Challenges of Governing GLOBALLY

A STRONG UNDERSTANDING OF THE THREE DISTINCT CORPORATE GOVERNANCE SYSTEMS AROUND THE WORLD WILL HELP MANAGERS CONDUCT BUSINESS MORE EFFECTIVELY IN OTHER COUNTRIES.

By Marc J. Epstein

Shortly after New Year's Day in 2009, just six months after Satyam and its politically influential chairman, Ramalinga Raju, were honored by the World Council for Corporate Governance, the company and its senior leadership became the subject of the largest corporate fraud investigation in India's history. Raju admitted to fabricating 70 billion rupees ($1.5 billion) of Satyam's assets and 95% of the previous year's revenue. Despite its record for good governance, this large, respected outsourcing firm saw its market value fall more than 80% in 24 hours. Long before the confession, shareholders had expressed dissatisfaction with Raju's leadership. Many charged that the board of directors and its members failed to meet their basic responsibilities.

Senior executives aren't the only perpetrators of corporate fraud. A scandal at Volkswagen (VW), Germany's largest carmaker, erupted in 2005 when it was discovered that managers and labor representatives had received improper benefits from the company and its suppliers. A quid-pro-quo agreement had developed between managers and labor that centered around the important role that union representatives play on German boards (workers' representatives have 50% of the seats on the supervisory boards of companies with 2,000 or more employees). In return, the local government, which was the controlling shareholder of the corporation with only 18% ownership (the voting rights of any single shareholder are limited to 20%), was satisfied with the ability to guarantee regional job security. Yet it seemed that the other shareholders may not have been receiving equal benefits, and the VW board found itself unable or unwilling to protect its minority owners from actions that didn't maximize the returns to everyone.

Understanding corporate governance practices globally should be a priority for managers who work in multinational corporations or with international clients.

Not all corporate governance failures involve financial fraud. In 2010, BP, one of the world's largest oil and gas companies, saw its market value fall by more than 50% in less than 60 days after the infamous explosion at a deepwater drilling rig off the U.S. Gulf Coast. The incident killed 11 employees and resulted in the largest marine oil spill in history, costing BP billions of dollars in compensation for victims and cleanup costs. The government investigation of the explosion revealed numerous causes and guilty parties. Many people have suggested that BP's board failed to put the right processes in place to ensure that reasonable safety measures were taken to prevent such a disaster.

These stories occur far too often in corporations all over the world. Enron, WorldCom, and Tyco in the United States and Parmalat in Italy immediately come to mind. Sometimes these failures are fraud, and sometimes they're the result of poor oversight. Nevertheless, they have caused us to reexamine the structures, systems, and processes of corporate governance.

As you know, corporate governance is the system by which corporations are directed, controlled, and made accountable to shareholders and other stakeholders. Failures such as those outlined above occur in a wide variety of companies and industries and in different countries around the world. Understanding corporate governance practices globally should be a priority for managers who work in multinational corporations or with international clients.

Here I'll describe three corporate governance systems—Anglo-American, Communitarian, and Emerging Markets—and provide a comparison that you can use to recognize and evaluate differences in practice. This is a summary of extensive work that I recently completed in response to many inquiries from senior managers who want to better understand how to evaluate corporate and board performance in other countries.

Table 1 summarizes some of the major differences in the general characteristics of each system.

Global Corporate Governance Systems

Corporate governance practices vary globally as a result of significant country differences, such as culture, history, regulatory systems, and economic and financial development. All of you who interact with corporate managers in other countries or have affiliates or subsidiaries throughout the world must understand these

Table 1: General Characteristics of Global Corporate Governance Systems

	ANGLO-AMERICAN	COMMUNITARIAN	EMERGING MARKETS
EXAMPLES OF COUNTRIES/REGIONS	United States, United Kingdom, Australia, Canada, South Africa	Japan, Germany, Belgium, Scandinavia	China, Eastern Europe, India, Brazil, Mexico, Russia
GENERAL CHARACTERISTICS			
	• Shareholder-centric	• Stakeholder-centric	• Stakeholder-centric
	• Market centered	• Bank centered	• Government/Family centered
	• Unitary board structure	• Two-tier board structure (supervisory & management)	• Board structure varies
	• Boards primarily composed of nonexecutive directors (and independent directors)	• Labor, founding family, and bank are common members—interlocking common	• Few independent board members
	• Common law legal system	• Civil law legal system	• Legal systems relatively weak
	• High levels of disclosure and more rules on disclosure	• Moderate levels of disclosure	• Low levels of disclosure
	• Large pay incentives for managers, including pay for performance	• Pay incentives moderate	• Pay incentives smaller

differences because it's critical to the evaluation of corporate board performance and to corporate success. It also has important implications for corporate governance, corporate financial and operational transactions, and global relationships.

