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Preface

One of the root causes of the Asian financial crisis was the failure in corporate governance. The social costs in terms of the resulting unemployment and distress were severe. Consequently, there has been a surge of interest in the principles of good corporate governance.

Asian business and other leaders wish to minimize the risk of indifferent governance in the future. While several governments and corporations have taken steps to enhance the enabling environment for corporate governance, the financial pages of the business press continue to report instances of significant corporate governance shortcomings in practice. Against this backdrop, it was felt that a set of principles at the heart of good corporate governance should be enunciated. From our own interactions with Asian private sector corporations, we have felt the need for specific pointers on implementing good corporate governance. This publication aims to serve as a guide for those who wish to embark on a program to strengthen governance practice in their organizations.

This booklet could also be helpful to investors, the media, and other stakeholders in understanding the essence of good corporate governance. Knowledge of the key principles would enable them to distinguish between companies that comply superficially with good practice standards and those that have a genuine commitment. Private sector enterprises will increasingly discover that traditional financial performance will be insufficient to attract investors on a sustained basis and will need to demonstrate conduct consistent with the principles of good corporate governance.

The Asian Development Bank expects to work with institutional investors, business enterprises, multilateral institutions, and bilateral agencies that share these beliefs and principles. From the vantage point of institutional investors, good corporate governance is a key risk management tool that can help preserve scarce capital in ways compatible with their values. The winners among the Asia and Pacific private sector will be set apart by their use of corporate governance as a competitive weapon. A key tenet of good corporate governance is that companies be run in the long-term interest of shareholders. Companies adhering to this principle will not only benefit their shareholders and other stakeholders, but also the wider economy and the environment.

Countries differ with respect to factor endowments, stage of development, the size of economies, the size of companies, extent of budgetary resources available for governance, the level of professional education, and the state of legal infrastructure. Accordingly, a uniform approach to the application of the principles may not be feasible. Considerable adaptation of the principles to local conditions may be unavoidable. What is more important is that the principles be applied in a manner that captures the essence of sound corporate governance. The principles of good corporate governance are necessary, but not sufficient, conditions for economic or financial success. However, the principles do not detract from success and indeed bolster the prospects for success in the marketplace. As more experience is gained and feedback received, suitable revisions will be made in future versions of this paper. ■

Abbreviations

ADB	Asian Development Bank	ICSA	The Institute of Chartered Secretaries and Administrators
AGM	annual general meeting	NED	nonexecutive director
CEO	chief executive officer	NYSE	New York Stock Exchange
ED	executive director	ROE	return on equity
EVA	Economic Value Added (a trademark of Stern Stewart & Co)	ROI	return on investment
ICGN	International Corporate Governance Network	SEC	Securities and Exchange Commission

Hermes Pensions Management

www.hermes.co.uk

Hermes Pensions Management is one of the largest pension fund managers in the City of London. Hermes is owned by the British Telecom Pension Scheme, which is also its largest client. Being owned by a pension fund gives Hermes a unique insight and close alignment to the needs of other long-term investors and pension funds.

Hermes' clients hold over 1% of the value of nearly all of the largest 800 quoted companies on the London Stock Exchange and also have index and active holdings in over 2,000 public companies worldwide, including over 100 companies in non-Japan Asia. Through its long-term holdings in index stocks, Hermes is necessarily exposed to underperforming assets and for this reason it places great emphasis on exercising its stewardship rights in all the companies in which it invests. As a result, it is at the forefront of the corporate governance movement in the United Kingdom. Furthermore, it has taken these principles to the next level by being the first major investment institution in the world to have established both UK and European shareholder engagement funds. After identifying companies underperforming their indices, Hermes' intervention and involvement as long-term shareholders aims to release the latent value that exists within the company. ■

Asian Development Bank

www.adb.org

The Asian Development Bank (ADB) is a multilateral development financial institution dedicated to reducing poverty in Asia and the Pacific. Established in 1966, it is now owned by 61 member governments. It is rated triple-A by all the major rating agencies. ADB extends loans to eligible governments in the Asia-Pacific region and in Central Asia. In addition, ADB extends loans to, and invests equity capital in, private sector enterprises. ADB strives to promote entrepreneurship, the quality of governance, and environmental and social development in its borrowing member countries.

ADB plays a catalytic role in helping mobilize stable and responsible domestic and international capital from institutional investors for investment in business enterprises operating in its target markets. In addition, ADB works in partnership with its borrowing member countries to help create an enabling environment for the development of the infrastructure sector, and the financial and capital markets. ■

Introduction

1. Corporate governance is a major concern in the Asia and Pacific region, especially in the aftermath of the 1997 Asian financial crisis. The size and frequency of recent corporate governance debacles show that poor governance is not only a formidable hurdle to surmount but is also at the forefront of economic development issues. A dilemma has arisen from recent experience: it is possible for companies to appear to comply with the requisite corporate governance rules without complying with the principles and spirit of good governance.
2. Accordingly, it will be helpful to investors, the media, and other stakeholders to be armed with the corporate governance analytical principles, skills, and tools that will enable them to distinguish between companies that comply superficially or cosmetically, and those which have a genuine commitment. Enterprises will increasingly discover that traditional financial criteria will be insufficient to attract investors and will need to demonstrate conduct consistent with the principles of good corporate governance.
3. Enterprises in Asia and the Pacific that genuinely embrace, adopt, and adhere to the principles could derive a multitude of benefits such as the availability and lower cost of capital, the ability to attract top talent and business partners, greater competitiveness, better financial performance and more transparency, and a more favorable impact on employment and the environment.
4. Corporate governance usually refers to the conduct of the board of directors. Recent events in the Asia and Pacific region and revelations elsewhere have shown that the practice of high-quality corporate governance is indispensable for building investor confidence and for sustained growth. Enterprises that strive for governance excellence will gain a long-term advantage. A review by Colin Melvin, Director, Corporate Governance, Hermes Pensions Management Ltd., of the evidence for a link between corporate governance and investment performance shows that a key driver of corporate performance is investor activism. McKinsey & Co. found that, other things being equal, investors reward well-governed companies by paying a premium for their shares.
5. The Asian Development Bank (ADB) has taken a wide range of steps to improve corporate governance in the region. ADB's aims include the promotion of corporate enterprises and financial institutions in its developing member countries to help accelerate economic growth and prosperity. ADB has invested in over 100 private sector enterprises and financial institutions in the Asia and Pacific region over the last 2 decades and has coinvested with governance-conscious institutional investors. This experience has provided ADB with a close look at actual governance practices in its investee enterprises that vary from the advanced to the rudimentary. The lessons gleaned from this experience have helped shape a set of corporate governance principles that have been crafted and tailored to the conditions of the region.
6. Ten core principles have been listed. An attempt has been made to model the principles in a manner consistent with global best practice. All the principles are interrelated and tied by the common threads of a performance orientation within the bounds of acceptable conduct. Good corporate governance requires an overriding commitment to a culture of governance that permeates all aspects of board and management conduct. The example and tone need to be set at the top to embed good corporate governance in an organization's culture.
7. This paper condenses the principal attributes of good corporate governance. Each principle addresses a particular facet of corporate governance. These relate to key board committees, the conduct of board members and others, the environment, the role of directors in turnaround situations, and the responsibilities of investors in influencing corporate governance. The principles recognize that effective corporate governance requires the partnership of the board with shareholders and management as well as the interface with an array of stakeholders such as employees, the media, creditors, and suppliers. Accordingly, some principles also encompass the conduct of shareholders and management and the management of the relationship with other entities that have a stake in the success of an enterprise.
8. Each principle is accompanied by a commentary describing tips and guidelines helpful to directors



and others who aspire to implement the principles. Detailed guidance on concepts and models can be accessed by referring to the extensive set of references listed at the end.

9. ADB expects to work with those institutional investors and private enterprises that share these beliefs and principles. From the vantage point of institutional investors, good corporate governance is a key risk management tool that helps preserve and grow capital in ways compatible with their values. The winners in the Asia and Pacific private sector will be set apart by the practice of high-quality corporate governance as a competitive weapon. A key tenet of good corporate governance is that companies be run in the long-term interest of shareholders. Companies adhering to this principle will not only benefit their shareholders, but also the wider economy. ■

Objectives

10. The objectives of the principles are to assist

- (i) enterprises design and implement their own corporate governance guidelines by benchmarking their practices against these principles;
- (ii) domestic and institutional investors, fund managers, as well as ADB, in their quest for excellence in corporate governance in investee enterprises; and
- (iii) governments in designing corporate governance regulations.

The Principles

Principle 1: Performance Orientation

11. The principal objective of business enterprises is to enhance economic value for all shareholders by making the most efficient use of resources. A company that meets this shareholder value creation objective will have greater internally generated resources, improving its prospects for meeting its environmental, community, and social obligations; pay taxes; reward, train, and retain key staff; and enhance employee satisfaction. A key focus area is a company's human capital strategy, which is a lead indicator of corporate success.

Principle 2: Nomination and Compensation Committees

12. A key success factor is the quality of leadership of an enterprise. A nomination committee with a written mandate and terms of reference consistent with good practice may ensure the selection of directors and a chief executive officer (CEO) of the highest caliber. Comprising mainly of independent directors, the committee should have a written definition of independence, inclusive of both subjective and objective criteria. A compensation committee should set the compensation policy for directors and senior management, commensurate with performance measured against comparable industry benchmarks and key performance indicators such as economic value added.

Principle 3: Disclosure

13. To ensure transparency, companies' annual reports should disclose true and fair accounting information prepared in accordance with applicable standards; consider substance over form in the presentation of accounts; disclose and discuss all material risks; disclose and explain the rationale for all material estimates; show manner of compliance, or explain deviations, if any, with applicable corporate governance codes; discuss goals, plans, and progress; and provide access to the register of shareholders showing beneficial ownership. In addition to annual disclosures, enterprises should comply with applicable continuous disclosure requirements. Disclosures should be timely and adequate to enable investors, third party analysts, or

rating agencies to assess the quality of corporate governance and the true financial condition of the enterprise.

Principle 4: Audit Committee

14. Audit committees with the following attributes are more effective: composed solely of independent directors, at least two of whom should have the requisite knowledge of accountancy, financial analysis, and financial reporting; at least one member should have a good understanding of the business of the enterprise; have a written mandate and terms of reference; engage only independent external auditors who should be answerable to the committee; and require that a suitable system of internal control and risk management is embedded into the fabric of the company; and focus on the substance of underlying transactions.

Principle 5: Code of Conduct

15. All enterprises must have a written code of business conduct and establish systems to ensure that it and all applicable laws are followed in letter and spirit.

Principle 6: Conflicts of Interest

16. Directors owe a fiduciary duty to the company that requires them to act in the best interest of the company. Actual and potential conflicts of interest should be identified, disclosed, and explained in sufficient detail to enable valid judgments to be made on their adverse impact. The persons who are conflicted should not participate in discussion and decision of the issue in question, nor be entitled to vote on any resolution where they are conflicted. Related party contracts should be disclosed in the annual report.

Principle 7: Environmental and Social Commitment

17. There is an inextricable relationship among the objectives of corporate performance, social development, and environmental protection. Enterprises, to be sustainable, will need to recognize and effectively deal with this triad of concerns, which, at times, may conflict with each other.



