In 2005, the CFA Institute sponsored the publication of two significant reports covering corporate governance. In early 2005, the CFA Centre for Financial Market Integrity published "The Corporate Governance of Listed Companies: A Manual for Investors," which is intended to suggest governance issues investors should consider when making investment decisions and raise awareness of their importance within the investment community.

Unlike many studies with a similar focus, the Centre's Listed Companies Manual does not attempt to create a set of best practices or prescribe absolute criteria in which to judge individual companies. Rather, the report aims to alert shareholders, as well as issuers of financial securities, to the primary governance issues and risks that affect companies (the major issues are outlined on the next page). The report states, "For corporate governance structures to work effectively, shareowners must be active and prudent in the use of their rights. In this way, shareowners must act like owners and continue to exercise the rights available to them."

Another major work of the CFA Institute, published by their Research Foundation, was "Corporate Governance and Firm Value," authored by Jean-Paul Page, CFA, with assistance from Denyse Remillard. The research monograph provides a comprehensive review of corporate governance, detailing how it is viewed within global equity capital markets as well as the scope and breadth of different stakeholder views. The overriding theme of the monograph is that corporate managers should practice good corporate citizenship not merely for the sake of complying with rules and regulations in order to avoid fines (or worse, criminal prosecution) but rather in order to create value for their shareholders.

"Governance failures like those at Enron, Tyco, Parmalat, Royal Dutch/Shell and Daewoo have created capital losses in the hundreds of billions of dollars for investors and have demonstrated the huge risks posed by corporate governance breakdowns."

Kurt Schacht, Executive Director of the CFA Centre for Financial Market Integrity.

Similar to the CFA Institute's "Corporate Governance for Listed Companies" manual, the author posits a framework that portfolio managers and security analysts can use to evaluate corporate governance systems at individual companies. Mr. Page states his purpose is "to describe what a value-creating corporate governance system should be like, establish the standards on which criteria can be based to allow financial analysts to study the governance system in a particular company, and suggest how analysts can go about analyzing a company's corporate governance system. Without explicit, justifiable standards, the evaluation of a complex issue such as corporate governance would be arbitrary and analysts could fail to identify the real sources of the company's success and longevity. In light of the recent events that have shaken investor confidence, however, it is as unrealistic to believe that current corporate governance models need no improvement."

To determine the real value of a company, the monograph describes how to analyze a corporate governance system using a set of standard principles. These standards are designed to gauge whether power belongs to shareholders, whether the board of directors and managers give precedence to efficient allocation of resources, and whether the rights and privileges of each stakeholder are respected. Mr. Page's insight extends to the shortcomings of the traditional definition of governance. He states that such views often fail to take into account the implicit rules, standards, and agreements that, in addition to legislation, regulations, and contracts, actually have an influence on firm decision-making. Because contracts, regulations, and laws cannot foresee every eventuality and are therefore incomplete, the role of corporate governance is not only justified but extremely important.

The monograph's primary premise is that corporate governance depends on who holds power in an organization, how that power is delegated and exercised, and the control mechanisms used. Power is always exercised within guidelines or constraints. For publicly traded corporations, the purpose of power is the creation of value, which is synonymous to the creation of wealth, increase in company value, and increase in share price. Mr. Page notes, "In governance systems focused on the creation of economic value, decisions consistent with the company objective are those that tend to maximize share price," and, "A corporate governance system based on value creation places shareholder interests above those of the other stakeholders (i.e., creditors, employees, suppliers, customers, and society as a whole)." Through the delegation of their power to the elected board of directors, shareholders have final

KEY CORPORATE GOVERNANCE FACTORS INVESTORS SHOULD EVALUATE

FROM "THE CORPORATE GOVERNANCE OF LISTED COMPANIES", PULISHED BY THE CFA CENTRE FOR FINANCIAL MARKET INTEGRITY

Board of Directors

- Whether a Company's Board has, at a minimum, a majority of Independent Board Members.
- Whether Board Members have the qualifications the Company needs for the challenges it faces.
- Whether the Board and its committees have budgetary authority to hire Independent third-party consultants without having to receive approval from management.
- Whether Board Members are elected annually, or whether the Company has adopted an election process that staggers the terms of Board Member elections.
- Investigate whether the Company engages in outside business relationships with management or Board Members, or individuals associated with them, for goods and services on behalf of the Company.
- Whether the Board has established a committee of Independent Board Members, including those with recent and relevant experience of finance and accounting, to oversee the audit of the Company's financial reports.
- Whether the Company has a committee of Independent Board Members charged with setting executive remuneration or compensation.
- Determine if the Company has a nominations committee of Independent Board Members that is responsible for recruiting Board Members.
- Whether the Board has other committees that are responsible for overseeing management's activities in select areas, such as corporate governance, mergers and acquisitions, legal matters, or risk management.

