 1.10.2, the distribution of ownership of Spanish listed companies is mainly in the hands of the boards of directors (22.2% in 2015) and the controlling shareholders (33.2% in 2015).

Under ownership concentration, the theory predicts that, due to the importance of the investment made, the large shareholdings will find incentives to exercise an effective supervisory role over the management team, thus reducing the possible expropriation of wealth that could be carried out. This approach has been evident in numerous texts and research projects (Fama & Jensen, 1983; Shleifer & Vishny, 1997; among others) that refer to business concentration as a mechanism that inhibits opportunistic behaviour of the direction.

On the other hand, the previous research argues that excessive ownership concentration could give the controlling shareholders sufficient power with which to transfer firm assets to finance other businesses and thus reduce the firm's value (Dahya et al., 2008). Indeed, the characteristics of the Spanish shareholding scenario lead to the existence of significant shareholders (holding more than 3% of the capital) or representatives of large shareholder groups that have the ability to influence management decision-making. In these situations, the influence of the main shareholders can lead to the extraction of private profits in their favour, and to the detriment of minority shareholder interests (Cuervo-Carruza, 1998), making this conflict of interest especially important.

Table 1.10.2. Distribution of ownership of Spanish listed companies

Ownership structure	***2015***	***2014***	***2013***
Board ownership	22.2 *8.1**	23.1 *8.5**	25.8 *10.8**
Controlling shareholders (excluding board ownership)	33.2 *31.0**	32.7 *30.4**	31.5 *28.4**
- Resident individuals	5.1 *0.7**	4.9 *0.6**	5.2 *1.2**
- Resident legal entities	19.0 *15.9**	18.1 *16.4**	18.8 *16.5**
- Non-resident individuals or legal entities	9.2 *14.3**	9.8 *13.4**	7.6 *10.8**
Treasury stock	1.2 *1.0**	1.3 *1.1**	1.2 *0.4**
Minority shareholders	43.4 *59.0**	42.9 *60.1**	41.5 *60.4**

Note: these data correspond to the companies of IBEX-35
Source: CNMV (2016a, 2015a and 2014a).

Thus, following the above discussion, it would be expected that the concentration of shareholding resulted in greater control over management bodies, making the problem of agency between shareholders and managers less important. However, the effect that concentration of ownership may have on the conflict of interests between majority and minority shareholders is likely to increase in such circumstances.

Accordingly, if the control mechanisms are not adequate, the directors appointed by the core stockholders could use their power to extract wealth in detriment of the minority shareholder interests, for example, by carrying out an erroneous policy of investments (Denis et al., 1997), excessive consumption of non-pecuniary goods (Jensen, 1986) or through the establishment of high remuneration for management members (Bebchuk et al., 2002).

In this context, there is increasing evidence of efforts being made to seek procedures that guarantee the efficiency of the Board of Directors as a mechanism for controlling the conflict of interests between minority and majority shareholders (principal-principal conflict of interests). The literature specifically focuses on the role of institutional shareholders in controlling management or majority shareholders because they are supposed to act actively to align the interests of minority and majority shareholders (Bethel & Liebeskind, 1993; Pound, 1992). However, it is worth mentioning that not all institutional shareholders may share the same interest or the same level of implication in the protection of the minority shareholder interests. Banking-industry relations in Spain answer to a continental financial system (like other countries such as Germany, France or Japan, among others). In this type of model, funding is provided, for the most part, by banks which, in many cases, participate in the ownership of the company funding, sometimes through complex pyramid structures of ownership. Without a little diligence, the political power of banking investees exceeds that which would correspond strictly to their direct participation. Moreover, as well as the aforementioned indirect stakes, the delegate exercises power through political rights inherited through company shares and if these are deposited in the bank, this power is further extended. In such cases, banks often maintain an active attitude in matters such as control of company management or strategic direction, sometimes acting to reorganize a company going through difficulties in order to monetize their investment in the future. Gonzalez (2001) concluded that the incentive of a bank to participate in company policy is not to reduce the conflict of interest between creditors and shareholders (in which case the company would not reduce risk by rejecting profitable projects) but to gain extra profit on company investments (from profitable projects) or to avoid liquidation costs (participation in companies with unprofitable) risky projects. Tejerina´s (2006) analysis shows that around 20% of firms had financial institutions as their main shareholder in 2002 in Spain. That data highlight the importance of that types of shareholders and their possible influence on the conflict of interest between majority and minority shareholders in the Spanish context (Manzaneque et al., 2016).

1.10.3. Market for Corporate Controls (M&A)

Certain situations give managers the opportunity to make decisions in their own interest, against the interests of shareholders (*Self-dealing*). In economies with an efficient takeover market (mergers and acquisitions, M&A), the control over manager opportunism or discretion could be exercised through the market (external corporate governance mechanism), which facilitates the transfer of corporate control to another new management.

In Spain, M&A played an important role in terms of investment and the number of transactions during the first years of the financial crisis (2006-2008) and also in recent years (2014-2015) (see Table 1.10.3).

Table 1.10.3. M&A in Spain. Investment and number of transactions (2006-2015)

Year	*Investment (Millions of euros)*	*Number of mergers and acquisitions*
2006	160.000	624
2007	293.000	740
2008	227.000	819
2009	54.200	485
2010	63.100	456
2011	60.700	389
2012	46.700	338
2013	28.700	414
2014	73.600	456
2015	88.200	585

Source: Own research taken from KPMG (2016).

In terms of corporate governance and control, Spanish legislation provides certain instruments which facilitate agility and efficiency within the takeover market. In particular, SCL has allocated two main instruments that enable transactions and prevent the selective expropriation of shareholders of the company: a) establishing transparency and information mechanisms that facilitate efficiency, reduce transaction costs and avoid the existence of control premiums; and, b) ensuring equal treatment to all the shareholders of the company in ownership transfer mechanisms that are comparable for all (see SCL and Law on structural modifications of companies). Also, the CBGSC (2015) recommends that the bylaws of the firm do not limit the maximum number of votes that may be cast by the same shareholder or contain other restrictions that make it difficult to control the company by acquiring its market shares (Recommendation 1, CBGSC, 2015).

1.10.4. Board of Directors' Practices

Spain has a corporate governance system of companies characterized by a single Board of Directors (Unitary Board System), in which different types of directors[142] co-exist with different functions and responsibilities, that is internal or executive directors and external or non-executive directors (independent or proprietary directors).

CBGSC (2015) establishes a number of recommendations regarding the board of directors (in total 53 recommendations, see Table 1.10.1) to which should be added those that are already included in the legislation. As we cannot examine all them we want to highlight those aspects related to structure and composition, operation and organization.

With regard to the *structure and composition* of the Board of Directors, size, duality, independent members and diversity are the salient aspects.

As far as the *size of the board* is concerned, the CBGSC (2015) recommend that the board *"have an optimal size to promote its efficient functioning and maximize participation"* (Recommendation 13, CBGSC, 2015), establishing that the size must be between 5 and 15 members. The literature on corporate governance gives reasons both against and in favor of large boards. Thus, some researchers support that large boards are characterized by diversity of criteria, opinions, and experiences, thereby increasing the monitoring capacities of the group (Adam et al., 2005) as they can afford greater diversity among their members (Klein, 2002). As the literature on board diversity maintains, boards with the presence of different types of members should provide more effective problem solving among stakeholders (Carter et al. 2003) and greater social capital – relationships with business networks and stakeholders – (Dang et al., 2014). Nevertheless, it is also accepted that large boards have greater problems with coordination and information because there is less speed and efficiency in the decision-making process (Lipton & Lorsch, 1992; Jensen, 1993). Taking all these views into account, it would appear that the existence of larger boards may entail as many advantages as disadvantages.

According to the data for the Spanish context, in 2015, the average number of board members was of 9.7 although the average for the 35 most liquid listed companies included in the main benchmark index of the Spanish stock market (hereafter, IBEX-35) was higher, with 13.1 members (13.3% in 2014 and 13.7% in 2013) (see Table 1.10.4). Therefore, the data show that this recommendation is being followed in 2015, since most companies take into account the size of the recommended board, in fact, only 12 companies (8.8% of the total) do not follow the recommendation (5 with boards of fewer than 5 members and 7 with more than 15 members) (CNMV, 2016a).

[142] For the first time, the distinction between different directors and their definitions are included in Spanish legislation (Art. 529 duodecies SCL).

Table 1.10.4. Characteristics of board of directors

Characteristics	***2015***	***2014***	***2013***
Size of the board (number of members)	9.7 *13.1**	9.5 *13.3**	9.9 *13.7**
Duality	43.8 *31.4**	44.3 *25.7**	39.8 *25.7**
Independent directors (proportion on total)	40.1 *47.6**	36.5 *45.1**	34.8 *46.5**
Female directors (proportion on total)	15.6 *19.6**	13.5 *16.7**	12.0 *15.6**
Board meeting (number of meetings)	10.7 *11.5**	10.2 *11.2**	10.2 *10.8**

Note: these data correspond to the companies of IBEX-35

Source: Own research from CNMV (2016a, 2015a and 2014a).

Duality exists when the Chairman is, at the same time, the Chief Executive Officer (CEO). The literature suggests that the agency problem is higher when there is CEO duality (Yermack, 1996; Tuggle et al., 2010). CEO duality implies more power on the board for the Chairman (Nahandi et al., 2011) and, consequently, less board effectiveness with regard to achieving shareholders' interests. In other words, CEO duality contributes to managerial opportunism and thus leading to decision-making which benefits management over and above the company's shareholders (Coles et al., 2001; Jensen, 1993). However, some authors (Brickley et al., 1997) consider that the separation of positions (CEO/Chairman) could lead to a lack of communication or transparency between them. Following this reasoning, the SCL (art. 529 septies SCL, introduced by Law 31/2014) established that duality may exist[143], provided that a favorable vote of two-thirds of the votes of the board is received. But the law also adds that if there is duality, a lead director must be appointed from among the independent directors with the following functions*: "convene the board of directors or include new points of the day to the board meeting already convened; coordinate and bring together non-executive directors; and, conduct the periodic evaluation of the chairman of the board of directors"* (Art. 529 septies SCL, introduced by Law 31/2014). In practice, in 2015, duality existed in 43.8% of firms (44.3% in 2014 and 39.8% in 2013). These percentages were lower for companies in the IBEX-35 (31.4% in 2015, 25.7% in 2014 and 25.7% in 2013).

Following common international practice, the presence of external directors on boards is recommended in the CBGSC (2015) and especially the presence of *independent directors*[144]. Accordingly, CBGSC (2015) recommends that the number of independent directors should represent at least half the board members. However, the code clarifies that a third of independent directors may be sufficient when the company does not have a large stock market capitalization or when the company has one or more shareholders controlling more than 30% of the capital stock (Recommendation 17, CBGSC, 2015).

[143] The lack of uniformity in international practice and the lack of an empirical basis supporting the desirability of separating these figures have led the legislator to refrain from prohibiting duality.

[144] Spanish Company Law (Art. 529 duodecies SCL, introduced by Law 31/2014) has incorporated the definition of independent directors as *"those who, appointed according to their personal and professional conditions, can perform their functions without being conditioned by relations with the company or its group, its significant shareholders or its managers"*.

Among the research about corporate governance, independence is one of the most analyzed issues in relation to how effective boards are at protecting shareholders' interests (e.g. Fama & Jensen, 1983; Jensen, 1993; Dahya et al., 2002). According to Mangena & Tauringana (2007), independent directors tend to commit to and engage with investors' information needs and encourage managers to satisfy them. Also independent directors are important to protect the interest of minority shareholders in the presence of controlling shareholders as they foster voluntary disclosure (Patelli & Prencipe, 2007). In the Spanish context, 40.1% of board members were independent directors in 2015 (36.5% in 2014 and 34.8% in 2013). In the companies included in IBEX-35, the presence of independent directors was higher, that is, 47.6% (45.1% in 2014 and 46.5% in 2013) (see Table 1.10.4).

With regard to *diversity*, the SCL has established that the director selection policy should seek a balance of knowledge, experience, and gender in the board´s membership (Art. 529 bis SCL, introduced by Law 31/2014). For its part, CBGSC (2015) has shown itself to be following the same lines as the normative, although the text has added that *"director selection policy should pursue the goal of having at least 30% of total board places occupied by woman directors before the year 2020"*[145] (Recommendation 14, CBGSC, 2015), thus giving greater weight and importance to gender diversity. There are three key theories highlighting the benefits of women's presence on boards of directors. Following the Agency Theory, female directors are tougher than male directors in the protection of the interests of shareholders (Adam & Ferreira, 2009) as they are more likely to raise more questions (Carter et al., 2003) and debate issues (Ingley & Van der Walt, 2005). In relation to the Resource Dependency Theory, *"female directors bring unique and valuable resources and relationship to their boards"* (Terjesen et al., 2016). Finally, Gender Role Theory supports the idea that there are qualities that women have that may be useful in the performance of director´s duties, such as flexibility, particularly when confronted with the need to overcome a difficult situation (Rosener, 1995). According to statistics prepared by the CNMV, the average presence of female directors on boards was 15.6% in 2015 (13.5% in 2014 and 12% in 2013). In the companies included in the IBEX-35, the presence of female directors was higher, that is, 19.6% in 2015 (16.7% in 2014 and 15.7% in 2013) (see Table 1.10.4).

Moreover, there are multiple potential benefits attached to board diversity as boards with different members should provide more creativity (Ferreira, 2010), a diverse perspective (Milliken & Martins, 1996), along with effective problem-solving (Carter et al., 2003). In particular, the unique vision of different nationalities is viewed as an important diversity issue. With regard to the presence of foreign directors, Spencer Stuart's study (2016), with a sample of 100 companies listed on the Spanish markets, shows that in 2015 the percentage of this type of director was 15.3% of the total number of directors (12.5% in 2014).

In relation to the *operation of the Board of Directors*, we would like to highlight

[145] With this initiative, Spain has taken a first, but less restrictive, step (30%) for the future transposition of the proposal for a *Directive of the European Parliament* and of the Council which states that the presence of women among the non-executive directors of listed companies will be 40% in the year 2020.

two important aspects, the frequency of board meetings and the evaluation of the board. In relation to the first aspect, CBGSC (2015) recommends that the *"board should meet with the necessary frequency to properly perform its functions, eight times a year at least"* (Recommendation 16, CBGSC, 2015). Board meeting frequency is a proxy for "effort" of the board (Andreas et al., 2012), that is, for the time dedicated by directors to monitoring management (Vafeas, 1999). Accordingly, Barros et al. (2013) suggest that a sufficient number of board meetings can lead to effective monitoring. In the context of Spanish listed companies, the average number of meetings was 10.7 in 2015 (10.2 in 2014 and 2013). In the companies included in the IBEX-35, the average was higher, with 11.5 meetings (11.2 in 2014 and 10.8 in 2013) (see Table 1.10.4). Thus, this recommendation was followed by 75% of companies in 2015.

With regard to the evaluation of the performance of the Board of Directors, SCL (Art. 539 nonies, introduced by Law 31/2014) requires the annual evaluation of the performance of their board and board committees, and the drawing up of an action plan to address any weaknesses detected. As a complement to this requirement, CBGSC (2015) explains how this evaluation should be carried out and recommends that *"every three years, the board of directors should engage an external facilitator to aid in the evaluation process"* (Recommendation 36, CBGSC, 2015). In addition, the new version of the code adds as a recommendation the individual evaluation of the directors, something which is currently inexistent. Board evaluation is regarded as a fundamental element to confirm the effectiveness of a board's performance (Ingley & var der Walt, 2002) helping to prevent corporate failures (Kiel & Nicholson, 2005).

Finally, in relation to *organization* of the board of directors, the objective of the different committees is to help boards of directors to achieve their goals, hence these committees are expected to have an impact on board effectiveness (Klein, 1995). The Spanish legislation (Art. 529 terdecies SCL, introduced by Law 31/2014) established that the board of directors may set up specialized committees within itself, with at least one audit committee (AC) and one (or two separate) nomination and remuneration committee (NRC) being obligatory. In both cases (AC and NRC), the law establishes that its members shall be non-executive directors, have at least two independent directors and that the presidents be elected from among the independent directors. In Spain, in addition to the previous committees, it is common for listed companies to have a delegated or executive committee, in fact, in 2015, 40.1% of the companies had a delegated committee with executive functions. The size of ACs and NRCs in the Spanish context in 2015 year was on average 3.7 members (3.5 in 2014 and 3.6 in 2013) and 3.7 members (3.7 in 2014 and 3.6 in 2013), respectively. In the companies included in the IBEX-35, the average was higher, with 4.3 members (4.0 in 2014 and 4.3 in 2013) and 4.3 members (4.3 in 2014 and 4.3 in 2013) for AC and NRC. As far as independent directors are concerned, in the year 2015, the dates reveal 64.6% (57.1% in 2014 and 55.8% in 2013) for AC and 63.9% for NRC (57.1% in 2014 and 54.1% in 2013). Finally, in 2015, the president of the AC and NRC was independent in 97.8% (86.9% in 2014 and 81.2% in 2013) and 95% (79.3% in 2014 and 72.5% in 2013) of companies, respectively (see Table 1.10.5).

Table 1.10.5. Characteristics of audit committee and nomination and remuneration committee

Characteristics		***2015***	***2014***	***2013***
Audit Committee	Size (number of members)	3.7 *4.3**	3.5 *4.0**	3.6 *4.3**
	Independent directors (%)	64.6 *72.7**	57.1 *67.4**	55.8 *66.4**
	Executive directors (%)	0.6 *0.0**	3.8 *0.7**	5.2 *0.0**
	Independent president (%)	97.8 *100**	86.9 *100**	81.2 *97.1**
Nomination and Remuneration Committee	Size (number of members)	3.7 *4.3**	3.7 *4.3**	3.6 *4.3**
	Independent directors (%)	63.9 *69.8**	57.1 *67.3**	54.1 *66.9**
	Executive directors (%)	0.2 *0.0**	4.0 *2.0**	5.6 *2.0**
	Independent president (%)	95 *100**	79.3 *n.a.***	72.5 *85.7**

Note: these data correspond to the companies of the IBEX-35
** n. a.: not available*
Source: Own research from CNMV (2016a, 2015a and 2014a).

1.10.5. Directors´ Remuneration Practices

We should mention that, in Spain, the principle of the gratuitousness of directors prevails unless the bylaws provide otherwise, therefore, the bylaws must specify the "compensation system" to be used to remunerate the directors (Art. 217 SCL). However, from 2014, it was established that directors in listed companies will necessarily be remunerated (Art. 529 sexdecies SCL, introduced by Law 31/2014).

On the issue of remuneration, there have also been important developments with the modification of the SCL, among which we must emphasize that the remuneration policy (together with a report drawn up by the nomination and remuneration committee) shall be in accordance with the provisions of the bylaws and shall be submitted to the binding vote of the Shareholders´ General Meeting every 3 years[146] (Art. 529 novodecies, introduced by Law 31/2014). Subsequently, each year the companies must prepare and publish an "Annual Report on Remuneration of Directors"[147], which will be submitted to the advisory vote of the Shareholders´ General Meeting. However, if the said annual report is rejected, the remuneration policy of the following year shall be submitted again for the approval of the Shareholders' General Meeting (even if the 3-year term has not expired).

In relation to the amount of remuneration granted to directors, Spain has opted not to establish limits, stating that the remuneration of directors should be reasonable in proportion to the size of the company, its economic situation and comparable figures

[146] Accordingly, Spain has followed the content of the Proposal for a *Directive COM (2014) 213* final of the European Parliament and of the Council amending *Directive 2007/36/EC* regarding the encouragement of long-term shareholder engagement and *Directive 2013/34/UE* with regard to certain elements of the corporate governance statement.

[147] The content of this report has been defined by Circular 4/2013, of 12 June, of the National Securities Market, which sets the annual report models remuneration of directors of listed companies and members the board of directors and the supervisory board of the Savings Banks that issue securities admitted to trading on official stock markets.

of other companies within the company market (Art. 217.4 SCL, introduced by Law 31/2014). To all this, CBGSC (2015) adds that remuneration should be sufficient to attract and retain directors but not so high as to compromise the independence of non-executive directors (Recommendation 56, CBGSC, 2015).

Also, CBGSC (2015) incorporates recommendations related to the remuneration applicable to executive directors, the characteristics of variable remuneration, claw back and termination payments. In relation to the remuneration applicable to executive directors, the code recommends that only executive directors should receive variable remuneration linked to the performance of the company and the directors themselves (Recommendation 57, CBGSC, 2015) and that a relevant percentage of that variable remuneration is linked to the delivery of shares or financial instruments referenced to the share price (Recommendation 61, CBGSC, 2015). The listed companies should consider the following conditions if establishing a system of variable remuneration (Recommendation 58, CBGSC, 2015):

- *Be subject to predetermined and measurable performance criteria that factor the risk assumed to obtain a given outcome.*
- *Promote the long-term sustainability of the company and include non-financial criteria that are relevant for the company´s long-term value, such as compliance with its internal rules and procedures and its risk control and management policies.*
- *Be focused on achieving a balance between the delivery of short, medium and long-term objectives, such that performance-related pay rewards ongoing achievement, maintained over sufficient time to appreciate its contribution to long-term value creation. This will ensure that performance measurement is not based solely on one-off, occasional or extraordinary events.*

Also, Recommendation 59 (CBGSC, 2015) states that a major part of variable remuneration should be deferred for a long enough period to ensure that predetermined performance criteria have been met effectively.

However, the main novelties of the text which is currently in force are: on the one hand, the recommendation of including the so-called "claw back clauses", by which the company can claim the repayment of the variable components when the payment has not been adjusted to the conditions of performance or has been based on inaccurate data (Recommendation 63, CBGSC, 2015); and, on the other hand, the setting of limits on payments for termination of the contract with directors, that is, the amount must not exceed the equivalent of two years of total annual remuneration and will not be paid until compliance with the established criteria is verified (Recommendation 64, CBGSC, 2015).

According to studies by the CNMV, the average compensation received by each member of the board of directors was €344,000 for 2015 (€318,000 in 2014 and €285,000 in 2013). The remunerations received by each type of director was: executive directors (including Chairmen and CEO), €1,394,000 in 2015, €1,311,000 in 2014 and €1,092,000 in 2013; executive directors (excluding Chairman and CEO), €967,000 in 2015, €1,004,000 in 2014 and €837,000 in 2013; proprietary directors, €90,000; and independent directors, €113,000 in 2015, €108,000 in 2014 and €125,000 in 2013. With respect to the different types of remuneration, fixed remuneration remains the most used modality (46% of total remuneration in 2015, 50% in 2014 and 55% in 2013), although this has fallen in recent years in favor of the use of variable remunerations (38% in 2015, 37% in 2014 and 32% in 2013) and other remunerations (10% in 2015, 7% in 2014 and 5% in 2013).

Table 1.10.6. Information on the remuneration granted to directors in Spanish listed companies

Remuneration granted to directors in Spanish listed companies	***2015***	***2014***	***2013***
Average remuneration per board	3,485	3,243	2,810
Average remuneration per director	344	318	285
Average remuneration per executive director (including executive chairmen and chief executive or operating officers)	1,394	1,311	1,092
Average remuneration per executive director (excluding executive chairmen and chief executive or operating officers)	967	1,004	837
Average remuneration per proprietary director	90	75	101
Average remuneration per independent director	113	108	125
Average remuneration per other external director	219	237	157
Distribution by item (%)			
- Fixed remuneration	46	50	55
- Variable remuneration	38	37	32
- Attendance fees	6	6	8
- Other remunerations	10	7	5

Source: Own research from CNMV (2016b, 2015b and 2014b).

With regard to the transparency of directors´ remuneration, the aforementioned "Annual Report on Remuneration of Directors" must include information on the past and present remuneration policies granted to directors, expressing the individual remuneration given to each of the members of the Board of Directors[148].

1.10.6. Shareholders´ Rights Protection

In large companies, minority shareholders are largely disinterested in the management of the company (known as shareholder absenteeism), thus they delegate voting rights in favor of the management body. This is because the expectations of minority shareholders' benefits do not offset the costs of identification, organization, and so on, in order to exercise their minority rights (Puente, 2017). Moreover, minority shareholders, especially in the context of concentrated ownership, have conflicts of interests with majority shareholders (a problem known as principal-principal) because the controlling shareholders may make decisions involving the extraction of wealth from minority shareholders.

With the aim of facilitating the participation of these minority shareholders in the management of the company, Spain[149] has witnessed the emergence of shareholders' associations in recent times. The mission of these bodies is to raise the concerns of its members before the governing bodies without necessarily altering the composition of the management body (Del Val, 2015). The possibility of creating these associations has

[148] The content of this Report is defined in Circular 4/2013 (modified by Circular 7/2015).

[149] In Spain, among other organizations, we must highlight *Asociación Española de Accionistas Minoritarios de Empresas Cotizadas*, which was created in 2005 with the aim of offering the channels for the effective presence of corporate interests within the respective listed companies.

been included in the SCL where the requirements that must be met to be able to exercise the role of representation of shareholders in the boards of listed companies have been regulated (Art. 539.4 SCL, introduced by Law 31/2014).

However, SCL has also promoted different measures to facilitate the individual participation of minority shareholders in the Shareholders´ General Meeting through the increase of information transparency. Among other obligations, listed companies must have a web page (Art. 11 bis and 539 SLC) in which all documents relating to the organization and operation of the general meetings are published with sufficient notice[150] (Art. 518 SLC), as well as the agreements adopted (Article 525.2 SLC). They must also enable an Electronic Shareholders' Forum, in order to facilitate the communication of shareholders prior to the holding of general meetings (Art. 539 SLC). Through this forum, shareholders can publish proposals relating to the agenda, adhere to them or carry out initiatives to reach the percentage necessary to exercise a minority right as is provided for by law.

With the approval of Law 31/2014, the minimum percentage for the exercise of minority rights in listed companies was reduced to 3% of the share capital (Art. 495.2 SLC), especially with regard to the inclusion of new items in the agenda of the meeting (Article 519 SLC), and established in 1,000 the maximum number of shares that may be required by the bylaws to attend the general meeting[151] (Article 521 bis SLC).

In addition, Art. 521 SLC states that participation in the general meeting and voting of the proposals included in the agenda may be delegated or exercised at a distance (postal correspondence, electronic or other means of distance communication) provided that the identity of the subject participating or voting and the security of electronic communications are guaranteed. Likewise, the company must articulate one of the following mechanisms to facilitate the distance exercise: a) Real-time transmission of the general meeting; b) Two-way communication in real time so that the shareholders can address the general meeting from a different location; or, c) A mechanism to exercise the vote before or during the general meeting without the need to appoint a representative who is physically present at the meeting. In line with the first mechanism, the CBGSC (2015) has introduced a new recommendation for the company to broadcast, through the corporate website, its General Shareholders' Meeting (Recommendation 7, CBGSC, 2015).

In practice, within the Spanish market, distance voting was used in 32% of listed companies in 2015 (compared to 27.5% in 2013) (see Table 1.10.7), a percentage that has not grown much since then. The aspect that has undergone a considerable increase has been the use of electronic media that has increased from 4% in the year 2013 to 23%, in 2015. On the other hand, the recommendation concerning the retransmission of the JGA through the corporate website has been one of the least followed recommendations, being pursued by just 31.4% of total listed companies (CNMV, 2016a).

[150] In addition to the information contained in the legislation, CBGSC (2015) recommends that the following information be published on the website prior to the General Shareholders' Meeting: "a) Report on auditor independence; b) Reviews of the operation of the audit committee and the nomination and remuneration committee; c) Audit committee report on third-party transactions; d) Report on corporate social responsibility policy (Recommendation 6, CBGSC, 2015).

[151] However, in the case of not having the minimum required in the statutes, Spanish legislation allows the share groupings to be able to attend meetings and / or to exercise the right to vote (Art. 189 SLC).

Table 1.10.7. Information on the use of remote vote in Spanish listed companies

Use of remote vote	***2015***	***2014***	***2013***
Listed companies that use remote vote (%)	32	29.1	27.5
Remote vote though electronic media (%)	23	2	4
Remote vote though other media (postal mail, messaging, etc.)(%)	77	98	96

Source: Own research from CNMV (2016a, 2015a and 2014a).

1.10.7. Shareholder Activism

Shareholder activism is defined as *"actions taken by shareholders with the explicit intention of influencing corporations´ policies and practices, rather than as latent intentions implicit in ownership stakes or trading behaviour"* (Garanova et al., 2014). In Spain, the phenomenon of shareholder activism is relatively recent, in fact, the first CNMV documents in which this phenomenon is named date from 2007 (Puente, 2017). It is possible to distinguish two types of activism (Alfaro, 2014): first, *old style activism*, frequent in the European context, which include all those demands to the management of the company focusing on the fulfillment of environmental, social, or governmental criteria; and, second, *new style activism*, rare outside of the Anglo-Saxon context, that seeks to take control of the company or force the board to take action with the aim of increasing profitability for the shareholder when they consider that the company is returning worse results than the competition.

Old style activism can also be divided into two large groups (Alfaro, 2014): on the one hand, those who demand the fulfillment of certain social or environmental commitments from the company. This group would mostly include campaigns organized by NGOs. On the other hand, there are those campaigns focused on issues relating to corporate governance. In this case, the shareholders are qualified investors (mutual funds or pension funds), whose weight can influence the direction of the votes and have the capacity to request the inclusion of a point in the agenda at the Shareholders' General Meeting, although they do not usually make use of this prerogative as their demands are often part of the proposals that must be legally approved at the shareholders' meeting.

In this field, two important players have gained increasing relevance in recent years: the so-called proxy solicitors and proxy advisors. "Proxy solicitors" are companies that help listed companies identify, locate and dialogue with major investors to secure voting at shareholder meetings. Their advice covers both demands about the fulfillment of environmental, social, or governmental criteria and compromised or hostile company acquisition operations. For its part, "proxy advisors" are entities that provide advisory services to investors, mainly institutional investors, in relation to the exercise of the right to vote derived from the ownership of shares in listed companies. In practice, in the Spanish context, the issues that tend to generate greater rejection on the part of the proxy advisors continue to be related to the remuneration of executive directors, the re-election of certain directors, both proprietary and independent, as well as the authorization to issue shares subject to the pre-emptive subscription right (Spencer Stuart, 2016).

New style activism[152] is usually carried out by hedge funds and aims to achieve economic profitability by taking an active position in the capital of the company. However, only when the interests of the hedge fund coincide with those of the other shareholders, is the existence of this investor beneficial for the whole (Losada, 2007).

Among the measures that the company can take to avoid shareholder activism are: the following: increasing information transparency as well as holding talks and fostering relationships with shareholders and investors in order to discover their concerns. In relation to information transparency, it has been established that its increase will have a deterrent effect on the actions of activists (Borveau & Schoenfeld, 2016). In the Spanish context, reforms in both the legislation and the code of good governance have resulted in more information being made public (some of which has already been mentioned, with regard to complying with the recommendations concerning the remunerations of the directors, and so on).

As for as contact with shareholders and investors is concerned, we highlight the following measures. One of the functions of the lead independent director mentioned in the CBGSC (2015) focused on just this aspect indicating that this director should *"maintain contacts with investors and shareholders to hear their views and develop a balanced understanding of their concerns, especially those to do with the company´s corporate governance"* (Recommendation 34, CBGSC, 2015). Also, recommendation 4 of the CBGSC (2015) states that the company must define and promote *"a policy of communication and contacts with shareholders, institutional investors and proxy advisors that complies in full with market abuse regulations and accords equitable treatment to shareholders in the same position"*. Finally, recommendation 32 (CBGSC, 2015) states that *"directors should be regularly informed of movements in share ownership and of the views of major shareholders, investors and rating agencies on the company and its groups"*.

1.10.8. Corporate Governance and Firm Performance

Every company has the objective of obtaining benefits and ensuring their long-term survival. In a context of large companies in which there is a separation between control and ownership, the board of directors is the responsible organ for decision-making. Accordingly, recommendation 12 of the CBGSC (2015) states that the board of directors should perform its functions guided by social interest, understood as *"the creation of a profitable business that promotes its sustainable success over time, while maximising its economic value"*. It is for this reason that the different codes of good governance have established recommendations on the ideal structure and composition of the boards of directors that allow them to carry out their supervisory and control functions. However, the financial scandals of recent times have called into question the functions carried out by this body, which has also led to the questioning of the monitoring by companies of

[152] In the words of Alfaro (2014) in the Spanish context *"there are only four companies in which this issue is relevant because they are not controlled by majority shareholders or groups of shareholders - Telefónica, BBVA, Santander and Iberdrola - like the rest. So the debate does not have the same meaning in Spain as in England or the United States"*.

many of the recommendations of the various codes. In fact, in many cases, the lack of follow-up has resulted in the establishment of certain normative provisions, as discussed above in the Spanish context.

Table 1.10.8. Overview of the empirical studies on the relationship of corporate governance and performance in Spanish context

	Sample/ Years	***Dependent variable***	***Independent variable***	***Relationship with performance***
Arosa et al. (2013)	307 SMEs/ 2006	Return on assets (ROA)	Board size	Negative
			Outside directors	Negative
Barroso Castro et al. (2009)	119 firms/ 1993-2000	Economic Profitability	Board size	Positive
			Independence	Negative
Cabrera-Suárez & Martín-Santana (2015)	544 non-listed family firms	Productivity (natural logarithm of the ratio of sales to employees)	Executive directors	Negative
			Duality	Positive
			Outside directors	Negative
Pucheta-Martínez (2015)	162 firms/ 2004-2011	Economic profitability	Board meetings	Positive
		Market-to-book	Board size	Positive (although from a certain point the relationship becomes negative)
Rodríguez et al. (2013)	121 firms/ 2009	ROE ROA Tobin´s Q	Board size	Negative
			Activity	Negative
Villanueva-Villar et al. (2016)	65 firms/ 2006-2012	Q (proxy for Tobin´s Q)	Duality	Positive
			Board meetings	Negative
	65 firms/ 2009-2012	Q (proxy for Tobin´s Q)	Board size	Positive
			Independent directors	Positive

Source: Own research

In any case, the interest aroused has led to an extensive study of the literature on the relationship between the size, composition and activity of the board and the performance of the company in the Spanish context (Arosa et al., 2013; Cabrera-Suárez & Martín-Santana, 2015; Lago-Peñas et al., 2016; Pucheta-Martínez, 2015, among others). In view of the results obtained in the various studies carried out both at national (see Table 1.10.8) above and international level, we can point out that there is no unanimity regarding the relationships obtained, depending on the variables used to measure business profitability, among other factors.

1.10.9. Corporate Social Responsibility

The increasing importance that has recently been assigned to the impact that business can have on the community (environmental impact, social impact, etc.), has led to the corporate social responsibility (CSR) of any company, but especially that of listed companies, achieving great relevance, as it has become an ethical obligation (with respect to different stakeholders) for those companies to communicate the positive and negative impacts that their activity (policies and practices) can cause (see Bloom and Gundlach (2001), McWilliams et al. (2006), among others).

The obligation to approve the company´s social responsibility policy, in the Spanish context, falls upon the Board of Directors and it is considered as a non-delegable faculty of this organ (Article 529 ter SCL). For its part, the new CBGSC (2015) has included specific recommendations concerning corporate social responsibility for the first time. Moreover, in addition to the three specific recommendations on CSR, there are four other recommendations that affect CSR less directly. With regard to the specific recommendations, first, Recommendation 53 assigns to a board committee, either existing or newly created (Corporate Social Responsibility Committee), the supervision of the CSR policy together with the rules of good governance Corporate and internal codes of conduct. Undoubtedly, this recommendation affects and drives the role of the corporate social responsibility of listed companies.

Second, Recommendation 54 (CBGSC, 2015) refers to the document that underpins the company's social responsibility policy, and which should, as a minimum, specify the following:

a) The goals of its corporate social responsibility policy and the support instruments to be deployed.

b) The corporate strategy with regard to sustainability, the environment, and social issues.

c) Concrete practices in matters relative to shareholders, employees, clients, suppliers, social welfare issues, the environment, diversity, fiscal responsibility, respect for human rights and the prevention of illegal conducts.

d) The methods or systems for monitoring the results of the practices referred to above and identifying and managing related risks.

e) The mechanisms for supervising non-financial risk, ethics and business conduct.

f) Channels for stakeholder communication, participation, and dialogue.

g) Responsible communication practices that prevent the manipulation of information and protect the company's honour and integrity.