Principle 8: Conduct of the Board of Directors

18. Directors are expected to preserve and enhance shareholder value. Their effectiveness can be enhanced if they are legally empowered, have the requisite qualifications for the board committees on which they sit, make the needed time commitment, given the appropriate directorship training, are suitably compensated, receive proper notice of meetings, have the right to propose agenda items, consult each other privately in the absence of management and executive directors, and provided with appropriate information to enable them to perform their monitoring role and evaluate the performance of directors. They should be proactive and diligent.

Principle 9: Responsibilities of Investors

19. The pursuit of good corporate governance in investee enterprises is a risk management tool.

Institutional investors, general partners, and fund managers have a fiduciary duty to actively monitor and vote on issues vital to the success of enterprises in which they invest as guardians of the savings entrusted to them. Enterprises will find it helpful to communicate with them, deliver in a timely manner true and fair disclosure reports, and remove impediments from voting by all shareholders by taking advantage of modern communications and follow a one-vote for one-share policy. The fair treatment of minority shareholders must be ensured and large institutional investors should lead the pursuit of shareholder rights.

Principle 10: The Role of Directors in Turnaround Situations

20. Directors of troubled companies must play a proactive role in turnaround situations, but avoid preferential treatment of creditors, or trade when the company is insolvent.

Appendix 1

Principle 1: Performance Orientation

1. *The principal objective of business enterprises is to enhance economic value for all shareholders by making the most efficient use of resources. A company that meets this shareholder value creation objective will have greater internally generated resources, improving its prospects for meeting its environmental, community, and social obligations; pay taxes; reward, train, and retain key staff; and enhance employee satisfaction. A key focus area is a company's human capital strategy, which is a lead indicator of success.*

2. The pursuit of sustainable, long-term shareholder value is of paramount importance. Managements should prepare long-term goals in terms of shareholder return objectives as well as strategies and business plans for review by the board. Their implementation should be monitored by the board and compared with the performance of competitors. If performance is anticipated to fall short of goals, early corrective measures should be considered by the board.

3. While shareholder return goals should be set in terms of metrics that are based on standard accounting techniques, it is critically important to set long-term goals also in terms of economic profit as distinct from measures based on accounting methodologies. Popularly used metrics based on accounting concepts are return on equity (ROE) and return on investment (ROI). Project investment criteria should be based on the net present value of cash flow technique. Metrics using accounting measures are necessary but the pursuit and recognition of economic profit must always be paramount in judging corporate success. The metric economic value added¹—a measure of economic profit—should be monitored and be used to make

capital allocation, investment and compensation decisions. Economic value added (EVA) equals the excess of returns on capital employed over the opportunity cost of debt and equity.

4. The shareholder value mandate should be tightly woven into the fabric of a company's management procedures, organization structures, budgets, incentive programs, recruitment, and corporate culture. To ensure a high degree of shareholder alignment, the same metrics that correlate to value creation and are monitored by the board should be used for planning, reporting, and compensation. Human capital is the resource that plays a pivotal role in the success or failure of a corporation. Boards must evaluate and have an input in human capital strategies through the promotion of a strategic, as opposed to a transaction oriented human resources department.

5. The decision to invest surplus capital in mergers can reduce shareholder value. Boards should make such decisions with particular care and, if necessary, return surplus capital to shareholders, rather than deploy it in value destroying activities. Common flaws are overpaying, or, acquiring businesses incompatible with the core competencies of the company. Conversely, the directors of a target company should be mindful that they do not reject a good offer contrary to the interests of its general body of shareholders. An active merger and acquisition market provides an impetus to good governance. Barriers to mergers can lead to complacency among entrenched underperforming managements and boards, leading to the suboptimal use of capital.

6. *Reforms:* Governments need to consider the removal of impediments to mergers and acquisitions. ■



Principle 2: Nomination and Compensation Committees

7. *A key success factor is the quality of leadership of an enterprise. A nomination committee with a written mandate and terms of reference consistent with good practice may ensure the selection of directors and a CEO of the highest caliber. Comprising mainly of independent directors, the committee should have a written definition of independence, inclusive of both subjective and objective criteria. A compensation committee should set the compensation policy for directors and senior management commensurate with performance measured against comparable industry benchmarks and key performance indicators such as economic value added.*

8. The effectiveness of a nomination committee can be enhanced with a written mandate listing its responsibilities.³ The main functions are:

- (i) Engage the most competent directors and a CEO by adopting a process designed to produce the desired result without bias. If necessary, the committee should employ an external search firm.
 - (ii) Be responsible for succession planning.
 - (iii) Make recommendations to the board on the appointment and term of directors and senior executives bearing in mind the need for a balance of skills on the board. Ultimately, directors should be elected by shareholders. Some observers believe that to maintain independence, major family shareholders of family-run firms should not be entitled to vote on the nomination of independent directors.
 - (iv) Define independence including both subjective and objective criteria and monitor director independence on a regular basis. The totality of circumstances should be considered in determining whether a board member is independent. Those who have relationships that might interfere with the exercise of independent judgment should be excluded. Various definitions of director independence are given in Appendix 2.
 - (v) Institute a process for monitoring director performance. Regular performance reviews of directors and of the board as a whole should be made, with independent directors meeting at least once annually in the absence of other directors. Director performance should be judged relative to the goals of the enterprise on issues they are directly responsible for.
 - (vi) Oversee the preparation of annual disclosure statements that directors are required to make.
9. Several traits are important in a director, one of which is the ability to add value to the enterprise. The selection must be made on merit devoid of political considerations and influence. According to Mervyn King and Geoffrey T. Bowes, “good corporate governance hinges upon the competence and integrity of directors and the board.” In selecting a director, the following factors and traits of candidates should be considered:
- (i) relevance of the candidates’ experience and knowledge to the enterprise, as well as managerial and leadership experience;
 - (ii) knowledge of the industry, investee company, and countries where the enterprise conducts its business;
 - (iii) record of diligence, integrity, and willingness and ability to be independent and objective as well as to serve actively as a director;
 - (iv) the frequency of absences at board meetings and the ability to make the time commitment to serving on the board considering his/her regular duties and memberships of other boards and the ability and willingness to act quickly in a crisis—in general, more than three to four directorships could be burdensome;
 - (v) limited insider relationships and links with competitors;
 - (vi) a track record of success in business with familiarity and experience with the role of a board member; and

(vii) a knowledge of relevant special issues such as environmental issues in the case of companies where such issues are of importance. If financial derivatives are important, then at least one board member must be literate and experienced in derivatives. Younger candidates should also be considered if they bring new skills or ideas of value to the enterprise.

10. Those who may not normally be considered in private sector boards are current government officials or regulators or those who have been legally disqualified. Directors should be subject to re-election at intervals of no more than 3 years. Directors that have served for 10 years or more should be not be regarded as independent.

11. *Compensation Committee*: The compensation of directors and senior management must be aligned with the interests of shareholders. The compensation of directors must be commensurate with the important responsibility that is entailed by the strict legal duties, potential liabilities, and the need to devote extra time and effort during emergencies. It should reflect the heightened responsibilities that directors are now expected to shoulder. The committee should set the compensation of the CEO. The performance bonus should be earned only if there is

outperformance by reference to key performance indicators and by comparing corporate performance with industry benchmarks. Care should be taken to avoid interlocking compensation committee memberships with boards of other companies. If external compensation consultants are used then these should be independent and must be selected, appointed, and be answerable to independent board members. References for the committee are the *Principles of Best Practice on Executive Remuneration* published by ICGN and *20 Questions Directors Should Ask about Executive Compensation*, available at the web site of the Canadian Institute of Chartered Accountants.

12. *Reforms*: Stock exchange listing rules and banking regulations should (i) require companies and financial institutions to have nomination and compensation committees comprising of a majority of independent directors; (ii) promulgate a definition of director independence; and (iii) require disclosure of the board meeting attendance record of board members and other board memberships of board members. Governments should enact legislation to disqualify errant directors whose track record shows their lack of competence in discharging the duties of directorship. An example of such legislation is the United Kingdom's *Director Disqualification Act 1986*. ■



Principle 3: Disclosure

13. *To ensure transparency, companies' annual reports should disclose true and fair accounting information prepared in accordance with applicable standards; consider substance over form in the presentation of accounts; disclose and discuss all material risks; disclose and explain the rationale for all material estimates; show manner of compliance, or explain deviations, if any, with applicable corporate governance codes; discuss goals, plans, and progress; and provide access to the register of shareholders showing beneficial ownership. In addition to annual disclosures, enterprises should comply with applicable continuous disclosure requirements. Disclosures should be timely and adequate to enable investors, third party analysts, or rating agencies to assess the quality of corporate governance and the true financial condition of the enterprise.*

- (i) *Disclosure of Major Risks and Accounting Estimates:* Published accounts and annual reports should be required to disclose the major risks, the major items that have been estimated, and deviation, if any, from applicable accounting, auditing, and corporate governance standards. Segment results should be disclosed as well as the degree of exposure to the risk of adverse impact from fluctuations in exchange rates, interest rates or other market prices, if material. Any information that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of securities should be disclosed. The essence of the Management's Discussion and Analysis is to provide a narrative description of the financial statements that conveys the context in which they should be viewed. It should include other information about financial performance and trends and risks with possible future consequences including those arising from off-balance sheet arrangements. Banks should also comply with the disclosure practices recommended by the Bank for International Settlements (see www.bis.org);
- (ii) *Disclosure of Corporate Governance System:* Annual reports should articulate the company's corporate governance system as well as compliance, or explain divergence, if any, with the stated system, or, applicable corporate governance codes. The corporate governance system and annual reports in English should also be accessible on the web site of companies that have websites see *Best Practices for Online Governance Disclosure*, Dominic Jones, The Corporate Board, at www.blunco.com. To allow shareholders to monitor the provision of nonaudit services, the company should disclose in its annual report and proxy statement an auditor independence policy and the fees paid by the company for each category of nonaudit services;
- (iii) *Corporate Boards:* Corporations should disclose upon appointment to the board and thereafter in each annual report or proxy statement information on the identities, core competencies, professional or other backgrounds, factors affecting independence, and overall qualifications of board members and nominees so as to enable investors to weigh the value they add to the company. Information on the appointment procedure should also be disclosed annually;
- (iv) The annual report and proxy statement should also include a copy of the audit committee charter, contain a statement by the audit committee that it has complied with the duties outlined in the charter, confirm that the audit committee pre-approved contracts for nonaudit services, and contain a statement by the audit committee that it believes that the external auditor's independence has not been impaired by the audit firm's provision of permitted nonaudit services;
- (v) *Internal Control Report:* Each annual report should contain an "internal control report," which shall: (1) state the responsibility of management for establishing and maintaining

an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the company's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. The external auditor shall attest, as a stand-alone assignment, to, and report on, the assessment made by the management;

- (vi) Data that should also be readily accessible by shareholders are: identities of major shareholders and others that control or may control the company, including information on special voting rights, shareholder agreements, the beneficial ownership of controlling or large blocks of shares, significant cross-shareholding relationships and cross-guarantees, as well as information on differential voting rights and related party transactions;
- (vii) Shareholders should be given sufficient information about any proposal involving strategic modifications to the core business

of a corporation, or the dilution of the shareholding or other economic interests of existing investors. Shareholders should be given sufficient information about any such proposal, sufficiently early, to allow them to make an informed judgment and exercise their voting rights. For any nonintentional material selective disclosure, a company must make prompt public disclosure, or for any intentional material selective disclosure, a company must make simultaneous public disclosure.

