



## LEADERSHIP ACUMEN Issue 16

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# Improving Governance Performance Rules-Based vs. Principles-Based Approaches

There is a debate raging in the Governance world these days about how to improve the level of Trust in our communities regarding the Governance bodies of companies, charitable corporations, Aboriginal communities, professional associations, and more. While many debates are underway, the highest profile ones are playing out in the various global securities communities, with other organizations taking their lead from there. To some Board members, these debates might seem quite detached from our day-to-day governance responsibilities. However; understanding the different positions in this debate, and the underlying rationales should help your Board better develop policies and practices to improve your governance transparency and enhance community trust in your organization's leadership.

### First and Foremost, This is About Restoring Trust

A fall-out from the continued litany of transgressions of our senior community leaders exposed in the media, is the overall deterioration in trust by the average citizen towards those in the privileged position of power, influence, and community responsibility.

Consider the media reports we have seen in the past months:

- Lord Conrad Black's irregular payment of bonuses to himself and key executives;
- Canadian Bernie Ebbers actions of WorldCom notoriety;
- Former Minister of Public Works Alfonso Gagliano's kick-back scandal;
- Chiefs and Councils embezzlement and/or leadership into bankruptcy of Aboriginal communities;
- David Peterson's infamous insistence that he was unaware of money laundering for the Russian mob by YBM Magnex International - a company that he served as a Director of the Board;
- Crown Corporation Hydro One and their Board's support for CEO Eleanor Clitheroe's huge perks package and questionable corporate/personal expenses;
- Canadian Priests of the Catholic Church exposed for alleged child molestation;
- Illegal fundraising or receipting practices by a few registered charities;
- Concern over trading practices/abuses in Canadian Mutual Fund companies.

As each one of these revelations slams into the public's conscience, the trust in Governors and Governance takes another 'hit'. And still, we encounter more conflicts of interest issues at the Governance level, as an almost every-day occurrence.

So, how do those of us who are trustworthy, honourable, and of good character restore this lost trust, so we can get on with the already difficult task of governing? Well, some feel we must stake-out new rules or principles for ourselves and our colleagues to follow. We try to ensure that members of our governance community follow guidelines, and we seek to make acceptable practices "public" in order to publicly hold ourselves accountable to these higher standards.

## **Rules vs. Principles – A Difference in Faith**

In pursuing the best way to restore the lost trust, various bodies look to different means to ensure improved behaviour.

In the global securities marketplace, restoring faith in governance by investors has become a time-sensitive, crucial initiative to ensure capital still flows into the trading arena; that stock prices are buttressed; and that investors will be able to accurately assess the value and potential of companies and/or funds. A quick look at the various jurisdictions shows how the faith in our colleagues differs.

- In the USA, the Sarbanes-Oxley Act was introduced into legislation by The House of Representatives and then the Senate who were concerned about the fact that CEO's, CFO's and Boards must be expressly accountable for the Financial Statements and Management Estimates published by their companies. This act is a specific rules-based approach and a requirement by all corporations operating in the USA. It confers special responsibility and expectations on Public Accounting Firms and Auditors, the Securities Exchange Commission, and State Legislatures to police the Act.
- Recently the US Securities and Exchange Commission (SEC) approved new Governance rules outlined by the NYSE and NASDAQ, for companies listed on their exchanges. Those who fail to comply by November 2004, risk being de-listed.
- In Canada, the TSE refused to enunciate hard and fast rules, preferring instead to outline Guidelines, then rely on shareholders to hold their Boards accountable for operating in relation to the guidelines. As of January 16, 2004 the Ontario Securities Commission published its proposals for best practices in governance, and requiring all Issuers to make regular disclosure about their practices against such best practices. The OSC has thus moved towards a quasi-rules based environment.
- In the UK, the Cadbury Commission of the London Stock Exchange released their Combined Code of Governance Principles and Best Practices. The suggestion being that companies self-report to the investment community against these standards as their approach to restoring trust in their market.
- The Hong Kong Laws regarding good governance were published as a "Code of Best Practices". These explicitly state that they are not intended as rules to be rigidly adhered to, but should rather serve as guidelines that companies should aim for.
- The German Panel on Corporate Governance essentially embraced the OECD's Principles of Governance and recommended transparency approaches to information and disclosure practices by German listed companies.
- CalPERS, the huge California Public Employees Pension Fund investor established Principles of Governance, which they presumably use to help decide whether or not they will invest in a particular company or Fund.

Outside the specific corporate governance realm, there are a multitude of *recommendations* but few hard and fast rules-based applications.

