Corporate governance for a changing world

Executive Summary

Oslo, 23 August 2016

The roundtable, co-organised by Frank Bold[1] and the SMART Project, University of Oslo Faculty of Law[2], brought together leading experts on governance from across Scandinavia to discuss corporate purpose and best practice how should corporate governance contribute to long-term sustainable value creation. The roundtable was part of a global series organised as part of the Purpose of the Corporation Project[3] with previous events held in London, New York, Zurich, Breukelen (the Netherlands), and Paris. The keynote speech was delivered by Idar Kreutzer (Finance Norway). In addition, Markus Kallifatides (Stockholm School of Economics) presented research on the corporate governance practice of the Nordic region, while Prof. Beate Sjåfjell (University of Oslo) introduced recent corporate governance developments and updates in the European Union. The following roundtable discussion was held under Chatham House Rule.

Keynote Speech: Idar Kreutzer, Finance Norway

Mr. Kreutzer's speech focused on the role of the company in society. He started his presentation by quoting Aristotle: "Wealth is evidently not the good we are seeking; for it is merely useful and for the sake of something else".

Mr. Kreutzer then raised the question of whether the world is now facing a tipping point. In the last decades the world has become more integrated, with more global trade and strong international institutions. This is now changing: there is a lack of trust in transnational cooperation, with Brexit being one illustrative example. Is the trend in today's society, bringing politics that focus more on short-term self-interest, and in that case, what consequences will this have for the global business world?

Mr. Kreutzer went on to look at the role of companies in this changing world, reminding roundtable participants that the purpose of the cooperation is neither to provide humanitarian aid nor to act as an NGO. Their role is to create value, produce goods and services, create jobs, develop skills and generate revenue for society – directly and indirectly. He advocated that one possible pitfall is to see companies as something fundamentally different to what they really are: a tool for balancing risk and creating the possibility of profit. This principle, however, does not mean that we should be indifferent to how companies generate their profits.

Mr. Kreutzer said he did not believe in overregulating companies and thereby restraining their possibility to serve as a value creator. He suggested that the solution is to balance stakeholder interests. This balance may be reached by working with the shareholder ownership community because shareowners design the governance structure of companies. Furthermore shareholders can help to establish investment principles that balance the social, environmental and profitable aspects of investing, thereby creating engagement and dialogue within companies. The role of investors should include engagement in standard setting, responsible engagement in governance of individual corporations, and risk management related to major social and environmental risks.

The key to this understanding is to share knowledge and experiences through communication within and between companies and investors. Developing shareholder (stewardship) strategies is a better way to reach our sustainability goals than through increasingly rigid regulations. But realistically, he stated, this strategy is unfolding very slowly. On a positive note, he pointed to a growing movement in the investment community, represented by the UN-supported Principles for Responsible Investment.

Finally, Mr. Kreutzer shared his view on universal standards and principles, such as the UN Principles on Business and Human Rights.[4] He argued that we must not underestimate the values of such principles as a means to reaching the goal of sustainability. Such universal principles serve a useful role as guidance and inspiration for companies when they create their own internal standards.

Corporate governance developments in the EU and remaining challenges

Prof. Beate Sjåfjell[5] emphasized the significance of good corporate governance as crucial for the survival of the companies themselves, and for the contribution of business to ensuring the achievement of the UN Sustainable Development Goals. She argued that the regulatory framework should seek to ensure that companies create sustainable value while staying within the planetary boundaries. Good corporate governance should thus lead to corporate sustainability; to the creation of value that on aggregate contributes to economic, social and environmental sustainability.

Prof. Sjåfjell went on to highlight recent developments in the EU:

- The ongoing reform process of the Shareholder Rights Directive, currently blocked in trilogue negotiations between the European institutions.
- The tentative discussion of shareholder duties in the EU, inspired by the international trend of stewardship codes. This is not expected to move very far, given the strong shareholder focus that dominates the EU corporate governance framework.
- The Non-Financial Reporting Directive, which was adopted by the EU in 2014, is a positive step but it does not prescribe verification (assurance) of what is reported, which is important in order to provide reliable information to investors.

Prof. Sjåfjell ended by pointing out that the biggest remaining challenge for corporate sustainability is the social norm of shareholder primacy, which she suggested should be mitigated to allow corporations to contribute to the systemic change that is needed to confront societal challenges.

Markus Kallifatides, Stockholm School of Economics[6]

Dr. Kallifatides presented findings from a recent empirical study conducted on 36 mid-cap and large corporations in Nordic countries to determine how and what affects corporate governance practice in the Nordic region.

The researchers conducted interviews with controlling shareholders, chairs and CEOs of participating corporations, with the intention to unveil and understand which factors influence corporate governance practice. In the Nordic region, companies typically have a controlling shareholder. The study found the profile of this controlling shareholder is decisive in how corporate governance is applied and practiced. The share ownership structure (dispersed or concentrated), level of commitment, category (State or private), degree of autonomy, and legal form (corporation, association, foundation) of the controlling shareholder play a key role. Under Nordic company law, controlling shareholders are potentially very powerful in relation to executive management, but the law provides little guidance how shareholders should exercise that power..

