

Regulating for Value Creation: Market Confidence and Contractual Freedom

Colin Mayer

Traditional View of Role of Corporate Governance

- Enhancing shareholder value
- Protecting shareholder interests
- Frequently reflected in policy recommendations

15 Years Ago We Had the Asian Crisis

- Recommendations of IMF and Alan Greenspan were end crony capitalism
- Asian countries should end their relationship systems
- They should adopt dispersed ownership

11 Years Ago We Had the Tech Com Crisis

- Corporate governance standards need to be strengthened
- Interests of management and shareholders need to be better aligned
- Accounting measures of performance need to be improved

4 Years Ago We Had the Financial Crisis

- The worst performing financial institutions during the crisis were those with the best corporate governance standards
- The banks that took the greatest risks were those that had the highest powered incentive arrangements
- Fundamental problem to identify correct purpose of corporate governance

What Should We Be Trying To Do?

- Enhance economic prosperity, entrepreneurship, innovation and value creation
- Do not care about shareholder returns or shareholder value
- Except in so far as they contribute to the these

Corporate Governance Proposals

Related to:

- Independent directors and chairmen
- Induction, servicing, rotation of boards
- Audit and risk management committees
- Executive compensation
- Investor relations
- Shareholder activism and engagement

Examples of Policies

- Better legal systems and contractual rights
- Stronger investor protection
- More say on pay
- More shareholder resolutions
- More creditor rights

The Correct Focus of Corporate Governance

- About structuring firms – ownership, boards, remuneration
- To achieve the right control and commitment
- To attain the firms' objectives

Implication

What is suited:

- For one country is not for another
- One industry is not for another
- One firm within an industry is not for another

- Diversity and contractual freedom are required
- Regulation designed to enhance markets may undermine this
- Prescriptive regulation is particularly damaging

Past Corporate Governance Models

- Japan 1980s
- US 1990s
- UK 2000s
- China 2010s

UK Model

- Cadbury Committee – independent directors, audit, remuneration, risk committees, comply or explain
- Dispersed shareownership
- Active market for corporate control
- Increasing institutional activism
- Strong creditor rights
- One of the worst performing economies with most serious failures

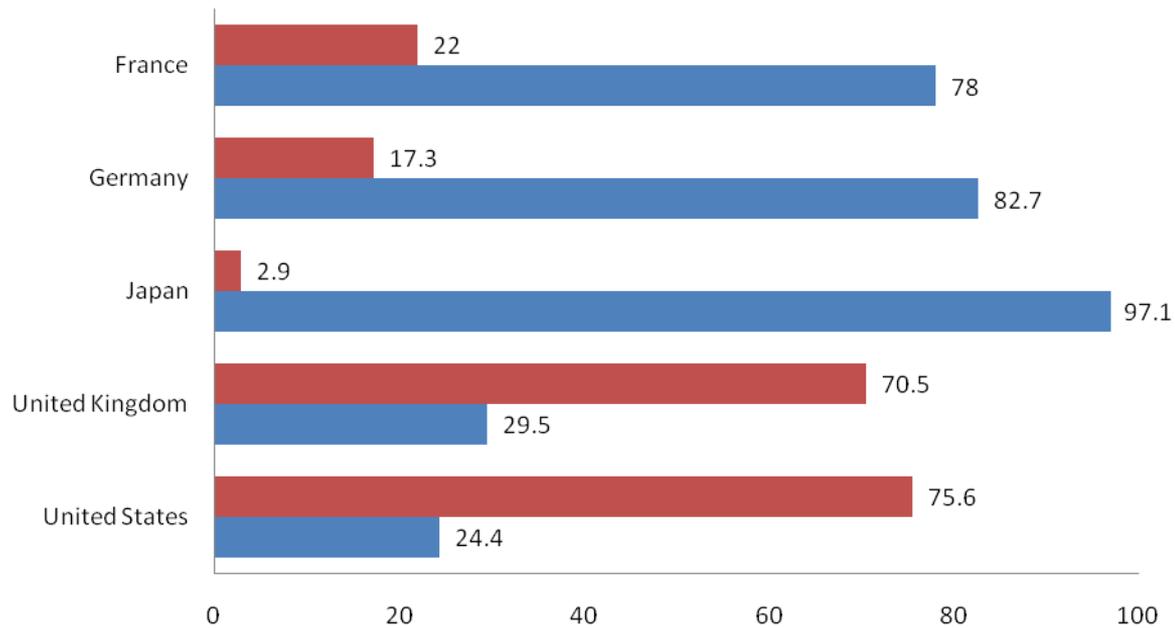
Short-Termism

- 30-40% of trades are high frequency
- Declining holding periods of shares from average of 8 years 70 years ago, to 4 years 30 years ago to less than a year now
- Exacerbated by market for corporate control
- Failure of commitment