- In Canada, the Canada Revenue and Customs Agency (CRCA) sets rules that outlines the minimum expectations and practices for which Charitable Organizations' Boards must comply in order to retain their Charitable status.
- The report: "Building on Strength: Improving Governance and Accountability in Canada's Voluntary Sector." (Also known as the "Broadbent Report") established a set of best practices and recommendations for Canada's Charitable and Not-for-Profit community in 1999, and in 2009 Bill C-4 the new Not For Profit Corporations Act was passed with clear rules and expectations for NFP Boards.
- In a much broader context, the OECD has developed Corporate Governance Guidelines that are "non-binding Principles" that reflect the views of member countries. The OECD also publishes governance guidelines for government bodies and NGO's.
- Many countries have specific laws against embezzlement and/or tax evasion which usually are the basis for police action against crooked politicians, businesses and individuals.
- The World Bank and International Monetary Fund create specific rules requiring transparency and democratic processes for countries/governments looking to receive their funds.

- Transparency International has garnered many signatures of countries that commit their companies, government institutions and individuals to the avoidance of bribes, kick-backs, etc. Those who break the rules, even outside their country are liable for prosecution and penalty in their home country.

As you can see, most jurisdictions around the world favour the use of Principles and Guidelines and extend a belief and trust in their organizations to subscribe to such principles. Such faith also leaves the vigilance of good practice to the larger community, and leaves unclear the specific consequences – however one assumes that public exposure of practices not in keeping with the principles will result in significant loss of face and credibility. In America, there is a tendency not to extend such trust, and instead to develop and insist on compliance to a specific set of rules. In such a system the consequences of non-compliance are clear, and supposedly swift, yet restricted to the jurisdiction of the regulatory body.

### **The Value and Challenges of a Rules-Based Approach**

Playing by the rules requires all members of a community to exhibit minimum standards of practice. In order to gain approval by a majority of members, the standards have to be essentially the minimally acceptable practices.

This can result in less-than-excellent standards. Take for example the Honk Kong Laws and Regulations on Governance. They stipulate an expectation that the Board of Directors holds a meeting twice per year. While this may well be appropriate for a small corporation (still questionable if it is a publicly listed corporation), it is clearly an inappropriate standard for a larger corporation. The recent NYSE and NASDAQ rules define an Independent Director as someone who has received less than \$100,000 of employment income from the company on an annual basis. Hmmm, in the heady levels of executive compensation in the USA, this may seem like a paltry sum; however, I would suggest many average citizens would see someone earning \$95,000 a year from a company, as someone who has a significant, vested interest in the organization.

With these exceptions set aside, rules such as those in the Sarbanes-Oxley Act have significantly improved corporate governance and executive staff reporting to the Board. It has also significantly eliminated any suspected collusion between auditors, bankers, and corporate officers as that which is under investigation in the Enron case.

Unfortunately, a rules-based approach also tends to encourage those to play games with the rules, to find loopholes in the rules, and to find ways around the rules. This has been evidenced in the past few months in both Canada and the USA by our political leaders shortly after passing new, restrictive, campaign fundraising rules!

Still, a rules-based approach can ‘snap’ the members of a certain community into action in a very short period of time, and hope to ensure a minimum new standard of practice, that will rapidly increase trust in their system.

### **The Value and Challenges of a Principles- Based Approach**

Principles essentially have no minimum standard of practice and can rise over time. Principles work to influence a broad set of practices conforming to a level of expectation by the community at large. The implication being, that if anyone in the community believes your practices to be skirting the issue, or non-genuine, then you have a problem of confidence in your actions. This then should leverage everyone up to a high standard of practice, as minimal compliance will not really be tolerated by most onlookers.

Principles also encourage organizations to start right away at moving their current practices in-line with the Principles, leaving room for continuous improvement over time.

Unfortunately, Principles do not explicitly require certain practices in order to retain one’s membership in a community. As such, it is hard for Principles to get everyone moving into new practices in a particular timeframe.

By leaving the onus on investors, or donors, or community members, to measure adherence to principles, it also leaves to these parties the responsibility to demand public reporting/ communication. This then eventually plays out by giving the media or special interest groups the responsibility to ‘police’ the practices of organizations.

Unfortunately this can lead to skewed demands or uneducated commentary about complex organizational practice and reporting.

Principles are very useful however, in allowing organizations to customize their interpretations of how best to implement new practices for the unique conditions and operational realities of their organization and industry. This should thus result in better, more appropriate governance actions compared to minimum compliance with a set of basic rules.

### **Putting this Debate to Good Use!**

Directors and Governors should be able to collect the various Rules and Principles that are relevant to their organization, and develop new Governance By-Laws, procedures, and practices to “tune up” their organization’s leadership behaviour. Self-disclosure of these new practices can enhance the community’s trust in your organization. We have provided web-links to some key reference Rules and Principles documents in this month’s “Exploring the Web” section.

