The Goodness of Business
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How Creativity, Business and Good Governance Build National Prosperity
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RICHARD CHANDLER
Founder and Chairman of the Clermont Group.
Singapore Head Office, June 2012.
The Business of Prosperity

“My vision is one of flourishing economies built by national leaders and entrepreneurs that unleash a nation’s creativity, innovation, and entrepreneurship to create prosperity for all.”

Creativity is the Garden of Prosperity

From ancient Athens and Renaissance Florence to Silicon Valley, history shows that creative societies are prosperous societies. Creativity brings efficiency but more importantly launches new industries, thereby fostering employment, trade and commerce.

Studies today demonstrate the close relationship between creativity and national levels of economic output, competitiveness, entrepreneurship and overall human development. Hence, government and policy makers should be keenly interested in how to foster a country’s creative capital and translate it into broad based prosperity.

Entrepreneurs Bridge Creativity with Prosperity

Entrepreneurs form the vital link between creativity and prosperity. They create goods and services which serve the needs of the marketplace. More efficient methods of production are discovered, employment is created, and the economy is stimulated and revitalised.

The key to national prosperity lies in creating an environment where creativity and entrepreneurship thrive. Education standards, rule of law, access to capital and fair taxation are all important. Strong corporate governance is also key. Corporate leaders, investors and national leaders must cooperate closely in shaping this environment. We call this partnership the Prosperity Partnership.

Prosperity is Built on Leadership

Economic strength and entrepreneurial vitality are the foundations of all great nations. This does not happen by accident. Creativity, innovation, and entrepreneurship must be carefully cultivated.

I have written this document to highlight the opportunity for national leaders, regulators, investors, and corporate management to build great companies and, in so doing, national prosperity.

RICHARD F. CHANDLER
Founder and Chairman,
Clermont Group
In a world of creativity, prosperity has no limits.

Richard F. Chandler
Creativity, Business and Prosperity
Creativity Drives Prosperity

“Human creativity and innovation, at both the individual and group level... have become the true wealth of nations in the 21st century”

United Nations Development Programme
Creative Economy Report 2013

The Link Between Creativity and Prosperity

Civilisation’s great advancements have been characterized by creative periods when new ideas in philosophy, science and arts came together to produce break-out developments. From ancient Athens, Renaissance Florence and China in the Ming dynasty, history shows that creative societies are prosperous societies.

In today’s knowledge-based economy, creativity plays an increasingly important role in driving economic and social progress. In the recent Global Creativity Index 2015 (GCI) published by the Martin Prosperity Institute, 139 nations were rated and ranked on indicators of creativity. The study showed that countries ranking high on the GCI were more likely to have high levels of economic output, competitiveness, entrepreneurship, and overall human development.

Businesses are the Commercial Expression of Creativity

Economists have long recognised the important role that entrepreneurs play in advancing society through creativity. Businesses are incentivised by the profit and loss system to search for novel solutions to problems and new combinations of resources.

It is therefore unsurprising that the ease of doing business for entrepreneurs is strongly related to a country’s GDP per capita. Through businesses, goods are produced to meet societal needs, jobs and employment are created, innovation is spurred, and opportunities are provided for individual growth and fulfilment. Thriving business will naturally stimulate economies and empower societies.
THE GCI AND ECONOMIC OUTPUT
THE GCI AND GLOBAL COMPETITIVENESS

Global Competitiveness Index

Global Creativity Index
Ease of Doing Business Scale

1 = Environment Most Supportive of Business
180 = Environment Least Supportive of Business

The success story of Singapore illustrates this truth. Today, Singapore ranks first in the world in the ease of doing business. It stands tall as one of the most developed countries in Asia today with a per capita income of around US$56,000, a figure similar to the United States. Nobody expected Singapore to survive in 1965 when it was forced into independence by Malaysia. It had very limited natural resources, lack of fresh water, constant conflict among ethnic and religious groups, substandard infrastructure, and an unskilled labour force. Singapore’s per capita income in 1965 was around US$500, the same level as Mexico and South Africa then. As businesses thrived and foreign direct investment continued to pour into Singapore, economic prosperity followed as a matter of course.

It is only through understanding the crucial link between creativity, businesses and national prosperity that proper national policies can be developed to foster long-term economic growth.

The Prosperity Partnership
In a healthy human body, each organ works in complete harmony with the other to create health and vitality. Similarly, corporate leaders, investors and national leaders each have an indispensable part to play in creating an enabling ecosystem for entrepreneurship and innovation to thrive.

Everything rises and falls on leadership. Great companies are led by ethical and effective corporate leaders who prioritise good corporate governance. Responsible investors provide not just capital but oversight for management performance. National leaders play a key role in removing impediments to the proper functioning of markets. Guided by transparency, integrity and meritocracy, trust can be established within the ecosystem. All actors should engage in frequent informal dialogues so as to remain responsive to the realities on the ground.

We call this cooperation between Corporate Leaders, Investors and National Leaders the Prosperity Partnership.
“Character is destiny.”

Heraclitus of Ephesus
Greek Philosopher
Corporate Leadership and the Foundations for Enduring Success
Good Businesses Meet Social Needs
We live in an interconnected and interdependent world. Our lives and our happiness are more than ever joined to the well-being of others. As our neighbour prospers, so do we. As our neighbour suffers, so do we. How do we contribute to making this world a better place for all and, in so doing, a better place for ourselves? There are few better ways than starting businesses that create goods and services that meet the needs of society.

Investing in the Prosperity of All
The creation of financial returns for shareholders is dependent upon the value created for consumers. The economic return is simply a reflection of the value and efficiency that the organisation creates in meeting consumer needs. This economic return or profit is reinvested in further innovation and returned as dividends to shareholders who have undertaken the financial risks.

In the 2000s, the global banking industry fell into disrepute as financial products (sub-prime mortgages and derivatives) were created that delivered no social value. The excessive pursuit of profit through speculation and leverage by many financial firms created the Great Recession of 2008. This abuse of social trust by the banking industry resulted in a backlash which expressed itself in the Occupy Wall Street protests. Legislators subsequently introduced new regulations aimed at restraining excessive bank leverage and bankers’ bonuses. The goal of the new regulations was to align banking activities with the responsible creation of social value – taking deposits and making loans which support the health and vitality of companies and households. This is a return to the values of banking of an earlier era, before derivatives and leverage turned Wall Street into a speculative casino with an ability to create systemic risks to a nation’s economy.

Lessons from the Great Recession
Returning to the lessons of history, the Great Recession in 2008 was an interesting test of American corporate resiliency. What did we learn from the financial tsunami that hit corporate America? Amongst the debris we can see the dangers of excessive credit and property bubbles. What was interesting was the impact of the crisis on some of America’s iconic companies in the banking and motor vehicle industries. The crisis swept away long-established investment banks such as Bear Sterns and Lehman Brothers while the venerable Citibank, Bank of America, and General Motors were rescued by the United States government. Left standing were JP Morgan and the Ford Motor Company.

The Value of Leadership, Purpose, and Culture
While many reasons explain the survival and failure of these household names, we would like to touch on a few: leadership, purpose, and culture. The companies that failed had largely lost the purpose and culture of their founders. General Motors was a disparate group of brands lacking any unifying ethos. Contrast this to Toyota or Mercedes Benz with strong brands and a quality focus. Citigroup, while having a unified brand, lacked a sense of purpose or strategic discipline. Bank of America and Citibank, in the all-out quest for scale, had bought so many businesses over the years that they failed to align their cultures and, as a result, lost their identity.

Identity, Self-reliance, and Survivorship
In contrast, JP Morgan and Ford had both strong leadership and a sense of culture and self that went back to the company’s founders. These “survivor” companies had cultures anchored in strong identities, traditions, and values. In difficult times, they did not need to look to management consultants and public relations agencies. They could look both within and to their founders to find their strengths, their values and their purpose.
Truth, Goodness, and Beauty

In reviewing great companies that survive and adapt to change, we see the importance of moral purpose, leadership, and values in building enduring prosperity. Are there any values that are a golden thread, expressing the essence of these great companies? Three values were common to Confucius, Leo Tolstoy, and Albert Einstein. These values are truth, goodness, and beauty. They can apply as easily to companies as individuals.

Let us look at iconic businesses that transformed society through their products. When one thinks of the social value created by the first Ford Model T motorcar, available only in black, how far is this really from Apple’s iPod, iPhone or iPad? When Google aspires to “do no evil” and Facebook to “give people the power to share and make the world more open and connected,” we see organisations aspiring to noble purposes which connect to the aspirations and meet the needs of young and old alike across our planet. Their aspirations reflect the values and goodness of great businesses.

“I believe that every right implies a responsibility; every opportunity, an obligation; every possession, a duty.”

John D. Rockefeller
Investor and Philanthropist
The Character of Corporate Leadership

Corporate leadership is responsible for the effective management of financial capital and human creativity. A company cannot have an ethical culture without ethical leadership. Companies with principled leaders act with integrity, transparency, and accountability in managing shareholder funds to create value for all stakeholders. Managers who observe good corporate governance practices place the interests of the business and its shareholders ahead of their own. This moral leadership builds trust and respect among corporations, shareholders, and communities.

In defining the moral character of an organisation, three concepts are important: social purpose, moral culture, and ethical standards.

“What is morally wrong can never be advantageous, even when it enables you to make some gain that you believe to be to your advantage.”

Marcus Tullius Cicero
Roman statesman
The Power of a Social Purpose

Every person seeks meaning and purpose in life. We all want to be a part of something bigger than ourselves, to connect with a noble cause or aim for a great goal. This is what engages our hearts and souls and creates a passion to succeed and achieve.

A well-articulated social purpose is the anchor for an organisation’s moral culture. While it is important to set ethical standards, they risk becoming a rulebook in the absence of a broader moral culture which creates an emotional and intuitive connection. When employees understand “why,” they are less likely to need rulebooks. An organisation cannot achieve lofty goals by lowly means.

More importantly, a social purpose focuses the organisation on understanding and meeting customer needs. Profit becomes a by-product of this value-creation process. The centrality of a social purpose aligns all employees not just around a noble goal, but also around an unwritten set of values and behaviours consistent with achieving the goal.

