



DIALOGUE IN CORPORATE GOVERNANCE
NEW CHALLENGES

A THOUGHT LEADERSHIP INITIATIVE



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New Challenges aims to re-position corporate governance as a dynamic and vital activity. It will help listed companies, through the actions of their boards, to earn the trust of capital markets and generate sustainable value. Effective corporate governance is a competitive imperative if listed companies are to access capital at lowest cost.

The *New Challenges* initiative in ICAEW's *Dialogue in Corporate Governance* thought leadership programme focuses on major issues of significance to listed company boards. The aim is to reinvigorate the study of corporate governance, moving it on from increasingly introspective debate about listed company board procedure and regulatory compliance.

What has changed?

Current frameworks such as the *OECD Principles of Corporate Governance* and the *UK Corporate Governance Code* see boards of listed companies as agents of absentee shareholders. Risks arise because board members' interests may differ from shareholders' (the agency problem) and because boards have more information about a company than shareholders (information asymmetry). To address these risks, corporate governance thinking has established principles, codes and rules to guide the composition, organisation and conduct of boards. In such areas, listed company governance responsibilities can become routine compliance exercises. For new board members, a vast amount of experience and best practice is available to help them.

Yet, directors of listed companies that follow the existing frameworks are at risk of failing, or being judged to have failed, with little prior warning or ability to take countermeasures. Increasing cross-border investment, growing proxy adviser influence over voting, the widespread practice of stock lending and the development of new financial instruments make it increasingly difficult for boards to identify and communicate with people whose views determine market sentiment.

Little is written about how boards should engage directly with people outside the company other than institutional shareholders. The lack of material in this area is becoming a potentially serious issue as the competitiveness of capital markets spurs greater specialisation and division of labour and the development of new products and services to cut costs and enhance returns. Attempts to prioritise direct engagement can violate principles of market fairness and a focus on the needs of institutional shareholders is becoming less effective where they own a declining proportion of shares in listed companies.

Modern listed companies no longer operate in a world where an identifiable and homogeneous group of domestic shareholders can be seen as representative of the markets. The capital markets exercise their power over boards through a host of market participants. These include not just institutional investors, but also hedge funds, private equity funds, sovereign wealth funds and activist investors who can intermediate between companies and the investing public.

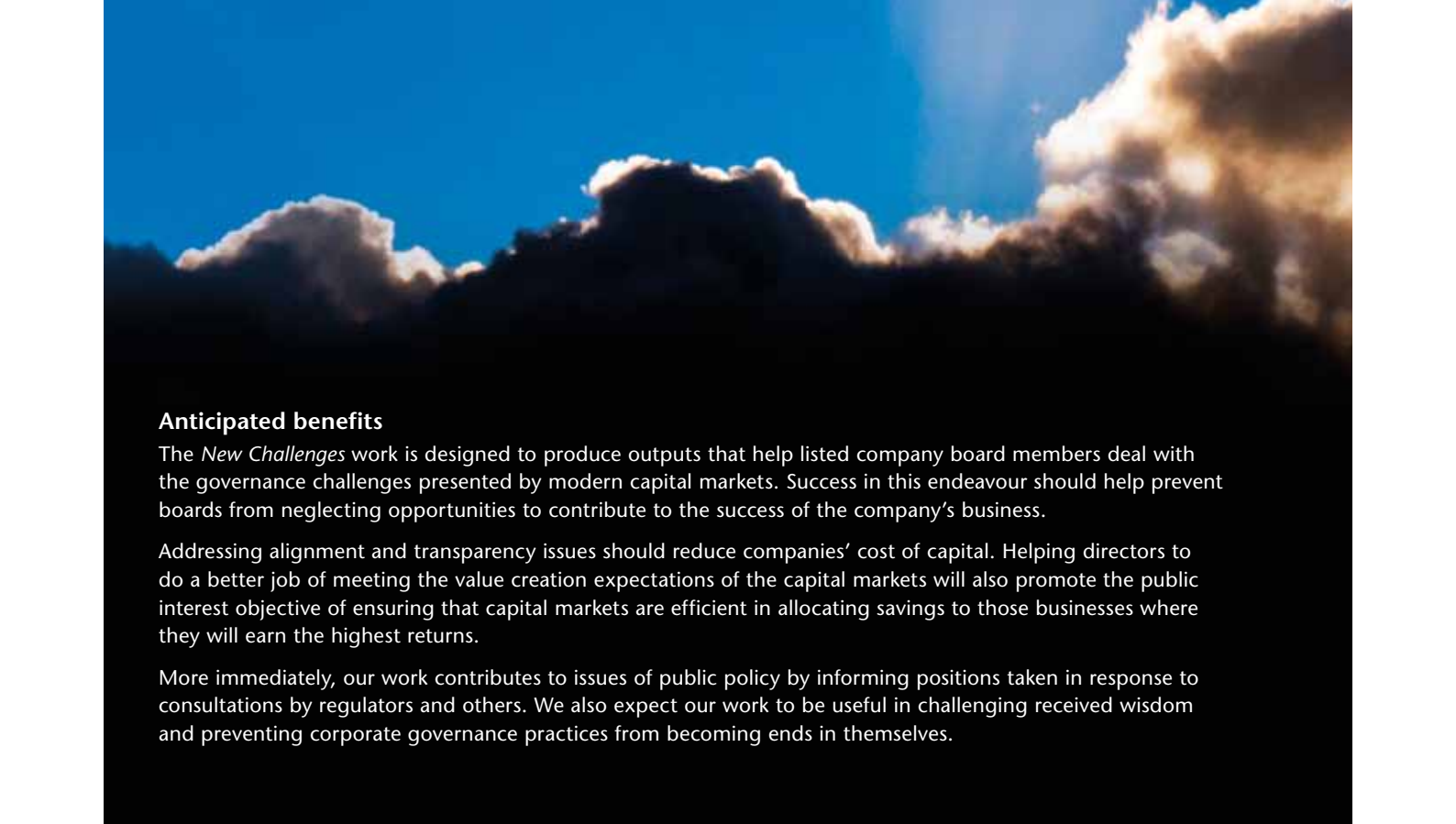
The real power of market participants can be difficult to judge until it is too late. Boards can also find their ability to access capital markets being denied or withdrawn through the actions of agents of market participants. They include regulators and gatekeepers, such as sponsors, brokers, audit firms, proxy advisory services, legal advisers and credit ratings agencies.