- (viii) The appropriate officers of the enterprise or the board of directors should affirm on a regular (at least annual) basis, the accuracy of the company's financial statements and the adequacy of its internal controls.

14. Reforms: Introduce international accounting standards. See *Report of the Disclosure and Accounting Standards Committee*, Singapore and *Corporate Disclosure in Annual Reports, A Guide to Current Requirements and Recommendations*, Hong Kong Society of Accountants. ■



Principle 4: Audit Committee

15. *Audit committees with the following attributes are more effective: composed solely of independent directors, at least two of whom should have the requisite knowledge of accountancy, financial analysis and financial reporting; at least one member should have a good understanding of the business of the enterprise; have a written mandate and terms of reference; engage only independent external auditors who should be answerable to the committee; require that a suitable system of internal control and risk management is embedded into the fabric of the company and focus on the substance of underlying transactions.*

16. *Charter.* The audit committee should have written terms of reference that has been approved by the full board. The committee should be appointed by the full board. The Audit Committee⁴ plays a vital role in ensuring the integrity of an enterprise. It has the following four critical functions, with decisions being made by the full board:

- (i) engaging, communicating with, and providing oversight of external auditors;
- (ii) ensuring the adequacy and effectiveness of a system of risk management and internal controls;
- (iii) ensuring that there is proper disclosure of the accounts giving a true and fair view, and favoring substance over form; and
- (iv) communicating with internal auditors.

17. Each audit committee member should be “independent”, i.e., not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the company, and as not being an affiliated person of the company, any subsidiary thereof or be related to any person in the company.

The following is a list of some of the practices of effective audit committees:

- (i) *Frequency:* Meet with an appropriate frequency (e.g. six times a year) and under

event-driven situations and to investigate the emergence of serious issues;

- (ii) *Internal and External Auditors:* Review the internal audit annual work plan and provide a direct channel of communication between the external and internal auditors and the board and assist the board in ensuring that the external audit is conducted in a thorough and objective manner;
- (iii) *Auditor Performance:* Review annually the performance of the external auditors and the extent of their nonaudit services, and the value for money obtained from auditors’ fees for both statutory audit work and nonaudit work;
- (iv) *Auditor Independence:* Review, at least annually, the auditors’ independence. The independent members of the committee should evaluate the conflicts of interest of auditors. Factors that may help contain this risk are: the auditors should not be beholden to management, there should be limits on nonaudit fees, the compatibility of nonaudit services with the auditors’ independence, absence of economic interests of auditors such as ownership of shares in the company to be audited that are not sold within 90 days of the auditor’s appointment, need for the rotation of audit firms and audit partners, a distance between auditors and company managements, absence of mutual employment relationships between the audit firm and the company to be audited, the appointment of auditors by the audit committee instead of management, limitations on nonaudit fees, broadening the universe of firms eligible to perform audits, and annual declarations by auditors confirming that they have maintained their independence (see the note below on auditor independence policy);
- (v) *Auditor Appointment:* The committee should recommend the appointment and compensation of external auditors to the board and the shareholders and should consider to competitively tender auditor

- selection, although the level of their fees need not be the primary or sole criteria. As a condition of appointment, auditors should be required to maintain and perform in accordance with a quality control standard. The board should be designated as the client of the external independent auditor;
- (vi) *Minutes*: The minutes of the committee's meetings should be circulated to the full board after each meeting;
- (vii) *Private Meetings*: The chairman, the chief executive officer, and the finance director and other members of the senior management team, together with the external auditors, can normally attend meetings of the committee, except when the committee wishes to meet alone. The committee should also confer privately with both external and internal auditors on a regular basis;
- (viii) *Internal Controls*: The committee should identify any significant weaknesses or failings, or a breakdown of checks and balances, and determine whether suitable remedial action has been taken. If failings are identified, the committee should consider whether the findings indicate a need for more extensive monitoring of the system of internal control. The committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing. Audit committees should certify that the company has adequate and effective internal controls. Best practice standards as laid down in reports such as the Turnbull Report,⁵ or the Committee of Sponsoring Organizations (COSO) report, should be adhered to;
- (ix) *Risk Management*: The committee should require the adoption and implementation of an appropriate risk management system and require that competent professionals undertake risk-prone activities or products and that they are provided with the requisite training and resources for performing their tasks appropriately. If the business involves trading or otherwise dealing in derivatives to a significant extent, at least one committee member should have knowledge and experience of derivatives. The risk of a funding shortfall in a defined benefit pension scheme should be addressed. If pension issues are significant, then a pension committee should be established (see pension governance at www.watsonwyatt.com). In the case of financial institutions, a risk management committee of the board should be established;
- (x) *Information*: The information provided by management and the independent auditor should fully inform the committee about any financial irregularity, regulatory investigations, potential liabilities and risks, and any other sensitive information that requires disclosure;
- (xi) *Compliance*: The committee should ensure that the enterprise has the systems for monitoring compliance with the Code of Business Conduct, relevant laws, and the enterprise's conflict of interest policy. It should monitor infractions and related remedial action. Monitoring a company's conflicts of interest policy should be the responsibility of the committee. Boards that fail to establish effective corporate compliance procedures may face substantial liability. Those who do may be treated more leniently by the courts. Auditors should be required to maintain all audit or review work papers for 7 years or more as mandated by law. Companies can adopt a corporate governance self-rating system (see <http://www.sec.gov.ph/sec-memo-5,s2003.pdf>);
- (xii) *Report*: The audit committee should submit an annual report to the board and its shareholders on its activities and findings. The committee should follow-up on its inquiries and recommendations;
- (xiii) *Advisors and Funding*: The committee should have the authority to engage



independent counsel or other advisors, as it determines necessary to carry out its duties. The company should provide appropriate funding to the committee; and

- (xiv) *Audit Committee Effectiveness and Performance*: The board should evaluate the performance of the Audit Committee and its effectiveness using criteria such as that in *Audit Committee Effectiveness–Self-Assessment Tool* designed by Brad Davidson and Clarence Ebersole.

18. *Auditor Independence Policy*: The Council of Institutional Investors (http://www.cii.org/corp_governance.asp) has recommended the following auditor independence policy:

- (i) An external auditor should not perform any nonaudit services for its audit clients, except:
- services that are required by statute or regulation to be performed by a company's external auditor, such as attest services; and
 - services related to tax return preparation, provided that such services should not include (a) the provision of advice regarding the structuring or any transaction, (b) serving as the company's advocate or representative in the tax audit process, (c) unless, however, these services are in connection with acquisitions or divestitures of company subsidiaries or business, and accounting and tax services provided in connection with an acquisition or divestiture.

- (ii) Under no circumstances should a company's external auditor provide:

- nonaudit services prohibited by relevant regulation;
- financial information systems design or implementation services;
- internal audit consulting services; or
- management consulting services.

- (iii) To ensure that the provision of permitted nonaudit services does not compromise the external auditor's independence, a company's management and the audit committee of the board of directors should formulate an auditor independence policy and compliance should be monitored by the board of directors. The audit committee's preapproval should be required for any contract for nonaudit services in excess of \$50,000 to be entered into with the company's external auditor.

19. *Reforms*: Governments and stock exchanges in the Asia and Pacific region should ensure that the fiduciary duties of audit committee members and other board members as well as those of external independent auditors are embedded in the law and in stock exchange listing rules. There should be strict rules requiring auditor independence. Regulations for penalties and auditor and audit committee liabilities should be introduced or clarified. Consideration should be given to establishing a body to regulate audit firms. ■

Principle 5: Code of Conduct

20. *All enterprises must have a written code of business conduct and establish systems to ensure that it and all applicable laws are followed in letter and spirit.*

21. A corporation's business can be severely adversely affected, and in certain cases, result in closure and a total loss to shareholders due to misconduct by the corporation, or its CEO, the board, or its employees. Misconduct can take various forms such as mismanagement, improper accounting and disclosure, inattention to product quality, valid customer complaints, bribery to or from customers, suppliers or others, and noncompliance with laws, or noncooperation with regulatory authorities. This issue is of critical importance to all stakeholders, including institutional investors. To show their seriousness in dealing with this risk, all enterprises should have a written code of business conduct to be posted on a web site.

22. Guidelines codifying business conduct should be succinct and sufficiently detailed to give a clear direction to staff and board members and other parties that deal with the corporation. A template setting out conduct guidelines can be accessed by reference to the *King Report on Corporate Governance*.⁶ In addition, the techniques that can be employed to help fashion implementable codes can be found on the web site of the Institute of Business Ethics. An antifraud hotline can be useful in identifying fraud, and in deterring unacceptable conduct and should be mandatory for listed companies.

23. Governments need to do their part in minimizing the risk of misconduct. Governments and regulators should set an example by conducting their own operations with transparency. They should create and implement:

- (i) a "freedom of information" measure that makes all government actions open unless there is a specific, agreed-upon necessity for secrecy;
- (ii) "whistle blower" protection and reward mechanism that prevents the use of legal intimidation to suppress legitimate complaints and reward whistle blowers;
- (iii) a requirement for the declaration of assets of all major public officials;
- (iv) prohibitions against conflicts of interest in government decision making; and
- (v) transparent and fair procedures for government contracts with private sector or other entities.

24. Developed economies should discourage and/or prohibit corrupt practices by companies incorporated in their jurisdictions in their dealings with developing countries. Any form of corruption, whether through improper paying or receiving of benefits, is not to be tolerated.

25. *Reforms:* Stock exchange bodies and regulators should require companies and financial institutions to publicize their codes of business conduct. Governments should introduce "whistle blower" regulations with suitable safeguards. ■



Principle 6: Conflicts of Interest

26. *Directors owe a fiduciary duty to the company that requires them to act in the best interest of the company. Actual and potential conflicts of interest should be identified, disclosed, and explained in sufficient detail to enable valid judgments to be made on their impact. Conflicted persons should not participate in discussion and decision of the issue in question, nor be entitled to vote on any resolution where they are conflicted. Related party contracts should be disclosed in the annual report.*

27. *Importance.* A major cause of corporate or bank failure, or underperformance, is the existence of conflicts of interest, including related party contracts and connected lending. Directors, management, supervisors, and staff should all be subject to written conflict of interest guidelines.

28. *Fiduciary Duty.* Directors, officers, and employees owe a fiduciary duty to the company, and must therefore avoid any actual or apparent conflict of interest with the company. Conflicts can arise when: an employee, officer or director takes actions or has interests that may make it difficult to perform his or her work objectively and effectively; when an employee, officer, or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company; and when employees put pressure on underwriters, stock analysts or auditors, or, give or receive tangible benefits or favors from them without disclosure and approval. Employees must immediately report such conduct. The CEO and board members must report any such circumstances to the corporate governance or audit committees. Those seriously conflicted (e.g., those related to competitors) should, in extremis, leave the board and new board members should eliminate such conflicts before assuming board membership.

29. *Process and Checks.* All material conflicts and material changes in them should be disclosed before a contract is authorized to enable an independent and objective decision as to the benefit of the contract, or arrangement, for the company. The conflicted officials, CEO or directors should not take part in making the decision and should absent themselves while the matter is under discussion by the un-conflicted parties. Management, directors, and auditors should pay special attention to such contracts to ensure that shareholder interest is not compromised. Related party contracts should only be entered into on an arm's-length basis.

