EXPERT ANALYSIS

INTERNATIONAL CORPORATE GOVERNANCE NETWORK (ICGN)

Taking the long view

George Dallas, policy director at **ICGN**, discusses the broad-sweeping developments in corporate governance and the topics that will dominate in 2019

Corporate governance has taken on a much more expansive role for businesses and investors than it had just a few years ago. It should be a central consideration for long term investors and one in which broader issues such as environmental strategy and social responsibility are factored in as potential risks or opportunities, and directly impact valuations. It is the softer and more nuanced side of business building. It is doubtful that long-term investments, mergers or acquisitions can truly be successful without a careful analysis of the issues it raises. ICGN's George Dallas explains.

In general terms, how has the thinking on corporate governance evolved since the financial crisis in 2008?

A lot has changed. Amongst other things the financial crisis stimulated greater thinking about the role of the institutional investor in the corporate governance process. It gave rise to stewardship codes and the general emphasis on investors playing an active and constructive role as part of their fiduciary responsibilities to beneficiaries. It also gave rise to thinking about far broader risks than those traditionally considered by companies, boards and investors. Systemic risk is a case in point. One of the things we're getting our heads around at ICGN is what systemic risk means and how it's relevant to corporate governance, investors and companies. Environmental concerns have certainly become more severe since 2008 and that needs reflection in the capital markets, particularly with regard to the continued threats of climate change. At this same time broader social issues such as human rights, mass migration and other geopolitical pressures have also emerged as critical systemic issues. It prompts the question as to what the private sector needs to do and how these risks play into corporate governance and the role that investors have.

Linked to this, the shareholder versus

George Dallas
Policy director, International Corporate Governance Network
London, UK
W: www.icgn.org

About the author

George Dallas has served as policy director at the International Corporate Governance Network since 2014, where he coordinates ICGN's governance polices and committees and plays an active role in ICGN's policy development and regulatory outreach on behalf of members, whose assets under management exceed $34 trillion. George is also a visiting lecturer at Cass Business School, University of London.

Previously, George served as director of corporate governance at F&C Investments (now BMO Global Asset Management) in London (£100 billion in assets under management). Prior to joining F&C, he was a managing director at Standard & Poor's. He is published widely in the fields of corporate governance and responsible investment, including the book "Governance and Risk" (McGraw-Hill, 2004).

George holds a BA degree, with distinction, from Stanford University and an MBA from the Haas School of the University of California at Berkeley.

stakeholder primacy debate has returned. I know many had thought this had died down as an issue, but it is coming back and the role of the stakeholder is becoming more focused upon, as we are seeing in the new UK Corporate Governance Code. Time horizon is part of this shift in perspective, as many of the large institutional investors have a significant portion of their holdings in pension funds or other long-term savings. This is capital that needs to be managed with a 30-50+ year perspective, and increasingly both companies and investors recognise the importance of stakeholder relations (employees, customers, communities, etc) in sustainable value creation and long-term company success.

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We also are becoming more aware of the limitations in our systems of financial accounting and reporting. In some markets 85% – 90% of the market cap of companies isn't explained by traditional accounting methods. The blanket term "intangibles" may relate to various forms of company capital – natural, social, intellectual – that are either not valued on the balance sheet properly or not valued at all. This prompts questions such as what is the right level of reporting and what are the types of drivers that companies and investors need to look at? This is stimulating a lot of focus on integrated reporting and integrated thinking.

What do you see as being the priorities for companies at the moment? Is corporate governance equally as important for small, medium and large companies?

Both investors and companies (the board of directors and the executive management) need to get to grips with environmental, social and governance (ESG) issues. The factors reflect the widening boundaries of corporate governance and the consideration of topics that were not squarely on the company agenda 10 or 15 years ago. These are now recognised as potential sources of opportunity and risk. Every company will have its own specific matrix or set of ESG issues that may be material to its own sustainable value creation. This will differ by company, industry and geography. However, ESG issues are sources of opportunities and risk that can affect a company's valuation, financial strength and performance. They have not been reported upon as robustly historically as they probably should have been.

Investors and directors of a company of any size should want the company to be well-governed for its own long-term sustainable success. However, the consideration of size does raise the question of proportionality: one size does not always fit all. We often forget that companies operate on a life cycle and have different stages of development. It is not as if governance is not a priority for smaller companies; it is just that the types of structures that are in place for small companies may not be necessarily the same as those that are appropriate for a more mature company. I do think investors want to see all companies – whether small, medium or large – have a willingness to take on more rigorous governance practices as they develop and evolve.

When should corporate governance considerations weigh in during M&A negotiations and structuring?

We're starting to think about businesses in different ways. Businesses are not just an earnings stream, a nexus of contracts or something that can fill a target financial or cash flow gap. Governance and softer issues do come into play, and businesses are also cultures. For the company being acquired, is its business model and foundation for wealth creation sustainable? Is its culture consistent, or at least compatible, with the values and culture of the company that is taking it on? During earlier periods, perhaps these issues may not have been fully considered; but culture, values, stakeholder relations and its ESG profile are hidden opportunities or risks that should be assessed in the context of normal due diligence.

What do you make of some of the latest moves to update corporate governance, for instance the EU Shareholders Right Directive (SRD) and the UK's new Corporate Governance Code?

The EU Shareholders Directive has been in the works for a while and it is putting stewardship on the map to a large extent, at least in Europe. We have been generally supportive of the direction it is taking. It is appropriate for the EU to focus on disclosure as a foundation for regulation, as opposed to prescriptive hard letter law. The Directive certainly clarifies the point that investors have a role in stewardship and it also lays down some obligations for investors – including remuneration votes and stewardship disclosures. The UK's new Corporate Governance Code is much more recent and has been in the works for a couple of years, ever since Prime Minister Theresa May came in. There are many dimensions to it but one of the headlines is the emphasis on the role of the stakeholder in corporate governance and what the board needs to do to ensure that it has a clear understanding of stakeholder interests.