The researchers found five dimensions of shareholding that influence corporate governance practice:

- Personality/Character (risk attitude, philosophy, private/state owned etc)
- Intention (benefiting a state, enrichening an individual or a family, time horizon, etc)
- Wealth (capability of participating in issue of new shares)
- Competence (capacity to make judgement – operational or financial)
- Reputation

They also found that shareholders select board members whose attitudes to ROI, ideas and ideals match their shareholding profile. In corporations with a controlling shareholder, the ownership profile will therefore to a large extent determine business strategy.

Dr. Kallifatides went on to speak about how this research also showed that the company laws of the Nordic countries allow a substantial amount of “tailoring” of the corporate governance practice, as the regulations allow and reinforce the strong position of dominant shareholders.

Since codes of corporate governance apply on a comply-or-explain basis, and they lack effective sanctions, they tend to be superficially respected and easily circumvented. The reasons why corporations opt not to comply with code provisions vary: the code may be seen as impractical, unnecessary, or an administrative issue. Based on his research, Dr. Kallifatides is skeptical of the idea that corporate governance codes can effectively promote sustainable corporate governance.

Finally, Dr. Kallifatides commented on how the chair has a special standing on the board in Nordic countries. Although the regulation does not differentiate between the chair and other board members, in practice the chair tends to be a predominant figure.

Roundtable discussion

Prof. Jukka Mähönen[7] moderated the round table session. The following questions framed the discussion at the Oslo roundtable

- How can sound corporate governance foster long-term focus and sustainable behavior?
- What incentives for short-termism exist in law and the Code of practice for Corporate Governance?
- How can board-level responsibility be promoted within Norwegian state owned enterprises?

In discussing these questions, the participants addressed several points. Key conclusions of this discussion included:

- The current corporate governance framework gives ultimate power to shareholders; it is therefore crucial that they embrace the long-term view. This remains a challenge.
- While it is not desirable to overregulate corporate governance, for certain sustainability issues it is necessary to change existing legislation.
- Compliance mechanisms can help companies to avoid legal risks and unethical behaviour. To be effective, such mechanisms must be transparent, i.e. disclosed, ideally verified, and implemented at all levels of management.
- For non-financial issues that are not regulated, it is important to further develop international standards and translate them into benchmarks in order to allow effective investor engagement.
- Corporate disclosure should include a clear statement of goals, steps taken to achieve these goals, and results. Corporate reporting should develop towards an integrated model.
- Incentives for directors play an important role in driving short-termism.
- The role of analysts is often overlooked; they should more carefully consider ESG issues and risks.

The role of corporate governance and of the regulation

The participants first discussed the role of the board. Some agreed that the decisive role of the board in corporate governance is an illusion. With 5-8 meetings per year, it is impossible to have the complete picture of the development of the company and of its operating environment. Furthermore, the information provided to the board members is often carefully selected by the CEO. Boards should not micromanage the business but rather focus on the overall strategy, culture, and disciplinary measures.

One participant stated that there is no conflict between maximizing profits, good corporate governance and sustainable behaviour – as one is impossible without the other, which should be documented by further research. However it was pointed out that tax-evasion and corruption can be extremely profitable and easy to hide.

The participants discussed the role of regulation in addressing this problem. Some agreed that it would be important not to over regulate corporate governance, but rather develop international standards which become the benchmark for sustainable businesses. But it was also pointed out that CEOs and board members often speak in favour of regulation in the areas of corporate non-financial performance and corporate governance. The reason for this is that it is difficult to defend business strategies and choices that favour sustainability over short-term profit if they go beyond legal requirements.

One participant pointed out that whilst investors agree on corporate social responsibility standards, they do not reflect them in their practice. Therefore in order to drive change, a change of legislation is necessary. On the other hand, if new legislation is passed in response to an immediate crisis, there is a high risk that the quality of such legislation will be low.

The role of compliance systems

It was pointed out that non-financial reporting is extremely important for investors who want to “make the right choices”. Investors need to look at how a company carries out its business (compliance with laws, ethics and non-financial governance standards), rather than focusing exclusively on what it delivers in terms of immediate financial returns. Investors need to read this information and assess it as they would financial information. In this respect, the challenge for investors and other stakeholders is to determine what an effective compliance programme should look like. Greater clarity is necessary in order to improve shareholder and stakeholder engagement.

The participants also discussed the link between corporate governance, due diligence and compliance mechanisms, and criminal law. Currently, companies can expect lighter sentencing in criminal cases if they can prove they have an effective compliance programme. This can work as an incentive, but may also represent a problem. When board members and owners are charged under criminal law, the tendency is to point to the corporation´s compliance systems (“compliance based defense”). To prevent using a compliance system as a mere façade, it should be implemented at all levels of the organisation and externally verified. However, irrespective of the quality of such systems, the corporate practice depends also on the risk the corporation accepts when entering into a new market or developing a new strategy, which should be also reflected in attributing criminal responsibility.