Corporate Leaders Set the Moral Culture

Establishing the moral foundations of an enterprise is key to building a great company that will withstand the storms and crises of history. A moral culture is first and foremost set by the example of a company’s leader. Good leaders establish a company’s values and moral culture within the context of a moral purpose.

In an address to graduating students at Wharton in May 2005, US Federal Reserve Chairman Alan Greenspan stressed that without ‘ethical principles,’ advances in science, technology and business were of qualified value. Recognizing the growing importance of the CEO in modern corporate life, Greenspan called for greater ethical business leadership, arguing:

“It seems clear that, if the CEO chooses, he or she can, by example and through oversight, induce corporate colleagues and outside auditors to behave ethically. Companies run by people with high ethical standards arguably do not need detailed rules on how to act in the long-term interest of shareholders and, presumably, themselves.”
Integrity is Putting Principles Before Profits

Character is most visible when it requires management to pay an evident price in choosing the honest path of integrity, rather than that of personal self-interest. Indeed, it is perhaps only when there is a price to be paid or a profit to be foregone that principles have true meaning.

Defining Ethical Standards

Integrity, transparency, and accountability are the ethical principles which guide moral behaviour. A company’s ethical standards may be expressed in a detailed manner in a code of conduct. However, rules can never replace principles. Rules can only define a minimum standard of behaviour and cannot by themselves engender a moral sense.

Moral Capital and Corporate Longevity

The value of moral capital is often unrecognised in the focus on short-term financial performance. Moral capital will seldom be mentioned when creating performance metrics. And yet when one looks back over the centuries, countries and companies often fail first at the moral level before they fail at the economic level. That is why ethical leadership is so important to the long-term success of an organisation.

If “character is destiny,” then organisations need to establish moral leadership and ethical behaviour alongside financial metrics when evaluating performance.

When one thinks of morality, we usually associate this with individuals more than organisations. It is no small challenge to put moral capital into the bedrock and balance sheet of an organisation (or a country). So meticulously and painstakingly built, moral capital is washed away on the first tide of failure. Its very fragility is the reason it must be assiduously cultivated and tended. One of the difficulties in nurturing moral behaviour is the difficulty of expressing it. It is challenging enough to write about personal values and beliefs. How does one create, articulate, and communicate corporate values that do not end up sounding patronising, arrogant, and self-righteous? Who decides what these values are?

“The state of corporate governance at a company to a very large extent reflects the character of the CEO.”

Alan Greenspan
Former Chairman of the Federal Reserve Bank of the United States

“If a business is not ethical, it will fail, perhaps not right away but eventually.”

Sir John Templeton
Investor and Philanthropist
A Performance Framework Provides Total Game Understanding

Far too often leaders take over the reins of an organisation and continue the plans, structures, and systems of their predecessors. If they stopped for a moment and thought about the role of a governance framework in setting the foundation for long-term performance, they might build a stronger platform for enduring success.

Great Leadership Builds Great Companies

Military organisations spend enormous time and energy training their officer corps. They know from experience that, in the field of combat, leadership is key. When we think of great military victories and great nations, we think immediately of the leaders who designed and executed the plans and programmes that achieved success. It is no different for companies.

Great companies are almost always founded by visionary leaders with a clear sense of purpose and the ability to see and capitalise on great opportunities. There are many types of leaders and leadership styles. Boards must select leaders whose skills, values, and approach are best-suited to the company’s mission and culture.

Combining Financial Value Creation with a Social Purpose

Many boards do not spend enough time debating and crafting the company’s strategic goals, culture, and values. In today’s complex world comprising diverse stakeholder interests, pure financial goals are insufficient.

The goal of all great companies is to create long-term shareholder and social value through the productive and ethical use of capital and resources. In essence, business and entrepreneurship are about finding a need and filling it – creating products and services which meet the needs, desires, and aspirations of customers. While many people believe the purpose of business is to make a profit, great businesses connect to a more important social purpose. Defining an organisation’s mission in relation to its value to society creates a valuable sense of meaning as well as accountability for actions and results.

The failure of most mission statements is that they are little more than slogans or buzzwords. A mission that engages employees in a shared journey must be placed in the context of a strategic vision, one which expresses how the leader sees the organisation’s role in the world, and how the company’s goals carry both meaning and significance.
Heritage and Culture Create Identity and Purpose

A good leader will articulate the company’s culture and values and put them at the centre of an organisation’s thinking and behaviour. Strong companies recognise that good cultures guard against behaviours that are short-term oriented or inconsistent with the firm’s moral principles.

Cultures and values that are simply rules and codes do not achieve understanding or alignment by employees. Far too often, the articulation of a corporate identity, purpose, and values is delegated.

This creates narratives and language associated with brand marketing rather than an authentic and durable enterprise. Slogans are a poor substitute for sincerity of purpose.

Strong and enduring companies have high levels of customer and employee loyalty. This brand capital is built up by corporations whose words and actions align with values that have intuitive and emotional connections to their stakeholders. Companies such as Proctor & Gamble, General Electric, and IBM are good examples.
Men’s spirits are lifted when the times are prosperous, rich and happy, so that their pride and arrogance grow. Good fortune, which leads them to rejoice, usually makes them stray from right counsels.

Cato the Elder
Roman statesman
Strategic Vision, Seeing the Big Picture
The first role of a leader is to define the organisation’s mission. Understanding context is key. Seeing and describing the strategic challenges and opportunities within a broader holistic context sets the stage for developing effective strategies based on unique understandings. A strategic narrative which defines the political, historical, economic, technical, cultural, and social context of the market within which the organisation operates provides a strategy framework.

The Power of Learning from History
Cycles are a constant throughout civilisation. Study history and one immediately sees the endless rhythm of the rise and fall of nations, economies, and companies. This knowledge is important in understanding the imperative of developing a strategy that can withstand the down cycles of an industry or country.

Discovering the Simple Big Idea
Ideally, the strategic vision sets out a transformative opportunity, or “simple big idea,” which acts as a golden thread or theme running through and uniting the organisation’s activities. Examples include Apple’s Steve Jobs’ idea that he “brought the liberal arts to consumer electronics.”

Good Strategy Starts by Finding the Right Question
Often organisations presume that the existing strategy is somehow correct and the game is to improve the quality of execution. In so doing they fall in to the common trap of doing the wrong thing righter. When results do not match goals it is time to re-examine assumptions – about goals, strategy, and execution.

A good place to start is by searching for the right question. Asking, “What is the question our strategy is trying to answer?” encourages new thinking. Another technique is to apply the beginners mind. This approach says that “if we started afresh, knowing what we know today, would we be doing what we are doing?”

When the US military invaded Afghanistan in 2001, they thought the mission was to eliminate terrorists. The strategy therefore employed “find and destroy” tactics. After many difficult years US commanders realised that with low levels of literacy, Afghan men had a choice between working in the opium trade or in terrorism. Across the border in Pakistan’s violent Waziristan valley, the literacy rate was 6% for men and just 1% for women. When the military mission was redefined to building a sustainable economy (thereby creating better-paying employment) the strategy shifted to focusing on development infrastructure such as schools, clinics, and cold storage for agricultural produce. This is a good example of redefining goals through better thinking.

Setting Goals and the Discipline of Limits
Knowing the destination is the first step to getting there. A clear strategic goal unifies the company’s focus. It forms the basis for tactical plans and actions. Being clear about what an organisation does not do is just as important as setting out what it does do.

Aligning Strategy with Competitive Strengths
Every organisation, like a person, possesses different knowledge, skills, and abilities (KSAs). Good strategy harnesses and empowers an organisation’s natural areas of competitive advantage.

Developing a “Through the Cycle” Business Strategy
A good “through the cycle” business strategy will incorporate a conservative approach to debt and avoid all forms of financial and operational complexity. If one reviews the failures of great organisations, excessive debt and complexity explain the demise of many – especially those in the banking and financial services industry.

“Of the world’s 100 largest industrial companies in 1912, just 19 were in the top 100 by 1995.”

The Art of Strategy

It was written in ancient texts that “for lack of a vision the people will perish.”
As with nations, so it is with companies.
The business schools reward difficult complex behaviour more than simple behaviour, but simple behaviour is more effective.

Warren Buffett
Investor
The next task is to position the company in the right part of the industry value chain, or to diversify across the value chain to be able to manage cost and product pricing volatility. A good example is the energy and power industries. Upstream energy companies are historically more profitable than downstream companies. Power utilities need to manage the volatility of fuel prices (coal, gas, oil), and the volatility in financing costs and tariff regulations.

By studying the cyclical history of an industry one can identify strengths and weaknesses in each part of the value chain as a basis for designing a stronger business model. IBM is a good example of a company which recognised the weakness of its core business as a computer hardware manufacturer. Rapid technological change creates formidable competitive challenges to sustaining leadership in the industry. IBM decided to refocus the company on IT services and built a much stronger business.

Communication: The Achilles Heel of Many Organisations

It has been said that most problems of mankind can be traced to poor communication. Unfortunately, one does not realise the cost of poor communication until the damage is done. At this point the task becomes infinitely harder.

Many leaders view communications as a soft non-essential, rather than the lifeblood that connects every action and activity of the organisation. Great companies are defined by leaders who take the time to craft, own, and lead their communications. Authenticity is prized above all. It is only through this laborious process that something of unique value is created.

Good companies are proactive, acknowledging the two principles of communications, namely:

- Perception is reality
- In a vacuum, people fear the worst

When communications are managed by a company’s lawyers the result is wordy, complex press releases which alienate stakeholders. In today’s world, plain speaking is a rare commodity. The test for good communications is to use language an expert can appreciate and a layman can understand.

Public companies have the challenge of managing shareholder relationships. A communications strategy can add significant value through expressing goals, managing expectations and framing results within the narrative of a company’s strategic plan. Investors react badly to negative surprises. The principle for investor communications is to under promise and over deliver.

“All men can see these tactics whereby I conquer, but what none can see is the strategy out of which victory is evolved.”

Sun Tzu
Chinese Military Strategist
The Science and Art of Organisation and Execution

Few companies have the right people and processes that enable them to excel. Lofty goals sit lamely on PowerPoint presentations, an expression of unfulfilled aspirations and hopes. Building the right teams and processes, the right systems and cultures, takes years. It requires discipline and a commitment to not compromise.

