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# Converging governance principles: Learning from best practices around the world

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The current economic crisis has damaged confidence in much of what we understood as the essential workings of globalization, such as the efficiency of the market, the mobility of capital and the availability of debt finance. Fundamental weaknesses in the international banking system have resulted in an unprecedented global recession and at the macroeconomic, corporate and individual consumer levels, there has been a crisis of confidence and a breakdown of trust.

Corporate governance principally exists to promote a climate of trust and accountability, without which a company's relationships with business partners, shareholders, consumers and other stakeholders are jeopardized, and access to finance is put at risk. It could be argued that the atmosphere of suspicion and mistrust in many markets, one that deepens with every new discovery of corporate mismanagement and excess, signifies a failure in prevailing governance structures and encourages a new look at exactly how companies should regard best practice.

The trend in recent years has been for governance models around the world to converge around commonly agreed principles. It is possible that the erosion of public confidence in business leadership will accelerate this trend. Although this may please some global investors, not everyone in Asia thinks that the growing influence of the Anglo-American system of governance should go unchallenged. Asian regulators have an opportunity to learn from mistakes made in Western economies and to seek local solutions to local governance problems — driving behaviors that combine local needs with global best practice.

Governance codes and regulations may have improved greatly across Asia, but the reality is that they are often poorly observed by companies and inadequately enforced by regulators and governments. In this context, it becomes all the more important for listed company boards to recognize the value of adopting best practice — especially in those areas of boardroom activity that cannot be touched by regulation.

From our experience advising boards of leading companies around the world, we have identified a number of best practices that will serve boards well as they seek to discharge their responsibilities effectively and efficiently, no matter where they are based.

## CREATING THE RIGHT SETTING FOR GOOD GOVERNANCE

More and more companies in emerging markets are looking to raise their governance standards. However, following the example of successful companies in more developed economies is not always the answer, since these companies often have to contend with a different set of issues. These could be structural (e.g., highly concentrated ownership), legal (a slow, inadequate or unreliable system), political (legislative and regulatory differences) or cultural (hierarchy, tradition, behavior protocols) and explain why a one-size-fits-all approach to governance is a mistake.

Despite the trend towards convergence, governance regulations in Asia are less stringent than they are in the West, particularly when it comes to disclosure and independence. It is tempting for boards to take a narrow, box-ticking approach to governance requirements, but those that do so are missing an opportunity to set themselves apart. Rather than simply ensuring that their companies conform to national expectations and regulatory frameworks, boards should be constantly seeking to improve their performance, accountability and transparency. After all, there is competitive advantage to be gained from such an attitude — numerous studies have found a correlation between governance performance and credit ratings, the cost of capital and the ability to attract foreign investment. Moreover, companies that are well governed tend to outperform the market during an economic downturn.

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## THE NONEXECUTIVE DIRECTOR

One of the signs of an effective, professional board is that it is fit for its purpose. The directors have been chosen wisely for their expertise and are clear about their roles and responsibilities. They know why they have been recruited and what is expected of them, both as individuals and as a team, and despite bringing multiple perspectives into the boardroom they can work well together. They are committed to the long-term interests of the business and have the time to devote to board service. They must discharge their fiduciary obligations, of course, but recognize that observing laws and regulations is just the start. Best practice in the boardroom goes well beyond compliance; it permeates every aspect of boardroom activity, from the conduct of meetings and the role of committees to time commitments and boardroom relationships.

While it may be tempting for some nonexecutive directors to be “hands-on” in the business, it is a mistake for them to get deeply involved in operations. In companies where the management is struggling or lacking in experience,

this may seem the right thing to do, but nonexecutive directors are most effective when they preserve their objectivity and help advise, guide and monitor the executive team, whose duty it is to run the business.

Nonexecutive directors are valued for their strategic insight, advice, networks and sector knowledge — not their operational skills. This is borne out by the steady shift toward greater independence in boardrooms across the world. The presence of talented and engaged independent directors can make a huge difference to the fortunes of a company.