Survey of Managerial Evidence

Which of the following best describes attitudes in your company:

- The company exists for the interests of all stakeholders
- Shareholder interests are given priority over others



■ For the shareholders(Shareholder interest should be given the first priority.)

■ For all stakeholders(A company exists for the interest of all stakeholders)

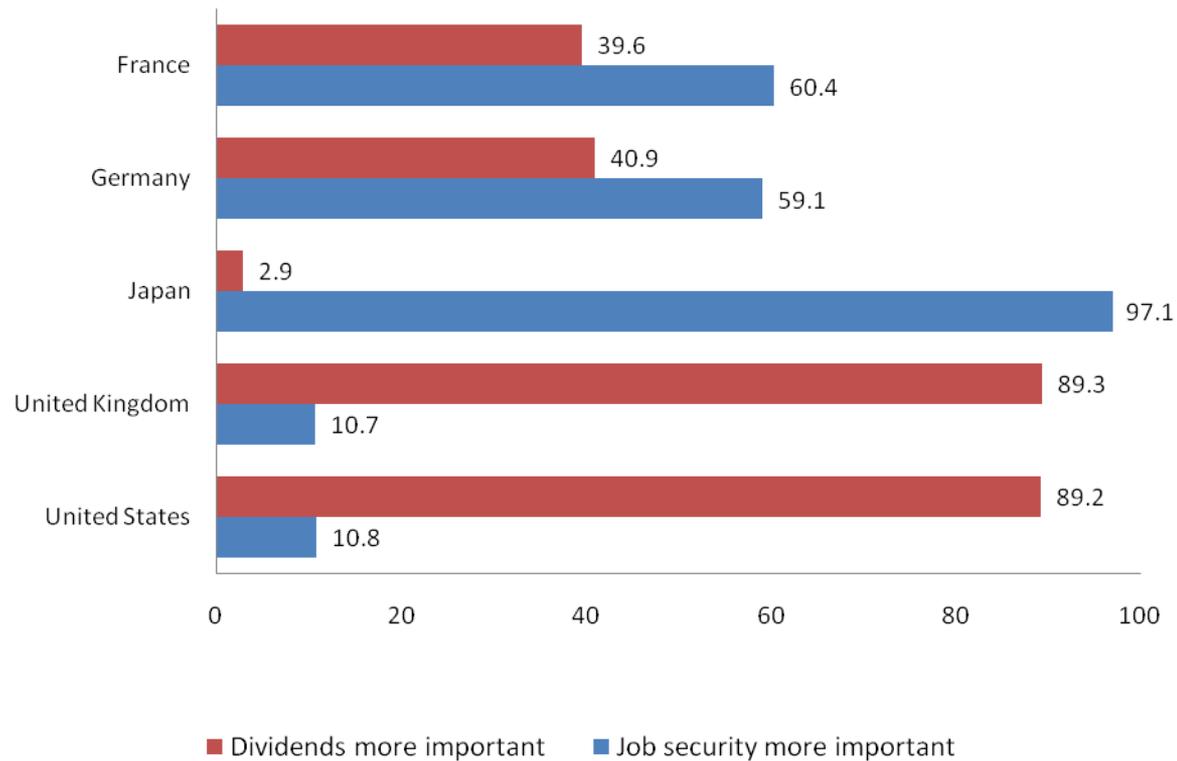
Number of firms surveyed: France, 50; Germany, 110; Japan, 68; United Kingdom, 78; United States, 82.

