

Dialogue in
corporate
governance

Beyond the myth
of Anglo-American
corporate governance

Consultation

Pressure points

Contrasting US and UK securities markets:
How they impact international policy,
investment, business and accounting

Dialogue in corporate governance



The globalisation of capital markets and capital flows, corporate scandals and newly developing economies are encouraging demands for consistency in corporate governance practices so as to reduce complexity and confusion. Dialogue can help facilitate a better understanding of different approaches to corporate governance and foster an appreciation of equivalent systems.

Difficulties arise in striving to achieve a single, global approach to corporate governance. There are too many deep-rooted cultural and structural differences for a single approach to work equally well in all countries and for all companies regardless of their stage of development and business. The ICAEW has launched the *Dialogue in corporate governance* initiative to challenge commonly held assumptions, identify fundamental questions, set challenges for future research and generate practical proposals. This will include:

- **Beyond the myth of Anglo-American corporate governance** – Contrasting US and UK securities markets and how they impact national and international policy, investment, business and accounting.
- **EU approaches to corporate governance** – Contrasting models of corporate governance in EU Member States, drawing out potential implications for future convergence.
- **Matching corporate governance to investor needs** – Exploring the different sources of finance as businesses evolve and the implications for corporate governance.

About the ICAEW

The ICAEW is the largest professional accountancy body in Europe and has over 128,000 members in 142 countries worldwide. Since the establishment of the Cadbury Committee in 1991, the ICAEW has played a significant role in the development of corporate governance in the UK.

If you would like to know more about *Dialogue in corporate governance* or *Beyond the myth of Anglo-American corporate governance* and relevant events and publications visit www.icaew.co.uk/dialogueincorpgov

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ISBN-10 1-84152-395-X
ISBN-13 978-1-84152-395-8

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Reprinted August 2006.

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Invitation to comment

Comments are invited on the pressure points identified in this paper and the related consultation questions.

Suggestions are also welcome regarding any additional corporate governance issues that are particularly relevant to dual-listed companies and international investors.

This consultation paper will be used as a basis for engagement with business leaders, the investment community, the accountancy profession and policy makers. It summarises issues highlighted in the following related discussion papers:

Policy dialogue: *Effective corporate governance frameworks – encouraging enterprise and market confidence*

Business dialogue: *Board responsibilities and creating value – demonstrating leadership and accountability*

Investment dialogue: *Shareholder responsibilities and the investing public – exercising ownership rights through engagement*

Accounting dialogue: *Disclosure responsibilities and building trust – promoting transparent and reliable information*

The intention is to develop a publication based on responses to this consultation together with other evidence gathered from market participants in late 2006.

Please e-mail or post your responses to:

E-mail: corporategovernance@icaew.co.uk

Address: Dialogue in corporate governance
Technical Strategy Directorate
The Institute of Chartered Accountants in England & Wales
Chartered Accountants' Hall
PO Box 433
Moorgate Place
London EC2P 2BJ
United Kingdom

Telephone: Kerrie Waring (ICAEW) on +44 (0)20 7920 8714

Unless otherwise stated, responses will be regarded as being on the

Executive summary

public record. Consultees should indicate specifically whether their responses should be treated as confidential. Standard disclaimers in responses received by e-mail will be disregarded for this purpose.

Drivers for change

Corporate governance is about the way companies are directed and controlled. It concerns the relationships and responsibilities of the board, management, shareholders, auditors and others within a legal and regulatory framework.

Each country has its own unique system of corporate governance reflecting different economic, legal and cultural circumstances. However, policy makers and market participants worldwide are pursuing the same ultimate objectives – to enhance public trust and investor confidence while encouraging enterprise.

Corporate governance has become a political issue. Market liberalisation and technological advances are encouraging the globalisation of capital. Accompanying this trend is the need for a level playing field to facilitate investor confidence and the equitable treatment of business.

Corporate scandals have further accentuated the need for companies and regulators alike to reinforce business integrity and instil market confidence. They face the challenge of developing national laws and practices to address problems while supporting the adoption of internationally accepted standards. The enactment of the US Sarbanes-Oxley Act with its impact on foreign registrants of the Securities and Exchange Commission (SEC) provides an example of how difficult it is to separate national and international issues.

