# CHAPTER 3
CORPORATE GOVERNANCE-THE INTERNATIONAL PERSPECTIVE

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“Global market forces will sort out those companies that do not have sound corporate governance.”

– Mervyn King
(Chairman: King Report)

3.1 INTRODUCTION:

Developments taking place worldwide have sparked off a growing interest in Corporate Governance, which is showing an increasing trend as time goes on and on. Liberalisation and deregulation the world over are inducing organisations to adopt good corporate governance standards. Markets are becoming more sophisticated and more complex due to the freedom that they enjoy in the global scenario. Greater freedom implies greater responsibilities. These also result in more volatile and inter-linked global economy. The fact that the world is getting smaller due to globalization is indisputable. At the same time, it is beyond doubt that globalization has bought with it competition and consequently, a stronger thrust on the implementation of Corporate Governance practices in all organisations.

3.2 CORPORATE GOVERNANCE- THE GLOBAL SCENARIO

Recent developments have shown that inadequate corporate governance standards in organisations can result into economic susceptibility. Effects are instantaneous. Detrimental developments taking place in one organisation can generate similar cyclical effects in other organisations or institutions. On account of this reason, Corporate Governance becomes indispensable for survival of the global economy. Consequently, it becomes obligatory for these organisations to adhere to mandatory corporate governance practices since inadequate governance practices can result into ineffective risk management and financial instability. Subsequently,
international institutions are initiating the development of standards and practices of good Corporate Governance. Numerous international initiatives have been taken in this regard by many countries around the globe.

3.3 CORPORATE GOVERNANCE AND CAPITALISM-THE CONNECTION

The Father of Economics, Adam Smith first talked about Capitalism in his book “The Wealth of Nations” It was his perception of the invisible hand of competition restrains free competition. The reason for Adam Smith's unyielding resistance to monopolies and their practices was due to the restrictions they posed on free competition and consequently they hampered effective management. Due to this, he believed that joint stock companies could never prosper because managers had no incentive to take care of the interests of the shareholders, as they would be too busy taking care of their own interests. The basic power structure of the joint-stock company form of business includes the many shareholders who contribute to the capital of the company and thus are the actual owners of business. They elect a Board of Directors to monitor the running of the company on their behalf. The Board, in turn, appoints a team of managers who actually handle the day-to-day functioning of the company. They periodically submit their reports to the Board. Thus managers are the agents of shareholders and function with the objective of maximizing shareholders’ wealth. The key issues in corporate governance are making sure that the managers actually act on behalf of the owners of the company i.e. the shareholders – and pass on the profits to them. The indispensable features of the joint-stock company are limited liability and dispersed ownership, which involve inefficient monitoring of management by the actual owners of the business. Managers enjoy actual control of business and may not serve in the best interests of the shareholders.
Capitalism is an economic system that is organized around the production and allocation of capital. The savings of individuals are the basis of all capital. People keep aside a portion of their income after consumption as savings. They then invest this with the hope of getting a good rate of return on it. These savings that are invested by individuals forms the basis of capital for organizations. There are several ways in which individuals in different economies accumulate and allocate capital. Different economies are organized in very different ways, and corporate governance is assigned to people and regulated by different authorities. The corporate governance systems in different countries are different due to the disparity in the ways in which organisations are formed and controlled. In many poor economies throughout the world, corporate sectors are controlled by a combination of state authority and wealthy families. The legal system of a country plays a crucial role in creating an effective corporate governance mechanism in a country and protecting the rights of investors and creditors. The socio-legal aspects determine the nature of corporate governance in the country.

Capitalism is a collection of economic systems throughout the world. In many countries, capitalism is a system where a handful of immensely wealthy families control nearly all organisations of a country and often the government as well.

(a) Shareholder capitalism:
Shareholder capitalism is a branch of Capitalism and is practiced in the United Kingdom and United States. It involves the kind of investors who have perfect knowledge about organisations in which they would like to invest. Hence, capital is directed to firms that can use it well. In other words, capital is kept away from firms that are likely to mismanage it because investors have to trust a company if they want to buy its securities and they need reassurance that the company will be run both honestly and cleverly. This is the main reason where the importance of corporate
governance reaches great heights. The corporate governance of large corporations in these countries is entrusted to CEOs and other professional managers. Investors play a major role by collectively monitoring the quality of governance of every organisation. A change in the share price of that organisation reflects their outlook towards the company. Globalisation has been responsible for internationalization of cross-border portfolios in between nations. Composition of shareholding differs from country to country. The pattern of share ownership is undergoing metamorphosis in several countries. This has led to a greater concentration of share ownership in the hands of institutional investors.

