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The Divergent Corporate Governance Standards and the Need for Universally Acceptable Governance Practices

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Abstract

Corporate governance mechanisms differ from organization to organization and from countries to countries. The governance mechanism in each organization is shaped by its own objective (vision, mission) & political, economic, legal and social history of a country. The governance practices adopted in any organization reflect mindset of top management and value systems adopted in that organization over a long period of time. For most of the organization the corporate governance standards did not evolve and emerge through a natural business process. It has been a forced adoption because of the requirement of legal compliance within a particular country or to confirm industry standard. Hence different organizations have set the code of corporate governance in their own way. In view of this, a pertinent question arises as to whether it is possible to have a set of universally acceptable corporate governance standards. Whether a standard corporate norms can be established at global level. As today, companies are not confined to one country only. They have crossed the borders and have presence in many countries. In such scenario, there is definitely a need of universally acceptable governance standard to be followed by each organization or firm. Since the mid-1990s, there has been much talk of the convergence of corporate governance systems to Anglo-American standards, and several trends have pointed in this direction. Comparative research in the field of Corporate governance has emphasized that Anglo-American corporate governance is characterized by low ownership concentration, one-tier boards and shareholder value norms, whereas high levels of insider ownership, two-tier boards and stakeholder concerns are more characteristic of continental Europe.

The objective of the paper is to discuss the issues like - whether companies should follow an Anglo-American model or European model and why the convergence of corporate governance standards is required in the globalized world. This paper also discusses that in such a divergent world, is it actually possible to have universal corporate governance norms, which would be uniformly followed by all the countries of the world.

Keywords: Corporate Governance, Globalization, Governance Models, Convergence, Shareholders right etc.

1. Introduction

"In a more globalized, interconnected and competitive world, the way that environmental, social and corporate governance issues are managed is part of companies' overall management quality needed to compete successfully. Companies that perform better with regard to these issues can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets while at the same time contributing to the sustainable development of the societies in which they operate. Moreover these issues can have a strong impact on reputation and brands, an increasingly important part of company value." (Note 1)

Corporate governance can be defined as the system by which business entities are monitored, managed, and controlled. At one end of the spectrum are the shareholders as owners of the business entity since they provide the ultimate risk

capital. At the other end are the 'managers' or the executive directors of the company who are in control of its day-to-day affairs. As the elected representatives of the shareholders it is the responsibility of the entire board of directors to direct operations of the company. As the owners of business the shareholders are expected to monitor and evaluate operations of the company as well as the performance of the entire board of directors and in particular the effectiveness of the full time or executive directors**.** A good structure of corporate governance is one that encourages symbiotic relationship among shareholders, executive directors and the board of directors so that the company is managed efficiently and the rewards are equitably shared among shareholders and stakeholders.

Convergence is indeed taking place for reasons related to the globalisation of financial and product markets, an increasing proximity of legal and institutional norms and a more open circulation of and attitude towards foreign ideas. Having said this, one should not expect uniform corporate governance institutions and arrangements in the world, just as one cannot expect the end of nation states in the foreseeable future. Ownership and control arrangements are still a part of a society's core characteristics and will remain to a considerable degree idiosyncratic.

More cross-border equity investment and the growth of domestic and international market institutions should be expected to result in a better mutual understanding between overseas investors and companies and consequently in an increased capacity for companies to access international sources of finance. Investors need to understand and assess their investments. Convergence in transparency and useful disclosure norms is therefore a key area where a lot needs to be done. A growing consideration of stakeholder interests is viewed increasingly as a key growth factor in the long-term value of companies. In multinational companies, stakeholders come from many different countries. The emergence of unified strategies to deal with these issues across national boundaries is in itself another driver of convergence.

The countries are now more concerned with what should be the best corporate governance practices. In last two to three decades, number of committees has been formed by different countries for recommending the corporate governance standards that should be followed by companies. The recommendations of few of the committees are listed in Table 1.

