Corporate Governance

This subject is currently the very height of fashion and figures prominently as a discussion topic in the PADA's consultation on investment.

It is yet another of those topics where authors appear to have kept the subject amorphous and nebulous by design; definitions vary wildly from author to author. These definitions range from the useless: "*…governance refers to the act or process of governing.*"[i] to the more substantial *"The framework within which the board controls and monitors the business of the company. It focuses on the responsibility of directors for setting strategic aims, establishing financial policies and overseeing the implementation as well as reporting to shareholders on the activities and progress of the company. We consider good corporate governance and effective management as vital to the successful implementation of a company's corporate objectives."*

This latter definition is taken from an article entitled "*The shareholders have spoken*" published by Legal and General Investment Management (LGIM) in their "*Fundamentals*" series on the topic of corporate governance and the financial system. As LGIM are widely recognised among investment managers as leaders in the field of corporate governance, and as printed definitions of the topic and descriptions of practices are not commonplace, we shall use this document, by quoting sections of it, as a prompt for our discussion and criticisms. We would wish to emphasise that we share the perception of LGIM as one of the stronger participants in the field of corporate governance, and one of the few to have committed their views to print. The majority are far, far worse than LGIM.

As with so much in finance, there really is little, if anything, new in the concept. Milton Friedman's response to the early consumer activism of Ralph Nader in 1970 noted: "*The discussions of the "social responsibilities of business" are notable for their analytical looseness and lack of rigor.*", which resonates strongly with today's position.

In this New York Times magazine article Friedman argued: "*There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*"

"*In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.*"

This article, incidentally, has been credited by Michael Jensen as the source of the initial impetus for his paper with William Meckling: "*Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.*", which, of course, is the seminal modern paper addressing the separation of ownership and control in the modern

corporation – the principal versus agent problem. Reverting to our earlier assertion that little is new, Jensen and Meckling quote Adam Smith on precisely this problem in their abstract.

"*The directors of such [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners is a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.*"

1970 also saw the publication of Albert Hirschman's classic "*Exit, Voice and Loyalty*", a discussion of the relative merits of consumer disengagement versus engagement. Though it transcends pure economics, considering much which is best described as politics, the praise of such notable economists as Ken Arrow and J.K. Galbraith for it was fulsome. Incidentally Ralph Nader was also sharing correspondence with Hirschman at this time. It would appear that there are timeless elements to this approach as noted recently by Louis Lowenstein of Columbia University in a paper on corporate governance: "*Exit, voice and loyalty are wonderful tools for analyzing capitalism, particularly the market breed where exit is so prevalent. American financial markets and corporate structures have evolved considerably since I first applied exit-voice, and those tools still work marvellously well.*"

Reverting now to the LGIM article, we should commence by noting that, under their definition, corporate governance focuses on the responsibility of directors in the direction of the firm. This has the problem that it omits to consider the legal framework within which companies are created and exist – the persona and life of a company are established within this, together with the general framework establishing directors' responsibilities. There is considerable empirical evidence which suggests that the legal system of a company's domicile is a far more significant determinant of investment returns than its ownership structure. The company's memorandum and articles of association set out the specific objectives and responsibilities. One might consider the difference here to be exogenous versus endogenous governance issues. Of course, to effect change in the legal framework, an exogenous issue, engagement would not be with management but with politicians and the legislature.

It may be that the new Company's Act 2006 is now thought perfect – though the alterations to regulations concerning the memorandum and articles of a company appear slight – but that would appear to be wishful thinking on rather a grand scale, and at 761 pages this Act does have a grand scale. It should be noted that many of the robust academic studies are explicitly considering issues of national law, institutions and custom - exogenous rather than endogenous issues; and many of the most robust empirical results are found in this exogenous domain. The extent of differences in customs internationally may be illustrated by the treatment of bribes or secret payments to foreign officials; in the US these have long been criminal, while in France and Germany they only ceased to be tax-deductible in the late 1990s in compliance with the OECD code. It is also relevant

here that one strand of discussion in the debate on new post crisis regulations has been upon bank capitalisation using equity with part paid and contingent liability characteristics.

