

# Corporate Governance and Director Accountability: an Institutional Comparative Perspective\*

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**This paper examines the role of boards of directors in light of institutional contingencies and recent best practice governance guidelines and regulation such as the United Kingdom Higgs Review and the United States Sarbanes-Oxley Act 2002. Particular attention is paid to discussing the role of independent directors across countries, and the implications for corporate governance innovation. It concludes by posing questions about recent corporate governance transformations and providing suggestions for future research.**

‘Having served on the board of public companies since 1993, [she] has watched the culture of boardrooms change from golf games, cigars and fancy dinners to meetings that begin at 6 a.m. and intense pressure to submerge oneself in ever-changing accounting and governance regulations.’ (*Wall Street Journal*, 21 June 2004, p. R4).

## Introduction

In the post-Enron era, corporate governance reforms around the world are fully underway to bring greater power balance within the firm – particularly reining in over-mighty chief executives – and to resolve power struggles among the different stakeholders. Corporate governance systems provide several mechanisms to ensure that firms are run effectively and maximize shareholder and/or stakeholder value. On the one

hand, the external market for corporate control seeks to direct managerial behaviour towards given market expectations and national legislation such as the Sarbanes-Oxley Act (SOX) 2002, which imposes new responsibilities on corporate executives, auditing firms and boards to solve conflicts of interests and increase firm accountability. On the other hand, the internal market for corporate control is conceptually entrusted to the board of directors. Boards are by definition the internal governing mechanism that shapes firm governance, given their direct access to the two other axes in the corporate governance triangle: managers and shareholders (owners). Boards of directors are one of the centrepieces of corporate governance reform. In effect, the board of directors has emerged as both a target of blame for corporate misdeeds and as the source capable of improving corporate governance.

Licht (2002) defines governance as the rules and structures for wielding power over other people’s interests, including the use and abuse of power. Organizational democracy is likely to be in jeopardy when a given stakeholder group has too much power. For example, some US business leaders claim that ‘an indiscriminate increase in

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\*Research support from the Vernon K. Zimmerman Center for International Education and Reserach in Accounting at the College of Business and the European Union Center at the University of Illinois at Urbana-Champaign is greatly appreciated.

[institutional investor] activism could harm shareholder democracy' (Roberts, 2004, p. 9). Among the factors that have triggered the debate on corporate governance reform and, particularly, on greater firm accountability, are high-profile corporate scandals (Maxwell, Enron, WorldCom, Tyco, Shell), the rise of shareholder activism (Coffee, 1991; Davis and Thompson, 1994), and growing social pressures on firms to become more socially and environmentally responsible (Aguilera *et al.*, 2004) and to report on it (e.g. triple bottom-line reporting initiatives).

Much of the weight in solving the excess (generally executive) power within corporations has been assigned to the board of directors and, specifically, to the need for non-executive directors to increase executive accountability. Roberts, McNulty and Stiles (2005) go beyond the traditional board studies that looked at board demographics and composition and open the boardroom black box by exploring the dynamics of its power and influence to assess board effectiveness. Their qualitative study of listed British firms in 2002 (commissioned for the Higgs Review) seeks to understand board processes and the necessity for compromise between the two generally accepted non-executive director roles: collaboration and control. One of the most interesting insights that Roberts, McNulty and Stiles (2005) set forth is that non-executive directors should not go beyond their roles or, in other words, substitute for the executive directors' role. In particular, they propose three sets of behaviours that will enhance board accountability without creating an unproductive dynamic in the board game: namely that non-executive directors' behaviour should be 'engaged but non-executive, challenging but supportive, and independent but involved'. As is discussed below, their emphasis is primarily on the relationship between boards (non-executive directors) and managers (executives), and less so on the critical relationship between boards and shareholders.

It is worth noting that what occurs in corporate governance within the UK, and, in particular, within the realm of the London Stock Exchange (LSE), is likely to have great consequences for the rest of the industrialized world for three reasons. First, the UK corporate governance system operates within a common law environment that grants strong rights to minority shareholders (La Porta *et al.*, 1998) and

is in many ways closer to US shareholder primacy than to the stakeholder-oriented corporate governance system of continental Europe. We could even speculate that emerging and non-developed countries are converging towards the UK corporate governance model as a middle-range model (Oman, 2003). Second, British financial regulators such as the Financial Reporting Council, the accountancy profession, institutional investors and the government have been the instigators and trend-setters of corporate governance innovations that spread all over the industrialized world (Aguilera and Cuervo-Cazurra, 2003; Cuervo-Cazurra and Aguilera, 2004). Lastly, given that the LSE houses the largest percentage of foreign-owned firms (24% as opposed to 17% on the New York Stock Exchange (NYSE), and 1.4% on the Tokyo Stock Exchange as of June 2004) and also hosts the majority of the world's cross-border securities trades and management (Clark, 2002), the United Kingdom might turn into a global corporate governance regulator since any regulation, code or listing standard endorsed by the LSE becomes by default a 'global gold standard of corporate governance' in the country of origin of an LSE-listed firm (Williams and Conley, 2005).

