

Lecture 1: International comparative corporate governance. An Overview.

Corporate Governance Debate: 200 Years of Controversy

“It’s only when misgovernment grows extreme enough to produce a revolutionary agitation among the shareholders that any change can be affected” - Herbert Spence, 1854.

Corporate Governance: Current Issues

Corporate failures and regulatory initiatives have placed corporate governance systems under closer scrutiny than ever:

- Enron; Worldcom (USA) – significant damage for the economy and the workers, losing not only wages but pension savings as well.
- Maxwell Group (UK) – massive industrial conglomerate with a publishing house in the core of the group, which published most of student textbooks; was found that Robert Maxwell stole from the group’s pension fund, then supposedly drowned and disappeared.
- Parmalat (Italy)
- VW (Germany) – everybody denied the knowledge except for 1 engineer that designed the software, denying that they tried to cheat the customer and regulators.
- LukOil (Russia)
- Hyundai (Korea) etc.

Significant consequences of those scandals:

Systemic level = investor losing confidence, implications for the functioning of the whole economic system and its most important institution, the stock exchange.

- “2/3 UK investors no longer feel confident investing in the Stock Market as a result of fraud and accounting problems at Enron and Worldcom” (Survey of UK investors by Cavendish Asset Management, October 2001)
- “If fund managers are truly to fulfil their duty of seeking to maximise value for their shareholders, then there will be times – certainly more than at present – where intervention is the right action to take” (Paul Myners, Institutional Investment, March 2001) à Roles of the participants etc.
- “It is crucial to effective corporate governance that the owners of the company hold the Directors to account for the Company’s performance” (The UK Department of Trade and Industry Modernising Company Law, July 2002) à “Post-Enron environment”

Areas of Concern

- ❖ Concentration of power in small number of executive directors:
 - o Organisations are getting bigger, the economic/political power of executives is growing (=consider MNCs), the decision making power is highly concentrated in hands of few executives à What are their interests? What is their accountability?
- ❖ Lack of balance in Board composition: “an executive capture of Boards”
 - o Independent directors are supposed to insure the interests of all groups; but often are members of the same industrial elite, being directors of other companies, having a web of informal personal relationships with executives à How independent actually are they?
- ❖ Deficiencies in accountability and audit

Chapter 1- Introduction

Wright, Siegel, Keasey & Filatotchev

Global financial crisis has reduced confidence in the quality of corporate governance (Walker).

Analysing the effects of corporate governance on performance requires the following: accounting and economic profits, productivity growth, market share, proxies for environmental and social performance, such as diversity and other aspects of CSR, and share price effects.

Symptoms of the stress within the current corporate governance regime:

- pressures on the businesses to perform short term
- directors now face almost unlimited responsibilities
- financial crisis has undermined the efficacy of audit

Impact of private equity and hedge funds on asset stripping and short termism

- The Walker Guidelines 2007 (UK): require private companies to report the same kind of information as publicly traded companies.
- The Alternative Investment Fund Management directive (EU): disclosure and regulatory burden - limits on leverage, minimum capital, remuneration policy

Financial crisis: who owns the risk and how risk is measured

- Need for Board ownership and risk management = appreciation of overall risk, risk mitigation by integration into broader governance structures
- Stress testing - holding of data across the firm to get an earlier warning of risk, avoid reliance on single risk measures - need for greater methodology
- Risk management has to be part of the culture deeply embedded within business

Corporate governance has to pay attention to varying institutional environments:

- In common law societies, investors are willing to take more risk, arms-length relationships
- Civil law societies have weaker legal protection for investors

Chapter 3 - History of corporate governance

Aguilera, Goyer & Kabbach de Castro

History of corporate governance is vast: dates back to the 16th-17th centuries, formation of East India Company and Hudson Bay Company.

However, the term “corporate governance” was coined in 1970s and was made official by the federal Securities and Exchange Commission (SEC) in the US in 1976.

→ Widespread corporate bribery, board passivity.

→ SEC introduced requirements to disclose information on independence of directors and use of audit, nomination and compensation committees.

Equity owned by insiders = “**alignment approach**”, where self-interest of managers is mitigated by allowing agents to be principals.