Aligning the Organisation around Goals and Values

Once a strategic goal is set, the CEO’s challenge is to Align, Connect, and Empower (ACE) the organisation around the execution plan and the organisation’s culture and values.

Capital Discipline

Good companies are rigorous in building a culture and process of disciplined capital management. The US energy company Exxon stands out as a company renowned for its capital discipline.

Measuring Performance: The Role of Key Metrics

Intelligent metrics are at the heart of good performance management. If chosen well, they will reflect the value creation drivers and milestones necessary to achieve the company’s goals.

“

The business schools reward difficult complex behaviour more than simple behaviour, but simple behaviour is more effective.

”

Warren Buffett
Investor
Rhythm and Tempo of Innovation and Re-invention
The organisations that succeed are the ones that don’t give up. Success is often built on the ashes of failure. Smart companies undertake regular evaluations and innovate at speed. This “rapid incremental innovation” recognises that winning is made in a daily journey of 1,000 steps rather than a single big leap.

Competitiveness Erodes with Scale
The ability to manage costs is imperative for corporate survival over the long term. All small and medium-size enterprises managed by owner-operators live and breathe competitiveness on a daily basis. Each of these entrepreneurs manages every expense with eagle-eyed discipline. Scale and success, however, bring complexity and create formidable challenges to creating a disciplined cost culture.

Safeguarding Winning Behaviours by Recording the Journey
Great companies usually do a few things extremely well. This competitive advantage is the foundation of the organisation’s success. Often this advantage is a mixture of creativity and discipline. Unique skills integrated with good structure and processes are usually developed during the company’s early years when a passionate founder was struggling to climb their “Everest of opportunity.” During this tumultuous early period when survival, let alone success, was paramount, the company likely also developed the earnest and self-reliant principles, values, and attributes which would contribute mightily to its development. This “soft capital” is as important, if not more so, than the firm’s product excellence.

Years later, new generations of management and the passage of time erode the memory of these powerful and valuable success factors. Slowly, then quickly, the company falters. This is why recording the company’s journey is vital. Good organisations invest in their own permanence by recording their struggles and triumphs. Great leaders across history wrote and recorded their stories. Alexander the Great, Julius Caesar, Augustus, Napoleon, and Churchill are examples. The historical record serves as a playbook for future generations so that good strategies continue and poor strategies are not repeated. Recording and communicating the founding principles, traditions, and values of the organisation create a corporate memory and help to hard-wire those essential and existential elements into the soul of the firm.

Managing the “Hubris Point”
Often, companies that are good at building success are poor at managing success. Their success leads to over-confidence and a loss of discipline. In a blind pursuit of opportunity beyond core strengths and competencies, resources are dissipated in what Jim Collins calls the “undisciplined pursuit of more.”

Recognising and managing this “hubris point” is a difficult challenge as it arrives at the apex of a company’s success – when self-belief is at its greatest. The hubris point is the greatest test of leadership. All who have ascended the heights of great achievement know that managing success is far more difficult than managing failure. Success subtly weakens the moral and psychological defences of integrity, humility, and wisdom. It corrodes good habits and disciplines by encouraging ego, arrogance, inattention, and presumption. This is why right leadership is central to long-term survival. This is a critical challenge for the boards of successful companies.
Performance Management and the Role of Compensation

*Few subjects of corporate management attract as much attention or are as emotionally charged as compensation. Studying the research and reviewing the lessons of history provide a fact-based platform to design compensation policies that align with an organisation’s culture and foster the building of strong, sustainable, and innovative companies.*

**Compensation Does Not Guarantee Survival**

Chief executives believe they are the creators of value and deserve outsized rewards for good performance. Shareholders believe that managers are stewards of shareholder capital and that top executives’ compensation should be fair in relation to the average compensation in the corporate sector.

In the late 20th century and early 21st century, executive compensation increased significantly. The United States in particular gained a reputation for high CEO compensation. When many large financial companies such as Lehman Brothers, Bear Stearns, Citibank, and Bank of America either collapsed or required a government rescue in 2008, public anger was aroused over excessive compensation for failed performances.

It must be recognised that few organisations survive over the long term. The rise and fall of corporations is part of the natural historical flow of the market. When the government steps in with corporate bailouts, this erodes financial discipline and is perceived — with good reason — as nothing more than a transfer of wealth from taxpayers to failed executives.

**The Business of Compensation**

Corporate remuneration practices in the US by the early 21st century had clearly become exceedingly generous. Not only were cash bonuses standard, but also share options, long-term incentive plans, and golden parachutes. Indeed, an industry had developed to advise on corporate compensation. Language was created to express the purpose of compensation (e.g., the need to “align interests”).

Over time, this compensation advisory industry kept ratcheting up executive rewards with increasing complexity. To be competitive, boards would use such advisors to benchmark compensation packages for senior executives. The end result inflated compensation, resulting in public disgust and shareholder anger.

**The Unintended Consequences of Excessive Compensation**

In the vanguard of the compensation game was the financial services industry, whose salaries and bonuses would often consume over 40% of corporate profits. The structure resembles not so much rewards for performance as a joint venture with shareholders. This philosophy was intellectually bereft of justification as, of course, executives took no risk while having a large share of rewards. Shareholders took all the risk, while receiving an inappropriate return on capital.

When the banking industry led much of the developed world into global recessions between 2008 and 2012, not only did shareholders lose, but also the taxpayers who contributed to government directed bank bailouts.

The “post mortem” on this experience drew the unsurprising conclusion that as executives were compensated for profits, but lost nothing in failure, they were incentivised to leverage their institutions in the pursuit of higher profits, stock market valuations, and bonuses. The result was a catastrophe, not only for their companies, but more importantly for national economies that inherited the problems of a highly leveraged household and banking system.
Finding the Right Question: Does Higher Compensation Produce Better Results?

So, what is the purpose and role of compensation? Are executives just rational economic humans who require incentives to produce their best? Is money the sole motivation for performance? Would top managers leave if they received less? Do the companies with the highest compensation produce the best results?

Research suggests not. Indeed, studies show that executive compensation is negatively correlated with performance. It is surprising that this evidence does not encourage greater examination of compensation cultures and practices.

What Motivates Elite Performers?

The truth is that most senior executives love what they do. In the public service, military, and non-profit worlds, we see talented leaders working happily for a fraction of the compensation on Wall Street. Research on the link between material wealth and happiness suggests that wealth affects happiness only up to a certain point of comfort. Beyond this, other factors are more important to creating fulfilment.

Aligning Compensation with Organisation Goals

The challenge for companies is to create and articulate compensation structures that appropriately reward gifted executives for creating strong and sustainable enterprises.

Language Is Important

History teaches us that share prices can be a poor measure of corporate performance over the short and medium term. Too often corporations talk of performance in relation to one quarter, or one year’s financial results. This performance is frequently measured in terms such as profits or return on equity. This can, and often does, create a conflict between short-term financial results and long-term sustainability. Rather than rewarding short-term financial performance, it would be preferable to reward the achievement of goals. Goals can be defined in terms that speak to long-term success and survival. These terms include financial strength, reputation, organisational creativity and innovation, competitiveness, and customer and employee satisfaction.

A Good Compensation Policy Includes a Framework and Principles Anchored in Values and Common Sense

A good compensation framework should rest upon a set of principles which explain the role of compensation in the culture of the company. The framework would set out the elements which the compensation committee, business unit leader, or HR department will use in evaluating performance. This would include both quantitative elements as well as qualitative elements.

The framework’s goal is to reward behaviour that is focused on the long-term success and health of the company. Swiss bank UBS adopted a nine-point framework (including reputation) in 2012 after a series of performance failures. Deferred compensation and compensation clawbacks within three years (if performance falls) also help focus attention on the long term.

Accountability to Shareholders

Recognising the often close and clubby nature of some boards, regulations that empower shareholder oversight for compensation act as a deterrent to excessive compensation.
Of the 30 firms listed on the Dow in 1950, only four (or 13%) survived on the index in 2012: AT&T, Du Pont, GE, and Procter & Gamble.

Moral Capital
Successful companies create social and shareholder value
Compensation: What the Research Says

- Empirical studies have found that CEO pay is negatively correlated with shareholder performance.
- A study by Raghavendra Rau, a finance professor at the University of Cambridge, concluded that the 10% of firms with the highest paid CEOs produced stock returns that lag industry peers over a five-year time span.
- A separate study by professors from Harvard, Yale, and INSEAD found that higher CEO pay relative to other executives (the CEO Pay Slice) was negatively associated with firm value as measured by Tobin’s Q.

- Firms with higher CEO pay have lower industry-adjusted operating income to assets ratio.
- Firms with higher CEO pay tend to make worse acquisition decisions.
- Higher executive pay results in CEO overconfidence and investor over-expectation of firm performance. Both of these factors resulted in subsequent poor performance for the stock.

![Cumulative Excess Returns (%)](image)
Corporate Governance and National Prosperity

Corporations manage a nation’s human and financial capital. Good corporate governance is therefore a critical component of the prosperity equation. Capital and investment amplify the impact of creative ideas and productive labour, accelerating economic development.

Countries with low productivity are often suffering from poor governance and inefficient management. Poor corporate governance practices are often part of a broader economic and social pattern in which entry barriers are high, resources are controlled by a privileged few, and conformity is prized. State-owned companies, oligarchic businessmen with political connections, corruption, hostility to outsiders, distrust, and poor governance all go hand-in-hand and, together, thwart people’s natural spirit of innovation.

The checks and balances that should guide managers to produce respectable returns on investment are missing or are distorted by politics. Corporate leaders are not held accountable by shareholders or regulators. Poor performance, related-party transactions, and opaque financial reporting are tolerated. Setting high standards of corporate governance should therefore be an important goal for a country’s economic policy makers.

Good Governance Improves Corporate Performance

How do we know that corporate governance matters? After all, investors with capital to allocate consider many factors – the size of the company, its earnings prospects, the outlook for the sector, the macroeconomic environment, and the yield on alternative investments such as bonds. But empirical research shows that corporate governance impacts investment decisions. In a landmark study published in 2003, Harvard Economist Paul Gompers distinguished between companies that are run as “democracies,” welcoming shareholder participation, and companies that are run as “dictatorships” by top management. Professor Gompers found that the share price of democratic companies outperformed dictatorships by 8.5% per year over a ten-year period.