The LGIM article initially asserts: "*Clearly, the UK's corporate governance framework failed to prevent the recent financial crisis.*" and continues much later: "*As the recent crisis has so clearly displayed, when corporate governance fails, the ramifications can be extraordinary.*"

This is simply nonsense. The UK's corporate governance framework applies to all companies in the UK; it is exogenous. What then was the role of Shell, or Tesco or my local garage in this crisis? That, of course, does not mean that specific endogenous failings in some companies may not have contributed. But there's rather a strange and deeply worrying mission creep evident here; since when was the objective of corporate governance the avoidance of financial crisis, rather than redress of the principal-agent problem associated with the separation of ownership and control?

In the wake of the crisis some have argued, unconvincingly, that the problems observed result inevitably from a governance issue, a devil-may-care exploitation of the limited liability nature of a banking company. There are, in fact, far more plausible explanations of the crisis as a complex co-ordination problem – for example, the British Academy's response to H.M. the Queen's question, as to the lack of forewarning by economists, which observes and attributes the crisis as: "*Everyone seemed to be doing their own job properly on its own merit. And according to standard measures of success they were often doing it well. The failure was to see how collectively this added up to a series of interconnected imbalances over which no single authority had jurisdiction. This, combined with the psychology of herding and the mantra of financial and policy gurus, lead to a dangerous recipe.*"

We may correctly be concerned by corporate governance where we are not owners to the extent that some governance failing creates externalities for which we, the public, bear the costs. The separation of ownership from control, for example, permits the payment to managers, as an incentive, of overly generous compensation which if considered as an alternate to investment in good corporate governance, can result in the creation of barriers to entry and restriction of competition. But this is very different from the prevalent discussion of bonuses and remuneration in investment banking.

The LGIM paper discusses the role of institutional investors and asserts: "*Arguably, large institutional shareholders such as LGIM are in a better position to identify potential corporate governance risks than incumbent boards and management due to our ability as outsiders to spot suboptimal governance structures. As external observers with no agenda other than the preservation of our own investment, institutional investors are appropriately motivated and incentivised to identify threats to a company.*" This argument is astonishing; it asserts that an external monitor with incomplete information and no control rights is intrinsically superior to an internal well-informed monitor with control rights.

It is impossible to judge whether the use of the word ***risks*** rather than something more correct, such as failings, is significant - though they differ in meaning materially. We wonder if it really is true that preservation alone is the objective of the share and policyholders of LGIM; a requirement to produce competitive investment returns would be more usual.

The LGIM report observes that one reason cited by institutional investors for declining to engage with companies is: *"2 If they don't like how a company is operating, they can simply sell their stake and walk away;"*

Some have argued that this is not feasible for large funds; that there is a condition "*too big to sell*." This is simply untrue and this argument is usually invoked by those who simply do not wish to recognise the transaction costs.

This choice is the heart of Hirschman's exit and voice analysis; the option, which has value, to sell and walk away. In addition, there is always the option to sell and walk away in a noisy manner, for example by drawing attention to the fact that the shares had been sold and stating reasons to the press. The LGIM article continues with: "*However, while this action is possibly logical for shareholders who are not closely connected with the management of a company, we feel it misses the point.*" If a shareholder is closely connected with management, then, of course, it is improper for them to sell or to buy unless there is no inside information that might be or might be perceived to be involved.

But that's not the point at issue, which is: "*Investors typically start their engagement process by meeting a company before an investment is made.*" To which we will respond: why should management take any notice whatsoever of an institution which is not (yet) a shareholder? The paragraph continues with the non-sequitur: "*Prevention is the best way of solving corporate governance concerns and if investors wait until something has gone wrong before they start to engage, it will often be too late to solve the problem.*" If this is to be asserted, it should be accompanied by the recognition that precautionary intervention may also be wasteful when it is based upon mistaken diagnosis.

Now we begin to get into the meat of problems: "*By engaging in a running dialogue with management, the most influential shareholders can challenge existing processes, identify potential issues facing a company and enhance the corporate governance framework as a whole.*" This suggests that there are different classes of shareholder and that their (varying) influence should be exercised outside of the formal processes defined in memorandum and articles of association – which, of course, is itself very poor corporate governance practice.