And third, underlining the importance of transparency, it is recommended that the company report in a separate document or in the management report, matters related to CSR[153], using, for this purpose, some internationally accepted methodologies (Recommendation 55, CBGSC, 2015).

Regarding the recommendations that indirectly mention aspects of CSR we can highlight the following: that listed companies publish on their website in good time before the Shareholders' General Meeting, along with other documents, the report on

[153] This recommendation entailed the transposition into national law of the *Directive 2014/95/EU* of the European Parliament and of the Council of 22 October 2014 amending *Directive 2013/34/EU* regarding disclosure of non-financial and diversity information by certain large undertakings and groups.

the policy of CSR (Recommendation 6, CBGSC, 2015); that the board of directors seek to reconcile its own corporate interests with, whenever appropriate, the legitimate interests of its employees, suppliers, customers and other stakeholders that may be affected, as well as the impact of the activities of the company on the community as a whole and on the environment (Recommendation 12, CBGSC, 2015); that the directors' selection policy should promote the target of at least 30% of the total number of members of the Board of Directors by 2020 (Recommendation 14, CBGSC, 2015); and, that the risk control and management policy identifies at least, and among other requirements, the different types of risk, financial and non-financial (including social, environmental, and reputational) that are faced by society (Recommendation 45, CBGSC, 2015).

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1.11. CORPORATE GOVERNANCE IN PORTUGAL: NEW CHALLENGES AND OPPORTUNITIES

Inês Lisboa
Maria Clara Guilherme
Nuno Teixeira

1.11.1. Overview of the Legal Framework of Corporate Governance in the Country

Portugal is a small size country that belongs to the European Union since 1986. It has a little less than ten million and three hundred people in around 92.212 km². La Porta et al. (1998) categorize Portugal as a French civil law country, with limited information transparency.

In Portugal, the main legal framework for corporate governance is in CSC (Código das Sociedades Comerciais – Commercial Companies Code), approved by the law decree number 262/86, of 2 November 1986, and subject to diverse modifications, the last one by the law decree number 148/2015, of 9 September 2015. It includes information about the firm's control and management, investors' rights and obligations, managers and members of other committees, protection of minority investors, creditors, and workers.

Listed firms are subject to high levels of regulation and requirement. The CMVM (Comissão de Mercado de Valores Mobiliários – Security Market Commission) had a corporate governance code approved by the law decree number 486/99, of 13 November 1999, that was changed on 1 July 2013. Although, the CMVM admitted a lack of self-regulation on corporate governance, and, in 2015 the IPCG (Instituto Português de Corporate Governance – Portuguese Institute of Corporate Governance) assumed the responsibility to create a new corporate governance code. This code was published in May 2016 and included recommendations about corporate control, executive and non-executive managers, supervision, remuneration setting, risk management, financial information, and auditing. Non-listed firms are also suggested to follow these recommendations.

Since 2006, the European Commission obligates listed firms to publish a corporate governance statement in their annual reports (IFC, 2015). In Portugal, the CMVM requires this statement with the philosophy of "comply or explain"; explain if the recommendations are followed or not, and if they are not followed, justify the deviation from recommendation, since 2001. In 2006 the Livro Branco (white book) appeared. It summarizes corporate governance in Portugal, and draws some comments and reflections to deal with best practices in this area.

The firm's corporate governance is an obligation of the board of directors (CSC, article 405). Usually, this board has a hybrid structure (also called monistic model), with both administrative and supervisory roles, but it can also have a two-tier board (dualistic model) with an executive board, a board of directors, a supervisory board and an auditing board (CSC, article 278).

The number of board members is defined by the firm's contract. It can be only one person if the common share is less than 200 000 euros, and it does not need to be a shareholder of the firm (CSC, article 390). For the listed firms, the average of members of the board was 10 in 2014 (CMVM – Annual Corporate Governance Report, 2014).

The board of directors can decide that one or more members will be responsible for some administration issues. It can also delegate an executive board to manage the firm, establishing some limits (CSC, article 407). The shareholders can use their vote in the general meetings. Usually, one share equals to one vote, but in the firm's contract, a different relation can be established (CSC, article 384). Finally, the shareholders only can deliberate about the firm's management at the request of the board of directors (CSC, article 373).

1.11.2. Ownership Structures of Companies in the Country

The financial crisis that started in 2007/2008 due to the increasing rate of mortgage default in the USA market, which led to an international banking crisis, had great impact in Portugal. The indebtedness increased as well as the interest rates. In 2008 two Portuguese banks went bankrupt and in 2014 the third one. Therefore, the public deficit increased, especially in 2010, and in April 2011 Portugal asked Troika's help to deal with this issue. As a consequence, the number of firms that asked insolvency, as well as the unemployment rate has increased. In the next table, we present the number of firms (total and listed firms) per year.

Table 1.11.1. Number of Portuguese firms per year

Year	*Number of firms* [(1)]	*Number of listed firms* [(2)]
2008	1 235 989	47
2009	1 199 843	45
2010	1 145 390	44
2011	1 113 559	44
2012	1 065 173	43
2013	1 098 409	43
2014	1 128 258	43
2015	1 163 082	43*
2016	1 144 823*	43*

*Source: [(1)] INE; [(2)] CMVM (excludes sports firms); * unofficial data*

Analyzing the Table 1.11.1 the following facts emerge: the total number of Portuguese firms is more a less stable, with a slight decline from 2008 till 2012, and an increase from 2013 till 2015. Moreover, most of the firms, around 99.9% are small and medium enterprises (INE, Instituto Nacional de Estatísticas – National Statistics Institute), it means, "employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million" (Recommendation 2003/361/EC – Annex, article 2). Around

68% are singular firms, suggesting that groups of societies are not prevalent in Portugal (INE). The Portuguese Association of family firms (APEF) estimate that around 70% to 80% of the Portuguese firms are family firms, those are firms that are detained and controlled by a family. The more relevant industries are a wholesale and retail trade, following by administrative and support services activities. The construction industry suffered a great decline from 2008 till 2016, while agriculture, and fishing industry registered a great increase (INE).

With regards to listed firms, the number of firms is very small, less than 50. The Portuguese stock index is PSI 20, composed of the 20 firms (since 2013 is composed only of 18 firms, the minimum number allowed) with higher market value. The distribution of shares is presented in the next table (last data available is 2014):

Table 1.11.2. Distribution of listed firms' shares

	2008	***2009***	***2010***	***2011***	***2012***	***2013***	***2014***
Free float	21.40%	22.50%	22.50%	22.30%	21.90%	24.30%	23.60%
Qualified participation	76.90%	75.60%	75.90%	75.70%	76.10%	73.30%	73.90%
Own shares	1.70%	1.90%	1.60%	2.00%	2.00%	2.40%	2.50%

Source: CMVM - Annual Corporate governance report

Table 1.11.2 shows that the number of own shares is residual, while qualified participation is in mean 75%. Moreover, on average, only one person (individual or firm) controls 52% of the firm' shares, while the state controls less than 4% (CMVM - Annual Corporate governance report). Finally, family firms are still prevalent in listed firms, representing around 54% of the total of listed firms, and 50% of PSI 20 in 2013 (Miralles, Miralles & Lisboa, 2014).

1.11.3. Market for Corporate Controls (M&A)

Mergers and acquisition operations, in addition to having goals associated with faster growth, greater resource efficiency and business diversification to minimize risk, contribute to the control and balance between the different agents (owners and managers). This happens because of incorrectness of management's thus, the results tend to become lower, leading to a drop in stock prices. Thus, the shares are more affordable, which contributes to the launch of acquisition and merger operations by players with greater financial capacity, they try to take advantage of the undervaluation of the target firm's assets. Such operations have, as their normal impact, the substitution of managers, and the loss of their rights, by others of greater confidence of the new owners. According to this view, mergers and acquisitions allow better regulation of the interests of both agents (owners and managers), since managers may have significant losses with their realization and, therefore, tend to try to prevent them from occurring, making companies larger and more profitable, and less accessible to any interested parties in their acquisition.

In general, there are two types of studies on the topic "Market for corporate control". The first type compares the financial performance of the firms involved prior to the transaction with the merged or acquired entity. The second type studies the reaction of the price of shares of both firms after the announcement of the operation to be carried out.

Regarding the first type of studies, at international level, there is no uniformity of results on the impact of this type of operations on the financial performance. Although there are several studies where there has been an improvement in financial performance after mergers and acquisitions (eg, Jensen & Ruback, 1983; Chatterjee, 1986; Barney, 1988; Camargos & Barbosa, 2008). It is also noted that there are several studies that evidence the opposite (for example, Meeks, 1977; Jensen 1986; Roll, 1986; Ravenscraft & Scherer, 1987; Haussman 2005).

In the second type of work, it has been verified that the shareholders of the acquired firms obtain high gains through the valuation of stock prices (Fama, Fisher, Jensen & Roll, 1969). As for the shareholders of the acquiring companies, as a general rule, they also benefit from gains from the valuation of titles by the market, since investors see the transaction as an opportunity for the firm to scale down and the ability to generate greater financial results in the future (Jensen & Ruback, 1983; Jarrel, Brickley & Netter, 1988; Bruner, 2003; Sudarsanam, 2003; Martynova & Renneboog, 2008).

With regard to the Portuguese market, around 80 mergers and acquisitions transactions took place, on average, per year, from 2011 to 2014, representing the operations in which the amounts were disclosed an annual amount of more than 7.5 billion of euros. In the following years, there was a very positive evolution of this kind of operations, with 160 in 2015 and 150 in 2016, representing in these years, the operations in which the values were revealed, amounts in the order of 15 thousand million euros (Institute of Mergers, Acquisitions, and Alliances, 2017). According to the Transactional Track Report (TTR, 2017), the most active sectors of the Portuguese market were: Real Estate, Finance, and Insurance, Information and Communication Technologies, Distribution and Retail, respectively.

According to TTR (2017), 75 operations made by foreign companies were registered in 2016 in Portugal (Inbound transactions). Spain is the main foreign investor with 17 transactions, which generated 2.49 billion euros. The second largest foreign investor is the US with 14 operations that moved 111.08 million euros. In the inbound transactions, the sector that attracted the most foreign investments was the Information and Communication Technologies, followed by the Financial and Insurance and Real Estate sectors, respectively. In relation to Portuguese firms that acquired foreign investments in 2016, three acquisitions were registered in Spain, two acquisitions in Mozambique and two acquisitions in France, in addition to a transaction in several other countries. The sectors with the greatest investment by Portuguese companies were: Marketing and Advertising, Chemical and Chemical Materials, Distribution and Retail, Glass, Ceramics, Paper, Plastics and Wood, Real Estate, Information and Communication Technologies, Tourism, Hospitality, Restaurants and Wind Energy.

Regarding the impact of these operations on the financial performance of the companies involved, although it is not an issue widely studied in Portugal, the results of some research work carried out on these operations in the national market are presented. Ferreira (2013) studied 50 firms that carried out business restructuring operations, and concluded that financial performance did not suffer significant statistical changes. Duarte (2015) studied 5 cases of mergers and acquisitions among companies in the food, construction, media and communications, distribution and pulp sectors, and found that financial performance improved in acquiring firms and that share prices were dependent on whether the news was positive or negative. Silva (2015) studied two merger operations in the telecommunications sector and found that the evolution of financial performance was quite different in both cases, which highlighted the importance of resource management capacity and the different organizational cultures of the companies involved. Baldé (2016) also studied the case of the merger between two of the main Portuguese telecommunications and media firms and concluded that there was a positive impact on the stock market when the transaction was announced, as well as in the moments after the operation. Regarding the financial performance of the new company, he found that there were no significant changes to the pre-operation results of the firms involved.

In this way, the market for corporate control in Portugal has been very dynamic, keeping in mind the role of the financial crisis of 2007/2008 that the country has gone through and which has reduced the value of the assets, creating opportunities for acquisition at lower prices companies with great potential. Thus, due to the dynamism presented by the market, it can be suggested that mergers and acquisitions have been one of the ways that domestic firms have adopted to achieve faster growth and a stronger competitive position in the market, through the efficiency of resources or business diversification. However, as can be seen from the above conclusions, the impact has not always been positive on financial performance, which also means that business concentration does not always contribute to a positive effect on the interests of shareholders by replacing management.

1.11.4. Board of Directors Practices

In Portugal, there are three models of corporate governance provided for in Article 278 No. 1 of CSC: the Latin model, which prevails in most firms, followed by the Anglo-Saxon model and the rather unexpressive the dualistic model, as it can be seen in Table 1.10.3.

By the end of 2006, only two modes were allowed: the Latin or monistic model, and the dualistic model. All the listed firms until that date adopted the Latin system. The reform of the CSC promoted by law decree 76-A/2006 came to add a new model of corporate governance, the Anglo-Saxon, and deepening of the two existing models: Latin model (board of directors/sole director, audit committee/statutory auditor) and dualistic model (direction, general counsel and certified public accountant). The new model (Anglo-Saxon) is based on the existing in the USA and in England and aims to facilitate Portuguese companies, especially those listed in the New York and London Stock Exchanges, as well as foreign investors, the possibility of replicating structures with remarkable cost savings.

Table 1.11.3. Models of Corporate Governance (in numbers)

Year	***Model***		
	Latin	***Anglo-Saxon***	***Dualistic***
2008	35	10	2
2009	33	10	2
2010	32	10	2
2011	32	10	2
2012	31	11	1
2013	31	11	1
2014	31	11	1

Source: CMVM - Annual Corporate governance report

As for the typology of the board of directors, the average size varied between 9.4 elements in 2008 (the lowest), and 10.6 in 2012 (highest value). In 2013 and 2014 it stagnated in 10 (CMVM – Annual Corporate Governance report). The number of non-executive directors was generally superior to executives ones and is higher in firms with Anglo-Saxon model than in those with the Latin model. This practice follows the recommendation of the Code of Corporate Governance "The Board of Directors should include a number of non-executive members to ensure the effective capacity of monitoring, supervision, and evaluation of the activity of the other members of the Board of Directors" (IPCG, 2016, III.3). Moreover, this code outlines that independence assumes the non-commitment of the directors and managers, without a direct link with the firm, i.e., are external elements.

Since the Corporate Governance Code of 2007, the CMVM recommended the existence of a minimum of 25% of independent directors in the total of members of the board of directors, in order to ensure that the non-executive members (independent and non-independent) had an effective capacity of supervision, monitoring, and evaluation of the activity of the executive members.

Table 1.11.4. Percentage of independents on the board of directors

2008	***2009***	***2010***	***2011***	***2012***	***2013***	***2014***
20.90%	21.60%	30%	29.10%	22.10%	32%	34%

Source: CMVM - Annual Corporate governance report

Analyzing Table 1.11.4 we can see that there were years in which the number of independent directors was less than the recommended. Although, the latest version of the code (IPCG, 2016) states in the chapter III.2 that the number of independent among the non-executive directors must rely on an appropriate proportion having regard to the governance model, the firm's size, the shareholder's structure, and the respective free float.

The number of annual meetings of the board of directors varied between 12 in 2008 (lower value) and 13 in 2013 (highest value) (CMVM – Annual Corporate Governance Report). With regard to the attendance, the rate varied between 93.3% and 96.7% to executive members, 77.7% and 90.2% to non-executive directors, and 78.10%

and 90.7% to independent non-executive directors. Data from 2008 to 2013 (after this year information about this issue was not reported).

The average rotation of the board of directors, from 2009 to 2014, was between 5.5 and 7.3 years. The weight of women in the management bodies increased from 2009 till 2011, but it slightly decreased in 2012, as it is shown in Table 1.11.5. From 2009 to 2012 no woman was the President, and in some firms, the boards were composed only of men. Finally, the average of non-executive directors was in all the years (from 2008 till 2012) slightly higher than those of executive ones.

Table 1.11.5. Directors' average age and gender

Year	*Executives (years)*	*Non-Executive (years)*	*% women*
2008	52.8	57.1	n/a
2009	53.6	56.2	5.60%
2010	52.7	57.1	5.90%
2011	52.7	57.1	7.20%
2012	52.6	58.0	6.60%

Source: CMVM - Annual Corporate governance report

1.11.5. Directors' Remuneration Practices

After the 2007/2008 crisis, the firm's sustainability in all industries began to be crucial. The financial crisis and the economic and financial scandals made public, reported cases of directors who received huge remunerations when compared with those of other workers. This was one of the main causes of financial disaster (Hill, 2009).

Directors' remuneration policies within the framework of governance consider that incentives must be clearly and unequivocally documented. Thus directors can promote performance and business activities in the long run. This strategy reduces the averseness of risky decisions and can promote the firm's sustainability, avoiding disproportionate or inappropriate remunerations payment that may sacrifice the firm's wealth. The Portuguese corporate governance code recommend regarding the interest alignment between the firm and managers, that part of the executive directors' remuneration should be variable, reflecting the firm' sustained performance, and avoiding excessive risk-taking (IPCG, 2016, V.3.1)

Executives' remuneration when mostly constituted of incentives directly related to corporate performance, has the beneficial effect of encouraging managers to opt for higher-risk projects and set long-term goals which maximize shareholder's value. Therefore agency conflicts are mitigated, increasing both executives and shareholder's wealth.

In Portugal, directors' remuneration of public limited companies is regulated in the CSC, title IV, chapter VI, article 399. The remuneration can be fixed or a percentage of the annual net profit and the maximum percentage should be allowed in the firm's agreement. The article 399 of the CSC also regulates the members of the board of directors of the dualistic model (German origin), by the remission of the article 429. However, the CSC does not provide minimum values. Moreover, number 1 of article 399 of the CSC adds that the remuneration of each director shall take into account the duties performed and the firm's economic situation. Firm's directors are not based on a contract employment, and so their remuneration can be reduced.

CMVM has published a regulation number 1/2010, of 7 January 2010, with the aim of increasing transparency at the level of directors' remuneration disclosure of listed firms. The disclosure of directors' remuneration became mandatory, individually and jointly with the goal of transparency. The new code of corporate governance has reinforced this issue (IPCG, 2016, V.2.3. and V.2.7).

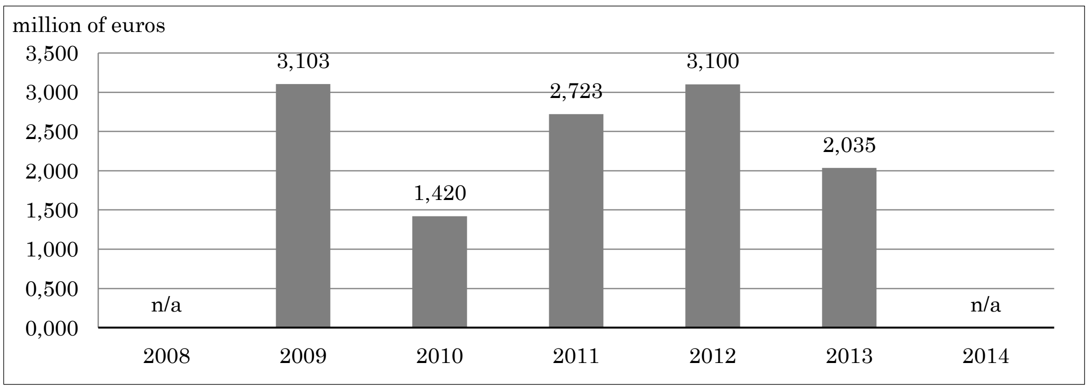
Table 1.11.6. Total remuneration paid to members of boards of directors of listed companies

Year	*Executives average (thousands euros)*	*Remuneration average (thousands euros)*	*Total (million euros)*	*Total remunerations paid*		*Unpaid*
				Variable	*Fixed*	
2008	n/a	n/a	n/a	n/a	n/a	29
2009	515,0	297,0	124,700	35.20%	55.90%	29
2010	449,3	264,0	125,500	23.80%	63.70%	32
2011	n/a	293,2	131,000	27.30%	60.60%	50
2012	n/a	240,4	110,000	27.80%	63.80%	92
2013	356,036	n/a	105,160	25.00%	75.00%	77
2014	n/a	n/a	100,569	24.00%	76.00%	n/a

Source: CMVM - Annual Corporate governance report

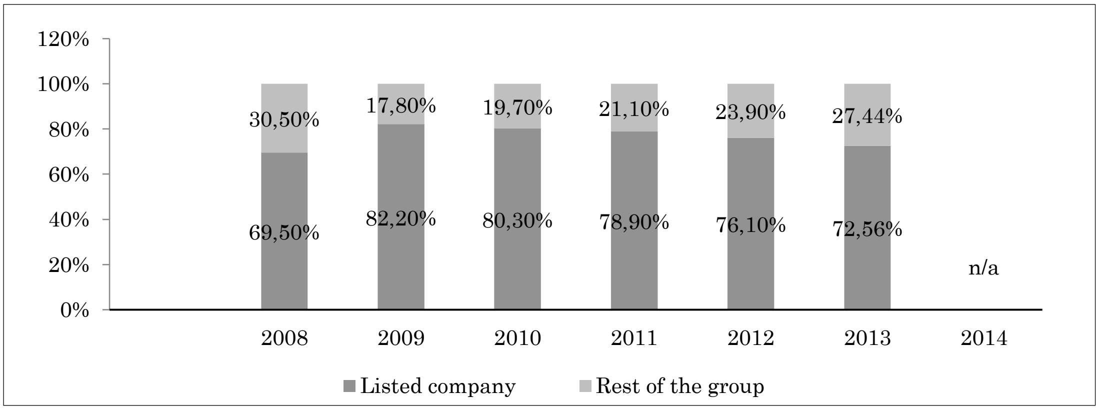
Analysing the previous table we can conclude that the total amount of remuneration has been decreasing from 2012, due to the Troika's contraction measures. For the same period the percentage of fixed remuneration has increased at the detriment of variable remuneration. This fixed remuneration were more relevant to non-members of the PSI20, and for non-executive directors, amounting to 90% of their total remuneration (CMVM – Annual Corporate Governance Report). Moreover, fixed remuneration is higher among the non-executive independent directors. The variable remuneration is more relevant to firm's directors, firms of PSI20, and executives. In the following figure the maximum value received by director in year is shown (with available information).

Figure 1.11.1. Maximum value received by director



Source: CMVM - Annual Corporate governance report

Figure 1.11.2. Proportion of the total remuneration paid to members of the boards by origin



Source: CMVM - Annual Corporate governance report

Analyzing Figure 1.11.2 we can see that since 2009, the weight of remuneration received from affiliated firms, other than listed firms, have increased. In this case, shareholders only indirectly support such remuneration, as may not have any control over the setting of its value.

Table 1.11.7. Percentage of firms with stock options and stock delivery as remuneration systems

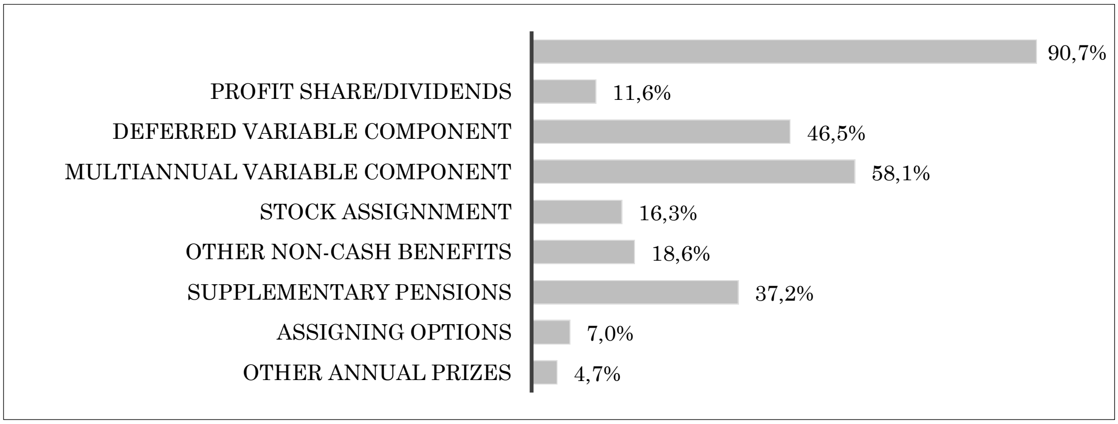
Year	***Stock Option***	***Stock Delivery***
2008	8.50%	14.89%
2009	11.11%	17.78%
2010	8.51%	20.40%
2011	11.36%	18.18%
2012	9.30%	13.95%
2013	n/a	n/a
2014	7.00%	16.30%

Source: CMVM - Annual Corporate governance report

The remuneration plans based on stock option are more frequent in Anglo-Saxon countries than in Portugal, due to the different models of the market. In Portugal, shares are charecterized by volatility, as free-float is relatively low, as well as the market itself. The issuance of stock options with a strike price lower than the price of the date of issue cannot be a mechanism of interest alignment between shareholders and managers since it allows them to obtain gains without the shareholders being also rewarded.

Until 2008, the number of companies that had plans to stock options and/or stock-based remuneration systems was not significant. After 2008, 2014 had the smallest percentage of stock options, while 2011 presented the highest with 11.36%, as it can be observed in Table 1.11.7.

Figure 1.11.3. Percentage of firms with different remuneration components (2014)



Source: CMVM - Annual Corporate governance report

Observing the previous figure, in 2014, to 90.7% of the firms, the annual variable remuneration is granted through bonus systems, awards, and participation in the firm's results. The trend has been for deferral of variable remuneration, which is already in practice in 46.5% of the firms. The variable remuneration with multiannual components occurs in 58.1% of companies. These compensatory schemes aim to associate the remuneration of executive members of the administrative organ to the long-term sustainability of the firm's results.

1.11.6. Shareholder's Rights Protection

Portuguese firms are characterized by ownership concentration, with the dominance of control by shareholders, usually a family (Miralles, Miralles & Lisboa, 2014). Likewise, it is necessary to ensure that the economic interests of minority shareholders are protected. Although, according to with Livro Verde (2011), the participation of minority shareholders is difficult in firms with shareholders who hold controlling interests.

The 2007/2008 financial crisis had its source in the financial sector, but it had a huge impact on the capital markets around the world. One explanation by academics and professionals for the poor performance of capital markets is that shareholders have not had access to all relevant information regarding the risk, and predictions concerning the firm's future (Acharya, Philippon, Richardson, & Roubini, 2009).

The CSC defines the rights and duties of shareholders and stresses the protection of minority shareholders. The shareholders are entitled to information that must be provided by the firm in general meetings or through the means of information at their disposal (articles 288 to 293, CSC). Likewise, the firms must provide, through their website, in Portuguese and English (to protect non-resident investors), access to information that allows the knowledge about the firm's development and actual economic, financial and government situation. Moreover, the code of corporate governance also calls the attention for the need of an investor's support office (IPCG, 2016).

Moreover, article 22 of the CSC warns shareholders' rights with regard to dividends, and article 156 to the proceeds from the firm's liquidation, in which the value must be shared by all shareholders in the proportion of their capital holdings. Regarding the transferability of shares and the need for consent for their sale, most listed companies are not subject to any limitations whether statutory or legal, nor any kind of imposition of limitations on the ownership of the shares (CMVM, 2014).

1.11.7. Shareholder Activism

The activism of shareholders is related to their ability to exercise rights associated with corporate governance, which are based mainly on the right to obtain information about the management and economic and financial evolution of the activity, to give opinion and have access to communications about decisions related to the strategic development and the choices of the board of directors.

In Portugal, the listed companies are largely dominated by families. For example, more than 54% of the Portuguese listed firms in 2014 were family owned (Miralles, Miralles & Lisboa, 2014). At the same time, the latest annual report on the governance of listed companies in Portugal (CMVM, 2014) shows that only 23.6% of listed companies' capital was dispersed by small shareholders. As a result, the majority of the share capital consisted mainly on qualified participations (with a percentage of not less than 10%), corresponding to 73.9% of total quoted capital. In addition, the firms had their own shares representing the remaining 2.5% of the market. Another indicator that reveals the high level of concentration of the Portuguese stock market is the weight of the three main shareholders in the total capital of the listed firms. Thus, the three largest owners of 37 (86%) of the 43 firms with titles valued at Euronext Lisbon in 2014 had participations superior to 50% of the total share capital (CMVM, 2014).

Thus, this data reveals the strong capacity of these large investors to influence the management of the largest national groups. On the other hand, it can be deduced that minority shareholders owning only 23.6% of the quoted capital usually do not have the capacity to try to influence the management of these firms. Thus, it can be deduced that traditionally, there is no significant shareholder activism in Portugal.

However, since 2013 we have witnessed an increase in the participation of international institutional investors, namely, investment funds, financial institutions, insurance companies, pension funds, risk capitals, among others, that given the fall in the value of Portuguese financial assets, have taken advantage of the capital investment opportunities and are present in more than 23% of the firms constituting the PSI20. As an example, more than 160 foreign funds are present in the Portuguese market, with EDP and Galp Energia being the targets of the largest foreign investment and CTT being the company with the highest shareholder structure held by foreign funds - more than 62% of the capital (Moreira, 2015).

This new reality has created new challenges in relations between investors and managers, namely, in terms of providing and disseminating information on the firm's management, and on the economic and financial viability of the business, since these entities have a more active role in relation to activity than private investors, usually with minority and irrelevant holdings.

In a study carried out by Moreira (2015) in the firms belonging to PSI20, about the activism of institutional investors regarding to the firm's management in which they hold participations, some interesting conclusions were obtained:

- The weight of their holdings in some firms is high, which shows their interest in controlling their management;
- They have an active position in exercising the right to vote and to attend the general meetings and to be represented on the board of directors. They vote in the deliberations and present proposals, and in more than 50% of the firms in which they hold participations, they are represented on the boards of directors;
- Intervene mainly in matters related to the economic and financial evolution of the firms, with the strategic options and their financial sustainability and with the policies of distribution of results;
- Companies positively accept the opinions and proposals of institutional investors, trying to reconcile their interests with the firm's activity, in a strategy of creating long-term value for all shareholders.

In this way, it can be deduced that shareholder activism in Portugal has been reduced due to the high concentration of capital of the main national firms in families or in business groups. However, the new reality of financial globalization with the progressive participation of international institutional investors in Portuguese listed firms incorporates new challenges in the relations between their management and owners, and it is expected in the coming years a greater requirement in the financial reports and in the quality of management.

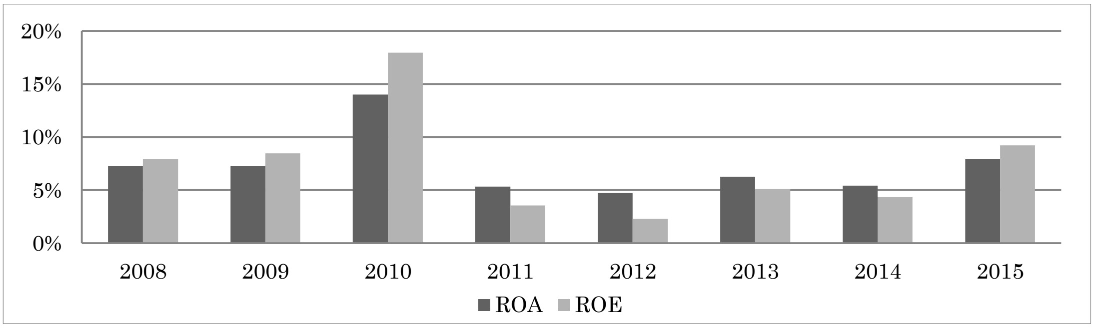
1.11.8. Corporate Governance and Firm Performance

The firm's financial performance shows how the firm has led with the market adversities, and whether the strategy has contributed to the bottom-line improvement (Kaplan & Norton, 1992).

There are diverse performance measures that can be grouped in: financial performance, operational performance, and market-based performance (Tierno, 2014). The most consensual measure of financial performance is a return on equity ratio (ROE), measured as net profit over total equity. Damodaran (2007) argued that this ratio relates the earnings left for equity investors after taking out the debt costs with the equity invested in the firm. Operational performance is usually measured using the return on assets ratio (ROA), the ratio between earnings before interests and taxes and total assets (Major and Marques, 2009). Finally, the firm's market-based performance is usually measured using Tobins' Q, which is the ratio between market capitalization and total assets (Tierno, 2014).

The following figures show the evolution of the firm's performance over the period from 2006 to 2015. The first one is to all Portuguese firms, while the second one analyses only Portuguese listed firms.

Figure 1.11.4. Evolution of financial performance of Portuguese firms



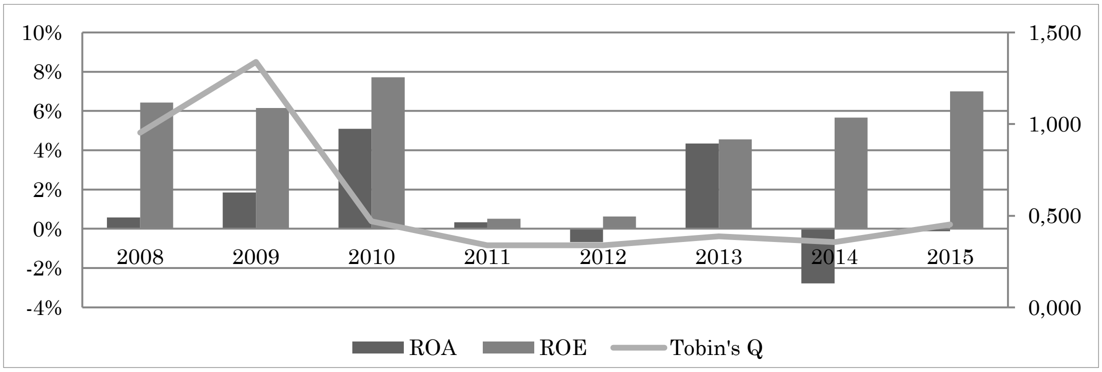
Source: INE

As shown in graph 1.10.4, Portuguese firms exhibit in mean positive returns from 2008 to 2015. The year of 2010 presents the highest returns, while the years of 2011 to 2014 the smallest ones. These last years overlap with the years of the contraction measures imposed by Troika's to help the country to surpass the public deficit.

Analyzing listed firms the conclusions are different, as return on assets was in 2012 and 2014 negative. Although the year of 2010 still exhibits the highest return (in mean), and the years of 2011 to 2014 the smallest ones, due to the reasons presented before. Regarding Tobin's Q, after the year of 2009, the market capitalization has decreased due to the financial crisis which had the main impact in the financial markets. In 2015 the market capitalization slightly increased but continued to be smaller compared to the values before the crisis.

Not all the firms present the same performance, and it can be influenced by the firms' corporate governance. Major and Marques (2009), analyzing Portuguese listed firms found that firms that follow the corporate governance recommendations present a higher level of performance. The recommendations of corporate governance aim to increase the firm's transparency and ensure the representation of shareholders' interests in the decision-making. Therefore, the agency costs between the principal and manager decreases, leading to higher financial performance (Jensen & Meckling, 1976).

Figure 1.11.5. Evolution of financial performance of Portuguese listed firms



Source: Sabi Database

Moreover, the financial performance can be also influenced by the choices made for corporate governance structure as it impacts the protection of shareholders' interests. Tierno (2014), analyzing Portuguese listed firms, found that an increase in the levels of board independence leads to an increase in ROE, supporting the recommendations of corporate governance. Outside directors may control managers' opportunism to expropriate the firm's wealth at the expense of financial investors. Similar results were found by Campos (2015). Moreover, Tierno (2014) found that when directors own the firm's shares the performance also increases, since the interests between managers and shareholders are aligned. Firms with the Latin model and controlled by the family have positive performance, measured by ROA and ROE, although the Latin model (the historical model in Portugal) has a negative impact on Tobin's Q. The negative impact on Tobin's Q ratio can be due to the fact that financial investors find it important to have an auditing board to control the firm's managers. Finally, when the CEO and the chairman are the same person the firm performance measured by Tobin's Q increases. This conclusion supports the stewardship theory which argues that managers behave in a collective way, aiming to increase the firm's wealth, but it contradicts the agency theory (Tierno, 2014).