Harvard Law Professor Lucian Bebchuk repeated Gompers’ study in 2010, focusing on shareholders’ rights to vote and approve mergers. Between 1991 and 2008, companies that included shareholders in decision-making had higher valuations and also achieved higher returns on their assets, faster sales growth, and higher net profit margins. Transparency and shareholder democracy helped to impose financial discipline and improve performance.

A Deutsche Bank study of 350 listed UK companies found that the best-governed companies had an average return on equity (ROE) of 15.9%, while the worst-governed companies had an average ROE of only 1.5%.

Benefits of Good Corporate Governance
Corporate Governance and Innovation

Creativity and innovation drive the 21st century economy. Which countries are the world’s best innovators, and why? One way to measure innovation is to look at how much revenue a country receives from exporting ideas — that is, royalties and licensing payments. By far, the countries most successful at selling their ideas abroad are Sweden, Singapore, and the United States. Japan falls quite far behind. China and the Republic of Korea both export lots of goods, such as computers and personal communications devices. But when it comes to exporting ideas, such as software, games, and entertainment content, China, Korea, and also Russia have made little headway.

Why are some countries more successful innovators than others? One factor might be education. But education levels in the leading ideas exporters are about the same as in the less successful countries such as the Republic of Korea, Russia, and Poland. However, the successful ideas exporters do have one thing in common: low levels of corruption and good corporate governance. We usually think of corporate governance in the context of large, established companies. But good corporate governance also contributes to innovation. Investment capital turns new ideas into products. All the great creative firms such as Apple, Google, and Disney are partnerships between gifted innovators and the investors who finance them. Silicon Valley was founded by the Dean of Stanford University’s School of Engineering as a venue for students to work with investors on commercialising their ideas.

If investors are few and far between — as they are in countries that mistreat shareholders — innovators have nowhere to go with their ideas.
Well Governed Companies Are “IQ Magnets”
Innovators need a flourishing economic environment with supportive social capital. Talent in the 21st century is more mobile than ever before. As social historian Richard Florida has documented, well-educated and creative people are willing and able to move across countries or around the world to find an environment that suits them. They are looking for communities, neighbours, colleagues, and – above all – workplaces that embrace openness, fairness, and opportunity. Companies with strong values and good governance become, in Bill Gates’ words, “IQ magnets” while talent “emigrates” from their moribund and opaque competitors.

Good Corporate Governance Reduces the Cost of Capital
The availability and cost of capital directly correlate to the quality of a country’s corporate governance standards. This can be a significant competitive advantage. Countries whose corporate sector operates under high governance standards improve both their access to and cost of capital.

Studies confirm that good corporate governance is rewarded with lower costs of capital. Economists Luzi Hail and Christian Leuz researched firms in 40 countries over a ten-year period. The average cost of capital was about 12% per year. But in jurisdictions with rigorous disclosure requirements, companies paid about 1.1 percentage points less. Companies in countries where securities laws are reliably enforced enjoyed even lower costs of capital – by about 0.7 percentage points. And companies in countries where investors can use private redress such as litigation to recover losses saved by another 0.7 percentage points. In other words, good corporate governance reduced capital costs from about 12% per year to about 9.5% per year on average. Extended over many companies and several years, this indicates billions of dollars in savings.

“I strongly believe that an efficient securities market and a high standard of corporate governance can do wonders for developing, emerging and transition countries.”
G.N. Bajpai
Former Chairman of the Securities and Exchange Board of India
Good Governance Is Rewarded by Investors

Companies with good corporate governance and a track record of value creation are rewarded with high stock market valuations and easy access to low-cost capital. Those with poor governance, opaque practices, and a history of capital inefficiency are shunned by investors.

University of Chicago Professor Christian Leuz looked at corporate governance from the point of view of investors, reviewing American shareholdings in 4,409 firms in 29 countries. On average, Americans held about 6% of the shares in the foreign companies. But they held substantially fewer shares in companies where a family or management controlled more than 30% of the stock – especially if those companies were located in countries with weak shareholder protections.

Investors often shun developing markets because they worry that insiders will divert corporate wealth for themselves. “Selfdealing” transactions can take the form of excessive compensation, non-cash perquisites, transfer pricing, self-serving financial transactions and outright theft. A study led by World Bank Economist Simeon Djankov reviewed 72 countries in 1999–2003. Djankov found that meaningful protections against self-dealing added substantial value to stock market capitalisation and also increased the value of capital-raising public offerings.
Corporate Governance and Investment Flows

A high stock market capitalisation benefits not only companies, but entire countries. When a market is highly valued, it is a source of wealth for domestic shareholders and corporations can easily raise capital on the international markets. However, international investors over the past decade have become aware of corporate governance risks. Failing to tackle inadequate corporate governance regulations and enforcement mechanisms is becoming more and more costly. Russia is an unfortunate example.

Russia’s leaders started with good intentions. In 1995, President Boris Yeltsin appointed a securities regulator with ministerial status and the parliament passed a law on Joint-stock companies with solid protections for shareholders. But powerful insiders were more interested in acquiring wealth for themselves than growing the stock market for everyone. The ink was barely dry on the new laws before they were flagrantly violated, and the Russian government refused to step in.

Many early pioneers of Russia’s stock market lost their investments to corporate theft and institutionalised fraud. Top managers used transfer pricing and related-party deals to strip cash out of publicly-traded companies like Gazprom and Novolipetsk Steel. Dubious legal proceedings were used to nationalise Yukos, Russia’s most profitable oil company. Investors who protested faced retaliation in various forms – some were barred from shareholders’ meetings, others saw their holdings diluted by new share issues, and some were physically threatened.
The main victim of Russia’s chaotic market was the economy as a whole. Russian stocks traded at price-per-earnings valuations almost 60% below their peers in other emerging markets. Global investors, especially managers of pension fund money, avoided Russia. And Russians themselves had little confidence in their own economic future. A 2008 survey found that one in every four Russians between the ages of 18 and 24 wanted to emigrate. Between 2008–2012, Russians moved $340 billion out of the country in capital flight – an amount roughly equal to Russia’s annual state budget.

Special corporate governance problems arise in economies like Korea and Japan, which are dominated by financial-industrial conglomerates. These oligopolistic structures conceal overlapping ownership interests and intra-group financial transactions, making it impossible for outside investors to evaluate the publicly-traded component companies. Like state-owned companies, conglomerates tend to chase expansion and market share rather than profitability. Since they have trouble raising equity investment and lack shareholder oversight, they accumulate too much debt. These problematic conglomerates, known in Korea as chaebols, have been known to accumulate debt-to-equity ratios well over 400%.

The chaebols’ undisciplined behaviour brought Korea to the brink of bankruptcy in the 1998 financial crisis. Since then, the Korean government has taken steps to reform them. They were ordered to lower their debt-to-equity ratios, switch from historical cost to market-based accounting, and consolidate their accounts. Members of a single group were barred from guaranteeing each other’s debts. And the ceiling on foreign ownership was raised from 13% to 37%.

Although the Korean reforms reined in some of the chaebols’ excesses, they left the fundamental structure of the Korean economy intact. History shows that investors will continue to avoid countries like Korea where corporate ownership is highly concentrated and poor transparency is the norm.
Separating Chairman and CEO Roles
To create proper oversight and avoid boards becoming informal clubs unwilling to challenge strong personalities, a strong non-executive chairman can add significant value.

Board Composition: Industry Competence and Commercial Common Sense
Quality boards combine leadership and industry expertise with broad-based commercial wisdom. Research has shown that the presence of women on boards is positively correlated with corporate performance. While social responsibility is important, social representation can create confusion and loss of business focus.

Independent Non-Executive Directors
The non-executives must be independently minded and comfortable challenging executives on goals, strategy, and performance. Simply having a majority of outside directors on a board does not mean that the individuals are necessarily independent of management.

Annual Election of Directors
The election of directors to a company’s board should be conducted on an annual basis thus allowing shareholders to review performance.

Accountability for Leadership Performance is the Board’s Key Responsibility
Does the board hold the CEO accountable for the financial and moral vitality and performance of the company? Is there an intolerance of excuses for failure? Is the company built to last? Has the CEO developed a credible succession plan? Do the company’s culture, values, and language align with sustainable value creation through constant innovation and competitiveness?

Communicating Strategic Vision and Goals
A fundamental measure of a company’s transparency is the rigour with which it addresses its shareholder relations. Good corporate leaders communicate their business vision, objectives, and performance metrics in order for shareholders to be able to monitor and evaluate progress.

Capital Stewardship
Managers who invest for scale rather than profitability allow capital to stagnate in unproductive enterprises or hoard capital without a clear need, depriving other productive enterprises of this valuable resource. The best corporate managers are those who realise that capital must be utilised to generate appropriate returns or given back to shareholders.

Reporting Performance
Management has a fiduciary duty to provide shareholders with timely, accurate, and complete financial reporting which reflects the company’s performance and financial condition.

Dividend Policy
A company should have a clearly stated dividend policy. Shareholders fairly expect that an appropriate portion of the company’s profits should be returned each year through regular and tax-efficient dividend payments. The dividend should be commensurate with the company’s profitability and capital investment needs. Shareholders are the company’s owners and dividends are the fair reward for the capital invested and risks undertaken.

Executive Compensation Aligned with Long-Term Prosperity
Remuneration should be determined by a compensation committee made up of outside directors. Rewards must be commensurate with an executive’s contribution to the long-term prosperity of the company. Dilutive stock options, excessive bonuses, and unjustifiable severance terms are inconsistent with thoughtful compensation principles.
Corporate Values and Code of Conduct
A statement of corporate values gives shareholders, employees, consumers, and society an understanding of the company’s philosophy, essence, and moral principles. Does the company have a code of conduct that sets out the ethical standards by which it operates? Breaches must be dealt with quickly and transparently, thereby demonstrating integrity and accountability for actions.

Related-Party Transactions
Transactions between related parties or divisions of a business group should be overseen by a subcommittee of the board of directors. There should be board approval for any transaction above a certain value, commensurate with the scale of the business, sector, or market.