30. *Annual Report Disclosure of Related Party Transactions.* The annual report should disclose related party transactions in accordance with the new *International Accounting Standard 24*. Such disclosure should cover (i) the business purpose of the arrangement, (ii) identification of related parties and the ultimate controlling party of the related party, (iii) how transaction prices were determined, (iv) a description of how any fairness evaluations were made with respect to such transactions, and (v) any ongoing contractual or other commitments resulting from the arrangement. A material related party transaction should not be concealed in an aggregate disclosure. An interests register should be kept.

31. *Reforms.* Governments should enact laws that prohibit management, directors, and the CEO from voting when they are conflicted and these should be reflected in a company's constitutive documents. Central banks should limit connected lending that has, in the past, led to the failure of several financial institutions. Governments, or stock market regulators, should pass regulations that prevent analysts from receiving compensation directly tied to investment banking fees, require brokers to reveal their direct or indirect financial interest in companies they assess, and restrict analysts trading in their personal portfolios. ■

Principle 7: Environmental and Social Commitment

32. *There is an inextricable relationship among the objectives of corporate performance, social development, and environmental protection. Business enterprises, to be sustainable, will need to recognize and effectively deal with this triad of concerns, which at times, may conflict with each other.*

33. *Rationale for Major Governance Concern:* Environmental and social issues, including labor practices, are major board concerns due to (i) the requirement to institute environment best practices by providers of debt and equity such as institutional investors, multilateral development banks, and others; (ii) the impact on public opinion and corporate image; (iii) the need to enhance an enterprise's competitive position; and (iv) the enforcement of criminal and civil penalties that impose liability upon directors for offenses committed by the enterprise. An effective environment management system (EMS) serves as a key due diligence defense against enforcement and penalties and may help secure director's and officer's liability insurance.

34. *Commitment to Environmental Excellence:* Boards of directors of enterprises need to make a commitment to excellence in environmental governance and set the tone from the top. Environmental consciousness has now reached a stage where denial of, or inattention to, environmental issues can be detrimental to long-term corporate profitability, competitiveness, and sustainability. Accordingly, good boards align corporate governance with environmental goals. A reference for directors on sustainable development is *Value, Growth and Success—How Sustainable is your Business: A Briefing Note For Directors*,⁷ available at: <http://www.defra.gov.uk/environment/acbe/pubs/pdf/directors.pdf>.

35. *Board Composition and Orientation Program:* Depending on the seriousness of the link between environmental issues and corporate sustainability, boards should include at least one member who is sufficiently experienced in environmental matters. In

such cases boards should also consider establishing a subcommittee dealing exclusively with environmental issues and the management of environmental risks and provide an orientation program to all board members on the methods to recognize and mitigate environmental and social risks.

36. *Environmental Management System:* Boards should require an effective EMS, with the following characteristics and checks and balances:

- (i) a clearly defined set of responsibilities with the expectation of a proactive approach from all links in the chain of command;
- (ii) a management information system that enables the appropriate monitoring of performance versus plan and compliance requirements and identification of early warning signals to ensure a proactive timely response;
- (iii) training that diffuses environmental knowledge throughout the organization;
- (iv) the ability to anticipate changes in, and compliance with, environmental regulations, ensure compliance with environmental covenants in loan agreements and compliance with company policies and procedures and benchmark them against appropriate ISO standards;
- (v) monitoring and acting on environmental policies of suppliers, favoring those that employ sound environment policies;
- (vi) monitoring the views and preferences of customers and stakeholders and acting on environmental implications of products sold, and making changes in product design and manufacturing processes over the life cycle of a product that is environment-friendly;
- (vii) monitoring environmental costs—armed with environmental costs, enterprises can make strategic choices such as continuing or discontinuing products; knowing the full



costs of production and processes will help minimize compliance costs, reduce operating costs, and relate the enterprise's environmental and financial goals;

- (viii) instituting a multidimensional performance measurement system for employees, which rewards gains made due to value-added environmental ideas and performance where environmental performance is truly important. Evaluations and rewards should highlight such contributions; and
- (ix) instituting an environment audit program including independent review for reporting to management and the board of directors.

37. The guidelines of the International Labour Organisation on labor practices should be accessed. ADB's environmental guidelines are helpful resources for the management of environmental issues.

38. There may be instances where a project, such as a road or a power generation project, should proceed for the greater benefit of society, in spite of its potential adverse effects on some people. In such cases, the people who may be adversely affected by the project should be consulted; compensated for their losses; and assisted to rebuild their homes and communities, reestablish their enterprises, and develop their potential as productive members of society at a level generally at least equivalent to that which was likely to have prevailed in the absence of the project. ■

Principle 8: Conduct of the Board of Directors

39. *Directors are expected to preserve and enhance shareholder value. Their effectiveness can be enhanced if they are: legally empowered, have the requisite qualifications for the board committees on which they sit, make the needed time commitment, given the appropriate directorship training, suitably compensated, receive proper notice of meetings, have the right to propose agenda items, consult each other privately in the absence of management and executive directors, and be provided with appropriate information to enable them to perform their monitoring role and evaluate the performance of the directors. They should be proactive and diligent.*

40. *Value Addition:* The primary duty of a board is to add to shareholder value by selecting a competent CEO, assisting the CEO, and evaluating the CEO's performance. Board members should maintain a cooperative and collegial atmosphere, bring their skills to bear on the issues at hand, share ideas to enhance performance, and bring their network of contacts for the benefit of the enterprise. The board should let the CEO and the management run the enterprise. However, in crisis situations, or serious underperformance, director's duties may call for a more proactive, hands-on, approach.

41. *The Role of the Chairman:* Sir Adrian Cadbury, in his book, *Corporate Governance and Chairmanship*, points out that:

“It is the chairman's task to turn a group of capable individuals into an effective board team. This demands application and an understanding of the nature and motivations, and strengths and weaknesses, of all members of the board. It means spending time with each director to appreciate how they see their roles as board members and in turn assisting them to contribute as incisively as possible to the work of the board. The object is to enable board members to work together as a team, in order that they may achieve as a group what would be beyond them separately. This requires a talent for listening, for leading, and for inspiring, and the time to do so.

All this is particularly true of a unitary board. Its potential advantages are its singleness of purpose and its capacity to integrate inside knowledge and outside experience in the service of an enterprise. Turning that potential into reality is the job of the chairman. Chairmen have to win agreement on the purpose of their boards and on how executive and outside directors can best work together in pursuit of that purpose. Members of an effective board work together as a team, but retain their independence of judgment, they also balance their loyalties to each other and to the board. These are some of the tensions at work within a board and without the right degree of tension boards would be too comfortable and complacent to do their job. It is for chairmen to manage these tensions constructively. There has to be a balance on a board between individuality and collegiality, and between continuity and change. It is chairmen who are responsible for finding these crucial points of balance.”

42. *Board Structure:* Some observers are of the view that, in private sector businesses, it is useful to separate the positions of the chairman and the CEO. The board should not be dominated by one person. The quality of a board is enhanced if at least half of the board members are independent of management. The board must not be unwieldy—a maximum of 11 members may be appropriate.

43. *Director Orientation:* Before accepting a board membership, directors should acquaint themselves with the history of the company, the annual reports of previous years, the minutes of previous board meetings, and any significant pending litigation. The directors must acquaint themselves with the strengths, weaknesses, and strategy of the company. The company should provide directors with an orientation program with a “helicopter” view and introduce directors to key personnel and shareholders. Directors should keep abreast of good corporate governance practices.

44. *Time Commitment:* Board members should limit their board memberships consistent with their ability to discharge their responsibilities diligently. Risks of



incurring director liability may rise when the number of board memberships increase beyond this level.

45. *Governance Manual*: The manual should contain (i) the detailed responsibilities of board members, which should be made available to them and be accessible to shareholders; (ii) a formal Charter of Expectations that each director should be expected to sign and be committed to; (iii) the list of matters reserved for the discretion of the board; (iv) the list of disclosures to be made by directors; (v) the requirement to include a statement by directors confirming the truth and fairness of the company's financial statements and the contents of prospectuses; and (vi) the list of fines and other consequences if directors violate, or omit to carry out their duties, under applicable law.

46. *Director Guides*: Directors will find guides such as those prepared by the UK's Institute of Directors, the National Association of Corporate Directors (NACD) and The Canadian Institute of Chartered Accountants (CICA) helpful in discharging their responsibilities. Each CICA guide includes a list of 20 questions that directors should raise (see [www.http://www.cica.ca/index.cfm/ci_id/14543/la_id/1.htm](http://www.cica.ca/index.cfm/ci_id/14543/la_id/1.htm)). See also *Board Role in Risk Management*, Mark Anson & Cindy Ma at www.nera.com and *Ten Commandments for Bank Directors*, T.K. Kerstetter.

47. *Consultation with other Board Members/ Shareholders*: Where warranted, particularly on contentious resolutions, the directors should discuss key issues, in advance, with other board members or shareholders.

48. *Voting*: Directors should vote in accordance with their independent judgment. If directors anticipate that they will be in a minority on an important issue, they should insist that a minority opinion is minuted.

49. *Dissent*: While directors should aim at building a cordial working relationship with each other and management, directors are entitled to dissent on important matters. To be effective, dissent should be in writing stating the reasons and require that the text of the written submission be made a part of the minutes. If dissent is intended, other directors should be consulted and informed in advance, if

possible, to avoid the element of surprise and to contribute to a sense of teamwork.

50. *Recusal in Cases of Conflict of Interest*: A director must always act with independence, objectivity, impartiality, and be free of bias. Where a director is conflicted on a particular resolution, he/ she should disclose the conflict and recuse himself/ herself (i.e., not participate in the discussions) and offer to exit the boardroom when the concerned matter is under discussion.

51. *Minutes*: Directors should require the minutes of board meetings to be sent to all directors within three business days of a meeting and submit their comments or approval. The minutes should state the reasons for the decisions taken. Tape-recorded proceedings may help in ensuring the accuracy of minutes. Minutes are legal documents and should be retained.

52. *Monitoring Role*: A key role of directors is monitoring the performance of the company and the CEO and to seek remedial action as needed. Not all data or information is critical to the success of an enterprise. Directors must be able to distinguish between information that is, or is not, vital for success. The main focus should be on the key performance indicators, the lead indicators, the main value drivers of the business, as well as early warning signals. Corrective action needs to be initiated if performance falls behind plan.

53. A monitoring tool that directors can use is a "dashboard" (see *Does Your Board Have an Effective Management System of Its Own*, by Carolyn Brancato, The Conference Board). A dashboard is a visual display of indicators considered to be the key information that should be monitored. The dashboard should report the key performance indicators. These are a few indicators, like those found on the dashboard of a car, which help determine if a company is on track in meeting its goals. The indicators can be financial, such as profit margins and return on equity, as well as nonfinancial such as customer satisfaction, quality control, staff departures, environmental compliance, the results of regulatory inspections, and action taken to comply with deficiencies noted by regulators. The information should be presented in

an easy-to-understand format by using tables, charts, graphs, or other diagrams. A high-quality dashboard monitoring system improves the board's efficiency and time management.

54. Each measure should have a "target" and an "actual" amount that focuses attention on which areas are performing and which need attention. By "drilling down" into the numbers used to compile each major statistic, the data can also be used to identify early warning signals. Performance should be judged relative to that of overall industry and competitor performance. In the case of funds and investment trusts, performance should be judged relative to other funds with similar investment objectives and risk tolerance thresholds.