A way forward

We want to study the impact on corporate governance of the market participants, gatekeepers and regulators whose behaviour plays a major role in determining whether boards endure and whether listed companies thrive. To succeed, boards of listed companies and the wider community of regulators and gatekeepers are learning to apply new principles of corporate governance. In a complex world characterised by *New Challenges*, we want to help articulate these new principles.

The role of ICAEW

ICAEW has an enviable reputation for its thought leadership work. Rather than promote ready-made solutions to problems, we seek to engage widely and identify underlying assumptions and disagreements that call for better understanding and evidence. To this end, we regularly issue reports, host roundtables and other events, commission research and participate in academic conferences. Our work is presented internationally to governments, regulators, standard-setters, business, investors and opinion formers and there is extensive engagement with leading academic researchers and institutions.



Anticipated benefits

The *New Challenges* work is designed to produce outputs that help listed company board members deal with the governance challenges presented by modern capital markets. Success in this endeavour should help prevent boards from neglecting opportunities to contribute to the success of the company's business.

Addressing alignment and transparency issues should reduce companies' cost of capital. Helping directors to do a better job of meeting the value creation expectations of the capital markets will also promote the public interest objective of ensuring that capital markets are efficient in allocating savings to those businesses where they will earn the highest returns.

More immediately, our work contributes to issues of public policy by informing positions taken in response to consultations by regulators and others. We also expect our work to be useful in challenging received wisdom and preventing corporate governance practices from becoming ends in themselves.

The issues of capital market innovation, alignment and transparency are much studied, but generally only from a particular perspective. For example, in recent times the activities of hedge funds, the use of contracts for difference, stock lending practices, management remuneration and ad hoc disclosure have all been looked at by regulators. However, it is understandable that this is done with the principal objective of deciding whether there needs to be new regulation.

Our work is conducted in an impartial and inclusive way. With a membership of over 136,000 chartered accountants, ICAEW is able to draw on the breadth of its members' involvement in all economic sectors to engage and work with a wide range of stakeholders from across the business, investment, professional, regulatory and academic communities.

New Challenges is also thoroughly international in outlook. This does not mean that it is based on the premise that there is or should be a single global governance model for listed companies. Indeed, ICAEW's previous widely-acclaimed *Dialogue in Corporate Governance* initiative *Beyond the Myth of Anglo-American Corporate Governance* explored differences between the US and UK corporate governance systems. Rather, our argument will be that all listed company governance models share common points of weakness in adapting to the realities of modern capital markets. In exploring ways of addressing these points, we want to learn from different markets and national regimes.