This article expands on Roberts, McNulty and Stiles' (2005) ideas regarding boards in the UK by developing a broader view of corporate governance that accounts for the different national institutions in which corporate governance is embedded and, subsequently, by employing an institutional comparative analysis method. It argues that national institutions such as the ownership structure or the enforceability of corporate regulations tend to enable as well as constrain diverse corporate governance mechanisms. Parallel to this comparative research, it asks the following questions: *for what purpose* and *to whom* should boards be accountable. We need to better understand the role of boards of directors in different institutional settings before we can engage in the debate of *how* to increase board accountability. As will be shown, these questions are contingent on the definitions of corporate governance and boards.

This article is divided into the following sections. The first section reviews the different elements within the corporate governance equation and highlights the comparative institutional contingencies. The second section looks at the

transnationality of governance practices, the cross-national conceptualizations of good governance and the key role of boards in the current governance debates. The third section examines the characteristics of boards of directors and their accountability and the fourth section compares the role of non-executive directors in different countries and their current composition. The article concludes with an assessment of the effects of recent governance changes and suggestions for future research.

### The corporate governance equation

The corporate organization is a social system or collective entity with pluralist interests and some common goals. Corporate governance refers to the distribution of rights and responsibilities among the different actors involved in the corporate organization (Aguilera and Jackson, 2003). Governance, be it in a country or in a team, will generate conflicts of interest and, hence, it requires the development of relationships and contracts among the different actors implicated. Agency theory accounts have dominated the corporate governance literature until recently. The agency theory of the firm (Fama and Jensen, 1983; Jensen and Meckling, 1976) suggests that when individuals engage in firm relationships, they are utility maximizers, self-seeking and opportunistic and, therefore, the governance system must introduce mechanisms that will align the interests of principals (owners) with those of their agents (the managers). Property rights theory (Alchian and Demsetz, 1972) complements the principal-agent relationship by recognizing that explicit contracts between the different actors in the firm and the distribution of firm value do not always capture the complexity of corporate governance, as contracts can be implicit and incomplete (Asher, Mahoney and Mahoney, 2005; Grandori, 2004).

Comparative corporate governance research is less likely to benefit from agency theory insights grounded in the Anglo-Saxon context. In effect, the agency view of governance can at times be myopic, particularly when tested in the non Anglo-Saxon context, for three reasons. First, it assumes that principals and agents, as collective groups, share homogeneous interests when, for instance, principals can range from family owners

to institutional investors often pursuing different, and even conflicting, goals. Heterogeneous principals with different rights are more prevalent outside the USA, where shareholder primacy dominates. Second, agency theory undermines the possibility that principals and agents might seek stewardship interests (Davis, Schoorman and Donaldson, 1997) such as firm sustainability or employee well-being (Aguilera, Rupp, Williams and Ganapathi, 2004). The nature of corporate governance systems outside the USA has brought more attention to non-shareholder value issues (Conley and Williams, 2005). Lastly, agency accounts tend to oversee the cognitive side of corporate players in the sense that agents and principals make decisions based on their cognitive map and personal values (Cybert and March, 1963; Forbes and Miliken, 1999), which are influenced by national culture and values.

Governance models in different countries allocate power within the firm differently. The most widely accepted, stylized dichotomy of power allocation is between the so-called shareholder-oriented models, characterized by seeking to maximize shareholder value (e.g. USA) versus stakeholder-oriented models, characterized by fulfilling the interests of the diverse stakeholders in the firm (e.g. Continental Europe and Asia). A classic corporate governance debate is the one dealing with convergence/divergence (Guillén, 2003) that discusses whether corporate governance models will converge towards a single model (i.e. the Anglo-American model) in light of globalization pressures. Recent arguments go beyond the convergence/divergence debate and state that in order to understand how corporate governance models are changing around the world and what practices get translated into different settings we need to take into account path-dependency legacies and national institutional settings.

The transition to market economies in Eastern and Central Europe is an excellent laboratory to analyse the diffusion and innovation of corporate governance practices (Aguilera and Dabu, 2005; Federowicz and Aguilera, 2003) in that region as well as in other emerging markets (Peng, 2004; Peng, Buck and Filatotchev, 2003). The distribution of firm value and corporate control, given the limited resources of the firm, is highly political and is coupled with cognitive maps of what to expect from the firm (Fiss and Zajac,

2004) and of national institutional characteristics (Aguilera and Jackson, 2003; Aguilera and Yip, 2004).

Corporate governance practices are contingent on the changing institutional environment. Thus, countries that have traditionally relied on long-term returns and patient capital from banks might have to adjust their governance practices in light of the changing institutional environment. This is particularly salient given the changes as financial markets become more international, larger and more liquid. Three specific trends are worth mentioning. First, we observe a relative decline in universal banks (e.g. in Austria, Germany, Japan and Korea), which traditionally exercised a monitoring and financial function in the overall corporate governance system, and now, increasingly, seeks greater profitability outside their industry relationships (Beyer and Hassel, 2002; Edwards and Fischer, 1996). Second, the rapid emergence of institutional investors as the dominant holders of financial assets is one of the distinguishing factors of the present landscape, where individual investors seek portfolio diversification and greater liquidity. For example, the total volume of assets of institutional investors in the United States more than doubled from 1993 to 2001 with investment companies having the highest share, followed by pension funds and insurance companies (OECD, 2003). In the UK, institutional investors are the largest owner of domestic equity. A third major change in the financial markets is the growth of savings for private pensions encouraged by government policies, and often in light of welfare-state retrenchment. This entails that company funds devoted to pensions need to be better secured to prevent corporate mishandling and abuses such as the Maxwell case in the United Kingdom in the late 1980s (Jackson and Vitols, 2001). The broader consequence of these national and global institutional changes is that national corporate governance might be more susceptible to foreign influences and, ultimately, innovation in corporate governance.

