Corporate Governance: A Policy for Europe

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The dominant paradigm amongst law and finance academics and the most influential policy prescription is that investor protection is key to financial development and economic growth. This policy has risen to the fore in international agencies such as the OECD and the World Bank as well as amongst governments around the world.

The basis for this assertion is that investor protection is critical to the willingness of minority investors to participate in the financing of corporations. In the absence of adequate protection, minority investors are exposed to self-interest of large shareholders and markets are dominated by these shareholdings. Participation by outside investors is then discouraged, and the development of financial systems is stunted. Furthermore, investment in some companies and industries is particularly dependent on external finance. The growth of these firms and industries is therefore impeded and economic development suffers.

The policy prescription is therefore straightforward. Strengthen investor protection and financial development will follow. This will promote external finance, which will accelerate economic growth.

This emphasis on investor protection takes several different forms. It stresses the importance of bank regulation and the protection of depositors through prudential supervision. It points to sound regulation of non-bank financial institutions, such as pension funds, life assurance firms and mutual funds. It takes the form of creditor protection and the establishment of insolvency procedures that preserve creditor rights and priorities. And it concerns the rights of shareholders to vote on corporate policies, to dismiss management and to litigate against injustices.

It is not difficult to see failures in financial markets that justify regulation. At the very least, they are prone to imperfect information that makes investors exposed to incompetence and bad management. More seriously, investors are at risk of fraud, which pervades financial markets more than any other because of the ease of perpetrating it, the difficulty of detecting and the frequent impossibility of prosecuting for it successfully even when disclosed. Furthermore, regulation can readily be justified by threats to financial systems as well to individual investors.

The pre-eminence of investor protection pervades most current financial market policy proposals. For example, the response in the US to financial irregularities is to intro-

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duce legislation that strengthens accounting standards, increases directors' fiduciary responsibilities, imposes larger penalties for corporate governance failures and encourages whistleblowing by insiders. Conflicts of interest are to be discouraged by raising barriers between different institutional activities, such as analysis and broking.

Nowhere is this policy more evident than in the context of European corporate governance and takeovers. I was recently involved in a debate in the Oxford Union – the debating chamber of Oxford University – which has been the training ground of British prime ministers from Gladstone to Blair for more than a century. There were two motions before the House. The first one was that "This House believes that business can be trusted" and the second one that "Enron could not happen in Britain". The speakers included the Chairman of the London Stock Exchange and the Director of the Institute of Chartered Accountants.

The proponents of the motion argued that the culture of British business is fundamentally different from the US and that Enron could not happen in the UK. There is less use of stock options as a form of executive remuneration and there is a less rule-based system of accounting meant which means that US style accounting scandals could not happen in Britain. For example, directors of British companies have had to sign off their accounts as being a true and fair representation of the financial condition of their firms for a long time. The implication of this is that the British system of corporate governance, of accounting, regulation and doing business is inherently superior to that in the US.

This is the latest twist in a debate that has been raging for decades if not the best part of a century about the comparative merits of different financial systems and forms of corporate governance. One officer of a German Great Bank observed in the early part of the last century that: "In Germany our banks are largely responsible for the development of the Empire, having fostered and built up its industries... To them, more than any other agency may be credited the splendid results thus far realized".

In the last ten years, we have seen the Japanese system held up as the model with Japanese banks posed to take over US industry. Then as the Japanese bubble burst and the economy went into recession the only model that the Japanese economy seemed to exemplify was that of crony capitalism.

As the bubble drifted from Japan to the US, Japan was replaced as the role model by the US. Up until just over a year ago we were all exhorted to adopt US GAAP as fast as possible and in preference to International Accounting Standards. The US was viewed as the engine of entrepreneurship and the new economy and the rest of us were plagued by sclerosis. But as its high-tech, internet bubble turned to bust, the US has been viewed as exemplifying the excesses of capitalism, the problems of paying executives with options, the home of accounting manipulations and the breeding ground of conflicts of interests between auditors, managers, credit rating agencies, analysts, brokers, investment banks, not to mention between government and business.