55. A key lead indicator is the quality of human capital. Directors need to evaluate human capital strategies of corporations. The consultancy firm Watson Wyatt's² research shows that—"superior human resource practices are correlated with financial returns. They are a leading indicator of increased shareholder value. Further, we found that superior human resource management leads financial performance to a much greater extent than financial outcomes lead good human resource practices. We were also able to identify certain HR practices as value drivers and throw a cautionary flag in front of some conventional practices actually associated with a decrease in financial performance."

56. *Director Liability*: Directors must carry out their functions with reasonable skill, care and diligence and may be liable if they are negligent. To minimize, or avoid, liability, directors should undergo professional director training; take decisions in conformity with the business judgment rule; follow procedures that ensure compliance with their duty of care and duty of loyalty; ensure that suitable director's and officer's liability insurance is in place; and seek legal advice. A higher standard of care is required of a director who has particular or professional qualifications in relation to matters where those skills or qualifications have particular relevance.

Companies often nominate their employees as nominee directors of subsidiary, or affiliated, companies. Such nominee directors may expose the companies that have nominated them to vicarious

liability, if actions that constitute breaches of director's duties by nominees are authorized by their employer. To contain this risk, nominators should seek legal advice to prevent the occurrence of such implicit liabilities.

Directors should ensure that adequate systems exist to enable the timely and accurate submission of reports and returns required by law, regulators and government agencies. A similar system should exist to ensure that appropriate and timely action is taken to rectify deficiencies identified by regulators.

It will be helpful for directors to familiarize themselves with the tips contained in *Personal Liabilities of a Company Director* at <http://www.elbornes.com/articles/persliab.htm> and in, *Flunking the Duty of Care, The Four Most Common Mistakes Made by Directors*, Michael F. Sullivan, Brickler & Eckler LLP.⁸ In summary the latter article states the following:

"Directors can minimize the risk of a bad decision resulting in a successful claim for breach of duty of care by taking the following steps:

- (i) document contemporaneously the analysis that goes into decisions and the recommendations made to the board;
- (ii) maintain a record which shows that the board was familiar with the experiences of its experts prior to their retention, and select and retain in a manner that will preclude receiving advice tainted by conflict of interest;
- (iii) take enough time to assemble and analyze data before making a decision to show both the reality and the appearance of due care to a third party who may not have access to the same kind of high-tech resources as the board; and
- (iv) consider cost-effective alternatives to obtain additional insight and liability protection when facing an important decision.

With these guidelines in mind, duty of care litigation may be nipped in the bud, as plaintiffs discover that



they will be attacking a documented record of attention to, and concern for, the corporation's interest."

57. *Director's Liabilities for Unpaid Taxes.*

According to David J. Rotfleisch:

"Directors have liabilities under various statutes, which, for example, result in liability for wages and vacation pay, environmental liabilities, workplace liabilities and liabilities under corporate statutes. However, it is with respect to amounts owing to the government for various taxes that most directors incur liability. Taxing authorities have been very zealous in recent years in going after directors for unremitted source deductions, unpaid sales taxes, etc. Accordingly, every director should:

- (i) familiarize himself with the withholding and remittance requirements;
- (ii) ensure that an appropriate system to withhold and remit has been implemented by the Corporation; and

- (iii) require regular written reporting ensuring that the remittance procedures are functioning."

58. *Fees and Compensation:* Directors are expected to perform an important task requiring both expertise and a substantial commitment of time. They should be adequately compensated for this. To align director and shareholder interests, part of the compensation of directors can be in the form of the company's equity shares. In addition, directors should have the right to engage consultants or advisors whose fees should be paid by the company. Expenses for director's and officer's insurance and for attending board meetings should be borne by the company.

59. *Performance Evaluation:* Good boards evaluate the performance of board members. Such boards find that meetings are run more smoothly, they receive better information, and they pay more attention to performance and strategy.

60. *Reforms:* Governments in the region should impose fiduciary duties on directors, liabilities for not performing the duties, and immunity in case of compliance with the business judgment rule. ■

Principle 9: Responsibilities of Investors

61. *The pursuit of good corporate governance in investee enterprises is a risk management tool. Institutional investors, general partners, and fund managers have a fiduciary duty to actively monitor and vote on issues vital to the success of enterprises in which they invest as guardians of the savings entrusted to them. Enterprises will find it helpful to communicate with them, deliver in a timely manner true and fair disclosure reports, and remove impediments from voting by all shareholders by taking advantage of modern communications and follow a one-vote for one-share policy. The fair treatment of minority shareholders must be ensured and large institutional investors should lead the pursuit of shareholder rights.*

62. As the largest sources of debt and equity capital, institutional investors can influence the behavior of managements and boards. Investors should use this ability to require high-quality corporate governance. This is a serious responsibility since it is in the interest of the millions of savers, on whose behalf institutional investors provide stewardship. Dispersed ownership can help if investors exercise their rights, but passivity the lack of objectivity, and conflicts of interest among institutional investors can often mean that under-performance can remain unchecked.

The low percentage of votes cast is indicative of the dormancy of the voting power of shareholders. Voting rights are part of a share's value and exercising these rights contributes to good corporate governance. 3 to 4 weeks notice should be given for shareholders meetings (see *A Guide to Best Practice for Annual General Meetings*, ICOSA). Shareholders should have equal access to information, be able to vote in person, or online, or in abstention, and equal effect should be given to votes, whether cast in person, or, in abstention.

63. A good model of the conduct of responsible investors can be found in reports such as "Shareholder or Shareowner" available at the web site of Hermes Pensions Management Ltd. at www.hermes.co.uk (see case study on Hermes Investment Management Ltd. in Appendix 3), the Hermes' Code of Conduct In Support of

Companies, and the pronouncements of the International Corporate Governance Network (www.icgn.org). Institutional investors can take the following steps:

- (i) seek the removal of impediments to cost effective and efficient voting as outlined in the Global Share Voting Principles of the International Corporate Governance Network (see www.icgn.org). Legal restrictions on the transfer of shares should be sought to be removed;
- (ii) vote on all material issues including the appointment of directors. Each director should stand for election on a regular basis and, in any event, at least once every 3 years and shareholders should be entitled to exercise their vote in respect of the election of each individual director;
- (iii) require prior shareholder approval for major strategic modifications to the core business of a corporation, or proposals that result in the dilution of equity, or erode the economic interests or share ownership rights of existing shareholders;
- (iv) engage corporate governance analysts well versed in the best practices of corporate governance and financial analysis;
- (v) communicate their views on corporate governance shortcomings to the boards of investee enterprises;
- (vi) encourage corporate governance ratings;
- (vii) require the inclusion of corporate governance covenants and conditions precedent in loan or investment agreements;
- (viii) avoid investing in instruments such as global depository receipts if the investor is denied voting rights of the underlying shares;
- (ix) adopt suitable criteria to screen investee enterprises for underperformance; and
- (x) be vigilant about investee underperformance, reporting delays, poor quality accounting, or



other red flags or early warning signals of corporate underperformance. In such cases investors should initiate steps to require prompt remedial action.

64. To undertake the aforementioned steps, responsible institutional investors can find the following helpful:

- (i) enunciate their corporate governance guidelines and principles;
- (ii) join associations of institutional investors that champion the rights of shareholders and corporate governance;
- (iii) adhere to, and require third party fund managers to adhere to, codes of conduct such as that of the Association of Investment Management and Research (see www.aimr.org);
- (iv) engage high caliber investment, accounting, and corporate governance professionals with suitable delegated authority;
- (v) provide a suitable budget for monitoring investee companies and allocate staff or delegate monitoring to a qualified, unconflicted, and trustworthy third party;
- (vi) request investee companies to nominate one independent director as principal liaison with investors;
- (vii) due to the different nature of underperforming companies, have a policy for engaging underperforming enterprises—a separate monitoring group for such investees may be considered;
- (viii) investigate who the responsible parties are and whether proper disclosure was made in cases where investor capital is put at undue risk in instances of intentional misrepresentation, fraud, aiding, and abetting by third parties and negligence by fund managers or other violations of their fiduciary duties; or where companies are unable to repay bond obligations, or have underperformed due to financial shenanigans. If warranted, file claims¹⁰ to recover investment monies and damages against the errant parties, including auditors, investment bankers, or external counsel, if they have been negligent, subject to conflicts of interest, or have aided and abetted the errant company, its directors, or managers;
- (ix) appoint a lead investor to act on behalf of a group of investors to lessen monitoring costs. In class action suits triggered by corporate fraud, institutional investors should be prepared to act as lead plaintiffs given the relatively large size of their holdings and the associated losses. The prestige of institutional investors that act as lead plaintiffs gives them the clout necessary for the defendants to pay meaningful amounts. The lead plaintiffs are more likely to have the human capital, the budgetary resources, and legal departments to support litigation;
- (x) consider nominating a qualified and independent nominee director as a champion of good corporate governance in underperforming enterprises;
- (xi) require internal and external fund managers to include the quality of corporate governance as part of their investment criteria;
- (xii) consider subscribing to external investment research services that are completely independent from investment banks and companies;
- (xiii) consider investing in corporate governance-oriented funds;
- (xiv) communicate closely with other institutional investors on corporate governance matters;
- (xv) proactively vote, or require fund managers to vote, on key issues at company annual or extraordinary general meetings;
- (xvi) all investors should be required to abide by best practice standards of valuing

investments. Reference can be made to such as those enunciated by the Association of Investment Management and Research (see www.aimr.com) and the European Venture Capital Association (see www.evca.com); and

- (xvii) train staff in good practices of corporate governance, analyzing and detecting corporate governance weaknesses, rights of shareholders, and in uncovering financial shenanigans.

65. For institutional investors to discharge these responsibilities, they should be run by qualified professionals without interference from other quarters; follow a systematic investment process requiring appropriate due diligence; have a policy for the retention of records, including e-mails; and adopt good practices of governance and management of their own internal operations. These relate to:

- (i) the composition, qualifications, compensation, and experience of their boards and trustees and the process for selecting them;
- (ii) quality of the CEO and the selection process, internal risk management systems, and portfolio management policies;
- (iii) conflict of interest policies;
- (iv) fund performance evaluation criteria; and
- (v) the criteria and procedures for engaging and removing fund managers.

66. Good practices for the governance of institutional investors can be found in (i) *The Governance Practices of Institutional Investors*, Report of the Canadian Standing Senate Committee on Banking, Trade and Commerce, chaired by The Honourable Michael Kirby; and (ii) *Institutional Investment in the United Kingdom—A Review* prepared under the chairmanship of Paul Myners. Mr. Myners mentions that it is helpful to state some basic principles of an effective approach to investment decision making, which are listed in only two pages. “The Review’s proposition is not that any

fund should be required to comply with them; simply that where a fund chooses not to comply with them, it should have to explain—publicly, and to its members—why not.”

67. Consistent with their fiduciary obligations to their limited partners, the general partners and fund managers of venture capital, buyout and other private equity funds, mutual funds, and investment trusts should use appropriate efforts to encourage the companies in which they invest to adopt long-term corporate governance provisions that are consistent with the principles outlined herein or in other comparable governance standards. Fund managers should disclose their voting practices.

