Regulating for Value Creation: Market Confidence and Contractual Freedom

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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.

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.

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, e.g., entrepreneurship and innovation
• Evaluation of impediments to appropriate balance between commitment and control — market protection and freedom of contracting