Management

- Whether the Company has adopted a code of ethics, and whether the Company's actions indicate a commitment to an appropriate ethical framework.
- Whether the Company permits Board Members and management to use Company assets for personal reasons.
- Analyze both the amounts paid to key executives for managing the Company's affairs, and the manner in which compensation is provided to determine whether compensation paid to its executives is commensurate with the executives' level of responsibilities and performance, and provides appropriate incentives.
- Inquire into the size, purpose, means of financing and duration of share-repurchase programs and price stabilization efforts.

Shareowner Rights

- Whether the Company permits Shareowners to vote their shares by proxy regardless of whether they are able to attend the meetings in person.
- Whether Shareowners are able to cast confidential votes.
- Whether Shareowners can cast the cumulative number of votes allotted to their shares for one or a limited number of Board nominees ("cumulative voting").
- Whether Shareowners can approve changes to corporate structures and policies that may alter the relationship between Shareowners and the Company.
- Whether and under what circumstances Shareowners can nominate individuals for election to the Board.
- Whether and under what circumstances Shareowners can submit proposals for consideration at the Company's annual general meeting.
- Whether the Board and management are required to implement proposals that Shareowners approve.
- Examine the Company's ownership structure to determine whether it has different classes of common shares that separate the voting rights of those shares from their economic value.
- Whether the corporate governance code and other legal statutes of the jurisdiction in which the Company is headquartered permit Shareowners to take legal or seek regulatory action to protect and enforce their ownership rights.
- Evaluate the structure of existing or proposed takeover defenses and analyze how they could affect the value of shares in a normal market environment and in the event of a takeover bid.■

oversight of a company's activities. As capitalism is founded on the principles of economic freedom and choice, Mr. Page notes the correlations between freedom, democracy, and economic development and translates this into three standards that depend for their justification on the value-creation objective (standards listed below).

In sum, the monograph frames the purpose of analyzing a company's corporate governance system. In comparing the analysis to that of financial analysis, Mr. Page notes, "Unlike traditional financial analysis, whose purpose is to evaluate and forecast financial results, governance analysis involves determining whether the factors behind the projected performance are present. Among these factors are the quality of the decision-making process, the integrity of the organization and the people within it, and the commitment of the various stakeholders involved in value-creating activities. Therefore, rather than trying to forecast results, governance analysis attempts to determine whether the conditions required to achieve the results exist."■

CORPORATE GOVERNANCE STANDARDS

CFA INSTITUTE, RESEARCH FOUNDATION, "CORPORATE GOVERNANCE AND FIRM VALUE,"

JEAN-PAUL PAGE, CFA, WITH ASSISTANCE FROM DENYSE REMILLARD

Standard #1. The ultimate power in a company must rest with the shareholders. The main problem such holders of small numbers of shares have when it comes to exercising power lies in coordinating themselves so they can directly or indirectly exercise influence on the company's important decisions. Indeed, institutional investors, notably, major pension funds, are much better placed to exercise control of a company and ensure compliance with the value-creation objective.

Rationale: By creating value, companies contribute to economic development and, by extension, to the well-being of society.

Standard #2. No shareholder should benefit from special advantages. Shareholders are the owners of the company, and each one has the right to demand to be treated as such and to benefit from the advantages associated with ownership. Accordingly, the governance system must guarantee that all shareholders benefit from the same advantages and, moreover, that they develop a sense of belonging. In addition to the protection provided by various laws and regulations, minority shareholders count on the company's governance system to ensure that all the players have the same rights and are treated equitably, that is, that no shareholders enjoy special advantages, particularly with regard to access to information.

Rationale: By according all shareholders the same rights and privilieges, companies earn investor confidence.

Standard #3. The shareholders must approve executive compensation. Because they do not themselves select the managers, they cannot control them directly. Consequently, the only way to ensure that shareholder and manager objectives coincide is to retain a right of oversight over compensation. This, of course, means that the executives must be evaluated and shareholders must have access to the information in this regard. "Executive compensation" must be interpreted in a broad sense to include all the benefits granted to managers, such as stock options, golden parachutes, pension plans, and profit-sharing plans. The shareholders must decide on any and all benefits granted to executives and ensure that the benefits are tied to the company's long-term performance. The goal is to make senior managers accountable to the shareholders, who are the ones financing the remuneration. The principle is simply that employees, regardless of their rank, should always answer to those with the power to set their salary. Compensation should be approved but not be set by the shareholders because, first, the shareholders are not experts in compensation matters and, second, salaries and benefits should, first and foremost, respond to market forces. For this reason, shareholders delegate the responsibility of fixing senior managers' compensation to the board of directors, which performs this function through a compensation committee.

Rationale: By allowing shareholders to approve executive compensation, the board holds managers accountable to shareholders.■