68. *Reforms*. In developing countries, where capital markets are at a nascent stage and institutional investors are developing, the positive influence that significant investors can exert on corporate governance could be absent. Governments should therefore foster capital market development, not only as a way to mobilize savings, but also to empower shareholders who can demand good corporate governance in investee enterprises. The following are some areas to be considered:

- (i) Enable electronic communication between companies and shareholders including the transmission of annual reports and notices of shareholder meetings, electronic proxy voting, and web-casting of shareholder meetings.
- (ii) Strengthen laws relating to minority shareholder rights including, among others, providing for low thresholds for requisitioning shareholder meetings; high thresholds for passing shareholder resolutions on critical issues; voting on director appointments using the cumulative voting technique that enables minority shareholders to gain seats on the board; rights of shareholders to sponsor resolutions at shareholder meetings or convene extraordinary meetings; and class action suits and shareholder derivative actions that enable legal actions by shareholders on behalf of companies



and actions against auditors for negligence. In the case of takeover bids, shareholders should have the right to be consulted and bids should not be rejected by boards without reference to shareholders.

- (iii) Impose a statutory fiduciary duty on the trustees, boards, and managements of institutional investors.
- (iv) Remove, or prohibit, undue restrictions on the transfer of shares.
- (v) Shift from a regime of asset allocation set in law to a regime that provides freedom to professional trustees in making asset

allocation decisions based on the “prudent expert principle.” Such a shift should not occur in isolation but should go hand in hand with the enunciation and implementation of high-quality internal governance standards of institutional investors.

69. The “prudent expert principle” is defined as (i) discharging duties with the care, skill, prudence, and diligence that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of like character and like aims; (ii) diversifying the holdings of each fund to minimize the risk of loss and maximize the rate of return; and (iii) discharging duties solely in the interest of, and for the benefit of, the beneficiaries. ■

Principle 10: The Role of Directors in Turnaround Situations

70. *Directors of troubled companies must play a proactive role in turnaround situations, but avoid preferential treatment of creditors, or trade when the company is insolvent.*

71. According to Ed Marks, President of Marks Consulting Inc.⁹

“A director’s role in a troubled company is very different from that of a director of a healthy business. The increased emphasis on directors assuming larger roles in managing a company’s affairs means that their responsibilities and time commitments must also increase. Troubled companies require deeper involvement from their boards and the assumption of some risk by directors.

Director involvement begins with meeting many of the major parties impacted by a troubled company and understanding their concerns. Outside turnaround consultants can help directors in analyzing and developing a turnaround plan, especially if the board and company management have limited turnaround experience or have damaged their credibility with lenders and other constituents.

Developing, managing and monitoring a turnaround are ultimately the fiduciary responsibility of the board. Failing to perform these functions conscientiously may leave boards and directors more vulnerable to lawsuits and may even reduce the protections of director’s and officer’s insurance.

A director of a troubled business best demonstrates his or her commitment to the organization by taking an active role in the company. Attending only quarterly directors’ meetings is wholly inadequate in turnaround situations. Frequent informal meetings with management, including attendance at important staff meetings, should augment formal directors’ meetings. Generally, involvement by directors bolsters confidence of management and staff that something is being done to right the business. Understanding relationships among the major

constituents in a turnaround is a director’s first step. Most turnarounds cannot succeed solely by restructuring lender debt. Other major constituents that must be addressed in varying degrees by directors are suppliers, customers, employees and shareholders.”

72. Some legal regimes impose special rules on the conduct of the business of a company when it is experiencing financial difficulties that may lead to liquidation. In these circumstances, it may be unfair and/or unlawful for a company to favor certain suppliers or customers and to pay some debts ahead of others. Further, directors may also incur personal liability to creditors if they permit a company to continue to carry on business while it is insolvent. Directors should seek legal advice at the first sign of serious financial difficulty. According to the *Principles of Corporate Governance in The Commonwealth*:

“The board must ensure annually that the corporation will continue as a going concern for its next fiscal year. The intent behind this principle is not that a corporation continues in perpetuity but to have a process in place which will prompt directors to act expeditiously when it is believed that the business may no longer be a going concern.

It is the responsibility of the board, all things being equal at the time the financial statements and annual audit have been completed and reviewed, to satisfy itself that the corporation will continue as a going concern in its next fiscal year. Any conclusion arrived at by the board that the corporation will continue as a going concern should result from the evaluation by the board of objective criteria. The conclusion should be reported in the financial statements for the benefit of the shareholders, but also be communicated as appropriate to the corporation’s other relevant stakeholders.”

73. In some jurisdictions, directors also owe a fiduciary duty to creditors when a company enters the “vicinity of insolvency.” In such situations the fiduciary duty may shift in favor of creditors. The board of directors of a solvent corporation should consider creditors’ interests if a proposed



transaction could potentially push the corporation to the brink of insolvency. While the advice of counsel should be sought, the following do's and don'ts can be helpful:

- (i) act to protect creditor's interests;
- (ii) install an early warning system, including monitoring bankruptcy and liquidity tests, and ensure early corrective action;
- (iii) require a contingency plan for major risk factors, an effective internal control system, and the proper maintenance of records;
- (iv) take decisions that satisfy the Business Judgment Rule—this may involve
 - (a) disclosure of financial difficulties in the annual report;
 - (b) viewing assets as a trust fund to be preserved for creditors and other constituents;
 - (c) conserving operating costs and cash flow; and
 - (d) maximizing assets, minimizing liabilities, and preserving wealth-generating capacity;
- (v) avoid repurchase or redemption of shares, or payment of dividends, if such payments will

lead to bankruptcy, or are impermissible under loan covenants;

- (vi) avoid related party contracts and carefully scrutinize payments to affiliates and related parties; and
- (vii) avoid the preferential treatment of one, or a group, of creditors as against others.

74. Experience has shown that directors of financially troubled enterprises are particularly vulnerable and, if they have not taken the appropriate steps, run the risk of being disqualified from performing the role of a director in the future. A handy reference is *Crisis Management for Directors* available at the web site of the Canadian Institute of Chartered Accountants.

75. Directors should ensure that companies discharge their binding obligations to employee pension funds and, in the case of defined benefit schemes, seek compliance with statutory minimum funding rules.

76. *Reforms:* Governments should enact laws to modernize bankruptcy procedures and provide for the protection of creditor rights. ■

Appendix 2

Definitions of Director Independence

A. Hermes Investment Management Ltd

1. Hermes endorses the Cadbury Committee's definition of independence: that nonexecutive directors "should be independent of management and free from any business or other relationship that could materially interfere with the exercise of independent judgment."

2. Hermes will interpret this to mean that to be considered independent a NED must not:

- be or have been an employee of the company
- serve as a director for more than 10 years or be over 70 years of age
- represent significant shareholders or other single interest groups (e.g., supplier, creditor)
- receive an income from the company other than NED fees
- participate in the company's share option or performance-related remuneration schemes
- have conflicting or cross-directorships
- have any other significant financial or personal tie to the company or its management which could interfere with the director's loyalty to shareholders. ■
- was formerly an executive;
- is, or has been paid by the Company in any capacity other than as a nonexecutive director;
- represents a trading partner or is connected to a company or partnership (or was prior to retirement), which does business with the Company;
- has been a nonexecutive director for nine years - i.e., three 3-year terms;
- is closely related to an executive director;
- has been awarded share options, performance-related pay, or is a member of the Company's pension fund;
- represents a controlling or significant shareholder;
- is a new appointee selected other than by a formal process;
- has cross-directorships with any executive director; or
- is deemed by the Company, for whatever reason(s), not to be independent. ■

B. National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI)

3. The issue of a nonexecutive director's independence has been highlighted by the Hampel Committee and a company's viewpoint on an individual's status is likely to be challenged from time to time. The ABI and the NAPF suggest the criteria set out below as the minimum likely acceptable to institutional investors. The assumption is that the individual is independent unless, in relation to the Company, the director:

C. Federal Deposit Insurance Corporation

4. "Independent of management" is generally a determination each institution may make. This term absolutely excludes a director who

- (i) is, or has been within the preceding year, an officer or employee of the institution or its affiliates;
- (ii) owns or controls, or has owned or controlled within the preceding year, assets representing 10% or more of any outstanding class of the institution's voting securities; and



- (iii) beyond this, the institution should consider whether the director
- has been, prior to the preceding year, an officer, or employee of the institution or its affiliates;
 - serves as a consultant, adviser, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates;
 - is a relative of an officer or other employee of the institution or its affiliates;
 - holds or controls, or has held or controlled, a direct or indirect financial interest in the institution or its affiliates; and
 - has outstanding extensions of credit from the institution or its affiliates. ■

D. California Public Employees Retirement System (CalPERS)

5. "Independent director" means a director who:

- (i) has not been employed by the company in an executive capacity within the last 5 years;
- (ii) is not affiliated with a company—that is, an adviser or consultant to the company or a member of the company's senior management;
- (iii) is not affiliated with a significant customer or supplier of the company;
- (iv) has no personal services contract(s) with the company, or a member of the company's senior management;
- (v) is not affiliated with a nonprofit entity that receives significant contributions from the company;
- (vi) within the last 5 years, has not had any business relationship with the company (other than service as a director) for which the company has been required to make disclosure under Regulation S-K of the Securities and Exchange Commission;

(vii) is not employed by a public company in which an executive officer of the company serves a director;

(viii) has not had any of the relationships described above with any affiliate of the company; and

(ix) is not a member of the immediate family of any person described above. ■

E. Council of Institutional Investors

6. An independent director is one whose only nontrivial professional, familial, or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship.

Notes: Independent directors do not invariably share a single set of qualities that are not shared by nonindependent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, members of the Council of Institutional Investors believe that the promulgation of a narrowly drawn definition of an independent director (coupled with a policy specifying that at least two thirds of board members should meet this standard) is in the corporation's and all shareholders' ongoing financial interest because

- (i) independence is critical to a properly functioning board;
- (ii) certain clearly definable relationships pose a threat to a director's unqualified independence in a sufficient number of cases that they warrant advance identification;
- (iii) the effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareholders or other board members; and
- (iv) while an across-the-board application of any definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small that it is far outweighed by the significant benefits.

7. Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation. The definition approved by members of the Council contains this basic formulation. It then adds to it a list of the relationships members believe pose the greatest threat to a director's independence. The existence of any such relationship will remove a director from the independent category.

8. The following notes are supplied to give added clarity and guidance in interpreting the specified relationships.

9. A director will not generally be considered independent if he/she has either of the following qualifications:

- (i) He/she is, or in the past 5 years has been, employed by the corporation or an affiliate in an executive capacity.

Notes: The term "executive capacity" includes the Chief executive officer (CEO) and operating, financial, legal, and accounting officers of a company. This includes the president, treasurer, secretary, controller, and any vice-president who is in charge of a principal business unit, division, or function (such as sales, administration, or finance) or performs a major policy-making function for the corporation.

An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 25% of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, equal joint venture partners meet the definition of an affiliate, and officers and employees of equal joint-venture enterprises are considered affiliated.

Affiliates include predecessor companies.

A "predecessor" of the corporation is a corporation that within the last 10 years represented more than 80% of the corporation's

sales or assets when such predecessor became part of the corporation. Recent merger partners are also considered predecessors. A recent merger partner is a corporation that directly or indirectly became part of the corporation or a predecessor within the last 10 years and represented more than 50% of the corporation's or predecessor's sales or assets at the time of the merger.

A subsidiary is an affiliate if it is at least 80% owned by the corporation and accounts for 25% of the corporation's consolidated sales or assets.

- (ii) He/she is, or in the past 5 years has been, an employee or owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants.

Notes: Advisers or consultants include, but are not limited to, law firms, accountants, insurance companies, and banks.

- (iii) He/she is, or in the past 5 years has been, employed by a significant customer or supplier.