2. Literature Review

The increasing economic globalisation has fuelled vivid debates on the similarities of and differences between national corporate governance systems and the barriers to the development of a single system of corporate governance (see e.g. McCahery et al. 2002).It is now widely accepted that corporate governance systems vary across nations. Ownership and board structure, managerial incentives, the role of banks and large financial institutions, the size and development of stock markets, company law, securities regulation, government involvement and other important aspects of corporate governance have been found to differ across nations (e.g. Baums 1994;Roe 1994;Prowse 1995; Gugler 2001;Vives 2000;Barca and Becht 2001). A classic distinction has been made between the market-based models of the United States and the United Kingdom and the alternative ('bank-based 'or 'control-based ') models of Continental Europe and Japan. *Market-based systems* are thought to be characterized by large and liquid stock markets, dispersed ownership, relatively high levels of minority investor protection (La Porta et al.1998) and the predominant role of institutional investors and other portfolio investors in share ownership, in addition to other characteristics like high product-market competition (Roe 2000), one-tier boards (e.g. Allan and Gale 2000) and performance-sensitive executive pay (Murphy 1999). In comparison, the *control-based systems* of Continental Europe are thought to be characterized by lower levels of investor protection, smaller and less liquid share markets, more concentrated ownership and a larger share of stock held by (founding) families, corporate investors (cross holdings) and governments (Barca and Becht 2000), in addition to greater attention to employee representation on boards in many countries (Blair and Roe 1999) and more government intervention.

There have been several attempts to explain these differences, which have been attributed to the legal system (La Porta et al.1999, 2000), political intervention (Roe 1991,1994) or even cultural differences (Licht 2001). In addition, economic theory would suggest that such differences exist because of international variations in market size, firm size, uncertainty and industry structure (Hansmann 1996;Thomsen and Pedersen 1999). Despite the widely-held view on the superiority of the Anglo-American system, there are also supporters of the alternative systems such as the labour-oriented, state-oriented, and other stakeholder-oriented systems, prevailing in countries of German, French, Scandinavian, and Asian legal origin. The supporters of these alternative systems argue that the chief advantage of these systems lies in the way they address the misalignment of interests between managers and shareholders. Whereas in common law countries this problem is resolved via the monitoring by the market for corporate control and regulation forcing managers to follow the interests of the shareholders, civil law countries mainly rely on large shareholder, creditor or employee monitoring.

Not too long ago, a consensus seemed to be emerging between academics and executives alike to the effect that the Anglo-American corporate governance model had triumphed and European systems were converging to US/UK standards (e.g. Hansmann and Kraakman 2000,2002;Coffee 1999,2002; Denis and McConnell 2002. Proponents of the convergence hypothesis tend to highlight the role of global capital flows in eliminating inefficient forms of governance. They aver that convergence is hastened by a realization that alternatives to U.S.-style shareholder-centric governance

have generally not succeeded. Several multilateral bodies are spurring on this process by urging the adoption of common standards (OECD [2000], World Bank [2001]). However, Khanna, Kogen & Palepu find robust evidence of *de jure* convergence at the country level. Interestingly, this is not driven by convergence to U.S. standards. Rather pairs of economically interdependent countries appear to adopt common corporate governance standards, especially if the pair of countries in question are in the same geographic region and are relatively developed economies.

3. Globalisation & Corporate governance standards

Global economic integration has been a key factor in the salience of corporate governance questions. Once confined to local economies, differently governed firms now compete with one another, as a multilateral trade agreements & regional economic blocks such as the European union have internationalised the product markets, capital markets, managerial markets, and, to lesser extent labour market.

Globalisation affects the corporate governance reform agenda in two ways. First, it heightens anxiety over whether particular corporate governance systems confer competitive economic advantage. As trade barriers erode, the locally protected product market place disappears. A country's firm's performance is more easily measured against global standards. Poor performance shows up more quickly when competitor takes away market share, or innovates quickly.

Globalisations second effect comes from capital markets pressure on corporate governance. First, firms have new reasons to turn to public capital markets. High tech firms following the US model want the ready availability of an initial public offering for venture capitalist to exit & for the firm to raise funds. Firms expanding into global markets often prefer to use stock, rather than cash, as acquisition currency. If they want American investors to buy and hold that stock, they are pressed to adopt corporate governance measures that those investors feel comfortable with. Despite a continuing bias in favour of home country investing, the internationalisation of capital market has led to more cross border investing. New stockholders enter, and they aren't always part of any local corporate governance consensus. They prefer a corporate governance scheme they understand and often believe that reform will increase the value of their stock. Similarly, even local investors may make demands that upset a prior local consensus. The internationalisation of capital market means that investment flow may move against firms perceived to have sub optimal governance and thus to the disadvantage of countries in which those firms are based.

