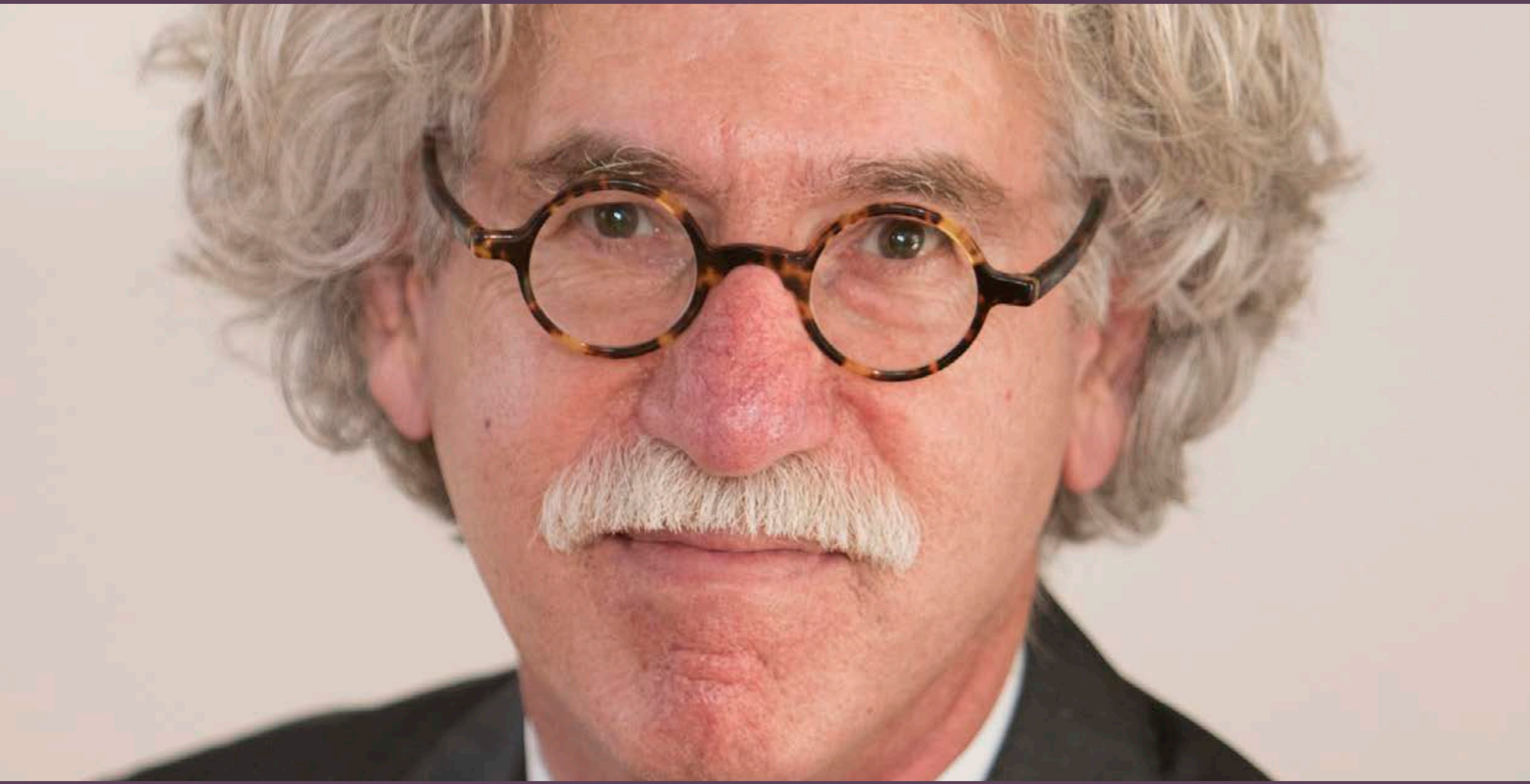
GOVERNMENTS & GOVERNANCE



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When the body of Robert Maxwell washed ashore in the Canary Islands in November 1991, the scandal over the media tycoon's epic misuse of shareholder funds and employee pensions was only just beginning to unravel. Investigators were never able to determine whether Maxwell committed suicide, had been murdered, or died of natural causes. But there is no doubt about something else: the fraud he perpetrated at the Mirror Group fueled reforms in Britain that spread and were adapted worldwide to form the modern corporate governance movement. What is striking, looking back, is how much the private sector was the author of those early reforms. Politicians and regulators were largely content, despite a firestorm of public outrage against Maxwell, to set the table for business, investors and professional bodies—many of whom were thought implicated, if only by inaction, in the scandal—to convene and agree governance solutions. Today, by contrast, it is striking in many markets how much the public sector and political interests, attentive to grassroots distrust of business leadership, are now driving corporate governance. More than ever, governments are seeking to write governance rules. Even in markets such as those in the GCC where lines between public and private sectors are more permeable, insights from this international phenomenon are important for companies and shareholders.