Let's look at some of the basic differences.

Anglo-American Corporate Governance System

The Anglo-American system of governance evolved in countries to which the U.K. exported its common law legal system during its colonial period, such as the U.S., Australia, New Zealand, Canada, and South Africa. Originally developed to protect private landholders from nobility, the common law legal system sets a broad legal precedent that protects shareholders and tries to prevent a company's leaders from acting against shareholder interests.

In the Anglo-American system, corporations focus primarily on the shareholder and aim to maximize shareholder wealth. Directors usually are elected by shareholders and can be replaced if shareholders aren't satisfied with the company's financial results. The system emphasizes transparency and disclosure about a company's audited financial status, board composition, and corporate strategy.

Since well-developed financial markets heavily influence corporate governance practices, the Anglo-American system is considered market-based with a large share of corporate ownership traded frequently on large, public exchanges. Under this system, corporate boards are structured as unitary boards and are composed primarily of nonexecutive directors (directors who aren't company employees) who represent the interests of large shareholders. These boards also have independent directors with little financial interest in the future performance of the firm. Critics of this system have argued that boards are frequently too large (with as many as 20 members) and that directors have often failed to dedicate enough time to their roles.

Communitarian Corporate Governance System

A Communitarian corporate governance system has evolved in much of continental Europe and in Japan. This system has its origins in the Romano-Germanic civil law codes developed more than a millennium ago. Instead of relying on strong legal protections for investors, performance is regulated through statutes, codes, and relationships with stakeholders.

The Communitarian system is relationship-based, which provides for a stakeholder-centric approach to governance and focuses on a broader set of stakeholders that often includes lenders, members of supply chains, customers, employees, and the community. These relationships allow stakeholders to wield strong control over corporations and hold them accountable. In Germany and Japan, for example, it's common for companies and banks to cross-invest in their suppliers and customers, creating associations of corporations that play an active role in deciding corporate governance standards. Boards often include representatives from various stakeholders who are representing their own interests. A banking representative may be interested in a decision's impact on the corporation but also on the bank he or she works for. Similarly, a union representative on the board is interested in the impact of a decision on the corporation and its shareholders but particularly on the workers that the union represents. This stakeholder orientation provides for a broader set of interests and representation on the board.

Corporate governance under the Communitarian system relies heavily on banks instead of capital markets for financing, and representatives from these banks often sit on the board of directors of a company that they finance. This system generally uses a two-tier board structure, dividing board functions between a supervisory board and a management board.

Critics of the system have argued that it fails to protect minority shareholders and lacks representation for outside investors.

Strategic oversight is an important board role in all three governance systems.

Emerging Markets Corporate Governance System

Emerging Markets countries—such as China, Brazil, India, Mexico, Russia, and much of Eastern Europe—still have relatively young legal systems that haven't fully developed the legal framework necessary to classify their corporate governance systems into the other categories. In China, for example, the first corporations were founded centuries after countries with more defined corporate governance systems began their corporate history. These countries also differ in legal traditions, language, and culture, so it's still uncertain how corporate governance will likely evolve there.

Yet there are some recognizable patterns. The lack of defined legal systems means that shareholders often have few credible legal protections, so boards are expected to vigorously monitor and protect shareholder interests. Also, low levels of disclosure and a lack of transparency often make it difficult for shareholders to exercise informed control over the company.

Corporate governance in Emerging Markets countries tends to be stakeholder-centric and centered around family or government relationships. In addition, large corporate shareholders dominate boards and are well known worldwide. For example, about 30 Korean family groups that are organized as chaebols (business conglomerates) control almost 40% of that country's economy. There's also a large amount of state participation. Even in countries where the government has privatized its corporate holdings, it often retains significant control over corporations by regulating equity markets or influencing board members. For example, often the government retains a regulatory interest in supervising large transactions that have an impact on the state. (All governments do this to some extent, but it's far more common in the Emerging Markets countries.)

