

# **Shifting Ground: Emerging Global Corporate Governance Standards and the Rise of Fiduciary Capitalism**

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### **Abstract**

This paper examines the long-term interests that large institutional owners (e.g. CalPERS, Hermes, USS) have in the development of global corporate governance standards, especially as governance standards increasingly become intertwined with other standards and regime parameters involved in the globalization debates. It argues that institutional owners have a unique perspective and voice to contribute to the formulation of global standards in a variety of areas based on their long-term financial interests. This conclusion is supported by an analytic review of the current state of global corporate governance, including multilateral initiatives (e.g. OECD, World Bank); an analysis of significant institutional investors, the role of various rating agencies (e.g. Fitch, Moody's), the International Corporate Governance Network and the growing role of various NGO's (e.g. CERES, Carbon Disclosure Project) in relation to corporate governance

### **Key Words**

Corporate Governance, Global Standards, Institutional Investors, Universal Owners, California Public Employee Retirement System, (CalPERS), OECD Corporate Governance Principles,

## I. Introduction

This paper argues that there is a global emergence of a double and partially intersecting set of corporate governance standards, the combined origins of which lie in the state sector, in the institutional investor sector which invests in equity markets across borders and among non-governmental organizations (NGOs) as they impact large institutional owners, governmental regulatory bodies and individual corporations. These emerging standards constitute both *de facto* and *de jure* global corporate governance standards. The drivers of these trends are the self interest of institutional investors and the expansion of the concept of fiduciary duty and obligation, originating in common law countries which (not coincidentally) are also the countries where large global equity institutional investors are domiciled.

The first part of this trend is familiar, but nonetheless significant as it emerges on a global scale: the growth and continuity of *traditional corporate governance issues* which emphasizes board of director independence, accountability to shareholders, maximization of long-term returns, and transparency. The second part, what we call *sustainability governance issues*, is quite new. It arises from the growing concern about ‘sustainable’ or ‘socially responsible’ development, investment and growth. In part this is a result of ‘socially responsible’ stockholder pressures using the proxy voting mechanism, and/or external pressures from NGOs for particular changes in corporate policies, e.g. global

human rights, environmental/sustainability issues. It is also a consequence of more traditional investor concerns with understanding long-term risk factors, as diverse as global climate change and gender discrimination.

This second trend has the potential to transform the terms of the global corporate governance debate. Until recently this debate has focused on block holder oriented ownership systems in civil law countries as diverse as France, Germany, Japan and Korea versus shareholder systems in common-law-based countries, particularly the U.S. and the U.K. Block holder systems were characterized as inclusive of and facilitating broad stakeholder-social concerns, while the Anglo-American shareholder model with its emphasis on fiduciary obligation was perceived as focused exclusively on maximizing shareholder return.

Building on our previous work (Hawley/Williams, 2000), this paper argues that economic and social trends in common law countries are in the process of expanding the concept of fiduciary obligation, in practice through market pressures, as well as in law, regulatory rulings and stock exchange listing requirements. This emerging concept and practice of fiduciary obligation has begun to intersect in important ways with many of the stakeholder claims of non-common law block holder models of corporate governance.

The rise of large institutional investors – the growth of what in previous writing we termed “fiduciary capitalism” – offers a compelling explanation for the coming together of traditional corporate governance concerns and many ‘stakeholder’ concerns.<sup>1</sup> As such, it has broadened the definition of corporate governance to encompass the long-term

economic and financial implications of many (but certainly not all) sustainable or socially responsible investment (SRI) issues.

The emergence of fiduciary institutions – particularly pension funds, mutual funds and insurance companies – as the primary owners of equity capital in the United States, the United Kingdom and other common law nations, and to a lesser extent in non-common law countries, reflects a sea-change in the ownership of corporate assets. This growth is often commented on, but less recognized is that, by virtue of their size, wide diversification, and tendency to index large portions of their portfolios, the largest of these institutional investors have become *universal owners* as they come to own a cross section of their national economy. As a result, their returns – and their ability to meet their fiduciary duties – depend in important ways on how well their national economies perform. Since they effectively own a cross section of the whole economy, they internalize both pecuniary and non-pecuniary externalities generated by individual portfolio companies. Thus, seen from the portfolio-wide perspective of a universal or other large diversified owner, maximizing shareholder return becomes a very complex calculation. It is not simply the sum of individual returns on a firm by firm basis and this recognition becomes one of the foundation blocks for the expanded and expanding definitions of fiduciary obligation. (Hawley/Williams, 2000: 1-29; 42-66)

This argument resonates with the collective themes of this issue of the Journal.

Specifically, we argue that the events analyzed are new, rather than recently noticed by analysts, and are tied closely to the recent global growth of (primarily) Anglo-American

institutional equity investors, principally by fiduciary institutions. Our argument for the emergence of fiduciary institutions on a global scale is rooted in the on-going expansion of global financial markets specifically, yet also in the ‘export’ of changing standards of fiduciary obligation. This is paradoxically both a response to the (apparent) retreat of the state in common law countries, while actually tied closely to the actions of regulatory authorities, as we demonstrate below. Thus, market actions by what might be called the ‘new fiduciaries’ is on the one hand a manifestation of seemingly neo-liberal institutional investors dominating equity markets, yet more apparently so than actually since some of these institutional investors have raised the standards of fiduciary obligation higher than state mandated standards, while also pressing regulatory authorities (in many cases) to adopt *de facto* standards making them *de jure*.

Charles Oman argues that, “As globalization enhances the strength of market forces relative to that of regulation by national and sub-national governments, corporate governance [as a market force] thus becomes still more important.” (Oman 2003:10) To a degree, this emerging process has already transformed both the markets and market actors, that is, traditional and sustainable trends in global corporate governance make their weight felt in how markets work (e.g. disclosure), in what is considered legitimate market activity (e.g. child labor developing countries), and increasingly, how markets will deal with negative externalities (e.g. climate change). Central to this trend is the enlarging scope of fiduciary obligation, defined by some large institutional owners themselves as well as by stock market exchange listing authorities and/or listing regulators. Thus, with the growth of de-regulation and the concomitant rise of market

mechanisms, market actors have been under far greater pressures to account for (and internalize) externality costs (e.g. environmental damage), and to consider social investment issues (e.g. education, public health). (Oman: 2003:10) These are the dynamics of emerging trends in sustainable governance.

