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Mitigating Financial Risks via Corporate Governance Oversight

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Abstract

Global financial crises stem from highly speculative risk factors, often due to inadequate corporate governance practices.

Over the past two decades, such inadequate corporate governance practices have incited major investor groups, and their advisors, to attempt to reform the global financial system, so as to safeguard their long-term investments.

Some 600 corporate governance conferences are now held every year worldwide, by major investor groups (e.g. Council of Institutional Investors/ CII in Washington DC, International Corporate Governance Network/ ICGN in London), governmental organizations (e.g. UNCTAD in Geneva, OECD in Paris, World Bank-IFC in Washington DC), financial institutions (e.g. asset managers, insurers, stock exchanges), and corporate associations (e.g. International Chamber of Commerce/ ICC in Paris).

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Prologue

The oldest references to the word “risk” stem from a nautical expression formulated in the second millennium BC by Phoenician trading seafarers, to express the great opportunities fraught with grave dangers which characterized their commercial expeditions.

The notion of “risk” then spread throughout the maritime world, and was associated in 1609 with the first expression of shareholder advocacy by Dutch investor Isaac Le Maire, at the Amsterdam Stock Exchange.

Afterwards, it was referred to by a host of academic scholars, accountants, attorneys, businessmen, investors, and statesmen, such as inter alia John Maynard Keynes in his *General Theory of Employment, Interest and Money* (1936), Peter Bernstein in *Against the Gods* (1996), Nassim Nicholas Taleb in *The Black Swan* (2007), and Scott Patterson in *The Quants* (2010). Quant models are considered responsible for the 1998 Long-Term Capital Management/ LTCM stock market failure, and other stock crashes, to the detriment of pension holders and other long-term oriented investors.

Actually, stockholders have been bilked throughout history, as demonstrated by the collapse of John Law’s French Indian Company in 1715; the UK banking panic in 1825; the U.S. banking panic in 1836; the Vienna stock market crash in 1873; the U.S. market crash in 1907; the Black Friday stock market crash in 1929; the Chrysler rescue in 1980; the Black Monday stock market crash in 1987; the Enron, Parmalat and WorldCom fiascos in 2001-2003; the 2007-2008 “subprime losses” of, among others, AIG, Bear Stearns, Citigroup, Lehman, Merrill Lynch, Soc-Gen, and UBS.

Today, over 600 corporate governance related conferences are held annually around the world, as reported by the weekly newsletter “Global Proxy Warch”.

Among the 200 or so international organizations involved in corporate governance matters, half-a-dozen could be considered to play a significant international role, spread among the following major categories:

1. International Corporate Governance Organizations

The two major global corporate governance organizations were initially founded by investors. They are the Council of Institutional Investors/ CII in Washington DC, and the International Corporate Governance Network/ ICGN based in London.

The CII, founded in 1985 in Washington DC, assembles 260 participating members from major pension funds, banks, law firms and corporations managing assets exceeding US\$ 3 trillion, as well as 23 Honorary International Participants from outside the U.S. In 1995, the CII contributed to host in Washington DC the first meeting of the International Corporate Governance Network/ ICGN.

The ICGN is reported to be today the premier global financial network, with over 500 institutional members holding equity assets of over US\$ 12 trillion.

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It is a non-governmental and not-for-profit organization, which now assembles asset managers, pension fund trustees, insurers, shareholder associations, investment clubs, governance experts, shareholder advocates, attorneys, auditors, proxy firms, corporate executives, stock exchange officials, rating firms, security market regulatory officials, etc.

The year-round activities of the ICGN are carried out by its various Committees, e.g. : Awards, ICGN Board Nominations, Accounting and Auditing, Corporate Governance Principles, Cross Border Voting Practices, Executive Remuneration, Non-Financial Disclosure, Securities Lending, etc.

The ICGN has organized 15 Annual Conferences and 10 Mid Year Meetings throughout the Americas, Africa, Asia, Australasia and Europe. It has also published a host of reports, such as the *ICGN Corporate Governance Principles* (1999, updated in 2006 and 2009), the *ICGN Statement of Principles on Institutional Shareholder Responsibilities*, the *Financial Auditing and Reporting - What Do Investors Want?*, the *Executive Remuneration Guidelines*, the *ICGN Securities Lending Code of Best Practices*, etc.