Separating Business and Politics
Independence is a valuable asset. Reputation is even more valuable. A good way to maintain independence and retain reputation is to create a healthy distance from politics. Funding political parties crosses this boundary.

Corporate Social Responsibility
A company has a responsibility for nurturing and protecting the physical, economic, moral, social, and regulatory environment in which it operates. Compliance with laws and regulations should be viewed as a minimum standard.

Shareholders’ capital should not be used for philanthropic purposes. Sometimes managers attempt to burnish a reputation for poor social responsibility or weak ethics by giving away shareholders’ money to charitable causes. Companies must act responsibly as employers and members of the communities where they operate. But excess capital belongs to shareholders to use as they see fit.

Democratic Capital Structure
Capital structures with a single class of shares enshrine the principle of “one share, one vote.” This concept is fundamental to shareholder democracy and ensuring management accountability.

Ease of Shareholder Participation
The opportunity must exist for shareholders to easily express their views on the management of a company. The primary avenues to exercise this voice are the company’s annual general meeting and extraordinary general meetings. There must be no impediments to shareholders’ ability to exercise their democratic rights.

Share Issues and Pre-Emption
Any new equity hikes should be offered first to all shareholders in proportion to their existing ownership interest.

Anti-Takeover Measures
A company should not enact anti-takeover provisions which entrench management and undermine shareholder rights and shareholder value. The value of the company should be determined by the market, without interference from management through poison pills or other defensive devices.

Maximising Liquidity
A company’s shares should trade on the stock exchanges that provide the greatest liquidity for shareholders.
The Clermont Group’s Principles of Good Corporate Governance are:

1. Commerce and capital are based on trust. Capital will naturally flow to markets where there is a fair and impartial application of just laws. Governments have a responsibility to create a trust-based economy that protects investor property rights through the rule of law being applied without discrimination.

2. Good corporate governance rests on the Cardinal Principles of integrity, transparency, and accountability.

3. Prosperity flows from a partnership among shareholders, management, customers, and regulators. Management’s role is to create long-term shareholder value as well as social value through the productive use of capital and resources in an ethical manner.

4. Management has a social responsibility to respect and nurture the physical, economic, moral, and social environment within which the company operates.

5. Shareholders are owners. They must have the attendant rights and responsibilities of ownership. A company’s structure should be based on the principle of “one share equals one vote.” Shareholders are responsible for electing the board of directors which, in turn, appoints the company’s management. Responsible shareholders provide oversight of management’s performance.

6. Good regulations support the Cardinal Principles. They enable shareholders to exercise their oversight responsibilities without burdensome and impractical rules and procedures.

7. Management is accountable to shareholders for the productive use of the capital entrusted to them and for their financial and ethical performance.

8. Capital is a valuable resource which must be prudently managed. When management cannot deploy capital productively in the business, it should be returned to shareholders.

Good corporate governance is based on management integrity, shareholder democracy, and a legal system where just laws are applied impartially.
“You cannot escape the responsibility of tomorrow by evading it today.”

Abraham Lincoln
Sixteenth President of the United States
Responsible Investors Provide Oversight
Intelligent Investors Are Responsible Owners

Few would disagree that investors have a duty to earn the highest return possible for a given level of risk. Conventional wisdom has it that macro-economic, industry, and company-specific fundamentals determine a stock’s performance. As a result, investment managers often focus their resources and efforts exclusively on these areas, losing sight of the fact they are also owners of businesses.

Good corporate governance, for which owners have ultimate responsibility, results in better-performing stocks. If investors have a duty to earn the highest return possible, do they not then also have a duty to be responsible owners of the businesses in which they are invested? Indeed they do. Intelligent investors understand this.

The Investor’s Role

A responsible owner recognises that, despite the costs attendant in exercising oversight of the companies in which they invest, it is in their interest to ensure the long-term health of these companies. Well-governed companies perform better – dramatically better – over the long-term. This means that investors who make the effort to improve governance in the companies in which they invest will themselves do better over the long-term.

The Absentee Owner

Just how important is responsible ownership? Important enough that Adam Smith raised the alarm concerning the ability of companies with broad shareholder bases to avoid corruption and protect the small investor. Much has changed since Smith’s day, but the fundamental point remains: good corporate governance is not something that occurs naturally. It is something that occurs only in the presence of responsible ownership. Smith worried that with owners too scattered to be responsible, “negligence and profusion” would prevail.

As ownership of public companies becomes more fragmented over time, individual shareholders have tended to abdicate their vital oversight role in holding boards of directors accountable for their financial and ethical actions. This lack of oversight is all too evident in the phenomena of excessive executive compensation, anti-takeover provisions, and related-party transactions.

Capital and investment are the fuel of creative enterprises. The successful allocation of these vital resources assists in financing industry and government, creating employment, reducing poverty, and providing opportunities for individual growth and fulfilment. Investors have a duty of stewardship which requires vigilance in overseeing the companies they own.
Shareholder Democracy

When shareholders invest in a company, they are entrusting their capital to the directors of that company. The shareholders are the company’s owners and each and every shareholder has a voice in how that company is run. This is expressed through a right to vote at the company’s annual general meeting and extraordinary general meetings. Through their votes, shareholders play a vital role in electing the most competent and ethical leadership to the company’s board of directors, which then appoints the company’s management.

The relationship between shareholders and management is also governed by law, which defines shareholders’ rights and management responsibilities. The voting rights of each investor should be equal to the number of shares owned.

This guiding principle of “one share, one vote” is central to both management accountability and shareholder democracy. When preferential treatment is shown towards certain shareholders, or the rights of others are constrained, the bedrock of shareholder democracy is compromised, creating opportunities for injustice, capital misallocation, and fraud.

Responsible Investors Provide Oversight

As history shows, strong regulations are not enough to promote good corporate governance. Responsible shareholders are crucial to good governance. They are best positioned to ensure management accountability for financial and ethical actions.

Intelligent long-term investors will engage in corporate governance issues as an intrinsic and necessary component of prudent investment management. This may require investors to challenge corporate leaders on operating principles or strategic direction. This is often called shareholder activism, but that implies something exceptional. Responsible ownership is a more accurate term.

“The price of greatness is responsibility.”

Sir Winston Churchill
Former Prime Minister of Great Britain
Activist Investors Initiate Change

“Activist investor” is a label given to private equity firms, hedge funds, and other investors who use their equity position in a company to influence the firm’s management. Activists may seek to persuade a company to return excess cash on its balance sheet to shareholders, replace a member of the company’s board, or shift the firm’s strategy.

Steadily growing in size and number and predominantly located within the United States, activist investors have targeted some of the largest companies in the global marketplace – inspiring a leadership change at Procter & Gamble in 2013, and Apple to buyback more than US$ 140 billion of shares in 2015. Their influence is without doubt and unlikely to fade. But there is regular and lively debate between market participants and commentators as to whether activists are a force for good for the businesses in which they invest, and the broader economy in general. Some argue that responsible activist investors can provide a much-needed check on business leaders, holding them accountable for their decisions and capital allocation. Others contend that activists reinforce short-termism and excessive attention to financial metrics, holding companies hostage with their demands, which are almost always stated publicly.

Activists as Responsible Stewards

Ensuring that shareholders’ rights and interests are heard and acted upon, activists can create positive change in a manner that passive investors often cannot, or simply will not. Effective campaigns by responsible investors have led to improved corporate governance, greater transparency within a business, and more efficient capital allocation. These activists work to be collaborative instead of combative. Their interest lies in the long-term strength of the business rather than its quarterly earnings. Studies conducted by researchers at Duke, Columbia, and Cornell universities suggest that activist investors often help make firms more efficient and innovative, playing a positive role not just in the company but also the broader marketplace as well.

Activists as Self-Interested Investors

Operating under the same “activist investor” banner but with a different set of values and objectives, other investors pursue short-term profits at the expense of the long-term health of a business. Seen through this lens, activists work aggressively to induce actions inimical to shareholders’ best long-term interests. Some do this by pressuring management to strip cash and assets from a company, or raise cheap debt to buy back shares. Others may call for spending in research and development to be slashed, or business units to be sold. After enjoying a quick spike in the company’s share price, the activist sells their position at a profit, and departs with little concern for the long-term effects on company.

Responsible Stewardship is a Question of Intent

These differing views highlight just how misleading and dangerous it can be to paint all activists with the same brush. Distinguishing between responsible and irresponsible actors is challenging and often subjective – the wisdom of an action often becomes clear only in retrospect. The role of the responsible investor, regardless of the label they are given or the market in which they operate, is to ethically and patiently work to serve not just their own interests, but those of the broader shareholder base and the company itself.
Responsible Investors and the “Law of the Farm”

To achieve long-term prosperity, we must invest for the long term. As a farmer must spend time each year ploughing his fields for a better harvest, so must investors take responsibility for the markets in which they invest. This is known as the “Law of the Farm” and is based on the ancient principle that we reap what we sow.

Every farmer knows that if his farm is to become more productive, he must invest something back into the land – it is not enough to strip off the low-hanging fruit and then move on. Yet, while no rational farmer would ravage his orchard in this way, participants in financial markets often have a short-term focus which takes no account of their actions on the companies or markets with which they invest or trade.

We frequently see a marked reluctance by participants in financial markets to work to improve the very markets which provide their livelihood. Why?

Reinvesting in the farm appears, to many people, to be time-consuming and thankless, requiring significant short-term costs. To the untrained eye, it may appear that the diligent farmer is merely “collecting rocks” as he patiently removes the obstacles to long-term productivity from his fields. In fact, he understands that doing this work today will bring reward tomorrow.

In addition, the farmer knows that the better and less volatile his marketplace, the more he is likely to gain. Investing time and capital in improving corporate governance, even if it benefits others more than it benefits ourselves, is vital to creating a more successful common future.

At the Clermont Group, we believe that every participant in the financial marketplace has an interest in addressing and resolving the impediments to the proper functioning of the market. We each have a common interest as “co-owners” of the market to take care of our shared “farm.”

That is why, when we invest in companies and capital markets, we take a long-term view. Like the proverbial farmer, we take care to remove the “rocks” that impede the long-term prosperity of the marketplace. This may include identifying structural impediments to capital flows, encouraging efficient capital allocation, or uprooting the weeds of corporate fraud.

