CORPORATE GOVERNANCE: AN EXAMINATION OF U.S. AND EUROPEAN MODELS

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Abstract

As the model for corporate governance has emerged in the US after decades of evolution, culminating with the Sarbanes-Oxley Act in 2002, there has also been interest in corporate governance models used in other countries. This has particular importance considering the increased competition for capital in international markets with investors wishing to make sound financial decisions by seeking information from companies, regardless of their national registry, that is open, accessible and accurate. This paper examines the framework for corporate governance in the US, its evolution over time, and reviews corporate governance models used in the United Kingdom, the Netherlands, Germany and Switzerland. A comparison of these models is provided presenting similarities and differences, strengths and weakness, and obstacles to harmonization.

Keywords: Corporate Governance, US, Europe, Models

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Introduction

There has been much attention focused on the anticipated convergence of accounting standards towards one universal system, especially with the actions of the U.S. in their announcement to move from U.S. GAAP towards IFRS. This anticipated move towards IFRS has also raised awareness as to whether a similar type of harmonization could take place with regards to corporate governance models as it is noted that in order for any unified capital markets to emerge, this harmonization would be necessary. However, many now realize that differences in corporate governance models exist due to diverse legal and cultural factors that may be very difficult to reconcile. These differences are so distinct, that evidence exists indicating that companies may shop for stock exchange listing policies and corporate governance requirements that are less costly and more beneficial to them (Oxera, 2006).

Corporate governance is the system in which organizations are governed and controlled and is primarily concerned with corporations and the relationship of their management and their shareholders. It is more broadly defined to include rules, processes, or laws by which businesses are operated, regulated, and controlled and encompass the corporate charter, bylaws of the corporation, formal policies and rules of law. The shareholders in a corporation forego certain rights with regard to management decisions made by the company in return for other rights, primarily for voting rights and the right to receive dividends. Shareholders delegate this decision making authority to professional management and to the board of directors, all of which make up the principal stakeholders in the corporation. Because of this delegation, management and members of the board are held accountable for their actions, which has been the subject of increased focus as to how this is best accomplished.

"Corporate governance is about accountability and communication. Accountability is about how those entrusted with day-to-day management of a company's affairs are held to account to shareholders and other providers of finance. Communication is also about how the company presents itself to all interested parties, including shareholders, potential investors, regulators, employees, and bankers. As companies increasingly look beyond their national boundaries and do business and raise funds at an international level, the issue of corporate governance becomes more crucial. The different stakeholders, particularly

international investors, demand more accurate corporate information. This puts additional pressure on a company's management to disclose high quality information and to be accountable to various interested parties" (Solani, p. 191).

Currently, frameworks for corporate governance are primarily shaped by the conventions and laws of each country in which the organization is incorporated. This system has resulted in a variety of different models with varying levels of accountability and disclosure requirements. However, as Solani (2005) notes above, as organizations enter into international capital markets, their stakeholders expect that their interests will be safeguarded and are seeking a level of corporate governance that will provide that protection. Therefore, an assessment of the differences of the U.S. model and those used in Europe provides a better understanding of these systems.

The U.S. Model for Corporate Governance

Historical Background and Evolution of the Model

The U.S. model for corporate governance follows the "Anglo-American" model which emphasizes the interests of shareholders, management and directors. It is based on a single-tiered (one-tiered) Board of Directors which is primarily comprised of non-executive directors who have been elected by shareholders. Some single-tiered boards have both executive and non-executive directors, while others may have the CEO (Chief Executive Officer) serving as the Chairman of the Board, creating CEO/Chair duality, and then utilizing separate functional committees, for example, audit, nominating, and compensation committees.

There are certain elements that are considered essential to define good corporate governance. These characteristics focused on what have been referred to as "Golden Rules" of governance and focus on concepts of ethics, aligning business goals, strategic management, organization, and reporting (Applied Corporate Governance). These basic concepts have resulted in requirements which encompass the rights and equitable treatment of shareholders, the interests of other stakeholders, the role and responsibilities of the board, integrity and ethical behavior, and disclosure and transparency (Sarbanes-Oxley, 2002).

Following the financial failures of Enron, Worldcom and Tyco corporations in the early 2000's, there was an increased interest in corporate governance and questions were raised as to the adequacy of current regulations. This scrutiny fueled the impetus for the passage of the Sarbanes-Oxley Act in 2002. This Act is an amendment to the Securities Acts of 1933 and 1934 and legislated specific revisions to the framework for corporate governance in the United States.