Despite different starting points, a trend towards convergence (Note 2) of corporate governance regimes has been developing in recent years. Pressures have been rising on firms to adapt and adjust as a result of globalization. Their products are having to compete directly on price and quality with those produced internationally, which mandates a certain *de facto* convergence of cost structures and firm organization that, in its turn, might spill-over on firm behaviour and decision making. But most important, convergence might be the result of globalization in the capital markets: new financial instruments (such as ADRs and GDRs), deeper integration of markets, stronger, international competition and the emergence and growth of new financial intermediaries have radically changed the corporate finance landscape in a global way, at least for the larger enterprises. The latter, along with the governments of their countries, are increasingly conscious that, in order to tap this large pool of global financial resources, they need to meet certain governance conditions.

4. Different Governance Models

There are broadly three models of corporate governance observed in the developed and the newly industrializing countries.

4.1 Outsider Model

4.2 Insider Model

4.2.1 European Model

4.2.2 East Asian Model

4.1 Outsider Model

At one end of the spectrum we have the widely discussed "outsider model" of the US and UK. The main feature of this model is the separation of control from ownership arising from widely dispersed equity ownership among large number of institutional and innumerable small shareholders. Consequently, the control of corporate units vests with professional mangers. This is also referred to as the principal-agent model where the shareholders (the agents) entrust the task of running the company to managers (the principals) who are in effective control of the company. Growing importance of the economies of scale and scope has necessitated the birth of large firm with its distant shareholders and professional management. This has given rise to the agency problem viz., how to ensure that the managers function in the interests of the shareholders and the stakeholders.

Both the UK and the US have a long tradition of equity ownership by individuals. During the last five to six decades these countries have witnessed emergence of a large number institutional shareholders like mutual funds, pension funds

and insurance companies that have come to hold ever increasing proportion of equity. Since there is a clear separation of control from ownership in these countries the primary objective of their regulatory and legal frameworks is to encourage and facilitate corporate governance systems that protect interests of the widely dispersed shareholders.

4.2 Insider Model

In contrast to this outsider model we have two types of "insider models", the European model and the East Asian model. The European continent represents one type of insider model, although there are several versions of it in different European countries as also in different sectors of a given country.

4.2.1 The European model

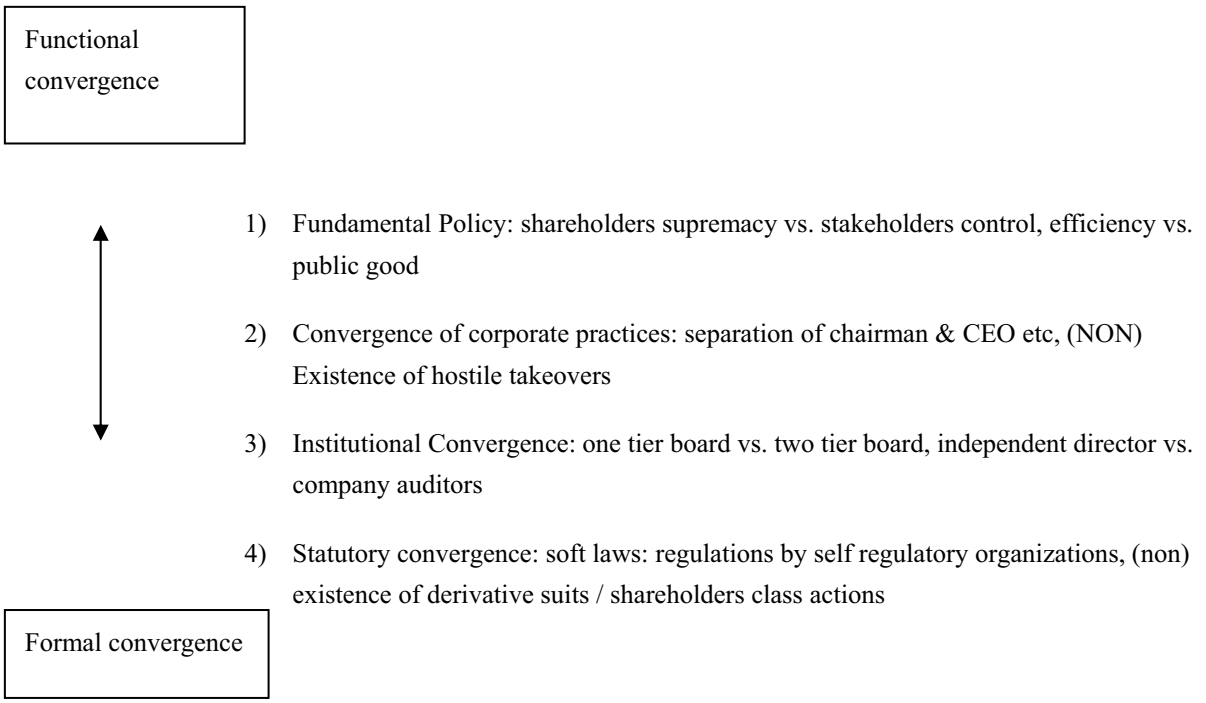
The main feature of the European insider model is that a small relatively compact group of shareholders (who maintain relatively longer term and stable relationship among themselves) are able to exercise control over corporate entities. The countries in which such an insider model is common are the ones that have witnessed less institutionalization of equity holdings than the Anglo-American outsider model. These countries also reflect much higher dependence of the corporate sector on banks as a source of finance. Generally, the corporate entities also have much higher levels of debt-equity ratios.