"*While shareholders may be well placed to offer valuable outside perspectives to a management team, to be motivated to take action, the gains need to be larger that the cost of effort.*" This actually contains the core of a major misunderstanding. It is management that will not undertake a revision to their behaviour unless they gain more than they expend as effort. But the gains to shareholders that arise from resolution from

the principal agent problem are costs to the management, a lowering of their excess compensation.

It also suggests that the advice offered unequivocally enhances a company's performance, and later the note asserts "*Whilst there is great value in institutional shareholder oversight, …*". This is a proposition for which we are unaware of any supporting evidence. Indeed if all shareholders were to engage, the result would be a management team which is inundated by advice which would most likely usually conflict.

There is an entire industry devoted to the provision of advice, management consultancy. Here, there really is significant evidence of faddism and ineffectiveness – even a cursory inspection of the airport business book section is very illuminating in that regard. Fairchild and Abrahamson from Columbia University expressed these concerns rather well in their 1999 paper: "*Management fashion: Lifecycles, triggers and collective learning processes*."

"*Our results suggest that management fashions intended to be both rational and progressive may in fact be irrational and thus, retrogressive from the point of view of the thousands of organisations and millions of managers and employees who use these fashionable techniques both nationally and globally. Such widespread perpetual change, if it is technically inefficient, has the potential to generate pervasive waste, burnout, and cynicism about the potential for all forms of advancement in management.*"

The question which should be asked is: if an industry which depends for its revenues and existence upon commissioned advice cannot deliver, an industry which holds the position of inside delegated monitor, what hope is there for the advice of a shareholder offering unsolicited advice, a mere external monitor?

The LGIM note continues with: "*Openly opposing a management team may cost individual shareholders directly and be highly time consuming and because it may weaken the share price of the company, it could be counter-productive to shareholder interests.*

Instead, the process of communicating concerns may be more successful for both parties if it is conducted behind closed doors and negative aspects are not displayed publicly."

This is simply appalling. It is market manipulation, a criminal offence. LGIM obviously considers transparency to be a one-way street. We cannot see how this practice could possibly be considered good corporate governance. If, of course, it were to become so, the efficient markets theories which drive passive index tracking portfolios – a material aspect of LGIM's business – would no longer be desirable as investment strategies. In selecting out the negative aspects for publication, there is deception and that is entirely inimical to trust, a fundament of financial services.

Incidentally why the management of a company should entertain at all any index tracking fund manager, whose holdings are passive and who has forgone the exit option, is not at all obvious.

The article continues, noting that monitoring is a highly costly business, and observes that there both co-ordination problems among many small shareholders and a 'free rider' problem. The article observes that LGIM: "*saw on average one bank every two weeks during 2008. …most of our concerns and issues were ignored*."

There are many possible reasons why this outcome may have come to pass, but we shall indicate just a further two of them - capture and domestication. These arise as problems under voice, particularly so when discussions are private. This position was considered by the Egg of Head in *MacBird!*[ii] in the context of dissenters in the US administration over the question of prosecution of the war in Vietnam.

"*In speaking out one loses influence.*
The chance for change by pleas or prayer is gone.
The chance to modify the devil's deeds
As critic from within is still my hope.
To quit the club! Be outside looking in!
This outsideness, this unfamiliar land,
From which few travellers ever get back in…
I fear to break; I'll work with for a change."

The more extreme form, domestication, is perhaps more worrisome since here the dissenter carries the appointed role of devil's advocate, and is retained in a role not dissimilar to a household pet, while like Cassandra being ignored.

The principles of corporate governance of the institutional shareholders' committee and the Combined Code both refer to a dialogue between shareholder and management, but fail to recognise that a dialogue may not, per se, modify behaviour which is based upon an existing agency-based incentive. If shareholders wish to signal in any dialogue that some modification to this behaviour is appropriate, then they must recognise that in order to be credible this signal must be costly. In the vernacular, talk is cheap.