- Use of bondings mechanisms (golden hellos, golden parachutes, bonuses, stock options) should align insiders’ own self-interest with those of the owners they serve
- Main bodies of insiders:
 - **Executives** - top management; often consultants when promoted to partners have to buy into their position to align interests; the greater ownership executives have, the more likely they are to employ firm’s resources towards long-term profitability; BUT managers can become entrenched and willing to maintain high risk profile → need for outsider control.
 - **Board members**; vigilance of the Board largely depends on the compensation of its members; director pay reached above \$200k for Fortune 500 companies + increase in stock options; Board members need to serve shareholder interests because 1) they are given a share of ownership, 2) they will face re-election problems.
 - **Employees**; incentivises + enables a psychological bond with the company and its objectives.

Equity owned by outsiders = “**control approach**” to governance, motivation to check up on managers and ensure that stakeholder interests are met.

- Collective control - outside investors are in position to implement monitoring tactics.
- 4 types of outsiders:
 - **Blockholders** = owners of over 5%, individual people or single corporations; != institutional investors because they have private interest (not on behalf of different clients) → enjoy concentrated ownership rights + private benefits such as trades priced at premium over subsequent trades of other shareholders;
 - 3 common types = family, corporations and government ownership
 - Family organisations account for approximately 65-90% of all business establishments worldwide; other shareholders need to prevent “**tunneling**” = transfer of resources from a company with low cash flows to a business subsidiary with higher cash flow rights.
 - Corporations often become blockholders before engaging in takeover or completing sale of stock
 - Government is either state ownership or SWFs; often has negative effect on performance of the firm = 1) governments invest often in emerging markets, 2) creates “soft” budget constraints that impede innovation and increase corruption, 3) lower monitoring results in random diversification, 4) political interests ex.create jobs misaligned with profitability
 - **Institutional investors** = pension funds, professional investment funds, university endowment funds;
 - Pension funds = fewer companies but higher ownership, longer periods, more involvement in decision-making.
 - Mutual funds = “broad but shallow” approach, financial controls over strategic
 - **Venture capitalist / Private Equity / Angel investors**

- Conflict with profit maximisation agenda of individual affiliates but increase overall profitability of the group

3) Mutual entrenchment - the extent to which managers are not subject to discipline from the full range of corporate governance mechanisms such as Board monitoring or threat of takeover.

- Commonly used tactics: manager-specific investment, poison pills, staggered board terms, greenmail.
- Managers collectively pursue their own interests (making themselves difficult to replace) at the expense of shareholders = more autonomy in decision-making and exercising their own benefit

Variations across different groups

1) Family controlled business groups

- Prevalence of pyramidal control structure - families can employ limited investment to control large amounts of assets to maximise their own wealth
 - More subject to severe agency problems
 - Pyramidal ownership has negative effects only when managers have high level of control rights
- Horizontal mechanisms do not function effectively because family owners and directors do not exert same level of control over one another
- Family ties allow founding family to abuse their control rights and result in inefficient allocation of resources

2) State-owned business groups

- Associated with generally low level of monitoring intensity
 - Often have pyramidal ownership to facilitate control and monitoring
- Extensive horizontal linkages can enhance monitoring control over state agents who might neither act to maximise shareholder benefits neither to protect state assets

3) Widely held business groups

- Bank ownership is linked positively to performance at high ownership levels
 - Concentrated ownership implies strong strategic control
- Cross-shareholdings facilitate productive exchange and reduce opportunism

Preview from Notesale.co.uk
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- 2016 Operating profit RMB 78 bln
- 71% of shares owned by (state-owned) China Petrochemical Corporation
- Listed in Hong Kong, minority shareholders include BlackRock, JPMorgan, Schroders
- 10-strong Board, with 4 independent directors, but strong prior connections to economic and political elites.
- *“The Company is independent from its controlling shareholder in terms of, among other matters, business, assets and finances”* (2016 Annual Report)

Global M&As by Chinese Companies

- China's outbound mergers and acquisitions (M&A) reached \$111 billion in 2016
- Significantly more than \$107 billion recorded in 2015
- The number of deals up to a record 300

Examples (2016)

