Corporate Governance in the next decade

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In an earlier article titled 'Perspectives in Corporate Governance' that appeared in this directory, I had traced the rise of corporation to its pinnacle of power and prestige in the 1980's and slow decline since then. This article deals with the attempts that the corporate community, the regulators and the governments have been making to rectify the weaknesses in the way corporations are run. It is rather dull and boring stuff, but it is useful to know the broad contours that corporate governance is going to adopt in the next decade.

It is widely believed that modern idea of corporate governance took birth with the path breaking article by Adolf A. Berle and Gardiner Means titled *The Modern Corporation and Private Property* that was published in 1932. In essence, the article which was culmination of concerns that were being felt for several decades, argued that the separation of control and ownership was at the root of the problems. (As a matter of fact, it was much earlier in 1776, that Adam Smith recognized the problems of separation of management from ownership in *Wealth of Nations).* The management run the corporations for their own benefits and the shareholders interests were affected.

Not that nothing happened in the intervening sixty years, we shall cut to 1992 Report of the Cadbury Committee. It recommended that companies should establish key board committees covering *audit* (composed of non-executive directors, responsible to the board); *remuneration* (responsible to the board for recommending remuneration of directors; *nomination* (a formal and transparent procedure for the appointment of new directors to the board); and that there should be at least three independent non-executive directors on the board. The board should include a balance of executives and non-executive directors, so that no individual can dominate the board's decision making. Finally, there should be separation between the roles of chair (responsible for running the board) and the chief executive officer (responsible for running the business).

In 1999 Ministers of Organization for Economic Cooperation and Development (OECD) approved the Principles of Corporate Governance and these quickly became the world standard. Financial Stability Forum included these principles as one of the 12 key standards for financial stability. These were revised in 2004 and since then have become truly the global standards. The Principles are intended to assist governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The first principles envisaged that a corporate governance framework based on rule of law, clear division of responsibilities among empowered supervisors will promote transparent and efficient markets. The second principle lays down the Rights of Shareholders and their Key Ownership Functions. Primarily, it says that shareholders should be able to register and transfer their shares and have a share in profits. They have a right to participate and vote in general shareholders meetings where they may ask questions and elect and remove directors. For effective participation adequate and timely flow of information is mandated. Capital structures that give disproportionate rights to some have to disclosed. For Institutional Investors it also lays down duty to disclose their policy on corporate governance. The third principle seeks to give equal rights to shareholders within same class and series, protect minority shareholders, prohibit insider trading and make the directors and executives disclose conflict of interest. The fourth principle recognizes the role of Stakeholders such as investors, employees, creditors, and suppliers in Corporate Governance. The fifth principle, on disclosure and transparency, advocates timely disclosure of accurate information including policies in respect of remuneration and related party transactions. Finally, the sixth principle lays down that Boards will perform certain key functions on an informed basis in an ethical and equitable manner.

Need for Review

Human race has entered into a phase where time is telescoped. Two centuries ago a decade did not make any perceptible change in the way people lived and worked and the way businesses and governments functioned. Today, the pace of technological change has cast its inevitable shadow on the way the society functions. By this count alone, a decade was a long enough period for the OECD to consider revision of the 2004 principles. On the top of it, the world went through the financial crisis that not only changed the legal and institutional landscape but also changed many of long cherished theories and demolished some dogmas. It was, therefore, necessary that the Principles of Corporate Governance should also be revised to keep in step with the changing times.

Why the Principles are important?

It is true that the OECD principles are not law that are mandated for every country. The countries can choose to read, interpret and apply according their own circumstances. But at the same time they are also one of the Financial Stability Board's Key Standards for Sound Financial Systems and provide the basis for assessment of the corporate governance component of the Reports on the Observance of Standards and Codes of the World Bank. While being assessed in any evaluation exercise, the approach followed is by and large that of comply or explain.

How to read the document?

Most of the international documents are soporific. The animated and sometimes bitter debates are hidden behind an innocuous change in words or sometimes in the arrangement of same words. To get some idea of this, it will be interesting to examine how the very first clause in the first sentence in the new principles has undergone a change. The 2004 version read as

"The corporate governance framework should promote transparent and efficient markets,"

The 2015 draft reads as:

"The corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources,"

Obviously, there are two changes. First, the word "fair" has been used to describe the markets that corporate governance framework should promote. Second, "efficient" now no longer qualifies the markets. It is only used to qualify the allocation of resources. Introduction of the word 'fair' signals that OECD is no longer satisfied by markets being transparent and efficient only, they want them to be fair also. Fairness assumes a great significance in the context of high frequency and algorithmic trading. Such markets may be transparent as information is available to the last microsecond and may also be proved to be efficient as the spreads are further squeezed. The question remains where does it leave the individual retail investor who is not able to muster the same muscle. By putting one single word in the document, the OECD has thrown its weight on one side of the HFT/ Algo trading debate. Now let us come to the second change. Earlier version of the Principles wanted the markets to be efficient. What does that mean? In the terms of Efficient Markets Theory (EMT), it means that current prices contain all the information and no excess returns can be earned by any form of technical or fundamental analysis. Even restrictions such as Insider Trading laws will have to be considered as barrier to markets becoming efficient. There are many valid criticisms to the EMT. In the last decade, the scenario in economic theory has changed considerably. Perhaps that is why OECD has decided to change its focus to efficient allocation of resources rather than trying to make the markets themselves efficient. Now, what I have said above is not gospel truth or that OECD has expressed these opinions somewhere. This is what I feel might be the effect of the changes. All that I intend to convey is that the document needs to be read with extreme care while being sensitive to nuances.