Source: Masaru Yoshimori, "Whose Company Is It? The Concept of the Corporation in Japan and the West." Long Range Planning, Vol. 28, No. 4, pp. 33-44, 1995

Dividends Versus Employment

Which of the following best describes views in your firm:

- Executives should maintain dividends even at the expense of employment
- Executives should maintain employment even if it involves cutting dividends



Number of firms surveyed: France, 68; Germany, 105; Japan, 68; ;United Kingdom, 75; United States, 83.

Source: Masaru Yoshimori, "Whose Company Is It? The Concept of the Corporation in Japan and the West." Long Range Planning, Vol. 28, No. 4, pp. 33-44, 1995

Why Does This Matter?

- Determines degree of commitment to employees and shareholders
- Shareholder commitment high in UK and US and employee and other stakeholder (supplier, customer) commitment low
- Employee and other stakeholder commitment high in France, Germany and Japan and shareholder commitment low

What is the Effect?

- Elicits high employee, supplier and purchaser loyalty in France, Germany and Japan
- But leaves companies exposed to expropriation by stakeholders
- Elicits high shareholder investment in UK and US
- But leaves companies and stakeholder exposed to expropriation by shareholders

In a Nutshell

Corporate governance arrangements are all about achieving appropriate balance between commitment and control

Implication for Corporate Governance

- Ownership, shareholder control, board structure, incentives intimately related to corporate activities
- Corporate governance about design of ownership, control, board and incentive structure to promote corporate activities and corporate values
- Unique to corporate circumstances

Implication for Corporate Governance Codes

- Uniform codes and prescriptive legislation not appropriate
- Problem of identification, eg inappropriate focus on dispersed ownership after Asian crisis and on high powered incentives in banks before financial crisis
- Problem of unintended consequences, eg independent directors in banks before crisis
- Problem of homogeneity if, for example, all countries had adopted “best practice” – cause of systemic instability

Role for OECD

- Important function in helping countries to identify impediments to promoting appropriate ownership, control, board and incentive structures
- Where are there deficiencies in financial institutions, laws, taxation, public institutions?

Example 1: Promoting Entrepreneurship

- Silicon Valley is networking and mentoring laboratory
- Successful entrepreneurs play critical role as general partners between limited partners and companies
- Relaxation of “prudent man” rule critical
- Elsewhere serious divide between institutional investors and firms
- VCs therefore complain that few profitable proposals
- Entrepreneurs complain inadequate finance
- Both are right because neither party willing to commit
- Elsewhere, entrepreneurship very different form

Example 2: SME Financing

- Banks critical source of financing of SMEs
- Serious shortage in UK
- Used to be workshop of the world
- Relied on local banks
- But exposed to local economies and frequently failed
- Bank of England encouraged consolidation in London
- Commitment to local industry destroyed
- Long-term bank finance dried up
- Very different structures in other countries

Example 3: Takeovers

- Most countries have significant impediments to hostile takeovers
- Very open market in UK
- Thought to promote efficient allocation of resources and managerial incentives
- Creates substantial shareholder value
- But undermines ability of firm to commit to employees
- Example: Kraft - Cadbury. Somerdale plant
- Regulations to protect minority investors undermine other stakeholders

Example 4: Executive Remuneration

- High powered incentives regarded as important for aligning managerial with shareholder interests
- Shareholders to have more say on pay
- High powered incentives exacerbated failures in financial crisis
- Problem that conflict between interests of shareholders and creditors
- Control of shareholders therefore undermined commitment to creditors

Example 5: Shareholder Activism

- Shareholder activism, engagement widely advocated
- Evidence that enhances shareholder returns and creates value for active funds
- Most successful where active funds have industrial as well as financial knowledge
- Therefore activist funds need to commit to expertise in organizations that restructure
- Similar to intermediation function required of general partners in VC
- Insider trading rules have impeded this in some countries

Summary

- In all cases necessary to define appropriate balance between commitment and control and regulation has interfered with this
- Regulation undermines this: protection of investors at expense of commitment to other stakeholders
- Countries can be assisted in identifying where failures to provide right balance
- But cannot be achieved through broad codes
- In its next phase OECD should seek to develop a more detailed understanding of required relationships
- It should use this knowledge to inform countries and provide basis for negotiating with entrenched interests

Examples

- Data on structure of ownership across countries
- Analysis of way in which markets operate, eg entrepreneurship and innovation
- Evaluation of impediments to appropriate balance between commitment and control – market protection and freedom of contracting