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THE OBJECTIVE: A *CULTURE* OF CORPORATE GOVERNANCE
Outline of Comments to be Made to the Third Asian Roundtable on Corporate Governance
The Role of Boards and Stakeholders in Corporate Governance

Theme VI: The Profile of Directors
What qualities should directors possess, and how do companies find competent directors?

Peter Dey, Chairman
Morgan Stanley Canada Limited

Introduction

- "Director qualities" represent the "sweet spot" of corporate governance reform.
- To address the issue of director qualities, I want to approach the topic first from the general perspective of reform in governance and the objectives we are searching for in governance reform and then relate the objectives to the specific issue of director qualities.
- To do so, I will take the liberty of talking about my own experience in governance reform — which will not be dissimilar to the experience of many of you — and extract from this experience the lessons (which are a work in process) on how to upgrade the quality of governance through improving the qualities of directors.
- The presumption about our common experience in governance reform is one that I think I am entitled to make because of the common standards that are being imposed upon corporations accessing capital markets in all of the major markets of the world by international investors.

"Where Were the Directors?"

- The Committee which I chaired in Canada resulted in a 1994 report with the above title. The title was controversial because it raised a question about the role of the board of directors in corporate governance.
- The title attempts to capture the defensive character of Canadian boards at the time; the Committee was formed as a result of a number of influences:
    i. there was a widespread debate in Canada about the importance of governance but the debate was disorganized and lacked focus;
    ii. there had been a number of high profile corporate failures, especially in the financial services sector, and questions were asked about the role of the directors in these circumstances;
    iii. there was a fear that if the private sector did not organize the debate and lead the reform, the public sector would seize the initiative and the end product would be less effective.

- The Report — and it is apparent from the title — identified the board of directors as the body in corporate governance systems most critical to enhancing governance.
- In doing this, we had the luxury of presuming that there existed a developed infrastructure for governance reform; by this, I am referring to well-developed business corporations statutes, well-developed securities regulatory systems, efficient markets in securities; (the fundamental necessity for this infrastructure is the theme of the OECD Principles of Corporate Governance).
- The initial Canadian focus was on the board of directors for three reasons:
    i. the board is responsible for supervising the management of the business of the corporation;
    ii. in discharging this responsibility, the board acts as a fiduciary and acts in the best interests of the company — interpreted to mean in the best interests of shareholders generally; and
    iii. the accountability for corporate performance ultimately falls to the board and this accountability is enforced both through the existence of the various legal liability mechanisms and through other corporate measures and market forces.

Upgrading the Board's Role in Governance

- To upgrade the board's role in governance, we recommended three types of reforms:
    1. we gave definition to the board's responsibilities, i.e. ensure the corporation has a strategy; understand the risks of the business; implement plans for management succession; have a communication policy; and implement internal control measures (post-publication of the Report, we were told this, i.e. defining board responsibilities, was the most important contribution we could have made to board empowerment);
    2. we introduced the concept of the unrelated director (by unrelated we meant independent of management) — if the board's principal responsibility is to recruit the CEO, evaluate the CEO and replace the CEO, then the board must not only in fact be capable of exercising these powers but also must be seen to be capable of exercising these powers;
    3. we made a series of recommendations on board structure and functioning including recommendations on the size of the board, committee structure (nominating committee, audit committee); the role of the chair of the board and also on board evaluation.
- None of these guidelines were mandatory. The only mandatory feature was that each corporation disclose its governance system.
- This occurred in 1995.
- We have now had five years experience; with this experience, I would like to talk about what we have learned about the process of governance reform in the hope that our experience may be of some value to others engaged in a similar process; and as I said, because governance is organic, reform is a work in process, I will also have the opportunity to learn from the experience of reformers in other jurisdictions.

The State of Governance – Five Years Later

- Although many boards responded positively to the 1994 initiative my concern five years later was that the commitment to good governance had lost momentum. Accordingly, the Committee reconvened five years after the initial Report to draw attention to this loss of momentum and to encourage our original sponsor, The Toronto Stock Exchange, to constitute a new process which would recapture the early commitment to governance.
- The principal conclusion from this reunion was that *although structural changes had been made to the way Canadian corporations are governed, these changes had not led to a more basic cultural change. The corporate community, in our view, had not yet fully endorsed a "corporate governance culture"*.