Notes: A director shall be deemed to be employed by a significant customer or supplier if the director

- is, or in the past 5 years has been, employed by or has had a 5% or greater ownership interest in a supplier or customer where the sales to or by the corporation represent more than 1% of the sales of the customer or supplier or more than 1% of the sales of the corporation;
- is, or in the past 5 years has been, employed by or has had a 5% or greater ownership interest in one of the corporation's debtors or creditors where the amount owed exceeds 1% of the corporation's or the third party's assets;

Ownership means beneficial or record ownership, not custodial ownership.



- (iv) He/she has, or in the past 5 years has had, a personal services contract with the corporation, its chairman, CEO, or other executive officer or any affiliate of the corporation.

Notes: Council members believe that even small personal services contracts, no matter how formulated, can threaten a director's complete independence. This includes any arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers—even if no other services from the director are specified in connection with this relationship.

- (v) He/she is, or in the past 5 years has been, an employee, officer, or director of a foundation, university, or other nonprofit organization that receives significant grants or endowments from the corporation or one of its affiliates.

Notes: This relationship includes that of any director who is, or in the past 5 years has been, an employee, officer, or director of a nonprofit organization to which the corporation or its affiliate gives more than \$100,000 or 1% of total annual donations received (whichever is less), or who is, or in the past 5 years has been, a direct beneficiary of any donations to such an organization.

- (vi) He/she is, or in the past 5 years has been, a relative of an executive of the corporation or one of its affiliates.

Notes: Relatives include spouses, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, aunts, uncles, nieces, nephews, and first cousins. Executives include those serving in an "executive capacity."

- (vii) He/she is, or in the past 5 years has been, part of an interlocking directorate in which the CEO or other executive officer

of the corporation serves on the board of another corporation that employs the director. ■

F. New York Stock Exchange's Definition

10. The following note has been extracted from the web site of McGuire Woods LLP at http://www.mcguirewoods.com/news-resources/publications/corporate_services/article667.asp.

On 12 March 2003, NYSE separately filed the director independence portion of its corporate governance proposals, which was in some respects modified from the August 2002 submission. Some of the changes were driven by the Sarbanes-Oxley Act of 2002, which became law just days before NYSE's Board of Directors acted on the Committee's recommendations in August, and the Securities and Exchange Commission's (SEC) rules implementing certain provisions of that Act.

11. As originally and currently proposed, NYSE director independence rules would

- (i) require that a majority of the directors of NYSE-listed companies be "independent";
- (ii) require that the board of directors affirmatively determine that a director has no material relationship with the listed company for the director to be considered independent and that such determination be publicly disclosed; and
- (iii) prohibit directors associated with current and former auditors and directors in interlocking compensation committee relationships from being considered independent.

In its recent filing, NYSE clarified its definition of "director independence" in the following key respects.

i. Former Employees and Independent Contractors

12. In its August 2002 filing with SEC, NYSE proposed that no director who is a former employee of the company can be independent until 5 years

after the employment relationship has ended. In its current proposal, NYSE intends to eliminate the per se bar to independence for all recent former employees in favor of a rebuttable presumption that any person who receives (or whose immediate family member receives) more than \$100,000 per year in direct compensation from the company has a material relationship with the company and is not independent until 5 years after he or she ceases to receive more than \$100,000 per year. The presumption applies to both employees and independent contractors who receive direct compensation from the listed company.

13. In its commentary on the proposal, NYSE states that the presumption of nonindependence may be rebutted by a unanimous determination by the existing independent directors that, based upon the relevant facts and circumstances, the payments do not constitute a material relationship. The listed company will also be required to disclose the specifics of such determinations.

14. For purposes of the rule, direct compensation does not include director's fees or pension or deferred compensation paid in respect of prior service to the company. Also, if the compensation recipient dies or becomes incapacitated, the presumption will cease immediately.

ii. Significant Suppliers and Customers

15. The NYSE intends to prohibit persons from being considered to be independent if they are executive officers or employees of, or if their immediate family member is employed in an executive capacity by, suppliers or customers that conduct business with the listed company at a level of \$1,000,000 or 2% of the gross revenue of the listed company, whichever is greater. Such prohibition would remain in effect until 5 years after

the customer or supplier falls below these thresholds.

16. The rule would permit the board to use its discretion to find a lack of a material relationship with regard to persons associated with suppliers or customers who transact less than these threshold amounts of business with the listed company.

17. The rule would also permit persons affiliated with consultants and advisors to the listed company (other than auditors) to be considered independent directors, subject to a finding of a lack of material relationship, as long as the compensation their firms receive as "suppliers" to the listed company does not exceed these threshold amounts.

18. During the 5-year period following enactment of the director independence standards, the 5 year "cooling off" period for determining presumptions and prohibitions will instead be measured as any shorter period following the enactment of the standards. Thus, for example, if measured a month after enactment, a person who has not been an employee of the listed company during the month, but who did receive over \$100,000 in direct compensation from the company 3 years before, will not be subject to the presumption of a material relationship even though the compensation was received within the last 5 years.

19. The SEC has not yet published for comment NYSE's latest corporate governance proposal, and therefore no deadline for comments has been established. However, once these corporate governance standards have been adopted, NYSE-listed companies will have 18 months, or, in the case of companies with classified boards, a total of 30 months after adoption to comply with the new independence standards. ■



Appendix 3

Case Study: Hermes Investment Management Ltd.

I. Introduction

1. Hermes places great emphasis on exercising stewardship at all the companies in which it invests on behalf of clients. The aim is to ensure that companies are run by managers and directors in the best long-term interests of shareholders. Hermes approach to stewardship is based on a fundamental belief that companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without.

2. Good stewardship creates value. These corporate governance guidelines explain in detail how Hermes will exercise its clients ownership rights in practice. The guidelines are intended as a basis for dialogue between companies and shareholders. Hermes will apply the guidelines with thought, giving due consideration to the specific circumstances of individual companies, and adopting a pragmatic approach where appropriate. ■

Hermes Investment Management Limited

3. Hermes is one of the United Kingdom (UK)'s largest fund managers with 36 billion pounds under management as of 30 September 2002. Hermes Investment Management is one of the largest pension fund managers in the city of London. It is owned by, and is the principal fund manager for, the BT Pension Scheme, the UK's largest pension fund. Hermes also manages portfolios for the Post Office Pension Plan and other major corporate and public pension schemes.

4. It takes its corporate governance responsibilities seriously. It has published its approach to governance in three documents, i.e., The Statement on UK Corporate Governance and Voting Policy, International Corporate Governance Principles, and the Hermes Principles. It has also established three funds focused on governance issues in which it has coinvested together with other governance conscious investors. It performs a stewardship role and takes active part in voting on resolutions proposed by its investee companies as well as publishes its approach at various fora in the world's capital markets. The full text of Hermes's corporate

governance policies and principles is posted on its web site at <http://www.hermes.co.uk>. ■

5. The governance approach of investors such as Hermes is twofold. First, if enterprises in developing countries wish to attract capital from such institutions, it will be to their advantage if they conform to the governance principles such as those that Hermes espouses. Second, domestic institutional investors in developing countries can consider adopting similar governance principles tailored to the specific conditions of their countries.

6. By way of illustration, some extracts from Hermes's statement on UK Corporate Governance and Voting Policy 2001 are given below. ■

II. Statement of General Principle

7. Directors of public companies are responsible for running companies in the long-term interests of shareholders. Shareholders and their agents have responsibilities as owners to exercise stewardship of companies. Corporate governance should provide a framework where both parties can fulfill these responsibilities.

8. A company run in the long-term interests of its shareholders will need to manage effectively relationships with its employees, suppliers, and customers; to behave ethically; and to have regard for the environment and society as a whole. Hermes's approach to social, environmental, and ethical matters is explained in Appendix 4 of its corporate governance document.

9. Nonexecutive directors (NEDs) should work cooperatively with their executive colleagues and demonstrate objectivity and robust independence of judgment in their decision making.

10. Hermes supports a standard approach to corporate governance. Hermes welcomes the publication of the Combined Code on Corporate Governance and will normally apply its recommendations. Consideration will also be given to the fuller discussions in the Cadbury, Greenbury

and Hampel reports that underlie the Combined Code. Where relevant, reference will be made to the policies of the National Association of Pension Funds and other related bodies. There are some issues that Hermes believes, primarily because of its investment policies, require greater emphasis or an alternative approach. In addition, the Hampel report left open some matters of detail for shareholders to resolve with company boards. This supplementary statement is intended to assist directors' understanding of Hermes' views on these issues. ■

III. The Board

A. Composition

11. The precise number of executive directors (EDs) and NEDs for any company is for its board to determine with the approval of its shareholders. It is the overall balance of the board that is important. Not all NEDs need to be independent but there should be a strong core of NEDs that are both independent and seen to be independent.

B. Role of NEDs

12. The key role of NEDs is to ensure that the chief executive and the board as a whole concentrate on maximizing long-term shareholder value.

13. There are three aspects of this for which NEDs should expect to be held accountable. These are the strategic function, expertise and the governance function.

C. Independence of NEDs

14. The board should have a core of at least three vigorously independent directors on whom shareholders can rely for the independence of their judgment and who can act as agents for change should the need arise. Hermes endorses the Cadbury Committee's definition of independence: that NEDs should be independent of management and free from any business or other relationship that could materially interfere with the exercise of their independent judgment.

15. Hermes accepts that not all NEDs need to be independent in accordance with this definition and that there can be a role for other NEDs provided a majority of NEDs satisfy the above test of independence. We believe that the final decision on whether NEDs are independent lies with the shareholders who elect them. There should be full

disclosure in the annual report of any factors to be taken into account in judging an individual's independence in accordance with the above criteria.

16. It is good practice for all boards to conduct an annual review of the performance of NEDs and the chairman and to consider the effectiveness of the board as a whole. The role of the NED is becoming increasingly complex and Hermes recommends that companies encourage NEDs to participate in the range of seminars and workshops offered by organizations such as Cranfield School of Management, Henley Management College, Institute of Directors and Spencer Stuart.

17. Hermes contributes to several of these development fora, which encourage a participatory approach and include case studies illustrating difficult situations. ■

IV. Voting

18. Hermes believes that a separate resolution seeking approval of the annual report and accounts should be tabled at all annual general meetings (AGMs).

19. Hermes welcomes the introduction of electronic proxy voting and encourages companies to adopt this as soon as practicable.

20. Takeovers are an important part of an efficient and competitive corporate environment but do not always add to shareholder value, particularly for the bidding company. Hermes's predisposition in a hostile bid is to support existing management, but this support is conditional. It does not apply where confidence has been lost in management, or for example, where synergistic or strategic benefits clearly justify a bid premium. Unreasonable or unjustifiably expensive defense tactics will not be supported.

21. Hermes acknowledges, on behalf of its clients, that shareholders have responsibilities as owners to participate in the stewardship of companies and that, in companies outside their home market, the primary way of achieving this is through proxy voting. Accordingly, Hermes will endeavor to lodge proxies at company general meetings, subject to



Appendix 3 *continued*

excessive costs or administrative difficulties. Companies, for their part, can promote good practice and system development in their own market, thus minimizing the obstacles to shareholder voting. Hermes recommends following the International Corporate Governance Network's Global Share Voting Principles to achieve this end.