That is how the UK rose to the fore. It has come to be seen as providing an appropriate balance between unrestrained capitalism of the US and the private benefit systems of Continental Europe and the Far East. It supposedly has good accounting standards, it

has led the way through the Cadbury Committee of establishing codes of good corporate governance conduct and it has well functioning markets in corporate control. Of course, the new found glory of British corporate governance will last just as long as the British economy performs tolerably well and can therefore be expected to end very shortly.

What should we learn from this volatile history of the rising and waning fortunes of different corporate governance systems. The first is that the search for the El Dorado of corporate governance will continue unabated for the foreseeable future. The belief that better corporate governance systems exist abroad is deep-rooted – in the UK we call it "the grass is always greener on the other side of the fence" phenomenon. The second lesson is that this view is fundamentally wrong.

We might not worry about the fundamental error of judgement if it were not for the fact that it afflicts a particular group of fairly important people, namely governments and regulators. And when governments and regulators suffer from delusions the rest of us face insanity.

There is no greater source of regulation than scandals. Regulatory inaction in the face of fraud or deception is impossible. In so far as audit failures reflect not only on the auditing companies but also on the standard setters and enforcers, it affects investors views about the reliability of accountancy firms in general and their regulators.

Perhaps the best example of this is the greatest scandal and corporate governance failure that the world has ever seen. I am of course referring to the South Sea Bubble. The Bubble not only consumed the South Sea Trading Company itself but also "a company for carrying on an undertaking of great advantage, but nobody to know what it is." or petitions for charters to "extract silver from lead", and "Puckle's Machine Company, for discharging round and square cannon-balls and bullets, and making a total revolution in the art of war". The response was the Bubble Act, which set back the development of incorporation in the UK for 100 years.

The latest examples are Enron and Worldcom in the US. These failures are perceived to be indicative of underlying failure of the US system of corporate governance, accounting and auditing. They are therefore systemic in nature and have prompted responses in the form of the Sarbanes-Oxley Act, as well as those from the New York Stock Exchange and NASDAQ.

In Europe over the past few years, we have had the Bouton report in France, the Baum Commission and the Cromme code in Germany, and the Higgs committeee in the UK. These have proposed a variety of reforms primarily focusing on the composition and role of boards, and the independence and responsibilities of directors.

In Switzerland, following the work of Professors PETER BÖCKLI and KARL HOFSTETTER, the Swiss Business Federation, Economiesuisse, and the Swiss Stock Exchange, SWX, published codes of best practice and guidelines on corporate governance.

Most seriously of all, in Europe we have had the European Commission proposing a new takeover directive. The absence of a market for corporate control has been regarded as a serious deficiency of European capital markets and a reflection of the antiquated systems of ownership and control that pervade European corporate systems. The

absence of a level playing field has been viewed as an impediment to the restructuring of European enterprises. The European Commission believes that the breakdown of barriers to a market in corporate control is a fundamental requirement for the establishment of an integrated European financial market.

Europe is littered with impediments to takeovers: voting right restrictions, dual class shares, pyramid structures of ownership, cross-shareholdings and staggered boards are just a few of the methods that management can employ to avoid the discipline of the takeover market. The way in which the Winter Committee report on takeovers recommended that this should be corrected was by providing predators with the right to break through at least some of these barriers, in particular voting right restrictions and dual class shares. This has provoked an outcry from countries that routinely employ these devices and the complaint that if some but not all barriers are penetrated then far from creating a level playing field in takeovers, a still more uneven terrain will result.

It is not clear how this particular debate will be resolved. There is a great deal of political horse-trading going between different countries but the likelihood is that some form of break-through provision will result. This will fundamentally alter the structure of corporate ownership and control in Europe.

It is difficult to dispute the objectives that lie behind these proposals. Enhancing corporate governance, imposing greater standards of care, facilitating international movement and trade in financial services, encouraging a level playing field in takeovers are like motherhood and apple pie. They improve financial efficiency, they diminish risks for investors, they enhance managerial oversight and monitoring and they increase competition. The political as well as economic appeal of enhancing regulatory standards is overwhelming.