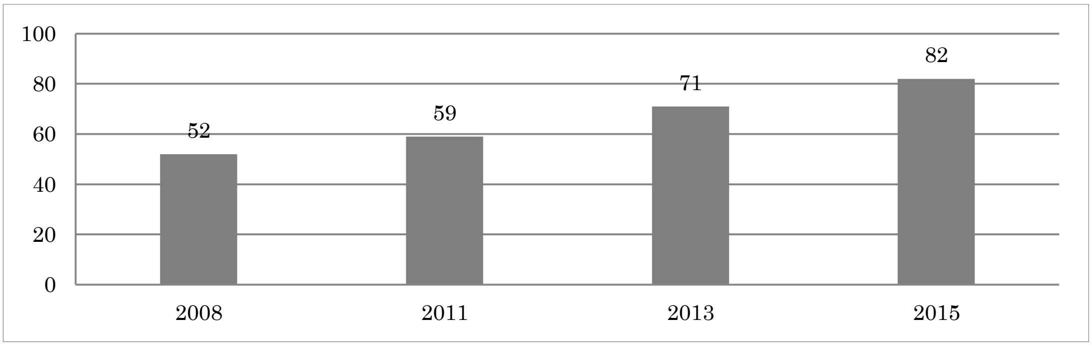
1.11.9. Corporate Social Responsibility

Firms should have an ethical attitude, making decisions that fulfill the interests of stockholders, and those who have their lives impacted by the firm. Not only monetary goals should be the firm's concern, but also social, economic and environmental issues. Being socially responsible is being beyond the legally required, is when a firm voluntary decide to contribute to the society and the environment (Livro Verde, 2001). Therefore, corporate governance mechanisms are crucial for corporate social responsibility, as it focuses on information transparency, and accountability. Ribeiro (2014) argued that these two fields are complementary, and may mutually reinforce. While corporate governance reports are obligatory to listed firms and recommended for the others, and it is the main reason for the Portuguese listed firms to do it (Ribeiro, 2014), sustainability reports are optional but recommended for all type of firms. Firms face several pressures to be socially responsible, namely from the consumer, suppliers, competitors, regulators, and even the society (Grace, 2011).

In fact, in the 21st century, the firms were encouraged to promote ethics, equity, transparency, and responsibility of business, leading to the increase of the relevance of corporate social responsibility. Moreover, the financial crisis, the increase in the energy price, and the scarcity of natural resources called the attention to the need of being responsible (PwC, 2012).

In the last years, Portuguese firms have become aware of the active role they can play in the society, being socially responsible and contributing to global sustainability. KMPG argued in its survey of corporate responsibility report (KMPG, 2013) that the number of Portuguese firms with reports on social responsibility is increasing (see Figure 1.11.3). In 2015, the percentage of firms with social reports is similar to firms globally.

Figure 1.11.6. Evolution of the number of firms with corporate social responsibility reports



Source: KMPG (2013 and 2015)

Most of the firms are listed firms and firms with a large-size dimension. Moreover, PwC (2012), and Ribeiro (2014) found that a part of these firms includes a chapter about sustainability in their accounting reports. Some of these firms submit the report for the external appreciation (PwC, 2012), and 90% of these firms use global reporting initiatives – GRI (KMPG, 2013). Additionally to these facts, analyzing the 100 firms more sustainable in the world in 2016, Galp Energia appears in 16th place, suggesting that, to some companies, being socially responsible is relevant. Although, Ribeiro (2014) argued that diverse firms have social marketing, but that is not translated into effective social responsibility actions. Some firms look for commercial benefit, to acquire prestige and reputation, and are not really concerned with global development.

The more relevant principles of social responsibly to most of the Portuguese listed firms are sustainability, ethical behaviors, accountability, and transparency (Ribeiro, 2014). Moreover, corporate social responsibility is a way to relate the firm and the society. For that, most of socially responsible firms have a commission regarding this issue, following the suggestion of corporate governance principles (III.5 "The complexity of the supervisory role advises the existence of specialized committees to support decision-making by the board of directors, without prejudice to the roles legally attributed to committees with the responsibilities of auditing or of remuneration", IPCG, 2016).

The social responsibility actions made by Portuguese listed firms are mainly monetary incentives, internships, voluntary actions made by workers', and consumers' reduction (Ribeiro, 2014). Consumers' reduction is the aim but only a part of the firms really controls the amount of savings (PwC, 2012). Being socially responsible provides the firm with competitive advantages, as its reputation increases, and consequently, the relationships with stakeholders can improve. Ribeiro (2014) found that the main reasons to Portuguese listed firms be socially responsible is to contribute to a global sustainable development, improve relations with stakeholders, and increase employment efficiency and motivation.

Grace (2011) has published a book about the first steps to be social responsible. It focus on the following topics: workers, environment, society, suppliers, and evaluation and sharing the firm performance. Firms can also be certified regarding this issue. Most of the Portuguese listed firms adopted ISO certifications, namely ISO 9001/2008, which is related to quality management, and ISO 14001/2004, regarding environmental management. The ISO 26000/2010, which focus on corporate responsibility, and is from the responsibility of Associação Portuguesa de Ética Empresarial (Portuguese Association of Business Ethics) is used only for one third of the companies in the sample, while the AA 1000APS2008, from the Institute of Social and Ethnical Accountability is followed by 17% of the firms (Ribeiro, 2014). The SA8000/2008 introduced by the Social Accountability International is not followed by any listed firms in the sample of Ribeiro (2014) and is seldom adopted by other Portuguese firms.

Finally, most firms have a strategy of social investment, but the majority of the firms do not make an analysis of it (PwC, 2012). Moreover, Ribeiro (2014) found that the annual amount spent by Portuguese listed firms on corporate social responsibility initiatives depends on the degree of compliance of the corporate governance recommendations, which in turn is linked to the qualifications of the board of directors.

1.11.10. Brief Review of Industrial Specifics of CG in the Country

At the level of the Portuguese industries, there are no specificities regarding corporate governance. However, given the numerous bankruptcies that have occurred in recent years, management in the Portuguese financial sector has been questioned by different economic agents and by society in general.

These institutions present some specific features in their activity that incorporates previously unrecognized risks. 1) Banking activity is based on permanent access to liquidity, generating a cash flow imbalance between the assets, mostly long-term, and liabilities, usually short-term. 2) The turnover is based on the interest obtained through the granting of credits, which increases the financial risk. 3) The financial statements are less transparent than those of other sectors, as it is not always easy to assess the quality of, for example, granted loans and existing derivative assets. 4) There is always the risk, in the face of unstable economic conditions, of a race to withdraw deposits or a drastic reduction in the credits obtained at the financial system, greatly conditioning the liquidity of these institutions. 5) Finally, banks, besides competitors, are also business partners, transacting the different types of financial products among themselves, and there is therefore, a danger of contagion when one of the parties fails to fulfill its obligations. Thus, there has been an increasing effort on the part of international and national regulatory entities, in the sense of having a more demanding regulation with several variables associated with corporate governance of financial institutions, with particular attention to aspects related to remuneration and composition of board of directors, to supervision of the management of institutions, to transparency of information provided and to risk management of the activity (Ramos, 2012).

With regard to the remuneration of the administrations, it became clear that the current generous levels of directors' remuneration were regularly associated with poor management performance, stressing the need to align the interests of managers and the (long-term) interests of the various stakeholders involved. Directive 2010/76/EU of the European Parliament and of the Council of 24 November (CdR III) stresses the importance of remuneration being linked to multi-annual objectives and provides for the setting up of a remuneration committee which monitors and defines the remuneration policy to be assigned to the board of directors, as well as the disclosure of this information. At the national level, in addition to the regulations with generic application on the subject, concerning to financial institutions, Bank of Portugal Notice 10/2011, of 9 January, establishes the principles and rules that regulate the remuneration policy and its disclosure requirements, and also define the need for a remuneration committee composed mostly of independent members and with at least one qualified and experienced member, specifically for the exercise of functions.

Regarding the composition of the board of directors, the General Regime of Credit Institutions, states that it must have a minimum of 3 elements and at least 2 must be executives. In addition, they must have the knowledge and qualifications appropriate for the position and non-executive directors should be independent in their actions, in order to objectively control the actions of the other members of the board.

As mentioned previously, credit institutions are subject to various specificities of their actions that increase the risk associated with their performance. Accordingly, in Portugal, and in line with international law, the securities code states that financial institutions should establish an independent risk management service responsible for adopting policies and procedures to identify and manage. Its activities, procedures, and systems, taking into account the level of risk tolerated, and to provide advice to the management body and to prepare and submit to the latter and to the supervisory body a report, at least annually, on risk management, indicating whether adequate measures have been taken to correct any deficiencies. Thus, it is expected that corporate governance contributes to a more sustainable management of financial institutions, based on a better control of business risks and on a more rigorous process in the evaluation of the performance of their board of directors.

In addition, the economic and financial crisis that has affected the lives of entities and citizens in recent years, coupled with constant concerns about the control of the public deficit, highlighted the importance of resource management in the state business sector and the need for financial sustainability in these entities, reducing the costs to be paid by economic agents, usually through a demanding tax system. Thus, corporate governance is also an increasingly important issue in the state's business sector.

Inclusively, in recent years, regulations have been published (for example, Law No.66-B/2007, which established rules for evaluating the performance of services, managers and employees) with the objective to establish a guideline of management good practices in the own Portuguese public administration, highlighting as guiding principles of decisions: economics (always select the least onerous option to achieve the intended objective), efficiency (always choose the alternative that maximizes the results against the resources used), effectiveness (always ensure the achievement of the objective and intended results) and quality (always optimize the quality of services provided to citizens and other entities).

With regard to the state's business sector, there are several problems to face in the coming years for the true implementation of corporate governance (Ferreira, 2009): how the State is acting as shareholder and related party; how to promote competition; how the rights of private shareholders are affected; how the rights of third parties related to the public company are guaranteed; forms of decision-making; which models for the administration and supervision; what duties do the administrators or public managers have; what are the consequences of the breach of these duties; under which circumstances they are held accountable for their actions. In addition, Vicente (2014) also refers as great challenges of the state public sector, the weak fulfillment of information duties in terms of the evolution of activity and financial sustainability, the distance to business practice at the level of day-to-day management of the activity and the reduced focus on profit and on the principle of remuneration and recovery of invested capital, as basic ideas of the viability of the activities carried out.

Thus, it is expected that corporate governance makes a strong contribution to the state business sector through changing attitudes in the management of organizations, questioning options, informing, in a quantified and detailed way, the compliance with the principles that illustrate what the state, entities, and society in general, expect from public management (Vicente, 2014).

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1.12. CORPORATE GOVERNANCE IN FINLAND: CURRENT STATE OF ART, CHALLENGES AND OPPORTUNITIES

Seppo Ikäheimo
Mirel Leino

1.12.1. Introduction

Corporate governance practices of smaller countries like Finland are typically analyzed in studies covering a large set of countries (e.g., La Porta et al., 1998). Each country is a representative of a certain cultural, legal or geographic area. A separate description of these smaller countries is rare, and such is also the case with Finland. Liljeblom and Löflund (2006) made a most recent analysis of corporate governance in Finland over ten years ago. Thus, there is a need for updating their analysis.

In this study, we combine large-scale comparison studies of several countries to identify how Finland compares relative to other countries, with studies focusing only on Finland. In addition, we benefit from surveys conducted by PwC and unique data sets collected by the authors. These surveys and data will provide updated knowledge on the current state of the art in Finnish corporate governance practices.

Our study focuses on six topics of corporate governance. We first discuss Finnish corporate governance requirements, recommendations and practices at a general level. Second, we approach corporate governance from the outside. We analyze the ownership of Finnish firms and how it has developed over time. Second, we define shareholder's rights in Finland and then discuss how they affect company performance. Third, we describe the market for corporate control in Finland with the help of antitakeover provisions. Fourth, we move to the core of internal corporate governance, especially the board of directors. We discuss board diversity, board practices and in a separate section their compensation. Fifth, we analyze the level and structure of executive compensation in Finland and their development over time. Finally, we focus on corporate responsibility issues and their fast recent development. In each section, we also discuss some key challenges and opportunities. We have excluded some very important topics partly due to the lack of our expertise and partly due to a lack of updated data. We do not discuss control issues, such as auditing, internal audit or risk management. We have also excluded investor relations and the influence of corporate governance on earnings quality.

1.12.2. Corporate Governance Requirements, Recommendations and Practices in Finland

The Finnish corporate governance model is based on the principle of majority rule, which promotes a strong ownership role and is balanced out by the principle of equal treatment, qualified majority requirements, and the rights given to minority shareholders, as well as a clear division between the responsibilities of the company's governing bodies. Good corporate governance of listed companies is based on a combination of laws and decrees, as well as self-regulation and other best practices. In Finland, the most essential domestic legal provisions are included in the Limited Liability Companies Act, The Securities Markets Act, the Auditing Act and the Accounting Act, which requires listed firms to use IFRS regulation in their consolidated account. Finnish listed companies are also bound by EU-level regulations, as well as the Rules of the Helsinki Stock Exchange and the regulations and guidelines issued by the Financial Supervisory Authority (Securities Market Association, Finnish Corporate Governance Code, 2015).

The highest governing body of a company is the general meeting. It must be held once a year, though extraordinary general meetings for handling a given matter must be held when requested by shareholders holding at least 10% of the shares.

The board of directors consists of directors appointed at the general meeting. The board of directors has extensive general competence covering all matters that are not within the general meeting's powers or part of the general competence of the managing director.

The board of directors has the power to appoint and discharge the managing director, who sees to the daily administration of the company in accordance with the instructions and orders given by the board of directors.

Listed companies have to elect an auditor at the general meeting. Auditors play an important role as a controlling body elected by the shareholders. Through the audit, shareholders receive an impartial opinion of the company's financial statements and report by the board of directors, as well as of the company's accounts and administration (Securities Market Association, Finnish Corporate Governance Code, 2015).

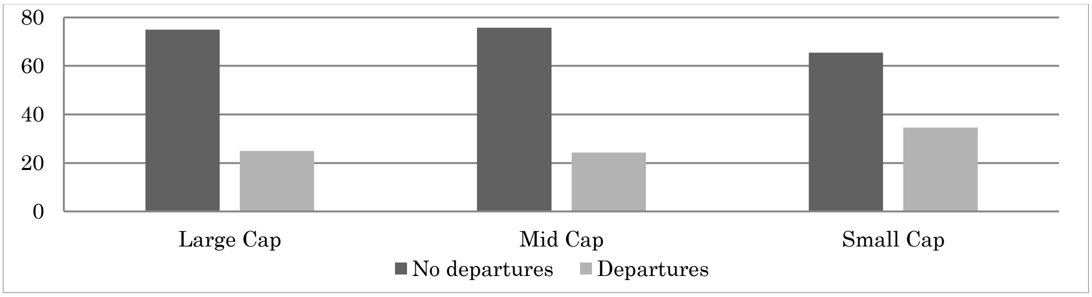
The Securities Market Association maintains the Finnish Corporate Governance Code, which concerns Finnish listed companies. The code includes recommendations concerning good corporate governance, which are completing the laws and regulations without an overlap with other regulation. The Corporate Governance Code obligates Finnish listed companies because it has been taken as part of the regulation governing the Finnish stock market.

The basis for the Corporate Governance Code is to standardize the procedures of listed companies and to develop the transparency of corporate governance and remuneration within the companies. The Code also helps the investors to form an overview of the procedures taken in the companies concerning good governance (Chamber of Commerce, 2017).

The Statement of Corporate Governance should be available on the webpage of the listed company. It is important that the statement is easy to find and as clear as possible. Sometimes the governance issues are opened in different pages rather than in one clear statement. Still, it is better to have one clear statement where investors can find all the governance issues than many different reports in many places. The company should do a new statement every year.

The Corporate Governance Code is devised to use with the 'Comply or explain' principle. This means that the companies should use all the recommendations mentioned in the code. Finnish companies, especially large cap and mid cap firms, rarely make departures from the Corporate Governance Code, whereas departures are more common among small cap firms (Figure 1.12.1), probably because First North (First North is Nasdaq's European growth market, designed for small and growing companies) listed companies do not have to comply with the Corporate Governance Code.

Figure 1.12.1. Departures from the recommendations of the Corporate Governance Code in 2016 (Chamber of Commerce, 2017, p.9)



1.12.3. Ownership of Listed Firms in Finland

Current Development

In Finland, the ownership structure has dramatically changed over time. The most recent comprehensive analysis of Finnish ownership by Keloharju and Lehtinen (2015) indicates that households own 17.0% of the value of Finnish listed firms, government and municipalities 14.1, corporations 14.0%, non-profit institutions 3.9% and financial and insurance corporations 3.5%. In addition, foreign investors own 47.5% of share values. Households' direct ownership fraction has dramatically declined (Rydqvist et al., 2014) especially as the legislation restricting foreign ownership was repealed in 1992, and foreign owners, especially institutions, have since become the biggest ownership group (Ylä-Anttila et al., 2004). Another major change occurred at the same time, as Finnish banks lost their direct share ownership due to Finnish banking crises (Jakobsson and Korkeamäki, 2015).

Although the ownership in Finnish listed companies is quite well spread, the ownership concentration has decreased over time. In 1995, about half of the listed firms had a single owner with higher than 25% ownership, whereas in 2011, only 18% had such an owner (Jakobsson and Korkeamäki, 2015). While there are still few major owners in firms, the ownership is otherwise spread to smaller portions. The State of Finland has such a stake in 10 cases of the 143 listed firms via Solidium, a holding company wholly owned by the State of Finland.

To conclude, there are few major owners who own portions of many companies, though the ownership structure is nonetheless diversified. Some of the largest pension insurance companies, such as Varma, Ilmarinen and Elo, are owners of many Finnish listed companies. In some of the listed firms, these pension insurance companies are even major shareholders (PwC Finland, 2017).

The State of Finland plays the greatest role as an owner in Finnish listed firms. Therefore, we take a close look at its corporate governance practices. For the State as an owner, corporate governance means primarily a coherent, well-functioning system of decision-making powers and supervision in state-owned and state-affiliated companies. Essentially, this means efficient ownership steering and exercise of shareholder control by the State as well as, more generally, sound administrative policies. The State's ambition is to be a responsible, active owner that encourages companies to embrace and uphold clear, transparent administrative systems conducive to increasing shareholder value (Prime Minister's Office, 2017).

To illustrate these concerns of the State as an owner, we present a couple of examples of its activities. In 2002, a decision was made to adopt a new policy under which the Chief Executive Officer or members of the executive management may not serve on company boards. A Government resolution on Supervisory Boards was issued in 2000. In 2004, the Cabinet Committee on Economic Policy issued a statement on the nomination of members to boards of directors and on the harmonization of the age limits for board membership. In 2006, the State has posted on its website company-specific information on remuneration for unlisted companies in which the State holds interests. In spring 2007, the State sought to promote and develop policies regarding executive remuneration, bonuses and the incentive rewards of key individuals (see Executive Compensation, Table 1.12.1). The guiding principles in these efforts have been to safeguard the interests of the owners and increase shareholder value (Prime Minister's Office, 2017).

All these policy issues indicate that the State of Finland as an owner of major Finnish firms pay considerable attention to the quality of corporate governance practices. Partly, this is due to political pressures under which state-owned firms do their business and partly due to the interest of civil servants to do proper work.

Challenges and Opportunities

A Recent discussion in the EU on better identifying shareholders and long-term shareholder engagement would pose a challenge in Finland. Currently, most of the foreign investors are nominee registered. This kind of ownership would leave most owners anonymous. Simultaneously, it passivates owners. Increased transparency of ownership and active involvement in improving the quality of corporate governance may bring value added in firms.

Another big debate concerns the State of Finland as an owner of listed firms. In these firms, political interests may influence strategic decisions, in which the State may also hold interests differing from those of minority shareholders. A careful analysis of the need for the State of Finland to act as an owner in these firms may also be a value-added task.

1.12.4. Shareholder's Rights Protection and Firm Performance

Current Development

Weimar and Pape (1999) classified Finland belonging to the network-oriented Germanic corporate governance group, and La Porta et al. (1998) classified Finland into Scandinavian civil law countries with their distinct features of strong legal enforcement, rather strong investor protection and special characteristics, such as shares with different voting power. Next, we briefly discuss the quality of shareholder's rights at three levels: legislation, codes and practice.

First, shareholder's rights are defined in the Finnish Company Act and the Securities Market Act. Hyytinen et al. (2002) analyzed the level of shareholder's rights protection in Finland. They classified shareholder's rights or minority shareholder protection following La Porta et al. (1998) into eight categories: one-share-one vote, proxy by mail, shares not blocked before meeting, cumulative voting or proportional presentation, oppressed minorities mechanism, preemptive rights,%age of share capital to call an extraordinary shareholders' meeting and mandatory dividend. The analysis by Hyytinen et al. (2002) showed that shareholder's rights in Finland had remained at the same level as that in common law countries in the analysis by La Porta et al. (1998).

Later, the Finnish legislation has applied directive 2007/36/EC legislation to shareholder's rights. This directive gives certain minimum standards for protecting the rights of shareholders: "The standards are protecting investors and promoting the smooth and effective exercise of shareholder rights attaching to voting shares. As regards rights other than the right to vote, member states are free to extend the application of these minimum standards also to non-voting shares, to the extent that those shares do not enjoy such standards already".

The directive contains the following standards (Official Journal of the European Union, 2007, Directive 2007/36/EC):

- Equal treatment of shareholders: The company shall ensure equal treatment for all shareholders who are in the same position with regard to participation and the exercise of voting rights in the general meeting.
- Information prior to the general meeting: Company shall issue convocation of the general meeting at least 21 days before the day of the meeting.
- The right to put items on the agenda of the general meeting and to table draft resolutions.
- The requirement for participation and voting in the general meeting.
- Participation in the general meeting by electronic means.
- Proxy voting: Every shareholder shall have the right to appoint any other natural or legal person as a proxy holder to attend and vote at a general meeting in his name.
- Formalities for proxy holder appointment and notification.
- Voting by correspondence.
- Removal of certain impediments to the effective exercise of voting rights.
- Voting results.

How these new standards have affected Finnish corporate governance remains an open question.

Second, the corporate governance recommendation refers to self-regulation, which originated from the UK where the first code was adopted in 1992. These kinds of codes have been globally adopted and follow the comply or explain the principle. Finland was not among the first countries to adopt the codes, as the first code was issued as late as in 2003. According to Renders et al. (2010), prior to 2003, Finnish recommendations were below average with a score of 15 (European average of 18.93), but the new code in 2003 reached 35 points (European average 33.46), indicating both improved quality of recommendation and average quality among European recommendations. Thus, over time Finnish Corporate governance recommendations have improved their quality.

Third, in a firm-level comparison of corporate governance quality as measured with anti-takeover devices, i.e. voting right restrictions, financial performance-based remuneration system for managers and higher shareholders' consensus, Finnish firms reach better quality than other Nordic countries, though lagging behind Germany and clearly Anglo-Saxon countries (Honoré et al., 2015). Using only anti-takeover provisions, the quality of Finnish corporate governance is better than in Denmark, but behind Norway and Sweden (Ikäheimo et al., 2011).

In Finland, the relationship between the quality of external corporate governance, i.e. anti-takeover mechanisms, and firm performance is positive, as measured with Tobin's Q (Siddiqui, 2015). Ikäheimo et al. (2011) find in Nordic countries similar results between anti-takeover provisions, especially dual-class stock, and Tobin's Q, though the discount decreases over time. On the other hand, the results by Ikäheimo et al. (2011) between anti-takeover provisions and operating performance showed opposite results, i.e. the amount of anti-takeover provisions increase operating performance. They argue that anti-takeover provisions are set by the major owners to control company management and to assure higher operating performance. At the same time, these provisions lower the probability of takeovers reducing company valuation.

Challenges and Opportunities

Legislation, codes and practices suggest that the quality of corporate governance is improving in Finland. In addition, the EU has focused much attention on improving shareholder's rights, and Finland rather easily adopts new elements in its legislation, codes and practice. Whether these measures have improved Finland's standing relative to other countries is another open question.

Typically, corporate governance quality is measured in terms of how the market for corporate control works. In Finland, due to concentrated ownership, this measurement does not capture the essence. Therefore, there is a need for developing a better measurement of corporate governance quality, which comprehensively considers both external and internal aspects.

The use of dual-classes of shares has diminished among large firms, whereas such an arrangement has remained rather popular among small recently listed firms, indicating some benefits of having concentrated power mainly among those who are highly involved in business decisions. It would be highly critical to examine, when and why dual classes of shares are removed, and whether this would affect the perceptions of international investors.

1.12.5. Market for Corporate Control

Current Development

In Finland, the most common acquisition type is open market purchase followed by a public tender offer and private acquisition, with cash-only deals predominating. Hostile takeovers are almost non-existent probably due to a concentrated ownership structure (Moschieri and Campa, 2014), whereas friendly M&A dominates the markets. Martynova and Renneboog (2011) suggest that in domestic deals, friendly M&A represent 98% of all 53 observations, with only one deal having an opposed bid. In cross-border deals classified by target's country, 19 were friendly and one was an opposed bid.

Companies can protect themselves against the market for corporate control with the help of preventive covenants in company bylaws. According to Finnish company law, shareholders decide on company bylaws at shareholders' meetings. Thus, among Finnish firms, this allows major owners to protect themselves against an outside takeover threat. The most common anti-takeover provisions of Finnish listed firms in 1999-2004 were an oppressed minority (i.e., in all cases, shareholders who oppose a merger were allowed to redeem their shares), two series of shares (35%) and a minority offered below 50% ownership (34%) (Ikäheimo et al., 2011). At that time, a mandatory offer was required if the ownership exceeded two-thirds of the votes. Later in 2006, the Securities Market Act lowered this threshold to three-tenths of the voting rights.

Challenges and Opportunities

In the EU, the legislation and market practices varies for the market for corporate control. This limits active markets for restructuring industries and making an industry more competitive. This is a major challenge, which is also reflected in Finnish takeover markets. High-quality amendments at the EU level may improve takeover markets in Finland, as well.

1.12.6. Board of Directors

Current Practices

According to Company law, the board of directors is responsible for the administration of the company as well as the proper organization of company operations. The board of directors appoints and discharges the managing director, approves the strategic objectives and the principles of risk management for the company and ensures that the company has established the corporate values applied to its operations. The duty of the board of directors is to promote the best interest of the company and its shareholders. A director does not represent the interest of the parties who have proposed his or her election as a director.

By electing the board of directors at the annual general meeting, the shareholders directly contribute to the administration of the company and thereby to the operation of the entire company.

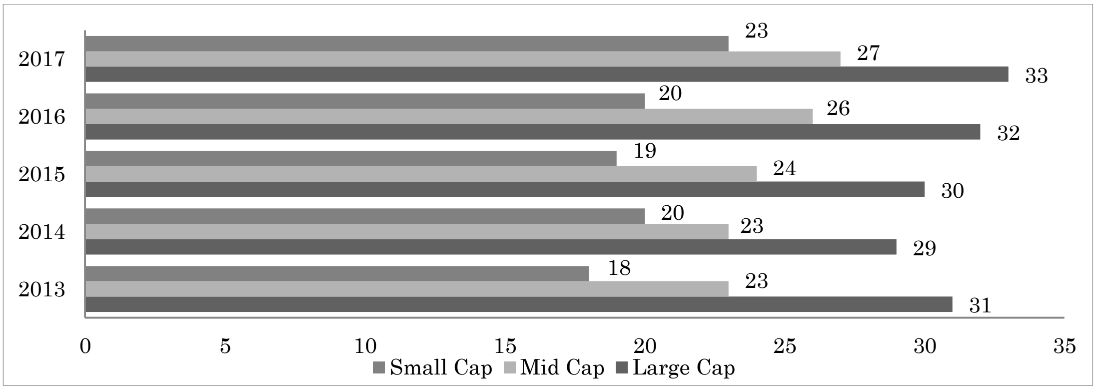
The board size of 7.9 members for Finnish listed firms in 2010 is very close to the European average of 8.5 members (Ferreira and Kirchmaier, 2013). Over time, the average size in Europe has decreased from almost 10 members in 2000. Prior studies indicate that smaller boards are better in decision-making (Hermalin and Weisbach, 2003). Analysis of the board size has shown that the size of the firm matters. In Finland, over the period of 2013-2017, the average number of members in the board has remained quite stable. In small cap companies, the average size is 5 members, in mid cap companies 6 members and in large cap companies 8 members. The sizes of the board of directors in Finland have been considered quite moderate, which is considered to be good for efficient work of the board of directors. Interestingly, none of the Finnish listed firms have over ten member in their board of directors (Chamber of Commerce, 2017).

When analyzing the boards of directors in Finnish companies, we can see that they mainly consist of non-executive directors; that is, a person with no employment or service contract with the company. The boards of Finnish listed firms are the most independent in Europe and at the same level as in US listed firms (Ferreira and Kirchmaier, 2013). According to the Finnish corporate governance code, a majority of the board members should be independent of the company. In addition, at least two directors who are independent of the company shall also be independent of significant shareholders.

Board diversity has been one of the major issues debated in the EU. The focus has been on gender diversity and whether this dimension of diversity should be regulated following the practice of Norway. A European comparison confirms that Finnish listed firms have high gender diversity. According to Ferreira and Kirchmaier (2013), the proportion of females on board among Finnish listed firms in 2010 reached 26%, whereas the average for the EU was a bit over 10% and under 10% for the US. Compared to the Norwegian 38%, Finland is clearly lagging behind. In the EU, gender diversity has doubled within a ten-year period.

A closer and more recent survey on gender diversity by the Chamber of Commerce (2017) of Finnish listed firms reveals interesting details. In 2017, 92% of the Finnish listed companies have both genders in their board of directors. As shown in Figure 1.12.2, the portion of women in the board of directors in 2017 is 33% for large cap firms, 27% for mid cap firms and 23% in small cap firms, suggesting that large firms have the highest gender diversity. The figure also shows a strong development in gender diversity during the survey period.

Figure 1.12.2. Gender diversity development during 2013-2017 for different size groups of Finnish listed firms (Chamber of Commerce, 2017)



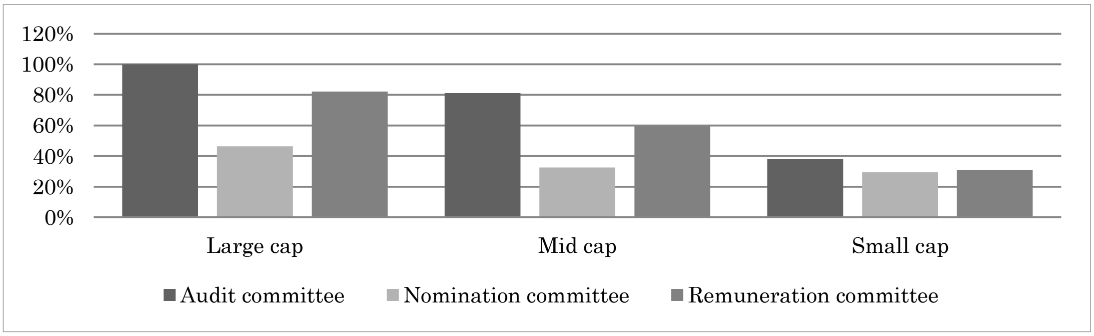
The Corporate Governance code has specifically mentioned women in the board of directors since 2003, recommending that there should be both genders in the board of directors of the company. This recommendation is based on the goal of expanding diverse knowledge in the board of directors. The code argues that diversity of the board of directors supports the company's business operations and development. In addition, the code requires that firms shall establish the principles on diversity for its own purposes, taking into account the scale of its business operations and the requirements of its development stage. Although the company can decide on the extent to which the principles concerning diversity are disclosed, the information disclosed should always include at least the objectives related to both genders presented in the board of directors, the means to achieve the objectives and an account of the progress in achieving these objectives.

The quality and transparency of board work have recently increased. These issues have been the focus of current Finnish corporate governance in three respects (Securities Market Association, Finnish Corporate Governance Code, 2015). First, the code requires that boards draw up a written charter for its work. Efficient board work requires that the main duties and working principles are defined in a written charter, the key contents of which shall be reported. Second, the information provided in the charter allows, for its part, the shareholders to evaluate the operations of the board of directors. In addition, the code requires that firms ensure that all directors have access to sufficient information about the company's business operations, operating environment, and financial position and that new directors are properly introduced to the operations of the company. By virtue of the Limited Liability Companies Act, the managing director has the duty of providing the board of directors and the directors with any information that the board of directors may need in order to see to its duties. Third, the board shall conduct an annual evaluation of its operations and working methods. In order to ensure the efficiency and continuity of its work, operations and working methods are evaluated regularly. According to the code, the firm has the duty of ensuring that the findings of such evaluations are provided, in confidence, to the body in charge of the proposal for the composition of the board of directors, as the finding may affect planning of the preparations concerning the composition of the board of directors. In addition, firms shall disclose the number of board meetings held during the financial period and the meeting attendance of each director.

In Finland, the increased use of committees has been one of the key trends in the development of board work. With the help of committees, the preparation of matters within the competence of the board of directors can be made more efficient, allowing some board members to concentrate more extensively on other matters. These committees assist the board of directors by preparing matters falling within the competence of the board of directors. The board of directors remain responsible for the duties assigned to the committees. In Finland, the committees have no autonomous decision-making power, and the decisions within its competence are taken collectively by the board of directors.

According to the Securities Market Act, Finnish listed firms must establish an audit committee. If the company has no audit committee, the law requires that the duties of the audit committee be discharged by the entire board of directors or that the company delegate them to another governing body. Other committees remain under the consideration of each firm. Next, we discuss the key committees, audit remuneration and nomination committees, their tasks and popularity (see Figure 1.12.3).

Figure 1.12.3. Committees in Finnish listed firms classified according to different size groups, year 2017 (Chamber of Commerce, 2017)



The audit committee is the most common committee in Finnish listed companies. Of the companies, 78 have an audit committee, thus accounting for over 60% of the Finnish listed companies. All large cap firms have audit committees, whereas only 38% of the small cap firms have one. The audit committee deals with the preparation of matters relating to the company's financial reporting and control. The legislation is based on the idea that an audit committee is responsible for these mandatory duties. The majority of the members of an audit committee must be independent of the company, at least one of the audit committee members must be an independent individual with special expertise in accounting, bookkeeping, or auditing and at least one member shall be independent of the company's significant shareholders.

A nomination committee is not required, and the firm may choose whether to have a board's nomination committee or a shareholder's nomination board. Thirty-seven companies had a nomination committee in 2016, representing approximately 30% of the Finnish listed companies. The existence of a nomination committee varies depending on the size of the firm. Nomination committees were found in only 46% of the large cap, 32% of the mid cap and 29% of the small cap companies (Chamber of Commerce, 2017). The establishment of a nomination committee promotes the transparency and the systematic functioning of the election process. The duties of the nomination committee may include the following: Preparation of the proposal to the general meeting relating to the composition of the board of directors; preparation of the proposal to the general meeting concerning the remuneration of the directors; identification of prospective successors for the directors; and presentation of the proposal for the composition of the board of directors at the general meeting (Securities Market Association, 2015).

Instead of a board's nomination committee, the company's general meeting may establish a shareholders' nomination board to prepare matters pertaining to the appointment and remuneration of the board of directors. The shareholders' nomination board consists of the company's largest shareholders or persons appointed by the largest shareholders. The shareholders' nomination board may also include members of the board of Directors (Securities Market Association, Code 2015). The state of Finland requires that the firms in which it is the major owner must establish a nomination board. Twenty-six of the Finnish listed companies had a shareholders' nomination board (Chamber of commerce, 2017). Either a nomination committee or a board can be found in 46.2% of the Finnish listed firms. The use of a nomination board naturally substitutes for a board's nomination committee, thus reducing its popularity.

Remuneration committees are common in Finnish listed firms, being found in 82% of the large cap firms, 59% of the mid cap firms, and 31% of the small cap. Typically, in smaller firms, with smaller boards, the whole board is involved in remuneration issues (Chamber of Commerce, 2017). The board can establish a remuneration committee to prepare matters pertaining to the remuneration and appointment of the managing director and other executives, as well as the remuneration principles observed by the company. Similar to an audit committee, a remuneration committee requires that the majority of the members shall be independent of the company. The managing director or other executives of the company shall not be appointed to the remuneration committee (Securities Market Association, 2015).