For example, institutional investors form a large chunk in some countries in Europe and the United States. In the United States, key institutional investors have focused on improving the accountability of corporate boards and managers. The California Public Employees’ Retirement System (CalPERS) which is the largest U.S. public pension fund and the Teachers Insurance and Annuity Association – College Retirement Equities Fund (TIAA-CREF) that is the largest U.S. pension fund have issued guidelines concerning the board of directors and their functions. The Council of Institutional Investors and the AFL-CIO have also issued guidelines relating to the corporate governance practices of the board of directors. Institutional investors diversify their portfolios and invest overseas. They tend to ensure that investment is made in companies that are consistently profitable. They are concerned with many factors influencing the company including governance and the company’s relationship with its stakeholders. While investing, institutional investors look at the level of transparency and accountability that the company has to offer. This, in turn, leads to a better flow of foreign direct investment amongst more and more countries.

(b) Family capitalism:
The most common system of corporate governance in the world is family capitalism, wherein the governance of a country’s large corporation is
entrusted to its wealthiest few families. Corporate governance in many countries is remarkably concentrated in the hands of a few wealthy families. Governance can deteriorate if the patriarch, or heir, controlling a large business group grows inept and excessively conservative or overly protective.

(c) Bank capitalism:
In bank capitalism, oversight by bankers substitutes for shareholder diligence. Bankers monitor the governance of other firms, and intervene to correct governance mistakes. In situations where the firms are misgoverned, banks withhold credit, thus directly affecting the working of the firm. This system can allocate capital efficiently only as long as the bankers are unselfish and capable.

(d) State capitalism:
In state capitalism, public officials supervise corporate managers, and intervene to correct any governance problems. But governance problems can arise if the public officials have inadequate ability or knowledge to make decisions. State capitalism delivered brief periods of high growth in many countries, but seems prone to serious governance problems of these sorts over the longer run.

3.4: CORPORATE GOVERNANCE AND THE CORPORATE OBJECTIVE:

Different governance systems articulate the corporate objective in different ways; depending on which of two primary concerns is taken as the main focus that is societal expectations and ownership rights. Some nations focus on the need to satisfy societal expectations and, in particular, the interests of employees and other stakeholders. This view is held in many countries in continental Europe like Germany, France and The Netherlands. It is also predominant in certain countries in Asia. Other countries emphasize the
primacy of ownership and property rights, and focus the corporate objective on returning a profit to shareholders over the long term. The corporate governance environment is shaped by stock exchange listing rules and a host of laws and regulations related to disclosure requirements and accounting standards, the issue and sale of securities, company formation, shareholder rights and proxy voting, mergers and acquisitions, fiduciary duties of directors, officers and controlling shareholders, contract enforcement, bankruptcy and creditors’ rights.

The relationship between a shareholder/stakeholder and the company is directly related with the level of transparency and accountability that the company has. A company that has a higher level of transparency and disclosures inspires confidence. On the other hand, companies that do not follow disclosure requirements and engage in malpractices such as related-party transactions will not be valued highly. They will also find it harder to raise additional capital. Corporate governance helps to restore investor confidence in countries that have experienced financial crises. Overseas investor confidence is also restored with the introduction of corporate governance practices. The impact of economic crises is not felt to a very great extent in countries where corporate governance standards and investor protection practices are high. However, emerging economies may initially face problems as the quality of corporate governance is might be inferior. This might affect the returns on investment which may be detrimental to growth.

3.5 GLOBAL INITIATIVES IN CORPORATE GOVERNANCE:

1. Modern interest in corporate governance improvement and the development of corporate governance codes in EU Member States dates to the early 1990’s and, in particular, a series of financial scandals and related
failures of listed companies in the United Kingdom. Member states of the European Union have various objectives:

- The Preda Report of Italy identifies shareholder maximisation as the primary objective.
- The Peters Report of Netherlands advises companies to “seek a good balance” between the interests of shareholders, who provide risk capital, and other stakeholders.
- The Viénot I Report of France states that the board is to promote the “interests of the company.”
- The Berlin Initiative Code calls on the management board and the supervisory board “to be aware of social responsibility to a reasonable extent.”

2. Voluntary guidelines and codes of best practices issued by regulating authorities and institutions provide only the basic guidelines for an organisation where corporate governance practices are concerned. The main obstacle, however, is that one particular code cannot apply to all when it comes to board practices. Hence, these guidelines and codes attempt to only establish standards for improved corporate governance. They are short of conformity and lack authority. Different countries have taken different initiatives in establishing and improving corporate governance scenarios.

- A major point of difference in corporate governance practices among member states of the European Union is that of the use of a unitary versus a two-tier board. In the majority of EU Member States the unitary board structure is predominant, although in five of these States, the two-tier structure is also available.
- Each system has unique benefits. The one-tier system may result in a closer relation and better information flow between the supervisory and managerial bodies; the two-tier system encompasses a clearer,
formal separation between the supervisory body and those being “supervised The codes express remarkable consensus on issues relating to board structure, function, roles and responsibilities. Many suggest practices designed to enhance the distinction between the roles of the supervisory and managerial bodies, including supervisory body independence, separation of the chairman and CEO roles, and reliance on board committees.