- Zhuhai Seine Technology acquired US Lexmark for \$3.4 billion (sector: Technology)
- Dalian Wanda acquired US Legendary Entertainment for \$3.5 billion (sector: Entertainment)
- Midea became the biggest shareholder of German industrial robotics group Kuka spending \$4.7 billion (sector: Technology)

From Principal-Agent to Principal-Principal Conflicts

- Principal-Principal conflicts emerge between dominant owners and minority shareholders
- PP conflicts are often found in transition and emerging economies
- Associated with concentrated firm ownership and weak legal and institutional protection of investors
- Weak institutions create incentives for controlling shareholders to extract “private benefits of control” – benefits at expense of minority investors
 - “Tunneling” of profits = financial benefits + geostrategic = Gazprom as a political tool
- State ownership a major source of PP conflicts

Governance Aspects of Principal-Principal Conflicts

- State as an owner may pursue non-economic objectives
- Social goals: preserving employment and social provisions
- Political goals: business strategy as a tool of political influence
- Former “Red Directors” often occupy key managerial positions
- Interests of private (minority) investors have a secondary importance
- This governance model may limit external investment and strategic support by Western investors and companies
- Transparency is a key aspect of governance reforms in countries like China, Russia, Brazil and India

Are Governance Systems Converging?

- Cross-border mergers and acquisitions (Renault-Nissan)
- Dual listings (Russian firms’ ADRs on the NYSE and LSE)
- Corporate reforms (South Korean Chaebols)

Lecture 8: Corporate Governance in Japan and East Asia

Japan and South Korea = “relationship” / “network” model of corporate governance; often considered superior to the shareholder-supremacy Anglo-American model (too short-term, transactional, confrontational) $\neq$ collaborative way of doing business.

$\Rightarrow$ Technological successes (economic miracles) in Japan and South Korea $\neq$ corporate scandals nowadays indicate problems (ex. Samsung).

Japan:

- Japanese Keiretsu conglomerate, with banks as the main relationship investors, offering voice and stable shareholding without exits
 - Annual general meetings (AGM) are a formality, decisions are taken behind the scene
 - Disruptions in meetings $\Rightarrow$ that's why they have meetings on the same day
 - After the Second World War, Americans tried to break up the family-ownership based system (Zaibatsu) yet it persisted in Japan with Keiretsu
- Outlook by China in 2011, Japan is still the 3rd largest economy in terms of GDP (GDP per capita higher than China)
 - Japan stock market is 2nd in the world
 - Because of the tsunami, manufacturing bases suffered as their infrastructure were destroyed
- Company with board of Kansayaku (corporate auditors) 99% of PLC
- Japanese industrial groups or '*keiretsu*' are held together by cross-shareholdings and a web of supply linkages and other forms of cooperation.

South Korea:

- The economy is dominated by industrial groups (*chaebols*) similar to Japanese keiretsu
- They represent highly diversified holdings often controlled by a family
- Very opaque systems of ownership and control; “pyramids” of cross shareholding

Statistics:

- Japan is 36th in the International ranking of CG (UK is 1st, followed by Canada, Ireland, US)
- Japan is 21st in the ranking of Clarity and Completeness of CG Requirements (1st - UK, US, Singapore, Australia)
- Global Financial Centre Index: Tokyo is 5th (London is 1st)
- Tokyo Stock Exchange is 3rd in the world by Stock Market Capitalisation

Japan in Context

- 1) Although China overtook Japan in 2011, Japan is still the 3rd largest economy in the world in terms of GDP after the US and China, and per capita GDP is still larger than that of China.
- 2) In terms of stock markets, Japan retains its 2nd position in the world
- 3) Japan retains the world leading high-tech industry, the significance of which was highlighted after the Earthquake & Tsunami in March 2011, which destroyed manufacturing bases of high-tech parts which halted the production of motorcars around the world.
- 4) History of Japanese Law
 1. Stage 1: 8th Century –Import of Chinese systems of law and civil service.