Challenges and Opportunities

Board work has become more active, and both quality and transparency have improved over time. Recent developments, especially in banking, have set new competence requirements for board members. This would put increased pressure on Finnish firms to search for good board candidates particularly from abroad. In the next section on board compensation, we show that the compensation level is internationally modest, thus presenting challenges for hiring competent board members.

The higher requirement and increased workload of board members could discourage some board candidates from committing themselves to as many boards as they might have done so earlier. This could also result in the need to expand the search to a larger pool of candidates.

The recent focus on control has underlined the board's responsibility for audit, internal control and risk management. This may limit opportunities to focus on business strategy. Having separate committees for control purposes can enable the rest of the board to focus on strategic issues.

We do not know the consequences of such committees, whether they improve board and firm performance – do nomination committees or a shareholders' nomination board change board diversity, do remuneration committees change the structure and time horizon of executive compensation, and do audit committees improve the quality of earnings or risk level.

1.12.7. The Directors' Remuneration Practices

Current Practices

The remuneration practices for directors of Finnish firms are very modest compared with those of their European counterparts. According to the analysis of Heidrick & Struggles (2011), the average compensation for independent board member in Europe is 77,000 euros per year, whereas the same figure for Finland is 48,000 euros. The difference becomes even larger when comparing the compensation for the chairman. In Europe, chairman compensation lies at the level of 292,000 euros per year, while the corresponding level in Finland remains at only 95,000 euros.

In a recent analysis by the Chamber of Commerce (2017), we find that board compensation has remained moderate. For large cap firms, the annual compensation provided to board members is 53,000 euros, for mid cap firms 30,000 euros and for small cap firms 21,000 euros.

The remuneration of board members consists of fixed compensation and very often a special compensation for board meetings and committee work. Typically, board members do not receive bonuses. Instead, especially in large cap firms, board members receive compensation in the form of shares. A typical compensation can consist 50 to 60% of shares and 40 to 50% of cash. The cash component is for taxes. Thus, in practice, board members receive most of the compensation in the form of shares. According to the Finnish Corporate Governance Code, directors' shareholding in the company promotes good corporate governance. Thus, this remuneration practice allows the company to increase the shareholding of directors (Securities Market Association, 2015).

Challenges and Opportunities

A low level of board compensation could pose a major challenge for Finnish firms, as this will not encourage the best competences to devote time to the firm. Typically, all board members receive the same compensation level, except for chairman, who receives a slightly higher level. In the future, it would be necessary to pay a different compensation for the board members to improve the quality of the board competencies. In addition, the chairman should have a much higher compensation at a level similar to that of other European countries.

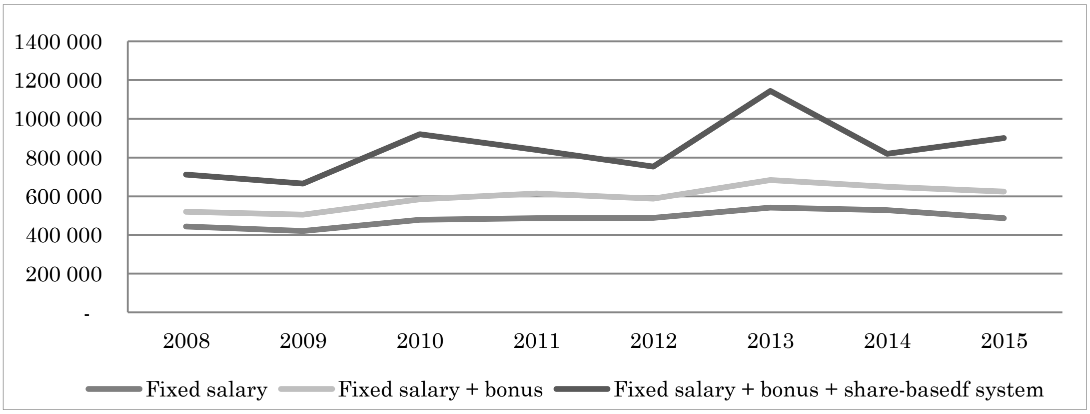
The Finnish practice of paying compensation in shares indicates that the board has taken the shareholders into consideration since such long-term ownership by board members would promote shareholders' interests by extending the board members' time horizon.

1.12.8. Executive Compensation

Current Development

In this section, we first briefly discuss the current level and structure of CEO compensation. Then we examine the practices of State-owned firms and finally discuss current developments in pension payments. In Finnish listed firms, executive compensation consists of fixed salary, bonuses, share-based compensation, pension and other benefits (Figure 1.12.4). In 2015, the CEO of listed firms earned on average 900,000 euros. Fixed salary comprises on average 54%, bonuses 15% and share-based systems 31% of all compensation. Compensation has moderately increased by 3.4% per year over the period of 2008-2015. By comparison, fixed salaries have annually increased by 1.3%, bonuses by 8.8% and share-based systems by 5.3%. Thus, the proportion of variable pay has increased for this time period. In share-based systems, executive stock options have lost their popularity, representing in 2015 only 28% of the executive stock options provided in 2008, whereas shares were more extensively used, in 2015 three times more than in 2008. The structure of the Finnish compensation system is very similar to compensation practices in France, Italy and the Netherlands in the year 2008 (Conyon et al., 2011).

Figure 1.12.4. The development of CEO compensation in Finland, listed firms in the time period of 2008-2015



Executive Compensation in State-owned Firms

Much criticism concerning the executive compensation has been focused on the compensation of CEOs in state-owned listed firms. The public press has criticized excessive compensation, especially in Sonera (telecom, today Telia) and Fortum (energy) with regard to their stock options in 2002. The state as an owner has put considerable effort into developing high-quality compensation systems for its firms. The guidelines used by the State of Finland for state-owned firms are described in Table 1.12.1. The development of guidelines also indicates their reactive nature – in 2004 stock options were banned in state-owned firms due to public discussion criticizing stock options in Sonera and Fortum.

Table 1.12.1. The development of the Finnish state-owned firms' remuneration guidelines 1994-2009 (Kostiander and Ikäheimo, 2012)

Remuneration trends	***1994***	***1998***	***1999***	***2000***	***2004***	***2006***	***2007***	***2009***
General	Launch of long-term incentives	Remuneration supports privatization efforts	Competitive remuneration, reward whole personnel: lower IPO issue prices, privileges in allocations, guidelines extended to all SOEs	Long-term incentives are introduced also for unlisted companies	Reasonable, predictable and transparent remuneration, encourages managements' shareholding, staff funds are introduced	The board of directors must ensure that no exorbitant benefits are given under any circumstances, equity based remuneration only for key employees	Highlights the role of board in role of board in preparation of remuneration, transparency and disclosure	Highlights the role of board in preparation of remuneration
Salary					"”reasonable" basic salary	"”reasonable" basic salary	"”reasonable" basic salary	"”reasonable" basic salary
Short-term	Max. bonus 20/30%			Max. 40%	Max. 40%	Max. 40%	Max. 40%	Max. 40%
Long-term	Option loans are adopted	Index based option schemes	Option schemes	Option model that incorporated both earnings and peer valuation & share compensation plans	State does not approve the use of traditional stock options, if used a part has to be subscribed	Options are excluded from compensation mix, equity-based pay should not exceed annual salary, two-year holding period for share rewards	Confirms the conditions of 2006	The board of directors is entitled to cancel the rewards or postpone payments
Pension and severance benefits				No retirement before age of 60, six month term of notice & salary	As before	No retirement before age of 60, 12-month term of notice & salary	As before	No retirement before age of 63, 12-month term of notice & salary

Pensions

In Finnish listed firms, the CEO may receive pensions voluntarily paid by the firm in addition to statutory pension payments. Such a system is currently used in 49% of the Finnish listed firms. Pensions based on a defined contribution are the most common method (81% of all voluntary pension systems), whereas the other 19% are based on a defined benefit. The cost to the firm of a defined contribution pension for the CEO was on average almost 150,000 euros per year in 2016, and for a defined benefit over 600,000 euros per year. This difference in the costs of these systems is striking. Due to changes in the compulsory pension system in 2005, voluntary defined benefit pension systems have become very expensive. After this change in the compulsory pension system, the CEOs of listed firms have received almost without exception only defined contribution systems (Chamber of Commerce, 2017).

Key Challenges and Opportunities

Despite considerable improvement in the transparency of the compensation systems for Finnish executives, some issues still remain obscure. The description of performance, based on which bonuses are paid, does not clearly indicate what drives top executive's incentives. Although firms report that bonuses are based on principles such as EBITDA, RONA, EPS, turnover or cash flow, but the target level and which the weight of each performance measure are not disclosed. Moreover, the reasoning for using a specific performance measure is not explained. For the shareholders and other stakeholders, this information is crucial to understanding the kind of financial incentives offered to executives.

In the financial service industry, it has been common since 2011 that 40-60% of the variable pay for CEOs should be delayed for at least three years, and that half of this delayed variable pay should be paid in shares. This not only extends the time horizon of CEOs but will also increase the required compensation level due to a longer time horizon. Currently, we do not know the consequences of such compensation practices.

EU regulation will require that say on pay be adopted in all EU countries. This will change the compensation systems in Finland. Based on experiences with say on pay regulation in the US, UK and Canada, it appears that share-based systems will gain more popularity and become more dominant in compensation systems, as it will provide shareholders with more direct influence on the compensation systems. Thus, incentive systems will most likely become more long-term oriented with more emphasis on variable pay.

As a consequence of the expected development among Finnish executive compensation practices, compensation dispersion will increase both between the CEOs (i.e., between well and poorly performing) and relative to the average employee if the CEO is successful. One of the challenges posed by this change is whether the egalitarian Finnish society can tolerate increases in compensation dispersion.

1.12.9. Corporate Responsibility

Current Development

In recent years, transparency regarding Corporate Responsibility (CR) has gained momentum in Finland. In terms of CR-related reporting, the top performers among Finnish companies are willing to assess the prospects of value creation through corporate responsibility. The number of companies disclosing information on value creation has doubled in just one year (2015-2016). This can be interpreted as a step towards more integrated thinking and reporting, which requires identifying and managing value drivers representing different forms of capital (PwC Finland, 2016).

Furthermore, there has been an increase in investors' interest in the corporate responsibility of the companies they invest in, especially making inquiries into companies' ESG (Environment, Social, Governance) performance. This increase in interest is easy to explain: investors want to protect the value development of their investments, which requires identifying and managing portfolio risks. This, in turn, means that companies relying on the will of their investors need to understand the role of corporate responsibility in value creation.

From 2017 onwards, based on the EU Accounting Directive (2014/95/EU), public-interest entities will have the obligation to disclose so-called non-financial information concerning their operations. Thus, all listed companies and other public interest entities will be required to release CR information. One of the new requirements is the diversity policy, which concerns administrative, management and supervisory bodies within the relevant company, though primarily affecting the board of directors.

PwC Finland (2016) reported the corporate responsibility practices in major Finnish firms including all listed firm and firms belonging to the largest 500 Finnish firms. In their report, they identify five interesting features. First, integrated reporting has gained a stronger foothold among Finnish firms, with 28 companies describing their value creation. The number has thus doubled in one year. Second, more than a quarter of the firms mentioned the Paris climate negotiations in their report. The Paris Climate Agreement was concluded at the end of 2015, just prior to publication of the firms' CR reports. These figures indicate that the agreement will drive an increasing number of firms to develop their operations in a changing business environment. Third, one-tenth of the firms mention the UN Sustainable Development Goals (2015) in their report. Fourth, several Finnish firms discuss the diversity of their administrative bodies in their reporting, with almost half of the firms mentioning the personnel diversity policy and principles, and more than one-tenth mentioning their policy and principles concerning the diversity of their administrative bodies. Fifth, the move from GRI G3 versions to the G4 version did not affect the popularity of the guidelines in Finland. It would appear that companies are not abandoning the GRI framework, but instead have applied the new requirements to the extent applicable.

Challenges and Opportunities

Legislation and normative frameworks have developed over time, with pioneers among major firms adopting these in due course after their introduction. From the outside, this development looks promising. What happens inside the firms, as well as when and how late-adopters will implement new frameworks, remain open questions.

1.12.10. Conclusions

This chapter adds to our knowledge of small country corporate governance regulation and recommendations for Finnish listed companies. For these firms, EU level legislation and recommendations play a central role in the development of corporate governance. Therefore, this chapter has focused on developments at the EU level. Development themes, such as shareholder rights, remuneration, diversity and corporate responsibility, are being closely followed and adopted in Finland. This promotes transparency and understanding of the practices within domestic and international investor groups.

Finnish corporate governance practices have been guided by three central themes: the principle of majority rule, the rights given to minority shareholders, and a clear division between the responsibilities of the company's governing bodies. Finnish corporate governance is of rather high European quality. Over the last ten years, Finnish corporate governance has faced no major scandals, and Finnish corporate governance legislation, recommendations and practices have mostly responded to developments arising outside Finland.

In Finland, the common corporate governance structure is the one-tier model, in which board members are non-executive directors, and operational management team members, including the CEO, are not members of the board of directors. When appointing members to the boards, the shareholders' nomination board has increased in popularity compared to the board's nomination committee, which was still some years ago the most common form of nomination body. Remuneration practices and levels are moderate compared to the European average.

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1.13. CORPORATE GOVERNANCE IN JAPAN

Fumiko Takeda

1.13.1. Overview of the Legal Framework of Corporate Governance in Japan

Traditionally, the Japanese governance system has been classified as a stakeholder governance system, which is typical in a code-law (or civil-law) country (La Porta et al., 1998; Ball et al., 2000). The stakeholder governance system is a contrast to the shareholder governance system prevalent in the common-law countries. In a stakeholder governance system, in addition to the shareholders, the other stakeholders can influence the management through cross-shareholding among affiliated firms, trading partners, and the main banks (Shleifer and Vishny, 1997; Hoshi and Kashyap, 2001). In particular, the main banks play a central role by collecting private information on borrowers, solving agency problems, and providing monitoring and insurance services[154].

However, during the long stagnation period that began after the collapse of the economic bubble in the beginning of the 1990s, Japan transformed its economic and business environment, including its corporate governance structure. In particular, the revised Commercial Code of 2001 and the Company Code of 2005 enabled Japanese firms to choose a committee system in which three committees (nominating committee, compensation committee, and audit committee) are placed above the board of directors (Itami, 2005). Under the committee system, the board of directors is responsible for management supervision, while executive officers are responsible for business management. The nominating committee determines the contents of the proposals, related to the election and dismissal of directors, for a shareholders meeting. The compensation committee determines remunerations for executive officers. The audit committee prepares audit reports related to the execution of duties by executive officers. However, a limited number of companies employed this new system.

Following a series of corporate scandals, including Seibu Railway (2004), Kanebo (2004), and Livedoor (2005), the Financial Instruments and Exchange Act of 2006 was enacted, which requires listed companies to submit annual securities reports, quarterly securities reports, and internal control reports. The listed firms are required to have financial statements audited by accounting auditors and also necessitated to establish an effective internal control system[155]. In addition, the Tokyo Stock Exchange (TSE) required listed companies to release a Corporate Governance Report.

However, the above steps failed to decrease the number of corporate scandals. After the major scandal of Olympus Corporation in 2011, the second major corporate governance reform was initiated under the government's Japan Revitalization Policy.

[154] A summary of the enormous amount of literature on the main bank system in Japan is provided by Aoki and Patrick (1995), and Hoshi and Kashyap (2001), among others.

[155] Nishizaki et al. (2012) reported that stock prices react negatively to the disclosure of internal control weaknesses (ICW) after controlling for other information released close to the disclosure date, audit quality, and other firm attributes. They conclude that the disclosure of ICW is informative to the market because it is less frequent and exceptional in Japan.

The revised Company Act of 2014 set stricter requirements on outside directors and outside statutory auditors (*kansayaku*), and introduced a softer alternative committee system, a company with audit and supervisory committees. Although the new system was criticized by the foreign investors for its incompleteness (Shibuya, 2016), according to the Japan Exchange Group, as of June 2016, 414 listed firms have chosen the new system and transformed into a new company with audit and supervisory committees, as compared to the 69 listed companies that chose to be the former company with three committees.

Under the Company Act of 2014, Japanese companies could choose one of the three forms of organizational structures: a company with three committees; a company with audit and supervisory committees; or a company with a *kansayaku* board. The last form of company with a *kansayaku* board is a system unique to Japan, where a company is legally required to have a *kansayaku* board, as well as a board of directors and an accounting auditor. To monitor the decisions made by the directors and the executive officers, the *kansayaku* board members are obliged to attend the meetings of the board of directors, without holding voting rights, and have the right to request reports on the business of the company, in order to investigate its operational and financial status. The term of office of the *kansayaku* board members is stipulated to four years, which is longer than two years for the office of directors. The *kansayaku* board is required to include outside auditors to secure independence and quality monitoring.

In addition, the Council of Experts Concerning the Japanese Version of the Stewardship Code, a group set-up by the Financial Services Agency (FSA), published a document called the "Principles for Responsible Institutional Investors <<Japan's Stewardship Code>>" (the Stewardship Code) in 2014. The goal of this document was to promote increased involvement of institutional investors in the companies that they invest in. As of December 2016, 214 asset management firms signed up for the Stewardship Code (Table 1.13.1). The Stewardship Code expects institutional investors to set a clear investment policy (Principles 1 and 7), and identify and manage their conflicts of interest (Principle 2). In addition, the active dialogue is called for between companies and investors (Principles 3 and 4). The enhanced understanding of circumstances surrounding the companies is expected to change investors' voting behaviour (Principles 5 and 6).

Table 1.13.1. Institutional investors signed up for the Stewardship Code

	May 2014	***Nov. 2015***	***July 2016***	***Dec. 2016***
Trust banks	6	7	7	7
Investment managers	86	141	150	152
Insurance companies	19	22	22	22
Pension funds	12	24	26	26
Others	4	7	7	7
Total	*127*	*201*	*212*	*214*

Source: Financial Services Agency (2016)

In 2015, the TSE formulated Japan's Corporate Governance Code (the CG Code) and set its five general principles to be as follows:

1) securing the rights and equal treatment of shareholders;
2) ensuring appropriate cooperation with stakeholders other than shareholders;
3) ensuring appropriate information disclosure and transparency;
4) outlining the responsibilities of the board;
5) engaging in dialogue with shareholders.

As of December 2016, 504 companies (19.9% of 2,530 companies) fully complied with the CG Code, and 2,143 companies (84.7%) complied with more than 90% of the CG Code[156]. In addition, Principle 4.8 of the CG Code states that companies should appoint at least two independent directors. Owing to these changes, according to the Japan Association of Corporate Directors (JACD), as of August 2016, more than 80% of the firms listed in the first section of the TSE[157] had multiple independent outside directors.

Considering these developments, this chapter reviews the changes in governance of Japanese companies, which have been stimulated by the government's initiatives in the last decade. The rest of this chapter describes the following issues: ownership structures in Section 1.13.2; market for corporate controls in Section 1.13.3; board of directors' practices in Section 1.13.4; directors' remuneration practices in Section 1.13.5; shareholders' rights protection in Section 1.13.6; shareholder activism in Section 1.13.7; corporate governance and firm performance in Section 1.13.8; and corporate social responsibility (CSR) in Section 1.13.9.

1.13.2. Ownership Structures of Japanese Companies

Traditionally, the majority of the shares in Japanese companies have been held by stable investors, such as affiliated companies, including the main banks. The unique feature of the ownership structure of such companies has been characterized by cross-shareholding among affiliated companies (Aoki and Patrick, 1995; Hoshi and Kashyap, 2001). The cross-shareholding structure is useful to lock-in control among long-standing business partners or affiliated companies in a business group (*keiretsu*). However, after the collapse of the economic bubble in the 1990s, Japanese companies experienced remarkable changes in their ownership structures, which include a decrease in the traditional cross-shareholding between banks and firms, and an increase in outside investors, such as foreign shareholders and individual investors. According to Nishiyama (2016), the cross-shareholding ratio declined from 30% in the early 1990s to 10.7% in March 2016. In terms of the market value, the Japan Exchange Group (2016) reports that the ratio of foreign shareholders increased from 7% in 1985 to 29.8% in 2016 (Table 1.13.2). The ratio of Trust Bank, a representative of domestic institutional investors, also increased from 2.5% to 17.7% in the same period. However, the share of

[156] Japan Exchange Group: http://www.jpx.co.jp/english/equities/listing/cg/.

[157] The TSE operates five markets. The first section deals with large companies; the second section deals with mid-sized companies; Mothers deals with high-growth startup companies; JASDAQ deals with startup companies in general; and the TOKYO PRO Market deals with professional investors. According to the TSE, at the end of April 2017, considering the first section (all five markets of the TSE), market capitalization and the number of listed firms amounted to 565.4 (586.8) trillion yen and 2,019 (3,560), respectively.

insiders, proxied by city and regional banks, and insurance companies, decreased from 20.9% and 16.4% to 3.8% and 5.7%, respectively.

Table 1.13.2. Shareholding at market value by investor category

Survey year	*1985*	*1990*	*2000*	*2010*	*2015*
No. of companies	1,833	2,078	2,587	3,616	3,613
City & Regional Banks	20.9%	15.7%	10.1%	4.1%	3.7%
Trust Banks	2.5%	9.8%	17.4%	18.2%	18.8%
Insurance Companies	16.4%	15.9%	10.9%	6.4%	4.7%
Business Corporations	28.8%	30.1%	21.8%	21.2%	22.6%
Foreigners	7.0%	4.7%	18.8%	26.7%	29.8%
Individuals	22.3%	20.4%	19.4%	20.3%	17.5%
Other Institutions	2.1%	3.4%	1.6%	3.1%	2.9%

Source: Japan Exchange Group (2016), and Suto and Takehara (2014).

The investors from the United States of America (the U.S.) and the United Kingdom (the U.K.) mainly comprised of institutional investors, who jointly held approximately 60% of the total foreign equity investments in Japan from the past 20 years (Bank of Japan, 1996-2015). Their governance logics and interests are shareholder oriented and are thus different from those of stakeholder-oriented domestic shareholders. Based on the data of firms listed in the first section of the TSE between 2005 and 2010, Saito (2015) shows that firms with a higher foreign ownership tend to have a larger number of outside directors on their board. Using the data between 2006 and 2012, Desender et al. (2014) reveal that the relationship between board independence and audit fees is positive only when there is a high level of foreign ownership, and that the influence of foreign ownership is particularly strong in firms which do not have large domestic owners, and have high levels of risk and show poor performance.

1.13.3. Market for Corporate Controls (Mergers and Acquisitions)

Before the 1990s, mergers and acquisitions (M&As) were less popular in Japan, when compared to the U.S. and Europe. However, since the latter half of the 1990s, Japan also welcomed a big wave of M&As. According to Recofdata (2017), the number of M&As involving Japanese companies increased to double digits every year in the latter half of the 1990s, and were recorded at over 2,500 in the mid-2000s. After showing a decrease following the financial crisis in 2008, the number of M&As once more reached over 2,500 in 2016. In addition, the value of cross-border M&As has surged for the last ten years, as low interest rates in Japan have allowed businesses to pursue larger deals (*Nikkei*, 2017a). These big deals include the purchase of ARM Holdings by the SoftBank Group, and the purchase of beer-making operations in Eastern Europe by a British chip designer and Asahi Group Holdings in 2016.

The number of tender offer bids (TOBs) increased after 1998, and reached over 100 in 2007, and thereafter decreased after the financial crisis of 2008. Although the number of hostile takeovers in Japan before 2000 was relatively few, they captured attention in the 2000s, as symbolized by the attempts of Steel Partners Japan Strategic Fund in 2003, and Murakami Fund and Livedoor in 2005; until 2008, when major foreign funds withdrew from the Japanese markets after the Lehman crisis.

One important reason for the recent increase in M&As in Japan is institutional change. To revitalize industries that were fatigued by the collapse of the bubble economy, the Japanese government revised the applicable laws and accounting systems to enhance M&As. In 1997, the Antimonopoly Act was amended to approve of holding companies, and the Commercial Code was amended to simplify merger procedures. Further, in 1999, the Commercial Code and the tax system were revised to permit corporate acquisitions using equity swaps and equity transfers for Japanese firms, though these were not permitted for foreign firms. Furthermore, the amendment of the Law on Special Measures for the Revitalization of Industrial Dynamism in 2003 allowed cash-out mergers and triangular mergers, where the acquiring firm provides shares of its parent firm (instead of its own shares) to shareholders of the target firm. This triangular merger had no restrictions with regard to the nationality of the parent firm of the target firm, and thus removed the restrictions on foreign firms involved in cross-border M&As.

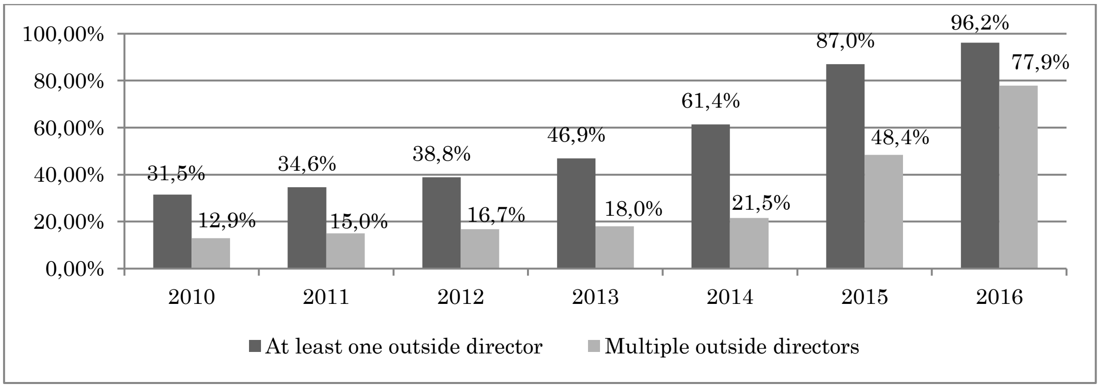
Inoue et al. (2013) examine whether M&As by Japanese firms have positive wealth effects on shareholders of the acquiring firms, by using the data on 658 domestic and 73 cross-border control acquisitions announced in the period between 2003 and 2010. They find that M&As by Japanese firms enhance shareholder wealth. The wealth effects were larger in cross-border acquisitions targeting developing countries and in acquisitions achieving full control of targets. They conclude that acquisitions by Japanese firms were efficient investments. Chikamoto et al. (2013, 2016) examine market reactions to Chinese acquisitions of Japanese firms between 1990 and 2009, and the U.S. acquisitions between 1996 and 2011. They find that both types of M&As tend to increase the stock prices of the Japanese targets, and that market reactions are significantly greater for the U.S. acquisitions when compared to the Chinese acquisitions. They conclude that market reactions increase for the acquirers operating in a developed country with high-quality institutions and corporate governance. Suzuki (2015) estimates the private benefits of control from stock price changes from approximately 262 TOB announcements between 1990 and 2011, finding positive results after 2006. He also reports that the estimated value of the private benefits is positively associated with the acquiring company's high share ownership before the TOB deal, but negatively associated with the presence of a block holder and a high share ownership ratio resulting from the TOB deal.

1.13.4. Board of Directors' Practices

Economic theory suggests that one of the important roles of the board of directors is to reduce agency costs. As an owner of the company and in order to enhance firm value, shareholders want to monitor the management. The board of directors is expected to act on behalf of the shareholders to monitor and restrict the activities of management to ensure behaviour that maximizes shareholder value. However, the conventional boards of directors of Japanese companies can be defined as a "management board" with functions centered on making business management decisions. To separate the supervisory and operational functions, in 1997, Sony Corporation, an electronic company, introduced the executive officer system, which rapidly spread in the late 1990s. However, for many companies, the appointment of few independent outside directors did not alone bring fundamental changes to the role of the board of directors. Thus, the next step was to transform the conventional board of directors (the management board) into a monitoring board that specialized in the supervision of the management.

Considering these developments, the corporate governance reforms undertaken in the 2010s, focused on the reforms of boards of directors that promoted the appointment of independent outside directors. As explained in previous sections, following the revised Company Act of 2014 and the CG Code of 2015, the number of companies that included outside directors on the board increased rapidly. According to the TSE, as of June 2016, among 3,500 listed companies (1,958 companies listed in the first section of the TSE), 2,045 companies (1,525 companies listed in the first section of the TSE) had multiple outside directors and 3,070 companies (1,883 companies listed in the first section of the TSE) had at least one outside director (Figure 1.13.1).

Figure 1.13.1. Companies listed in the first section of the TSE with outside directors



Source: Tokyo Stock Exchange (2016).

Using the data of firms listed in the first section of the TSE between 2005 and 2010, Saito (2015) finds that firms with a large size, high foreign ownership, outside auditors, and high market-to-book ratio are more likely to have outside directors on their board. He also analyzes the selection of outside directors, coming from various backgrounds, including other firm' executives, bankers, lawyers, academics, accountants, consultants, or bureaucrats. He reports that (1) information technology companies are less likely to hire outside directors from banks as they are less dependent on bank loans; (2) firms with a high business risk tend to have lawyers as outside directors'; and (3) firms with high overseas sales tend to appoint former bureaucrats. He concluded that Japanese companies choose outside directors for the directors' advice.

In contrast to the rapid increase in outside directors, the diversification of the board members is not sufficient in Japanese companies. The Japan Revitalization Strategy encourages companies to employ more female directors and managers by stating that listed companies should have at least one female director on their board. Owing to this government initiative, according to the 2015 Population Census[158], the number of female directors in Japan increased to more than 700 thousand, which accounted for 24.4% of the total number of corporate directors. However, according to the World Economic Forum's Global Gender Gap Index 2016, Japan ranked 111 among 144 countries[159].

Morikawa (2014) investigates the determinants of the number of female and foreign directors in Japanese companies, based on the Survey of Corporate Management and Economic Policy conducted by the Research Institute of Economy, Trade, and Industry; and the Basic Survey of Japanese Business Structure and Activities conducted by the Ministry of Economy, Trade, and Industry for the fiscal year 2011. He reports the following findings: (1) listed and long-established companies, subsidiaries of parents, and unionized companies are less likely to appoint female directors; (2) owner-managed companies tend to have female directors and chief executive officers (CEOs); and (3) foreign directors tend to be hired by foreign-owned companies and companies engaged in overseas operations.

1.13.5. Directors' Remuneration Practices

Directors' remuneration can be discussed using the principal-agent framework. When ownership and management are separated, shareholders expect managers to maximize firm value, while managers pursue their own reputation and interests. In addition, shareholders may not be able to observe managers' behaviour. In order to solve the conflicts of interests between shareholders and managers under information asymmetry, the remuneration should be determined by business results, and in order to match the interests of managers with those of shareholders, companies tend to employ annual incentive compensation, such as performance-based bonuses and long-term incentive compensations, including stock compensations and cash-based mid-term performance bonuses.

According to the Commercial Code in Japan, the board of directors was responsible for determining the value of executive compensation. Executive compensation mainly consisted of cash salary and cash bonus, while stock-based compensation was not used until the revised Commercial Code of 2001 introduced the stock acquisition rights system. Among prior studies examining the determinants of Japanese executive compensation, Nakazato et al. (2011) use the data based on the income tax paid by the richest executives in 2004, reporting that executive pay is positively associated with firm size, and is not significantly related to the accounting profitability or stock returns.

The CG Code of 2015 states that the remuneration of the management should

[158] 2015 Population Census: http://www.stat.go.jp/english/data/kokusei/.
[159] World Economic Forum: http://reports.weforum.org/global-gender-gap-report-2016/rankings/.

include incentives such that it reflects mid- and long-term business results and potential risks, and promotes healthy entrepreneurship. The CG Code of 2015 also suggests that the proportion of remuneration that is linked to mid- and long-term results, and the balance of cash and stock, should be set appropriately. Despite the emphasis on performance-based compensation, pay levels and practices for Japanese CEOs are rather different to the CEOs of other major developed countries. According to Morita et al. (2016), among Japanese companies with annual revenues over one trillion yen, the average CEO salary is one-tenth of their U.S. counterparts. The key difference in compensation levels mainly results from the fact that Japan's incentive compensation is lower than that of the other major developed countries. In particular, performance-based compensation accounts to less than half of the total direct compensation in Japan; approximately 70% in France, Germany, and the U.K.; and approximately 90% in the U.S.

However, as stated in the CG Code of 2015, several Japanese companies reviewed their remuneration systems. According to Willis Towers Watson (2016), the number of companies that decided to issue stock options as stock-based compensation, increased from 81 in 2009 to 407 in 2016; the number of companies that introduced executive compensation of the Board Incentive Plan Trust increased from 4 in 2013 to 223 in 2016; 607 companies listed in the first section of the TSE established compensation committees, following the recommendation of the JACD; and the number of companies adopting equity-based executive compensation, including stock options trust plans and restricted stocks, is estimated to reach approximately 1,100 by the end of June 2017 (*Nikkei*, 2017b). We note that the big increase comes from newly-introduced alternatives-stock ownership plans arranged in trusts that emerged in 2012 and restricted stocks introduced in April 2016. These changes are expected to impact executive pay practices.

1.13.6. Shareholders' Rights Protection

The shareholders' legal rights are quite strong under the Company Act of 2015 (the Company Act) (Goto, 2014). In order to control dividend payments, replace the board of directors, and access a corporate ballot, shareholders have the rights to alter a corporate charter without board consent. To amend a corporate charter provision, though the shareholders do not require board consent, they require an affirmative vote on the special resolution at a shareholders' meeting. This means that without board consent, the shareholders can introduce a charter provision that grants them the power to make decisions on ordinary business matters, the power for which is usually given to the board. Using charter amendments, shareholders can also delegate to the board the responsibility for decisions on dividend payouts.

However, shareholders' power to set executive compensation is rather limited in Japan (Goto, 2014). Although the Company Act stipulates that compensation of directors shall be fixed by a resolution in a shareholders' meeting, case law has limited the scope of this shareholder right. Moreover, there is no mandatory disclosure of individual compensation, except for directors of publicly traded companies who receive a compensation of 100 million yen or more.

Considering the election and removal of directors, the default rule is a majority standard, where a majority of votes cast by shareholders can reject a candidate proposed by the management or remove any director at any particular time. Shareholders also have the right to submit proposals in shareholders' meetings. In addition, shareholders who hold three percent or more of the company's voting rights for six months or longer can demand that directors call an extraordinary meeting. Shareholder derivative lawsuits are permitted as an exception to the general rule, in which the board of directors have the right to raise a claim on behalf of the corporation. Within this limited scope, plaintiff shareholders face few restrictions to initiate derivative lawsuits.

Recently, the CG Code of 2015 set the first principle of the rights and equal treatment of shareholders. Under this principle, companies should take appropriate measures to secure the rights, and equal treatment of minority and foreign shareholders. Thus, Goto (2014) concludes that shareholders' rights in Japan, under the Company Act, are among the strongest in the world. Although foreign investors tend to criticize Japanese companies for not paying sufficient attention to shareholders' interests, the problem does not lie in the legal rights, but in conventional practices, such as cross-shareholding.

1.13.7. Shareholder Activism

Historically, the management of listed companies in Japan tended to have friendly and stable shareholders, who did not sell their stocks, and rather supported the management. In addition, more than nine out of ten listed companies held their shareholder meetings on the same day in the 1990s (Tabuchi, 2014)[160]. This practice was previously justified by the companies as a protection against professional racketeers (*sokaiya*) who sought to extort money from companies by threatening them of disrupting the shareholders' meetings. However, the police have since cracked down on the *sokaiya*. Although the *sokaiya* no longer pose a threat as cross-holdings have gradually dissolved, shareholder activism started to gain attention as activist investors took a hostile approach against managements. Typically, activist shareholders take the following measures to influence the management: closed engagement; public campaigns; shareholder proposals; empty voting; litigation; and hostile takeovers. Among these measures, empty voting never made an improper resolution or voted down a proper item of agenda in Japan (Matsushita, 2016).