But these policies come at a price. There are many objections that are raised against regulation, relating in particular to the accountability of regulators, the direct and indirect costs of regulation and the moral hazard problem associated with the provision of public insurance. However, there is a further concern that I want to emphasize here that is, I believe, particularly applicable to corporate governance.

The costs of regulation are not only borne by savers and financial institutions but also by the users of capital, namely firms. One of the most pronounced differences in corporate sectors across countries concerns the ownership and control of firms. Levels of concentration of ownership differ pronouncedly from the highly dispersed systems of the UK and US to the highly concentrated of Continental Europe, Japan and the Far East.

These slides illustrate this point. Slide 1 shows the percentage of listed companies in different countries that have a single shareholder or voting block that commands a majority of votes in a company. It shows that in majority of listed companies in Austria, Belgium, Germany and Italy there is a single voting block commanding more than 50 % of votes. In the Netherlands, Spain and Sweden it is between 25 % and 40 %. In contrast in the UK and US it is around 2 %. Figure 2 shows that the difference is even more pronounced in relation to the percentage of companies in which there is a single voting block with a blocking minority, i.e. more than 25 % of the votes in a firm.

Figure 1

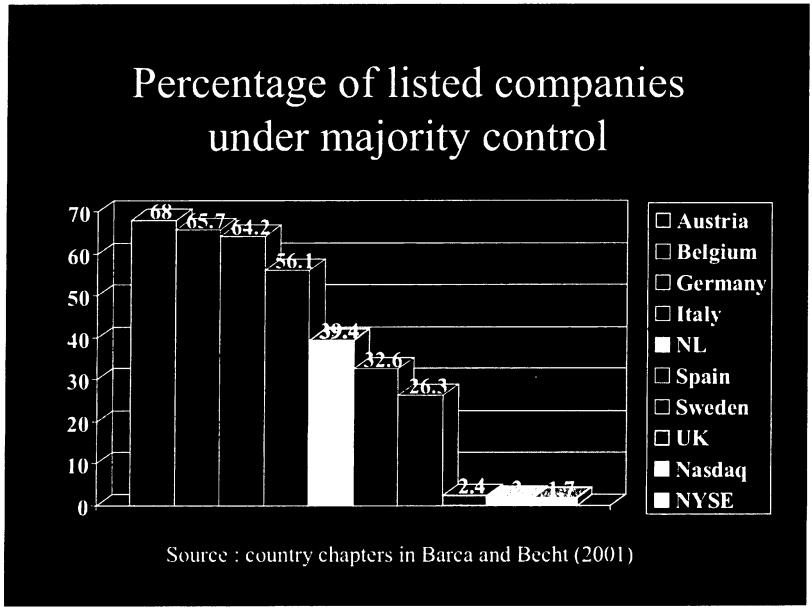

Figure 2

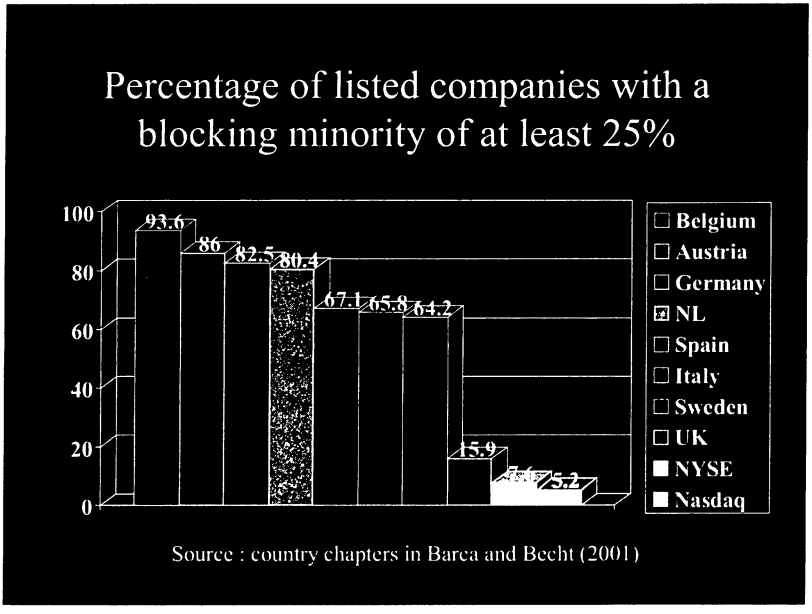

Figure 3 illustrates another feature of many Continental European companies that is largely absent from large listed firms in the UK and US and that is the dominance of family ownership. The Porsche family controls all of the voting shares in their firm even though they only have a small percentage of cash flows. Finally figure 4 is an example of the way in which management can protect itself against the discipline of markets in corporate control. Ownership in ING is widely dispersed through the Administratie Kantoor but the holders of the share certificates have no voting rights.

Principal-agent theories tell us that the corporate governance problems associated with dispersed ownership are quite different from those of concentrated ownership. As guardians of investors' savings, the role that financial institutions should perform in monitoring their corporate investments should therefore vary appreciably across countries.