- Forms a part of the "Third Arrow" (Japan Revitalization Strategy, Revised in 2014) of "Abenomics" (the economic policies advocated by Japanese Prime Minister, Shinzō Abe), placing a high priority on the enhancement of corporate governance of Japanese companies.
- A draft of the Code, entitled "Japan's Corporate Governance Code—Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid-to Long-Term" (the "Draft Code"), was released in December 2014 for public comment.
- New Corporate Governance Code, based on the "comply or explain" came into effect in June 2015 ⇒ for the first time in Japanese history, shareholder interests were emphasized!

Introduction of the Corporate Governance Code and Stewardship Code in Japan

- **Keidanren** (Japan Business Federation) had been fiercely resisting the introduction of the corporate governance code, but those concerned about the endangered global position of the Tokyo Stock Market and Tokyo as an international market, had been pushing for its introduction.
- To get around the resistance from listed companies, the Stewardship Code was introduced in February 2014 to gain support for a corporate governance reform from institutional investors and this, in turn, acted as a pressure on the listed companies to "accept" the introduction of the Corporate Governance Code.

Too early to assess the effectiveness of both codes

- The Corporate Governance Code is modelled on the OECD Principles of CG.
 - Borrowing something that is fundamentally different to the Japanese economy - is "one size fits all" approach really useful? - Can it enable to sustain innovative growth?!
 - Some argue that the uniqueness of CG (insider employment) = competitive advantage
- The Stewardship Code is modelled on the UK Stewardship Code.
- Borrowing other systems – received wisdom but effective? – Does "one size" fit all?
- What is the reform trying to achieve?
- Local "experts" are adamant that the CG reform is not a reaction to any scandals – unlike the various reforms introduced after the recent financial crisis in the West
 - But Japan, like other countries, is not without corporate scandals

Case study: Olympus Scandal

- Massive losses in the early 1990s
 - Olympus made losses of more than US\$1.5bn on risky investments
 - Loss concealment: "loss separation scheme"
- Many Japanese businesses delayed recognising losses through window dressing of accounts ("tobashi" = "flying away") ⇒ In 2007, Japan's accounting rules changed: larger companies had to consolidate their accounts.
- Concealment by the presidents
 - Top management concealed the losses for over 20 years through three presidents
 - All three presidents came from a small office in Olympus' finance department that was responsible for investments
 - No information on the losses was ever disclosed to the board of directors
- The scheme unravels
 - In 2011, Olympus felt safe enough to appoint an outsider as president

⇒no such thing as emerging market economies - whole range of mixtures of institutions and infrastructure with different levels of development ⇒powerful relationship between level of economic development and institutions

- Differences in legal frameworks in emerging markets.
- Legacy of colonial past (e.g., Brazil vs India) and legacy of postcommunism (e.g., China vs Russia)
- Overlapping legal frameworks: co-existence of common and civil law traditions as a historic legacy (e.g., Mauritius)
- Most importantly, legal frameworks in EM are still evolving making a profound impact on firm-level governance arrangements
- An increase in the State's role in firm-level governance (e.g., Venezuela, Brazil, China)
- ❖ Institutional differences (**institutional voids**) in emerging markets
 - Chinese companies always outbid in M&A tenders = go-global policy
- ❖ Whereas EM firms are under less pressure to demonstrate compliance with formal rules, they pursue normative legitimacy in order to demonstrate moral worth, and cognitive legitimacy in order to reduce stakeholders' uncertainty about the organization
- ❖ Corporate governance models centered on family and state control
- ❖ Business groups in emerging markets are mechanisms to deal with institutional void
- ❖ Governance mechanisms are shaped not only by regulatory institutions but also social norms, traditions and culture
- ❖ National institutions affect effectiveness and efficiency of specific governance practices (e.g., ownership concentration, shareholder activism, etc)
- ❖ Governance factors (e.g., board functions, ownership patterns) conform to the institutional expectations of broader groups of stakeholders, in addition to shareholders
 - For example, family control is an outcome of less liquid capital markets AND traditional orientation towards family values and social connections in South Korea and elsewhere.

Relevance for IB research:

- Efficiency is only part of the firm's legitimization process.
- Considering the importance of the EM firm's stakeholders in addition to its shareholders in the context of gaining legitimacy offers a richer perspective on the institutional antecedent factors of firm-level governance systems and business strategy.
- Institutional poly-centrism: it is important to consider multicountry institutional effects, especially when EM firms are involved in global markets.
- Institutional changes in EM and a balance between efficiency and legitimacy as governance objectives.