Previous shareholder activism campaigns include hostile takeovers attempted toward Shoei Company Limited by Murakami Fund in 2000, Nippon Television Network Corporation by Livedoor and Murakami Fund in 2005, the Bull-Dog Sauce Company Limited by Steel Partners Japan Strategic Fund in 2007, when the first poison pill was exercised, and the Electric Power Development Company Limited (operating under the brand name J-POWER) by the Children's Investment Fund (TCI) in 2007. These attempts were not successful as the target companies had stable shareholders and public opinion was generally against hostile takeovers (Matsushita, 2016). Another

[160] In 2017, less than three out of ten listed companies held their shareholder meetings on the same day (Nishiyama, 2017).

example is the proposal of share exchange between Tokyo Kohtetsu Company Limited, and the electric furnace steel maker, Osaka Steel Company Limited, the majority of whose shares were owned by Nippon Steel in 2007. This proposal was rejected as a result of a proxy fight waged by the Japanese activist fund Ichigo Asset Management, which opposed the share exchange (Nakamoto, 2007). In addition, foreign fund managers sided with Olympus Corporation's ousted president, Michael Woodford, who demanded answers for the accounting fraud of 2011 (Tabuchi, 2014).

Hamao et al. (2011) examine 916 activism events, where 34 activist funds targeted 759 companies between 1998 and 2009. Approximately three quarters of the events intensified between 2004 and 2007. In terms of the number of filings, the top activists were Sparx, Atlantis, and Murakami. Among 34 activist funds, eight were run by Japanese nationals and 17 were reported to have a hostile attitude. Among 916 events, 356 cases (39%) were regarded as hostile cases. Hamao et al. (2011) show that unlike the U.S. market, firms subject to activism are targeted for their high cash balances and under-leverage. In other words, activist funds aim to reduce cash holdings, which were very high when compared to other advanced countries[161], and increase dividends and share buybacks.

More recently, activist shareholders targeted companies with large market capitalization (Matsushita, 2016). For instance, Third Point, one of the most well-known activist hedge funds in the U.S., proposed Sony Corporation to carve out its entertainment business and make an offering of shares to the public in the entertainment business, although Sony Corporation refused to accept this proposal in 2013 (Sakoui, 2014). Third Point also proposed FANUC Corporation, a robotics company, to conduct a buyback of a large number of its shares and increase the amount of dividends. This proposal might have prompted FANUC Corporationto to take the proposed action in 2015 (Harding, 2015). In addition, Third Point announced the acquisition of a major stake in Seven & I Holdings Company Limited in 2015, urging its board to separate the struggling Ito-Yokado supermarket chain from the group, in order to improve its corporate value; and to oppose the former CEO, Toshifumi Suzuki's bid to remove Ryuichi Isaka as the head of the profitable Seven-Eleven operation (*The Japan Times*, 2016).

In addition, C&I Holdings Company Limited, which was related to the Murakami Fund, submitted a shareholder proposal to Kuroda Electric Company Limited, an electronic trading company, to elect four outside directors nominated by C&I Holdings Company Limited. Although this proposal did not pass at the extraordinary shareholders' meeting, shareholders who owned 40% of the voting rights voted for the proposal (Lewis, 2015). Another activist fund, Effissimo Capital Management, brought a derivative action to recover for damages caused by the directors of Nissan Shatai Company Limited, claiming that the directors violated their duties when the company deposited a large amount of cash in a subsidiary of Nissan Motor Company Limited, the parent company of Nissan Shatai Company Limited, although the Yokohama District

[161] Aoyagi and Ganelli (2014) report that the average ratio of cash holdings to market capitalization of listed companies was more than 40% during 2004-12 in Japan, which was much higher than 15-27% in other Group of Seven (G7) countries. In the end of fiscal 2015, cash holdings by listed companies rose to a record (*Nikkei*, 2016).

Court dismissed the case in favour of the directors in 2012[162]. Finally, Stardust, an affiliate of the private-equity company MBK Partners, completed a tender-offer for Tasaki & Company Limited a jeweller, in 2017 (*Nikkei*, 2017c).

After the release of the Stewardship Code of 2014, Japanese institutional investors started actively participating in shareholders' meetings. A well-known example is the annual shareholders' meeting of Otsuka Kagu Limited, a furniture retailer, in 2015, where a feud over the sales policy within the firm's founding family culminated between the founder and chairman, Katsuhisa Otsuka, and his daughter and the firm's president, Kumiko Otsuka. Major institutional investors, including insurance companies and pension funds, clearly supported the president's proposals (*The Japan Times*, 2016).

Matsushita (2016) summarizes that the common objectives of shareholder activism in Japan were to improve capital efficiency and corporate governance. Thus, activist shareholders tended to demand a buyback to increase the amount of dividends, carve out unprofitable businesses, or change business strategies. In addition, they occasionally advocated changes in corporate governance by increasing the number of outside directors and employing stock-price-linked remuneration of directors. Matsushita (2016) expects that the number of shareholders supporting the management could decrease in the future as more cross-holdings are dissolved, and warned that managements of listed companies should take into account the possibility that they will be targeted by activist shareholders.

1.13.8. Corporate Governance and Firm Performance

Until now, we reviewed the ongoing governance reforms in Japan. However, there is limited empirical evidence that has examined whether and how the change in governance triggered by the reforms improved corporate performance. The exceptions to this are the following two studies: Aoyagi and Ganelli (2014), and Kato et al. (2017). Aoyagi and Ganelli (2014) study the relationship between corporate cash-holdings and corporate governance in Japan. Using the data of non-financial companies between 2000 and 2013, they show that better corporate governance, reflected in the "Proprietary Bloomberg Score,"[163] reduces cash holdings, suggesting that Japan's corporate governance reforms are likely to reduce high corporate cash holdings, and choose a more efficient use of resources.

Kato et al. (2017) examine whether and how payouts and cash holdings are related to corporate governance in Japan, by using the data of listed non-financial companies between 1990 and 2011. Their study shows that, on an average, Japanese companies have reduced their cash holdings and increased their payouts after 2000. They also report that good governance proxied by foreign ownership, management ownership, and ownership by financial institutions is negatively associated with cash holdings, and positively related to

[162] Nissan Shatai Company Limited's press. Retrieved February 13, 2013 from the World Wide Web: http://www.nissan-shatai.co.jp/EN/IR/PDF/NEWS/20130213_hanketsu_kekka_E.pdf.
[163] The "Proprietary Bloomberg Score" includes the measure of board size, ratio of outside directors, and disclosure quality.

payouts and operating performance, reflected in return on assets (ROA) and Tobin's Q, while the opposite is true for poor governance proxied by bank loans.

1.13.9. Corporate Social Responsibility (CSR)

Traditional Japanese companies possess ethical self-discipline passed down over generations while conducting business. The most famous discipline is the "triple satisfaction" among three stakeholders: sellers, buyers, and the society. By satisfying the interests of these stakeholders, companies are expected to establish and maintain long-term business relationships by assuring product quality, contributing to social causes, and providing employment to the society, among others. Although the traditional main banking system did not urge companies to disclose information to the outsiders, following the unwinding cross-shareholding and the increase of institutional investors, the disclosure of non-financial information has gradually been introduced since the late 2000s, and includes disclosures, such as Corporate Governance Reports and International Control Reports. In parallel, large companies sought to strengthen investor relations and began to issue CSR reports voluntarily.

One of the notable moves by Japanese businesses was that the Japan Business Federation (*Keidanren*) incorporated several ISO[164] 26000 elements into the fifth edition of its Charter of Corporate Behaviour released in 2010. ISO 26000 is ISO's standard on an organization's public responsibility, and was published in 2010. This standard clarifies the social responsibility by setting seven core subjects: organizational governance, human rights, labour practices, the environment, fair operating practices, consumer issues, and community involvement and development. Later, Japan adopted ISO 26000 as an official standard following its adaptation of JIS[165] in 2012. According to the survey conducted by the CSR Forum, Japan, more than half of the 200 respondents use ISO 26000 or *Keidanren*'s Charter of Corporate Behaviour (CSR Forum Japan, 2014). Another CSR survey conducted on approximately 2,000 companies by the Tokyo Foundation, found that many companies pursue issues related to the environment, human rights, and (domestic) women's advancement, while fewer companies address issues on (domestic) poverty and hunger (Tokyo Foundation, 2014).

The change has been accelerated by the Japan Revitalization Strategy. Japan's Stewardship Code of 2014 and the CG Code of 2015 indicate that institutional investors are expected to conduct sustainable investments. In addition, in 2015, the Government Pension Investment Fund, the world's largest pension fund, became a signatory of the Principles for Responsible Investment (PRI)[166], which was launched by the United Nations Global Compact in 2006. The PRI highlight the role of institutional investors in environmental, social, and governance (ESG) issues, and advise investors to actively use their rights to improve ESG issues of the companies they invest in. According to the Japan Sustainable Investment Forum (2016), among 1,633 PRI signatories globally, 53

[164] ISO stands for the *International Organization for Standardization.*
[165] JIS stands for the Japanese Industrial Standards.
[166] Details of the PRI are provided in the UN webpage: https://www.unpri.org/.

were Japanese as of the end of 2016. As of 2016, the balance of total sustainable investment was 57.05 trillion yen in Japan, of which 56.25 trillion yen were made by domestic institutional investors.

Motta and Uchida (2017) examine the relationship between the CSR ratings and the ownership structures of Japanese firms between 2006 and 2011. They use the Toyo Keizai CSR database, which is based on the firms' responses to questionnaires on the following four issues: environment, social engagement, corporate governance, and employment relations. They find that institutional ownership in 2005 is positively associated with the likelihood of subsequent improvements in environmental ratings and that this improvement is more evident in domestic institutional investors who signed up for the PRI. In contrast, they do not provide robust evidence on the relationship between the CSR ratings and foreign ownership.

Suto and Takehara (2014) examine the effects of foreign ownership on the corporate social performance (CSP) of Japanese firms listed between 2007 and 2011. Unlike Motta and Uchida (2017), they find a more positive relationship between the CSP and foreign ownership, when compared to the relationship between the CSP and domestic ownership, by using different CSP indices, which were based on the following five dimensions: employee relations, social contributions, organization security and product safety, internal governance and risk management, and environmental preservations. To summarize, prior studies report that corporate governance tends to affect CSR activities of Japanese companies. However, whether foreign or domestic investors provide more positive influence remains an empirical question.

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2.1. CORPORATE GOVERNANCE IN POLAND

Leszek Bohdanowicz

2.1.1. Introduction

The Polish system of corporate governance began to evolve during the process of transition from the central planning economy to market economy in the nineties of the XX century. This transition was characterized by challenging political choices, economic experiments and the lack of a consistent scientific theory which could support decision-makers (Mesjasz, 2011). Aggestam (2004) identified some barriers which Poland encountered when introducing its new socio-economic system: lack of experience, lack of patterns of behaviour, weak legal system, poorly developed market institutions as well as a financial system, inadequate human capital, insufficiently developed ownership structures.

During this transition, the foundations of the capital market were created and the ownership structures of companies were reshaped (Mortimer, 2009). Tamowicz (2011) emphasised that following the Anglo-Saxon corporate governance model had initially led to the establishment of dispersed ownership structures. But later the Polish government changed its privatisation strategy and tended to sell large blocks of shares to foreign investors combined with making them available in a public offer. A similar strategy was chosen by all countries of Eastern Europe at the time (Berglof and Pajuste, 2003). As a result, their systems of corporate governance became similar to the systems typical for other countries of continental Europe. Kozarzewski (2007) concluded that it was more favourable for Poland for three reasons. Firstly, the corporate control market did not exist or was insufficiently developed. Secondly, the investment potential of the Polish society was poor. Thirdly, Polish companies suffered from inadequate know-how as well as a limited number of managers with sufficient skills. Foreign strategic investors who held a controlling stake in a company's ownership were able to cope with these problems.

All these barriers were overcome and solid foundations for the Polish system of corporate governance were set up. This system continued to evolve and develop. Nowadays, it has many features of the mature continental European system and is similar to the German system of corporate governance (Jeżak, 2010). The main aim of this chapter is to describe the key features of the Polish system of corporate governance as well as legal regulations, institutional solutions and corporate governance practices in Poland.

2.1.2. Overview of the Legal Framework of Corporate Governance in Poland

The Polish system of corporate governance is regulated by hard law and soft law. The most important legal act in Poland is the Code of Commercial Partnerships and Companies of 2000, which replaced the Polish Commercial Code of 1934. The Polish system of corporate governance is also influenced by acts regulating the functioning of the capital markets and business relations, that is:

- The Accountancy Act of 1994;
- The Bankruptcy and Rehabilitation Law of 2003;
- The Investment Funds Act of 2004;
- The Act on Public Offering, Conditions Governing the Introduction of Financial Instruments to Organized Trading, and on Public Companies ("Act on Public Offering") of 2005;
- The Act on Trading in Financial Instruments of 2005;
- The Capital Market Supervision Act of 2005;
- The Protection of Competition and Consumers Act of 2007;
- The Act on Auditors and Their Self-Governing Bodies of 2009.

In addition, from 2002 Polish listed companies had to apply the principles of the code of good practices in corporate governance based on the regulatory approach 'comply or explain'. This code was not legitimized by an official law in Poland and was not adopted by the Polish Parliament. Up to now, in Poland there were six codes developed by the Best Practice Committee, and then by the Warsaw Stock Exchange Corporate Governance Consultation Committee:

- Best Practices in Public Companies in 2002;
- Best Practices in Public Companies in 2005;
- Code of Best Practices for WSE Listed Companies of 2007;
- Code of Best Practices for WSE Listed Companies of 2010;
- Code of Best Practices for WSE Listed Companies of 2012;
- Best Practice for GPW Listed Companies 2016.

The current code of best practices is titled 'Best Practice for GPW Listed Companies 2016' and entered into force on the 1st of January 2016. This code is composed of an introduction and six sections:

1. Disclosure Policy, Investor Communications – 4 recommendations and 21 detailed principles;
2. Management Board, Supervisory Board – 7 recommendations and 11 detailed principles;
3. Internal Systems and Functions – 1 recommendation and 6 detailed principles;
4. General Meeting, Shareholder Relations – 3 recommendations and 18 detailed principles;
5. Conflict of Interest, Related Party Transactions – 1 recommendation and 6 detailed principles;
6. Remuneration – 4 recommendations and 4 detailed principles.

New code changed strongly in its structure. In its introduction, it is stated that the code had gained its structure in accordance with the European Commission Recommendation of 9th of April 2014 on the quality of corporate governance reporting (2014/208/EU). Polish listed companies have to publish annual statements in which they point out whether they apply the principles. If not, they should indicate the reasons for non-use.

2.1.3. Ownership Structures of Companies in Poland

The Polish system of corporate governance is characterized by concentrated ownership. According to various pieces of research, the median of the largest blockholder in Polish listed companies ranges from about 42% (Aluchna, 2015; Jerzemowska et al. 2015) to about 46% (Bohdanowicz, 2017; Tamowicz and Przybyłowski, 2006). The differences in results depend on measurement period, sample and identification of indirect ownership. It was underlined by Aluchna (2015) who indicated that the ownership of Polish listed companies is highly concentrated and the largest shareholder in her sample owned 42.88% of shares, but she estimated that taking into account indirect ownership and shareholders' agreements increased ownership concentration up to 50.12%.

Table 2.1.1 shows the mean, median and standard deviation of the ownership concentration (measured by the percent of shares owned directly and indirectly by the largest shareholder) of Polish companies listed on the Main Market of the Warsaw Stock Exchange at the end of 2015. The mean of all companies amounted to 46.12% and the median 49.69%. Both measures were the highest for banks. The mean amounted to 60.53% and the median 57.11%. The lowest measures were observed for service and trade companies. The mean amounted to 45.13% and the median 45.87%.

Table 2.1.1. Ownership concentration of Polish listed companies at the end of 2015 (% of shares owned directly and indirectly by the largest shareholder)

Sector	*Mean*	*Median*	*St. Dev.*	*No.*
Industry	46.31	50.00	23.26	139
Service and trade	45.13	45.87	22.50	215
Banks	60.53	57.11	20.81	15
Other finance	45.43	49.57	22.11	45
All	46.12	49.69	22.84	414

Source: Own elaboration.

Also, the in-depth analysis showed that the ownership of Polish listed companies is strongly concentrated. Jerzemowska et al. (2015) showed that the cumulative share of the three largest shareholders at the end of 2012 was 54%. Moreover, 59% of the companies had a shareholder holding more than 50% of the shares, while only 17% had no shareholder holding more than 20% of the shares. In this study, the largest group of the biggest shareholders was sequentially individual shareholders who were also the members of companies' authorities (43%), strategic investors (24%) and the state (5%). Similarly, Adamska (2013) analyzed the ownership structures of Polish listed companies and the stakes of different types of owners in companies' ownership. She pointed out that the largest stake in this ownership is owned by respectively strategic investors (the mean of the stake is 50.51%), the state (45.92%), individual investors (35.60%) and financial institutions (26.02%).

2.1.4. Capital Market and Market for Corporate Control

The Warsaw Stock Exchange was established at the beginning of the transition in 1991. At the first trading session there were only five former state-owned companies listed (Tonsil SA, Próchnik SA, Krosno SA, Kable SA and Exbud SA). Today the WSE is one of the most dynamic and the most important stock exchanges in Central and Eastern Europe. Warsaw Stock Exchange SA is joint-stock company and is also publicly held, but still controlled by the Polish government. Nowadays in Poland companies are listed on the Main Market of WSE and the alternative share market for smaller companies (New Connect).

Table 2.1.2 shows the number of companies listed on the Main Market of the Warsaw Stock Exchange, domestic market capitalization and share turnover value between 2012 and 2016. At the end of 2012, 438 were listed on the Main Market of the WSE (395 Polish companies and 43 foreign ones) and the domestic market capitalization was 523,390.23 million PLN (approximately 168,857 million USD). In comparison, at the end of 2016, 487 companies were listed (434 Polish companies and 53 foreign ones), and the market capitalization amounted to PLN 557,123.58 million (approximately 133,305 million USD[167]).

Table 2.1.2. Companies listed on the Main Market of The Warsaw Stock Exchange

Year	*No. of listed companies*	*Domestic market capitalization (in PLN mil.)*	*Share turnover value (in PLN mil.)*
2012	438	523,390.23	202,880.00
2013	450	593,464.45	256,147.00
2014	471	591,164.93	232,864.00
2015	487	516,785.16	225,287.00
2016	487	557,123.58	202,293.00

Source: https://www.gpw.pl/analizy_i_statystyki_en. Retrieved June 18, 2017 from the World Wide Web.

Similarly, table 2.1.3 shows the number of companies listed on the alternative share market (NewConnect), domestic market capitalization and share turnover value between 2012 and 2016. The number of companies listed on this market amounted to 406 companies (398 Polish companies and 8 foreign ones) at the end of 2016 and dropped from 429 companies at the end of 2012 (421 Polish companies and 8 foreign ones) and 445 companies at the end of 2013 (434 Polish companies and 11 foreign ones). Market capitalization of the companies listed on NewConnect was much smaller than market capitalization of companies listed on the Main Market of the WSE and ranged from 11,088 million PLN (approximately 3,577 million USD) in 2012 to 9,799 million PLN (approximately 2,345 million USD) in 2016. Also the NewConnects's share turnover value is small in comparison to the Main Market. It amounted to only 1,360 million PLN (approximately 325 million USD) compared to 202,293 million PLN (approximately 48,404 million USD) in 2016.

[167] The drop was caused by a change in the exchange rate.

Table 2.1.3. Companies listed on NewConnect

Year	*No. of listed companies*	*Domestic market capitalization (in PLN mil.)*	*Share turnover value (in PLN mil.)*
2012	429	11,088	1,303
2013	445	11,028	1,226
2014	431	9,122	1,435
2015	418	8,664	1,949
2016	406	9,799	1,360

Source: https://www.gpw.pl/analizy_i_statystyki_en (Retrieved June 18, 2017 from the World Wide Web)

To sum up, the Warsaw Stock Exchange is one of the most dynamically developing stock exchanges in the Central and Eastern Europe, but with such a highly concentrated ownership of listed companies, the market for corporate control in Poland is not active. Although there were 279 M&A transactions with a total value of 11.2 billion USD in 2016 (Emerging Europe M&A Report 2016/17), mergers and acquisitions are mostly carried out as block transactions agreed with dominant shareholders as well as management boards and then possibly tender offers for dispersed investors. Hostile takeovers are relatively rare in comparison to Anglo-Saxon countries, though they are possible and their number even slightly increased (Radwan and Regucki, 2015). The most spectacular hostile takeover in Poland was the takeover of the family owned jewelry company W. Kruk SA by the textile company Vistula&Wólczanka SA in 2008.

2.1.5. Board Model and Functions

The Polish board model is a two-tier one and corporate boards in Poland consist of two separate bodies, i.e. a management board and a supervisory board. Both of these bodies are collegial organs and the most of their decisions require a resolution. Management boards are the only permanent organs of the companies and they are responsible for managing the companies' affairs and their representation. In reality, they are the powerful and real decision-making boards. Their functions include the formulation of a strategy and managing companies' operations. In joint stock companies, the general meetings of shareholders and supervisory boards may not issue biding instructions to the management boards in the area of management. Sołtysiński (2014) noted that the management board has competence in all matters when the law does not empower the general meeting of shareholders or the supervisory board to perform a particular function.

Supervisory boards are responsible for the permanent supervision of companies in all their activities and should be convened as the need arises, but not less frequently than three times in the financial year (Art 389 of CCPC). According to the Code of Commercial Partnerships and Companies the special duties of these boards include consideration and approval of the management board report on the operations of the company and of the financial report for the previous financial year, with regard to their conformity with the books and documents, as well as with the actual state of affairs, and proposals of the management board concerning the division of profits or the financing of losses, as well as submitting to the general assembly annual written reports on the results of such evaluation. In order to perform its duties, the supervisory board may review all documents of the company, request reports and explanations from the management board and the employees and review the state of the company's assets (Art 382 of CCPC).

Articles of association can extend supervisory boards' responsibilities. Their duties can also comprise entering into contracts with top managers, approving long-term plans and annual budgets, selecting external auditors, representing companies in disputes with their management, approving the issue price of new shares, accepting unified texts of the articles of association, granting approval for the purchase or sale of real estate, giving investment guarantees, purchasing shares of significant value, purchasing or selling movables, establishing or liquidating company divisions, setting up new subsidiaries, and the sale of preferred shares or their exchange for ordinary shares (Jeżak, 2010; Koładkiewicz, 2013).

Management boards consist of one or more inside members, but the size of management board is left to the discretion of the general meeting of shareholders. Members of this board are called and dismissed by the supervisory board unless the articles of association allow for another approach. Table 2.1.4 shows the frequency of supervisory board size of the Polish companies listed on the Main Market of the Warsaw Stock Exchange in 2015. 53 management boards amounted to a minimum number of members (12.80%), 126 counted only two members (30.44%), 105 three members (25.36%) and 71 four members (17.15%). In addition, 30 supervisory boards amounted five members (7.25%) and 29 of them counted six or more members (7.00%). The average number of supervisory board size was 3.0411 and maximum was 11 members.

Table 2.1.4. Management board size of Polish listed companies in 2015

Supervisory board size	*No. of companies*	*%*
One	53	12.80
Two	126	30.44
Three	105	25.36
Four	71	17.15
Five	30	7.25
Six or more	29	7.00
All	*414*	*100*

Source: Own elaboration.

The supervisory boards are composed of only outside directors and consist of three or more members in private companies and five or more members in public companies. They are called by the general meeting. Individually, the article of association may allow for a different approach to their election. Table 2.1.5 shows the frequency of supervisory board size of the Polish companies listed on the Main Market of the Warsaw Stock Exchange in 2015. The most supervisory boards counted five members, that is 266 of 414 (64.25%). 67 supervisory boards amounted six members (11.84%). 11 supervisory boards counted both seven and eight members (2.66%) and 10 supervisory boards amounted ten or more members (2.41%). The average number of supervisory board size was 5.7391 and maximum was 15 members.

Table 2.1.5. Supervisory board size of Polish listed companies in 2015

Supervisory board size	*No. of companies*	*%*
Five	266	64.25
Six	67	16.18
Seven	49	11.84
Eight	11	2.66
Nine	11	2.66
Ten or more	10	2.41
All	*414*	*100*

Source: Own elaboration

2.1.6. Directors' Remuneration Practices

The Polish Code of Commercial Partnerships and Companies of 2000 states that "the supervisory board shall determine the remuneration of the members of the management board employed under an employment contract or another contract unless the statutes provide otherwise. The general assembly may authorize the supervisory board to decide that the remuneration of the members of the management board shall also include the right to a specified share of the annual profit of the company which is designated for distribution among the shareholders […]" (Art 378 of CCPC). Moreover, "the members of the supervisory board may be granted remuneration. The remuneration shall be determined by the statutes or a resolution of the general assembly. The remuneration of the members of the board in the form of the right to participate in the profits of the company for a given financial year, designated for distribution among the shareholders […] may be granted solely by the general assembly. The members of the supervisory board shall be entitled to a reimbursement of the costs connected with participation in the work of the board" (Art 392 of CCPC).

The problem of directors' remuneration is also raised by Best Practice for GPW Listed Companies 2016. According to them, every company should have a remuneration policy applicable at least to members of the company's governing bodies and key managers. This policy should determine the form, structure, and method of determining the remuneration of members of the company's governing bodies and key managers.

In practice, the most important component of the Polish top managers' pays is salary, which in 2015 accounted for 54% of total remuneration. Then, bonuses accounted for 36%, benefits for 6% and remuneration from subsidiaries for 4%. Long term incentives plans still do not play a significant role in Poland. Only 32% of the largest Polish listed companies implemented these plans. The best paid top manager in 2015 was Janusz Filipiak, the CEO and majority shareholder of IT company Comarch SA, who earned 15,400,000 PLN, that is approximately 3,947,600 USD (PwC, 2016).

Several researches on executive remuneration were conducted in Poland. E.g. Bohdanowicz (2016) investigated the relationship between top managers' remuneration and company performance. On the basis of data from 293 Polish companies listed on the Warsaw Stock Exchange and a total of 1,118 observations for the period between 2008 and 2013, there was identified a positive relationship between lagged ROA and executive remuneration in the whole sample, and also the positive relationship between lagged Tobin's Q and executive remuneration, when managerial ownership was higher than 5%. While Radwan and Regucki (2015) investigated the number of stock option plans adopted by the companies listed on the WSE between 2003 and 2012. They concluded that a large number of the Publish public companies had stock-based remuneration for company officers. The most common legal basis for those programmes is a conditional increase of share capital, which may involve issuing of warrants or bonds with priority subscription rights.

2.1.7. Shareholders' Rights Protection

In Poland shareholders rights are safeguarded by the Code of Commercial Partnerships and Companies of 2000 (CCPC). Generally, shares of Polish companies may be registered or bearer ones. Registered shares may be changed to bearer shares or the opposite change may be made at the request of a shareholder (Art 334 of CCPC). The shareholders shall be entitled to participate in the profits shown in the financial report, audited by an auditor, which has been designated by the general assembly for distribution to the shareholders. The profits shall be divided in proportion to the number of shares. If the shares are not paid for in full, the profits shall be divided in proportion to the effected payments for the shares. The sums to be divided among the shareholders may not exceed the profits for the previous financial year, increased by the undivided profits from previous years and by the sums drawn from the supplementary and reserve capitals created out of profits which may be allocated for dividends. That amount shall be reduced by uncovered losses, own shares and by the sums which according to the law or the statutes should be allocated, from the profits for the previous financial year, to the supplementary or reserve capitals (Art 348 of CCPC).

The company may issue shares with special rights attached to them, such rights to be stipulated in the statutes (preference shares). Preference shares, with the exception of non-voting shares, shall be registered shares. Such privileges may concern in particular the right to vote, the right to dividends or participation in the division of assets in the case of liquidation of the company. Such privileges in respect of the right to vote shall not apply in the case of a public company (Art 351 of CCPC). A single share may carry no more than two votes. In the event that such a share is changed into a bearer share or disposed of in breach of certain reserved conditions, the privilege shall expire (Art 352 of CCPC). While shares which are preference shares in respect of dividends may entitle the rightholder to dividends which exceed by no more than half the dividends, designated to be paid out to the shareholders entitled to non-preference shares. Shares which are preference shares in respect of dividends shall not enjoy priority of satisfaction over the remaining shares (Art 353 of CCPC).

Since the Polish system of corporate governance is characterized by the high concentration of ownership, the main conflict of interests exists between majority and minority shareholders. In these circumstances, majority shareholders are able to extract personal benefits from control (Dyck and Zingales, 2004; Renders and Gaeremynck, 2012). Hence Code of Commercial Partnerships and Companies of 2000 in Poland imposed a number of regulations protecting minority shareholders:

- Upon an application of the shareholders, representing at least one fifth of the share capital, the election of the supervisory board shall be made by the next general assembly by way of a vote in separate groups, even if the statutes provide for a different procedure for appointing the supervisory board (Art 385 of CCPC).
- The shareholder or shareholders representing at least one twentieth of the share capital may request that the extraordinary general assembly be convened, as well as that certain matters be placed on the agenda of that assembly, the statutes may authorize shareholders representing less that one twentieth of the share capital to request that the extraordinary general assembly be convened (Art 400 of CCPC).
- The shareholder or shareholders representing at least one twentieth of the share capital may request that certain matters be placed on the agenda of the next general assembly. The request shall be submitted to the management board not later than fourteen days prior to the scheduled date of the assembly. That deadline shall be twenty-one days in the case of a public company. The request shall include a justification or a draft of the resolution concerning the proposed item on the agenda. The request may be submitted electronically (Art 401 of CCPC).
- The attendance list, with the names of those participating in the general assembly, together with the number of shares represented by each of them and the number of votes, signed by the chairperson of the general assembly, shall be drawn up immediately after the election of the chairperson and shall remain displayed during the deliberations of the assembly. Upon a motion of the shareholders, representing one tenth of the share capital represented at the general assembly, the attendance list shall be checked by a committee elected for that purpose, which committee shall comprise at least three persons. The persons who propose the motion may elect one member of the committee (Art 410 of CCPC).
- A majority of two-thirds of the votes shall be required for the adoption of a resolution on a major change of the objects of the company. For the resolution to be effective, shareholders who do not agree to the change shall have their shares bought out. The shareholders present at the general assembly who voted against the resolution shall, within two days of the general assembly, and those absent – within a month of the date on which the resolution is announced, deposit with the company their shares or certificates proving that such shares have been deposited at the disposal of the company, otherwise, such shareholders shall be deemed to have agreed to the change (Art 416 of CCPC).
- In case of buy out the shares shall be bought out at the price quoted on the regulated market, at the average rate of the last three months prior to the adoption of the resolution or, where the shares are not quoted on the regulated market, at the price determined by an expert appointed by the general assembly. Should the shareholders fail to appoint the expert at the same general assembly, the management board shall, within one week of the date of the general assembly, request that the registry court appoint the expert so that shares subject to the buyout can be valued. The statutes may provide for a change in the objects of the company without the buyout if the resolution is

adopted by a majority of two-thirds of the votes, in the presence of persons representing at least half of the share capital (Art 417 of CCPC).

- A resolution of the general assembly which contravenes the statutes or good practices and harms the interests of the company or is aimed at harming a shareholder may be challenged in an action brought against the company for an annulment of the resolution. The following parties shall have the right to bring an action for an annulment of a resolution of the general assembly:

  1) the management board, the supervisory board, and their individual members,

  2) a shareholder who voted against the resolution and, following its adoption, requested that his objection be recorded in the minutes; the requirement as to the voting shall not apply to a holder of a non-voting share;

  3) a shareholder who, without valid reason, was not allowed to participate in the general assembly;

  4) the shareholders who were not present at the general assembly; however, only where the general assembly was wrongly convened, or where the resolution concerned a matter not included on the agenda.

- The general assembly may adopt a resolution on a forced buyout of shares of the shareholders representing not more than 5% of the share capital (minority shareholders) by not more than five shareholders, holding jointly not less than 95% of the share capital and where each of them holds not less than 5% of the share capital. The resolution shall require a majority of 95% of the votes cast. The statutes may provide for stricter requirements for the adoption of the resolution. The shareholders who are to buy the shares out and who voted in favour of the resolution shall be jointly and severally liable towards the company for the payment of the entire buyout sum (Art 418 of CCPC).

- A division of a company shall require a resolution of the general meeting or general assembly of the company being divided and each of the acquiring companies, such resolution to be adopted by a majority of three fourths of the votes, representing at least half of the share capital, unless the articles of association or the statutes provide for stricter requirements. A division of a public company shall require a resolution of the general assembly adopted by a majority of two-thirds of the votes, unless the statutes provide for stricter requirements. In the case where there are different classes of shares in a company involved in a division, the resolution shall be adopted in a vote held separately for each class of shares (Art 541 of CCPC).

2.1.8. Shareholder Activism

Shareholder activism can be described on the basis of actions taken by institutional and individual investors. Institutional investors are one of the most influencing groups of shareholders around the world, but the findings on their role in corporate governance are ambiguous. On the one hand institutional investors are perceived as having the ability to cope with agency problem and exercise influence that successfully pressures firms to make appropriate long-term investments (David *et al.*, 2001), but on the other hand, they are perceived rather as passive and uncommitted (Tilba and McNulty, 2013).

It is similar in Poland. Słomka-Gołębiewska (2015) indicated that institutional investors sometimes seek to contact the supervisory or management board's members if they are dissatisfied with a performance of investee company, but none of them even considers public criticism or litigation. But institutional investors in Poland create their own corporate governance guidelines, improve standards of corporate governance and set up the organization which represents their interests (Słomka-Gołębiewska, 2010). E.g. there was established the Chamber of Fund and Assets Management, which represents the investment fund companies environment, as well as the Polish Private Equity and Venture Capital Association, which represents the interests of the private equity and venture capital community.

In addition, the Association of Individual Investors which supports individual shareholders was set up in Poland (Stowarzyszenie Inwestorów Indywidualnych, SII). This association was established in 1999 and now is the member of Euroshareholders, Euroinvestors as well as the World Federation of Investors. The Association of Individual Investors has more than 11 000 members. Its activities are: organizations of conferences and trainings, publishing of periodicals, stock market analysis, protection of investors 'rights, current interventions, legal support, participation in general public companies' meetings, opinion-making activity and influencing the legislative process, discounts offered by the association's partners to its members, e.g. commissions, publications, training.

Generally, shareholders activism in Poland continues to evolve. In view of this, Balewski (2016) highlighted that the Polish system of corporate governance still evolves and it can be expected that the progressive solutions will be undertaken. These solutions will address some problems of corporate governance, also in relation to shareholders activism.

2.1.9. Corporate Social Responsibility

Nowadays corporate social responsibility is a subject of great interest of academics and practitioners. Also, Polish leading universities deliver programs and courses on CSR for master and postgraduate students (Wołczek, 2014). Interest in CSR has grown gradually. Hys and Hawrysz (2013) underlined five stages in its development in Poland:

- the period of embryonic development (1997-2000), described as a stage of silence and complete lack of interest;
- the stage of "awakening" (2000-2002), when the idea of CSR aroused reservations or even opposition among business leaders or publicists;
- the stage of interest (2002-2004), at this stage burst of interest in the idea of CSR took place and leading companies publicly were recognizing the importance of rules of ethics and social responsibility;
- the stage of activity (2004-2005), at this stage specific projects in some, crucial for the functioning of companies, areas were implemented;
- the stage of advanced activities (since 2006), at this stage the aim is to link CSR to other strategies.

The research by KPMG (2014) showed that Polish managers of large and medium companies are aware that CSR is important for their companies. 71% of them believes that companies should report on non-financial outcomes and 77% that CSR positively affects company performance, buy on the other hand this study indicated that only 46% of these companies carry out CSR activities.