This article is divided into four sections in which we develop evidence and examples of the trends outlined above. The next section ownership trends in foreign equity and looks at the role institutional investors and financial service firms have played in the standards debate. The following section explores the place of multilateral organizations in the development of global corporate governance standards while the next section examines the issue of NGOs and their impact on expanding conceptions of fiduciary duty. The final section reviews recent developments in public and private sector national and regional policies and their impact on the concept of fiduciary duty and, hence, on the development of global corporate governance standards.

## **II. Institutional Investors and Market Based Actors**

The first global trend that we have identified is a concern with *traditional corporate governance issues* that is driven in large part by the self interest of institutional investors. It results directly from their substantial holdings of foreign equity which at the end of 2001 were about \$5.16 trillion. Fully 78% was held by investors from only nine countries: the United States, the United Kingdom, Germany, Luxembourg, Switzerland, Italy, the Netherlands, Japan, and France. The U.S. and the U.K. alone accounted for 42% of the total. While these industrial countries are the source of the lion's share of

investments in foreign equities, they are also the major recipients of foreign equity investment accounting for 57% of the total, with the U.S. and the U.K. receiving 22% of the world's holdings of foreign equity. (IMF 2003) In fact, "these Anglo-American investors now account for most of the traded volume in many of the world's stock markets." (Shin /Gourevitch 2002:14)

Thus, there is an important nexus between global corporate governance standards and the rise of institutional investors, particularly in the industrial countries, but also in emerging markets. This nexus centers on their interest in protecting portfolio investments and their status as minority investors when investing in foreign companies. In addition to the difficulty of investing across borders arising from differences in language and custom there are differences in legal rules and their effective enforcement. Pyramidal holding patterns, lack of transparency and timely disclosure, differential voting rights, and other practices disadvantage minority shareholders and are particularly burdensome to foreign shareholders – but not only to foreign shareholders. Domestic investors and, particularly in emerging-market countries, nascent institutional investors also have a special interest in good corporate governance, especially in the equitable treatment of minority shareholders. Since their equity investments will likely be concentrated in local companies, and they will be major beneficiaries *if* those companies are well governed, well run, and provide adequate protection to minority shareholders – domestic and foreign – from exploitation by controlling block shareholders.

As the most important institutional investor activist in the United States, the California Public Employee Retirement System (CalPERS) has been in the forefront in promoting international standards through, for example, its well developed set of proxy voting guidelines, many dealing with issues of corporate governance.<sup>2</sup> In 2001 it combined its domestic and international guidelines into a unified set of Global Proxy Voting Principles. (CalPERS 2001a) CalPERS has also formed an alliance with Hermes Investment Limited of the U.K. in which each institution agrees to use the other country's specific proxy voting guidelines for home country proxies and to bring home market expertise to bear on situations calling for case-by-case analysis.

In emerging markets, CalPERS screens countries for transparency, political stability, the quality of the legal system, shareholder protection, and labor practices. Within companies it screens for compliance with the Global Sullivan Principles of Corporate Social Responsibility and the ILO Declaration of Fundamental Principles of Rights at Work. It also looks at a wide range of risk factors that might affect either the return or the safety of its investments. (Genesis 2003) In effect, it has broadened fiduciary duty to include a variety of traditional and sustainable governance factors view through the lenses of risk analysis and a risk rating system.

CalPERS recognizes that effective corporate governance depends not only on individual company policies and practices, but also on the degree to which the political, cultural, and legal environment of a country is friendly to shareholders in general and foreign shareholders in particular. The fund assesses the overall corporate governance

environment in a country and in 2002 took the controversial action of pulling “out of stock markets in Indonesia, Malaysia, Thailand and initially the Philippines, citing concerns about corporate governance, political instability and labor standards.” (Pesek 2003) This action provoked outcries in emerging markets, but certainly focused attention on what CalPERS viewed as economy wide problems for investors in these countries and demonstrated the global reach of its standards.

### *Institutional Investors and International Organizations*

While CalPERS is one of the few public pension funds attempting specific country risk analysis, the International Corporate Governance Network (ICGN), the principal international organization of institutional investors whose members hold assets exceeding US\$ 10 trillion, has adopted a similar approach. Like many issuers and supporters of corporate governance codes the ICGN began with traditional corporate governance stands on issues such as board member independence and the separation of the CEO and Chairman. These standards were supported by traditional statements on the primacy of shareholders such as “the overriding objective of the corporation should be to optimize over time the returns to its shareholders” and “the board of directors, or supervisory board, as an entity, and each of its members, as an individual, is a fiduciary for all shareholders.” (ICGN 1999)

However, over time its view has evolved from a narrow focus on corporate governance practices at individual companies to a realization that good governance must be supported by legal, political and, perhaps, cultural institutions that allow owners to exercise their rights and responsibilities and that provide avenues of redress when rights are abridged.

In 2003 a review of their Statement on Global Corporate Governance Principles explicitly recognized that when making asset allocation and investment decisions “ICGN members will also take into account the *governance profile of the market.*” (Emphasis added) The review goes on to state “the governance profile of a market will be defined by the manner in which the market addresses the issues of disclosure, insider trading and other issues of investor protection.” (ICGN 2003a) This recognizes that good governance practices at a particular corporation may not translate into effective, responsible ownership without support from the appropriate institutional framework. Listing standards, commercial codes, governmental regulation, and the quality of enforcement mechanisms all play a significant role in defining the governance profile of the market. In addition, ICGN has produced a number of reports such as the Cross Border Proxy Voting Study which details the difficulties institutional shareholders face when investing outside their home markets. (ICGN 2003b)

The ICGN perspective reflects a growing sophistication on the part of institutional investors. While it is important, for example, to have independent directors at the board level, it is equally important that legal rules and local customs be friendly to ownership. This is difficult to achieve across borders and for minority shareholder, particularly where the business culture is unfriendly to *local* minority shareholders and issues of transparency with regard to controlling interests are not well accepted. As Charles Oman notes, “The value of improved corporate governance for development cannot, however, be considered in isolation.” (Oman 2003:5) He goes on to argue that the most severe problem facing minority shareholders in emerging markets is “the need better to *protect*

*minority shareholders' rights*, and better *enforcement* of the rules and institutions of corporate governance as a whole.” (Emphasis in original) (Oman 2003:18) Global standards are a particularly effective way to counter cross border problems because their formulation allows different interests to be represented and for international and local investors to come together around common concerns.

