

## **CORPORATE GOVERNANCE**

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Nowadays Corporate Governance is prominent among the concerns of both private and institutional investors.. Unfortunately, the cause of such concern is principally due to a number of companies scandals (such as the Enron case), in which negligence in Corporate Governance has been the key factor. Irresponsibility at top levels has resulted in inappropriate decisions at all levels, causing heavy losses both financially and in the work force.

Controversy about misconduct at directorship level in big corporations has underlined the need for more ethical behaviour, and for a recognised code of ethics. Merely acting according to the law and to internal rules does not prevent shareholders and others with an interest in the firm from feeling defrauded.

The concern for good governance codes began in the U.K., where in 1991 the London Stock Exchange created the Cadbury Committee which is still a benchmark for any company conscious of the need for good governance practices. This Committee published its recommendations and its code in December 1992. It is a voluntary code although listed companies are expected to declare if they have complied with its tenets in their annual reports. If they do not comply, they must explain their motives at the annual general shareholders meeting. The code deals with two main subjects: the board of directors and the preparation of financial reports.

It is significant that the Committee's May 1995 report commented that board of directors are ever more aware of their responsibility, that there are more independent directors since the code's publication and that more subjects are studied than before.

The Cadbury Committee was followed by the Greenbury Committee, dealing with directors and executives remuneration, and more recently by the Hampell Report, combining both reports.

It must be emphasized, however, that the British Government is planning to pass laws based on the recommendations in view of the scarce actual observation of the codes. The English codes have given rise to similar ones in almost all organised markets.

The main objective of Corporate Governance is to achieve a balance between board, executives and shareholders, and to solve problems arising from conflicting interests, based on the principles of transparency and security, with the participation of shareholders and the Board of Directors.

Not until the publication of the Olivencia Code in 1998 did Spanish listed companies begin to adjust the structure and composition of their boards. The aim was to give an impression) of transparency and instil confidence in the directors among shareholders.

The Olivencia Code was created in 1997 by the Cabinet following a proposal by the Minister of Economy and Finance. On the 28<sup>th</sup> of February the Cabinet agreed to a special commission for the study of a code of ethics for Boards of Director, appointing D. Manuel Olivencia Ruiz and D. Luis Ramallo García as President and Vice-president, respectively.

This Commission was charged with a double task: firstly to draw up a report dealing with Boards of Directors of companies in the financial area; and secondly the elaboration of a code of ethics on good governance that these companies could adopt voluntarily.

The Olivencia Code consists of three parts: the introduction, describing the Cabinet's agreement to create the special commission, its origin and its aim; the second part entitled: "Report on the Board of Directors", describing the problems currently faced by them; and the third part called: "The Code of Good Governance", with 23 recommendations or measures.

The government's intention is that the report should respond to the demand from professionals and the markets themselves for greater efficiency, agility, responsibility and transparency in Corporate Governance of companies in the financial area.

In this way greater credibility and more efficient defence of shareholders interests may be achieved. The Government also underlines, at the beginning of the Agreement, the growing need for this measure due to the policy of privatisation and the sale of public companies, resulting in a greater number of shareholders with the right to take a more active part in administration.

In the "Report on the Board of Directors", the Code establishes that the Board should basically be an instrument of supervision and control, to harmonise the company management with the interest of those who finance it and run the risks. The Commission feels that supervision is the main function of the Board of listed companies with three fundamental responsibilities: to become conversant with company policy, to control management, and to provide a link with shareholders.

The Olivencia Code is not compulsory but consists of a series of recommendations which companies may adopt voluntarily. The commission considers that as long as investors are aware of the standards of governance, there is no need for legislation to control it.

The Code's recommendations are mainly intended for listed companies, specially those with a great percentage of free float shares. But they are useful for all those companies which obtain funds in capital markets, even if they are not listed. And there are doubtlessly companies in other fields which could benefit from the recommendations to organise their governance structure.

One of the most important of the 23 recommendations in the code of good governance is the proposal to Boards of Directors to assume the function of supervision as the nucleus of their duty. The Boards should also accept independent members with professional prestige who are connected with the executive staff or the main shareholders.

In order to achieve maximum efficiency, a board should consist of between 5 and 15 members. The age limit should be around 65 to 70 years old for executive directors and the chairman, and more flexible for the other members. The Code suggests that the figure of the Secretary should be given more relevance, thus reinforcing the independence and stability of the post and emphasizing the role of ensuring both the formal and material legality of the Board's acts.

The Code also recommends the constitution of commissions of control, consisting entirely of external directors, for matters concerning auditing, appointments, remunerations and fulfilment of the norms of governance.

Listed Companies should impose compulsory resignation in such cases where a director's behaviour could have a negative effect on the Board's dealings or the company's reputation. The Board will also be responsible for supplying prompt, accurate and reliable information to the markets, specially in connection with changes in the shareholding structure or other important developments. All periodical information, including the annual reports, should be verified by the Commission in charge of audits. In its annual report the Board should include information about its rules of governance, and explain those that do not conform with the Code's recommendations.

An analysis of the results of an annual survey on the Olivencia Code carried out by the CNMV shows that its aims have not been completely fulfilled and that the recommendations which are least observed are those concerning directors age limits, the formal procedure for the election of directors, the transparency of remunerations and the creation of control commissions composed exclusively of external directors.

For that reason the Aldama Commission published the Aldama Report on 8th January 2003, an update of the Olivencia Code incorporating the experience of the previous four years granting legal status to the principles of transparency and security. The Board and the General Shareholders meeting will be self governed. It addresses several matters dealt with in the previous report, together with new ones.

This Report consists of six sections: section I and II analyse topics related to principles of transparency and loyalty; section IV deals with boards of governance; section V with providers of professional services and, finally, section VI contains a series of ideas on the scope of the recommendations and how they should be implemented.

An innovation contained in the Aldama Report is the designing by the firm of a web page to inform the shareholders, investors and agents in the market, about economic and other relevant facts related to the firm; disclosure of agreements with other companies; and to inform on the feasibility of voting by mail or e-mail.

The Aldama Report proposes that the issue of an "Annual Report on Corporate Governance" by companies should be enforced by law, in order to standardise information. In this way investors can analyse the information provided by the firms more easily. Also, this information should be updated through the web.

The Aldama Report's general principles are being taken into account by other European countries. Self regulation together with the obligation to inform is the best course for good governance of listed companies. However, for the effectiveness of these principles a code of practices is necessary, the breach of which must be justified. These practices were already included in the Olivencia Code 23 recommendations, but the Aldama Report reforms them in very important aspects, explicitly or implicitly.

The success of the Aldama Report can be seen in the Government decision to implement a law based on the main ideas on transparency and shareholder protection contained in this Report. The "Law of Transparency" including many recommendations from the Aldama Report, received the approval of Parliament in July 2003. Specifically, in accordance with the Law, listed companies must publish a report on corporate governance every year. This report will be sent to the CNMV and published as a relevant fact. Moreover, the framework and the contents of the Report will be established, in the rules implementing the Law, by the Ministry of Economy or the CNMV. As a rule this development requires a detailed explanation on the system of governance of the companies, and how it is carried out in practice: who the main shareholders are; businesses linked to shareholders, directors, managers, and other associated companies; risk control systems; the way shareholders meetings work; and the implementing of corporate governance.

Fulfilment of good governance rules is the responsibility of the CNMV. The Commission will ask for any necessary information and will publicize any relevant fact related to the fulfilment of the good governance rules by a company.

Finally, the lack of a report on corporate governance or failure to publish the report, omissions, false or misleading information, is considered by the Law of Transparency to be a serious infringement.