The Clermont Group believes in investing in our shared economy, building long-term prosperity for all who depend on the market “farm” for their economic welfare, whether individuals, companies, or nations. It is a matter of common sense. If you want the farm to take care of you, you must take care of it. We must all play our part in ensuring the ethical functioning of financial markets, which provide the lifeblood of capital so vital to our national economies and individual prosperity.
Leading Reform at Novolipetsk Steel
In the mid-1990s, Sovereign acquired 25% of Novolipetsk Steel (NLMK). With 41,000 employees and revenues of $2 billion per year, Novolipetsk was a jewel in the crown of the new Russian economy. The company produced hot and cold-rolled steel, as well as value-added products such as cold-rolled steel sheet, electrical steel and other speciality flat products. Thanks to its low raw material costs and modern production technologies, Novolipetsk was one of Russia’s leading exporters.

Between 1995 and 1996, however, Novolipetsk’s profits declined by 90%, from $480 to $40 million. Sovereign learned that the company’s management was diverting profits away from shareholders and the tax authorities. The practice, common in Russia at the time, was called “tolling” – an arrangement in which metal products are sold to an offshore trading company at below-market prices. In effect, tolling was a way to siphon profits out of Russia.

Sovereign responded by creating a reform group with other foreign investors, advised by Salomon Brothers. Sovereign pressed for board representation for minority shareholders and an independent audit of the steel mill. Sovereign’s campaign drew international attention.

Sovereign made legal history by winning a string of landmark decisions against Novolipetsk, including a decision confirming the right of minority shareholders to board representation. However, it proved difficult to enforce the courts’ ruling. Novolipetsk retaliated against minority shareholders with a dilutive share issue and Sovereign was forced to divest its stake.

Despite the mixed results at Novolipetsk, Sovereign demonstrated that corporate governance standards could be upheld even in a turbulent and troubled country like Russia in the 1990s. Sovereign’s activism also intensified scrutiny of tolling arrangements, which have now virtually disappeared from the Russian economic scene.

Richard Chandler and his brother Christopher were the principals of Sovereign Asset Management from 1986 to 2006. During that time, Sovereign worked to promote good corporate governance in challenging environments.

The [NLMK] legal battle... is part of a wider struggle to establish and enforce the concept of shareholder rights in Russia’s half-formed market economy.

John Thornhill
Financial Times, 1997
Improving the Investment Environment in Russia

In 1998, the Russian government defaulted on its domestic debt obligations, sending a shock wave through global financial markets. At the same time, Russia allowed the rouble to fall 70% against the dollar. Although Sovereign had sold its own Russian debt holdings long before the default, concerns remained about the impact of the crisis on Russia’s fragile new market economy. Devaluation had wiped out savings across the country. Major Russian financial institutions were on the verge of bankruptcy. Russians were experiencing a crisis of confidence in the very idea of a market economy.

Prosperity International, the research division of Sovereign, analysed Russia’s situation in a paper entitled Russia – Seven Steps to Prosperity. The paper outlined the practical steps that Russia needed to take to improve its investment climate, accelerate reforms and strengthen its economic outlook. The paper was circulated among the Russian Parliament, the International Monetary Fund and several major investment banks. In 1999, it was incorporated into the Party Platform for the “Our Home is Russia” party, led by former Prime Minister Victor Chernomyrdin.

In April 1999, Sovereign hosted a landmark conference to discuss how to rebuild Russia’s capital markets. Conference participants, including investment banks and representatives of Russia’s leading broker-dealer association, took on a number of projects to improve transparency and corporate governance at Russian companies. For example, shareholder coalitions were organised to press for improved accountability at the energy giants Mosenergo and Unified Energy Systems. With Sovereign’s encouragement, Moscow-based investment banks added corporate governance reports to their research coverage of Russia.

Gazprom: Reforming a Giant

When Sovereign invested, Gazprom was the largest company in Russia and one of the largest in the world. It produced 19% of the world’s natural gas and owned 6% of the world’s reserves. Sovereign began investing in Gazprom in 1994 and remained a shareholder of Gazprom for a decade.

Despite its vast assets, Gazprom was a company in trouble. In 2000, eight years after its creation, Gazprom had amassed $9 billion in debt and $2 billion in tax arrears. It had posted two consecutive years of losses and its market capitalisation was only $6.8 billion.

Gazprom’s management, which was composed mainly of holdovers from the Soviet-era gas ministry, had a reputation for being incompetent and even corrupt. Careful study of the company’s accounts revealed that profits were being diverted to a little-known gas trader called Itera. An audit by the Russian parliament found that Gazprom had issued hundreds of millions of dollars in unexplained loans, mostly interest-free. The Russian press reported that overpriced pipeline construction projects were being awarded to friends and relatives of company insiders.

In 2000, Sovereign supported UFG and other minority shareholders in appointing Boris Fyodorov, Russia’s well-respected former minister of finance, to the board of directors of Gazprom. UFG, a Moscow-based investment bank founded by American Charles Ryan and Boris Fyodorov, led a campaign to improve corporate governance at Gazprom for many years. This was the first time that an independent director was placed on the board of a state controlled company in Russia. Fyodorov’s ascension to the board was a turning point in the battle for reform at Gazprom and in Russia. Responding to the Russian government’s expressed interest in liberalising Gazprom’s ownership structure, Sovereign also prepared a series of recommendations on how the ownership structure could be reformed.

By taking principled and well-publicised positions regarding corporate governance at Novolipetsk Metal, the Chandlers advanced the level of dialogue and understanding regarding shareholder rights in Russia.

Jim Dannis
Head, Eastern European Banking,
Salomon Brothers
However Gazprom’s management resisted further reforms. They blocked minority shareholder’s nominations to the Board of Directors in 2001 and had a significant block of voting stock frozen on spurious claims.

In 2001, after continued efforts by minority shareholders to improve corporate governance and bring greater transparency to the company, the Gazprom board replaced CEO Rem Vyakhirev with Alexei Miller. With the ousting of the old guard, Gazprom began to modernise. The company’s stock was listed on Russia’s main stock exchange and progress was made on liberalising domestic gas rates. Gazprom began to recover assets that had been transferred for a fraction of their value to parties believed to be connected to the former management team.

Sovereign continued to address and promote governance at the company, producing papers entitled *Gazprom: Managing for Growth* (2001) and *Russian Gas Tariff Reform: From a Spark to a Flame* (2002). In 2003, Sovereign met with CEO Miller to discuss reforms at the company. A joint press release by Sovereign and Gazprom affirmed their mutual commitment to improving governance standards.

Although progress in reforming Gazprom was slow and uneven, the company is a far cry from the loss-making, corruption ridden entity of the 1990s. As of 2015, Gazprom had a market capitalisation of $49 billion and its 2014 profits were just over $4 billion.

“Sovereign Global...is well known among the emerging markets community for pressing for shareholder value and better governance.”

Vladimir Lisin
Chairman of NLMK’s Board of Directors
*Barron’s*, 7 March 2005

“Sovereign’s unwavering support as a long-term shareholder has played a major role in the development and introduction at Gazprom of higher corporate governance standards. This, in turn, has helped Gazprom to reinforce its position among leading international energy companies.”

Alexei Miller
CEO, Gazprom

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SK Corp: Changing A Culture

In 2003, Sovereign acquired a 14.9% interest in SK Corp, one of Korea’s largest industrial groups. With 30,000 employees, SK Corp had interests in chemicals, petroleum, energy, construction, shipping, and communications.

Shortly before Sovereign purchased its stake, SK Corp had been shaken by scandal. The Chairman, Chey Tae-Won, and nine other executives were charged with a $1.2 billion fraud at an affiliated company, SK Global. Eventually, all were convicted. SK Corp’s share price fell to an 18-year low.

Sovereign saw its SK Corp investment as an opportunity to promote a new vision of business practices in Korea – a vision of companies run by ethical leaders, where capital was allocated efficiently and where shareholder rights were respected by management and protected by regulators.

Sovereign highlighted the principles of good corporate governance through dialogue and national advertising. In 2004, a multi-million dollar national advertising campaign entitled *Stand Up! Korea* was developed as part of a programme to promote ethical business leadership and address the “Korean discount” – the reason why companies in Korea often trade on the stock market at significant discounts to their international counterparts.

Sovereign pushed SK Corp to cut its debt and issue monthly financial reports. It also offered to help the company develop stronger internal audit controls, a capital expenditure policy focused on return-on-equity, and a code of ethics. Sovereign emphasised the importance of Board oversight, telling SK Corp that: “Only a board which represents the interests of all shareholders and adheres to international standards will be a positive force for change in Korean business.” Together with other minority shareholders, Sovereign nominated five well-respected and independent Korean nationals for the board of directors. However, only one was elected.

To Sovereign’s disappointment, SK Corp’s discredited chairman was released on bail and allowed to return to the helm of the company. An attempt by Sovereign to bar convicted criminals from the SK board failed in the Korean courts. To this day, there has never been a full investigation into the 2003 fraud and no attempt has been made to recover the company’s losses.

Sovereign’s high-profile reform efforts made corporate governance a national issue in Korea. The discussion and awareness Sovereign generated contributed to reforms in many other progressive Korean companies, and helped inspire a greater focus on holding senior business leaders accountable for their actions. In 2013, Chey Tae-Won was given a four-year prison sentence for embezzlement – a decision upheld by South Korean courts in 2014.

“Of all the benefits, direct or indirect, brought to Korea by Sovereign, the most important is the understanding that the owner of a company is its shareholders... The ‘Sovereign effect’ is concretely measurable at shareholders’ meetings across Korea, where it is no longer a rarity to see outside shareholders voice their objections to proposals by company management or confront chief officers with questions.”

Professor Kim Wi-Saeng
The Graduate School of Management
at the Advanced Institute of Science and Technology Daejeon, The Republic of Korea

“The Chandler brothers contributed greatly to Korea by raising the awareness of corporate governance and provided an impetus for big companies to change.”

Seo Jae Hyeong
President of International Investment Advisors

Sovereign’s corporate governance campaign in South Korea included national advertising on the value of transparency.
If you want to rise to the fore...

Look up.
Think about.
Try out your conclusions.
Believe in yourself.

Shahidah Chia
www.jw.com

If you want world acclaim...

Shake your hand.
Stamp your feet.
Scream your name.