### *Financial Service Firms*

The recent emergence of corporate governance concerns by the financial service firms provides an important, additional point of market based leverage for the self interest of institutional investors in good governance, adding a new dimension to the global standards debate. These firms include Moody's and Fitch as well as proxy-service firms such as the Investor Responsibility Research Center (IRRC) and Institutional Shareholder Services (ISS) and rating firms such as GovernanceMetrics International, Davis Global Advisors and Proxinvest in France and Hermes in the UK.<sup>3</sup>

Institutions such as IRRC and ISS provide advice on proxy issues, monitor corporate-governance trends and, may even execute proxy instructions for individual clients. Lately, they have also provided corporate-governance products that rate specific companies.

Others like GovernanceMetrics International, Davis Global Advisors and Proxinvest provide institutional research about corporate-governance practices at specific companies and about general issues of concern to institutional investors. The coverage of corporate governance issues by major rating agencies such as Standard & Poor's, Moody's and Fitch received a substantial boost from the Enron *et al* scandals where 'good' financial numbers masked serious corporate governance problems. The result in the U.S. was a

blizzard of proposed legislation, most prominently the Sarbanes – Oxley Act and a revision to stock exchange listing standards designed to, among other things, enhance director independence. The U.S. Securities and Exchange Commission also adopted a number of shareholder friendly rule changes, which are discussed below. (Solomon 2003)

To many observers, one of the fundamental problems of this period was that directors acted as lapdogs rather than watchdogs. Many also felt the rating firm’s traditional focus on “hard numbers” had masked serious corporate-governance risks at some companies. At least partly to restore lost credibility, the major rating agencies now include corporate governance as an important part of their overall company ratings. While these moves fill a gap in previous rating systems, they are also a direct response to the demands of institutional-investor clients for more inclusive ratings. Because of their worldwide reach this response goes some distance to establishing *de facto* market based “global standards” against which to rate the corporate governance performance of individual companies.

In addition to the traditional measures of financial health, financial rating agencies now gather and evaluate information on a host of corporate-governance issues. By and large, the issues are the traditional ones. Is the role of CEO and Chairman combined and if it is, are board meetings chaired by an independent director? Does the board contain a sufficient number of independent directors? How is independence defined? Is the audit committee chaired by an independent chair and is a majority of its membership independent? Do shareholders have basic rights with respect to secure ownership

registration? Is transparency adequate with respect not only to financial statements but to management discussion and governance information?

Also, rating firms have quite recently become interested in overall companies governance policies related to business ethics and the way firms manage risk. Are the policies actually applied? Is a committee of the board responsible for corporate governance? Is there a way to identify and consult with stakeholders? Is there a corporate statement on business ethics? Does the company have defined corporate policies to address material business and financial risks? Is a committee of the board charged with risk management?

By asking these questions and using the results, the ratings agencies are imposing a *de facto* global standard. The managing director of Standard and Poor's Australia and New Zealand offices, for example, has said that, "We are looking for early warning signs as much as anybody. There's a focus on good and bad corporate governance and they can be embodied in our basic ratings." (Elliott 2003) By including corporate governance standards in their overall ratings they have directly joined corporate governance to economic performance since ratings influence the volume of capital flowing to different firms and, particularly, the terms on which capital is made available. Thus, the market based ratings agencies provide something sorely missing from codes of best practices. The ratings provide an *enforcement mechanism* for corporate governance standards with a global reach. A poor corporate governance structure or failure that results in a down grading of a credit rating and hence higher capital costs will focus the attention of owners as well as management in a way that bad publicity or condemnation by an institutional

investor is unlikely to accomplish. Setting and enforcing corporate-governance standards – particularly across national borders – has always been a creative dance between regulation, prescription and market forces.<sup>4</sup>

### *Conclusion*

As major suppliers of capital to foreign markets institutional investors have a deep, interest in global corporate governance standards. This interest in *traditional corporate governance issues* has only grown with the increased integration of capital markets and growing globalization. The result has been a market based standard setting process at major institutional investors such as CalPERS, Hermes, and others. Furthermore, these institutions have banded together, principally through the International Corporate Governance Network, to formulate and promulgate global standards. By and large the institutions have left the adoption and enforcement of their standards to the market, though they have been greatly helped by the recent inclusion of corporate governance metrics in many financial service firm's rating systems.

## **III. The OECD Principles and Multilateral Organizations**

While institutional investors were beginning to promulgate and support global standards in the 1990's, this was also a time of nationally-based reports and their often explicit code of best corporate governance practice (e.g. Cadbury in the U.K., Viénot in France). These reports had impacts well beyond national borders as institutional investors, regulators, and corporate governance scholars searched for best practices that would lead to better managed companies and, consequently, to more lucrative investments. The need for international principles was clear to many important actors. If institutional investors,

particularly from the U.K. and the U.S. were to continue to make capital available in foreign markets, they would have to play the role of “responsible” owner. Furthermore, as foreign and typically minority shareholders, they needed assurance that that local, controlling shareholders would not appropriate their investments by self dealing or other forms of malfeasance. In protecting their investments, institutional investors would be greatly aided by a clear set of guidelines assuring that portfolio companies, wherever located, would be subject to minimum standards of corporate governance.

### *The OECD Principles of Corporate Governance*

Global corporate governance standards focused on traditional concerns took a major step forward in the spring of 1999 with the adoption of the OECD Principles of Corporate Governance. (OECD 1999) The Principles were heavily influenced by the codes promulgated by institutional investors (e.g. CalPERS), international organizations (e.g. ICGN) and national bodies (e.g. Cadbury). While they were adopted by representatives of the industrial countries as guiding principles, they are not binding on OECD member countries or the world at large. Nonetheless, they quickly became an important framework for emerging standards in local markets. (Shin/Gourevitch:47) As the preface to OECD Principles states, “there is no single model of good corporate governance.” (OECD 1999:8) Instead, the Principles are intended as a “reference point” for policy makers to use as they develop their own legal and regulatory framework. (OECD 1999:13)

The Principles state that shareholders should have the rights and the necessary information received in a timely manner to act as informed owners. They also go directly to the issue of minority shareholder rights by asserting that all shareholders of the same class should be treated equitably and that insider trading and self-dealing should be prohibited. The Principles are explicit on the responsibilities of the board to monitor management and that “the board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.” (OECD 1999:21)

However, the Principles take only a general position on important issues such as the definition of independence of board members or the degree of independence of particular board committees such as the audit and compensation committees. Nor does it take a position on the chairman’s role and whether the same individual should be the chief operating officer of the company as well as the chairman.