By concentrating on how boards relate to the various faces of the capital markets, the *New Challenges* initiative complements other ICAEW thought leadership programmes that deal with other aspects of the savings chain linking the investing public and individual businesses:

- The interaction between the ultimate consumers of savings and investment products and financial services providers, intermediaries and regulators is the subject of the ICAEW Financial Services Faculty's programme *Inspiring Confidence in Financial Services*.
- Capital market transactions such as initial public offerings, other capital raising exercises and private equity buyouts are covered by the *Financing Change* programme of the ICAEW Corporate Finance Faculty.
- *New Challenges* also draws on ICAEW's *Market Foundations* work, for example on issues such as the public interest, the need for governance to be underpinned by respect for the rule of law, principles of good regulation, and the rights and obligations of legal entities.

THREE NEW STRANDS OF THOUGHT LEADERSHIP

INNOVATION

We identify major changes affecting listed companies in response to pressures in competitive capital markets. These include the development of new products and services, the entry and growth of new market participants and gatekeepers, and new forms of regulatory intervention. We focus on those developments that seem not to be satisfactorily addressed by current corporate governance frameworks and identify the challenges that they present to listed company boards in trying to fulfil their responsibilities. We also seek to identify ways in which boards have adapted to these challenges.

Changes in capital markets have implications for the sustainability of the **comply or explain** approach to corporate governance first developed in relation to the Cadbury Code and still applied to the UK *Corporate Governance Code*. This works best when there are active institutional investors and so, despite its popularity, comply or explain is threatened in the longer term by the declining proportion of listed company shares owned by institutional investors and the increasing tendency for companies' governance to be scored on the basis of a box-ticking exercise performed by intermediaries.

Major changes that we focus on include:

- the market entry and increasing importance of hedge funds, private equity funds, sovereign wealth funds and activist investors;
- new products such as hybrid instruments that combine features of debt and equity, and derivatives contracts that are linked to aspects of the performance of corporate debt and equity instruments;
- stock lending and other return-enhancing offerings;
- changes in the services offered by sponsors, brokers, audit firms, proxy advisory services, legal advisers and credit ratings agencies; and
- new regulatory initiatives particularly to achieve international harmonisation and co-ordination in the face of increasing cross-border activity.

ALIGNMENT

It is no longer enough for corporate governance to focus its alignment efforts on the principal-agent relationship between shareholders and boards. There are a host of relationships that matter from a public policy standpoint involving a wider range of market participants, gatekeepers and regulators. The public policy objective of effective behavioural alignment is to inspire confidence and trust among the investing public that capital markets are efficient in allocating savings to businesses where they will be put to best use.

In our work on aligning interests we consider the full range of means by which market participants, gatekeepers and regulators seek to incentivise boards, managers and each other to act in the interests of those they are meant to serve. Particular attention is paid to the reasons why certain types of incentive have fallen out of favour, how different stakeholders compete to ensure that incentives serve their particular interests and the challenge that private equity incentives present to publicly listed equity markets.

TRANSPARENCY

Our starting point is the importance that is attached to transparency in current corporate governance frameworks. There is an expectation of timely and accurate disclosure of all material matters affecting the company, including its financial situation, performance, ownership and governance. Conventionally, transparency obligations are seen as falling mainly on the boards of listed companies but this needs to be questioned and the potential obligations of other parties need to be considered.

We analyse how the overall objective of transparency – which is essential for building confidence and trust – should be interpreted in the complex world that we describe in *New Challenges*. And, if transparency obligations are to be seen as extending more widely to capital market participants, gatekeepers and regulators, how can such new obligations be agreed and enforced?

SUMMARY

Existing corporate governance frameworks are principally concerned with boards of listed companies acting as agents of absentee investors. In the main, they address potential agency and information asymmetry problems by establishing principles for the composition, organisation and conduct of boards. This approach needs to be developed to deal with new challenges. In particular, boards of listed companies need to be seen to be meeting market expectations for value creation. If not, they can be removed, not just through a takeover, but also by significant new capital market participants.

To address such threats, boards have to learn to engage with a variety of market participants, gatekeepers and regulators, rather than a homogeneous class of shareholders. The *New Challenges* initiative helps to articulate the new principles of corporate governance that are needed to do this. As well as helping boards, it also promotes the public interest objective of ensuring that capital markets are efficient in allocating savings to those businesses where they will earn the highest returns.

MAKING A CONTRIBUTION

If you are interested in *New Challenges* and in discussing our ideas or learning more about forthcoming publications and events, please contact:

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ICAEW is a professional membership organisation, supporting over 136,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

Because of us, people can do business with confidence.

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