Discussion of these Rules and Principles at the Board table is at once both a good professional development activity and an active expression of Fiduciary and Trusteeship Duty.

A Board should be clearly aware of all Rules to which it must comply – as a result of the business corporation laws, tax laws, environmental and/or civic laws. And, it should be aware of the recommended Principles of Governance that might be issued by a professional body, association or Commission directed at their sector, which define expectations of community for good governance practice.

While the Rules v. Principles Debate may be intriguing to some Directors, and boring to others; the resultant proclamation of Rules or Principles as they apply to your organizational sector, are very important to be understood, discussed, and applied to your future governance practices.

### **Beyond Governance Rules and Principles – Organizational Social Responsibility**

Good Governance practice has been further augmented in the past year by rise in importance of Corporate Social Responsibility. This is based on an understanding of the expectations that our communities have regarding the ‘social contract’ that your organization has with its community/communities.

This may include public reporting, open-ness to input, access points for complaints about services or tips regarding illegal actions of employees. It may also include the concept of an Ombudsman to address community and/or employee and/or contractor issues.

<b><i>Financial/Service Performance</i></b> (Shareholders)	vs.	<b><i>Trust</i></b> (Board/Management)	vs.	<b><i>Social Responsibility</i></b> (Stakeholders)
<ul style="list-style-type: none"><li>• Attractiveness to investors</li><li>• Reputation Risk</li><li>• Effective Crisis Management</li></ul>		<ul style="list-style-type: none"><li>• Policy Implementation</li><li>• Surveillance/Supervision</li><li>• Ops Risk Management</li></ul>		<ul style="list-style-type: none"><li>• Communication/Transparency</li><li>• Accountability</li><li>• Avoidance of Damage</li></ul>

Being, and being seen to be, a good ‘corporate citizen’ by members and stakeholders now lifts the standards of governance into a whole different realm. No longer can Governors or Board members be content to live by rules, or adapt processes to exemplify principled practices. Instead the organization’s senior leaders must commit to be in tune with, proactively communicating/ listening to, and actively accessible/accountable towards their community of citizens and stakeholders. This is a philosophy that transcends an inside view, and instead recognizes the bigger Stewardship role organizations have.

Providing a vehicle for open access, suggestions and tips is one such mechanism organizations can use to advance towards this Social Responsibility role. Another is to ensure that corporate philanthropy is disseminated

proportionally to the jurisdictions of operation, not just where the biggest tax advantages lie. Yet another, is to work towards the development of community human resources, environmental resources, and others so that they will provide sustainable input to the success of the organization in the ever-advancing world of customer expectations for innovation and service.

In the world of Governance, our better-educated and web-connected citizens are constantly raising their levels of expectations for its leaders. Rules, Principles, and Social Responsibility guidelines can help ensure that as Directors, Governors, and/or Political leaders, we keep ahead of the rising expectations, and build back the faith in Leadership that is so important both for the sustainability of our communities and the sustainability of our institutions.

## Exploring the Web!

This month, the connections take you to sites with more perspectives on the issues surrounding Governance Rules and Principles:

<http://www.calpers-governance.org/principles/domestic/us/page01.asp>

California Public Employees Retirement System (CalPERS) Governance Principles (April 1998)

[http://www.oecd.org/document/49/0,3343,en\\_2649\\_34813\\_31530865\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,3343,en_2649_34813_31530865_1_1_1_1,00.html)

OECD's Governance Principles (Updated April 2004)

<http://www.corporate-governance-code.de/eng/news/rede-crommes.html>

German Panel on Corporate Governance: Corporate Governance Rules for Quoted German Companies (January 2000)

<http://www.frc.org.uk/corporate/combinedcode.cfm>

UK – The Combined Code: Principles of Good Governance and Code of Best Practices (Updated June 2008).

[http://www.hg.org/articles/article\\_444.html](http://www.hg.org/articles/article_444.html)

Hong Kong Corporate Governance Guide (November 2004)

<http://www.sec.gov/rules/sro/34-48745.htm>

Securities Exchange Commission of the USA: Approval of the NYSE and NASDAQ Amended Corporate Governance Rules (November 2003)

[http://www.osc.gov.on.ca/en/SecuritiesLaw\\_rule\\_20050617\\_58-101\\_disc-corp-gov-pract.jsp](http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20050617_58-101_disc-corp-gov-pract.jsp)

Ontario Securities Commission – Proposed Multilateral Instrument 58-101 Disclosure Of Corporate Governance Practices

<http://www.clearviewpartners.com/>

ClearView Partners' new offering *Clearview Connects* – an enterprise-wide or even community-wide confidential, anonymous hotline and reporting system for the monitoring of potential wrongdoing or compliance concerns.

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