It is widely recognised that countries with effective corporate governance systems are more likely to attract foreign direct investment and enhance economic prosperity. In short, if corporate governance is strong, investors benefit from reduced risks and hence the cost of capital is likely to be lower.

In aspiring to meet international norms many countries are updating company law and introducing corporate governance codes. For this purpose, US and UK models are often viewed as a successful benchmark with clear and broadly consistent features set out in corporate governance codes, listing rules, company law and securities regulation.

Prospects for convergence

The globalisation of capital, corporate scandals and newly developing economies are encouraging demands for consistency in corporate governance. Harmonising standards in areas such as shareholder rights, board accountability, disclosure and oversight could provide real benefits to business and investment by reducing complexity and confusion.

Policy makers are challenged with striking the right balance between market forces and regulation by implementing internationally accepted corporate governance principles of responsibility, accountability, transparency and fairness. To this end, the European Union presents an example of how countries with very different legal structures, national traditions and history are attempting to align corporate governance practices through co-ordination led by the European Commission.

However, many difficulties arise in striving to achieve a single, global approach to corporate governance. There are too many deep-rooted cultural and structural differences for a single approach to work equally well in all countries. This difficulty is highlighted by the differences between US and UK securities markets when they are assumed to share a single Anglo-American model of corporate governance.

The myth of Anglo-American corporate governance

There is a perception of an Anglo-American corporate governance model because both the US and the UK have widely dispersed share ownership and focus on shareholder value. Each country has a common law legal system, long-established and efficient stock exchanges and companies with a single, unitary board structure.

However, while there are strong similarities between the US and the UK, the fundamental balance of responsibility, accountability and power accorded to market participants is different. Hence the assertion that Anglo-American corporate governance is, in fact, a myth. In a similar vein David Alexander and Simon Archer wrote 'On the myth of Anglo-Saxon Financial Accounting':

'...these notions constitute a myth, in the sense that they reflect a certain historical truth regarding both the origins of the accounting professions in the English-speaking countries and certain important shared ideas and institutional characteristics, but fail to take account of fundamental differences in both thought and, even more, practice.

The key point we wish to make about myths is not that they are false, as they may not be an obvious contradiction to reality and indeed may be at least partially true. Rather, our argument is that their truth-value is of little importance compared to their symbolic or metaphorical value.'
The International Journal of Accounting, 2000

Given the global significance of US and UK securities markets, the presumption of a single Anglo-American model can cause confusion and impoverished debate around corporate governance issues in other countries. This may lead to undue emphasis on adopting institutional features and processes of an Anglo-American model which may not be compatible with unique national traditions.

Learning from differences

In identifying differences between US and UK corporate governance systems the intention is not to decide which system, if either, is better. The differences are rooted in history and in particular, the challenges facing the US as an economy in transition in the early twentieth century. To this day, history affects the behaviour and expectations of managers, board directors and investors in US and UK companies.

Nevertheless, market participants operating internationally would benefit from a level playing field in corporate governance. Convergence can promote wider business opportunities, fairness and investor confidence and dual-listed companies and international investors can encourage the transfer of good governance practice. These areas of arbitrage have been structured in a series of discussion papers which:

- set out how business and investors interact at a practical level in both the US and the UK;
- explore opportunities and challenges for international business and investment arising from differences between the US and UK governance systems; and

- identify priorities for action by policy makers that will help promote improved performance and not simply advance convergence by eliminating differences on paper.

The following sections of this consultation paper summarise the pressure points and key questions arising from each of the discussion papers. Each section aims to encourage dialogue around how corporate governance can support:

- policy makers in promoting prosperity, market confidence and public trust;
- shareholders who have confidence in their investments to deliver pensions and insurance and protect savings;
- businesses that are accountable, create value, motivate people and drive enterprise; and
- the accountancy profession in helping to facilitate the flow of capital through transparent, efficient and trusted information.