### **Cross-national influences in corporate governance and transnational regulation**

Governance practices travel the industrialized world. Isomorphism exists, but mostly there is a

translation of practices to fit the national institutional settings such as the development of a capital market or the structure of the labour market. Financial internationalization, shareholder mobilization and corporate scandals all trigger corporate innovation that often occur across borders. The post-Enron era has led to the awareness and renaissance of codes, regulations and good practices that are either enacted by law or endorsed by different institutions, such as accounting associations or stock exchanges. The UK is a pioneer and trend-setter in codes of good governance. For example, most of the practices suggested in the Cadbury Report (1992) have been incorporated in the transnational corporate governance guidelines issued by the OECD in 1999.

An example of transnational influences is the logic behind the Higgs Review. The US corporate scandals in late 2001 fuelled reactions across the Atlantic by the UK government. According to Jones and Pollitt (2004, p. 164), the UK 'wanted to be seen to react quickly to the [US] crisis, but also to head-off potential consequences of US regulation and legislation for companies of British origin which are listed on the NYSE'. Consequently, the UK Chancellor of the Exchequer and the Department of Trade and Industry commissioned the Higgs Review, which was issued in January 2003, proposing some guidelines on how to improve the independence and accountability of non-executive directors. The Higgs Review displays a slight (British) sarcasm towards the attractiveness of the US corporate governance model but, unlike the Cadbury Report that brought to light the importance of non-executive directors on the board, the Higgs Review goes further. It emphasizes what Roberts, McNulty and Stiles (2005) seem to miss, that is, the need to strengthen the channels of communication between shareholders and the board (via the senior independent director). The US/UK comparison of corporate governance is interesting because, despite sharing a common legal system, they have chosen to address corporate innovation in very different ways, as illustrated by comparisons between the situation before and after the Sarbanes-Oxley Act (Black and Coffee, 1994; Jones and Pollitt, 2004; Keenan, 2004).

An ongoing research question and, more recently, a policy debate, is over the identity of the governance traits that guarantee good corpo-

rate governance practices. In effect, empirical evidence on the link between prescribed good governance and economic returns is rather thin. This is mostly because there is no agreement on how we define good governance. Is good governance having staggered boards or the legal obligation of the board to consult shareholders in the face of a hostile takeover? Should good governance relate to those governance structures that maximize shareholder value or should it take into account maximizing customer satisfaction, employee benefits and a clean environment? The answer is closely tied to the nature of the corporate governance system. Although the shareholder-oriented model is claimed to be the superior paradigm of corporate governance (Hansmann and Kraakman, 2001), the competing stakeholder-oriented paradigm is gaining momentum, as illustrated by the following two examples.

First, the European Union is seeking to harmonize and improve corporate governance among the European Union Member States, as described in the Action Plan 'Corporate Governance and Company Law' – which proposes a set of initiatives aimed at 'strengthening shareholders' rights, reinforcing protection for employees and creditors and increasing the efficiency and competitiveness of European businesses' (EU, 2004). These governance principles are aligned with the broader belief that "well managed companies, with strong corporate governance records and sensitive social and environmental performance, outperform their competitors" (EU, 2004). Second, the OECD Principles of Corporate Governance (1999) endorsed by World Bank and the International Monetary Fund, as well as prominent institutional investors such as CalPERS, highlight the need for equal treatment of all shareholders and underscore the relevance of other stakeholders with which the firm interacts, such as employees and environmental interests. These two examples reflect the ideological distance from the shareholder-oriented model.

Codes of good governance have spread quickly throughout the industrialized world since 1992 and, interestingly enough, those countries seeking foreign direct investment and having weak protection for minority shareholders have developed the greatest number of codes (Aguilera and Cuervo-Cazurra, 2004). One of the most active

countries in issuing codes of good governance is the UK. For example, the UK Combined Code approved in November 2003 is an effort to integrate several codes of good governance – the Cadbury Report (Committee on the Financial Aspects of Corporate Governance, 1992), the Greenbury Report (Study on Directors' Remuneration, 1995), the Hampel Report (Committee on Corporate Governance, 1998), and the most recent (Higgs Review) – into a set of guidelines laying out the principles of good governance.

Good governance codes and guidelines are enforced through diverse mechanisms, not always involving legal enforcement. The UK tends to rely on soft regulation (following the principle of 'comply or explain') to signal what non-executive directors should do, but ultimately leaving it up to individual firms to decide how to innovate corporate governance. The USA relies on legislation enforceable in the court system to ensure adequate governance. One of the problems with codes of good governance is that it is hard to assess whether or not codes are simply a box-ticking corporate governance tool decoupled from a transformation in the firm's corporate governance culture. Thus, one could ask whether non-executive directors in different countries will have the capacity or cultural predisposition to behave as suggested by the Higgs Review or by the further refined prescriptions of Roberts, McNulty and Stiles (2005). That is, will board culture in a globalizing world be shifted towards the Anglo-American expectations of independence and accountability? The answer is probably not.