4.2.2 The East Asian Model

The typical East Asian form of corporate governance model embodies a purer version of the insider model where "the founding family" generally holds majority of the controlling shares, directly or through other holding companies, most of which in turn may be controlled by the founding families. The main difference between the European and the pure East Asian version is that, in the East Asian case, close knit families are generally the controlling entities. The East Asian insider model is therefore far simpler version of the European insider model. The European insider model, on the other hand, is characterised by a variety of controlling forms including one interesting form where the controlling shareholders are backed by complex shareholder agreements. Countries with predominantly insider form of organisations are more tolerant of their activities even when such activities are not fully in the interests of the common shareholders.

Corresponding to these corporate Governance models one can notice the following three government industry models to see the impact of government-industry relationships on corporate governance. These models can be summarized as shown in the table 2:

5. What is Convergence?



Source: *Kenichi Osugi: What is Converging? ASIAN-PACIFIC LAW & POLICY JOURNAL; Vol. 9, Issue 1 (Winter 2007)*

The driving forces and barriers to convergence are subject to a heated debate (O'Sullivan, 2003). The view rooted in neo-classical economics starts with the premise that enhanced global product and labour market competition combined with financial integration leads firms to converge on a set of 'best practices' in corporate governance.

The 'best practice' is defined as perfected Anglo-American corporate governance, with its primary objective of maximizing the shareholder value, improving access of savers to investment opportunities and firms' access to external funds (Jensen, 2000; Hansmann and Kraakman, 2004). In contrast, the 'varieties of capitalism' perspective claims there is no best way to organize an economy. The forces of competition and financial integration do operate, but before they make an impact on corporate governance in a specific place, they are 'filtered' through existing, mostly nationally based institutions. As specific configurations of institutions are likely to respond differently, even if exposed to similar pressures, corporate governance will continue to differ depending on the institutional context in which it is embedded (Hollingsworth and

Boyer, 1997; Hall and Soskice, 2001). Hansmann and Kraakman (2000) have identified three incentives for governance convergence: logic (persuasive arguments for the superiority of a particular model), example (competitive success of a particular model) and demonstrated competitive advantages. These forces work in the same direction when influential shareholders or company managers adopt international governance structures that are perceived to work better, for example, when European managers adopt US/UK governance principles because comparable companies in the United States and the United Kingdom have a higher market value, lower capital costs or other advantages.

Clearly, these forces must be weighed against other powerful forces that block convergence or even promote divergence, that is to say, the same factors that created differences in corporate governance in the first place. Bebchuck (1999) and Bebchuck and Roe (1999) explain why ownership concentration does not automatically adjust to efficient levels and why a controlling shareholder structure with a high ownership concentration (a *control-based* structure) does not automatically develop into a non-control-based structure (a *market-based* structure), even when the market-based structure maximizes the financial value of the firm.

One important reason for this is the existence of private benefits for controlling shareholders that are not shared with minority investors (Bebchuck 1999; Bebchuck and Roe 1999). When firms have already adopted a mixed ownership structure with some minority investors, the gains of selling more shares to the public must be shared by these investors, and this reduces the incentive to give up private control benefits (Bebchuck and Roe 1999). Bebchuck (1999) therefore predicts that control-based governance systems will emerge when the private benefits of control are large. In market-based systems, managerial control benefits may encourage the persistence of market-based governance structures (dispersed ownership). Because of vested interests in maintaining the status quo, incumbent managers may resist the formation of controlling blocks (Bebchuck and Roe 1999) and fight hostile takeovers. Gains from the formation of large blocks of control will again be shared with the market, reducing the incentive to form such blocks in market-based systems (Shleifer and Vishny 1986).