Before exploring those lessons, it is instructive to trace the intersection of politics and business from corporate governance origins. In May 1991, just months before Maxwell's plunge into the Atlantic, three UK groups had tapped Sir Adrian Cadbury to chair a committee to probe "the financial aspects of corporate governance". Two of these—the accounting profession and the London Stock Exchange—were private sector bodies. The third was the Financial Reporting Council (FRC), an independent regulator. The resulting Cadbury code was not the first formal standard of corporate governance; Ireland's pre-dated it by a year. But the Cadbury report gained international traction like none other.

Despite the presence of regulators, the text was crafted by capital market players and then implemented as a voluntary code under the then-novel comply-or-explain approach. Over succeeding years UK governments pressed for periodic reviews of the code, but still left decisions over content almost entirely in the hands of the private sector. In a parallel track, the Bank of England, concerned about the scarcity of skilled independent directors at UK companies, had served as a catalyst, but not operator, in founding Pro Ned, a clearinghouse of board candidates. In France, the employers' organization asked banker Marc Viénot to author a code, while the country's fund management association later framed rival standards. Similar trajectories could be found in other jurisdictions; the public sector provided the nudge to improve corporate governance, but private sector entities managed content. Even the first international principles issued by the Organisation for Economic Co-operation and Development (OECD), a body composed of sovereign states, were based largely on guidance generated by an elite private sector body chaired by US super-lawyer Ira Millstein.

Throughout the period, corporate governance was largely considered an arcane and specialized corner of the capital market, drawing comparatively little public attention except episodically in response to scandal. It is no accident, for instance, that the Cadbury Committee's charge was to focus narrowly on the "financial aspects" of governance. To take one simple but telling gauge, a Google search of the term 'corporate governance' for March 1998 yields 1.35 million results. The same search for March 2016 yields 32.9 million.

Arguably the tide began to turn toward more fulsome attention in the run-up to the election of Tony Blair's Labour party in Britain. In a 1996 speech in Singapore Blair announced that he would aim to build something he termed a "stakeholder economy", one that would be "run for the many, not for the few." Sure enough, in 1999, amid mounting public dismay over high executive remuneration, Trade and Industry Secretary Stephen Byers unveiled legislation that sought to solve a political problem using a corporate governance toolkit. The act would, by 2003, compel each listed company to put its remuneration report to an annual, non-binding shareholder vote of confidence. Here was government intervening in governance not merely as a convenor, but as a definer of content. Note that the Blair government acted not in response to investors—who were conspicuously absent among advocates of 'say on pay'—or on grounds of corporate performance, but to address voter pressure on a matter of social equity. We have since seen 'say on pay' legislation spread to multiple markets for similar reasons.

Labour sought to extend the approach to other corporate governance frontiers in efforts to demonstrate responsiveness to public concern about CEO pay. While it decisively lost the May 2015 general election to the Conservatives, Labour adopted a platform that promised to compel employee participation on the board remuneration committees of public companies. That would have marked a radical shift in UK practice toward the German co-determination model of board oversight. Across the Channel, the European Commission took a more direct approach, adopting hard limits on compensation at financial institutions as a means of responding to public opinion that such enterprises were principally responsible for the financial crisis. EC measures imposed a cap on bonuses and required regulatory approval of certain pay packages.

Other examples followed of governments seizing the initiative to accomplish public sector objectives through changes to the rules of corporate governance. Perhaps the most dramatic was the least heralded at inception. In 2003 Norway's parliament adopted legislation mandating a quota of 40% women on company boards, with implementation starting in 2006. Once again, the impetus was not related to market failure in a narrow, economic sense; it was to satisfy social pressure for gender equity. At first, other jurisdictions, even those elsewhere in Europe, took scant notice of Norway's action as anything but an idiosyncratic move by a small and peripheral market. But in 2012 the European Commission announced its own 40% soft quota of women on corporate boards for the whole of the EU. Member states have since adopted versions of that. Further afield, India now mandates at least one woman on every public company board. And in the UK, which has so far shunned prescribed quotas, both the last and current governments have used the bully pulpit unreservedly to press rapid gender diversification of corporate boards, holding out the prospect of legislation in the absence of progress.

Of course, more empirical evidence seems to be surfacing every day that demonstrates a connection between diversity and performance. So there is increasingly a legitimate business case to be made for measures aimed at breaking up what may be depicted as a monoculture at the top of many public companies. But the impetus behind lawmakers' quota initiatives, as well as steps they have devised to rein in remuneration, may fairly be characterized as stemming from political rather than value objectives.