In some countries, being a non-independent director is associated with high status and not necessarily with the intensive review of accounting, financial and governance documents. For example, Spanish boards tend to be family members (this is not always obvious due to different last names) or politicians (often appointed when the firm was state-owned). In some cases, particularly in collectivist-oriented countries and where there is strong hierarchically based economic organization, corporate practices such as 'whistle-blowing' (a move carefully crafted and protected under the Sarbanes-Oxley Act) would be highly stigmatized and very likely to damage the careers of those coming forward. Thus, it is hard to imagine that firms in Japan might introduce a whistle-blowing hot line. They will probably 'translate' this mechanism to fit

their own corporate culture. Moreover, based on cultural differences, directors across countries will have different concepts of what constitutes ethical and fair behaviour.

### **The role of boards of directors: rubber-stampers or adversaries?**

Corporate governance research has made good progress in analysing the demographics of boards and their structure (Daily, Dalton and Cannella, 2003). This section addresses the question of what the role of directors is and to whom they are accountable. This will, hopefully, help us understand how they can fulfill their tasks more effectively.

The board has been formally defined as ‘the link between the shareholders of the firm and the management entrusted with undertaking the day-to-day operations of the organization’ (Stiles and Taylor, 2001, p. 4). Zahra and Pearce (1989) identify the main functions of the board as strategic, controlling (monitoring managers and accountability) and institutional (building links with investors and stakeholders). Sociological research from different theoretical traditions has studied who directors are, and what they do for the firm. Notably, the class-hegemony theory has focused on interlocking directorates to support their arguments about the perpetuation of elites (Mizruchi and Schwartz, 1988) and resource-dependence theory sees boards as co-optative mechanisms to match the firm with environmental demands (Pfeffer, 1972; Zald, 1969).

The US legal tradition defines directors as the fiduciary agents of the corporation – those designated to hold assets in trust or to exercise authority on behalf of someone else – and, as such, they have two main legal duties: care and loyalty. Bagley (2002, p. 780) states that the duty of care asks directors ‘to make informed and reasonable decisions, and to exercise reasonable supervision of the business’, while the duty of loyalty requires them ‘to act in good faith and in what they believe to be the best interest of the corporation, subordinating their personal interests to the welfare of the corporation’. However, the reality is much less restrictive as there is a great deal of scope for interpretation of what the interest of the corporation should be. In effect, Blair and Stout (2001) show that even the US

‘shareholder primacy’ claim, where directors should exclusively serve shareholder interests, is not enforced by US corporate law, and directors are, in fact, mediators between the many different stakeholders that bear residual risk and have residual claims on the firm.

The board duties outlined in the OECD Principles (1999) also emphasize overseeing management, but they more explicitly state the duty of ‘fulfilling its accountability obligations to the company and to the shareholders’. The fact that the OECD introduces the concept of accountability is fascinating because, as pointed out by Licht (2002), accountability is not a universal concept. In fact, the word accountability does not exist *per se* in most romance languages, Hebrew, or Russian, and it is often translated as responsibility. The literal translation in Spanish is ‘to report’ (*rendir cuentas*). In addition, as discussed by Licht (2002), different countries understand and implement corporate accountability in different ways that reflect the diversity of their corporate governance systems.

Board structures are not homogeneous across countries (Hopt and Leyens, 2004; Keenan, 2004). This might justify a diversity of ownership structures. Most notably, company law in France, Germany, The Netherlands and China requires and/or allows listed firms to adopt a two-tier board (as opposed to a unitary board) composed of a Board of Management (or decision-making unit) and a Supervisory Board (or monitoring unit). For example, in Germany the supervisory board (*Aufsichtsrat*) is by law composed of independent or non-executive directors and includes employee representatives (50% in companies with more than 2000 employees). One of the key goals of this board structure is to ensure the independence of the two boards by making sure that executives are not too powerful. The dual-board structure, strongly embedded in some national systems, is currently being questioned. For instance, the EU lets new firms registering under European statutes (*societas europea*) to choose between one or two-tiered systems (Hopt, 2002).

A comparative perspective underscores the immense power, charisma and leadership given in the US corporate governance system to the chief executive officer (CEO), usually also exercises the role of chairman of the board. In fact, in the USA, the split of these two roles is

generally perceived as a transitional arrangement or a sign of weakness, particularly in the case of new outside CEOs (Khurana, 2002). The over-centralization of power in the CEO is evident in the gap between the CEO's salary and that of other executives. The stratification gap reflected in the compensation dissonance between the CEO and the line employee is much larger in the USA than in Continental Europe where contingent pay never fully developed. If we turn to the Japanese case, where CEOs fulfill a *quasi* honorific role as opposed to a strategic role, CEO succession fits within the firm culture of low conflict and a seniority-based labour market.

Two other key players stand out in the US corporate governance system: the CFO and CRO. Zorn (2004) has documented the rise of the CFO (chief financial officer) to share the driver's seat with the CEO. This phenomenon is further strengthened by the Sarbanes-Oxley Act requirement for the company's CEO and CFO to sign off on the accuracy of quarterly financial reports – financial misreporting is punished with criminal penalties. According to the Spencer Stuart Board Index 2003, new directors with accounting backgrounds now form 5% of the newly appointed directors on S&P 500 firm boards whereas, before the introduction of Sarbanes-Oxley Act, there were no directors with this background on S&P 500 boards. Second, we

also expect to see the emergence of the chief risk officer (CRO), formerly a glorified insurance-buyer, with dual reporting duties to the audit committee of the board and to the CEO or CFO.