Prior to Sarbanes-Oxley (SOX) most of the requirements established regarding corporate governance had been established by the U.S. stock exchanges. In 2002, the former Securities and Exchange Commission Chairman, Harvey Pitt, asked the New York Stock Exchange (NYSE) to review its corporate governance listing standards. At that time, the NYSE appointed the Corporate Accountability and Listing Standards (CALS) Committee to review those standards with the goal of "enhancing the accountability, integrity, and transparency of NYSE-listed companies" (Soltani, p. 167). Later that year, the CALS Committee recommended new standards and changes to existing corporate governance and disclosure practices which were adopted by the NYSE and submitted to the SEC for approval. Because at that time, the rules on corporate governance were set by the stock exchanges, the NASDAQ Stock Market had rules that were slightly different from those of the NYSE but were acting to harmonize those rules with SOX requirements and propose new rules that would reconcile with those of the NYSE. In essence, the new NASDAQ and NYSE rules were very similar and would "narrow the definition of an independent director, require a majority of independent directors on corporate boards, require independent director approval of director nominations and executive officer compensation, expand the scope of audit committee authority, and tighten the qualification requirements for audit committee members" (Solani, p. 168). Similar rules were adopted by the American Stock Exchange (AMEX) in 2002.

Specifically, SOX narrowed the definition of an independent director, required that a majority of the directors on the board be independent, required independent director approval of director nominations and executive officer compensation, expanded the scope of audit committee authority and tightened the qualification requirements for audit committee members (Sarbanes-Oxley, 2002).

In addition, several other changes occurred as a result of the passage of SOX in that the requirements for corporate governance are applicable for all SEC registrants and are mandatory with regard to compliance over certain officers and the corporation. In this manner, the SEC has established "clear accountability of a public company's CEO and CFO for the accuracy of the company's public disclosures, and to strengthen and reinforce the role played by the board of directors and key board committees in the oversight of corporate management" (Butler, Goldberg and FitzGerald, 2004).

Through this regulation, the structure of corporate America has not changed, but the accountability of a public company has changed. Through the requirements that the financial statements be certified under Section 302 of the Sarbanes-Oxley Act, the accountability now is with the CEO and CFO, personally, and it is primarily with the board to maintain an independent majority of board members.

The European Model

Just as in the U.S., corporate governance has received much more attention in Europe over the last decade, as well. Several committees examined how governance could be strengthened and in 2003, the European Commission proposed a framework for corporate governance. The Commission recognized that there were many differences in the systems that were currently being used and cited mostly legal and cultural reasons. However, they still wanted to design systems that would maintain shareholder rights and protections for third parties, particularly creditors. They also wanted a system that would provide enhanced disclosures including providing information in annual reports that discuss related parties, risk management, composition and operation of board and committees, description of shareholder rights and disclosures of shareholders having major holdings or voting and control rights (Solani, 2005).

Although on the surface the objectives of the proposed European model may appear to align with those of the U.S. model, there are some significant differences that would pose serious barriers to harmonization. Some of these major philosophical differences include the European emphasis on the stakeholder rather than the shareholder, the prevalence of two-tiered boards which are structured with a supervisory board (wholly or partly non-executive) and a management board (executive) and the move to prohibit CEO/Chair duality.

The United Kingdom

The United Kingdom (UK) has a system of business regulation that is principles based rather than rules based. Their approach takes the position that good governance is essential to manage the corporation effectively and to provide accountability to the shareholders. The UK model is based on the 'UK Corporate Governance Code' which was formerly called the 'Combined Code on Corporate Governance. This Code establishes good governance practices relating to the role and composition of the board and its committees and the development of a sound system of internal control. However, it operates on the basis that companies can choose to adopt a different approach that may be more appropriate for them. This market-based approach enables the board to retain flexibility and is basically a system of 'comply or explain' (UK Corporate Governance Code). In other words, if a corporation chooses to take a different approach, they are required to explain these reasons to their shareholders who then must decide if the approach chosen is acceptable. This 'comply or explain' approach enables judgments about many issues, including the independence of non-executive directors, on a case-by-case basis. This system exemplifies the importance of the relationship between the company and its shareholders and not between the company and the regulators which in turn, has gained strong support from companies, investors and regulators in the UK.

Under the current laws, shareholders have extensive voting rights, including the right to appoint and dismiss individual directors. Benefits of this system are that it has provided strong corporate governance at a relatively low cost. Oxera (2006) found in a study that the "UK was ranked as the leading country in terms of corporate governance" and these more favorable requirements were a major reason why some companies chose to list their securities in the UK rather than in the U.S. (p.5).

Germany

Corporate governance in Germany is based on several laws including the German Stock Corporation Act, German Codetermination Act and the German Corporate Governance Code. It is a model which focuses

on stakeholders and is very legalistic in its nature and emphasizes cooperative relationships among banks, shareholders, boards, managers and employees in the interests of labor peace and corporate efficiency" (Barnett, p 27). Some of the major features of this system is that it utilizes a two-tiered board model which includes a management board and an executive board and emphasizes the protection of all stakeholders, especially employees and lenders. This special relationship with employees is known as 'codetermination' which recognizes the role of labor in the decisions made by German corporations. However, not only does labor have a 'seat' at the board table, the German system also acknowledges the role of creditors and is known as a bank-based system which recognizes the ownership position of banks in companies to whom they lend.