Pressure points and consultation questions

Policy dialogue: Effective corporate governance frameworks

Effective corporate governance frameworks promote prosperity, market confidence and public trust. Policy makers are challenged with striking the right balance between market forces and regulation by implementing internationally recognised corporate governance principles of responsibility, accountability, transparency and fairness.

1. Regulatory conflicts

Recent scandals have prompted reactions from national governments and regulators. In the US, new rules have been introduced on the back of the Sarbanes-Oxley Act of 2002. In the UK, the Combined Code on Corporate Governance was revised in 2003. When they differ, new national regulations and codes can lead to costly confusion and complexity for businesses and investors operating internationally.

How can the exchange of information and co-operation between policy makers be encouraged to mitigate regulatory conflict and overload?

2. Impact of regulatory burden

Since the enactment of Sarbanes-Oxley a number of non-US companies have de-listed from US securities exchanges and potential new issuers are opting to list in other markets. Despite the liquidity of US securities markets, their attractiveness may be diminishing as a result of perceptions of increased regulatory cost and complexity.

Is there a danger of regulation affecting the long-term attractiveness of US securities markets to non-US companies?

3. Shareholder-led versus regulator-led corporate governance

The UK generally adopts a shareholder-led approach to corporate governance relying on interaction between investors and business. The US prefers a regulator-led approach through rules relating predominantly to disclosure and enforced by the SEC and securities exchanges.

What are the benefits and disadvantages of both a shareholder-led and a regulator-led approach to corporate governance?

4. Markets for corporate control

It is common in the US for boards to use anti-takeover devices, such as poison pills, to discourage hostile takeovers. In the UK, shareholders decide whether or not a hostile takeover should succeed and the board's power to frustrate takeovers is curtailed by the City Code on Takeovers and Mergers.

In a takeover, should the law enable directors as fiduciaries to pursue a corporate interest that differs from that of the current shareholders?

Investment dialogue: Shareholder responsibilities and the investing public

The primacy of shareholders as company owners over other stakeholders is recognised in both the US and UK. Institutional investors play a significant role in the governance of companies in both markets. They are the guardians of other people's money through the management of pensions, insurance and savings products and are expected to act responsibly in exercising their ownership rights.

5. Shareholder engagement and improved corporate performance

In the US and the UK, institutional investors actively engage with directors to encourage improvements that they consider will increase the value of their investment. In each country the way in which shareholders influence boards differs because of differences in incorporation rights, the regulatory environment and the ability to engage directly with directors.

How does shareholder oversight and engagement actually improve the corporate governance and performance of companies in both markets?

6. Shareholder rights and company law

In the UK, the Companies Act 1985 gives shareholders power to influence boards and hold them to account. The Act includes powers to vote on fundamental issues affecting the company and the authority to appoint and remove directors. The US has a decentralised approach to company law at state level where shareholder rights are generally weaker than those in the UK. There is a greater tendency for shareholders to resort to court action for redress if there is dissatisfaction.

To what extent should shareholders be empowered to participate directly in fundamental decisions affecting companies and hold directors to account?

7. Contrasting use of proxy proposals

In the US, non-binding shareholder proposals serve as the primary mechanism by which shareholders can express dissatisfaction. There are minimum shareholding requirements to put forward a proposal which may be included in a company's proxy statement and then put to the annual general meeting. In the UK, a minimum threshold of 5% or more of the issued share capital is required to place a resolution on the agenda of a general meeting.

How effective are shareholder proposals as a means of influencing the governance of companies?

8. Shareholder influence on board composition

Shareholders in the UK have the right to appoint or remove a director on the basis of a simple majority of the votes cast. In the US, while there is a trend for companies to adopt their own version of majority voting, many use a plurality voting system. Under this system, it is not possible to vote against a director and an uncontested director can be elected on the basis of a single affirmative vote regardless of the number of votes withheld.

To what extent should shareholders be afforded powers to influence or determine the composition of boards?