The Structural Response

- Let me try to paint a picture of the type of corporation which we characterized as having responded only structurally to the initiative; the structural response has many of the following characteristics:
  - a beautifully crafted system of governance, proudly disclosed
  - a board of directors which meets at regularly scheduled times and seldom if ever deviates from this schedule
  - a board of directors which owns little or no stock and is compensated only in cash
  - a board of directors which does not have a non-executive chair or has a passive lead director
  - a board of directors which does not actively participate in setting the agenda for board meetings
  - a board with directors who would find a rescheduled board meeting or a board meeting which runs longer than planned, a major inconvenience
  - a board which is pre-wired to approve virtually all of management's initiatives after little discussion
  - a board of directors which does not have a formal director evaluation process
  - a board with directors, some of whom are deafeningly silent, and try to make up for the silence by being the first to make a motion or second a motion on a topic which the other directors have debated
  - a board with some directors whose "director books" make a loud cracking sound when the books are opened for the first time at the directors' meeting
- I could go on, but you get the picture.

A Culture of Corporate Governance

- It is in the interests of each marketplace that the market be characterized, amongst other things, for its genuine commitment to corporate governance.
- What is meant by a culture of corporate governance? The mode of behaviour of the principal players in governance systems, i.e. the directors, shareholders, officers (and other stakeholders) must reflect a deep and abiding commitment to governance ─ a commitment which comes naturally.

How to Develop a Culture of Governance

- The question then is how does one go about changing the mode of behaviour of corporate officers and directors to develop a culture of governance.
- I have reflected on the roots or sources for the development of a culture in any context and my conclusion is that for any particular mode of behaviour to become part of a culture, the behaviour must be a product of passion. A culture of corporate governance means that the principal players, the directors, care deeply about the corporation and about the governance process engaged in by the board.
- The directors, in addition to having a passion for governance itself, (which is simply a process for achieving corporate objectives and not an objective of itself), must have regular one-on-ones with officers of the company; board meetings must be viewed as a command performance and a welcome outlet for director concerns; directors must constantly work to achieve the appropriate balance between management and the board ─ this relationship, i.e. the relationship between management and the board must be characterized as one of "constructive tension"; this relationship is the key to a good governance system; management must view the board as a vital resource to the execution of the corporation's business plan; and the characteristics outlined above of a corporation responding to governance reform structurally must be absent.

How to Energize Boards of Directors, i.e. What is the Source of Passion for Governance?

- Developing a culture of corporate governance requires leadership and leadership comes from the chair of the board. The chair of the board should not be the CEO. As chair, the CEO has a conflict of interest. The board is responsible for supervising management; the CEO's responsibility is to manage the business. These two separate responsibilities should not be confused. All boards should have a non-executive chair to drive the development of a culture of governance.

Board Constitution

- The constitution of the board should be a matter for continuous review. It is a basic principle of a well-governed board that director recruitment is managed by a nominating committee comprised of a majority of unrelated directors.

- The qualifications required to be an effective director have been steadily rising. Qualifications include financial literacy (not debits and credits, but understanding the principal financial parameters for valuing the business and for assessing its performance), an understanding of the strategic planning process, an understanding of human resource development and an ability to understand and execute the specific responsibilities imposed on the board.

- Corporations in all jurisdictions would be better positioned to participate in a globalized business environment if greater diversity were brought to the composition of boards. Too often, new directors are recruited from the "old boys network", that is to say, people known well to the existing board who are much like the existing board. Potential sources of new directors include former senior public servants and the growing number of qualified women in management; it is important to broaden the pool and it is important to ensure that the board has the appropriate skill set for supervising the company's business.

- In recruiting directors, the nominating committee must be able to detect that passion for governance and for the successful management of the business of the corporation.

- An important component of the director recruitment process is a regular and aggressive evaluation of the contribution of individual directors and of the effectiveness of the board generally. Too often, board changes only come as a result of gross underperformance. Continuous revision of the constitution of the board will ensure that the appropriate skill set is present on the board at all times and will send a strong message to the existing board that the board is willing to reconstitute itself if it feels that directors are not contributing.

- In a recent discussion with an individual who I would characterize as a very attractive candidate for any board, his stated criteria for joining a board were:

  1. Is the meeting schedule for the board compatible with the candidate's schedule?;

  2. Is the corporation engaged in a business that the candidate is interested in and therefore the candidate is in a position to make a contribution?; and

  3. If the candidate doesn't like the direction of the corporation is the candidate willing to walk from the board? (This same director noted with astonishment the few, if any, resignations by Canadian directors from boards over disagreements with the policy direction of the corporation.)

Concluding Thought

- We are beyond structures for corporate governance; structuring a governance system is not rocket science. Anyone can "just do it!".

- We must pursue a culture of corporate governance.

- International investors manage mobile pools of capital acutely sensitive to the quality of governance in various marketplaces. Any suggestion of a less than diligent approach to corporate governance increases the risk premium investors will demand thereby raising the cost of capital for corporations dependent on the marketplace thereby making the corporations less competitive.