This system is unique in that it addresses several differences that exist in German capital markets. Because of its stark differences, the international community has reservations regarding this model and the German Corporate Governance Code has addressed these critics. Unlike most other models that are primarily focused on shareholders, this system recognizes the importance of other stakeholders and their influence in the capital markets. This is significant as the market capitalization in Germany is unlike that of those in other countries. For example, the stock market represents about 30% of GDP in Germany as compared to 122% in the United States. In addition, corporate ownership is much more concentrated in German companies than is in the U.S. and has a preponderance of family-owned companies ("Germany's Flawed Corporate Governance: Boards Behaving Badly," 2009). However, many German companies recognize that the U.S, system of governance may be more beneficial and for this reason, have chosen to list their shares in the U.S. instead. A prime example and much publicized case was that of the Pfeiffer Vacuum Company, whose CEO, Wolfgang Dondorf, chose to list its stock in the U.S. and stated reasons of the enhanced transparency to public investors which is inherent in a market-based system permitting them to compete more wholly in the global market (Kaen and Sherman, 1999).

The Netherlands

The Parliament in the Netherlands has just passed a new Corporate Governance Act in 2013 amending the Code of Corporate Governance (2004) which was enacted in order to encourage proper conduct by company management and board members to protect investors. Although this is a shareholder model, the Dutch system does recognize that there are many other stakeholders involved with interests that should be represented and that companies have a level of corporate social responsibility to uphold. The legal requirements dictate the use of a two-tiered board structure utilizing an executive board and a supervisory board, which is a non-executive board representing shareholders and employees.

There is an increased focus on transparency for investors inherent in the Dutch System. This system provides that shareholders have timely and accurate information. However, this transparency has also generated criticism in that opponents believe that the increased transparency could lead to a loss in a company's competitive edge.

Switzerland

The Swiss system of corporate governance differs rather dramatically from the models used by other European countries. It is based on the Swiss Code of Best Practice for Corporate Governance (2002) and it sets the guidelines for public limited companies in Switzerland. The primary principle of these regulations is to direct businesses to act in the shareholder's best interests. However, in this system, a great deal of autonomy is given to shareholders to make decisions regarding the top levels of management and they have the final authority on many important decisions made in the corporation including the election of the board and the selection of the external auditor.

This system establishes one that provides that shareholders have extensive power and rights. For example, in preparation for the General Shareholder Meetings, shareholders have advance notice, are encouraged to comment on agenda items, they may request additional information and have the right of inspection. On the other hand, some critics have noted that shareholders may have too much influence, especially those with large stock holdings as they may have undue power which could result in unethical practices or corruption.

In 2007, the Swiss Business Federation claimed that the Swiss Code was deemed a success. They felt that the self-regulatory system provided a functional system while "allowing companies the necessary room

for maneuver" (Swiss Business Federation, p, 1). The Code was strengthened in 2007 by adding recommendations on remuneration which are "based on the self-regulation principle [while permitting] companies to retain their flexibility (Swiss Business Federation, p.1).

Comparison of Models

In Table 1, the models for corporate governance used in the United States and the four European countries previously examined are compared. This Table highlights similarities and differences with regards to some relevant parameters of the models.

It would appear that according to these descriptions, we have extreme models of corporate governance with Switzerland at one end of the continuum with their goal of self-regulation and flexibility to that of Germany at the other end which many believe have a model that is very rigid and overly legalistic. The other countries examined appear to be somewhere in the middle, but they each differ from each other.

Table 1. Comparison of Corporate Governance Models in the US and European Countries

	United States	**United Kingdom**	**Germany**	**Netherlands**	**Switzerland**
Goals of Corporate Governance	Shareholder model	Shareholder model	Stakeholder model	Shareholder model	Shareholder model
Board Structure	One-tiered	One-tiered	Two-tiered	Two-tiered	One-tiered
Mandatory	Required by SOX	Comply or explain	Required by law	Comply or explain	No
CEO/ Chair Duality	Permitted	Not Permitted	Prohibited	Not Permitted	Permitted
Appointment of Independent Auditor	Independent Audit Committee	Independent Audit Committee	Supervisory Board	Shareholders through the Audit Committee	Shareholders elect
Required Disclosure	Limited in 10K, details in Proxy Statements	In Annual Report, less than U.S. requires	In Annual Report	In Annual Report	In Annual Report
Independence Achieved	Committee Structure	Committee Structure	Board Structure	Board Structure	Shareholder Autonomy

Conclusion

The significant differences noted in these corporate governance models would need to be addressed before any discussion of convergence could take place. It is important to note that these differences not only stand in the way of harmonization, but they also may be impediments leading companies to evaluate listing alternatives to choose requirements that provide the most advantageous costs and benefits to them. On the other hand, companies cannot ignore the importance that corporate governance plays in the capital market. A 2002 study by McKinsey found that "investors would be willing to pay as much as an 18 percent premium for companies that they believe have superior corporate governance" (Monks and Minow, p. 340). All these factors will play vital roles in any move toward global capital markets in the future.

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