The principles have been arranged in chapters, each principle has got a chapter of its own. The chapter begins with enunciation of the principle in bold letters. This is a summary statement of a few lines. The principle is elucidated in several sub principles. As a matter of fact these sub principles are most important and carry the principle message. What follows below each sub principle is called annotation. It is here the concept is explained in plain words. This is where the committee expresses its views about the various practices. It asks the governments to ensure certain practices while it supports some others. Some other practices are simply encouraged. Some are declared as best practices while regarding some, the committee is content to state that it is followed in many or a few jurisdiction. These annotations provide a ready guide to the governments and regulators as to where they exactly want to pitch their regulations in the context of global practices while they try to be sensitive to the local environment.

Some Major Changes

It might not be possible to summarise the principles in an article where 2500 words is prescribed as the upper limit but I will give my own understanding as to how the principles have changed in a major way. While the 2004 version was content with articulation of division of responsibilities among the regulators, the current draft seeks to ensure effective supervision and enforcement. The concept of private enforcement has been introduced. Further, the words "*When regulatory responsibilities or oversight are delegated to non-public bodies, it is desirable to explicitly assess why, and under what circumstances, such delegation is desirable"* assume significance when we think of the regulatory powers that have been delegated to demutualised Stock Exchanges. As if on a cue, another sub principle explicitly states, *"Stock markets should be regulated in a way that supports effective corporate governance".* The annotations further elaborate that "*In view of the variety of forms that Stock Exchanges have taken and their profit maximization nature, an effective and nuanced supervision is called for".* Finally the First Principle introduces a brand new sub principle on international cooperation.

Coming to the Second Principle, we notice that it concerns the rights and equitable treatment of shareholders and their key ownership function. This covers both the second and the third principles of the 2004 version. The first thing to notice here is that the word "equitable" has been added in the chapter heading itself to signify merger of the two earlier principles. There is renewed emphasis on information being provided to shareholders. Practices that disempower the shareholders such as voting by show of hands and holding meetings in remote locations has been mentioned as one of the impediments. On remuneration, perhaps owing to the attention the issue has received after the Global Financial Crisis, the new version has changed the position from "*Although board and executive contracts are not an appropriate subject for approval by the general meeting of shareholders"* to *"..it is important for shareholders to know the remuneration policy as well as the total value of compensation arrangements made pursuant to this policy. Shareholders also have an interest in how remuneration and company performance are linked when they assess the capability of the board and the qualities they should seek in nominees for the board."*

Another important development is in regard to the clear position that OECD has taken in relation to Related Party Transactions (RPTs). It now requires countries to broadly but clearly define the RPTs, set their materiality thresholds and provide for their approval either by the Board or the shareholders. On the disclosure front, clear recognition of materiality has been done and due place has been accorded to non-financial information. In the recent times there has been some debate as to what position Boards should take in respect of aggressive tax policies followed by the management. These policies are not exactly illegal but are seen as bordering on tax evasion by the public and the governments. Should they object to such tax policies they might be failing in their fiduciary duty towards the shareholders. This dilemma has been resolved by OECD principles by specifically stating that *"The duty of care also does not extend to an obligation to pursue aggressive tax avoidance".*

Institutional Investors, Stock Markets and other Intermediaries.

There is no straight and uncompromised relationship between the performance of a company and the income of the ultimate beneficiaries of the shareholding. A new principle has been introduced as Principle III regarding the role of Institutional Investors to ensure that a sound incentive structure is provided throughout the investment chain. To my mind, the most far reaching introduction is in respect of the way votes are cast by custodians or nominees. Earlier, the principles, only provided that the votes are to be cast in the manner agreed upon with the ultimate beneficiaries. Now they are required to vote in line with the directions issued by the ultimate beneficiaries - "*Custodian institutions holding securities as nominees for customers should not be permitted to cast the votes of shareholders on those securities unless they have received specific instructions to do so".*

Finally, proxy advisors, analysts, brokers, rating agencies and others, that provide analysis or advice is relevant to decisions by investors are now required to disclose and minimize conflicts of interest that might compromise the integrity of their analysis or advice.

Conclusion

The subject is so vast that a complete book is necessary to analyze the revised principles and to anticipate what effects these might have on the way corporate governance shapes up in the coming decade. This article does not claim to have dealt with the subject to any degree of comprehensiveness. My attempt has been to make the readers aware of the importance of what is going to come very soon and whet their appetite for reading and analyzing new issues.