US policymakers, despite cultivating a reputation for keeping non-financial objectives out of capital market frameworks, have in recent years proven nearly as drawn as their international counterparts to the siren call of corporate governance as an antidote for social faults. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, for instance, contained at least two measures that may be described as falling into this category. First, Congress wrote Section 1502 to crack down on human rights abuses in the Democratic Republic of the Congo. It required corporations to disclose if their products contain so-called conflict minerals, such as diamonds, mined and traded in war-torn areas. Second, Dodd-Frank Section 953(b) ordered the Securities and Exchange Commission to develop rules mandating that listed companies disclose a ratio comparing CEO pay with median compensation of all other employees. There may be entirely legitimate reasons for both, just as for board quotas and pay curbs. But they were not measures asked for by either business or (with a few exceptions) investors, and they had at best only indirect relevance to corporate performance or investor protection.

The raucous 2016 US presidential candidate election campaign offered perhaps the strongest evidence so far that the gray line between civil government and corporate governance may be thinner than ever. The Occupy movement, which had kindled public wrath at Wall Street's role in the financial crisis, had long faded from the scene by the time candidates on the right and left opened their party nomination campaigns for the White House. But grassroots resentment, it turned out, was simply waiting to be stoked. Democrat Bernie Sanders built his entire insurgent effort during primaries and caucuses on the promise to break up large financial institutions, crack down on high CEO remuneration, and compel corporate boards to consider social interests. Former Secretary of State Hillary Clinton, for her part, felt obliged to compete in those same contests with parallel policy ideas such as curbs on short termism ("quarterly capitalism"), disclosures on corporate political spending, bars on tax inversions, controls on drug pricing, and fresh attacks on board approval of skyrocketing CEO pay.

More surprising, perhaps, were volleys launched against Wall Street by candidates standing for the nomination of the Republican party, which had traditionally been identified with enterprise.

Businessman Donald Trump, for instance, was highly critical of political donations by big financial institutions and floated the idea of appointing hedge fund firebrand Carl Icahn as US Treasury Secretary. Texas Senator Ted Cruz cited the rise of “crony capitalism” and painted big Wall Street banks as villains. With trust in CEOs low and skepticism about business high, there seemed few political rewards to be reaped from a platform advocating that business should be left to its own devices, at least at the time of this writing.

Of course, not all markets in the GCC region would draw a clear distinction between civil governance and corporate governance, especially where the state or the ruling family plays a guiding or catalytic role in the economy. But the lesson that may be drawn from the interplay of these forces in other markets is that parties in control of corporate governance rule-making are most likely to be those who maintain a healthy ‘license to operate’—that is, who are perceived as maintaining public trust. Even in close-knit GCC markets the rise of social media and the import of outside ideas and practices, arguably, have enhanced the importance of public confidence in enterprise as a social factor in political and economic stability. The lessons from elsewhere seem clear. In the immediate aftermath of Robert Maxwell’s death the private sector in Britain, France and elsewhere was still considered worthy enough to fix itself. But by the turn of the millennium, sentiment had switched decisively against the market as its own physician. Rightly or wrongly, business was tagged as lagging in addressing matters such as income inequality, gender discrimination, and economic opportunity. Public policy had to intervene with correctives or risk political backlash or social unrest. Enterprise has therefore had to live with rules developed by and for outsiders that may be overly rigid and inapt for effective private sector use.

How could private sector actors seek to regain leadership or forestall excessive intervention in corporate governance by political actors? Or to put it another way, how might business claim a license to operate to assume a leading role in governance standard-setting? The answer must involve collective action, since no single enterprise has sufficient clout to earn a license to operate on behalf of an entire sector. But pursuit of a collective reputation for trust is an odyssey marked both by the “tragedy of the commons” as well as by what Bank of England Governor Mark Carney has dubbed the “tragedy of the horizon”. That is, while actors might have a shared interest in cooperative behavior, they have individual commercial motives that often compel them to work against the common good. Moreover, while they might have common interests in long-term objectives, a range of structural factors tend to force them to act short term. Thanks to these twin ‘tragedies’, it is rare to find markets where companies proactively demonstrate joint capacity to behave long term and contribute meaningfully to ameliorating legitimate social faults. Indeed, it is often rare in many markets to be able to identify high-profile business leaders prepared to advocate such collective action.

There are exceptions, though. Focusing Capital on the Long Term (www.fclt.org) is a project initiated in 2013 by McKinsey and the Canada Public Pension Plan Investment Board; its advisory board consists of corporate, institutional investor and sovereign wealth fund leaders. FCLT seeks to position influential capital market actors as champions of sustainable economic growth. Other similar vehicles have arisen to address issues such as climate change. Cases with the greatest prospect for success are those that equip business with eyes on, and the ability collectively to react to, fast-evolving social pressures. They can in this way hope to bank social capital that earns them the trust to develop and self-police the next round of corporate governance reforms—before political actors do it for them.