Roles of the Board Globally

Though significant differences in corporate governance practices exist, some general principles are present globally that are critical for effective corporate governance. Boards of directors are usually expected to fulfill three separate but related roles: accountability, senior-level staffing and evaluation, and strategic oversight. (For more details on roles and responsibilities of corporate boards, see Marc J. Epstein and Marie-Josée Roy, "Corporate Governance Is Changing: Are You a Leader or a Laggard?" *Strategic Finance*, October 2010, pp. 31-37).

Accountability

In Anglo-American countries, boards of directors traditionally have been responsible for holding managers accountable to shareholders. In the Communitarian system, it's common for the corporation, management, and board to also be accountable to other stakeholders, such as

Table 2: Internal Determinants of Corporate Governance Systems

CORPORATE GOVERNANCE MECHANISM	ANGLO-AMERICAN	COMMUNITARIAN	EMERGING MARKETS
BOARD COMPOSITION, SYSTEMS, & STRUCTURE			
Board composition	• Balance between internal and independent directors	• Few independent directors	• Independent directors rare
Board structure	• Unitary	• Two-tier	• Varies
Board accountability	• Shareholders	• Stakeholders (including entire value chain and employees)	• Stakeholders and government or founding family
Executive compensation	• Large performance pay	• Moderate performance pay	• Little performance pay

employees, suppliers, and customers. In the Emerging Markets system, boards are typically accountable to the controlling shareholders in the corporation, which can be the state, a family group, or a corporate conglomerate. Thus, it's common to have representatives of these other stakeholders on boards in non-Anglo-American countries.

Senior-Level Staffing and Evaluation

Evaluating senior management, determining their compensation, and having important input to senior staffing decisions are important roles for the board in all three governance systems. But there are important application differences. In the Anglo-American system, many corporations pay managers a huge amount of compensation for their performance in exchange for relentless attention to financial returns. In the Communitarian and the Emerging Markets systems, pay levels, performance-based pay, and the role of the board in determining pay are considerably smaller.

Strategic Oversight

In all three governance systems, strategic oversight is an important board role. In the Anglo-American system, managers focus on strategy formulation, and the board, though providing some oversight, often plays a more passive role in approving important strategic moves. In the Communitarian system, the management board is more assertive in its strategic oversight role and is often more involved in the formulation of strategy than in oversight only. And in the Emerging Markets system, many board members view the formulation and oversight of strategy as the primary role of the board.

Though these specific roles manifest themselves differently in different settings, they greatly impact the mechanisms that ensure managers fulfill shareholder expectations regarding corporate performance.

Internal Determinants of Corporate Boards

How successfully a board performs its duties depends on several internal factors that differ substantially among the three global governance systems (see Table 2). These factors may affect managers' roles and interactions with the board, as well as their compensation. They include:

1. Board composition,
2. Board systems and structure, and
3. Performance evaluation and compensation systems.

Board Composition

Board composition choices determine board competencies, skills, and power structures. Many corporate governance experts and international guidelines advocate increased board member independence and increased numbers of nonexecutive directors on boards, yet the role of nonexecutive and independent directors is markedly different in each corporate governance system.

In the Anglo-American system, boards are composed primarily of nonexecutive directors who represent the interests of large shareholders, as well as independent directors with no significant financial interest in the future performance of the firm. Usually there are stringent requirements for board independence since these board members often have a significant amount of power. In Canada, for example, 70% of companies have independent directors serving as their board chair.

In the Communitarian system, independent directors are less common but still hold a considerable amount of power. Since national codes and companies typically don't stress the independence of board directors, most corporation board members in Japan, Italy, and much of continental Europe are internal. This is partly because of codetermination laws that mandate high levels of employee participation on the supervisory board.

The Emerging Markets system features many of the regulatory requirements of the Anglo-American system with regard to independent directors, but truly independent directors are uncommon and wield little power relative to controlling interests on the board. In China, for example, listed companies are required to have two independent directors. Despite these requirements, many believe that Chinese directors show few signs of true independence and are still strongly influenced by the government.

Board Systems and Structure

Board systems and structure are the mechanisms typically used to translate board roles, responsibilities, and composition into decisions. They also vary significantly across governance systems.