Shahidah Chia
www.jw.com

To make a flower blossom...

To make a beautiful flower bloom, a root must be planted deep in the earth and a constant supply of water must be provided.

Shahidah Chia
www.jw.com

Not a speck of dust...

When it is truly your turn, it will stand out more than before. This is, if you were once in some other place.

Shahidah Chia
www.jw.com
The strength of the nation derives from the integrity of the house.

Confucius
National Leadership Sets the Stage for Prosperity
The Character of National Governance
National leaders with clear visions, consistent policies, pragmatic regulations, and strong values build trust. Confidence attracts investment and stimulates entrepreneurship and creativity. Conversely, governments whose leaders lack strong principles and moral courage create uncertainty, increasing the perception of risk and raises the cost of capital. National trust is ultimately a reflection of the character of national governance.

Laws and rules are one thing. Compliance standards can be something completely different. Some countries have strong compliance cultures and others extremely weak. Sometimes the laws are not applied, not applied fairly or consistently, or are subverted by bribes. Often, outdated or poorly-designed regulations, complex procedures, and bureaucratic inefficiency undermine and deter compliance.

National Leadership Establishes the System of Economic Opportunity
National leaders define their country’s model for economic value creation. Prosperity is built by fostering entrepreneurship, innovation and social mobility. Good leaders encourage entrepreneurship through regulations and institutions that ensure equal opportunity for all. In well-governed societies property rights are protected, the rule of law is enforced, and the justice system is both effective and impartial.

As the individual reaps what he sows, so the nation, being a community of individuals, reaps also what it sows. Nations become great when their leaders are just men; they fall and fade when their just men pass away. Those who are in power set an example, good or bad, for the entire nation. Great will be the peace and prosperity of a nation when there shall arise within it a line of statesmen who, having first established themselves in a lofty integrity of character, shall direct the energies of the nation towards the culture of virtue and development of character, knowing that only through personal industry, integrity and nobility can national prosperity proceed.
State Ownership of Business Undermines Competition and National Competitiveness
In countries where the economy is dominated by large state-owned enterprises, there will be fewer opportunities for entrepreneurs. Competition will be limited and business efficiency poor, resulting in higher prices for consumers and reduced national competitiveness. In this system, a culture of risk-avoidance undermines innovation and economic vitality.

Excessive State Capitalism Encourages Capital Misallocation and Malinvestment
History teaches that no nation ever built and sustained its economic strength through state capitalism. The simple reason is that national resources are poorly invested when managed by unaccountable civil servants. High levels of corruption are often found in state capitalism.

The Dangers of a “People, Power and Politics” Model
Often, to the detriment of society as a whole, a country’s economic opportunities are monopolised by well-connected business groups. All kinds of countries – whether wealthy or poor, free market-based, or state-oriented – can fall into this trap. Politicisation of economic life suffocates innovation, entrepreneurship, and competitiveness. Talent emigrates to societies with more social mobility and economic freedom. The long-term consequences for the economy are severe.

This type of economic model is defined by what we call a “people, power and politics” culture. In such societies an inner circle of politically influential elites, tribes, or oligarchs control disproportionate economic opportunity, assets and wealth. When political leaders and their associates dominate economic life, who you know is more important than what you know. Ambitious business people compete for political patronage instead of competing to develop better products, invent new technologies, and lower production costs. Financial capital and management time are spent on nurturing relationships while productive investment is neglected. The results are corruption, wasted resources, capital misallocation, unfair competition, and lower economic competitiveness.

Social Mobility Creates Political Legitimacy
The ultimate test of a national leadership is its ability to build national prosperity and social mobility for its citizens. Social mobility is the opportunity and ability of any citizen to elevate themselves through creativity, hard work, and integrity. Open, transparent, and meritocratic societies provide equal opportunities for individuals and companies to climb the ladder of success. Competition, creativity, innovation and entrepreneurship are rewarded. Advancement is based on what you know rather than who you know. Where principles, productivity and performance are valued, entrepreneurial creativity is unleashed, resulting in broad based and inclusive prosperity and well-being. This dynamic, in turn, fosters political legitimacy and national respect.
Corruption Perceptions Score

0 = Most Corrupt
100 = Least Corrupt

Sources: World Bank Dataset (2016); Transparency International,
Corruption Perceptions Index, (2016).
INNOVATORS NEED A POSITIVE INVESTMENT ENVIRONMENT

Innovation Index

Corruption Perception Score
0 = Most Corrupt 10 = Least Corrupt

Corporate Transparency Score
0 = Low Transparency Requirements 1 = High Transparency Requirements

*The Innovation Index is the revenues the country receives from international payments of royalties and licensing fees (exports) as a proportion of GDP.
Trust and Transparency: The Oxygen of Fair and Efficient Markets

Capital and investment are the lifeblood of healthy economies. For capital to be available to those who need it most and use it best, it requires a fair and efficient marketplace. Trust is the foundation upon which the capital market stands and therefore determines both the availability and price of capital. Legislators, regulators, and the judiciary are charged with creating and enforcing the regulations which create trust and transparency.

Trust: The Importance of Confidence and the Cost of Uncertainty

Capital is like water. It irrigates ideas and nourishes innovation. Just as technology is based on scientific laws, capital and investment are influenced by economic and moral laws.

Trust and transparency are the oxygen of economic activity. They are the invisible glue that binds trade and commerce. What creates trust? It is the framework of legal, social, economic, cultural, and political rules, codes, and traditions that shape relationships in a society.

All Equal Under the Law

When a nation’s leaders and institutions create an ethical, trust-based society founded upon the rule of law, they lay the foundations for long-term prosperity for their nations. It is no coincidence that the richest countries in terms of GDP per capita have the lowest levels of corruption.

A distinguishing feature of a strong economy is not that it is free from corporate wrongdoing, but that it ensures accountability for wrongdoers and certainty of justice for all market participants.

Corruption Robs Nations

Corruption depletes national wealth. Corrupt politicians invest valuable public resources in projects that will benefit themselves rather than the communities they serve. Corruption also hinders the development of fair market structures and distorts competition, which in turn deters investment.

A striking example is the resource-rich country of Nigeria. Nigeria is the largest oil producer in Africa and among the world’s top five exporters of liquefied natural gas. Despite its oil wealth, 61.2% of the population lives in absolute poverty. Nigeria ranks 32nd from the bottom out of 167 countries evaluated in the Corruption Perception Index published by Transparency International. It is estimated that corruption has cost the country over $112 billion in 2014. If corruption remains at present levels, the cost of corruption would amount to almost $2,000 per person each year by 2030.
“The only stable state is the one in which all men are equal before the law.”

Aristotle
Greek philosopher
The Role of Regulators and Institutions

"Property must be secured, or liberty cannot exist."

John Adams
Second President of the United States

What Makes a Good Regulator?

A good securities market regulator has balance, foresight, and flexibility. Balance is needed to weigh the preservation of free market competition against the importance of protecting investors. Regulators must police fraud and negligence. But intentional malfeasance must be distinguished from errors and business judgments that were made in good faith. Heavy-handed or onerous regulations can make it hard to raise capital, forcing companies to turn to foreign markets with more balanced regulations.

The bane of regulators everywhere is unforeseen consequences. When a new regulation is issued or changed, market participants often react in unexpected ways. A dramatic example was the deregulation of the American mortgage market in the 1980s. In a sincere effort to stamp out discrimination in the housing market, regulators tried to make it easier for low-income people to get mortgage loans. But deregulation went too far. Newly-minted mortgage brokers sprang up in low-income communities, peddling no-documentation loans with zero money down. Instead of keeping the risk themselves, these brokers sold the high-risk "sub-prime" mortgages on through the financial system. The result is well-known – countless foreclosures and the global financial crisis of 2008.

A good regulator is both tough and flexible. He or she must take responsibility for the rules being properly enforced. Having good regulations on the books with poor enforcement is worse than no regulation at all – signalling to the market that rule of law is absent. Arbitrary or politicised enforcement adds a whole new level of risk – so-called “political risk” – to the market and will certainly alienate most foreign investors.

At the same time, the regulator must be willing to adapt their plans, views, and even regulations themselves as the market evolves. Regulating a securities market is a tougher task than regulating other sectors of the economy. The financial markets are constantly changing and innovating. A good securities regulator changes with the market, replacing or eliminating outmoded rules that stifle growth and responding quickly to new challenges.

One of the best ways for a regulator to stay flexible is through regular, formalised contact with thoughtful market participants. Market participants can help the regulator to avoid unforeseen consequences. They can point out emerging problems in their early stages. They can also help the regulator understand how the rules are working in practice.

Regulators Set Rules for Corporate Behaviour

Capital markets facilitate the flow of capital between capital providers and capital users. Capital will naturally flow to markets where there are clear and enforceable investor property rights and where just laws are applied impartially. A nation’s legislative, regulatory, and judicial institutions are responsible for formulating and implementing the rules which create a transparent, trust-based business culture and capital marketplace.
The Importance of Regulation which Encourages Shareholder Oversight

Adam Smith, the great economist and theorist of free markets, identified a central problem for public companies. In *The Wealth of Nations*, published in 1776, he wrote that diffuse shareholders may be unwilling to take responsibility and ensure management accountability. This has been exacerbated by a combination of shareholder dispersion and the prohibitive costs of enforcing shareholder democracy through class action lawsuits. In its place, a moral vacuum has developed that threatens the efficient working of our markets.

In many countries, regulations make it extremely difficult for shareholders to exercise their oversight responsibilities. Often regulations are too onerous. Sometimes they are impractical. Frequently, management teams create corporate by-laws (e.g., poison pills) which shelter them from scrutiny. Where regulations are intelligently designed, shareholders are able to call extraordinary meetings of the company and replace incompetent or negligent directors. Regulators and the media should encourage shareholders to exercise oversight and improve the quality of corporate management. Such actions result in stronger companies and economies. The benefits are shared by all stakeholders.
Good Regulation Promotes Trust and Attracts Investment

History has shown that transparent, high-trust societies create prosperity through their ability to attract capital and encourage entrepreneurship. In contrast, societies with unclear property rights, inadequate laws, and weak enforcement mechanisms tend to become suffocated by intrusive bureaucracies and widespread corruption.