9. Pre-emption rights

Pre-emption rights are not common in the US but are a fundamental shareholder right in the UK to protect against wealth transfer and the erosion of control. In the UK, companies must obtain investors' agreement if they want to increase their share capital by more than 5% in any 12 months and 7.5% over a three-year period without first offering the shares to existing shareholders.

Do pre-emption rights adversely affect competitiveness and are shareholders deterred from investing if a company does not provide such rights?

Business dialogue: Board responsibilities and creating value

Boards of directors are responsible for acting in the long-term best interests of the company for the benefit of shareholders. Effective boards require skilled leadership, balanced decision-making, good judgment and integrity to drive long-term company performance and value creation.

10. Duty of care and the Business Judgment Rule

Directors in both the US and the UK are empowered to manage a company's affairs in a fiduciary capacity. Under the duty of care, directors are assumed to have the requisite competence to fulfil their responsibilities by acting on a fully informed basis, in good faith and with due diligence. That errors of business judgement are not considered a breach of the duty of care is made explicit under Delaware's Business Judgment Rule which is designed to protect directors in taking calculated business risks within their authority.

How does the Business Judgment Rule impact upon the ability of US directors to discharge their fiduciary duties and is there any substantive difference from the position in the UK?

11. Board balance and the role of non-executive directors

US boards are typically comprised almost entirely of non-executive directors who traditionally perform a monitoring role, acting as a check and balance to the power of the CEO. In the UK, there are typically fewer non-executive directors with around one third of the board comprised of executive directors. UK non-executive directors are expected to perform an oversight function while working collaboratively with executives on strategic issues.

How do differences in the relative roles and proportions of non-executive directors and executive directors in the US and the UK impact on company performance?

12. Separating or combining the roles of the Chairman and CEO

In the US, a single individual assuming the role of both Chairman and CEO is traditionally seen as a strength providing a clear strategy and enabling speed of decision-making. In the UK, almost all FTSE 350 companies separate the two roles so that decision-making power is not overly influenced by one individual.

What are the key benefits and/or disadvantages of either separating or combining the positions of the Chairman and CEO?

13. Strengthening independence

In addressing perceived inadequacies around the independence of non-executive directors, new requirements have been introduced on both sides of the Atlantic. Criteria around what constitutes independence have been developed relating to issues such as material relationships, family ties, board tenure, compensation and cross directorships.

Are independence criteria for directors different in substance between the US and the UK?

14. Level and make-up of executive compensation

High levels of executive compensation are a concern for shareholders in both the US and the UK. Equity-based compensation is considered a major contributing factor to corporate scandals involving accounting fraud. As a result, governments have strengthened disclosure regulations and institutional investors engage with companies on issues around levels of compensation, length of service contracts, termination severance, retirement pay and performance measures.

To what extent is it seen as feasible or desirable in the US and the UK for levels of compensation to be influenced by investors or regulated by governments?

15. Non-executive director incentivisation

In the UK, non-executive director compensation is comprised mainly of an annual fixed fee and is relatively low compared to the US. This reflects a widely held belief that conflicts of interest arise if those who are setting targets for executive directors also benefit if those targets are met. By contrast, US non-executive directors are often paid with stock options on the basis that they will be more effective if they have a personal stake in the company's success.

Is company performance enhanced if non-executive directors are compensated with stock options or other performance-related incentives?

Accounting dialogue: Disclosure responsibilities and building trust

The disclosure of meaningful, reliable and timely information to shareholders is of fundamental importance for informed investment decision-making and market confidence. High levels of financial disclosure are characteristic of both US and UK corporate governance models.

16. Disclosure controls

Section 302 of the Sarbanes-Oxley Act requires the CEO and CFO of all SEC registered companies to sign off on annual and quarterly filings. This has led to a strengthening of processes and controls related to disclosure and increased involvement of executive management.

To what extent will new US requirements on disclosure controls increase the demands placed on non-SEC registrants?

17. International Financial Reporting Standards (IFRS) convergence

It is common to distinguish UK principles-based, true and fair financial reporting from the more complex rules-based US system. Some supporters of the UK tradition are concerned that a rush to converge US GAAP and IFRS will mean that the UK's adoption of IFRS in line with EU regulations will lead to a deterioration in reporting quality.