Nowhere is this more in evidence than in the differences between developed and emerging economies. The financial and corporate governance needs of enterprises in developing and transition economies are quite different from those in developed economies. For example, the significance of bank versus market finance is quite different across economies.

Similarly, within particular economies, the financing and governance requirements of small firms are quite different from those of large and those of high tech industries quite different from those of more traditional manufacturing and service firms. For example, venture capital emerged to meet a specific financing and governance requirement of start-up and developing corporations. Venture capital funds work in very different ways from other mutual funds, and banks and business angels work in quite different ways from venture capital funds. Furthermore, the funding of venture capital firms in Japan is quite different from that in the UK and US – primarily through banks rather than pension funds and life assurance firms as in the UK and US.

What this points to is a considerable variety in the needs of firms across countries, time and activities. The heterogeneity of financial institutions and financial systems is a reflection of those needs. But still more significantly, those needs change in unpredictable ways. We would have been hard pressed to predict the remarkable growth in venture capital thirty years ago. We would have seriously understated the significance of derivatives in corporate activities. We are still only beginning to appreciate the relevance of securitization to corporate finance.

In the context of the importance of diversity and innovation in corporate finance, the concern that regulation raises is its inevitable tendency to homogenize. Corporate governance rules prescribe the structure of boards, the way in which they operate, the way in which executives can be remunerated, the employment and rotation of auditors, the separation of functions between different types of activities. To avoid accusations of arbitrary or unfair conduct, regulators have to operate according to well-defined, pre-specified rules. Only a very modest amount of variation can be permitted before regulation becomes unworkable or unenforceable.