The ten major ICGN Corporate Governance Principles can be sketched as follows:

- **Corporate Objectives:** optimizing long-term growth matched vs. specific equity peer groups.
- **Voting Rights:** upholding the “one share = one vote” principle.
- **Disclosure and Transparency:** corporations should disclose all relevant material information on a timely basis.
- **Corporate Boards:** splitting the Chair and CEO functions, with a majority of independent directors.
- **Executive Remunerations:** aligning remuneration with long-term profitability.
- **Strategic Corporate Focus:** major strategic core business focus should be made with prior shareholder approval.
- **Peer Group Benchmarking:** corporations should strive to excel in their specific peer group benchmarking comparisons.
- **Accounting and Auditing:** external auditors should be proposed by the Audit Committee of the Board, for approval by shareholders.
- **Corporate Citizenship:** adequacy with major codes, e.g. OECD Anti-Bribery, ISO 14'000 Environment Certification, U.N. Global Compact, etc.
- **Corporate Governance Implementation:** corporate governance disputes should ideally be resolved through negotiation and arbitration, before resorting to securities class actions.

2. Governmental Organizations

In Geneva, UNCTAD created in 1972 the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting/ ISAR, which organizes international conferences and publishes reports promoting adequate corporate disclosure principles.

In Paris, the OECD organizes since 1994 a series of corporate governance meetings. It issued the successive 1999 and 2004 OECD Principles of Corporate Governance.

In Washington DC, the Global Corporate Governance Forum of the World Bank's International Finance Corporation/ IFC has organized since 1999 a host of conferences and training sessions, while publishing regular reports on its activities.

3. Financial Institutions

Several prominent financial institutions are now focusing on corporate governance issues.

Among the major stock exchanges, the NYSE Euronext Exchange deserves to be commended for its innovative International Advisory Board (inherited from the 1995 early initiatives of Bourse de Paris), which covers a great many issues, including corporate governance.

In the Middle East, the Dubai International Financial Center/ DIFC founded the Hawkamah Corporate Governance Institute in 2006, for the promotion of adequate governance principles throughout the Middle East-North Africa/ MENA area.

4. Corporations

Several major corporations cover corporate governance topics in their Annual Reports. However, they rarely address certain major governance topics, such as for instance “one share = one vote”, disclosure of detailed executive remunerations, strategic corporate focus or peer group benchmarking.

The International Chamber of Commerce/ ICC is striving to integrate corporate governance sessions into its programs, targeted at corporations worldwide. Corporate governance topics were covered in its 2008 “Corporate Governance Roundtable” in Paris, and its 2009 “Rebuilding Financial Markets” Conference in Monaco.

5. Securities Class Actions

The impact of securities class actions is a relatively new phenomenon. After recovering over the past decade US\$ 20 billion on behalf of American shareholders affected by attested corporate misbehaviors, several leading U.S. law firms are now focusing on Europe.

The growth of class actions results from the failure of conciliation, mediation and/or arbitration procedures to resolve major fraudulent corporate management behaviors..

Could adequate corporate oversight mitigate financial risks ?

While stock market losses affected mostly individual investors a generation ago, they now affect the pensions of millions of retirees worldwide.

We are currently witnessing a growing corporate governance awareness, as demonstrated by the 600 corporate governance related conferences now held annually worldwide, as compared to only a dozen conferences limited to the U.K. and the U.S. two decades ago.

A new generation of corporate leaders won't be allowed to run their business like some of their more autocratic predecessors did. Board directors are also likely to worry more about their increased oversight responsibilities.

Executive compensations are likely to be shifted from short-term to long-term outlooks, and short term oriented speculative hedge funds are likely to be better monitored.

Several academic institutions are also contributing to the development of adequate corporate governance practices, such as Harvard University, Stanford Law School, and the Millstein Center for Corporate Governance and Performance at Yale.

Moreover, corporate governance rating agencies now exert a growing impact, particularly the Corporate Library, the European Corporate Governance Services/ ECGS Group, Egan Jones, Glass Lewis, Governance Metrics International/ GMI, Proxy Governance and RiskMetrics.

In the U.S., a significant impact could be generated thanks to the growing supervision of the Federal reserve, the Public Company Accounting Oversight Board/ PCAOB and the Securities Exchange Commission/ SEC - together with other leading regulators and supervisors worldwide.

Time will tell whether regulatory officials, economists, and corporate governance professionals versed in the history of finance can contribute to reduce the recurrence of financial crises, and thus reduce their impact on equity investments, particularly those of pension funds.

This input relates to topics covered by the author in various UNCTAD conferences and reports, as well as in his chapter *Impact of Corporate Governance on Financial Markets* of the Palgrave Macmillan Studies in Banking and Financial Institutions treatise *Globalization and the Reform of the International Banking and Monetary System* (London, 2009) by a dozen authors, among whom Webster University Professor Otto Hieronymi in Geneva, who co-edited this book.

This book proclaims that financial crises appear to spread like pandemics. Ergo, a global corporate governance surveillance system (inspired from that of the Geneva-based World Health Organization/WHO to eradicate diseases) could be developed so as to immunize major critical sectors throughout the global financial arena.