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The Origin of Regulation, Corporate Governance Models and Shareholder Engagement

ESG & Sustainability Transformation

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The world's first formal corporate governance code appeared in the United Kingdom in 1992. The Cadbury Committee was convened in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accounting profession to review what it called "the financial aspects of corporate governance". Its formation was a result of the Caparo and Polly Peck scandals in the country.

Caparo made a successful takeover bid for Fidelity, only to discover that Fidelity's profits had been significantly overstated.

The market had been pumping up Polly Peck's share price for years on the basis of financial statements that turned out to be misleading.

The Cadbury Committee was set up because of perceived problems with accounting and governance.

As the committee began its work (but before it was due to publish its report), the Maxwell/Mirror Group scandal had begun to emerge and the Bank of Credit and Commerce International (BCCI) had collapsed spectacularly following money laundering and other regulatory breaches. It was clear that much needed to change.

Much of what the Cadbury Committee recommended is still considered best practice today and has been incorporated into laws and guidelines around the world. For example, the committee recommended that every public company should have an audit committee that meets at least twice a year. Notably, when the report was published, only two-thirds of the 250 largest companies in the UK had such committees (although they are now widespread). The core theme of the report was that no individual should have "unfettered decision-making power"; for example, the roles of chairman and chief executive (CEO) should not be combined, a practice that was common at the time.

A set of guidelines for good governance has been developed from the basic concepts of accountability and alignment. Governance varies from country to country based on culture and historical development as well as local corporate law. At the most basic level, some countries, including Germany and the Netherlands, have two-tier boards, with supervisory boards consisting entirely of non-executive directors who oversee executive boards; others have single-tier boards, with some dominated by executive directors (as in Japan), some

with the CEO also serving as chairman (most commonly seen in the United States and France), and some in between (as in the United Kingdom).

The Cadbury Code model of recommendations that companies should follow or explain any non-compliance has also been questioned around the world. It is now difficult to find a market that does not have a formal corporate governance code.

Since Japan passed its own law in 2015, the United States is now the only major market in the world without such a law, largely a consequence of corporate law being set at the state level, rather than the federal level. Most markets adopt the language of "comply or explain," although the Netherlands favors "apply or explain" and Australia uses the blunt "if not, why not?" language. However, the thought process is the same: The law expects compliance with relevant standards or a thoughtful and intelligent discussion of how the board operates on the fundamentals. These discussions are gaining increasing attention, not least because they provide boards with an opportunity to explain how they are working to deliver value to the business on behalf of both shareholders and other stakeholders.

The willingness of companies to engage in thoughtful dialogue about their differences from various guidelines. Some companies may view corporate governance negatively, because they perceive it as inflexible. Indeed, there is a risk that investors will approach corporate governance rules with inflexibility, expecting compliance rather than accountability – which is not the intention of the code. Sometimes this apparent inflexibility can arise from a failure to communicate, particularly through the reliance on proxy advisory firms (a highly focused group led by ISS and Glass Lewis) to mediate some of the dialogue on governance and voting issues.

These advisory firms tend to adhere to the details of corporate governance laws when making recommendations about how their clients should vote. Some argue that the role of proxy advisers is to interpret the standards strictly, and that shareholders should actually apply the flexibility that comes from a deeper understanding of the specifics of individual companies. In this analysis, the problem of inflexibility may arise more from the tendency of investor clients to follow proxy adviser recommendations, with little independent assessment of whether those recommendations are correct, than from the rigor of the recommendations themselves.

Shareholder engagement is an active dialogue between companies and their investors, with the latter expressing clear views on issues they care about (often including ESG issues). Interaction helps ensure that board members are held accountable for their actions, which will hopefully in time help improve the quality of their decision-making.

For minority shareholders – of whom institutional investors are the majority – a key issue is that they are not abused by dominant or controlling shareholders. In many cases, protections for minority shareholders are built into company law, and often exist in listing regulations and other formal protections. These protections are often reinforced by corporate governance rules, but the issues are so fundamental (in terms of avoiding abuse of minorities and protecting their ownership) that in most countries, minority shareholders benefit from basic legal protections.

Minority shareholder abuse can involve taking money out of a business in ways that benefit controlling shareholders but not the broader majority shareholder base, which explains why there are often higher reporting requirements around related party transactions and the right for non-conflicted shareholders to approve them. Minority shareholders will also not expect the company in which they invest to change significantly if they do not have the opportunity to vote on the matter. For example, in the UK listed equity market, the tests applied are as follows:

• If a transaction affects more than 5% of any of the company's assets, profits, value or capitalisation, additional reporting is required (Type 2 Transaction).

• If a transaction affects more than 25% of the assets, profits, value or capital of any company, there must be a shareholder vote to approve the deal based on detailed reasons (Type 1 Transaction).

Another important means of shareholder protection is pre-emption rights. These rights ensure that an investor has the ability to maintain his or her position in the company. Fundamental to corporate law in many markets (for example, in the United States) is the idea that a company should not issue shares without giving existing shareholders the right to purchase an amount sufficient to maintain their current holdings. Because these rights come before the rights of potential outside investors, they are called pre-emption rights, and the existence of these rights is why large corporate share issuances are often referred to as "rights issues."

Because these rights come before those of potential outside investors, they are called preemptive, and the existence of these rights is why large corporate share issues are often referred to as "rights issues". Even when issues are not fully preemptive, there is often an expectation that larger institutional shareholders will be offered what is known as a soft pre-emption, that is, an allocation equivalent to their existing shares but in a less formal, less legal way (which may allow for a quicker issue). Larger issues are more controversial, as are issues at prices that may be lower than the current share price. An example of a model that is particularly unpopular with minority rights advocates is "general mandate" resolutions in the Hong Kong Special Administrative Region, which seek to authorize the issue of up to 20% of the share capital, potentially at a discount. There is a clear disadvantage from such transactions to existing shareholders.

A final way that minority shareholders may feel exploited is through dual-class shares. Typically, one class is restricted to a company's founders (or a limited group chosen early in the company's life), which receive more voting rights than the class of shares that subsequent shareholders can invest in, which are often more freely traded on the stock market (and which are issued freely to reward employees, especially in the case of US technology companies). Furthermore, management, which often benefits directly from more voting rights and often controls voting, will feel less accountable to the broader shareholder base, with less aligned interests.

Dual-class shares have traditionally been frowned upon by many investors and are rare outside the United States (though Volkswagen, for example, is a European example). However, they are becoming more visible and more common because of the recent success of technology companies, whose founders want to maintain voting control. The Council for Institutional Investors, a U.S.-based group, has taken a stance on dual-class shares, recognizing that they can provide some stability in the early stages of a company, but urging that they be subject to sunset clauses so that the two classes can merge after at most seven years (a period after which academic evidence suggests that dual-class shares will generally have a negative impact on a company's performance). In one controversial case, Snap Inc. (parent company of Snapchat) took the dual-class route further and issued shares without any voting rights; Indeed, since the company has indicated that it is unlikely to pay dividends, these instruments are actually sold more like warrants than shares.

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