Other factors at the systemic level also create barriers to changes in ownership structure (Bebchuck and Roe 1999). Ceilings and other limitations on ownership by financial institutions, as practiced in the United States, place a limit on their ownership shares in individual firms (Roe 1991). The existence of complementary institutions in a given system, e.g. a large and well-functioning stock market, as in the United States and the United Kingdom, or an active banking sector, as in Germany, may influence the ownership and capital structures of firms based in that system (Roe 1994). Legal systems may provide varying degrees of protection to minority investors (La Porta et al.1998). The incumbent organizations/institutions, finally, will always lobby for continuation of their own existence (North 1991).

6. International comparison between common law and civil law countries

Based on the work of La Porta et al, Table 3 summarises shareholders rights and the mechanisms to protect them in common law versus civil law countries. Shareholder rights are classified into three categories: the voting powers attached to shares, the rights that supports the voting mechanism against interference by insiders and possible remedial rights.

No common law country in the sample has a commercial code that requires shareholders to deposit their shares prior to a general shareholders meeting. In addition these countries company codes strongly favours mechanism to protect the rights of the minority shareholders (high percentage of oppressed minority rights and low barriers to call an extraordinary shareholders meeting). However, in only 44 % of the cases, shareholders have the first opportunity to buy newly issued stocks. Moreover, the principle of one share one vote' seems less reality than often stated. No mandatory dividend rules exist in these countries.

In civil law countries the picture is far more heterogeneous. Fernch civil law countries offer the worst legal protection to shareholders. Only 5 % in this group allow voting by mail and on an average 15% share capital is needed to call an extraordinary shareholders meeting, which is the highest among all legal families.

Compared to other civil law countries, French civil law companies performed better that german civil law countries on share blocking for shareholders meeting and for preferential position of existing shareholders to newly issued stock.

They did even better than Scandinavian civil law countries with respect to oppressed minority protection and the cumulative voting / proportional representation criteria.

While corporate governance mechanisms differ from country to country, there are two broad categories of financial systems, which differ, in their very basic structure. These are the market-based system exemplified by the British and American systems and the bank based system typified by Japan and Germany. Varying paths of financial evolution situate countries at different points in this market-institution spectrum with the ir positions determined by the nature of their economic endowments and the historical and political forces that shape their societies. The Indian situation may be thought of as a combination of these two conflicting models.

Though the basic corporate legal structure is Anglo-Saxon, share ownership is far less dispersed and financial institutions play a much bigger role in financing corporate activity. Share ownership and board representation of financial institutions give these bodies the abilities to serve as important monitors of management activities though the relationship. The powers, however, are considerably limited as compared to those in typical bank-based systems and universal banking is not widespread. Nevertheless, financial institutions, have, in general, failed to fulfill even their limited role in corporate governance.

7. Conclusion

Although the debate has generated an extensive body of theoretical and empirical work, the conclusions remain opaque. There is yet no consensus as to what system of corporate law is the best one and whether legal convergence should be encouraged on a global level. A number of theoretical studies argue that regulatory and institutional convergence of corporate governance practice worldwide is likely, but the studies are in disagreement as to the direction of the convergence. In particular, will the Anglo-American model dominate or will a new hybrid model emerge?

Corporate governance must adapt to fit its ever-changing environment. Certain combinations of governance mechanism may work for certain periods of time. Change, however, will inevitably occur. When it does, how well a country's corporate governance system adapts to its changed environment, not how well it adheres to any particular model, will determine its success. The convergence debate overlooks this point. In fact, it assumes the opposite. For over a decade, the debate has largely been premised on the false assumption that the American model finished evolving and had reached the end in the evolution of corporate governance. Academics built elaborate theories to explain whether the rest of the world would adopt the endpoint American model. The Japanese government based its reforms on the endpoint American model. International organizations conditioned financial aid on recessionary countries adopting the endpoint American model. Ironically, during this time the American model did not exist even in America.

While academics and policy makers sold the American model, America was busy changing it. It used shareholder primacy, driven by hostile takeovers, to carry out much needed restructuring in the 1980s. It insulated directors from hostile takeovers allowing them to use their valuable discretion to build on their newly restructured companies during the 1990s. It increasingly utilized bank monitoring to create another efficient tool to reduce agency costs throughout this era.