Definitions of independence are more stringent in some countries than others, and in more mature economies the proportion of independent directors on boards is usually very high. In Asia, it is common for the promoter and the promoter's family to retain a significant influence on decision making and for complex interconnections to exist between executives and nonexecutives. However, even family- or promoter-controlled companies and state-owned enterprises (which dominate the Asian business landscape and are also to be found in France, Spain and other European countries) are recognizing the value that independent-minded directors can bring to a board composed mainly of majority shareholder representatives.

Appointing directors who do not have a conflict of interest is extremely important, but independence is no guarantee of competence. Without real experience, business expertise, insight and common sense, directors will lack the ability to challenge management, particularly in critical areas such as strategy or risk management.

So what does the profile of the ideal director look like? The results of the many board assessments we have conducted in Europe tell us that the most valuable and efficient board directors are those who have operated at the CEO or executive committee level, have relevant experience, can bring

new perspectives, and who are independent of mind, not just on paper.

In addition, good nonexecutive directors have the confidence to speak out when appropriate, the humility to consider the views of others, and the courage and integrity to follow their conscience at a time of crisis. They offer a combination of broad business experience and specific knowledge relevant to the company, such as technical, regulatory or international expertise. They have the time to commit, read board papers thoroughly and participate actively in debate. They acquire a deep understanding of the company's business and yet understand that eventually they may need to be replaced by someone with a set of skills and experience that more closely mirrors the evolving strategic direction of the business. This combination of qualities is not easy to identify, reinforcing how important it is for boards to adopt a formal, structured process for the selection of new directors.

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## BOARD COMMITTEES

An effective board delegates wisely. It is normal for the board to charge the CEO and senior executive team with running the day-to-day operations of the company and executing the agreed-upon strategy, but it also delegates many of its own functions to committees of the board. Working to a clear charter, committees tend to be small and comprise mainly independent nonexecutive directors and are expected to refer any key decisions to the main board for approval.

In most countries, the law requires every board to have an audit committee to supervise the company's financial well-being and reporting systems. Only relatively recently has it become a requirement in the United States and United Kingdom for at least one audit committee member to be a financial expert, although nowadays the commit-

tee chairman usually also has a financial background. For a number of years, the membership and conduct of audit committees came under fierce scrutiny from shareholders, media and government concerned that illegal and fraudulent practices had too often gone undetected in global businesses. Most recently, the focus of attention has shifted to the remuneration or compensation committee, in the light of perceived excesses in senior executive pay.

In markets where disclosure of executive pay is mandatory, compensation committee membership has come under intense scrutiny, with boards frequently criticized for rewarding underperformance. The work of this committee is crucial in creating a compensation model that does not reward the short-term interests of management at the expense of the long-term interests of the company. A fair and transparent compensation structure strengthens the board's ability to challenge senior executives by ensuring that they are aligned with shareholder interests and holding them accountable for achieving sustainable growth.

The third committee that is becoming increasingly common is the nomination committee, which oversees the nomination and appointment of directors.<sup>1</sup> In some Asian countries it is not yet a requirement, although the existence of a nomination committee is a good indication that the board is taking its governance responsibilities seriously — signaling its intent to replenish the board with the best possible mix of talent and expertise that reflects the company's future strategy. Nomination committees increasingly are having to justify their choices, and this is made easier when they retain neutral advisers to manage a rigorous, transparent and structured approach to the recruitment of directors.

Succession planning is the responsibility of the whole board, but the lead is often taken by the nomination committee. CEO succession is the first priority, but many boards will get involved in senior executive team succession and

take an active interest in the talent pipeline further down the organization. The governance of a company cannot be considered in good shape if the board does not pay close attention to succession issues or regularly discuss the future of its leadership team.<sup>2</sup>

Boards that have adopted high governance standards tend to appoint strong committees with a well-defined charter and clear processes. Such committees conduct detailed work behind the scenes, providing the full board with good information and sound analysis, thereby contributing to effective decision making. By contrast, committees that are established primarily to satisfy statutory requirements rarely function effectively.