Again, in the Anglo-American system, a unitary board typically combines executive directors (company executives who are on the corporate board) and nonexecutive directors. Boards usually are organized into committees—such as audit, nomination, and compensation—that perform much of the board's functions.

In the Communitarian system, the executive directors and nonexecutive directors are divided into two separate entities. The management board, composed mainly of senior-level management, is primarily responsible for managerial decisions, such as strategy, marketing, and product development. The supervisory board, composed of company insiders, such as employees, as well as company outsiders, such as independent accountants, is primarily responsible for overseeing executive management, accounting, senior-level staffing, and evaluation. Employees also can play a significant role in determining the composition of the supervisory board. Shareholders elect the supervisory board, and the supervisory board appoints members of the management board. In Germany, employees elect a third to a half of the members of the supervisory board. In addition, representatives from founding families or national banks may also serve on this board.

In the Emerging Markets system, the board structure varies between countries and even among corporations in the same country. Some corporations have adopted the two-tier board structure of Communitarian countries, and others utilize the unitary board structure of the Anglo-American system. The largest shareholders, usually the state or family groups, often are permitted to control the boards.

Performance Evaluation and Compensation Systems

Performance evaluation and compensation systems also differ among governance systems. In the Anglo-American system, boards are expected to perform rigorous evaluations of senior manager and corporate performance. It's common to structure executive compensation so that a large percentage of that pay is tied to the financial performance of the corporation. Evaluation procedures only recently have become part of corporate governance in the Communitarian system, and most companies in the Emerging Markets system lack explicit evaluation mechanisms. In the two latter systems, large performance-based pay is significantly less common and accounts for a much smaller percentage of overall executive compensation than in Anglo-American countries.

External Determinants of Corporate Board Systems

External factors also affect how boards of directors perform their roles and responsibilities. Three that determine key components of corporate governance are:

1. Markets,
2. Legal systems, and
3. Ownership and control structures.

These mechanisms (see Table 3) ensure that corporations act according to national expectations regarding corporate governance. An understanding of these external factors will provide managers with insight into board regulation, objectives, operations, and decisions.

Markets

The existence of markets for ownership and control of corporations is an important aspect of corporate governance since the threat of takeovers increases when mechanisms for governance fail. Takeovers are most common in the Anglo-American system, particularly in the United States, while the existence of a controlling shareholder in the Communitarian and Emerging Markets systems lessens the likelihood of a takeover.

Beyond corporate control, stock markets determine the returns available to stockholders in a corporation and diversify ownership. In the Anglo-American system, these

Table 3: External Determinants of Corporate Governance Systems

CORPORATE GOVERNANCE MECHANISM	ANGLO-AMERICAN	COMMUNITARIAN	EMERGING MARKETS
MARKETS			
Financial markets	• Strong and active	• Weak and not commonly used	• Volatile
Investment purpose	• Short-term return	• Long-term return	• Policy and political goals
Methods of finance	• Financial markets	• Bank credit and retained earnings	• Private and state-owned banks
LEGAL SYSTEMS			
Legal history	• Common law system	• Civil law system	• Combined systems that are still rapidly evolving
Transactional methods	• Contracts	• Relationship-based transactions	• Relationship-based transactions
OWNERSHIP & CONTROL STRUCTURES			
Ownership structure	• Diverse individual and institutional ownership	• Concentrated family and corporate ownership	• Concentrated family, corporate, and government ownership
Minority shareholder protections	• Strong	• Moderate	• Weak
Dominant control	• Voting and board representation	• Cross-holding, pyramidal groups, lending relationships	• Internal mechanisms and external mechanisms

markets are quite active. More than 6,000 domestic companies are listed publicly in the U.S., and more than 1,000 are listed in the U.K. But only a relatively small number of firms are listed in Communitarian countries. In Germany, for example, there are fewer than 500 listed companies. In Emerging Markets, stock exchanges are developing rapidly, although there is a great deal of variation across countries. China, for example, has become a "dominant force" in the initial public offering (IPO) market in the last two years with its large exchange in Hong Kong. Yet in Mexico, only a small percentage of transfers occurs through the public markets.