Boards of directors are supposed to hold managers accountable and to report to shareholders about managerial conduct. However, while the relationship between directors and managers has historically been strong, either due to its cosiness or to its contractual nature and, it has recently improved thanks to pressures from regulatory groups and market forces. The relationship between board and shareholders has been largely ignored. Montgomery and Kaufman (2003) suggest that there are two serious flaws in the shareholder-board relationship that are likely to threaten the entire equilibrium of the corporate governance system: (1) poor exchange of information between boards and shareholders' and (2) shareholders' failure to influence boards. Consequently, directors are supposed to represent constituencies who are unclear about their preferences and who have few mechanisms to demand director accountability.

Historically, shareholders have been almost universally passive towards the board for various reasons. The exception is when directors are also the shareholders, in which case you do not have to develop a shareholder-director relationship. It is important to keep in mind that shareholder

Table 1. Listed corporate equity by type of shareholder (in percentages at year end)

Type of Shareholder:	USA			UK <sup>c</sup>			Germany			France			Sweden		Japan <sup>d</sup>		
	1986	1993	1996	1976	1993	1996	1985	1993	1996	1982	1994	1996	1993	1996	1983	1993	1996
Households	51	49	49	28	18	21	17	17	15	38	19	23	16	19	27	24	20
Financial sector:	51	46	47	60	61	68	15	29	30	24	8	30	23	30	42	44	42
Banks	...	...	6	...	1	1	...	14	10	...	4	7	1	1	...	22	15
Pension funds <sup>a</sup>	...	31	28	...	51	50	...	7	12	...	2	9	8	14	...	18	12
Investment funds <sup>b</sup>	...	11	12	...	7	8	...	8	8	...	2	11	14	15	...	3	—
Other financial firms	...	4	1	...	2	9	...	—	—	...	—	3	—	—	...	1	15
Non-financial firms	15	—	—	5	2	1	51	39	42	22	58	19	34	11	25	24	27
State	0	—	—	3	1	1	10	4	4	0	4	2	7	8	0	1	1
Foreign	6	5	5	4	16	9	8	12	9	16	11	25	9	32	5	7	11
Other	—	—	—	—	2	—	—	—	—	—	—	—	10	—	—	—	—
Total	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Notes:

— not applicable.

... not available.

<sup>a</sup>Includes insurance companies.

<sup>b</sup>Includes mutual funds.

<sup>c</sup>UK figures are for end of 1994 instead of the end of 1996.

<sup>d</sup>For Japan, pension and investment funds are included under other financial institutions.

Sources: OECD (1995, p. 17; 1998b, p. 16; 2004, p. 33); Berglof (1988).

structures are quite diverse across countries as shown in Table 1, and ownership patterns continue to shift. In the USA, ownership dispersion and legal restrictions on institutional investor activism – until the repeal of the Glass-Steagall Act in 1999 – led to the ‘strong managers-weak owners’ paradigm introduced by Roe (1994) and to the 1980s empowerment of managers at the expense of owners. In the UK, ownership concentration is higher, and institutional investors are key owners, unlike their American counterparts. British institutional investors (generally speaking) have been more active and considerably more interested in influencing managerial change and making boards of directors accountable (Black and Coffee, 1994). In continental Europe, industrial banks and other corporations within the conglomerate or pyramidal structure have until recently been majority owners, frequently sitting on the board so there was little room for minority shareholders to express their voice. Ownership patterns are slowly changing as Japanese banks are divesting themselves of industrial shares, and European companies are privatized. A remarkable transformation can be seen in the case of French firms that shifted their ownership pattern from domestic and state-owned cross-shareholdings to high levels of foreign ownership, primarily Anglo-American mutual and pension funds (Goyer, 2001; Morin, 2000).

At the core of what directors do and to whom they are accountable is how directors are nominated. Although most countries’ company law gives shareholders the power to elect board members of their choice and, thereby, hold directors and managers accountable, the day-to-day practice is quite different. The so-called democratic process of corporate governance where one share equals one vote generally devolves to the board’s nomination committee when it comes to the selection of new directors. The politics of board election are particularly interesting because it involves the danger or opportunity of putting the agendas of underrepresented stakeholders such as labour or special interest groups on the table.

The first decision in the selection process is who has the power to nominate directors and to draw up the list of the nominees. In the USA, management puts forward the list of nominees, and shareholders have the option of voting ‘yes’ or abstaining, but they are not allowed to vote

‘no’. As Eckbo (2004) puts it, this is how it works: ‘if 99 percent of the voters abstain, management’s proposal for directors still passes (although with obvious embarrassment)’. The signalling of abstaining has some power, as Michael Eisner of Disney discovered in March 2004 when an unprecedented 45% of shareholder votes were withheld, and he decided to resign as Chairman of Disney’s board. This is not unique to the USA. Less than one quarter of OECD countries allow voting by mail, that is, the shareholder (or representative) must appear in person to vote (Eckbo, 2004).