Figure 3

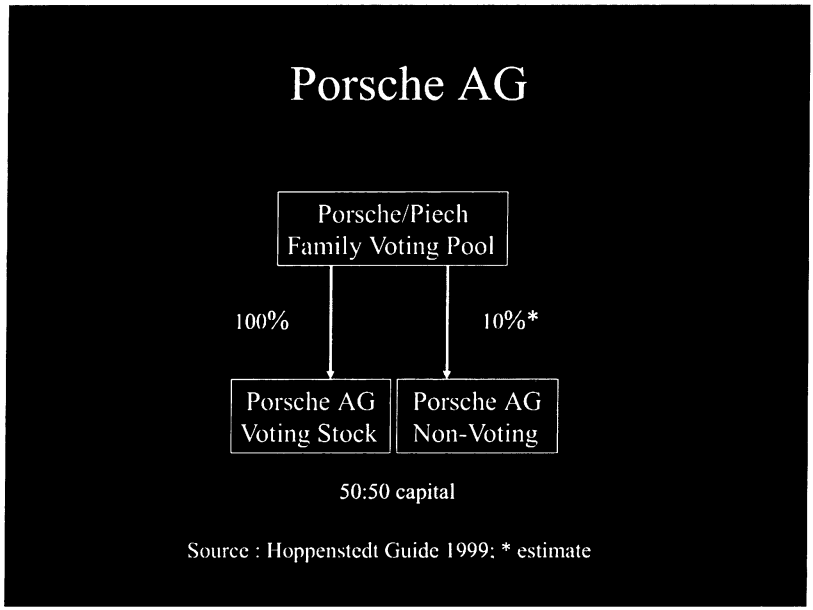

Figure 4

The central argument then is that, possibly the most serious risk of financial regulation and corporate governance rules is not the cost that it imposes on investors and financial institutions but its effect on corporations and the rest of the economy. Regulation threatens diversity and innovation in financial institutions and systems. This is a particular concern in relation to regulation at an international level. There is a natural inclination for regulators to favour harmonization. Not only is it tidier and avoids "runs to the bottom" but it also allows best practice from one regime to be imposed elsewhere.

And therein lies the heart of the problem. There is a presumption not only in harmonization but in regulation more generally of best practice. There are best ways of running businesses and organizing corporate governance. Adopting these best practices improves corporate performance and financial systems. But there is another view and that is best practice varies across countries, time and activities. What is suited to one economy is quite different from another. What is suited to one firm is quite different from another.

According to this view, regulation should not be picking winners. It should encourage the market to identify winners and push out the frontier of best practice. It should be minimizing interference in the operation of financial institutions. It should not be substituting for markets but promoting them.

Critical to the promotion of markets is the provision of information. The one failure that we know pervades financial markets is asymmetries of information. Investors need to know the basis on which they are investing. They need to know the systems of protection that they provide. They need to be able to price the risks that they incur. But they should not have the nature of those risks prescribed in some regulatory office.

US financial regulation has traditionally placed greater emphasis on "private contracting" than the public contracting system of European financial markets and the Far East. Private contracting emphasizes disclosure, private insurance and auditing rather than conduct of business rules and compensation funds. It promotes rather than substitutes for markets. Recent experience has demonstrated the potential vulnerability of private contracting. It relies not only on *caveat emptor* but also on the accuracy of information and the integrity of auditors. It is particularly vulnerable to the failures that we have witnessed over the past year. Superficially at least, public contracting offers greater investor protection. But an alternative policy is to strengthen disclosure, auditing and private insurance rather than impose the uniformity of public contracting.

In sum, I have not disputed the necessity for financial regulation or belittled its significance in the context of systemic risks. On the contrary, I have acknowledged the magnitude of failures that can afflict financial markets. However, I have warned against the current trend to see salvation in regulation, encouraged by a line of academic thought that links tough investor protection directly with strong economic performance. Not only do I believe that this association is incorrect but I also think that it can be positively damaging in a context that sees any regulation as better than none and counts the number of regulatory rules as being a positive indicator of regulatory standards.

Instead, I have suggested that we should think very carefully about the real sources of

market failure in financial markets and target regulation very specifically at these to promote rather than substitute for the operation of markets. I have argued that one set of policies that is critical to this is information disclosure and transparency and I have advocated devoting particular attention to their implementation.

There are two areas of corporate governance that illustrate these principles well. The first is in relation to the board. Non-executives are in a unique position to gather information about the company from within, to evaluate the performance and integrity of executive management and to inform investors. But several conditions need to be fulfilled for this to happen. Firstly, investors need to be able to rely on the agents they appoint to perform this function. Non-executives need to be good, independent and highly motivated. This means that they should be properly remunerated, well trained, appropriately appointed and effectively sanctioned when they fail to perform.

Secondly, investors need to have access to all relevant information. Some of this relates to strategy and is appropriately communicated by executive directors. But other information concerns management competence, integrity and process for which independent assessments are required. For non-executives to be able to evaluate these, they need to have access to similar information and personnel to executives.

Non-executives should be viewed as the investors' internal agents, not external part-timers who turn up for board meetings, and are fed information and good lunches by executives. They should be able, and expected, to move freely through the firm, accessing whatever information from whomever they wish. They should be given the resources (rooms, personnel, data, data systems etc) that allow them to evaluate performance, to uncover failures and in particular to evaluate corporate and managerial performance against appropriate benchmarks. The days of the well-meaning amateur are over. We need a cadre of properly resourced non-executives playing a primary performance evaluation function. This will allow them to question management effectively about the strategic direction of the company, its acquisitions, major investments, diversifications, and divestments.