In this respect, one participant brought up the lack of enforcement of the anticorruption legislation in the Nordic companies as compared to the practice in the US. Strong enforcement would drive improvement of corporate compliance and governance in this area.

The role of corporate disclosure and of international standards

Several participants endorsed the view that shareholders and investors are key in driving change. They argued that international standards need to be developed in greater detail with respect to key sustainability issues so they can be employed as a benchmark in order to assist investors in their investment decisions and to create a level playing field for companies. In this respect, corporate disclosure – or “non-financial” reporting – is extremely important.

Idar Kreutzer pointed out that corporate governance is not a linear process, but a complex network of interactions that boards must understand. He suggested a simple three-step model for corporate disclosure to be implemented by boards that would help to foster a sustainable business and improve communication with investors:

1. State clearly your plans. In this respect, less is more: it is better to focus on one key area – preferably selected on the basis of international standards – rather than trying to get better at «everything» at once.
2. Implement change and document the steps taken.
3. Report on the consequences of what you have done. Even if the corporation achieved nothing substantial, it should be reported. This will be useful to avoid mistakes the next time the corporation considers making similar changes.

This will then provide a tool for implementation of sound corporate governance and it will provide useful information to investors and the financial community.

One participant suggested that non-financial reporting should be integrated with financial and strategy reporting and that these reports be verified by an independent body.

Drivers of short-termism

The participants noted that the drive for short-termism comes primarily from shareholders. The prevalent strategy of investors is to maximise returns in the shortest possible time by investing in companies that can provide them with the best and quickest returns. In the current corporate governance framework that gives ultimate power to shareholders. It is therefore key that they embrace the long-term view. If the government expects investors to act as responsible, long-term oriented shareholders, it must prove it is possible by acting in such a way in its own role as a shareholder.

The participants also discussed the role of directors in short-termism. They pointed to incentive systems that align directors' personal interests with short-term results. In the Nordic countries, the culture is focused on building consensus. That means that if the prevalent norm is to focus on maximising short-term profits, it is difficult for any director to stand out and challenge this logic.

Finally, the participants pointed to the role of analysts whose practice has been focused on analysing financial reports and largely ignoring non-financial data, except in cases where the analysed corporation has already faced ethical or similar problems.

About

Frank Bold is a public interest law firm leading a collaborative project on the Purpose of the Corporation, which brings together business, regulators, civil society and academics to forge a new vision for the future of corporate governance and company law, and more generally the role of business in society. The academic basis for the project is provided by Dr. Jeroen Veldman and Prof. Hugh Willmott, who run the Modern Corporation Project at Cass Business School, London (themoderncorporation.org)

References

1. Frank Bold is a purpose driven law firm with four offices in the Czech Republic as well as offices in Brussels, Belgium and Krakow, Poland. The firm uses both business and non-profit approaches to solve social and environmental problems. Frank Bold provides legal expertise in corporate accountability and corporate governance to the European institutions as well as to civil society, municipalities, and businesses. Frank Bold initiated the Purpose of the Corporation Project.
2. The SMART Project is an international research project with 25 partner institutions, coordinated by the University of Oslo Faculty of Law, and funded under the European Union's framework programme Horizon 2020, Grant agreement 693642. Project website: uio.no/smart.
3. The Purpose of the Corporation Project is a collaborative, independent initiative led by the purpose-driven law firm of Frank Bold (www.purposeofcorporation.org). The academic basis for the project is provided by Dr. Jeroen Veldman and Prof. Hugh Willmott, who run the Modern Corporation Project at Cass Business School, London (themoderncorporation.org). Jeroen Veldman is Senior Research Fellow at Cass Business School, City University, London. He has held appointments at Cardiff Business School, the Utrecht School of Governance, Utrecht University and a visiting professorship at UPMF, Grenoble. His research addresses the historical development of the public limited liability corporate form and its status in and between organization studies, management, company law, economics, finance, accounting, politics, and corporate governance. Hugh Willmott is Professor of Management at Cass Business School, City University, London and Research Professor in Organization Studies, Cardiff Business School, UK. He has held visiting professors at Copenhagen Business School and the Universities of Uppsala, Lund, Innsbruck, Sydney and the University of Technology, Sydney. He previously held professorial appointments at the UMIST (now Manchester Business School) and Cambridge. He co-founded the International Labour Process Conference and the International Critical Management Studies Conference.
4. UN Guiding Principles on Business and Human Rights http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf
5. Professor of Law at the University of Oslo and coordinator of the SMART project.
6. Dr. Markus Kallifatides, Associate Professor at the Stockholm School of Economics and Director of the Center for Governance and Management Studies.
7. Dr. Jukka Mähönen, Professor at the University of Oslo, Faculty of Law.

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