Staggered (or classified) boards are yet another mechanism to weaken shareholder voice. This board structure makes only one-third of the board eligible for re-election each year and, hence, reduces accountability for two-thirds of the board members. Sears, Roebuck & Co., Federated Department Stores Inc. and Gillette Co. are examples of companies that continue to operate under staggered board structure in the name of shareholder interest despite shareholder resolutions calling for board structural change (Hymowitz, 2004). These roadblocks in the selection process confirm Pareto’s theory of the reproduction of élites, and they are likely to exclude the voices of minority shareholders unless an alternative mechanism is in place.

The Securities and Exchange Commission (SEC) in the USA has recently proposed an election reform to facilitate shareholder-nominated directors on the ballot. This proposed reform has met with strong managerial opposition claiming the reform would over-expose the company to special interest groups. The alternative in place in the USA is to return to proxy contests, which are very expensive, not easy to exercise and, at the end of the day, quite limited (despite the fact that the SEC reviews all excluded proposals). This is not the case in the UK, Australia, New Zealand and Canada, where shareholders have a common law right to propose resolutions at annual shareholder meetings and, consequently, may initiate major decisions (OECD, 2004, p. 60).

## Independent directors

At the crossroad of board debates is the role of independent directors (also called outsiders, or



non-executive directors (NEDs)), particularly in light of their presumed weakness in preventing corporate scandals or holding executives accountable. The law has generally not differentiated between insider and outsider directors and assigns equal liability to insiders and outsiders, despite the differences in their roles. The role of the independent director is in the midst of change, particularly if we make national comparisons. Corporate governance reformers are increasingly focusing on NEDs in hopes that they will bring greater transparency, accountability, and efficiency to corporate governance. Perhaps the most progress in this direction has been made in the context of the UK, where the government commissioned the Higgs Review to investigate how to increase the effectiveness of the NED.

The boards in the largest publicly traded companies by country vary in the percentage of independent directors, degree of accountability and other board characteristics as shown in Table 2. A few other issues are worth noting. The SpencerStuart Board index finds almost no difference in board independence of US S&P 500, biotech and Silicon Valley firms. British boards' signature trait is the separation of the CEO and chairman functions. In addition, according to the SpencerStuart index, 80% of the British firms nominate a senior independent director as suggested in the Combined Code (in accordance with the recommendation of the Higgs Review), and 72% provide social and environmental reports. The audit committee of Italian firms is independent by definition because it follows the two-tier board structure where one tier is the board and the other is the audit committee elected by majority shareholders. Annual board evaluations have become a corporate governance best practice as well as a requirement of the NYSE and the Combined Code in the UK but it is not fully adopted across countries.

One of the key difficulties in comparing corporate governance practices is how to define the independence of non-executive directors. The independence definition almost varies by code and country (Gregory and Simmelkjaer, 2002; OECD, 2004, pp. 89–94). For example, the Higgs Review provides detailed guidelines of the characteristics that will grant non-executive directors independence. These characteristics include dis-

qualifying a potential board member as independent for being a former employee of the company or group less than five years after employment, having close family ties with any of the company's advisers, directors or senior employees, having served on the board for more than ten years or representing a significant shareholder. If any of these conditions apply to an appointee, the company's annual report must provide the rationale for independence. In addition, the Higgs Review also introduces the figure of a 'senior independent director' to interact with shareholders and address their concerns. In Japan, outsiders are those who have never worked for the firm or its subsidiaries. In the USA, the SEC established that a person who is not an executive officer or shareholder owning 10% or more of any class of voting equity securities is considered independent for the purposes of serving on the audit committee (OECD, 2004, p. 107). Reflecting the concentrated ownership of Spanish quoted firms, the Spanish code of good governance (Olivencia Report) recognizes the commonality of significant shareholders serving on the board by introducing the figure of 'proprietary directors' – these are non-executive owners, and are considered outsiders but not independent.

The appointment of non-executive directors is consistent with the appointment of directors in general and, hence, tends to be rather informal and in the hands of existing managers. For example, the Higgs Review notes that almost half of the non-executives surveyed were recruited through personal contacts or friendships. In order to introduce greater accountability into the boardroom, the different corporate governance codes (e.g. the Combined Code in the UK and the Olivencia Code in Spain) and listing requirements (e.g. NYSE listing) recommend that nomination committees be composed exclusively of non-executive directors. Sweden is probably an outlier with an external committee – composed of the main institutional investors and chaired by the chairman of the board – orchestrates the non-executive selection/nomination process choosing from the larger shareholders (OECD, 2004, p. 99).