The Principles are incorporated into other OECD documents and thus set corporate governance standards for a broad range of initiatives. In particular, they are incorporated into the OECD Guidelines for Multinational Enterprises which seeks to “be an important instrument for shaping globalisation” and to “provide a government-backed standard of good corporate conduct that will help to level the playing field between competitors in the international market place.” (OECD 2000:3) The Guidelines call for multinational companies to “support and uphold good corporate governance principles and develop and apply good corporate practices” particularly as articulated by the OECD Corporate Governance Principles. (OECD 2000:19)

The Principles are currently undergoing a review. While concluding that they have provided an excellent framework for discussion, the review notes that “taken as a whole it is clear that attention has shifted toward implementation and enforcement of measures to meet the outcomes advocated by the Principles.” (OECD 2003:4) Thus, while the core Principles are expected to remain essentially unchanged, it is likely the revision will place greater emphasis on implementation issues, particularly the protection of minority and foreign owner’s rights. At the same time, the Principles have been expanded to include a number of emerging issues including executive compensation and whistle blower protection. (OECD 2004) To implement the former, the 2004 revision states that “the equity component of compensation schemes for board members, key executives and employees should be subject to shareholder approval.” (OECD 2004:6)

While the OECD Principles, as revised, echo statements issued by various institutional investors and others such as the Cadbury Code in the U.K., both the original and the revisions contain an explicit recognition of stakeholders that is typically absent from most Anglo – American thinking on corporate governance. They state that “the corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprise.” (OECD 1999:31)

#### *The Global Corporate Governance Forum*

While the Principles amounted to global guidelines, additional action was needed if they were to actually form the basis for corporate governance practices around the world,

particularly in emerging markets where governance concerns had come to the fore after the Asian financial crisis of the late 1990's. To this end the Global Corporate Governance Forum, a joint effort by the World Bank Group and the OECD, was established in April of 2002 and was charged with promoting initiatives to foster corporate governance reform in developing and emerging markets.

The main work of the Forum is carried out though jointly sponsored World Bank / OECD Corporate Governance Roundtables around the world. Many roundtables produced white papers and other reports discussing policy objectives and attempting to prioritize reforms specific to each region. The Forum takes as its starting point the OECD Principles, but encourages each roundtable to interpret and apply the principles to the specific environments and needs represented.

Recently a World Bank report used the OECD Principles as implemented by the Forum as a benchmark representing “the minimum standard that countries with different traditions could agree upon, without begin unduly prescriptive. In particular, they are equally applicable to countries in the civil and common law traditions, different levels of ownership concentration, and models of board representation.” (Fremond/Capaul 2002:9) The OECD Principles have succeeded in becoming minimum “best practice” global standards, but the issue of implementation remains.

Thus, the report's main finding is that while by 2002 over 43 emerging-market countries had developed their own corporate governance codes of best practices, “generally, there

is a discrepancy between the letter of the law and actual practices.” (Fremond/Capaul 2002:2) Countries around the world are very good at *adopting* codes of best practices. Making the codes *effective* has been another matter. The report notes that while “the OECD Principles assume that countries have an efficient legal and regulatory framework in place and that securities regulators have the means and capabilities to enforce the rules and regulations of their capital markets ... this is often not the case.” (Fremond/Capaul 2002: 2) Indeed, the Enron and post-Enron corporate scandals in the U.S. and similar crises in other advanced economies (e.g. Parmalat) have raised parallel questions.

The lack of legal infrastructure and, perhaps, the ability or will to create one, has important implications for global standards. First, standards are, at best, a first step. While they can certainly provide a basis for discussion resulting in the adoption of codes of best practices, by themselves they cannot assure the practices will be implemented or that the governance of corporations in a particular country will adhere to those practices. This limitation is particularly important for international investors who would like to rely on standards to protect their rights as minority, foreign shareholders and to provide timely, transparent information. The report concludes, “In countries with weak regulatory environments, concentrated enforcement through the market regulators may be preferable to enforcement through the courts.” (Fremond/Capaul 2002:2)

#### *Other International Organizations*

Not only does the Global Corporate Governance Forum coordinate closely with the OECD and the World Bank, it also coordinates with international initiatives such as the

Commonwealth Secretariat, International Confederation of Free Trade Unions, the Centre for International Private Enterprise, the Coalition for Environmentally Responsible Economics (CERES) and the Global Reporting Initiative (GRI). These organizations are dedicated to promoting codes and standards, particularly in environmental areas, but in other areas as well. Some overlap directly with emerging sustainable corporate governance agendas, particularly when it comes to the effective monitoring of environmental and labor standards. For example, the Global Reporting Initiative, an official collaborating center of the United Nations Environment Programme, has the mission to develop and disseminate globally applicable Sustainability Reporting Guidelines for the “voluntary use by organizations for reporting on the economic, environmental and social dimensions of their activities, products, and services.” (GRI 2002:1) Currently, more than two thousand companies worldwide report under this program.

The GRI Guidelines contain an explicit awareness that economic, environmental, and social goals are best achieved when companies have good corporate governance structures. “The borderless global economy requires equally borderless governance structures to help direct private sector activity toward outcomes that are socially and environmentally, as well as economically, beneficial.” (GRI 2002:2) Thus, the Guidelines explicitly treat governance as a main reporting element. They recognize that “pressures on corporations to establish and maintain high standards of internal governance are accelerating.” Furthermore, “effective corporate governance depends on access to relevant, high quality information that enables performance tracking and invites new

forms of stakeholder engagement.” (GRI 2002:2) Transparency is crucial to achieving GRI’s goals, and it strongly overlaps with the traditional governance agenda in this regard.