Some CSR initiatives have been undertaken in Poland, including Responsible Business Forum and the Respect Index. Responsible Business Forum operates since 2000 and is the think-and-do-tank organization. Its main aim is the promotion of corporate social responsibility in Poland and its main activities comprise: helping businesses develop their social responsibility, building businesses coalition that focuses on solving social problems, creating a forum where managers, the state administration and nongovernmental organizations can exchange information on CSR, promotion of corporate social responsibility solutions adequate to the needs and capabilities of companies in Poland. Responsible Business Forum co-operates with CSR Europe, World Business Council for Sustainable Development, Global Reporting Initiative, Business in the Community, and CSR 360 Global Partner Network (http://odpowiedzialnybiznes.pl/english/). Moreover, from 2007 Responsible Business Forum organizes also the Social Report Competition. In this competition awards are granted for the CSR reports. This initiative promotes CSR, sustainable development and environmental protection. Its main aim is drawing attention to non-financial reporting (http://raportyspoleczne.pl/informacje-o-konkursie/).

In 2009 the Respect Index was established. That is the first CSR index in Central and Eastern Europe. The main aim of the Respect Index project is the identification of responsible and sustainable public companies, which also are characterized by high quality reporting and well-developed investor relations. Similarly to other WSE exchange indices (e.g. WIG), this index represents a real reference for professional investors; hence companies comprised by the index should be attractive to investors and have growth potential (http://www.odpowiedzialni.gpw.pl/root_en).

The important role in the development of CSR in Poland is also played by ISO 14000 norm and ISO 26000 norm. E.g. ISO 26000, which was titled *Guidance on social responsibility*, defined the principles of social responsibility in several areas (organizational governance, human rights, labor practices, the environment, fair operating practices, consumer issues, community involvement and development). These principles comprise: accountability, transparency of actions, ethical behavior, respect for stakeholder interests, respect the rule of law, respect for international norms of behavior and last but not least, respect for human rights (Hys and Hawrysz, 2013).

Although some initiatives on Corporate Social Responsibility are established in Poland, academics and practitioners are aware that CSR is still underdeveloped. K. Wołczek (2014) underlined that the development of the CSR concept in Poland is still at an early stage and some of the areas are developing slightly more dynamically than others, but some are still characterized by stagnation.

2.1.10. Conclusions

According to Weimer and Pape's (1999) taxonomy, the Polish system of corporate governance is regarded as a Germanic one (Jeżak, 2010), although Aggestem (2004) described it as a mixture of market-oriented system (Anglo-Saxon) and network oriented system (Germanic). At the same time she indicated that in contrast to the German system, the Polish one is characterized by the short term time horizon of the economic relationship. Moreover, unlike Germany, there is also no codetermination law in Poland. But the Polish system of corporate governance, like other Germanic systems, is characterized by concentrated ownership, a two-tier board model and a moderately active market for corporate control.

It should be also underlined that the accession to the European Union was very important for the development of the Polish system of corporate governance. From this accession the capital market and system of corporate governance have started to integrate with the markets and systems of other EU countries (Kachniewski *et al*. 2008). But the process of total convergence with other EU countries seems to be doubtful. Tricker (2015) underlined that between countries, also the EU countries, there are legal differences in company law, contract law and bankruptcy law, different standards in legal processes, stock market differences (e.g. capitalization or liquidity), differences in the market for control, differences in ownership structures, historical differences and expectations and also cultural differences. Despite this, today the Polish system of corporate governance is still the subject of changes especially shaped by EU directives and resolutions or influenced by political environment. E.g. there have recently been enacted the provisions of the Market Abuse Directive (MAD II) and the Market Abuse Regulation (MAR), which aim to increase market integrity and investor protection.

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2.2. CORPORATE GOVERNANCE IN GREECE

Kontogeorga N. Georgia
Georgios L. Thanasas
Smaraidos Sp. Vassilis

2.2.1. Overview of the Legal Framework of Corporate Governance in Greece

Corporate Governance is defined as the "procedures and processes according to which an organization is directed and controlled" (ECB 2004). Its purpose is to help build an environment of trust, transparency, and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies (OECD, 2015).

In Greece, the corporate governance framework has mostly developed through the adoption of mandatory legislation or regulation, most importantly Law 3016/2002, as well as through a number of discreet legislative acts, which transposed several European directives into the Greek legal framework, establishing new corporate governance rules. Moreover, Law 2190/1920 on companies limited by shares, "Societes Anonymes", (as amended by Law 3604/2007) contains core governance rules (HCGC, 2013).

More specifically, Law 3016/2002 (as amended by article 26, Law 3091/2002) "On corporate governance, board remuneration and other issues" mandates the participation of non-executives and independent non-executives on the boards of Greek listed companies, as well as the establishment of an internal control function and the adoption of internal regulations.

Furthermore, Law 3693/2008 (as amended by Laws 4144/13, 4336/15 and 4449/17) "Harmonization of Greek Legislation to the provisions of European Directive 2006/43/EC on statutory audits of annual and consolidated accounts" which requires the creation of audit committees and imposes a number of significant disclosure obligations on companies' ownership and governance.

Another law, which transposes European directive into the Greek legal framework, is Law 3884/2010 "Incorporation into Greek law of Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies", which includes further obligations regarding disclosure of information to shareholders.

Law 3873/2010 "Integration into Greek law of Directive 2006/46/EC of the European Parliament and of the Council on the annual accounts and consolidated accounts of certain types of companies and Directive 2007/63/EC of the European Parliament and of the Council requiring a report by independent experts in case of merger or division of public limited companies" incorporates provisions addressing to some extent any financial irregularities by promoting greater disclosure and transparency in companies' and group financial statements and reports, while further facilitating cross-border investments by simplifying merger or division procedures.

What is more, the following, basic capital market rules and regulations also apply to listed companies:

Law 3401/2005 on the prospectus issued in the case of public offer of securities (implementing Directive 2003/71/EC on the prospectus to be published, when securities are offered to the public or admitted to trading), Law 3461/2006 on optional and mandatory public takeovers (implementing Directive 2004/25/EC on takeover bids) and the Athens Stock Exchange Regulation (codified version dated 16 August 2011, as approved by Hellenic Capital Market Commission Decision No. 594/19 August 2011) (Yannikas , 2017).

In addition, a number of important efforts have been made in the past to define best practices for corporate governance in Greece. In 1999, the Hellenic Capital Markets Committee (HCMC) produced a White Paper titled "Principles on Corporate Governance in Greece – Recommendations for its Competitive Transformation", also known as the "Blue Book", which was closely modeled on the OECD Principles. SEV (Hellenic Federation of Enterprises) also developed a limited number of broad corporate governance principles in its "Principles of corporate governance" published in 2001 (HCGC, 2013, p.3). However, Greece was the only country in the European Union (EU) that did not have a widely endorsed and applied "comply or explain" corporate governance Code setting out standards of good practice for corporate governance.

What is more, the Bank of Greece Governor's Act 2577/9.03.2006 as in force, includes a framework of operational principles and criteria of the Organization Corporate Governance Framework and Internal Control Systems of credit and financial institutions, and relevant powers of their management bodies (Delloitte Greece).

Finally, the Hellenic Corporate Governance Council (a joint initiative of the Athens Stock Exchange and the Hellenic Federation of Enterprises (SEV)) published on June 28, 2013 the "Hellenic Corporate Governance Code for Listed Companies (HCGC)". The Code aims "at promoting the continuous enhancement of the Greek corporate institutional framework and broader business environment as well as the improvement of the competitiveness of its members and of the Greek economy as a whole" (HCGC, 2013).

2.2.2. Ownership Structures of Companies in the Country

The share of global market capitalization held by countries classified as having dispersed ownership is no longer dominant. The market share of countries with concentrated ownership structures has increased from 20% to 34%, since the adoption of the Principles of Corporate Governance in 1999.

Regardless of the country classification, there is a wide diversity in ownership structures of individual companies in each country, and the ownership characteristics in each country have changed over time (OECD, 2017).

In general, the Greek stock market is mostly dominated by family-controlled firms. Spanos (2003), mentions that "in Greek listed companies, like in other European countries, ownership is concentrated. Large families usually control most of the companies and members of the controlling families usually serve as the top manager", while Kapopoulos and Lazaretou (2007) argue that the Greek listed firms cannot be considered as having a diffused ownership structure, though the dispersion of shares is rather low. Authors studied profitability-based performance using data for 175 Greek listed firms. Their findings imply that few shareholders control the firm's management. They also provide evidence that medium- and small-sized firms are usually controlled by a family and there is no separation of ownership and control.

In their research, Lazarides, Drimpetas, and Koufopoulos (2009) seem to confirm this conclusion. According to the authors, members of the family or the controlling group are actively involved in management. If managers are not members of the family or the controlling group, they are closely connected with these groups and their decisions are subjected to their control and monitoring. What is more, institutional investors are not actively involved in managing or in controlling and monitoring the decisions and actions of the controlling group.

Within this context, we could argue that Greek firms, in their large majority, are mainly family-controlled. However, regarding the banking sector, the situation seems to differ. According to recent OECD data, the listed banks are mainly characterized by dispersed ownership. At the end of 2012, of the 256 companies listed on the ATHEX, 212 companies (82.8%) were groups (OECD, 2017, p.12).

2.2.3. Market for Corporate Controls (M&A)

Companies in the global economic environment are forced to adapt to the new era by implementing new management practices, modifying their productive processes, and developing new projects through strategic partnerships introducing new activities. As Tampakoudis et al (2011) note, both economic globalization and business internationalization rapidly change bearing their impact on the level of competition. In other words, companies worldwide follow the new era of popular practices such as mergers and acquisitions, aimed at improving competitiveness and increasing market power by reducing production costs and giving access to quality raw materials to innovate their technology.

Although, mergers and acquisitions are not considered a new phenomenon, as business consolidation has already been applied in the previous century, the number of mergers between companies has increased over the years. The global context and the current financial crisis have contributed to all the above (Andrade and Stafford, 2004, Bruner, 2002).

According to Tampakoudis et al (2011), "In Greece, mergers and acquisitions demonstrate a recent upward trend with the number and value of corporate combinations increasing steadily, indicating, in turn, positive future prospects". As the business environment denotes, international and domestic factors introduced the framework in Greece for the increase of mergers and acquisitions and furthermore set the appropriate grounds for future development.

Since Greece is a member of the European Union and the Eurozone, it is easy for international investors to invest in the domestic market. International funds, according to the standards of European laws, provide alternative financing methods with low interest rates and increasing liquidity through financial institutions and funds. On the other hand, the domestic market underwent major reforms, introducing market liberalization, harmonizing Greek accounting standards to International (IFRS), privatizing parts of the public sector and modifying legislative codification. All the above assisted in developing an active and modern market as regards corporate control.

2.2.4. Board of Directors Practices

According to the general principle, "the board should provide effective leadership and direct the company's affairs to the interest of the company and all shareholders, ensuring that the management properly implements the company's strategy. The board should also ensure the fair and equitable treatment of all shareholders, including minority and foreign shareholders" (HCGC).

Members of the Board

Greek AEs have a one-tier board, consisting of directors. Greek company law does not set upper limits on the size of the board. According to best practices "the size and composition of the board should enable the effective fulfillment of its responsibilities and reflect the size, activity, and ownership of a company" (HCGC, 2013, p.30).

The Law requires a minimum of three members and allows shareholders to determine board size in statutes. Best practices suggest "that the board's size and composition should reflect a balance between executive, non-executive and independent non-executive members such that no individual or group can dictate decision-making on the board of a listed entity" (HCGC, 2013).

More specifically, article 3 of law 3016/02 (as amended by Law 3091/02) states:

"1. The board of directors is composed of executive and non-executive members. Executive members deal with daily company management issues, while non-executive members are charged with addressing all company issues. The number of non-executive members of the BoD should be smaller than 1/3 of the overall number of members. Should this number happen to be a fraction, it is rounded to the next integer. There should be at least two independent members among the non-executive members. Independent members are not mandatory when representatives of the minority of shareholders are expressly named and participate in the BoD.

The BoD defines which members are executive and non-executive. Independent members are appointed by the general meeting. Should a temporary member be elected by the BoD until the first general meeting as a replacement for another non-executive member that resigned, passed away or was revoked for any reason, the elected member should also be independent".

Independence

Independent non-executive members should be free of material conflicts of interest with the company and not have close ties with the management, controlling shareholders or the company. During their tenure, independent non-executive members are not allowed to hold more than 0.5% of the company's share capital or to have a relation of dependence with the company or persons related to the company. Independent members are appointed by the general meeting of shareholders. The board should determine whether individual candidates are independent before they are proposed for election by the general meeting of shareholders.

According to the SCGC and Law 3016/2002, a board member is not independent if he:

- Is or has been an employee, senior executive or chairman of the board of the company or its subsidiaries within the last three years (Law 3016/2002);
- Receives or has received during the 12 months prior to his appointment any compensation from the company other than the board membership fees approved by the general meeting of shareholders;
- Has or has had within the past year a material business relationship with the company or its subsidiaries, particularly as a significant client, supplier or consultant of the company, or as a partner, shareholder, board member or senior executive of an entity that has such a relationship with the company or its subsidiaries (Law 3016/2002, article 4);
- Has been the external auditor of the company or its subsidiaries or has been a partner or employee of a firm that provides external auditing services to the company or its subsidiaries within the last three years;
- Has a second-degree kinship with or is the spouse of a non-independent board member, senior executive, adviser, or significant shareholder of the company or its subsidiaries (Law 3016/2002, article 4);
- Controls directly or indirectly through related parties more than 10% of the voting rights of the company or represents a majority shareholder of the company or its subsidiaries;
- Has served on the board for more than 12 years from the date of his first election" (Yannikas, 2017).

Consequences of Breaching the Provisions of Law 3016/02

In case of non-observance of the obligations of Law 3016/02, the Hellenic Capital Market Commission may impose on the members of the Board of Directors (or any other person, whether or not a member of the Board of Directors, to whom the relevant powers of the Board have been delegated, a reprimand or fine from three thousand up to one million euros (L. 3756/09).

Appointment/Removal of Directors

Board members are generally elected by the shareholders' meeting, unless they are appointed by certain shareholders named in the articles of association (for example, certain minority shareholders). The SCGC recommends that the board provide a list of nominees for approval by the general meeting of shareholders, accompanied by adequate and timely information on the nominees. Greek company law limits the term of board members to 6 years. The Code follows best practices in recommending that board members be submitted for election or re-election by shareholders every 4 years. The Code also aims at ensuring that the board knows the company and understands its business to a satisfactory level.

Board members elected by the shareholders' meeting can be freely removed by a shareholders' resolution before the lapse of their term. Board members appointed by certain shareholders under the articles of association can be removed by those shareholders (Yannikas, 2017).

Restrictions

Members of the management or supervisory board cannot be less than 18 years old, but there is no maximum age limit. In addition, there are neither nationality restrictions, nor statutory gender requirements. However, good CG practices, as described in the Code, suggest “that the board should be diversified as to gender and the company should pursue the optimum diversity, including gender balance, in the composition of its board and senior executive team”.

Directors' Remuneration Practices

The level and structure of remuneration should aim to attract, retain and motivate board members, executives and employees who will add value to the company with their skills, knowledge, and experience. Board members' remuneration is determined by the articles of association and the shareholders' meeting. Under the SCGC, the board should establish a remuneration committee composed entirely of non-executive board members, the majority of whom should be independent. The remuneration committee should, among other things, be responsible for:

- Proposing the remuneration of each individual executive board member to the board, including bonuses, incentive payments, and share options;
- Reviewing and making proposals to the board on the total annual package of variable compensation in the company;
- Reviewing and making proposals to the board (and, through the board, the general meeting of shareholders, when required) on the company's share option and/or share award programs;
- Regularly reviewing the salary of executive board members and other contractual terms, including severance payments and pension arrangements (Yannikas, 2017).

In addition, good CG practices and the SCGC suggest that the remuneration setting process should be performed with objectivity, transparency, and professionalism, and be free from conflicts of interests. The remuneration of executive board members should be linked to the corporate strategy and should be aligned with the company’s objectives, as well as its aim to create long-term value. Accordingly, executive remuneration should ensure an appropriate balance between:

- fixed components (i.e. basic salary);
- variable performance-related components including annual cash bonus payments and, when deemed necessary, share-related long-term incentives (i.e. restricted shares with lock-in period (restricted shares are those on which transfer restrictions apply over a specific period), stock options and comparable instruments);
- Other contractual arrangements such as pension, severance payments, significant fringe benefits (including in-kind benefits) and other awards (HCGC, 2013, p 24).

Shareholder's Rights Protection

Greek law is based on a mandatory principle dictating that each share holds one vote in the Shareholders' General Meeting, with the exception of preferred shares, that may be issued with limited voting rights and even with no voting rights (Law 2190/20, art. 30, par.1)

It is marked that Law 3604/2007, allows shareholders to participate in the meetings through teleconference, and introduced cumulative voting in order to elect the board of directors through separate candidate lists (58), as well as voting by proxies (Law 2190/20, art.28, par. 6 and 7).

According to Greek law, shareholders hold the mandatory right of participation in the distributions of each year's net profits. This right sets the participation ceiling to less than 35% of the net profits after deductions for the formation of ordinary reserves, unless a minimum of 65% of the shareholders of the paid up share capital decide differently. The remainder of the net profit is used according to the provisions of specific law and in case such a provision does not exist, all profits must be distributed to the shareholders. The only case when the remaining net profit is not distributed is in cases when the company requires additional internal funding or if the shareholders' meeting decides otherwise (Law 2190/20 art. 45). After liquidating the net profits, the shareholders are entitled to the amount of the liquidation according to the nominal value of their shares.

The shareholders hold the right to request from the board of directors that the amounts paid to each member of the company's board or managers in the course of two previous years be disclosed at the ordinary annual meeting. Moreover, all the benefits granted to those persons for any reason and the contracts signed between them and the company must be disclosed.

Additionally, the shareholders have the right to request from the court to conduct an extraordinary audit of the company and also request that the decisions of the shareholder meetings be taken via roll call voting. Furthermore, a shareholder holds the right to request from the board of directors to make the draft resolution on of the meeting's agenda subjects available to all. During the ordinary meeting, any shareholder in Greece has the right to request from the board of directors to provide him with information that is useful for the assessment of the meeting's agenda.

It is essential to note that, during the annual meeting, the shareholders representing at least 20% of the paid up capital may request from the board to provide them with all the information about the company subject-matters and the financial statement of the company. Moreover, during the annual meeting, shareholders representing at least 10% of the paid up capital may request from the board to provide all the actions that damage the company, while shareholders representing at least 2% of the paid up capital may request from the court the annulment of the decision, made at the shareholders' annual meeting. Additionally, the shareholders may block decisions on the annual meeting regarding the transactions between the company and conflicted persons and request reduction on directors' benefits.

Finally, there is a provision on minority shareholders in Greek law. To this end, the Greek State adopted the so-called "Minority Rights". According to those rights, at least 5% of the shareholders representing the paid-up capital may request the convocation of an extraordinary meeting and set the meeting's agenda. The same percentage allows shareholders to request the introduction of an issue to the agenda of the meeting already set by the board of directors. Additionally, they can ask to postpone the shareholders' meeting convened by the board of directors:

- Law 2190/20, art. 30 par.1
- Law 2190/20, art. 28, par. 6 and 7
- Law 2190/20, art. 45

2.2.5. Shareholder Activism

Shareholder activism is an act that is applied mostly to companies listed on the stock exchange and involves the active participation of minority shareholders within the company. The rationale behind shareholder activism relates to monitoring the level and quality of Corporate Governance applied by each company in respect of the company's shareholders (Cossin & Caballero, 2013).

Shareholder activism is a new trend aiming to defend the Capital Market on one hand, and on the other hand in creating share profitability. This act, dictates the implementation of Corporate Governance practices, which increase the company's value and consequently that of its shares. The above ensures the consolidation of the company and the profitability of the investment portfolio of shareholders (ICR, Corporate Governance White Paper, 2008).

Although Greece is a developed country and follows the European acquis by adopting the European laws and directives, shareholder activism still remains in an infant stage. In 2016, the Hellenic Investors Association (SED), introduced shareholder activism in Greece and began promoting this act to protect shareholders in the country. Moreover, the Hellenic Capital Market Commission strongly supported this act in order to inform shareholders in Greece regarding Shareholder Activism and force them to organize themselves and support their interests and rights.

Besides the acts of the Hellenic Investors Association and some of the Hellenic Capital Market Commission, no major events of Shareholder Activism have been reported in Greece.

2.2.6. Corporate Governance and Firm Performance

Corporate governance provides a framework for firm practices and behavior. Its purpose is to create an atmosphere of trust among the four groups involved, namely:

- the shareholders;
- the Board of Directors;
- the management acting in an executive capacity;
- the remaining members who have an interest in the firm, such as the stockholders, the creditors, the government, etc.

Insufficient rules of corporate governance have led large firms to economic scandals, mainly due to illegal acts of top financial executives. In turn, their actions destroyed the trust that existed between the investors and the firms and magnified the precariousness in international markets.

In Greece, there were no large financial scandals such as Enron in USA (or similar), but the Stock Exchange has lost its credibility towards investors who have lost trust in the financial decisions of management teams of listed firms.

Most of the listed companies in Greece do not have adequate corporate governance mechanisms. Listed companies' ownership concentration remains high, which has created a strong bond between the main shareholder and the management team. Family firms are still predominant in the Greek capital market. Internationally recognized Board structures, such as board committees, or issues regulating the director's independence and qualifications, and the education of the director have yet to be addressed in most sectors, with the exception of the banking sector, which is the oldest sector in Greece (over 100 years) (Tsifora & Eleftheriadou, 2007).

Usually, the board mainly works as a non-active component in the company, complying with managerial decisions. Non-executive board members do not monitor the management effectively, in lieu of acting as shareholder agents. This is the situation in most of the (family-owned) public companies in Greece; It is quite widespread that the Board serves the interests of the family rather than the firm.

Although regulations define certain requirements concerning board independence, it is hard to decipher whether the board actually fulfills these demands. The point that listed companies should acknowledge is that a well-operating board holds a highly competitive advantage in the business world. What this indicates is that is that the greatest obstacle family–owned listed firms need to overcome is revising their Corporate Governance policy, introducing modern standards and establishing appropriate ratios between the private and public firm's about provided agency costs.

Many studies examine the mechanisms of corporate governance in publicly traded Greek firms, and check the connection between their governance standards and the performance of the firm. Out of the total set of principles in corporate governance, four different performance ratios have been selected, that is, Tobin's Q, ROA, NPM, and EBITDA margin. Apart from the classical firm-specific factors that have been examined as potential firm performance determinants (e.g., age, size, liquidity, leverage) we also included corporate governance mechanisms such as the board size and composition, leadership structure and auditing. Our results highlight the importance of board size and board independence as the two governance characteristics that enhance corporate profitability.

However, the role of these governance mechanisms weakens during the crisis, while auditing by Big 4 auditors seems to provide the appropriate impetus for corporate performance. Regarding firm- specific determinants of corporate performance, we see that the effect of leverage on performance is strengthened during the crisis. This result is not a surprise in the sense that the Greek debt crisis was swiftly linked with a disruption in bank lending and exclusion from international financial markets. In addition to leverage, liquidity is another significant determinant of profitability during the crisis.

Companies with an expanding Board of Directors achieve better internal control of the firm and hence perform better than companies with a smaller number of members in the Board of Directors. Also, firms which introduce corporate governance systems are characterized by high profitability ratios.

Furthermore, firms with an expanded group of shareholders do better than firms with a small group of shareholders or family-owned firms. In brief, the study strongly suggests that firm performance is in direct relation with corporate mechanisms.

2.2.7. Corporate Social Responsibility

Directive 2003/51/EC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings provides for the disclosure of certain non-financial social, environmental and ethical issues. This obligation has been implemented in Greece for large SAs. For these companies, the annual management report must include information on non-financial performance indicators (in particular, environmental and employee issues).

Greece's economic downturn has affected donations, charity and philanthropy budgets of domestic firms severely affected by the crisis, mostly those that superficially adopted CSR, exclusively for purposes such as public image and marketing enhancement. Companies that have engaged in CSR from a strategic perspective will probably continue to support their voluntary policies, programs and practices as in this case '(...) the success of the company and the success of the community become mutually reinforcing' and '(...) the more closely tied a social issue is to the company's business, the greater the opportunity to leverage the firm's resources and capabilities, and benefit society' (Skouloudis, Evangelinos, Nikolaou, & Leal Filho, 2011)

2.2.8. Brief Industrial Specifics of CG in the Country

The implementation of corporate governance in Greece was sharply exercised about two decades ago. The structure of the traditional Greek firm is purely based on family ties, which, consequently, makes adaptation to the general principles of corporate governance difficult. Nevertheless, the banking sector (the oldest in Greece with more than 100 years of activity), the shipping industry, the construction industry, the refinery and the fuel sector, due to the nature of their large-scale financial operations and activities, are highly extrovert and have adopted the general principles of corporate governance.

Today the traditional Greek firm is operating in an unfavorable economic and highly competitive environment. There is an overriding need to reorganize its functional and organizational structures.

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2.3. CORPORATE GOVERNANCE IN TURKEY: CG APPLICATIONS FOLLOWING THE GLOBAL FINANCIAL CRISIS

Dilvin Taşkın
Ece Erdener Acar

2.3.1. Introduction

From a broad perspective, corporate governance is a system of laws, rules, and factors that control operations of a company (Gillan and Starks, 1998). More specifically, La Porta et al. (2000) defines corporate governance as *"a set of mechanisms through which outside investors protect themselves against expropriation by the insiders"*. On the other hand, again from a financial perspective, corporate governance is defined as a mechanism dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments (Shleifer and Vishny, 1997). Beyond the definition, it is very clear that separation of ownership and control between capital providers and those who manage the capital created the demand for corporate governance structures (Gillan, 2006). Therefore, corporate governance structure and quality of corporate governance in a country is directly affected by country factors such as the quality of laws, the depth and liquidity of securities markets, the quality of banking system, the level of enforcement, disclosure infrastructure and culture (Ararat and Orbay, 2006) as the capital providers and the parties who manage the capital differs among countries depending on the institutional and legal environment. Thus, from a legal point of view aim of corporate governance structure is to mitigate the conflicts between management and owners in common law countries mainly in countries with high investor protection; where it mitigates the conflicts between majority and minority shareholders in code law countries in which investor protection is poor.

Considering that Turkey an emerging economy and a code law country primarily depending on bank monitoring, large blockholders and concentrated ownership this chapter aims to put forward the corporate governance structure in Turkey considering the global financial crisis. The overall structure of the chapter is as follows: the structure and development of corporate governance in Turkey are explained in the first part in details. After that, the second part of the chapter focuses on the special issues, aftermaths of the crisis, the developments in the corporate governance applications and finally, an analysis is provided that concentrates on the impacts of corporate governance traits and the global crisis on operating performance of Borsa Istanbul manufacturing companies.

2.3.2. Corporate Governance Practices in Turkey

Corporate management practices have gained valuable attention in recent years with its moderating role on information asymmetry and agency problems, therefore, influencing financial crisis and company scandals that broke out in recent years. Due to the high desire to improve utilization of opportunities in the financial area of domestic financial markets, countries are harmonizing their legislation with the international level and realize a set of regulations.

Representing a developing economy's capital market, Turkish capital market is practicing corporate governance regulations especially in order to attract foreign capital investment, increase competitive power of the economy and capital markets and overcoming the crisis with less damage. Within this context following the current practices worldwide Capital Markets Board (CMB) in Turkey pioneered the improvements to the framework for corporate governance and issued Corporate Governance Principles in July, 2003 (which is amended in 2005), aiming to improve shareholders rights and provide equal treatment to all; enhance financial reporting quality regarding disclosure and transparency issues; regulate the relationship between the stakeholders and company; and improve structure of board of directors. Not only issuing corporate governance principles was enough for the improvement of a legal and institutional framework for good management practices, but also in line with international standards again CMB in Turkey upgraded accounting, reporting, and auditing standards. In 2005, use of International Financial Reporting Standards (IFRS) became mandatory for listed companies that would also light the way for governance issues in Turkey.

Moreover, the Turkish Commercial Code has had significant effects on regulating business life, thereby corporate management practices in Turkey. Turkey is a code law country whose commercial code was derived from the French Commercial Code with the influence from German, Italian and Swiss Commercial Codes in the early republican era. From this point of view one of the main problems affecting corporate management practices in Turkey is the inconsistencies between commercial code and capital markets law. Commercial Code of Turkey was under the effect of French code law which has least protective minority shareholders' rights (La Porta, 1998) hence code law countries with poor investor protections indeed have significantly smaller debt and equity markets (La Porta et.al., 1997). On the other hand, Capital Markets Law is under the effect of Anglo-Saxon culture. However, the complete the big picture of improvement for corporate governance commercial code was in turn replaced by a new commercial code, effective from July 1, 2012, which redefines the rules bounding commercial, financial and capital markets in Turkey.

In the below table the summary of Turkish corporate governance regime highlights is provided in the context of corporate governance principles.

The first section of CMB Codes of Corporate Governance discusses the principles on shareholders' rights and their equal treatment. Issues such as shareholders' right to obtain and evaluate information, right to participate in the general shareholders' meeting and right to vote, right to obtain dividend and the rights of minority shareholders are included in detail in this section. Matters such as keeping records of shareholders and the free transfer and sales of shares are also discussed hereunder.

Table 2.3.1. Corporate governance issues in Turkey

Ownership and Control Structures	*Shareholders' Rights*	*Transparency*
• Lack of central company registrar • Weak disclosure regulations on the transparency of ownership • Weak risk management and internal audit practices • Poor reporting on connected lending, transfer pricing and related party transactions, and on identity of insiders • Weak contractual status of employees and professional managers • No disclosure requirements on privately entered share purchase agreements or shareholder agreements	• Inefficient Judiciary (lack of private enforcement) • No role for shareholders in major asset transactions • Weaknesses in regulations related to preemptive rights and mandatory bidding • Legal barriers to shareholder activism • Wide use of privileged share classes and share groups • Lack of independent research	• Poor accounting and reporting standards (except publicly owned companies and banks) • Weaknesses in financial reporting especially in relation to consolidation • Delays in disclosure of material events (which does not include consolidated entities) • Limited audit capacity • Lack of credible non-financial information disclosure

The second section discusses the principles regarding disclosure and transparency of information. Within this scope, principles for the establishment of information policies in companies with respect to shareholders and the adherence of companies to these policies are discussed. The conditions of today's global financial economy and circumstances faced in Turkey have been taken into consideration while setting single standards for the procedures for providing information via periodic financial statements and reports and detailing such standards through consideration of functionality.

The third section is mainly concerned with stakeholders. A stakeholder is defined as an individual, institution or an interest group that is related to the objectives and operations of a company in any way. Stakeholders of a company include the company's shareholders and its workers; creditors, customers, suppliers, unions, various non-governmental organizations, the government and potential investors who may consider investing in the company. This section includes the principles, which regulate the relationship between the company and stakeholders.

The fourth section includes principles concerning functions, duties, obligations, operations, and structure of the board of directors; remuneration thereof, as well as the committees to be established to support the board operations and the executives.

Borsa Istanbul provides a mean to measure the compliance of the companies to corporate governance codes and provide a corporate governance index measure. Being listed under corporate governance index is not obligatory, but still, the exchange offers huge discounts on the shelf registration and registration fees if the company is listed in the index.

Five independent rating agencies monitor the compliance of the companies with the corporate governance practices. First, the rating agency analyzes the current and past shareholder structure. The existence of block shareholders is determined and the existence of a business interest with the block shareholders is investigated. The equal and timely dissemination of information to all shareholders is another factor to increase the governance rating of the company. Further, protection of the minority shareholders is examined. Companies with cumulative voting systems and where the minority interests are considered get higher ratings. Companies that announce the general meeting to their shareholders at least one month before the meeting starts on web sites, as well as national magazines and those who organize the event in city centers where it is accessible for the majority of the shareholders, will get better credits. Having a consistent dividend policy and distributing a fair amount of dividends are other evaluated criteria. The meeting frequency and the attendance of the board members to the meeting of the board of directors are rating factors as well. The selection of independent members of the board, their background and qualifications and their relationship with other corporations and the number of members on the board are of crucial importance. The entire criterion is also evaluated regularly after being included in the corporate governance index.

Based on the above-mentioned criterion the companies are rated on a 0-10 scale, and companies who have the total compliance with the governance codes are rated 10. Companies should at least have an overall rating scale of 7 to be included in the corporate governance index of Borsa Istanbul. As of June 2014, 48 companies are evaluated under corporate governance index.

2.3.3. The Aftermath of the Global Financial Crisis

2007/2008 was recorded as the most serious financial crisis since the Great Depression. Eichengreen and O'Rourke (2009) suggest that in terms of the decline in world output, stock market indices and world trade it is worse than Great Depression. Many financial institutions were either bankrupt or were bailed out. Of course, bankruptcy was not limited to financial institutions; a large number of companies also witnessed the difficulties brought by the crisis.

Crisis in the subprime market in the US, and the related liquidity squeeze, has a major impact on financial institutions and banks in many countries (Kirkpatrick, 2009) and emerging markets suffered from the crisis even more than developed markets since the capital flows stopped to these countries and they also witnessed export shocks.

Turkey had two severe crises in its history in 1994 and 2000/2001. The crisis in 1994 resulted mostly in the high public-sector deficits and high interest rates on loans. Other factors deepening the crises between 1990 and 2000 were the functional losses of public banks (Yendi et al., 2012).

While the Central Bank was applying fixed exchange rate policy, the inflation declined from high levels to moderate levels and caused a huge appreciation in the value of the Turkish Lira (Comert and Colak, 2014). These developments led to a current account deficit which further resulted in sudden reversals in capital flows. Despite the efforts to maintain the level of the currency by increasing the interest rates and intervening to the exchange rate, the value of the lira continued to decline sharply. Following these developments, Central Bank had to change the exchange rate system from fixed to floating. The change in the system caused the value of the dollar to double in value in less than a month, causing the liability section of the banking system double too. These results caused many banks to go bankrupt and further resulted in financial difficulty also in the real sector.

Following these crises, the main concern of the government became to stabilize the financial system, to reestablish its relationship with the real economy and to maintain public financing balance. To achieve these aims a new regulatory program was launched, which was named as “Transition to Strong Economy Program”, which targeted to increase the stability of the financial system.

The program brought results soon after the start of the implementation and the global economic conditions accelerated the recovery of the Turkish economy. The expansionary policies of the developed countries increased the credit generation and these funds were directed to emerging markets which had higher returns (Mohan and Kapur, 2009). Those funds were used to finance real sector and the increase in privatization and foreign direct investments served also as other sources of funds. Accordingly, the period from 2002 to 2008 Turkish economy showed a high growth and low inflation.

Unquestionably, the global crisis showed its epidemic effects at the third quarter of 2008. The decline of the exports followed by the decline in the industrial production index triggered the decline in the GDP. In the global crisis interest rates and inflation declined but there was no effort to reduce the current account deficit as in the earlier crises, since the sharp decline in private demand made it unnecessary (Uygur, 2010). Despite the deteriorating outlook, Turkey witnessed an average of approximately 5% GDP growth in the 2009-2015 period. It is believed that the policies undertaken during the 2000/2001 crisis enabled the global crisis to be less effective on Turkey compared to the other emerging markets.

2.3.4 BIST Corporate Governance Index

Borsa Istanbul initiated a corporate governance index for the companies, which apply and report corporate governance activities publicly. The aim of this index is to measure the price and performance of the companies that are traded in Borsa Istanbul and that comply with the overall corporate governance compliance grade 7 over 10 and 6.5 for each of the main components. The grades are assigned by the institutions that are approved by Capital Markets Board of Turkey (CMB hereafter) and grades reflect the overall compliance of the companies to the corporate governance principles. The calculation of the index is initiated on 31.08.2007 and the initial value of the index is 48,012.17.

In 2013 the calculation of the grading methodology was revised by CMB and a new two-phase system was designed as the base grade and additional grade. According to the new system, all the corporate governance principles dictated by CMB are accepted as minimum requirements and the base grade is calculated over 85 points. In the second phase, the efficiency of the principles, their applications and their added-value to the firms is evaluated and additional grades are given over a 15-point ceiling. With the new calculations, functional compliance, as well as the formal compliance to the principles evaluated and the new methodology pushed the grades downward.

The firms which would like to be traded under the Corporate Governance Index are evaluated by the grading firms licensed by CMB and report their grades to CMB. The grading is done under four titles equity holders’ rights (25% weight), public disclosure and transparency (25% weight), stakeholders’ rights (15% weight) and board of directors (35% weight).