Is complete convergence between US GAAP and IFRS possible or will US standards always need to be different to reflect the US legal environment?

18. Timeliness of financial reporting

Companies in the US and the UK are required to publish annual reports and accounts. In addition, the UK requires half-yearly reporting within 90 days, while in the US, quarterly reporting is required within 35 days.

To what extent does quarterly reporting either improve market efficiency or encourage short-termism and compromise reporting quality.

19. Convergence of auditing standards

The UK has recently anticipated new EU requirements by adopting International Standards on Auditing (ISAs). The US, through the Public Company Accounting Oversight Board (PCAOB), is developing its own detailed standards which address US legislation requirements, including the internal control over financial reporting requirements of Section 404 of the Sarbanes-Oxley Act.

How are US auditing standards likely to influence the development of principle-based ISAs?

20. Non-financial disclosure

The launch of the UK's mandatory Operating and Financial Review (OFR) has emphasised the role of principles and judgement in reporting. However, experience with the US Management Discussion and Analysis (MD&A) suggests, that in a litigious environment, SEC registrants will use formulaic drafting and caveats to protect management from risk.

Is it realistic to expect non-financial disclosure to evolve beyond current US practice?

21. External audit and the role of audit committees

Section 235 of the UK Companies Act requires that auditors are appointed by and report to shareholders. In the US, auditors are employed by and report to the board's audit committee, under federal securities regulation.

What are the practical implications of differing external auditor reporting lines and how do the roles of audit committees in the US and UK differ?

Forthcoming discussion papers



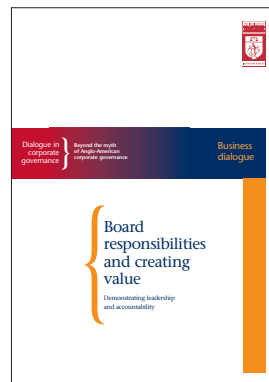
Policy dialogue:
Effective corporate governance frameworks – encouraging enterprise and market confidence

Effective corporate governance frameworks promote prosperity, market confidence and public trust. The US and the UK are amongst the world's most successful economies, each with a strong tradition of corporate governance. This paper explores how policy makers are challenged with striking the right balance between market forces and regulation in supporting internationally recognised corporate governance principles of responsibility, accountability, transparency and fairness.



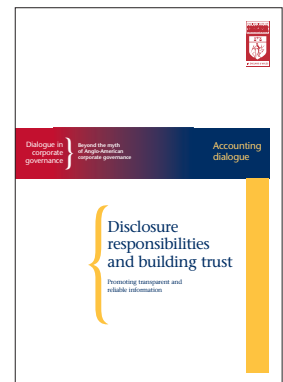
Investment dialogue:
Shareholder responsibilities and the investing public – exercising ownership rights through engagement

Institutional investors play a significant role in the governance of companies in the US and the UK. They are the guardians of other people's money through the management of pensions, insurance and savings products and are expected to act responsibly in exercising their ownership rights. This paper explores the role of shareholders in corporate governance and their rights and responsibilities.



Business dialogue:
Board responsibilities and creating value – demonstrating leadership and accountability

Boards of directors are responsible for acting in the long-term best interests of the company for the benefit of shareholders. Effective boards require skilled leadership, balanced decision-making, informed risk-taking, good judgement and integrity. This paper explores how US and UK boards operate differently and the role, responsibilities and powers of directors in each jurisdiction.



Accounting dialogue:
Disclosure responsibilities and building trust – promoting transparent and reliable information

The disclosure of meaningful, reliable and timely information to shareholders is of fundamental importance for informed investment decision-making and market confidence. High levels of financial disclosure are characteristic of both US and UK corporate governance models. This paper explores the role of the accountancy profession in helping to facilitate the flow of capital through transparent, efficient and trusted information.



Chartered Accountants' Hall PO Box 433 Moorgate Place London EC2P 2BJ
Tel 020 7920 8100 Fax 020 7638 6009 www.icaew.co.uk/corporategovernance
November 2005