Three big questions

- ❑ "International Mobility of Governance":
 - If firms in EM and Russia respond to multiple institutional pressures in DM host countries, will their governance "import" Western standards? Will they "export" their own standards to EM? (e.g., Alibaba)
- ❑ • Efficiency vs legitimacy:
 - There are different elements of the legitimization process, which include efficiency, moral and cognitive legitimacy. Do these dimensions complement or substitute each other?

Quality of national laws at protecting:

- 1) Corporate shareholders (above)
- 2) Minority shareholders
 - Grant minority shareholders a right to nominate representatives on the Board
 - Use voting caps and one-share-one-vote principle (ban dual class shares)
 - Lower minimum percentage ownership required to call an extraordinary shareholder meeting
 - Mandatory bid rule requires acquirer to take a tender offer to all shareholders first - exit at fair price for minority holders
- 3) Creditors
 - Granted rights to pull a collateral from a firm without waiting for a completion of reorganisation procedure
 - Ranked first in the distribution of the proceeds
 - Decision making power to veto or approve reorganisation
 - Difference between creditor-oriented vs debtor oriented = liquidation bankruptcy vs reorganisation which enables company to continue operations after restructuring

LLSV Index:

- a) English legal origin = Ireland, US, UK ⇒ leader in terms of quality of shareholder protection
- b) German legal origin = Austria, Germany, Switzerland
- c) French legal origin = Belgium, France, Greece, Italy, Spain, Netherland
- d) Scandinavian legal origin = Denmark, Finland, Iceland, Norway, Sweden ⇒ stakeholder-oriented
- e) 2004 EU Accession = Cyprus, Czech Republic, Poland, ...
- f) 2007-9 EU Accession = Bulgaria, Croatia, Romania

- ❖ The historical origin of a country's laws is highly correlated with a broad range of its legal rules and regulations, as well as with economic outcomes
 - Shleifer and Vishny (1997) : legal protection of outside investors limits the extent of expropriation of such investors by corporate insiders, and thereby promotes financial development
 - Legal rules governing investor protection can be measured and coded for many countries using national commercial (primarily corporate and bankruptcy) laws
 - Legal rules protecting investors vary systematically among legal traditions or origins, with the laws of common law countries (originating in English law) being more *protective of outside investors* than the laws of civil law (originating in Roman law) and particularly French civil law countries
 - Government ownership of banks, the burden of entry regulations, regulation of labor markets, incidence of military conscription, and government ownership of the media vary across legal families
- ❖ Common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations
 - Civil law is “policy implementing”, while common law is “dispute resolving”
 - Common law : formed by appellate judges who establish precedents by deciding specific legal disputes
 - Judicial independence from both the executive and legislature are central
 - Civil law tradition is the oldest, most influential, and most widely distributed in the world
 - Originates in Roman law in which legal scholars to ascertain/formulate rules
- ❖ French civil law tradition is usually identified with the French Revolution and Napoleon's codes, which were written in the early 19th century
 - Give state power to alter property rights and insure that judges did not interfere
 - German and Scandinavian legal traditions are based on Roman law
 - Both French and German civil origins have more entry and labor regulation, higher state ownership of the media, and heavier reliance on conscription
- ❖ Civil law is generally associated with lower shareholder and creditor protection, less efficient debt enforcement, and higher government ownership of banks
 - Higher income per capita is generally associated with more developed financial markets, better shareholder and creditor protection, more efficient debt collection, and lower government ownership of banks
 - Investor protection is associated with more developed financial markets
- ❖ Compared to common law countries, civil law countries generally have more legal formalism, lower judicial tenure, and sharply lower constitutional acceptance of case law
 - Compared to French civil law, common law is associated with
 - a) better investor protection, which in turn is associated with improved financial development, better access to finance, and higher ownership dispersion
 - b) lighter government ownership and regulation, which are in turn associated with less corruption, better functioning labor markets, and smaller unofficial economies
 - c) less formalized and more independent judicial systems, which are in turn associated with more secure property rights and better contract enforcement