The GRI Guidelines consist of five sections, one of which is Governance Structure and Management Systems. This section requires the governance structure of the organization to be described along with the scope and responsibility of major committees responsible for economic, social and environmental performance. Director independence is crucial to effective monitoring so the company should report the percentages of the board of directors that are independent, non-executive directors. In good financial fashion, the GRI ask reporting companies to specify the link between executive compensation and the achievement of the organization’s financial and non-financial goals. And the Guidelines call for mechanisms for shareholders to provide recommendations or direction to the board. Taken together, these reporting requirements are consistent with and support the general thrust of the global standards movement for good corporate governance, while integrating traditional and sustainable trends in emerging global governance standards.

### *Conclusion*

In sum, the self interest of institutional investors as manifested through international organizations such as the ICGN and the OECD have resulted in the OECD Principles. These are effectively global corporate governance standards focused on traditional concerns such as board independence, structure, accountability, and transparency. They also articulate the rights of shareholders and the standards necessary to protect them,

particularly when the shareholder is foreign or minority or both. Thus, the Principles and their 2004 update would seem to complete the program begun by institutional investors in the 1990's.

However, since the late 1990's there also appears to have been a partial convergence taking place between the sustainability concerns of multilateral institutions such as the Global Reporting Initiative and institutional investors involved in traditional corporate governance reform directly and indirectly through multilateral groups such as the ICGN. The GRI's emphasis, for example, on transparency and its concern for risk are important for institutional investors and they can be expected to play an increasingly important role in the types of standards put forward. This issue is explored in greater detail in the next section.

#### **IV. Non-Governmental Organizations (NGOs) and Expanding Conceptions of Fiduciary Duty**

Beginning in the late 1990's a new trend contributed to the expanding definitional boundaries of fiduciary obligation. We identify this trend as *sustainable corporate governance* issues, and it may foreshadow the emergence of *de facto* global standards or at least the emergence of a locus around which *de facto* standards are debated. This trend arises from what are variously called social and/or sustainable aspects of economic performance and which are increasingly seen as directly related to a variety of governance issues typically in the form of considering risk factors as part of fiduciary duty and maximizing long-term return.. These newly emerging elements are what

Stephen Davis has termed the market forces of ‘civil economy’, parallel to (and in some cases rooted in) various sectors of civil society. (Davis 2002: 2-4; Cornelius/Kogut 2003)

Some participants come from the U.S., U.K and European institutional investors and others from the socially responsible investment (SRI) community, yet others come from traditional mutual funds and non-corporate pension funds.

The previous section discussed the Global Reporting Initiative (GRI) as an increasingly important element expanding what heretofore have been narrower definition(s) of corporate governance. The cumulative results of ‘civil society’ actions since the mid-90’s have increasingly broadened the *de facto* and to a limited degree *de jure* definitions of fiduciary obligation to include social, environmental and economic (SEE) elements. This has occurred in various venues so that the boundaries of fiduciary duty have, inch by inch, come to include significant elements of what previously were consigned to either SRI circles or characterized as stakeholder issues.

The link between SEE issues and governance is not an ethical one; rather, the connection is risk analysis. Below we discuss how environmental issues have emerged as a significant theme in an expanded definition of corporate governance by looking at both the long(er) term financial bottom line of both individual firms and perhaps more importantly at the collective long-term bottom line of large equity portfolios. Similar developments have taken place that focus on various social and economic issues, e.g. labor conditions in emerging economies, cost of pharmaceuticals and public health. This section does not attempt to review all these developments, but rather focuses on

environmental issues as an example of the emergence of ‘civil economy’ forces. (For further examples see, Universities Superannuation Scheme 2003; Cogan 2003; Innovest 2003b.)

In retrospect, the introduction of the Global Reporting Initiative’s (GRI) framework; for disclosing social performance made 2002 a watershed year for the incorporation of SEE issues into (increasingly routine) corporate governance, risk and performance analysis.

The GRI’s origins are in a well-known and increasing influential U.S. NGO: CERES, the Coalition for Environmentally Responsible Economies.<sup>5</sup> Noteworthy is CERES’ focus since 2002 on fiduciary obligation and climate change arguing that, “Neglecting to assess ... [climate change] risks is neither prudent nor responsible. The more information on [for example] climate-related damage accumulates the more refusal to examine these [environmental] risks carries for the potential for breach of fiduciary duty.” (Innovest 2002:1)

In its 2002 study *Value at Risk* CERES suggested that fiduciaries particularly in the U.S. have not considered the long-term financial impact of climate change and that they “seem oblivious to both the practicality and affordability of early mitigation measures.”

(Innovest 2002:1) For U.S. fiduciaries the increased globalization of their investment portfolios in the last decade implies that they “imply cannot ignore climate change policy and regulatory developments in other parts of the world.” (Innovest 2002:11) To ignore these developments courts unacknowledged or unrecognized risk (political, environmental, social, regulatory) and would constitute a violation of fiduciary obligation.

While the *Value at Risk* Report is significant for its focus on the role large institutional investors should play in order to fulfill their fiduciary obligations, the argument is not as fully developed and therefore not as powerful as it could be. In particular, it does not account for interactive impacts on a whole portfolio. For example, climate change may to some extent be caused by the coal power generation industry, and CERES is correct in focusing attention on that sector as courting financial risk. Yet, following the logic of universal ownership, risk (e.g. regulatory, tort liability, political) is not restricted to the coal power generation industry since current and future negative externalities directly impact a wide variety of other sectors, geographical regions and firms. Including a specific analysis of, in this case, negative externalities and their impact on a universal owners' portfolio extends and deepens the formulation CERES has begun. Such a comprehensive, holistic analysis would more accurately assess the valuation of coal power generation on the entire portfolio.

What is particularly important about the *Value at Risk* report and CERES subsequent commissioned report, *Corporate Governance and Climate Change*, is the integration of a long-term 'stakeholder' goal formulated in terms of a corporate governance perspective, and the use of governance as a means to engage firms. The latter report argues for what it calls 'sustainable governance' by "building on the momentum of the still-evolving corporate governance movement." (Cogan 2003:14) The basis for this linkage is the potential long-term alignment of the interests of shareowners (including their interests as 'citizens'), labor and management. The report argues that this emerging alliance is fed

through a convergence of market-led initiatives<sup>6</sup>, government requirements in various countries, shareholder pressures, and the role of NGO/stakeholder pressures on all of the above.