Allocation of capital can never happen in a moral vacuum, as there is always competition for capital. If capital is to be allocated to the most productive members of society, then property rights must be protected, taxes must remain reasonable, and bureaucracy must not be in a position to obstruct the market’s operation. Businesses must enjoy equal access to opportunity and information in order to evaluate investment opportunities and risks accurately.

The Goal of Regulation is to Encourage Responsible Investment and Entrepreneurship

To foster a dynamic economy, regulators must encourage the business community’s desire and ability to take risk. The touchstones are fairness, consistency, and lightness of touch. Balanced regulation which sets out clear and easily understood rules fosters trust, deters malfeasance, and encourages economic activity. The natural fairness with which rules are applied determines the investment climate in which risk is assessed and decisions are made.

Regulators must be careful not to stifle entrepreneurship through over-regulation. When the cost of compliance becomes excessively burdensome and the penalties unnecessarily harsh, commerce and entrepreneurship will be constrained.

Property Rights Create Incentives for Investment and Mobilise Capital

The best foundation and incentive for investment, entrepreneurship, and risk-taking occurs when registered and enforceable title to assets provide certainty of ownership and access to credit. When risks are rewarded, entrepreneurs and investors will engage in economic activity. The establishment and maintenance of healthy economies is dependent on the impartial application of just laws which provide for, and protect, the property rights of investors. This is the responsibility of legislators, regulators, and the judiciary.

Where there is weak protection of property rights or little certainty of justice provided by the legal system, capital will be both scarce and expensive. In such circumstances, corporate activity will be characterised by negligence, fraud, and capital misallocation, leading to weak and volatile economic cycles.

In *The Mystery of Capital*, the Peruvian economist Hernando de Soto writes, “Respect in Western nations for property and transactions is hardly encoded in their citizens’ DNA; it is rather the result of having enforceable property systems. When any citizen fails to act honourably, his breach is recorded in the system.” Societies which protect their citizens’ property create the legal foundation upon which a marketplace can function effectively.
Property Rights
(0 = Non-existence of Secure Property Rights; 10 = Strongest Level of Property Rights)

Rule of Law
(-2.5 = Weak Rule of Law; 2.5 = Strong Rule of Law)

Prosperity and Property Rights

Prosperity and the Rule of Law
Codes and Principles
Corporate Governance Codes can raise standards, but they only work if enforced. The United Kingdom’s Corporate Governance Code is taken seriously by corporations and has enhanced shareholder value. But other countries – such as Russia and Argentina – have corporate governance codes that seem impressive on paper, but they continue to tolerate violations of shareholders’ rights. Some corporate governance protections are more important than others. Overly ambitious codes that include “everything but the kitchen sink” can be counterproductive, especially in developing markets.

Drafters of codes need to be sensitive to context. New markets need simpler rules than more advanced markets. Markets where ownership is dispersed need different regulations than those dominated by controlling shareholders. The most important priorities are promoting transparency, preventing insider deals, ensuring that shareholders have voting power, and making managers accountable for their performance.

Defining Global Standards
Regulatory agencies are best placed to lead in the setting and harmonisation of global standards by building partnerships with other market participants and across jurisdictions. By setting the right goals of regulation and building intelligent frameworks, regulators can enhance the quality, consistency and results of rules and regulations.

Different regulatory approaches are needed for different contexts. In emerging markets, regulators must focus on the basics: protecting property rights, deterring theft, and providing shareholders with understandable information. In more developed markets, battles for control, insider trading and accounting fraud are common issues. While context is important, investors need global standards so that they can compare corporate governance regimes across companies and countries. There is still work to be done in this area.

When What is Legal is Not Moral: Differentiating the Letter from the Spirit
It is impossible for any legal system to address every activity and action. Frequently, especially in less developed countries, laws are unclear or poorly implemented. Some individuals will endeavour to benefit from the gaps and ambiguities in legal codes. Their defence is that they do not create the laws, and that to be held to a higher (moral) standard would put them at a competitive disadvantage. Such a philosophy is an abrogation of personal responsibility for ethical behaviour. The logical outcome is a society acting at the lowest level of legally permissible behaviour. This results in a legalistic state.
“In a state where corruption abounds, laws must be very numerous.”

Tacitus
Senator of the Roman Empire
During his 30 years as a top executive at India’s largest insurance company, G.N. Bajpai strove to make his company an international leader. When he became the third chairman of India’s Securities and Exchange Board (SEBI) in 2002, he brought that same ambition to the regulator’s job. His mission, he said, was to make SEBI “a leader not only nationally but globally.”

Mr. Bajpai was one of the first regulators in the world to take on hedge funds, demanding that they comply with “know your client” procedures that were standard for other market intermediaries. He also urged rating agencies to rate corporate IPOs, as a way of making them more accessible to ordinary investors. He stepped up enforcement, pursuing more than 500 cases a year.

Where Mr. Bajpai really made his mark, however, was in corporate governance. He believed that good governance is “the key to wealth creation, wealth management and wealth sharing in any society.” Under Mr. Bajpai’s leadership, India adopted a strong corporate governance code modelled on the British Code of Corporate Governance and OECD Principles of Corporate Governance.

Mr. Bajpai then went a step further and introduced an innovative approach to corporate governance ratings called the Corporate Governance and Value Creation Rating (CGV). The CGV system, which is now used by India’s credit rating agencies, looks at traditional measures of good governance, such as a corporation’s bylaws, rules of disclosure, and voting procedures. But it also measures the benefits of good governance. Specifically, the CGV assesses whether a company is creating wealth, whether it is managing its wealth effectively, and whether it is sharing its wealth equitably.

Mr. Bajpai also recognised the importance of timeliness and communication in the stock market. A year into his chairmanship of SEBI, a major IPO for the Oil and Natural Gas Corporation went awry. When shares of the oversubscribed offering were allocated, mistakes were made. The problem became public and investors who had traded on their erroneous allocations started to lose money. Short-sellers rushed in to take advantage of the confusion.

Mr. Bajpai personally suspended trading, supervised a reallocation of shares, and announced an expert-led top-to-bottom review of India’s market infrastructure. His quick intervention calmed volatility in the markets and helped to maintain investor confidence through the crisis.
In 1994, Russian President Boris Yeltsin appointed Dmitry Vasiliev, a 33-year-old economist from St. Petersburg, to be the first securities market regulator in post-communist Russia. Dr. Vasiliev was asked to create a federal securities commission modelled on the American SEC and to start writing regulations from scratch.

From the beginning, Dr. Vasiliev understood that a securities market regulator is, at the end of the day, an advocate for the “little man” and the “outsider.” As in many countries around the world, the powerful and well-connected in Russia were willing and able to use their political clout to promote their interests. Dr. Vasiliev believed his job was to make sure that the voiceless – small Russian shareholders, pensioners, and foreigners – received fair treatment.

One of Dr. Vasiliev’s first moves was to set up an expert commission of leading market professionals who met monthly to advise him on regulatory reform. He persuaded the Russian parliament to pass a law on joint stock companies that required corporations to share financial information with all their shareholders. Supra-majority shareholder approval was mandated for major corporate actions, giving a de facto veto to minority shareholders. Companies were not allowed to discriminate against foreign shareholders.

Dr. Vasiliev understood the importance of a broad-based market. Markets thrive in “nations of shareholders,” where share ownership is widely dispersed and the public is active in the market. Dr. Vasiliev travelled around Russia explaining the basic concepts of stocks and bonds.

A public information campaign distributed plain-language materials explaining investors’ rights. Dr. Vasiliev single-handedly created mutual funds as vehicles for public investment in Russia.

But Dr. Vasiliev lacked enforcement power. To use his own words, his commission was “toothless.” Even as Dr. Vasiliev was busy setting up offices and hiring staff, President Yeltsin was handing over controlling stakes in Russia’s most valuable corporations to his political allies. Rather than growing market capitalisation, these “oligarchs” began to strip cash and assets out of their new holdings en masse. When minority shareholders complained, the oligarchs responded with dilutive share issues to friendly parties and one-sided restructuring deals.

Dr. Vasiliev courageously fought back. He used one of his few real powers – to refuse to register new share issues – to thwart dilutive share issues. But, ultimately, the political cards were stacked against him, against foreign investors and against small Russian shareholders. Dr. Vasiliev resigned in protest in 1999. Soon afterwards, the government took away the securities commission’s ministerial status and eliminated its few remaining powers.
We are inspired by our conviction that good corporate governance is an essential foundation for national prosperity.

Richard F. Chandler
Great Companies are National Role Models
The Importance of National Champions as Role Models
A country’s largest companies play an important role in driving economic growth. While these companies are economically important, they are also significant in defining national standards of corporate behaviour, effective capital allocation, and social value creation.

If these companies, through strong leadership and responsible actions, set high governance standards, they will command the respect of investors and the community. In so doing they build confidence and social trust, leading to higher stock market valuations and reduced corporate financing costs.

Partnering to Achieve Progress
The Clermont Group invests in world-scale companies that play a major role in their countries’ national economies. We work with and support corporate leaders who are focused on creating long-term shareholder value in an ethical and socially responsible manner.

We assist leaders of our investee companies to apply a holistic approach to building long-term performance. In creating a “partnership for prosperity,” we offer guidance on corporate governance, strategic thinking, disciplined capital management, and effective communications for building stakeholder and community trust.

Investing in the Prosperity of All
The Clermont Group’s success is inseparable from the health of the countries and markets in which we invest. When injustice undermines corporate prosperity, it undermines national prosperity.

As a responsible investor, we understand that we have responsibilities to the communities in which we invest, and to all stakeholders of a business. Clermont always works to put principles before profits, reflecting our belief that character is the foundation upon which true long-term prosperity is built.

“Nobody made a greater mistake than he who did nothing because he could only do a little.”

Edmund Burke
British Statesman
Great companies have enlightened, ethical, and transparent business practices. They foster healthy societies, vibrant economies, and lasting national prosperity.

Richard F. Chandler
Founder and Chairman,
Clermont Group
The Clermont Group is an international business group with its headquarters in Singapore. Founded in 1986 by New Zealand-born entrepreneur Richard F Chandler, the Clermont Group builds and invests in businesses in healthcare, financial services and energy. These businesses employ over 5,000 people around the world.
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