Thirdly, investors need to have this information regularly and rapidly communicated to them, subject to competitive safeguards. Non-executive directors should have direct access to investors and auditors without executive directors being present and they should play a prominent role in investor relation and shareholder meetings.

Defining the independence, appointment, remuneration, role and accessibility of non-executive directors and auditors are key determinants of good corporate governance. Some of these could be set out in articles of association or contractually specified as part of the duty of care of non-executive directors and auditors.

But while investors should know the basis on which non-executive are employed there should be no presumption of uniformity. For example, while independence is critical for non-executives to perform whistle-blowing functions, some companies look to non-executives to provide advice and experience. For them, independence is unduly restrictive.

The role of non-executives should therefore be precise but not uniform. Some may be

appointed for their knowledge of the industry and others for their ability to monitor. On this basis, self-regulation is preferable to statutory intervention, perhaps backed up by the threat of statute if institutions and companies fail to adopt adequate standards of care.

The second area in which corporate governance standards need to be clarified is in relation to the role of institutional investors. Institutions like pension funds, life assurance funds and mutual funds hold significant blocks of shares in companies and are in a strong position to solicit and evaluate information about the performance of their management. Individual investors delegate authority and pay substantial fees for the management of their portfolios to these institutions. Despite this, institutions have played a very modest role in corporate governance. This has been variously attributed to free rider problems, preference for exit over voice, and an unwillingness to be in the position of insiders when it comes to intervening in the management of firms. None of these are very compelling arguments given that an intermediary should be the medium for collecting and communicating the views of its investor clientele.

But at present, investors are provided with no information about the resources that institutions devote to corporate governance, the degree to which they exercise their voting rights, and the extent to which they interact with board members. Again the presumption should not be that there are uniform codes by which institutions operate but investors should have the right to know what institutions are doing on their behalf and how they are solving the collective action of representing individual investor views.

In summary, I have argued that diversity of corporate governance systems should be viewed as a strength not a weakness of the European financial systems. Regulation should promote diversity not stifle it. To achieve this, European corporate governance policy should be focusing on disclosure, not just of accounting information but also about corporate governance by boards of companies and institutional investors. For the first time, Europe now has the opportunity of leaping ahead of the US in this regard. As the US is currently discovering there is a serious problem of combining the pragmatic approach of substance over form of European disclosure with a litigious system in the US. Sarbanes-Oxley is trying to require auditors and directors to take a broad view of the true and fair nature of financial reporting. But in diluting the precision of its rules in search of a more pragmatic view of fairness, the US corporate system is opening itself up to wave of litigation that will consume directors, auditors and investors in endless courtroom battles to the benefit of just one group – the lawyers. Now more than ever is the time to be a corporate lawyer in the US.

The risk is that Europe will throw away this opportunity to leap ahead of the US for the neatness of harmonization. In contrast, the Swiss approach, in particular of the Swiss Exchange, SWX, on disclosure of information about corporate governance practice and corporate performance is precisely what I am advocating. The underlying principle is of disclose or explain rather than comply. So with the European Commission pressing on towards harmonization perhaps the next model to which people will turn in a few years time will be here in Switzerland.

In conclusion, I never told you how that vote in the Oxford Union on whether business could be trusted and whether Enron could not happen in Britain. I should first of all tell you that the audience was mainly members of the Association of MBAs. I should also say that I was opposing the motions. Well the outcome was that the motions were overwhelmingly rejected and the House concluded that business could not be trusted and Enron could happen in Britain. On the same day an article appeared in the Financial Times reporting a survey of which professions people in Britain thought could be trusted. At the bottom were businessmen ranked with politicians and journalists. At the top alongside the clergy, lawyers and teachers were university professors. We may enjoy no power, pay or prestige but at least we are trusted by the public to do nothing, earn nothing and to take no credit for it.