Another important example of linking environmental concerns to corporate governance is the Carbon Disclosure Project's (CDP) report titled, "Carbon Finance and the Global Equity Market". (CDP: 2003) What is important is that the report looks to the 'new fiduciary' to link carbon and climate change issues to corporate governance, and thereby to advance what should be market induced *de facto* global governance standards. The report argues:

Over the past five years in particular, the ambit of fiduciary responsibility has broadened considerably. In most OECD countries, fiduciaries are legally obligated to observe some variant of the 'prudent man' rule. That rule provides...that fiduciaries discharge their duties with the care, skill, loyalty, and diligence that a 'prudent investor' would display under similar circumstances.<sup>7</sup> (CDP 2003:32)

Closing out 2002 in the U.K. Hermes Pensions Management developed *The Hermes Principles*, to date probably the most comprehensive and sophisticated approach explicitly integrating long-term performance aspects of governance with a complex and focused conception of fiduciary duty. Most importantly, Principle 10 explicitly states, "Companies should support voluntary and statutory measures which minimize the externalization of costs to the detriment of society at large." (Hermes 2002:18) Two aspects of the principle stand out. First, it calls for voluntary compliance when effective and for statutory action if voluntary compliance fails. Second, Hermes' argument is based on the idea that it makes no sense to 'rob Peter to pay Paul', that is, for firms to create

negative externalities which are incorporated in the (short and long-term) costs of others firms owned in the same portfolio.

### *Conclusions*

NGO's such as CERES, the Global Reporting Initiative, the Carbon Disclosure Project and Hermes with its Principle 10 argue for including types of risk analysis (e.g. climate change) that overlap traditional corporate governance concerns at effectively managed companies as an important extension of fiduciary obligation. This extension is the second important trend that we identify and its emergence has the potential to strongly influence global corporate governance standards and the relationship between corporations and society. By reinforcing traditional corporate governance concerns of board independence, transparency and accountability with issues of sustainability, it promises to expand the definition of fiduciary duty and, thus, what is meant by good corporate governance. This trend also has an important impact on public policy is examined in the follow section as both NGOs and some major market actors have placed pressure on governmental regulators and listing authorities to adopt elements of the expanding definition of fiduciary duty.

## **V. Public and Private Sector National and Regional Policy Developments: Selected Trends Expanding Fiduciary Duty**

In addition to market based approaches to corporate governance and the multilateral approaches characterized by the OECD Principles, corporate governance standards are importantly influenced by the actions of various regulatory agencies and stock listing authorities. In particular, because of the size of U.S. financial markets, the Securities and

Exchange Commission's standards have global reach. Changes in regulatory rules as well as listing standards impact traditional corporate governance concerns and increasingly sustainability issues as well. Recent changes have expanded fiduciary responsibilities and may well come to have an important influence on the way corporate governance standards evolve in the future.

### *Cross Listing and Races to the Top*

It has been argued that one significant consequence of global cross listing of stocks and equity market competition is a global 'race toward the top.' (Coffee 2002) Thus, when issuers of equity can increasingly choose where to list, listing requirements come to have global reach and consequence. Rather than list in markets with few requirements and therefore lower standards, some firms chose to cross list on highly liquid markets (mainly in the U.S. but also in the U.K.) that have strong protections for minority shareholders.<sup>8</sup> (McBride 2003) These deep, liquid markets have higher and currently increasing governance and disclosure standards.

Cross listing has an important implication for global standards because this is a way for foreign firms to voluntarily – and credibly – subject themselves to higher corporate governance, disclosure and accounting standards than they would face at home. This is a classic market based response to the global standards problem and “by opting for a higher disclosure regime, the migrating firms enhance their share price and become able to raise additional equity at lower cost.” (Coffee 2002:6) Cross listing also reduces information

asymmetries inherent in foreign investing by opting into U.S. investor protection regulations.

Another example of the movement toward higher, market-based standards is the listing requirements of the Brazilian Novo Mercado, launched in 2001 by BOVESPA (the Sao Paulo stock exchange). Listed companies are required to meet many of the best governance practices in the U.K and the U.S. The goal is to lower the cost of capital for listed firms relative to the main Brazilian market, and to attract non-Brazilian investors as well. As a result Merrill Lynch placed the market at the top of their rankings for protection of minority shareholders. The Novo Mercado's listing standards are private sector initiated, but supported by the government which allows pension funds to invest a higher proportion of assets in listed companies and the state-owned development bank which offers better terms to companies listed there. (Fremond/Capaul 2002:10)

In Canada we see post-Enron pressures on its corporate governance standards from U.S. listing requirements, most especially for cross-listed firms. Canada's situation is more complex because its economy is highly integrated with the U.S since in 2002, for example, more than 50% of the Toronto Stock Exchange's value (constituting 177 firms) is cross-listed on U.S. markets. (Armstrong 2002) Thus, the passage of the Sarbanes-Oxley legislation in the U.S. and significant revisions of the New York Stock Exchange listing requirements "has placed pressure on Canadian public companies, their directors, officers and advisers, and pressure on Canadian regulators to examine the adequacy of the Canadian corporate-governance regime". Thus, Canadian firms and their regulators have been placed squarely in the middle of a race to the top. (Levin 2002:18) Here there

is an interaction between market based standards and regulatory mandate since firms are not choosing the higher standards, but are forced to accept regulatory changes as a condition of continued listing.

*“Social Responsibility”, Governance and Fiduciary Duty*

Transparency and accountability, especially post-Enron and post-Parmalet, have become the new philosopher’s stone of global governance standards. As governance practices change to make data and process more transparent, new issues and topics which had been off the governance agenda have emerged in numerous countries and in some multilateral venues as well. Issues of sustainable governance and social responsibility, as noted above, are increasingly important as an expanding dimension of governance even though they remain as yet largely absent from the OECD Principles.

The trends in NGO thinking which explicitly link ‘stakeholder’ issues to both corporate governance and fiduciary obligation noted in the last section are increasingly finding expression in regulatory actions and commercial code revisions in some common law countries. For example, a recent revision to the Canadian Business Corporations Act makes it easier for ‘social investors’ to engage management as active owners by focusing on social and environmental issues. These revisions are in part responsible for an upsurge in engagement in 2003, with some large minority proxy votes focusing on issues such as overseas supply-chain management.