2.3.5. Corporate Governance Index and Its Evolution

The calculation of the index started in mid-2007, but the constituents of the index were very limited. Since, after 2012 the law mandates a "comply or explain" basis, more firms are willing to adapt to the corporate governance principles. Table 2.3.2 shows the number of the firms in the index and their average ratings. It is seen that both the number of the firms as well as the average rating of the firms increase.

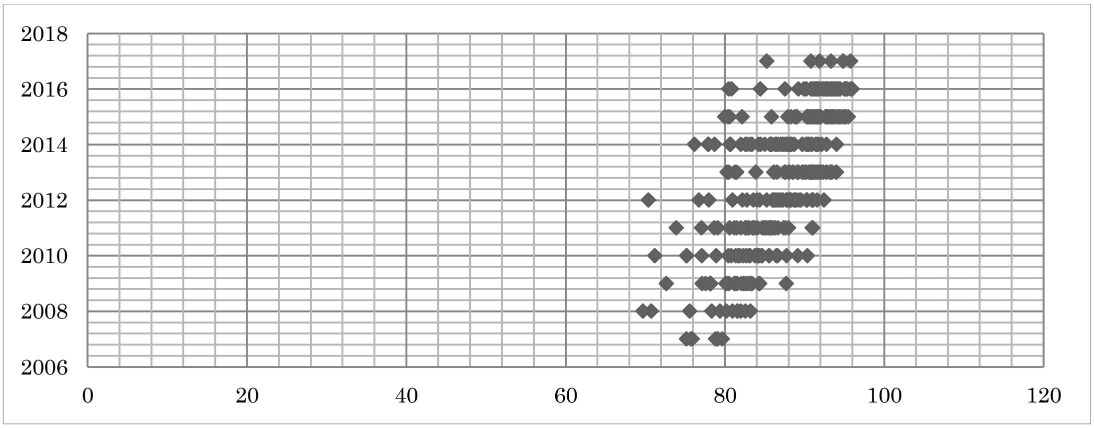
Table 2.3.2. Number of firms in the corporate governance index and their average ratings

Year	***Number***	***Average Rating***
2007	6	77,4
2008	12	78,83
2009	24	81,14
2010	31	82,73
2011	37	84,18
2012	44	86,83
2013	48	89,68
2014	54	86,46
2015	54	90,96
2016	50	92,05
2017*	7	92,39

Note: Most of the companies did not report their rating reports as of the date of this chapter is prepared.

Figure 2.3.1 shows the dispersion of the companies' ratings over time. The ratings tend to increase except for the year 2014. But generally, we can say that the ratings are dispersed to the higher grades, there are only a few companies with lower grades.

Figure 2.3.1. The dispersion of the companies' ratings over time



2.3.6. BIST and Board of Directors

According to the initial and revised (2015) Corporate Governance Principles of OECD the independence of the Board of Directors is affected by the percentage of the independent board members. The active participation of the independent members in the board is considered as good governance and this participation is also demanded by the shareholders.

The responsibilities and the rights of the members of the board of directors are dictated by Turkish Commercial Law revised on 2011 and by Capital Markets Board of Turkey in 2011. Especially CMB released the Corporate Governance Principles in 2011. Those principles and the law necessitate the existence of independent board members for the publicly owned companies. Even if the codes dictate the presence of independent members on boards, it is seen that in practice most of the companies already had independent members on their boards.

With the change of the Commercial Law in 2011, the amendment that the corporations can be established by five people is abolished and it is now made possible to establish a corporation with only one person. In the old law, people who were not the partners to the corporation could not be involved in the BOD. The new law withheld this necessity and it is no more an obligation to be a partner to be on the board of directors. The new law also makes a tremendous change in the board of directors' meetings. The physical existence of the members in the board of directors' meetings is no longer obligatory; it is now probable that the members can attend the meetings using technological devices and vote.

According to the report from the Board of Directors in Turkey prepared by Corporate Governance Association of Tukey several characteristics of the boards as of February 2016 are presented in Table 2.3.3 and Table 2.3.4 Group 1 represents the companies with market values greater than 3 billion TRY (Turkish Lira) and the average value of the outstanding shares over 750 million TRY, Group 2 represents the companies with market values greater than 1 billion TRY and the average value of the outstanding shares over 250 million TRY, Group 3 represents other companies that are traded in National Market, Second National Market and not covered by Group 1 and 2. Group 1, Group 2, Group 3, BIST 100, BIST 50, BIST 30, BIST Corporate Governance, BIST Financial and BIST Emerging consists of 29, 37, 316, 100, 50, 30, 50, 84 and 20, respectively as of the report date.

Table 2.3.3. Number of independent, women and foreign members and CEO characteristics

CEO characteristics	*Member*				*Chairman*		*CEO-Duality*
	Total	*Independent*	*Women*	*Foreign*	*Women*	*Foreign*	
Group 1	283	89	21	51	2	2	0
Group 2	308	95	32	40	2	1	2
Group 3	2068	631	269	155	22	25	49
BIST 100	845	248	89	108	7	7	7
BIST 50	460	143	46	67	4	3	0
BIST 30	294	94	25	47	2	2	0
BIST Corporate Governance	446	139	45	60	6	4	3
BIST Financial	665	205	85	54	8	2	8
BIST Emerging Companies	95	15	21	0	0	0	9

Source: Corporate Governance Association, Board of Directors Research, 2016

Table 2.3.4. Percentage of independent, women and foreign members among total members

	Independent	*Women*	*Foreign*
Group 1	31%	7%	18%
Group 2	31	10	13
Group 3	31	13	7
BIST 100	29	11	13
BIST 50	31	10	15
BIST 30	32	9	16
BIST Corporate Governance	31	10	13
BIST Financial	31	13	8
BIST Emerging Companies	16	22	0

Source: Corporate Governance Association, Board of Directors Research, 2016

CEO-duality is almost non-existent in Group 1 and Group 2 companies, whereas it is approximately 15% in Group 3 companies. In 40% of the emerging companies, CEO-duality exists, but as a general conclusion, it is possible to say that CEO-duality is very limited in the listed Turkish companies. When Table 2.3.2 is analyzed it is seen except for the emerging companies percentage of the independent members is around 30%. Since it is noted that the existence of independent board members and an independent audit committee and separation of the role of the CEO as the chairman of the board will affect the independence of the board (Ryan & Wiggins, 2004), Turkish companies are doing well in terms of the board independence.

2.3.7. Data and Methodology

The aim of this part is to analyze the determinants of operating performance and see if the corporate governance characteristics have a significant impact on performance. The data, regarding the corporate governance traits of companies and financial statements, is collected from the website of "Public Disclosure Platform of Turkey". The data related to stock prices and the stock market index is collected from the website of Borsa Istanbul. The analysis covers the period between 2007 and 2014 for the manufacturing companies that are traded in Borsa Istanbul. The firms with missing information about corporate governance are removed from the analysis. In order to see the impact of corporate governance characteristics and the impact of global crisis on performance panel regression models are used.

$$ROA_{i,t} = c_{i,t} + \beta_1 \sum CGT_{i,t} + \beta_2 \sum FSF_{i,t} + +\varepsilon_{i,t} \tag{1}$$

$$ROE_{i,t} = c_{i,t} + \beta_1 \sum CGT_{i,t} + \beta_2 \sum FSF_{i,t} + +\varepsilon_{i,t} \tag{2}$$

Return on assets (ROA) and return on equity (ROE) are considered as performance indicators of companies. CGT (Corporate Governance Traits) stands for the factors that affect the good governance of a company. The shares of the biggest shareholder, CEO-duality, size of the board are the factors that we would like to control for the corporate governance characteristics of firms. FSF (Firm-Specific Factors) are the control factors like age, share of openness to the public (free-float rate), size of the company (logarithm of total assets), D-public (dummy that takes the value of 1 if the company has government ownership), and foreign share (percentage of foreign ownership in the company). We also added DCrisis in order to control for the global crisis. Since the global crisis started to affect Turkey by the end of 2008; we gave a value of 1 for the years after 2009 and 0 for the years before 2009.

2.3.8. Empirical Results

The results of the regressions are presented in Table 2.3.5 and Table 2.3.6. When we look at the determinants of ROA we see that share of the biggest shareholder, age and size of the firm has a statistically significant effect. The share of the biggest shareholder has a negative effect on ROA, a finding that is consistent with the literature. Size also has a negative effect similar to many studies in the literature (Banz, 1981; Fama & French, 1992). The dummy for the crisis is not statistically significant, yet the coefficient is still negative.

Table 2.3.5. Determinants of ROA

Dependent Variable ROA				
Independent Variables	***Coefficient***	***Std. Error***	***t-Statistic***	***Prob.***
Biggest Shareholder	-1.15E-05*	6.53E-06	-1.765350	0.0779
Age	0.598224***	0.213370	2.803695	0.0052
Ceo-Duality	0.205312	0.168431	1.218966	0.2232
Free-Float Rate	-0.010345	0.013345	-0.775188	0.4384
D-Public	-0.163305	0.418584	-0.390136	0.6965
SIZE	-14.07502***	5.256895	-2.677440	0.0076
Board Size	0.091140	0.087718	1.039011	0.2991
Foreign Share	0.009376-	0.005584	1.679083	0.0935
DCRISIS	-0.487738	0.304543	-1.601540	0.1096
C	95.67070***	35.98729	2.658458	0.0080
R-squared				0.560180
Adjusted R-squared				0.488190
F-statistic				7.781386
Prob(F-statistic)				0.000000

*Note: ***, ** and * represent statistical significance at 1%, 5% and 10%, respectively. In this model, fixed-effect panel regression is run according to the Hausman test statistics.*

Table 2.3.6 explains the determinants of ROE. As the free float rate increases the ROE increases well. As the ownership is dispersed, it is more likely that the investors' rewards will be bigger. We can suggest that companies with higher free-float rate are governed better. Among the corporate governance traits, board size stands as the only factor affecting ROE. As the number of members in the board increases ROE also increases, implying that the board diversity increases performance. This is a finding which is also in line with the resource dependence theory. In this model the dummy for the crisis is statistically significant at 1% level and positive. This may pinpoint to the erosion in the total equity of the companies after the crisis.

Table 2.3.6. Determinants of ROE

Dependent Variable ROE				
Independent Variables	***Coefficient***	***Std. Error***	***t-Statistic***	***Prob.***
Biggest Shareholder	9.05E-07	3.53E-06	0.256279	0.7978
Age	0.000743	0.001427	0.520343	0.6029
Ceo-Duality	0.011214	0.029386	0.381603	0.7028
Free-Float Rate	0.050498***	0.009519	5.305011	0.0000
D-Public	0.104670	0.065783	1.591137	0.1119
SIZE	0.039850	0.028716	1.387766	0.1655
Board Size	0.019312**	0.008326	2.319383	0.0206
Foreign Share	-0.000143	0.000616	-0.232213	0.8164
DCRISIS	0.109100***	0.028283	3.857401	0.0001
C	-0.569456***	0.213629	-2.665631	0.0078
R-squared	0.065472			
Adjusted R-squared	0.056711			
S.E. of regression	0.367217			
F-statistic	7.472914			
Prob(F-statistic)	0.000000			

*Note: ***, ** and * represent statistical significance at 1%, 5% and 10%, respectively. In this model random-effect panel regression is run according to the Hausman test statistics.*

2.3.9. Conclusion

The global crisis resulted in a huge number of bankruptcies and bailouts, pointing to a governance problem both in financial and non-financial institutions. In many countries, legal structures are modified to solve the corporate governance problems.

Turkey witnessing very severe crises both in 1994 and 2000/2001 period, applied various structural reforms at the end of 2001. With the change of the Turkish Commercial Law in 2011, corporate governance principles were also legalized. The codes are not compulsory but rather there is a “comply or explain” basis. Despite that, when we analyze the companies, application of the principles starts before the law. Following the 2001 crisis, most of the companies tried to change their management styles and tried to adapt to the principles dictated by OECD.

As the applications of the corporate governance principles increase, the corporate governance index has started to be calculated for the companies that are traded in Borsa Istanbul in the mid-2007. It is seen that the number of companies that are eligible to be included in the index is very limited, namely six, but later on as the time passes more and more companies are added to the index and the average ratings of the companies are increasing.

When we analyze the board of directors for the Turkish companies, it is observed that about 30% of the board consists of independent members. CEO-duality is also limited in all groups except for the emerging companies, but there is still room for improvement in terms of the existence of women members.

In the final part of the chapter, we analyzed the factors that determine the ROA and ROE of Borsa Istanbul manufacturing companies for the period between 2007 and 2014. We added corporate governance factors like the size of the board, the share of the biggest shareholder, and CEO-duality. We included a dummy variable to control for the impact of the global financial crisis. We also used firm-specific control variables.

The results show that the biggest shareholder has a negative effect on ROA, whereas the board size has a positive effect on ROE. As it turned out crisis to had a positive effect on the ROE, which was good for shareholders.

As an overall conclusion, it is possible to suggest that Turkey has come a long way in the developments of corporate governance practices. Both, in terms of corporate practices and legal enforcements, many companies are trying to be more transparent and protect shareholder rights. Moreover, even the family-owned businesses are determined to use professional management. However, when we look at the companies that have shares traded in Borsa Istanbul only 50 companies out of 380 are announcing their corporate governance ratings. Only this is enough to show that, more things should be done for development.

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2.4. CORPORATE GOVERNANCE IN EGYPT

Ehab K. A. Mohamed
Mohamed A. K. Basuony

2.4.1. Preamble

Egypt has witnessed a period of political and economic instability over the last few years. However, in 2014 the Egyptian government started applying a transformational reforms program, targeted at encouraging the economy, improving the environment of the country's business and acting as stable and comprehensive development. The reforms are aimed at rebalancing macroeconomic aspects and improving governance and investment climate. These reforms include the Civil Service Reform Law in 2016 inviting and attracting local and foreign investments and eliminating and removing investment obstacles and barriers and such as the Investment Law, the Industrial Licensing Law and the Company Law. These reforms together with the regular reestablishment of stability, confidence, and immovability are starting to produce positive outcomes. The economy is improving step by step with the annual rates of GDP growth getting 4.3% in 2015/2016, up from an average of only 2% during the period 2010/11-2013/14. The overall budget deficit declined in the first half of FY17 to 5.4% of GDP, down from 6.4% in the same period last year. Subsequently, the floatation of the local currency, the exchange rate has primarily exposed some instability but has consequently started to enhance and strengthen, particularly with the solid foreign investment and money transferred from the Egyptians who working outside Egypt (World Bank, 2017).

Furthermore, responding to improvements in the world of capital markets regulation, regulatory authorities in Egypt in association with international agencies have consequently considered the design of new regulatory frameworks to improve corporate governance. Egypt, as an emerging country, is likely to require stronger and more effective governance mechanisms than their developed counterparts if they are to become equal, full and active participants in the global financial market (Mohamed et al., 2013).

2.4.2. Overview of the Legal Framework of Corporate Governance in Egypt

The origin of the Egyptian corporate legal framework is in French civil law. Nonetheless, Anglo-American common law concepts took prominence in the Egyptian corporate law with the drafting of the Central Depository Law in 2001 and the Capital Market Law in 2002. The main bases for the corporate governance legislation in Egypt are the Companies Law; the Capital Market Law; the Central Depository Law and the Law on the Central Bank, the Banking Sector, and Money (UNCTAD, 2007; EBRD, 2016).

Corporate governance started to take a focal point in the late 1990s. At that time, the Egyptian government recognized the need and importance of having a unified business law that would ensure that all businesses in Egypt follow the same law and adhere to the same regulations in order to remove conflicts and obstacles to local and foreign investments in Egypt. This effort to replace the old laws and dispersed provisions with a new unified law comes as a result of Egypt's willingness to implement a comprehensive economic reform program that covers all the economic facets. As part of the corporate governance program, the Egyptian government invigorated its capital market via boosting investors' confidence and enhancing the capital market reputation. This was done to persuade more Egyptians to invest in the domestic markets rather than investing abroad and also to attract more foreign capital. The Egyptian government recognized the need for a high level of corporate governance practices to achieve its objectives. Therefore, the reform program promotes sound financial principles, adoption of international accounting and auditing standards, and availability of reliable corporate information (Dahawy, 2008).

The International Monetary Fund and World Bank conducted an assessment of corporate governance in Egypt in 2001; Egypt is the first Arab country to undergo a ROSC analysis (ROSC 2001). Egypt's corporate governance practices were assessed against the requirements of the OECD Principles of Corporate Governance. The results revealed that 62% of the principles were adopted by the companies that were examined. Following the ROSC assessment, Egypt issued new rules to guarantee companies' adoption of corporate governance principles. The most significant ones were the new listing rules issued in 2002, known as 'CASE 2002' (Dahawy, 2008). The World Bank conducted another assessment of corporate governance practices in Egypt in 2004. The results of the assessment indicated that 82% of the OECD principles were implemented. Hence, corporate governance in Egypt appears to be continuously improving, particularly in the areas of basic shareholders rights and disclosure standards (ROSC, 2004; UNCTAD, 2007).

To further improve the investment environment the Egyptian Institute of Directors (EIoD) was established by the Egyptian government in 2003. A major objective of the EIoD is improving corporate governance practices and spreading awareness of best practices in Egypt through a range of training and advocacy activities, including the provision of information on corporate governance principles, codes and best practices. The EIoD works together with a number of international organizations to develop manuals to help implement corporate governance, organize national and international conferences, and offer competitions to create better awareness not only locally but also regionally (Dahawy, 2008; Mohamed et al., 2013).

In 2005, the first Egyptian Code of Corporate Governance (ECCG) was introduced by the Ministry of Investment and the General Authority for Investment and Free Zones (GAFI). The code provided guidelines to be implemented primarily in listed joint-stock companies and companies that used the banking systems as a major source of finance. The Capital Market Authority (CMA) contributed further to the corporate governance reforms by restructuring its organization and initiating three major sectors: (a) the

Corporate Finance and Corporate Governance sector; (b) The Market Regulation sector; and (c) the Market Surveillance and Enforcement sector, in addition to other central departments and units (Mohamed et al., 2013). The code was reviewed in 2011 and most recently in 2016. However, Egypt has opted for the so-called "comply or explain" approach, where the code recommends companies to comply with its recommendations and in case of noncompliance, to clearly explain the reasons why certain recommendations have not been followed; hence, there are no mandatory requirements to this end. As a result in 2014, only two out of the ten largest listed companies provided a "comply or explain" statement with the annual report. However, these statements are merely declaratory and not very informative (EBRD, 2016).

On the other hand in 2006, a Code of Corporate Governance for State-Owned Companies was issued by the Ministry of Investment. This code is based mainly on the ECCG and the report of the OECD working group on privatization and corporate governance of State-owned assets (UNCTAD, 2007; Mohamed et al., 2013; EBRD, 2016). Similarly, The Central Bank of Egypt issued a Decision on the Corporate Governance Guidelines and Instructions for Banks in 2011, with the aim of developing the Egyptian banking system and maintaining its integrity through the application of international best practices. Banks' application of these rules should be commensurate with their size, scale, and complexity of their operations and risk appetite.

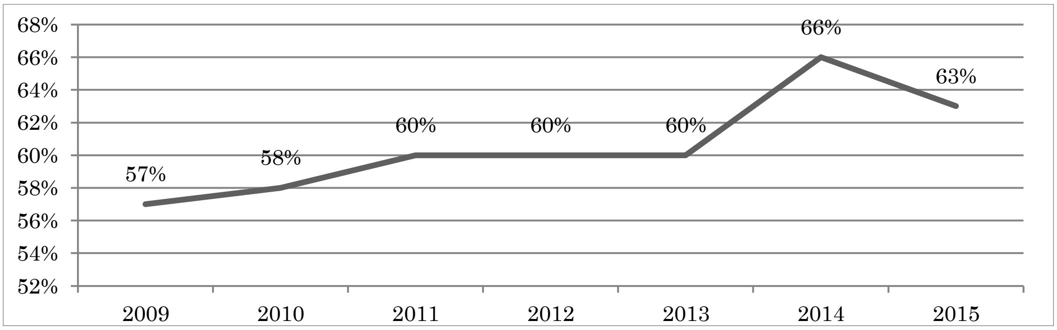
Furthermore, various non-profit organizations have also become aware of the importance of corporate governance in improving the business environment in Egypt. The Egyptian Junior Businessmen Association (EJB) embarked on an awareness campaign that included workshops and roundtables, as well as issuing the Corporate Governance Manual for Family Businesses in October 2006, which is the first guide for family companies not only in Egypt but also in the MENA region (Dahawy, 2008).

2.4.3. Ownership Structure of Companies

The stock market in Egypt has been characterized by the dominance of private investors for a long time, with private investors having a control of more than 60%. However, the market structure changed in the last few years whereby institutional ownership has increased. The surge in institutional trading could be mainly attributed to the increase in bond trading since institutions are the key players. Nonetheless, the Egyptian market is still characterized by the dominance of retail investors who account for 50 to 60% of the market over the last few years (www.egx.com.eg). Moreover, it should be noted that the largest 20 or so companies in Egypt are not listed on the stock exchange (OECD, 2010).

Figure 2.4.1 below shows the patterns of average ownership concentration in a sample of the top 30 companies listed in Egypt over the period 2009-2015. As it can be seen, the average percentages are (60%) for the years 2011, 2012 and 2013.The highest percentage is (66%) for the year 2014 and the lowest percentage is (57%) for the year 2009.

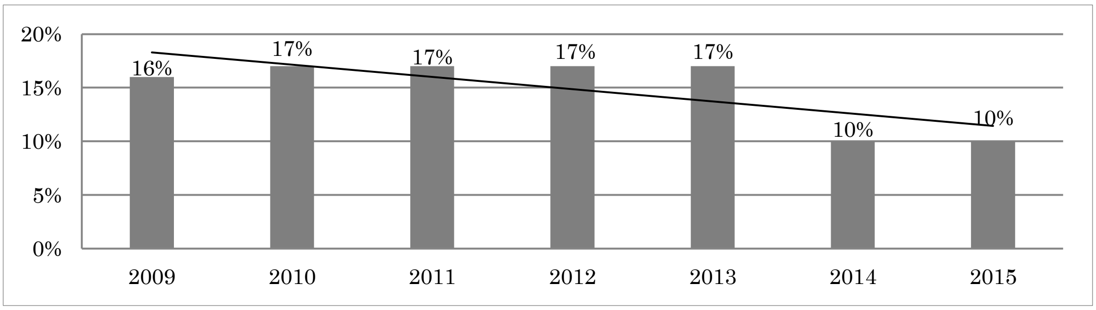
Figure 2.4.1. Ownership Concentration over the period 2009-2015



Omran (2009) examined the post-privatization corporate governance using a sample of 52 newly privatized Egyptian firms over a period of 10 years, from 1995 to 2005. He documented that the state gave up control over time to the private sector, but still controls, on average, more than 35% of these firms. His results also revealed a trend in private ownership concentration over time, mostly to the benefit of foreign investors. Similarly, Abdel Shahid (2003) reported the presence of highly concentrated ownership structure in the Egyptian market in a sample of the 90 most actively listed companies at the end of 2000.

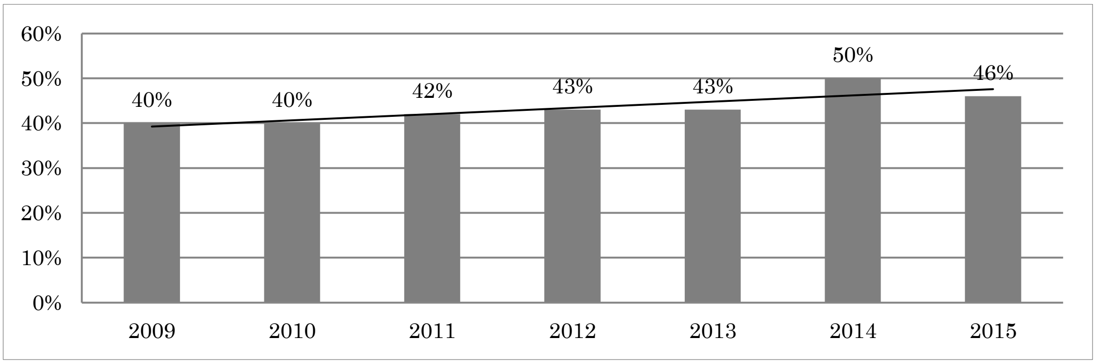
Figure 2.4.2 below shows the patterns of average director ownership in a sample of the top 30 companies listed in Egypt over the period 2009-2015. As it can be seen, the averages for director ownership for the years 2010, 2011, 2012 and 2013 are 17%. For the year 2009, the average of director ownership is 16%, while the averages for the years 2014 and 2015 decreased to 10%.

Figure 2.4.2. Director Ownership over the period 2009-2015



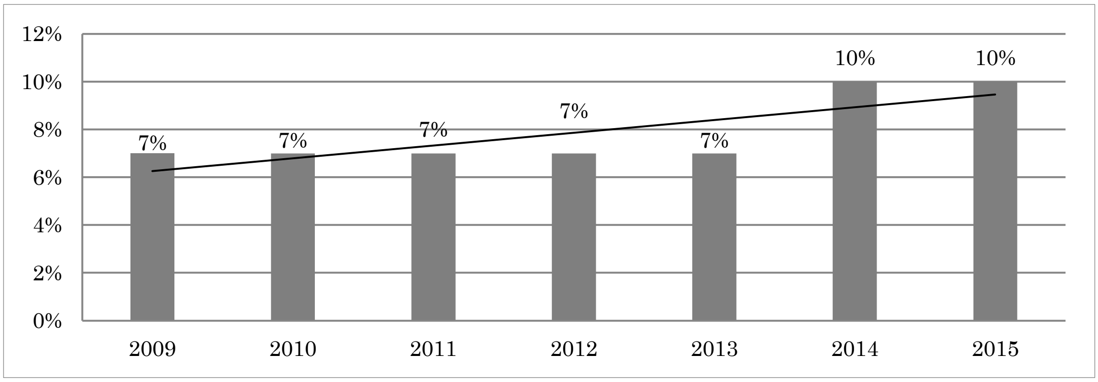
Moreover, figure 2.4.3 below shows the patterns of institutional ownership in a sample of the top 30 companies listed in Egypt over the period 2009-2015.The average of 40% prevailed in the year 2009 and continued to 2010. However, a slight increase in the average was maintained for the following three years until a sudden spurt of 7% occurred in the year 2014 followed by a 4% decrease in 2015 to become 46%.

Figure 2.4.3. Institutional Ownership over the period 2009-2015



Furthermore, figure 2.4.4 below illustrates the averages of foreign ownership for the period 2009 till 2015. The average of 7% of foreign ownership was maintained for the first five years followed by a 3% increase to reach 10% in 2014 and 2015.

Figure 2.4.4. Foreign Ownership over the period 2009-2015



2.4.4. Market for Corporate Control

The Capital Markets Authority Law of 1992 is the main legislation regulating the acquisition of corporate control. The law regulates the acquisition of publicly listed companies and requires any acquisition of 10% or more of a publicly listed company to be formally made to the company, acquired at least two weeks in advance. In turn the company subject to the acquisition should notify the regulatory authorities and all shareholders holding at least 1% of its shares within one week of receiving the prospective purchaser's notice. Moreover, in the case of an acquisition of more than 15% of a company in public offering or at least 30% of shares that are traded on the exchange, the potential acquirer must make a tender offer approved by the CMA. Such tender must be announced in two widely circulated newspapers and must remain open for at least one week (OECD, 2010).

The law stipulates such provisions to improve the corporate governance of publically listed companies by preventing the formation of block-holders that may result in shareholder abuse. Furthermore, the tender rules necessitate that an independent opinion must be made available to the shareholder's post any acquisition of one-third of the outstanding shares of a company. Nonetheless, minority shareholders are forced to sell outright in instances of acquisition of 90% or more of a company. Thus, there is high concentration prevalent in Egyptian-listed companies (OECD, 2010).

Though the legal framework regulating the acquisition of control in listed companies seems reasonably developed, the actual cases of merger or acquisition are very rare. The Egyptian stock market has not experienced hostile takeovers. Taking into consideration the high ownership concentration, it is not surprising that such takeovers did not occur (OECD, 2010).

2.4.5. Board of Directors Practices

Egypt adopts a one-tier system for boards of directors of listed companies. The Egyptian Corporate Governance Code recommends that boards should be comprised of a majority of independent non-executive members; however, there is no legal requirement for boards to have independent members. In its definition of independence, the codes merely focus on negative “non-affiliation” criteria, without any guidance on what it is expected from independent directors in practice (e.g., independent mind and character). Therefore, it is not surprising that only four of the ten largest listed companies explicitly stated that they have independent board members, however, no explanation is provided as to why these board members are considered independent (EBRD, 2016).

It is also noted that boards appear to be relatively large, with an average of nine members and it is very common for legal entities to serve as board members. There is no legislation to assign key functions to the board of directors. On the contrary, shareholders are given the authority to approve the company’s budget and to decide on other management issues, this may undermine the board’s strategic role. The Corporate Governance Code does not require the separation of the roles of chair of the board and CEO. It is very common to combine these two roles in Egypt. That is very concerning since this concentration of powers is not offset by an adequate representation of independent directors. Furthermore, Gender diversity on boards of Egyptian listed companies is very limited. Though, it appears that the boards of the ten largest listed companies possess an appropriate mix of skills (Mohamed et al., 2013; EBRD, 2016).

Most large companies have audit committees to support more effective functioning of the board; however, these committees appear to lack the needed independence to make them effective. Other committees are not common in Egypt. Board evaluations and appointing corporate secretaries are nonexistent. It is not possible to assess how boards work in practice since disclosures on the number of board meetings and board activities are very scarce. The framework underpinning fiduciary duties is still undeveloped. Conflicts of interest situations appear to be regulated by law, but there is no clear evidence that boards are effectively monitoring them (EBRD, 2016).

Figure 2.4.5 below shows the patterns of board size in a sample of the top 30 companies listed in Egypt over the period 2009-2015. As it can be seen, the minimum number of board of 11 members prevailed for the years 2009 through to 2013. On the other hand, the year 2014 witnessed the maximum number of board members of 14 members decreasing to 13 members in 2015.

Figure 2.4.5. Board size for a sample of top 30 EGX over the period 2009-2015

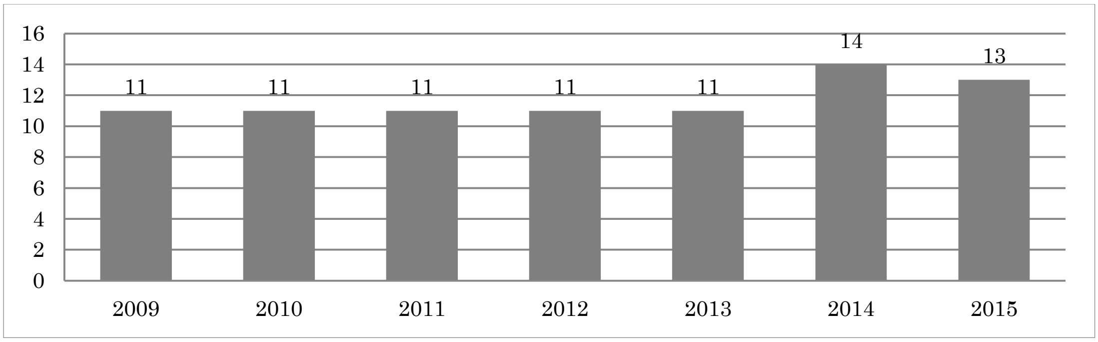
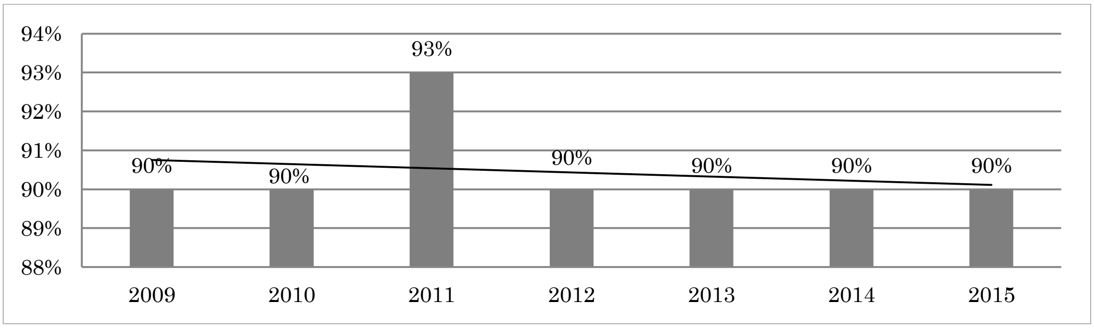


Figure 2.4.6 below shows the patterns of CEO duality in a sample of the top 30 companies listed in Egypt over the period 2009-2015. While the years starting from 2009 through to 2015 maintained an average of 90% of no duality, which means that there is a split between the president and CEO of 90%, the year 2011 was the only year with an average of 93% of no duality.

Figure 2.4.6. CEO Duality for a sample of top 30 EGX over the period 2009-2015



2.4.6. Directors' Remuneration Practices

Measuring the risk profile of an organization is very important as evident by the current financial crisis, particularly in the financial sector institutions, to avoid major corporate governance failures. The existing legal framework in Egypt only necessitates the formation of audit committees, the formation of other committees are not mandated. The Egyptian corporate governance system does not require the establishment of remuneration committees and boards are under no obligations to develop or disclose the remuneration policy of board members and key executives. Furthermore, the current legal framework does not explicitly require the evaluation of the performance of the board of directors in its key duties. This can prove to be a major weakness, particularly in large listed companies (OECD, 2010).

Therefore, it is very difficult in Egypt to assess the performance of boards and whether they perform their functions in accordance with the internationally recognized standards. In compliance with the listing rules, corporate boards are required to report annually on their activities to both the EFSA and the EGX. It is expected that board committees should contribute to such report by outlining key issues and recommendations. However, in practice, the reports submitted by boards of directors usually do not include essential information that facilitates proper accountability. The reports often exclude the basic information on meetings' attendance by board members and information concerning their remuneration packages (OECD, 2010).

2.4.7. Shareholders Rights

The Egyptian Companies Law stipulates the shareholders' rights in participating and voting in both the general and extraordinary meetings and legally speaking shareholders are not impeded from exercising their key rights. Shareholders are entitled to discuss the documents presented to them in the meetings and may raise questions to the board. Shareholders representing 5% of the capital may call a general shareholders' meeting as well as add items to the meeting's agenda. Shareholders have the right to nominate directors and enjoy pre-emptive rights in case of capital increases (OECD, 2010; EBRD, 2016).

However, the legal requirements for share voting force shareholders to deposit their shares at the head office of an authorized bank few days prior to the meeting and till the closure of the meeting in order to attend ordinary meetings. Therefore, the participation of minority shareholders in meetings is somehow hindered by such legal provisions as well as shareholders behaviour that result in low participation of minority shareholders. The fact that very often minority shareholders are very passive and do not exercise their rights is mainly due to the low awareness of their rights as shareholders. The culture in Egypt makes it normal for the minority shareholders to accept of their limited role in governance in the current ownership context (OECD, 2010).

Recent legal and regulatory reforms attempt to facilitate for better exercise of shareholders rights by minority shareholders. To avoid leaving the major decisions to the majority shareholder or block holders without an effective check, the regulators give minority shareholders the legal rights to challenge majority shareholder. Nonetheless, minority shareholders are yet to take full advantage of the legal framework and they often shy away from challenging the controlling shareholders. Perhaps making the voting on a greater number of potentially sensitive matters by secret ballot could enhance participation of minority shareholders as it has been witnessed that they get more engaged where voting is done in secret like for example in the case of dismissing board members. Shareholders activism could also be further encouraged by stopping the practice of proxy voting that allows voting to be conducted through another shareholder of the same company. Adoption of technology like electronic voting may help overcome the problem of proxy voting.