This analysis shows that the convergence debate observes little and obscures much. The convergence approach should be abandoned. Little utility exists in measuring the distance between broadly defined governance models that are constantly evolving in unpredictable ways.

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Notes

Note 1. Source: Who Cares Wins: Connecting Financial Markets to a Changing World, p. i, UN Global Compact, 2004.

Note 2. Gilson (1998) looks at convergence in terms of function (when existing governance institutions are responsive to change without a change in the rules), formality (when the legislative framework is adapted) and contractual (when companies have to adapt contractually as domestic institutions are not flexible enough to accommodate change and political obstacles will not allow formal convergence).

Table 1. Corporate Governance Reports of different countries

Report	**Country**	**Description**
Tradeway commission, 1987	USA	Importance of audit committee mentioned. Designing best practices for audit committees. Emphasized that audit committees are primarily meant to check corporate frauds
Cadbury committee, 1992	UK	Role of board in governance system emphasized. Best practices for board composition & functioning developed. Audit committee, remuneration committee and nomination committee to be formed by corporations.
Hilmer Report, 1993	Australia	Best practice code for the composition and functioning of boards prepared.
Dey Report, 1994	Canada	Board responsibility and board composition were the primary thrust, a total of 14 principles prepared by the Toronto Stock Exchange Committee on corporate governance
Vienot Report, 1995	France	Focus on board responsibility, formation of audit, nomination and compensation committee
Greenbury Report, 1995	UK	Directors compensation standard set and disclosure of remuneration emphasized
Peters Report, 1997	Netherlands	Code prepared by Amsterdam Stock Exchange on the composition and functioning of two-tier board
Hampel Report, 1998	UK	Disclosure & quality of board governance stressed upon
Bajaj committee Report, 1999	India	Prepared by committee set up by confederation of Indian Industries. Board structure addressed and accountability to investors emphasized
Birla committee Report	India	Prepared by committee set up by SEBI. Clearly influenced by Cadbury report and is a rehash of all the above reports.

Source: Norburn D (2000), "international Corporate Governance Norms'" European Business Journal, Vol 12 No 3, pp 116-133

Table 2. Government Industry Models

Model	**Countries**	**Salient features**
Government as Referee	USA, UK, Hong Kong, Australia, New Zealand	• Government totally impartial with respect to the market; • Government stands on the sidelines; Government intrudes if or when abuses need to be prevented or perpetrators of illegal acts have to be punished; • Government's emphasis on fairness and unregulated market forces; Minimize regulations; Open transparent, accountable forms of corporate governance; • Auditors and lawyers have an important role to play; . Corruption tends to be low.
Government as Manager	France, Italy, Spain, China, Vietnam, Singapore, Indonesia, Malaysia, Thailand, India	• Govt. neither recognizes nor respects the market and does not trust it; • Economic nationalism & protectionism; intervention and control; • Promotion of national corporate champions; • Corporate Governance is opaque, secretive and closed, with little public accountability; • Bureaucracy is powerful.
Government as coach	Germany, Austria, Switzerland, Netherlands, Sweden, Norway, Denmark, Finland, Japan, Korea, Chinese Taipei, Thailand, Malaysia, Indonesia	• Sidelines partiality; • Administrative guidance Support system, subsidies etc.; • Organized competition; • Semi-transparent/ semi-opaque corporate governance with limited public accountability; • Considerable scope for corruption.

Source: Lehmann, (1997).

Table 3. Shareholder rights and protections across countries

	1	2						3
	One share one vote	Proxy by mail allowed	Shares not blocked before meeting	Cumulative voting / proportional representation	Oppressed minority	Pre-imptive rights to new issues	% of share capital to call an	Mandatory dividend
Common law countries								
English origin average	0,17	0,39	1,00	0,28	0,94	0,44	0,09	0,00
Civil Law Countries								
French Origin Average	0,29	0,05	0,57	0,29	0,29	0,62	0,15	0,11
German Origin Average	0,33	0,00	0,17	0,33	0,50	0,33	0,05	0,00
Scandinavian Origin Average	0,00	0,25	1,00	0,00	0,00	0,75	0,10	0,00

Source La Porta et al 1997

Note: common law countries are characterized by legislation based on precedents from judicial decisions. Common law includes the law of England and those laws modeled on English law. Civil law is based on statutes and comprehensive codes as primary means of ordering legal materials, and relies heavily on legal scholars to ascertain and formulates its rules. The distinction is made between the French commercial code, German Commercial code and Scandinavians civil law.