22. Management of companies run in the long-term interests of shareholders can be confident of Hermes' continuing support. Hermes is committed to applying its corporate governance and voting policies with thought, giving due consideration to the specific circumstances of individual companies, and will adopt a pragmatic approach where appropriate. Hermes will reconsider, at the request of a company, any company-specific circumstances that may make it inappropriate to apply Hermes' standard policies.

23. Hermes will contact companies to explain its reasons for voting against or abstaining on resolutions. Hermes prefers these discussions to be kept private. Hermes welcomes correspondence from companies in which its clients invest and where appropriate wishes to encourage discussions with company directors and executives.

24. Corporation's ordinary shares should feature one vote for each share. Corporation should act to ensure the owner's rights to vote. Fiduciary investors have a responsibility to vote. Regulators and law should facilitate voting rights and timely disclosure of the levels of voting. ■

V. Hermes' Business Principles

Hermes' overriding requirement is that companies be run in the long-term interest of shareholders. Companies adhering to this principle will not only benefit their shareholders, but also the wider economy in which the company and the shareholders participate. We believe a company run in the long-term interest of shareholders will need to manage effectively relationships with its employees, suppliers and customers, to behave ethically, and have regard for the environment and society as a whole.

Communication

Principle 1 Companies should seek an honest, open, and ongoing dialogue with shareholders. They

should clearly communicate the plans they are pursuing and the likely financial and wider consequences of those plans. Ideally, goals, plans and progress should be discussed in the annual report and accounts.

Financial

Principle 2 Companies should have appropriate measures and systems in place to ensure that they know which activities and competencies contribute most to maximizing shareholder value.

Shareholder value

Principle 3 Companies should ensure all investment plans have been honestly and critically tested in terms of their ability to deliver long-term shareholder value.

Principle 4 Companies should allocate capital for investment by seeking fully and creatively to exploit opportunities for growth within their core businesses rather than seeking unrelated diversification. This is particularly true when considering acquisitive growth.

Principle 5 Companies should have performance evaluation and incentive systems designed cost-effectively to incentivize managers to deliver long-term shareholder value.

Principle 6 Companies should have an efficient capital structure which will minimize the long-term cost of capital.

Strategic

Principle 7 Companies should have and continue to develop coherent strategies for each business unit. These should ideally be expressed in terms of market prospects and of competitive advantage the business has in exploiting these prospects. The company should understand the factors which drive market growth, and the particular strengths which underpin its competitive position.

Principle 8 Companies should be explain why they are the "best parent" of the businesses they run. Where they are not best parent they should be developing plans to resolve the issue.

Social, ethical, and environmental

Principle 9 Companies should manage effectively

Appendix 3 *continued*

relationships with their employees, suppliers, and customers and with others who have a legitimate interest in the company's activities. Companies should behave ethically and have regard for the environment and society as a whole.

Principle 10 Companies should support voluntary and statutory measures which minimize the externalization of costs to the detriment of society at large.

VI. Shareholder or Shareowner?

Hermes believes that companies with active and informed investors achieve superior returns over the long-term and, accordingly has been a leader in promoting better stewardship at investee companies for over a decade. Passive fund management should include active ownership and our index-tracking funds benefit from an active approach to ownership. The 40 person team involved in governance and engagement are not reserved just

for our focus funds. Following the Myners Report, all institutional investors are being required to take an active role in monitoring performance. To that end the Institutional Shareholders Committee (ISC) has published guidelines for trustees and their agents. Hermes welcomes the guidelines as a benchmark for the fund management industry and an endorsement of our stewardship activities.

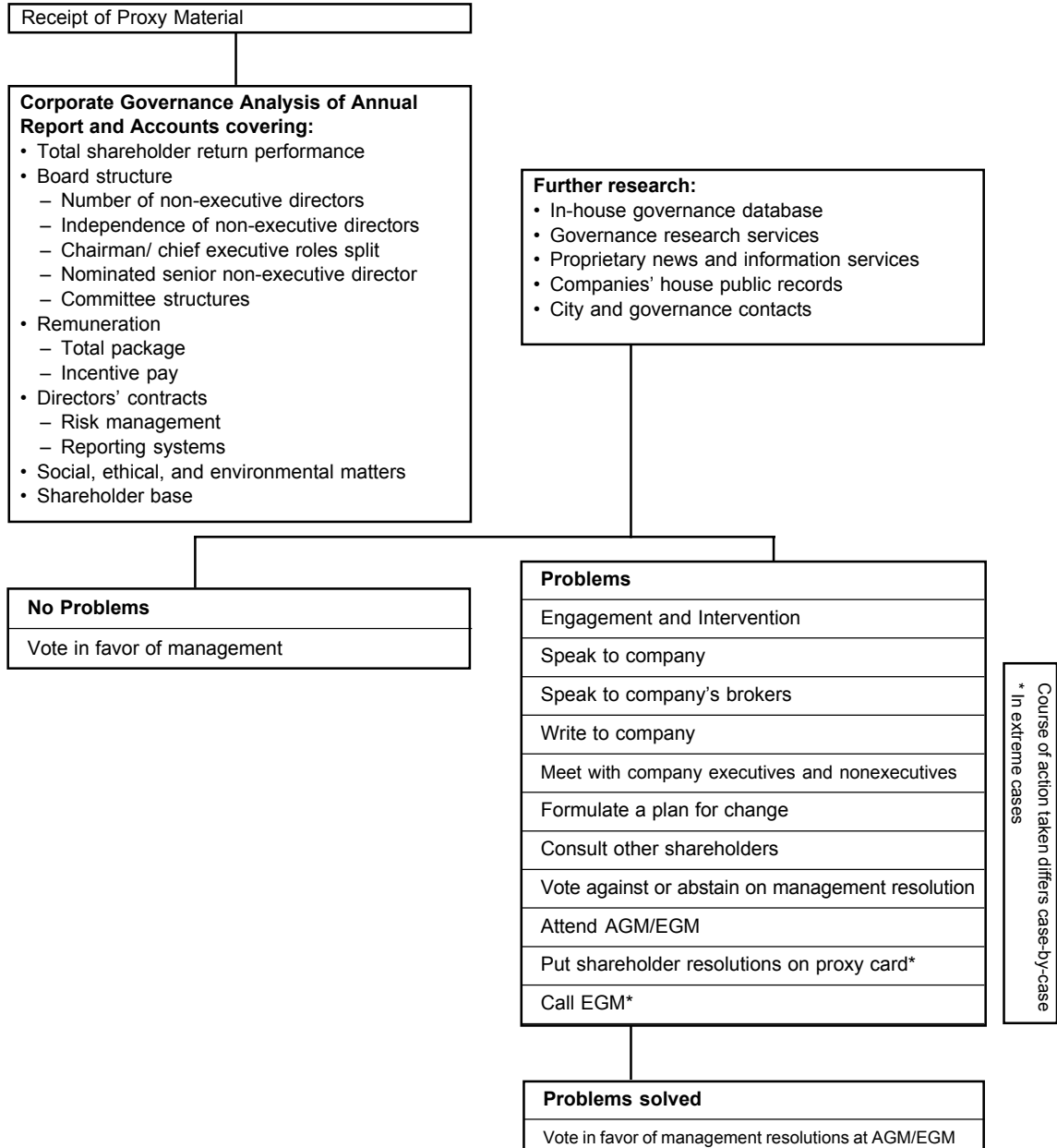
With our fully integrated approach to corporate governance and investment management, including our ownership of the only institutional shareholder engagement (Focus) fund, we believe that we are uniquely positioned to meet the letter and spirit of the guidelines (see table). Additionally, our expertise in the field of engagement is available to investors with portfolios managed by third party managers for mutual clients. We welcome the opportunity to carry out governance and intervention activities on behalf of our existing and future clients. ■



Hermes' Approach

Myners/ISC Requirements Statement of activism policy Owners should be clear about what they expect from companies: <ul style="list-style-type: none"> – it should be clear, consistent and comprehensive – it should be well-communicated 	Hermes' Approach Published and sent to all UK investee companies: <ul style="list-style-type: none"> - Corporate Governance and Proxy Voting Statement - Hermes Principles on strategy and performance
Monitor performance of and have dialogue with investee companies Owners should have a systematic process which: <ul style="list-style-type: none"> – reviews company performance – undertake core ownership duties (voting and engagement/dialogue)\ – identifies situations where further intervention is merited 	See chart overleaf. Votes clients' shares at all UK general meetings. Graduated approach: proxy voting decisions based on annual report disclosures, discussions with company and independent analysis. Database of contract and vote. Companies included in "core engagement program" or "focus funds" if further intervention merited.
Intervene where necessary Owners should be able to explain reason for, objective of, and measures of success of intervention	Company-specific. Companies included in "core engagement program" on basis of formal proposal approved by Corporate Governance Committee which oversees engagement process. Similar but more detailed approach for "focus funds".
Escalate intervention on a case-by-case basis <ul style="list-style-type: none"> – Meetings with management, board, advisers – Intervene jointly with other investors – Public statements in advance of AGM – Call EGM/put shareholder resolutions at AGM 	Regularly meets with executive and nonexecutive directors on both company-specific and general governance and performance issues. Works with other investors as appropriate. Prefers not to take public route unless all other alternatives exhausted but when necessary will use press and general meetings to drive change.
Evaluate impact of activism and report to clients <ul style="list-style-type: none"> – Auditable process – Agree format of reports to clients 	Has staff of 40 focused on governance and stewardship activities. Broad range of backgrounds/expertise including corporate (pic board-level), investment, legal, financial, strategic management consultancy and forensic accountancy.

Hermes' Corporate Governance Function



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- (i) The Value of Corporate Governance, Colin Melvin, April 2003 (available at www.hermes.co.uk).
- (ii) Corporate Governance Develops in Emerging Markets, Campos, Newell & Wilson, *McKinsey on Finance*, Winter, 2002 at www.mckinsey.com
- (iii) The concept of Economic Value Added has been popularized by the consulting firm Stern Stewart & Co. An explanation of the concept can be found at www.sternstewart.com.
- (iv) 7 Common Traits of EVA Companies, Tad Leahy at www.businessfinancemag.com.

² Human Capital and Shareholder Value

- (i) Human Capital Index: Measuring your Organization's Greatest Asset at <http://www.watsonwyatt.com/search/publications.asp?Component=Strategy&ArticleID=7379>.
- (ii) Human Capital Index®: Human Capital As a Lead Indicator of Shareholder Value at <http://www.watsonwyatt.com/research/resrender.asp?id=W-488&page=1>.

³ Model Terms of Reference of Nomination and Remuneration Committees

- (i) Guidance Note, Nomination Committee – Terms of Reference, at the web site of The Institute of Chartered Secretaries and Administrators (ICSA) at www.icsa.org.uk.
- (ii) A set of written terms of reference is available at www.bhpbilliton.com/bbContentRepository/AboutUs/Governance/NomsCommittee.pdf.
- (iii) Guidance Note, Remuneration Committee – Terms of Reference, at ICSA's website.

⁴ Audit Committee Effectiveness

- (i) Jim Kaplan's Auditnet at www.Auditnet.org/corgov.htm. In particular see Audit Committee Effectiveness-Self Assessment by Brad Davidson and Clarence Eberse.
- (ii) Best practices and sample audit committee charters are included in the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees at www.nyse.com/content/publications/NT000113C6.html.
- (iii) Various materials at the KPMG Audit Committee Institute web site at <http://www.kpmg.com/aci/additional.htm>.
- (iv) The Financial Aspects of Corporate Governance, The Cadbury Report, 1 December 1992.
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