While the acquisition of corporate control is governed by the Capital Markets Authority Law of 1992, the right to transfer shares is unrestricted. However, certain transferability limitations apply in the case of the transfer of founder shares. MISR for Central Clearing, Depositary and Registry handles the ownership registration for all shareholders. Furthermore, the delay in settlement processes is resulting share blocking practices and also there were cases of partially paid-up shares that were allowed to exercise the right to vote. Such practices are inconsistent with international best practices, though the current legal reforms are trying to deal with such issues. Though insider trading is prohibited, there is limited evidence of enforcement. Shareholder agreements are common and appear to be enforceable between parties; however there no requirement for disclosure (OECD, 2010; EBRD, 2016).

In the current legal framework, both individual and institutional shareholders enjoy the same rights. In contradiction to the OECD's Principles, institutional shareholders are no obliged to disclose their voting policy or declare any conflict of interest that might arise for exercising their voting rights. This is of particular interest since significant portions of the ownership of many listed companies in Egypt often include state-owned banks and pension funds. It will be very beneficial to motivate institutional shareholders to take their role more earnestly by requiring them to disclose their voting policy to the regulatory authorities. Similarly, the process could be further improved if a representative from the supervisory authorities attends the shareholders' meetings (OECD, 2010).

2.4.8. Corporate Governance and Firm Performance

The literature on the effect of corporate governance on firm performance provides inclusive evidence; particularly in developing countries. Abdel Shahid (2003) found that the ownership dispersion impact Return on assets and return on Equity but had no impact on stock market performance indicators such as P/E and P/BV in a sample of the 90 most active Egyptian listed companies in 2000. Also, Elsayed (2007) investigated the relationship between CEO duality and firm performance in a sample of 92 firms from 2000-2004; he reported that that board leadership structure had no direct impact on corporate performance. However, the additional analysis demonstrates that the interaction between industry type and CEO duality had varying impact on corporate performance across industries. Moreover, using a sample of 52 newly privatized Egyptian firms over a period from 1995 to 2005, Omran (2009) found that ownership concentration and foreign ownership had a positive impact on firm performance, while employee ownership concentration had a negative one. On the other hand, and the change in the board composition following privatization, particularly the increased parentage of board independence had a positive effect on firm performance.

Furthermore, Mohamed et al. (2013) examined the effect of corporate governance mechanisms on firm performance using cross sectional data from non-financial companies listed on the Egyptian Exchange. Using a sample comprises of companies on EGX100 index for the year 2010, they examined the effect of ownership structure and board structure on both book and market value firm performance. The results showed that both the ownership structure had no effect on the performance of firms operating in Egypt. While the only board structure factor that had an impact on firms' market performance was board independence. Meanwhile, firms' book performance was influenced by both CEO duality and board independence.

2.4.9. Corporate Social Responsibility

Historically, the Egyptian corporate sector made a significant contribution to community development. Historically, Egypt's educational and healthcare facilities were established through corporate giving (El-Awkaf). However, these corporate social activities came to a sudden halt after the 1952 revolution and the nationalization of Egypt's large companies that followed in the 1950s. This resulted in a private sector that mainly consisted of small businesses that were unable to compete with charitable entities. The political changes in the 1950s resulted in the state taking over the responsibility for social and economic development. Contribution by the corporate sector to community development in the past seven decades has witnessed various changes. The diverse political alterations acted sometimes as a catalyst for corporate sector's contribution to social and economic development and sometimes these political alterations acted as a barrier to many philanthropic activities (CSR Middle East, 2012; Basuony et al., 2014).

Furthermore, the motivation for corporate involvement in CSR activities in Egypt differs from that elsewhere. CSR in Egypt is strongly influenced by country's religious beliefs. Egypt is a predominantly Islamic country with Coptic Christian minority and has a prevailing culture of giving, practiced in both its Islamic contribution of zakat and the Christian tradition of ushur (tithing). Egypt is characterized by paramount loyalty and solidarity values that often supersede most of other societal rules. Money is usually used to provide the poor with food and clothing, and facilitating health and educational services. Religious organizations in Egypt largely depend on zakat and ushur and are involved in several endeavours to implement sustainable development schemes instead of simply providing donations for the poor. Nonetheless, such initiatives are based on a contribution from community and corporations as part of their religious duties and not as part of their responsibility toward society (CSR Middle East, 2012; Basuony et al., 2014).

As a response to the UNDP 2007 Business Report and to encourage sustainable business practices in Egypt, the Egyptian Corporate Responsibly Center (ECRC) was established. It was the focal point of the UNGC in Egypt and represented a joint initiative between the UNDP and the Industrial Modernization Center (IMC) tasked with providing companies with the support needed to implement the Ten Principles of the UNGC, and also supporting the MDGs in Egypt. ECRC goals are to improve the national capacity to design, apply and monitor sustainable CSR policies, and to promote gender equality in the workplace. To achieve these goals the centre provides business development advisory services, as well as capacity building and training for the private sector. Moreover, the centre encourages comprehensive business models encouraging large multi-national firms to expand their production and sales operations in order to include “the poor” at the “base of the pyramid” (BOP) as employees, consumers or entrepreneurs (Zeitoun, 2017).

As of 2014, the ECRC had conducted and completed three key sector diagnostics around CSR in the following main sectors: 1) financial; 2) textile; and 3) agri-business. The ECRC is also starting to work in the area of sustainable finance, with a new initiative launched with the Arab African International Bank (AAIB) called Mostadam (case study provided in Chapter Two). Finally, in line with the Women’s Empowerment Principles, the ECRC is currently collaborating with the American University in Cairo (AUC) School of Business, the International Finance Corporation (IFC), the UNDP and IMC on a novel Women on Boards initiative to promote greater participation of women on the executive level.

Nonetheless, corporate social responsibility in Egypt is still viewed as a non-institutionalized phenomenon and is perceived mostly as a philanthropic concept. Firms treat CSR activities as marketing and public relations campaigns rather than well-conceived programs designed for sustainable socio-economic development. This is not surprising taking into consideration that Egyptian companies operate in an environment where CSR compliance is mostly voluntary. Most companies lack the necessary consistency and seriousness of purpose in their approach to social responsibility initiatives (CSR Middle East, 2012).

Though, following the Arab Spring and Egyptian uprising in 2011, a new turn occurred due to the state's noticeable failure to achieve social and economic equity, let alone development. Corporate social is now regarded as a legitimate alternative remedy for the country’s economic ignominies and its social inequalities. However, there are some questions that need to be answered; should CSR act for just cause? Should CSR Stay low-key and independent or become institutionalized? Additionally, the increasing wave of globalization and the growing influence of westernization has resulted in a dramatic shift in society’s value system (CSR Middle East, 2012).

2.4.10. Concluding Remarks

Egypt has a well-established stock market (The Egyptian Exchange) with a market capitalization of USD 55 billion, the Egyptian Exchange is fairly liquid, and it seems that the volume of trades is relatively high. However, little information is provided by the Egyptian Exchange on fundamental corporate governance matters. Then Egyptian Corporate Governance Code is based upon OECD’s Principles of Corporate Governance and is issued by the Egyptian Institute of directors. Egypt has opted for 'comply or explain' code which does not really fit the legal environment and culture of the country.

Therefore, it is unsurprising that the code of corporate governance is poorly implemented and there is very little disclosure on the level of compliance. Unfortunately, not much action is taken by the regulating authorities to ensure compliance, resulting in a very poor and unconducive institutional environment that does not promote corporate governance. The existing legislations are inconsistent and case law referring to the Corporate Governance Code is hardly accessible. This unfavourable environment has resulted in Egypt being poorly ranked by international organizations with regard to investor protection, competitiveness and corruption perceptions (OECD, 2014; EBRD, 2016; GAN, 2016)

However, in the last few month of 2016 and early part of 2017 there has been a drive to improve the investment environment in the country and the Egyptian government started implementing a transformational reform program. The program meant to rebalance and improve governance and investment climate. These reforms together with the gradual restoration of confidence and stability are starting to yield positive results. The authorities should increase transparency in the area of the market for corporate control in particular and ownership structure of companies in general. The Egyptian government needs to take the necessary actions to have a strong financial sector based on well-established financial market, in order to keep pace with international developments and enable the vision of a solid economy that will be recognized internationally. While the Egyptian Corporate Governance Code might provide adequate coverage of the key matters, more efforts need to be made to ensure compliance and better disclosure in a market with a nascent disclosure culture (Mohamed et al., 2009).

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2.5. CORPORATE GOVERNANCE IN COLOMBIA: NEW CHALLENGES AND OPPORTUNITIES

Sandra Gaitan
Jimmy Saravia

2.5.1. Introduction

The government of Colombia has made a great effort to promote the implementation of good corporate governance practices in Colombian companies. Since 2001, the adoption of good corporate governance practices has become an important issue not only for public corporations but also for institutions such as pension funds, hedge funds, stock brokers and government agencies. In this chapter, we discuss the evolution of the legal framework of corporate governance in Colombia, in particular, we examine the impact of the different laws enacted in the country and the creation of the code of best corporate governance practices (Country Code). We focus on the changes in the Country Code that took place since the global financial crisis of 2008. We then examine the ownership structure of listed corporations and the market for corporate control in Colombia, and we find that due to the concentrated ownership structure of firms the market for corporate control is not a very strong governance mechanism.

We then discuss the practices of corporate boards of Colombian listed companies and their remuneration practices, and find that there are opportunities to enhance the transparency of these board of directors practices and that more research is needed in this area. We continue with an examination of shareholders rights protection in the country and shareholder activism. We find that although there are several good laws that protect shareholder rights, there are deficiencies in the application of the laws. On the other hand, we find that shareholder activism is starting to gain in importance in the country and that minority shareholders, such as pension funds and hedge funds have started to make their voices heard.

Regarding the important topic of corporate governance and firm performance, we find that evidence regarding Colombian firms is not conclusive. One problem is that historically there has been a small number of firms in the Colombian stock market and for this reason, it is difficult to make reliable statistical inferences. We conclude with a brief discussion of corporate social responsibility and a brief examination of industrial specifics of corporate governance in Colombia.

2.5.2. Overview of the Legal Framework of Corporate Governance in Colombia

The history of the legal framework of corporate governance in Colombia begins in 2001 when international corporate scandals surprised the markets and regulators around the world and triggered a financial crisis. In view of this situation and following the promulgation of the statement of good corporate governance practices, which had been established by the Organization for Economic Cooperation and Development (OECD) in

1999, the Colombian government decided to make new laws mandating good governance practices in order to guarantee the development of the Colombian stock market.

With the enactment of law 275 of 2001 which established the corporate governance framework in Colombia, the *Superintendencia Financiera de Colombia* (SFC), the key regulator of the Colombian financial system, also became the main corporate governance regulator in the country. Moreover, this law granted the faculty to the SFC to develop a code of best corporate governance practices (Country Code).

The Country Code was developed in close collaboration with CAF (*Development Bank of Latin America)* and it was implemented in 2007. Following the global financial crisis of 2008 the Country Code was revised again in 2013 with the support of CAF. This resulted in the implementation of the New Country Code in 2014, which is better adapted to the business environment and overall Colombian Economy and is more specific in its recommendations than the old Country Code. In both instances Colombia closely followed the corporate governance guidelines given by CAF (2005, 2013).

Both the new and the old Country Codes identify five great corporate governance areas, namely: *(i) Shareholder Rights and Equal Treatment (ii) General Assembly of Shareholders (iii) Board of Directors (iv) Control Architecture (v) Financial and Non-Financial Transparency and Information* which are the most relevant aspects to evaluate a corporate governance regime as acknowledged in the academic and practitioner literatures. The Country Code has a "comply or explain" regulatory approach. The Code establishes precise recommendations on each of the above mentioned points and each issuer company is required to report whether they comply with each recommendation, and in each case explain how they comply with the particular recommendation or explain why they are not currently complying. This information is made available to the public in the form of a standard questionnaire or "survey" which each listed firm must fill out and publish in its company web page. Moreover, to ensure that the information is not out of date, firms are required to upload an updated version every year, so that investors are able to take appropriate investment decisions based on key financial and corporate governance facts. The regulators do not penalize listed firms for non-compliance, however, it is expected that the market will discipline firms that do not implement good corporate governance practices.

While the equitable treatment of shareholders was discussed in the 2007 Country Code, the new Code is more specific regarding the importance of providing information to shareholders and defending their rights. The new Code recommends that the firm must have a corporate web page to provide timely information to shareholders, and to have an office for investor relations. Moreover, it recommends that the firm organizes quarterly conference calls and that it provides ample information on the structure of conglomerates. Importantly, it recommends that shareholders with more than 5% of the ownership may have the right to ask for an audit of the firm. There are also recommendations to prevent insider trading such as adopting measures to prevent the top management from trading during SEOs or M&A events.

Another important aim of the Country Code is to revitalize the role of the *General Assembly of Shareholders* in order to promote shareholder activism. The Code recommends that the assembly meetings be announced to shareholders so that they have sufficient time to prepare, that there is ample publicity for the announcement of the meeting, and that the shareholders are informed about the meeting through the corporate web page and their emails. Another important recommendation is that the corporation provides a detailed agenda to shareholders indicating every point to be discussed in the General Assembly together with all relevant information so that shareholders may exercise informed voting. Also, it is recommended that shareholders can propose one or more subjects to be discussed on the agenda no matter their ownership participation.

Regarding the Board of Directors, the new code promotes a model of board that cares about the strategy, supervision, and control. However, it is left to each company to set up a specific structure of board suitable to their own characteristics. In addition, the new Code provides a list of detailed explanations about the board's function, its regulation, the way that it operates, guidance on how to act in case of situations involving potential conflicts of interests, how to reward board members, and how to organize governance mechanisms. The new code establishes specific recommendations for the corporate governance of conglomerates. This is very important in the Colombian context as this kind of firm organization has become very common, regulators have identified that it is a priority to have guidelines on this topic to prevent abuses in the transactions between firms belonging to the same conglomerate.

Also, the new Code dedicates a special section to discuss the importance and best practices of risk management. In this regard, the Code recommends that the board institutes a risk committee which has the duty of supervising the firm's risk management, and provides a very detailed description of its functions. This is important because the market and operational risk are some the most important issues for the sustainability and success of firms. Moreover, in this chapter of the Code there is a control architecture section that addresses issues related to the control of the operations of the firm that discusses the importance of risk control and monitoring.

Finally, the last section of the new Code is dedicated to the importance of information disclosure and accountability. This section is concerned with the appropriate communication of all relevant information regarding the firm to the market and to the shareholders. The new Code dedicates special attention to these issues, especially for the case of conglomerates so that companies may transmit relevant and timely information to all interested parties.

Regarding the adoption and implementation of the recommendations stated in the Country Code, we can distinguish two time periods based on the work of Gaitan (2009) and Trujillo-Dávila and Guzmán-Vázquez (2015). The evidence provided by Gaitan (2009) suggests a very low level of adoption of good corporate governance practices during 2001-2009. Gaitan shows that despite the fact that law 275 of 2001 required Colombian listed firms to implement a good corporate governance code; companies were slow to elaborate their own internal good corporate governance codes. More importantly, Gaitan provides data showing that after the introduction of the first Country Code in 2007 only a fraction of all listed firms made changes to their existing corporate governance codes. This evidence suggests that during the period 2001-2009 good corporate governance practices had a low priority for managements of Colombian firms.

In contrast, the evidence provided by Trujillo-Dávila and Guzmán-Vásquez (2015) indicates that a radical change occurred in Colombian corporate governance practices in the period from 2010-2013. According to these authors the Investors Relations program (IR program) of the Colombian Stock Exchange (Bolsa de Valores de Colombia), first implemented in 2011, was the key catalyst for this change in attitude towards good corporate governance, including more transparency and revelation of company information. According to this work, the key argument that seems to have persuaded the management of Colombian listed firms to adopt better corporate governance practices, is the claim by the Colombian Stock exchange that in order to attract funds from foreign investors, and to achieve greater availability and lower cost of capital, their level of transparency and revelation of company information needed to improve. Trujillo-Dávila and Guzmán-Vásquez (2015) construct an information revelation index and show that the level of revelation of information of large and medium capitalization listed Colombian firms during the period from 2010 to 2013 increased by about 24 percentage points. Hence, their evidence suggests that, in contrast to the earlier period, during the period 2010-2013 the managements of Colombian listed firms had a better understanding of the importance of good corporate governance practices and how these practice were important for the competitiveness of their firms.

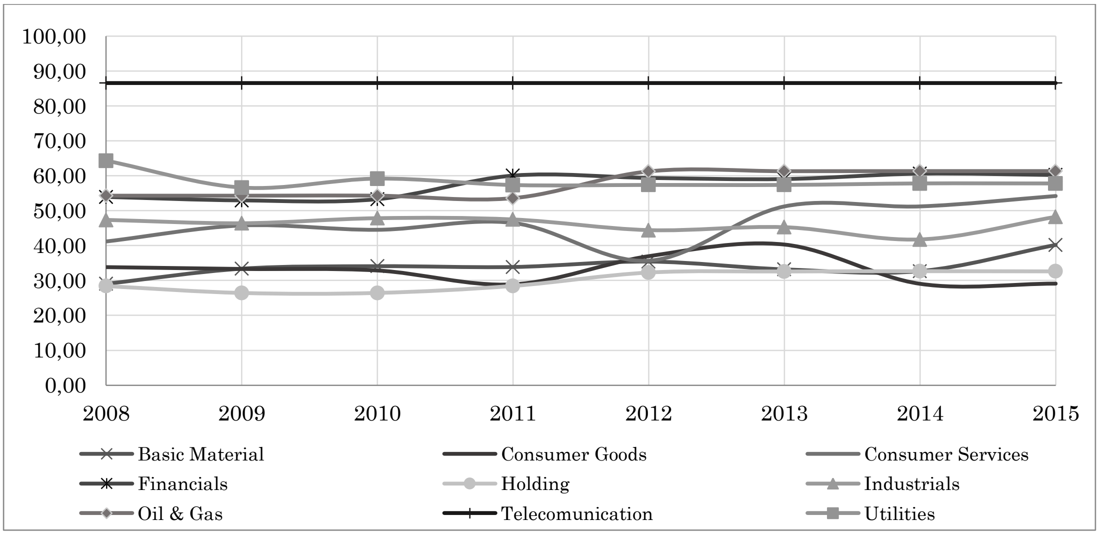
2.5.3. Ownership Structures of Companies in the Country

In the corporate governance literature, a firm is considered to have a controlling shareholder when an individual, institution or government owns at least 10% to 20% of the shares of a company (La Porta et al. 1999). In Colombia, in most industries, there is a controlling shareholder who owns more than 20% of the ownership stake of each listed firm. The latter is reflected in Figure 2.5.1 which shows industry averages for the holdings of the largest shareholders of Colombian listed firms. Moreover, the figure shows that there has been no substantial change in the ownership structure of listed companies in the country over the last ten years.

This evidence is consistent with international corporate governance theory. According to Denis and McConnell (2003) corporate governance mechanisms, which lead controlling managers to create value for shareholders, can be classified into internal mechanisms (Board of Directors, Ownership Structure) and external mechanisms (The Takeover Market, The Legal System). In the Colombian market, we see an important participation of internal mechanisms of control, especially through the ownership structure of listed firms.

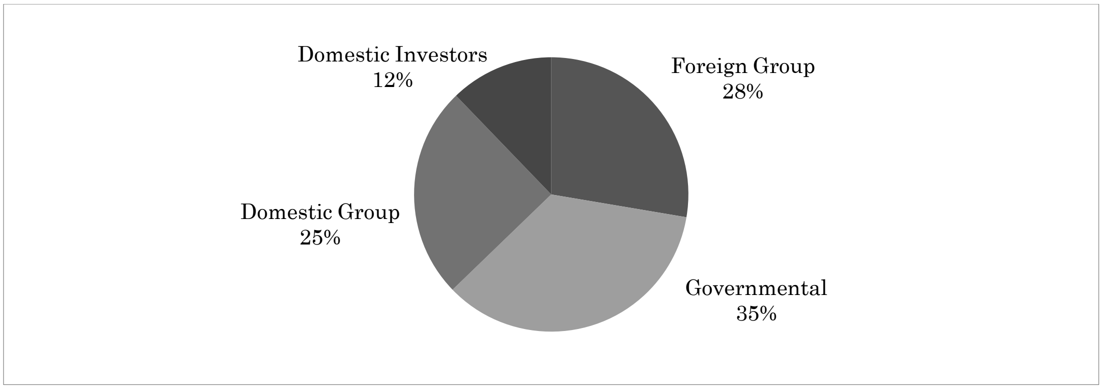
Doidge, Karolyi and Stulz (2007) suggest that corporate governance at the country level is more important in less developed markets, such as the case of the Colombian market than corporate governance at the firm level. However, they also find that corporate governance at the country and the firm level are complements and that both are important to have well-governed firms. Since there is relatively weak corporate governance at the country level in Colombia (Vasco et al., 2014), it is logical to expect a priori that there will be high concentration of ownership as a substitute corporate governance mechanism. This is precisely what we observe in Figure 2.5.1.

Figure 2.5.1. Percentage of shares held by the largest shareholder (Industry Average, 2008-2015)



Regarding the largest shareholder, we have examined 43 Colombian listed firms to explore the identity of the largest shareholder. In Figure 2.5.2 we classify the largest shareholders in four groups: Governmental, Foreign Group, Domestic Group and Domestic Investors based on the characteristics of the largest shareholder. We observe that in the Colombian market there is an important participation of the Government who owns 35% of the listed companies, especially in sectors such as utilities, telecommunication, and oil & gas. The second largest participation is from Foreign Groups who own 28% of the listed firms with investments in the financial, consumer services, consumer goods, industrials, utilities and basic materials. Domestic Groups own 25% of the listed firms in sectors such as financials, utilities, industrials and consumer goods. Finally, Domestic Investors, which are mainly firms engaged in investing in the Colombian stock market, own 12% of the listed companies.

Figure 2.5.2. Largest shareholder's Identity in Colombia listed firms in 2015



2.5.4. Market for Corporate Control (M&A)

According to the corporate governance literature acquisitions may be classified into mergers and tender offers. Importantly, while mergers are usually conducted with the collaboration of the incumbent managers and are usually considered friendly transactions, tender offers are often made directly to shareholders to overcome the resistance of incumbent managers and are described as hostile takeovers (Jensen and Ruback, 1983). Importantly, corporate governance researchers have found that shareholders of the target firms tend to benefit greatly from both mergers and tender offers. On the other hand, they have also found that firms that perform a tender offer tend to over-perform in the long-run (up to five years after the acquisition) while firms that merge underperform in the long-run (Loughran and Vijh, 1997). The generally accepted explanation of these facts is that tender offers usually create shareholder wealth because they involve the disciplining of target managers or the appointment of more efficient managers, while mergers tend to destroy shareholder wealth during the post-acquisition period as it does not involve improvements of corporate governance such as the removal of less efficient incumbent management.

In Colombia the market of corporate control is characterized by the absence of tender offers (hostile takeovers). In practice, acquisitions consist of friendly mergers that count with the collaboration of the management of the target firm. The reason is that, as we describe in the previous section, Colombian firms have very high ownership concentrations. The owners, their families, and friends are usually also the managers and directors of the firm, and therefore hostile takeovers are not feasible. In addition, for some of the largest and more important listed firms, the ownership is concentrated in economic groups. This suggests that when mergers occur these tend to benefit the interests of the economic groups and they do not necessarily create wealth for the outside shareholders.

2.5.5. Board of Directors' Practices

Board of directors is the main internal control mechanism of corporation. They are responsible for the well-functioning of the firm and must perform internal monitoring to protect shareholder wealth (Fama and Jensen, 1983). For this reason, the issue of board of directors' practices is one of the main topics in corporate governance. Azar and Grimminger (2011) have summarized the main findings of the Colombian corporate governance institute "Confederación Colombiana de Cámaras de Comercio (Confecamaras)" regarding board of director practices. They observe that the impact of the Country Code was likely to be limited at the time of their investigation, as most companies tended to comply only with what is required by Colombian law and not with the recommendations in the Code. For instance, companies would comply with the preparation of the country code survey since its elaboration is required by law; however, firms would not follow most of the recommendations stated in the Code.

One of the main duties of the boards of directors Colombia is to be loyal to the company and to shareholders. However, the study by Azar and Grimminger (2011) finds that, while Colombian law establishes joint liability for the board of directors in cases of malfeasance, there was no mechanism in place to assess the board's degree of compliance to their duties. Another key responsibility of Colombian boards of directors is to set the strategy of the firm. Yet the study finds that although the boards have the necessary information to exercise their role, in most cases the information is not timely. It is observed that only in the largest Colombian companies' boards of directors are usually well prepared and informed.

With respect to board characteristics, Colombian law requires that boards of directors must have a size ranging from a minimum of 5 to a maximum of 10 members, from which at least 25% of directors must be independent (Ley 964 de 2005). In this regard, corporate governance studies have found that in practice Colombian boards of directors tend to comply with the minimum percentage of independent directors required by law (Azar and Grimminger, 2011). On the other hand, although Colombian firms do not provide detailed information regarding director independence requirements, a recent study by Gaitan (2017a) finds that overall the directors of Colombian firms are experts who possess the necessary skills to successfully exercise their role.

Azar and Grimminger (2011) find that one of the main weaknesses of Colombian boards of directors relates to the monitoring, supervision, and handling of conflicts of interest. While Colombian CEOs are usually not the chairman of their boards and there is a clear separation between these two roles, the authors observe that evidence from surveys suggests that conflicts of interest are not discussed in board meetings in Colombia and that there is no mechanism to disclose a potential conflict of interests. In addition, they find that Colombian corporations disclose very little information regarding the practices and the actual performance of the committees of the board of directors. Moreover, Colombian firms lack well-developed practices to evaluate board performance, not to mention the means to evaluate the performance of each director individually. On the other hand, Colombian firms are required by law to have an audit committee formed by independent directors. However, very little is known about the composition of other committees such as the compensation and nomination committee, the corporate governance committee and the risk management committee. Finally, although the new Country Code establishes the importance of evaluating and implementing risk management measures, in practice, Colombian boards of directors tend not to discuss risk management policies adopted by their firms in their meetings. One possible explanation is that Colombian corporate culture still lacks a full understanding of the importance of risk management for the long term health of the business.

To conclude, we find that there is still very little information available regarding Colombian board practices in the corporate governance literature. New studies on these issues are needed as such investigations could help design and implement best corporate governance practices that enhance the role of the board of directors in the country.

2.5.6. Directors' Remuneration Practices

The Colombian commerce code (Código de Comercio in its article 187 number 4), establishes that the directors' remuneration must be approved by the general shareholder meeting. In addition, the new Country Code recommends that corporations should have a remuneration policy for the board of directors and that the total effective cost of the board of directors should be published on the company website. However, although in Colombia the majority of the companies that trade in the stock market publish the remuneration policy for both their board and its committees, only a few corporations publish the total amount of the directors' remuneration.

In consequence, we find that there are no academic studies about remuneration practices in Colombia. On the other hand, international consultancy firms that make surveys about these practices around the world sell information about remuneration practices of Colombian boards of directors. Thus, a recent survey conducted by an international consultancy firm finds that Colombian corporate boards are remunerated by session or by monthly payment and that if a member of the board participates in a board committee it receives additional payment. More importantly, according to the study the remuneration of Colombian directors is up to 40% lower compared to the remuneration of directors of companies in other Latin American countries (Dinero, 2017).

In sum, we find that although at the moment firms disclose their remuneration policy for their boards of directors, the revelation of the total remuneration amounts is less than transparent. Importantly, we also find that there are opportunities for future research in the field of director remuneration practices in Colombia as there are currently no academic studies available which would permit us to better assess the current situation of this important corporate governance dimension in the country.

2.5.7. Shareholder's Rights Protection

Regarding shareholder's rights protection in Colombia, the new Country Code of 2014 recognizes shareholders' property rights and states that they have the right to influence the way the corporation is run through their participation and vote in the annual General Shareholders Assembly, to request and receive timely information and to participate in the profits generated by the firm. Thus, the country code recommends an equitable treatment of shareholders and measures to achieve this in practice such the approval by the board of directors of a concrete procedure to communicate with shareholders and to receive their request for information and to provide them with relevant information. To prevent the dilution of the capital of shareholders, the Code recommends that the details of ownership structure be published on the corporation's web page and that the corporation must explain in detail all operations that may result in the dilution of the capital of shareholders. On the other hand, in order to provide information to shareholders regarding the profits or losses of the company, the Code recommends that corporations must organize events (such as podcasts or video-conferences) to present quarterly results to their shareholders and to market analysts.

Shareholders rights are also protected by the provisions of the Colombian commerce code (Código de Comercio). For instance, the commerce code in its article 191 states that shareholders can challenge resolutions made in the General Shareholders Assembly if these do not comply with the internal statutes of the corporation or with Colombian law. Additionally, article 830 of this code states that if a controlling shareholder abuses its rights and causes damages to other shareholders, minority shareholders can sue the controlling shareholder in court and may receive indemnification.

In practice, however, although the laws give substantial protection to shareholders through these and other articles of the commerce code, there are problems with the application of the law as it is usually too costly and too time-consuming for shareholders to obtain redress from the courts. This is reflected in measurements taken by the World Bank's World Governance Indicators (WGI) project regarding the effectiveness of the rule of law in Colombia. In particular, the WGI's rule of law indicator which measures perceptions regarding the quality of contract enforcement, property rights, police and the courts among others, shows that while the effectiveness of the rule of law in Colombia has improved substantially in the last 20 years, it still lags other Latin American countries, such as Chile and Brazil, in this respect (World Bank, 2015).

2.5.8. Shareholder Activism

Traditionally, shareholder activism did not have an important role in the governance of Colombian firms. However, this started to change with the enactment of law 275 of 2001 which specifically mandates that in order to be eligible to receive investments from pension funds Colombian corporations must first adopt a good governance code (Gaitan 2009, p. 144).

More recently, the participation of pension funds and hedge funds as a percentage of the total ownership in the Colombian stock market has increased substantially, so that in the last ten years has reached an average of between 50 to 60%. This presence of pension and mutual funds has had a positive impact on corporate governance in Colombia through increased shareholder activism. For example, in 2015, in an extraordinary shareholder meeting of Grupo Exito, one of the main retailers in Colombia, Casino Group (the controlling shareholder of Grupo Exito with 54.84% of the votes) approved the acquisition by Grupo Exito of assets of its subsidiaries in Argentina and Brazil for USD 1,826 million, at a time of heightened uncertainty in those Latin American markets. Minority shareholders in Colombia who had 31.5% of the votes (including Colombian pension funds with 18.1% of the votes) were understandably worried about the increased risks and the possibility of minority shareholder expropriation as Casino Group was the controlling shareholder of both the acquiring company and the targets (La República, 2015). Following the approval of the transaction, institutional investors such as Porvenir sold part of their share participation and the stock price of Grupo Exito fell strongly. In addition, minority shareholders including institutional investors sued Grupo Exito. Although the result of this legal action by shareholders is still pending, this episode illustrates that shareholder activism is becoming an important force that controlling shareholders will have to reckon with in the Colombian stock market which will likely improve corporate governance in Colombia.

2.5.9. Corporate Governance and Firm Performance

The Colombian stock market is characterized by having a small number of listed firms. For instance, as of May 2017 there were only 69 issuers in the Colombian stock market. Of these, only about 20 are liquid and are listed in the COLCAP index which is the main stock market index in Colombia. Hence, studies on the relationship between corporate governance and market performance for Colombia are confronted with the difficulty that observations are generally too few to make reliable inferences. Thus, Langebaek and Ortiz (2007) construct a corporate governance index for Colombian firms to study the relationship between corporate governance and Tobin's q but do not find any significant relationship between these two variables.

On the other hand, Gutierrez and Pombo (2007) examine the relation between corporate control (voting rights) and performance of Colombian companies from 1998 to 2002. They find that ownership and control are positively associated with firm performance measured as ROA and ROE even for affiliate firms. Additionally, they construct an index using a survey of the companies to evaluate corporate governance standards. However, they do not find any evidence of a significant relationship between better corporate governance practices and firm performance.

One way researchers can increase the number of observations in their samples is to include non-listed companies in their studies and examine accounting measures of firm performance. Thus, Benavides and Mongrut (2010) study the effect on the ROA of Colombian firms of issuing a good governance code in accordance with the requirements of law 275 of 2001. The authors find that the firm's ROA improves about 1% after the introduction of the good governance code.

Several of the relevant studies that examine the relationship between governance and performance for Colombia do so as part of a regional study of this relationship for Latin America. In a recent study, Trujillo and Guzman (2015) construct an information revelation index to examine the relationship between information revelation and Tobin's q in six Latin American countries (Colombia, Brazil, Mexico, Peru, Argentina, and Chile). The authors find a positive and significant relationship between their revelation index and Tobin´s q, which suggests that good governance as measured by a higher information revelation index improves firm performance as measured by Tobin's q.

In another study for Latin American countries, Fuenzalida et al. (2008) investigate the relationship between ownership concentration and required a return on equity. They conduct their study for five Latin American countries (Brazil, Chile, Colombia, Peru and Venezuela) and conclude that, on average, stockholders require a higher rate of return on their investments in companies with the highest ownership concentration compared to companies with the lowest ownership concentration in Latin America. According to these authors, their findings suggest that in Latin America minority shareholders face higher risks of expropriation at the hands of majority shareholders.

In sum, although the results are not conclusive, the studies suggest that while there is a positive relationship between corporate governance and accounting measures of firm performance (ROA, ROE) this does not necessarily reflect value for the shareholders as measured by market measures of firm performance (Tobin's q). The reason is that since the control of the company is entrenched, the corporation will not necessarily pay out the benefits of good performance to shareholders in the form of dividends, or generate capital gains in the long run. However, recent studies that report improvements in information revelation suggest that increased transparency in recent years will help align the interests of shareholders and management in Colombia so that good accounting performance will likely translate into good market performance in the future.

2.5.10. Corporate Social Responsibility (CSR)

There are two main corporate governance philosophies in the world. While Anglo-American countries follow a shareholder-wealth maximization model of corporate governance in which the key goal is to create value for shareholders, other non-Anglo-American markets, such as Germany, follow a stakeholder orientation in which controlling shareholders are constrained by other groups such as communities, the environment, and employees (Eiteman et al. 2013).

For the case of Colombia, we find that the Country Code follows a shareholder wealth maximization orientation and that the interest of other stakeholders is not fully recognized. Moreover, recent studies have found that there is no national corporate social responsibility policy or vision in place in Colombia. For instance, a study conducted by Jansen and Veeneman (2016) finds that in Colombia there is no central organization responsible to provide support for the implementation of CSR policies in Colombian companies. Instead, there are several decentralized institutions that give advice and recommendation in this area, such as Pacto Global, Global Reporting Initiative, Cecodes, among others. Also Jansen and Veeneman find that Colombian companies have a rather short term vision regarding the implementation of CSR policies as opposed to a long term business perspective. Moreover, according to these authors, there is a lack of culture regarding the meaning of CSR, there are no measures for the promotion of CSR, and even more companies tend not to share their experience in these matters.

Nevertheless, we would argue, in contrast, that although there is no centralized authority and there certainly are difficulties such as a lack of CSR culture, Colombian companies have started to adopt corporate social responsibility policies of their own accord and are starting to show some progress in this direction. Moreover, we find that subsidiary companies have established effective CSR strategies following the international standards of their parent companies.

2.5.11. Brief Industrial Specifics of CG in the Country

Regarding industrial specifics of corporate governance in Colombia there are important differences between governance in financial institutions and companies of the real sector. While the corporate governance of financial institutions is highly regulated through obligatory norms issued by the Superintendencia Financiera de Colombia (Colombia's financial regulator) based in part on international regulations such as the Basel accords, the corporate governance of companies in the real economy is regulated mainly through the commerce code and the Country Code. While the latter relies on a nonbinding comply or explain regulatory approach, the corporate governance regulations of the commerce code are very general and usually do not cover any specific governance recommendations such as those found in the Country Code. Hence, the corporate governance standards maintained by the financial sector are much higher than those of companies in the real sector. However, recent studies found that there is not statistically significant between the adoption of corporate governance practice of financial firms in Colombia and the shareholder profitability explained by the fact that per se those financial firms have more regulation and control that those required by the country code (Gaitan, 2017b).

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