3.6 INTERNATIONAL COMMITTEES ON CORPORATE GOVERNANCE:

Many countries around the globe have taken numerous initiatives with regard to improving corporate governance practices. This is because they have recognized and understood the need for best practices considering globalisation and increasing shareholder base of organisations around the world.


The declared objective of the Cadbury Committee was "to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them".

The Committee investigated accountability of the Board of Directors to shareholders and to the society. The Cadbury Code of Best Practices had 19 recommendations, which were not mandatory; the companies listed on the London Stock Exchange were required to clearly state in their accounts whether or not the code had been followed. The companies who did not comply were required to explain the reasons for non-compliance.

The OECD groups 30 member countries sharing a commitment to democratic government and the market economy. With active relationships with some 70 other countries, NGOs and civil society, it has a global reach and its work covers economic and social issues from macroeconomics, to trade, education, development and science and innovation. It is well known for its publications and its statistics. Ministers at the OECD Council meeting at ministerial level on 26-27 May 1999 endorsed the OECD Principles of Corporate Governance. They were developed in response to a mandate given to the Organisation by the OECD Council meeting at ministerial level in 1998 to develop a set of standards and guidelines on good corporate governance.

3. **Basel Committee on Banking Supervision- “Enhancing Corporate Governance in Banking Organization” Basle, Switzerland (1999).**

The Basle Committee on Banking Supervision, which is a committee of banking supervisory authorities, was established in 1975. It has central banks from Belgium, Germany, Italy, the Netherlands, Sweden, Switzerland, the United Kingdom Canada, Japan, Luxembourg, France and the United States and senior representatives of bank supervisory authorities as its members. The permanent Secretariat of the Committee is located in Basle and its meetings are conducted at the Bank for International Settlements (BIS) in Basel.

4. **The Business Roundtable.**

The Business Roundtable was established in the United States in 1972. It is an alliance of CEOs of organizations throughout the
United States. This organisation has been effective in bringing out numerous papers on the subject of Corporate Governance. They are:

i. Statement on Corporate Governance (September 1997);
ii. Statement on Corporate Responsibility (October 1981);
iii. Corporate Governance and American Competitiveness (March 1990);

3.7 CORPORATE GOVERNANCE CODES- A COUNTRY-WISE LISTING:

Countries have developed several codes and standards to improve corporate governance practices. Also, many international organisations have come forward and developed corporate governance standards in the global arena. Many statements and reports have been issued and published with regard to this. Some of them are mentioned below.

**France**
- Viénot I Report-July 1995
- Hellebuyck Commission Recommendations (Updated)- October 2001
- Viénot II Report-July 1999

**Germany**
- Amendment to the German Corporate Governance Code - The Cromme Code-12 June 2006
- Corporate Governance Code for Asset Management Companies 27 April 2005
- The German Corporate Governance Code (The Cromme Code) 26 February 2002
- Berlin Initiative Code-June 2000
- German Panel Rules-July 2000

**United Kingdom**
- Cadbury Report (The Financial Aspects of Corporate Governance) 1 December 1992
- Greenbury Report (Study Group on Directors' Remuneration) 15 July 1995
- Audit Committees - Combined Code Guidance (the Smith Report) January 2003
- The Combined Code on Corporate Governance June 2006
- Hermes Statement (Updated) January 2001
- Turnbull Report September 1999

**United States:**
- Asset Manager Code of Professional Conduct November 2004
- Final NYSE Corporate Governance Rules 3 November 2003
- Report of the NACD Blue Ribbon Commission on Director Professionalism 2001
- TIAA-CREF Policy Statement on Corporate Governance March 2000

**Australia**
- Revised Corporate Governance Principles and Recommendations, 2nd August 2007
- Principles of Good Corporate Governance and Best Practice Recommendations, March 2003
- Horwath Corporate Governance Report, 2002
3.8 **CONCLUSION:**

Corporate governance initiatives around the globe have grown significantly during the last decade. Regulatory authorities of numerous countries have been instrumental in issuing corporate governance codes which have resulted in increased transparency and disclosure norms in those countries. Just as laws differ from country to country, so do the corporate governance practices vary in the same manner worldwide. Different countries have different set-ups of Corporate Governance practices that are based on several factors like the political, economic and social background of that country. This gives rise to the question as to whether a universally accepted code of corporate governance is attainable. Although corporate governance can be defined in a variety of ways, generally it involves the mechanisms by which a business enterprise, organized in a limited liability corporate form, is directed and controlled. It usually concerns mechanisms, which holds corporate managers accountable for corporate conduct and performance.