For example, in the United States during the 2003 proxy season Institutional Shareholder Services, a major proxy advisory firm, reported the continuation of a trend that “during

the past few proxy seasons, ballot issues pertaining to corporate governance and executive compensations have begun to converge with social and environmental proxy issues.” Furthermore, socially responsible investors “have infused their corporate responsibility campaigns with economic justifications, risk assessments, and ultimately, concerns surrounding long-term shareholder value.” (ISS 2003:44)

Two actions in Australia suggest the integration of stakeholder and stockowner concerns based on an expansion of fiduciary obligation. The first is the recently formulated listing standards by the Australian Stock Exchange which includes a statement on the ‘legitimate interests of stakeholders’, saying that “there is a growing acceptance of the view that organizations can create value by better managing natural, human, social and other forms of capital...[and that] the performance of companies is being scrutinized from a perspective that recognizes these other forms of capital...[and to] demonstrate their commitment to appropriate corporate practices.” (Australian Stock Exchange 2003:59)

The second is the action of the Australian Securities and Investment Commission, the government’s regulatory body, which issued a set of draft guidelines for all investment funds concerning labor, environmental, social and ethical factors in investment companies’ product-disclosure statements. The action follows revisions to the country’s Corporations Act that required disclosure of SEE information as part of a firm’s material valuation information and is thus both a reflection of NGO and other pressures and also a facilitator of the growth of sustainable governance trends.

Unlike developments in common law nations, there has not been a similar trend in continental European nations, nor in the E.U. as a whole. This is principally due to the absence of a fiduciary tradition or a legislatively established fiduciary obligation. This lack is reinforced by the absence of large, local institutional investors which could act as corporate-governance activists. At the same time various forms of stakeholder law and tradition have to a degree – perhaps a significant degree – influenced the European and E.U. SRI agenda and therefore impacted policies and behaviors of many European firms.

On the other hand, related developments on the E.U. level have two relevant foci: the growth of sustainable development and proposed changes in E.U.-wide company law. The former concerns issues that have in common law countries increasingly been integrating into expanding definitions of corporate governance while the latter refers to what in common law nations are considered traditional governance concerns. In obvious contrast to common law countries, these two trends remain distinct in E.U.-wide policy circles. (Férone *et al* 2001)

However, in May 2003 the European Commission issued an “Action Plan” which seeks to “strengthen...shareholder rights, reinforcing protection for employees and creditors and increase...the efficiency and competitiveness of business” (European Commission 2003) The Action Plan is purposefully ‘flexible’ in application while referring to itself as being ‘firm on principles.’ It rejects an E.U. wide best practice governance code and instead opts for a ‘few essential rules’ and the coordination of individual national

governance codes of best practices. It rejects a one-size-fits-all model given “the many different national models” that exist in the E.U.

The Action Plan focuses on transparency and timeliness of information in order to better inform large shareholders, including large minority foreign shareholders, and thereby it seeks to empower them. The Plan reflects the approach put forward by the High Level Group of Company Law Experts in 2002. Both reports stressed disclosure (which is obviously extremely important), but reject any form of mandated, or “comply or explain” standards for institutional investors, while recognizing their increasing growth and impact in some member states. (European Commission 2002)

The case for E.U. wide good company law and for good corporate governance practices reflects the realities of the globalization of financial markets generally and, particularly, the huge growth of institutional equity investment. In this regard, it is an adjustment to the growth and development of both offshore institutional fiduciaries and the terms under which they operate in their home, typically common law, countries. As we argue throughout this paper, this is due to their own internal developments as well as changes in regulatory practice that expands the boundaries of fiduciary obligation. This is reinforced by external stakeholders, as well as by activist stockholders within institutions.

Furthermore, although an SRI orientation is by many measures more prevalent in Europe than in some common law countries (certainly more so than in the U.S.), EU wide SRI is to date entirely separate from proposed corporate governance reforms, and indeed, where

governance reforms exist they are restricted to statements of principles; specific standards and rules remain to be worked out, at both the E.U. and member-state levels.

*U.S. SEC Regulatory Rulings: Proxy Process, Mutual Fund and Investment Advisers Voting Disclosure*

U.S. standards have a tendency to become *de facto* minimum global standards. During 2003 three extraordinarily important regulatory decisions by the U.S. SEC focused on providing shareowners in mutual funds more direct influence over firms and on shareholder nomination of directors. Underlying these historic decisions is the recognition of the rise over the last twenty years of fiduciary institutional investors as dominant actors and, specifically, as corporate governance activists. The SEC actions address the complex relations among primary fiduciaries (like mutual funds) and the agents they contract with such as money managers and investment advisers. These three changes have the potential to dramatically enlarge the scope of fiduciary duty and all rely on transparency as a critical means to a corporate governance end. Mandating (and enforcing) increased transparency assumes that market actors (mostly institutional investors) will use this information to both structure investment portfolios as well as use corporate governance engagement and activism to promote change within industries and firms (e.g. on climate change.) As such, they are market enabling reforms which recognize the potential power of large institutional investors.

In January 2003 the SEC announced two related rule changes, both focused on proxy transparency, one directed to mutual funds and the other directed to investment advisers. In relation to mutual funds the SEC adopted a rule requiring a mutual fund to make

public “the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities ... [and to] require a fund to file with the Commission and make available to its shareholders ... its record of how it voted proxies related to portfolio securities.” (SEC 2003a) The new rule, which goes into effect in 2004, will subject 3,700 mutual funds with \$2.0 trillion of equity, or about 18% of all publicly traded equity, to dramatically greater transparency and, thereby enabling individuals and institutional investors to evaluate the efficacy of proxy voting practices, guideline and processes.

Related to its first action, the SEC recognized that in some circumstances the financial interests of investors may well conflict with the management of the funds, in particular, “when a fund’s adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund. In these situations, a fund’s adviser may have an incentive to support management recommendations to further its business interests.” (SEC 2003a) Proxy voting transparency would permit investors to better monitor such potential conflicts of interests.