The high expectations of the role of the non-executive are interesting if we take into account the existing empirical studies showing mixed results regarding the relationship between firm performance and board independence (e.g. Dal-

Table 2. Comparative analysis of board structure in 2003 (selected countries)

	USA (1)S&P 500	USA (2) Biotech	USA (3) Silicon Valley	CAN(4)	UK(5)	NL(6)	ITALY(7)	SPAIN(8)	SOUTH AFRICA (9)
Average board size	11	8	7	12.3	10.8	5.1	14	12.6	12
Average annual board meetings	7.8	6.6.	7.4	9.4	≥ 8	6.8 (11)	12	9.4	4
Outside directors (%)	80	78	75	77	52.1	91 (12)	57 (13)	36 (16)	34
Separation CEO and Chairman (%)	23	28	—	77	83.3	98	Low	68	88
Average outside directors' age	60	60.7	56	—	58	60.7	57.9	56	54.1
Have three key committees (%) (10)	80	100	77	92	91.3	89	Low (15)	85	—
Director's retirement age	70/72	—	69	70	—	—	80	70	69.7
Fully independent audit committee (%)	98	100	96	91	—	94	100	100	50
Fully independent compensation committee (%)	96	100	94	81	86.7	73 (14)	16.7	67	33
Fully independent nominating committee (%)	91	100	88	83	—	Low	Low	67	28
Average annual director's pay (cash retainer)	\$ 43,667	\$19,630 (11)	\$24,972	Can.\$40,000	£35,000	32,000 Euros	41,400 Euros	45,544 Euros	R62k
Lead/Senior Director	36	—	12	—	83	—	0	—	—
Formal annual board evaluation	87	—	—	86	43	—	—	—	42

— information missing.

Sources: Data for these Spencer Stuart Board Indexes are taken from the most recent company proxy filings. [www.spencerstuart.com](http://www.spencerstuart.com)  
 (1) 2003 Spencer Stuart Board Index. Includes SandP 500. (2) 2003 Biotech Board Index. Includes 25 leading publicly traded biotech companies. (3) 2003 Silicon Valley Board Index. Region's top 100 technology companies that are publicly traded at one of the major stock exchanges (NYSE, NASDAQ or American). (4) 2003 Canadian Board Index. Top 100 Canadian firms. Information also came from survey data. (5) 2003 UK Board Index. 150 largest British firms by market value, excluding investment trusts. (6) 2004 The Netherlands Board Index. 100 largest companies listed on the EuroNext including 25 AEX and 25 Amx, plus 50 companies randomly selected. We refer exclusively to the 'supervisory board' for companies with two-tier boards (93% of the sample) as opposed to one-tier board companies (7%). (7) Italia 2003. Spencer Stuart Board Index. Osservatorio del Consiglio di Amministrazione delle Società Italiane. I am reporting only blue-chip companies, Mib30. (8) 2003 Spain Board Index. Represents 76 surveyed publicly traded companies. (9) 2003 South Africa Board Index. 93 respondents: 76% limited companies, 4% privately owned companies, 13% stated-owned companies and 7% undeclared. (10) audit and compensation and nominating committees. (11) Biotech firms are less likely to pay up-front compensation through retainers. This number applies to the 92% of companies that pay a cash retainer. (12) One-tier boards met an average of eight times a year. (13) This measure is self-reported by companies but without justification hence it is not fully reliable since only 49% disclosed the independence of non-executive directors. (14) Independence refers only to the Chairman. (15) Nomination committee is quite infrequent. (16) This number includes only independent directors and excludes proprietary outsider directors.

ton *et al.*, 1998; Dulewicz and Herbert, 2004; Peng, 2004; Weisbach and Hermalin, 2003), and no/null moderating effects on the board size-firm financial performance relationship (Dalton *et al.*, 1999). In fact, some scholars argue that a supermajority of independent directors will lead to worse performance (Bhagat and Black, 1999). However, research has also shown some effects of board composition on executives' behaviour such as executive reactions to hostile takeovers or CEO turnover being more sensitive to firm performance (Dahya, McConnell and Travlos, 2002; Weisbach and Hermalin, 2003).

There are strong perceptions that independent directors lead to increased good governance. This is true both at the market level and at the actor level. Fernández-Rodríguez, Gómez-Ansón and Cuervo-García (2004) demonstrate that the market responds positively to firm announcements of compliance with the voluntary codes of good governance such as having a majority of non-executives in the board. At the actor level, in particular, Anglo-Saxon institutional investors, who do not have the resources or ability to monitor the multiple boards of firms in which they invest, have a strong preference for independent boards and have devoted a great deal of effort in support of this board structure (Black, 1992; Monks and Minow, 1995). The rationale behind this position is that independent boards are more likely to behave in the shareholders' interest rather than managerial interests. The most important task at the mercy of corporate governance guidelines and various stakeholders trying to increase board accountability is how one can motivate non-executive directors to go beyond box-ticking practices and deeply engage in their monitoring and strategic advice role. After all, to many, Enron's board was an exemplar of best practices on paper (KPMG), but the corporate culture was flawed (Finkelstein and Mooney, 2003).

Another concern is how directors' independence will resonate with their role as mediators among different stakeholders and advisors to managers (and particularly to the CEO). As suggested by Roberts, McNulty and Stiles (2005), there could be a dichotomy between a weak board with poor independence and one with powerful non-executive directors who slow down and reduce board decision-making and flexibility by exercising too much control. The question is

whether all firms, regardless of ownership pattern, industry or other contingencies, should be submitted to the 'one-rule-fits-all' principle of majority non-executive directors. Randøy and Jenssen (2004) would probably argue against since their study shows that firms in highly competitive industries will already be 'monitored' by the market and, therefore, they should have fewer outside board members. In effect, they find a negative relationship between board independence and firm performance in industries with highly competitive product markets among publicly traded Swedish firms and attributed the detrimental effect on the predominance of the director's *resource* function over the *monitoring* function.