Market listing requirements play another important role in corporate governance. In the Anglo-American system, these regulations have become a dominant mechanism for implementing corporate governance reforms. Several large stock exchanges in Anglo-American countries have adopted mandatory listing requirements that include more stringent corporate governance measures, such as the qualification and roles of board members, having a majority of independent directors, and having a requirement for certain committees such as audit and compensation for publicly traded companies. Many Communitarian and Emerging Markets stock exchanges have followed suit more recently.

Legal Systems

Legal systems affect other aspects of corporate governance, including investor protection for minority shareholders, ownership structure, and financial markets. They also are an important aspect of how investors are protected.

The Anglo-American corporate governance system, developed from the common law tradition, often exhibits the best legal protection for investors and tends to provide better enforcement of these laws. The Communitarian corporate governance system, derived from the civil law system, has developed other mechanisms to ensure that capital is allocated efficiently. These include concentrated ownership and control, mandatory dividends, and limited equity markets.

Countries in the Emerging Markets system have even fewer shareholder protections than in civil law countries and have evolved a severely concentrated ownership structure to compensate for these weak protections. In addition, the state often plays a much more active role as a corporate owner.

Ownership and Control Structures

Concentrated ownership and minority control mechanisms can be viewed as corporate governance mechanisms that evolve in the absence of basic shareholder protections. As a result, the most concentrated ownership structures are usually in Emerging Markets economies. One of the most glaring examples of this concentration is in China, where the state still owns majority holdings in most of the large firms, and Hong Kong, where a small group of business tycoons controls most large companies through concentrated shareholdings.

There's considerable ownership concentration in Communitarian countries as well. In Germany and Japan, for example, large banks, corporate groups, or families can control large portfolios of companies. Although these groups don't always hold majority stakes, they use a variety of tactics to steer the company in the direction that they prefer. These tactics include cross-shareholding, where two or more companies controlled by the same family group or government invest in each other, and pyramidal shareholding, where a company owns a sizable minority stake in a holding company that owns smaller stakes in more companies.

In Anglo-American countries, financial institutions, including pension funds, own more than 60% of all equity capital, yet ownership is quite dispersed. In this system, countries typically lack a controlling shareholder, so officers and directors have more control over decisions. This means that boards are responsible for ensuring that these decisions are in the best interests of the shareholders.

Closely related to ownership and control of corporations are the existence and enforcement of minority shareholder rights. These rights deal with voting privileges, corporate meetings, and dividends. For example, can major shareholders control corporate decisions, and must these decisions be for the benefit of the entire corporation, for all of its shareholders, for all of its stakeholders, or for only the small limited set of controlling shareholders? For an individual small owner of stock, the Anglo-American system provides far more protection both by regulation and through the legal system. In other systems, small shareholders must often just go along with what a major shareholder wants whether it is in their best interests or not.

In Emerging Markets economies, the state is frequently the controlling owner and can use its political power to derive wide control over corporations. In China, for example, rules surrounding the boards of directors of major corporations and financial markets are structured to give the state control over corporations. Even in countries where the state has started to turn control of corporations over to the private sector—such as in India, Brazil, and Russia—governments continue to wield significant power because of their ability to control the legal framework and market environment.

Understanding the Systems Is Critical

As corporations become more global, senior financial executives constantly deal with international contractors, licensees, affiliates, suppliers, and subsidiaries. Since these global associations and entities are often subject to different regulatory regimes and corporate governance systems, their decision-making processes can provide surprises. They may choose to ignore that your bid is the lowest and choose a higher-cost bid from a controlling shareholder, but it may be that the decision is to choose a contract from a controlling shareholder that benefits their relationship and benefits the other corporation—who is a common shareholder on multiple entities. Also, it may seem strange to a U.S. manager that a corporation might decide to make decisions that benefit the environment or the labor union over shareholders since the U.S. model is shareholder focused. Remember: The other systems aren't better or worse, but they *are* different—and it's important for managers to understand this as they are doing business in other countries. To better understand decisions and constraints and to conduct business around the world more effectively, executives must understand the context, regulations, and processes of corporate governance in other countries. Without this understanding, evaluating and/or improving performance globally is difficult. **SF**

Note: This article draws heavily from Marc J. Epstein, "Governing Globally: Convergence, Differentiation, or Bridging," in Eds. Antiono Davila, Marc J. Epstein, and Jean-François Manzoni, *Performance Measurement and Management Control: Global Issues*, Emerald: U.K., 2012.

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