The Elusive Quest for Global Governance Standards

Lucian Bebchuk and Assaf Hamdani

Sloan Foundation Corporate Governance Research Conference, March 2009

Main Points

- Companies with dispersed ownership (NCS companies) vs. companies with a controlling shareholder (CS companies): Governance arrangements that are beneficial for one type of companies are often irrelevant or even counter-productive for the other type.
- While the difference between CS and NCS firms has been recognized, it has not been reflected in the design and use of governance metrics.
- Any global single governance metric is bound to miss the mark in either cross-firm comparisons or cross-country comparisons.
- The influential global metrics extensively used by scholars and shareholder advisers -- the Corporate Governance Quotient (CGQ), the Anti-Director Rights Index, and the Anti-Self-Dealing Index -- are inadequate for assessing governance around the world.
- Going forward, the quest for global governance standards should be replaced by an effort to develop separate methodologies for assessing governance in CS and NCS companies.
- We identify the key features that these separate methodologies should include.

Demand for Global Metrics

- Widespread recognition that adequate investor protection is important, and
- Globalization of capital markets

=>

- Interest by researchers, policymakers, and investors in cross-country and cross-firm comparisons of governance.

Supply of Global Metrics:

- The Anti-Director Rights Index and the Anti-Self-Dealing Index:
  - Applied in over 100 studies
- Riskmetrics's CGQ system:
  - Widely used by investors and pubic firms; growing use by academics.

Some Fundamental Differences between CS and NCS companies (1)

Contestability of Control:

- Control is contestable in NCS companies but not in CS companies.

Implications:

- Rules governing control contest are important for investor protection in NCS companies but largely irrelevant for investors in CS companies.

Some Fundamental Differences between CS and NCS Companies (2)

Nature of agency problems:

- The insiders from whom public investors need protection are controlling shareholders in CS companies and managers in NCS companies.

Implications:

- Rules that increase the power of the majority of shareholders vis-à-vis he board might protect shareholders in NCS companies but are unlikely to do so in CS companies.
- Rules that give power to minority of shareholders are more likely to be beneficial for public investors in CS companies than in NCS companies.

Some Fundamental Differences between CS and NCS Companies (3)

Existence of collective action problems:

- Collective action problems significantly impede the ability of a shareholder majority to exercise its powers in NCS companies but not in CS companies.

Implications:

- Rules that enable the majority of shareholders to overcome collective action problems are important for NCS companies but commonly irrelevant for CS companies.

Example: Rules Governing the Ability of a Majority of Shareholders to Replace the Board

CGQ system:
* Seven provisions out of fifty-five focus on features of the company's poison pill and takeover defenses.
* But among CS firms with a majority controller, these arrangements are irrelevant.

The Anti-Director Rights Index:
* Three out of six components focus on the ability of the majority of shareholders to exercise their voting power: shareholders' rights to call a special meeting, to vote by mail, and to vote without depositing shares.
* But for CS firms with a majority controller, these arrangements are irrelevant.

The Anti-Self-Dealing Index:
* No weight given to such arrangements.
* OK for assessing investor protection in CS firms, but misses something of importance for investors in NCS firms.

Going Forward: Cross-Firm Comparisons

- Need to have a separate methodology for assessing investor protection in CS firms and a separate methodology for assessing investor protection in NCS firms.

- Any assessment methodology that applies a single metric to firms regardless of ownership structure will miss the mark with respect to CS companies, NCS companies, or both types of firms.

Going Forward: Cross-Country Comparisons

- How well a country protects public investors in NCS companies does not determine how well it protects public investors in CS companies, and vice verse.
- Need to keep separate scores (and not blend them together) for:
  - How well a country protects public investors in NCS companies (the country's NCS score);
  - How well a country protects investors in CS companies (the country's CS score).
- This is important for:
  - Cross-country comparisons of average investor protections in public companies when countries have different proportions of CS and NCS companies.
  - Using the right country control in comparisons of firms around the world.
  - Studying political economy impediments to reforms and prospects for reform.

CS Methodology

For use in:

- Assessing governance in CS firms.
- Assessing how a country protects public investors in CS firms.

Should:

- Give relatively less weight to arrangements governing:
  - control contents
  - voting procedures (except for votes where the minority has power to shape outcome)
- View more positively:
  - arrangements insulating directors from the majority of shareholders
  - arrangements enabling a minority of shareholders to block majority wishes.
- Pay closer attention to:
  - self-dealing, taking of corporate opportunities, and freezeouts
  - separation of cash flow and voting rights
  - director independence from the controller (and not only management)

NCS Methodology

For use in:

- Assessing governance in NCS firms.
- Assessing how a country protects investors in NCS firms.

Should:

- Give significant weight to rules governing control contests.
- Give significant weight to rules governing shareholder voting procedures.
- Give significant weight to the rules governing the scope of shareholder power to intervene.
- Give significant weight to executive compensation.

Conclusion

- The quest for a global governance metric should be replaced with an effort to design separate CS and NCS methodologies.
- By identifying the key elements that should and should not be included in each of these separate methodologies, our work provides researchers, policymakers, and investors with a useful framework for evaluating governance of public companies around the world.