In the areas of monitoring corporate behavior generally and assessing the risk aspects of SEE issues specifically, the SEC has broken new ground with regard to its definition of the parameters of fiduciary duty. Prior to the SEC’s ruling it was not a fiduciary obligation to report to investors proxy policies, procedures, voting guidelines or actual votes cast. Thus, all proxy matters could be ignored if a fund chose to do so, effectively voting with management by default. By defining voting and reporting on procedures and policies as a fiduciary duty, the SEC suggests that funds examine their publicly traded

firms in all their aspects, *not just their financials*. This enables investors to use mutual fund proxy voting as an avenue to influence corporate behavior, but certainly does not guarantee that they will.

In its second action the SEC promulgated a revision to rules affecting proxy voting by about 6,200 investment advisors managing about \$19 trillion in assets. In some regards the new parameters of both fiduciary duty and governance are more explicitly developed in this ruling that states,

an adviser is a fiduciary that owes each of its clients duties of care and loyalty...including [in regards to] proxy voting. The duty of care requires an adviser...*to monitor corporate events and to vote proxies*. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interests of its client and must not subrogate client interests to its own. (SEC 2003b) (Emphasis added)

It is noteworthy that fiduciary duty is defined *broadly* -- ‘to monitor corporate events’ -- and not narrowly as a financial matter, as was the previous practice. Thus, for example, a corporate event that might put the reputation of a firm at risk and thereby damage its long-term prospects is a legitimate focus for the duty of care and loyalty. It remains to be seen what the phrase ‘to monitor corporate events’ will come to mean, but the SEC’s argumentation behind its ruling suggests increased investor (and more generally shareowner) power. Similar pressure on mutual funds exist in a number of countries, particularly in the U.K.’s requirement that all institutional investors have in place (or say why they do not) a policy on SEE issues, and the increased specific mandates for governance in the recent revision of the Combined Code.

The third major SEC action began in the summer of 2003 with a Commission staff report reviewing direct shareowner participation in the nomination of board members. (SEC 2003c) Under current regulations shareowners can nominate directors, but companies are not required to place these names on the proxy ballot. The proposed reform allows shareholders, under certain circumstances, to nominate candidates for the board and to require that those nominees be included in the proxy material sent out by the company. The proxy process (in its many complexities) has been at the heart of management's ability to retain control of the firm through its domination of director nominations, as well as through its ability to dominate proxy material and the process of voting. These rule changes have the potential to open up the proxy process to shareowner influence in significant ways. Because the proxy process is at the center of the corporate governance process these rule changes may hint at future changes in global standards particularly as they are extended to the governance of institutional investors.

### *Conclusions*

In sum, across a variety of nations and regions regulatory bodies and some stock exchanges (typically under regulatory and market pressures) have in quite significant ways begun to expand the boundaries of fiduciary duty, and have facilitated fiduciary activities, particularly by mandating greater information transparency. By doing so they have opened the way for the establishment of *de facto* principles if not as yet clear standards, particularly in the areas of accounting, listing, and corporate governance standards. When companies decide to voluntarily cross list or to list on an exchange with higher corporate governance standard this is a neo-liberal response. But it also meshes with a regulatory response to perceived inadequacies when listing requirements are

strengthened by the SEC or when the fiduciary responsibility of mutual funds is redefined by regulation. These trends often mirror other global standards, particularly the OECD Principles, but they often lead those standards and, therefore, point the way to the future.

## **VI. Conclusion**

We have argued that both traditional corporate governance concerns and new sustainable governance foci are emerging as *de facto* and *de jure* global standards. These developments naturally raise concerns and questions about the imposition of global standards derived from common law based fiduciary institutions as the drivers of global trends. However, this concern should not be framed primarily in the terms of the ‘old’ Anglo-American model that simply fosters maximization of shareholder value regardless of externality and other consequences. While remaining a concern, it is increasingly counter balanced by the forces of fiduciary obligation, as they begin to be enlarged beyond a simple notion of profit maximization calculated on a firm-by-firm basis, and apart from calculations of risk whether they be market, social, political or regulatory.

We note in conclusion that the expansion of fiduciary obligation in recent years, and its impact on both common law and civil law legal systems, results from the interaction of financial, market and political pressures to create more responsible and responsive corporate behavior. Furthermore, the interest that institutional investors in common law countries (primarily the U.S. and the U.K.) have in good governance, transparency, protection of minority shareholder rights, effective regulatory bodies and adequate judicial recourse are parallel to the interests of local investors whether they are from an

emerging market or an advanced industrial country or from a country with a common or a civil law tradition. In particular, these trends have the potential to begin a long process of internalization of negative externalities and a fostering of positive ones. The trend toward increasing cross-border equity investment reinforces the common concern of institutional investors and is likely to be best served by common standards across markets.

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## Endnotes

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<sup>1</sup> Gordon Clark (2000) also explored similar issues with an emphasis on pension funds in his book *Pension Fund Capitalism*. This argument is also very much along the lines of a paper by Plihon et al (2001).

<sup>2</sup> Other institutions in the U.S such as TIAA-CREF and the various state pension funds and Hermes Pension Management and Universities Superannuation Scheme in the U.K have also played a particularly active role in developing corporate governance standards.

<sup>3</sup> Shin /Gourevitch 2002 (53-54) note that “The development of reliable, objective criteria regarding corporate governance performances of firms is critical to any reform process.” They also note the current

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efforts at firms such as Standard & Poor's, IRRC and GovernanceMetrics and recommend that "These efforts deserve official encouragement and support."

<sup>4</sup> Shin/Gourevitch 2002 (4) recommend that "U.S. private-sector firms should support the creation and dissemination of objective, third-party corporate governance indices."

<sup>5</sup> CERES was formed in the late 1980's as a project of the Social Investment Forum to develop a coalition to influence corporations to adopt environmentally sustainable policies. It was only recently the CERES began to focus on the potentially critical role of institutional investors as dominant owners in this effort, previously having focused attention on individual firms.

<sup>6</sup> For example, the large reinsurance firm Swiss Re began in 2002 to inquire about members of boards of directors' attitudes toward liability issues related to global warming.

<sup>7</sup> Our reading of fiduciary obligation as broadly understood under common law is that there is no legal equivalent under civil law (and other) legal traditions, although the management of others' monies does have strict legal guidelines.

<sup>8</sup> In the U.S. cross listing is in the form of American Depository Receipts (ADR) and in the U.K as Global Depository Receipts (GDR).