In some ways, this represents UK corporate governance moving in a European direction, which is interesting, if not ironic, particularly in the age of Brexit. It's a different positioning towards stakeholders and the company's role in society more broadly, and I think we are starting to see it in the US as well, though this thinking is less well developed there. The UK government is seeking to promote a longer term perspective in financial markets and to develop its own industrial economy, and sees the role in corporate governance in contributing to that end. It remains to be seen if the UK will succeed in producing the type of Germanic, long-term manufacturing and industrial base that the government is looking for. But if nothing else, it is positive and sensible to emphasise that stakeholders do need to be paid attention to and that stakeholder relationships can be very important in affecting a company's long-term ability to create sustainable value.

Are there a significant divergences in approach between jurisdictions?

Yes. To broadly generalise, the US is very shareholder focused, whereas Europe and other parts of the world have more of a stakeholder perspective. This often boils down to a stakeholder versus shareholder dialogue but what we try to encourage at ICGN is to think of company-centric governance: what is the sustainability of the company itself? That is what directors need to think about in terms of their own directorship duties and investors with long term investments also need to think about it. These are not irreconcilable, but they can be positioned to seem that way. I believe if we think first about the interest of the company itself that might be one way of squaring the circle.

What could Brexit mean in terms of corporate governance in Europe?

Brexit seems to be evolving and who knows even now what its destiny is going to be. But if it does go through as scheduled I think it will have an impact on governance in Europe. The UK has long been a thought leader in corporate governance and one of its standard bearers. I don't think that will go away, but its influence may diminish as the EU is influencing corporate governance in Europe with greater emphasis on stakeholders and ESG issues – a so-called "Rhineland capitalism". This strong stakeholder orientation – I would say stronger than in the UK or the US – will continue, if not broaden, particularly given the EU's emphasis on sustainable finance as a core policy.

Europe also has different ownership structures, with controlled ownership still the dominant form of ownership on the continent. In some European jurisdictions there is concern about the potentially short-term influences of institutional investors, seeking short term profits at the expense of a company's long-term development. Market protections with various forms of differential ownership structure exist in Europe, such as the Florange Act in France or the current consideration of a 250-day holding period for hostile takeover in the Netherlands.

ICGN and its investor members (whose assets under management are in excess of $34 trillion) are generally supportive of the European focus on sustainable finance, but we are concerned that the protectionist measures that are diluting minority shareholder rights are retrograde and at odds with the goals of stewardship that come with the new Shareholder Rights Directive.

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Do you see any particularly worrying developments? We note that ICGN has issued comments on dual class shares, for example.

Dual class shares have been and continue to be a concern in relation to the broader issue of ownership rights. We have seen it in Hong Kong, Singapore and many other countries and it is becoming very prevalent in the hi-tech sector in the US. Differential ownership issues come into play when you are talking about loyalty shares or other types of restrictions that are not minority shareholder friendly. This pops up usually under the banner of trying to promote long-termism and protect companies from the short-term animal spirits of the market. Dual class share structures may, for some period in a company's development cycle, provide a degree of warranted protection, but this should not be indefinite. We're concerned that this is a real problem in terms of entrenchment of management and the diminished accountability to minority shareholders. We believe that any benefits of being protected from market forces from dual class shares will ultimately erode and lead to pernicious entrenchment and controlling owners pursuing their own private benefits at the expense of minority investors and the company as a whole. This is a real concern.

Stock exchanges, particularly the ones operating as for-profit institutions, have a very clear conflict of interest in seeking listing and trading volumes in a very competitive global market. We are seeing that the issue of dual class shares is in some ways the manifestation of stock exchanges competing with one another to lower standards, almost as a race to the bottom. They lower shareholder protections as a way to attract new issuance volume – as opposed to enhancing the rights of investors as a fundamental stakeholder in the exchange. We also think this is unfortunate.

There is also the potentially troubling issue of common ownership—defined as when you

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have an investor holding equity stakes in more than one company within the same sector. There is a confluence of micro-economic reasoning and legal analyses which, when pulled together, suggests that when common ownership occurs this somehow has the effect of making that sector less competitive, with the economy and the consumer suffering. In the face of controversial empirical evidence some scholars are proposing quite draconian remedies which would absolutely run counter to the notion of investor stewardship. Any index investor and most active managers are going to have multiple holdings of companies in the same sector. To suggest that they shouldn't be in a position to vote or engage and exercise their rights is extreme. To suggest that there is any explicit or implicit encouragement by common owners of companies not to compete with one another is simply ludicrous.

What will the ICGN be especially focused on in 2019?

We have many initiatives on the go and will provide ICGN policy commentary on a range of issues including systemic risk, engaging boards on climate change, ESG reporting, and the role of creditors in corporate governance. But I specifically would like to highlight capital allocation as something that we will be focusing on more, and this is an issue where corporate governance and corporate finance come together in some ways. The key questions are how to allocate capital in terms of assets and how to fund them as from both providers of debt and equity capital. It raises specific questions relating to the appropriateness of share buybacks and how the company's financial structure an provide a sustainable equilibrium to enable the company to keep their creditors happy, but also generate sufficient returns for shareholders. This also involves thinking about returns on capital and the cost of capital and how this is reported in the context of financial policy. In the governance perspective these issues haven't been as focused on as much as they possibly could be. ICGN will be publishing a Viewpoint report on this in 2019.

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