In the near future, US-listed companies will be required to certify that their boards are made up of majority non-executive directors, with the implication that this reform will decrease the power of the CEO and achieve a balance of power in the board. This cultural shift in the US boardroom seems remarkably close to the existing UK board practices. The 2002 Sarbanes-Oxley Act and the new listing standards of the New York Stock Exchange and the Nasdaq Stock Market mandate greater independence from corporate directors, and majority independence in the audit committee. In Japan, the corporate law revision of 1993 offers companies a choice between *kansayaku* (these are auditors participating in board meetings with the responsibility of monitoring and policing management decisions) or a single-tier board with committees, but with the overall goal to increase the role of 'outsiders'.

The call for greater independence (power) from the non-executive directors might be coupled with greater responsibility and liabilities. In fact, the popular business press reports on the risky legal environment in which non-executive directors operate. However, a comparative study by Black, Cheffins and Klausner (2004) finds a functional convergence of very small actual liability across countries despite diverse legal systems. This higher demand for non-executive directors in firm boards in the US stock markets might lead to a tight non-executive director labour market, particularly when independent directors have an increasingly heavy work-load, are legally accountable, and are subject to risk their reputations.

## Conclusion

This article has discussed the boards and, in particular, the resurgence of non-executive directors in light of their accountability. A critical challenge for the flawed relationship between directors and shareholders is the ‘independence paradox’. To obtain adequate information critical for accountability duties, non-executive directors are dependent on executives – those that in turn they are supposed to supervise and be independent from. This is not only the case in the USA, where ownership is dispersed and there is a one-tier board; information asymmetry also occurs in The Netherlands, despite the two-tier board structure of some companies (Hooghiemstra and van Manen, 2004). The dilemma goes further because non-executive directors are meant to increase the firm’s social capital, which might be constrained by the rigidity of the system.

There is a heated debate on whether or not it is necessary to have a ‘one-rule-fits-all’ policy or it is sufficient to suggest guidelines and leave some flexibility in the corporate governance system that will generate greater mutual trust and openness between the board and the CEO. As shown by Black and Coffee (1994), the US Glass-Steagall Act introduced severe rigidities into the corporate governance system, and particularly among institutional shareholders, that caused UK and US institutional investors, both in common law systems, to behave and perform very differently.

Moreover, boards can easily become overwhelmed with reporting requirements stemming from hard law such as the US Sarbanes-Oxley Act, as well as voluntary codes and initiatives from the accounting, legal and consulting professions. Directors are being asked to be more engaged, more accountable and more effective than in the past. For example, AIG revealed its concern over the new regulatory environment and its \$300m per year expense to fulfill the new requirements (Roberts, 2004). Professional groups such as auditors, lawyers and accountants try to restore legitimacy and, consequently, to introduce further rigidity in the system. Accounting firms are concerned with being sued, and they have developed a voluntary ‘enhance audit’ that will also cost companies more.

The two sides of the story for public companies are as follows. On the one hand, a potential consequence of over-regulating the corporate

governance environment is that it might detract from flexibility and risk-taking, to the point that some of firms might consider going private, and small or foreign companies might be deterred from listing on some markets because of the higher demands. On the other hand, restoring investor confidence by raising the accountability bar might translate into higher market capitalization and, hence, it might pay off in the long term. Institutional investors have pushed the movement of greater accountability, CalPERs being one of the most visible actors. For example, CalPERs, under the leadership of Sean Harrigan, votes ‘against the re-election of directors of any company that employs its auditor to provide non-audit services such as tax and management consulting’ (Tucker, 2004, p. 1). This policy has led CalPERs ‘to vote against directors in 90 percent of 3,000 US companies during the recent annual meeting season’. Some legal scholars argue that no one can legislate for ethics and integrity and, instead, that there must be a system of trust in place (Romano, 2004). The Tyson report argues for better development (appraisal and training) and recruitment practices of non-executive directors. However, if non-executive directors need to be more accountable to shareholders, then shareholders should have mechanisms to voice their interests and to hold directors accountable to shareholders. It is not the same thing to have an investor relations’ office as to offer tools for open communication.

Future research should explore the consequences of the amount of reporting and governance requirements. For example, it is too early to tell whether the requirements will deter foreign companies from listing in the USA. A pattern that is increasingly seen among US-listed firms is that when these firms travel abroad, they are required not only to conform with the rules of the host country but also hold to the US standards. In effect, US corporate law is going further by prosecuting companies quoted in the NYSE that do not fulfill US regulations outside US borders. This dual, and sometimes multiple, country compliance requirement can cause a conflict of interest between different legal systems, corporate governance rules or ethical codes. It can be the case that multinational corporations become institutional entrepreneurs and engage in legal arbitrage in the international corporate governance market to benefit from comparative institutional advantages.

This conflict suggests that we must look more closely at the multiple layers of regulation in which actors and firms are embedded.

Corporate governance is recognized as a vital factor in economic growth and financial stability (Oman, 2003). Therefore, efforts should be directed to promoting effective corporate culture in which there is balance between those who own the company, those who represent the owners and those who ultimately run the company. Governance is about individual as well as mutual accountability not only to firm shareholders, but also to all stakeholders. Future corporate governance should aim at a sustainable corporate governance model.

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