## THE ROLE OF THE CHAIRMAN

A board may be outstanding on paper, but it will not function well unless it is run by a chairman who combines substantial business experience with a range of “soft skills.” He or she sets the priorities for the board and has the most influence over board dynamics, which play a huge part in how well a board performs. A good chairman will encourage debate, ensure that the views of every board member are heard and work hard to achieve consensus. In some cultures, especially those with a strong sense of hierarchy, it can be extremely difficult for directors to challenge or contradict openly, and it is the chairman's job to ensure that concerns are listened to, maintaining regular contact with directors outside meetings.

The chairman should also ensure that there is a steady, relevant and meaningful supply of information from management to the board. Nonexecutive directors do not want to be swamped by extraneous detail, but they do need to be confident they have sufficient information to reach an informed judgment on any topic up for discussion at the board meeting, and that they are not deliberately being kept in the dark.

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<sup>1</sup> In the U.S., this is known as the governance and nominating committee. As with the other two committees, its members must all be independent.

<sup>2</sup> More detailed articles on succession planning can be found on the Spencer Stuart web site, [www.spencerstuart.com](http://www.spencerstuart.com).

Board meetings without executives present are becoming more common. Such meetings can be useful, but the chairman has to ensure that they do not create or reinforce divisions between nonexecutive directors and the management team. In the U.K., it is common practice for nonexecutive directors, led by the senior independent director, to meet once a year to discuss the performance of the chairman.

The profiles of chairmen differ greatly from country to country. Executive chairmen are common in Asia, but frowned upon in the U.K. In the U.S. and southern Europe, the roles of chairman and CEO are usually combined, but more companies have come to realize that separating the roles can be worthwhile because it can prevent power from concentrating in the hands of one person. It enables the chairman to focus on the increasingly complex task of running the board, providing advice and support to the CEO, and playing an important role in the CEO evaluation process. In addition, the introduction of the lead independent director (in the U.S.) and the senior independent director (in the U.K.) has served to achieve some of the same objectives by strengthening the voice of independent directors in the boardroom.

Best practice would indicate that board independence is improved by having a chairman who was not previously the company's CEO, for two reasons. First, a good CEO does not necessarily have the qualities of an effective chairman — the skills are quite different. Second, it is tempting (and counter-productive) for a former CEO to intervene in management activities; so it is better if he hones his chairman skills elsewhere.

## BOARD ASSESSMENT

As the custodians of corporate governance, it makes sense that boards should be prepared to have their per-

formance assessed on a regular basis. After all, if the CEO's performance is to be evaluated, why should the board not go through something similar? In some more mature markets, the annual board assessment has become a reporting requirement, although it is left to boards to decide what process to adopt. In the U.K., for example, assessments tend to be handled internally two years out of three, with an external adviser brought in to facilitate every third year.

In Asia and most other emerging markets, board assessments are rare and often treated with some suspicion. Few companies want to expose the inner workings of their board to outsiders, or suffer loss of face, preferring instead to handle assessments internally. This will probably change over time, as the perceived threat of external assessment subsides and its positive value is understood. In those countries where boards are required to have an assessment, external facilitators are usually brought in every three years.

A sensitively handled board assessment can be a hugely constructive exercise, teasing out concerns and leading to genuine improvements in decision-making processes and overall board effectiveness. Not only does an assessment measure collective and individual performance and set out expectations for the coming year, but it can also surface specific gaps in knowledge and training needs, resulting in better informed directors making enhanced contributions to the business.

## CONCLUSION

The way a board works in practice has everything to do with talent, relationships and specific circumstances and much less to do with codes and regulations. Many critical aspects of a board cannot be regulated: for example, how thoughtfully a board is constituted, whether independent

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directors think and behave independently, and the skill with which a chairman orchestrates meetings and brings out the best from the talent at his or her disposal.

Despite the trend towards convergence, there are significant voices in Asia calling for a more “organic” approach to corporate governance that takes local political, economic and cultural realities into account. As national regulatory frameworks evolve, boards will do well to look beyond statutory requirements, adopt proven best practices and develop some of their own — all of which will help them function effectively and bring lasting value to the businesses they govern.

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Based in Mumbai, Anjali Bansal leads the firm’s India offices and is a core member of the global Board Services, Financial Services, Industrial and Technology, Communications & Media practices. Julie Hembrook Daum co-leads the North American Board and CEO Succession Practice. Bertrand Richard co-leads the Board Services Practice.