As the concern in this facet of corporate governance is that of agency costs, it is worth revisiting Jensen and Meckling's seminal 1976 paper on the monitoring and social product of security analysts: "*One of the groups who seem to play a large role in these activities is composed of security analysts….There is also a large body of evidence which indicates that the security analysis activities of mutual funds and other institutional investors are not reflected in portfolio returns, i.e. they do not increase risk-adjusted returns over a naïve random selection buy-and-hold strategy. Therefore, some have been tempted to conclude that the resources expended on such research activities…is a social loss. Jensen (1979) argues that this conclusion cannot ne unambiguously drawn because there is a large consumption element in the demand for these services.*

Furthermore, the analysis of this paper would seem to indicate that to the extent that security analysis activities reduce the agency costs associated with the separation of ownership and control, they are indeed socially productive. Moreover, if this is true, we expect the major benefits of the security analysis activity to be reflected in higher capitalized value of the ownership claims to corporations and **not** *in the period-to-period portfolio returns of the analyst. Equilibrium in the security analysis industry requires that the private returns to analysis (i.e. portfolio returns) must be just equal to the private costs of such activity, and this will not reflect the social product of this activity which will consist of larger output and higher* **levels** *of the capital value of ownership claims. Therefore, the argument implies that if there is a non-optimal amount of security analysis being performed, it is too much not too little (since the shareholders would be willing to pay directly to have the "optimal" monitoring performed and we don't seem to observe such payments.)".*

As this was being written, the Financial Reporting Council produced a report on the status of corporate governance, including shareholder engagement. It is obvious from this report that many of the views expressed in this essay are shared more widely among the investment community and that a substantial number do avoid and will continue to avoid engagement. It appears that engagement is fundamentally a politically driven process. With which in mind, it should be obvious that voice would tend to arise as a technique in political processes, while exit is the natural market solution.

PADA's unique problem is that this is a newly created investment fund, which as yet has no assets. It will, as time progresses, become a significant source of capital financing for the UK. While the fund is attracting new savings, it wants the investments in which it places those funds to be priced as lowly as possible. Any actions which raise prices now, as might be expected from the Jensen & Meckling analysis, are therefore currently counter-productive.

It is possible that this will change as time progresses and the value of the invested accumulated endowment grows, but that depends upon the relative sizes of the future present value of contracted contributions beyond that future date and the value of the fund at that time; a bridge that can be crossed when we arrive at it.

The question of corporate governance has recently acquired a high public profile with Lord Myners' comments on the inadequacies, perceived by him, of the official reviews and recommendations on the financial crisis. Lord Myners is, of course, a very prominent member of the engagement movement in corporate governance.

The inadequacies of this movement are, in fact, laid bare by Lord Myners' comments and proposals. Lord Myners began his comments with as assertion that: *"…but a share certificate is a right and entitlement of ownership which carries with it certain responsibilities*"

That is an incorrect understanding of the position of ownership of a share. Once I have subscribed the capital represented by a share certificate, I have no further liability in

respect of it. Liability is explicitly limited to the original subscription. The words liability and responsibility are synonyms. This limitation of liability does not apply to all forms of capital asset – for example, if we own commercial property, we would be liable for its demolition costs should it become dangerous. In fact a share is only a claim on the residual assets of the company after all other claims have been met - there is very little which is free to be used without let or hindrance. When we buy shares from other investors, our liability is limited to the amount agreed as payable unless there are other warranties or conditions attached to the sale, but even here there is no obligation to the company.

Lord Myners' proposals that shareholdings should hold differential voting rights, based upon the length of ownership, build on this miscomprehension and result in unintended follies. If we have differential voting rights among shares we have effectively created differing classes of share – and with different classes we will observe different prices. Trading on a stock exchange, which of course relies upon the homogeneity of the instrument traded, would be restricted or impossible; listing would lose purpose. And Stock Exchange listing rules are a material source of governance practice and enforcement; the Exchange is an external monitor with control rights.

All things considered, it is difficult not to conclude that corporate governance is now a process which is political rather than economic in nature and indeed one that carries economic cost rather than benefit.

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[i] "What is corporate governance?" Colley, Doyle, Logan and Stettinius 2005 – ISBN 0-07-144448-3

[ii] "*MacBird!*" Barbara Garson, Grassy Knoll Press 1966