PART

INTRODUCTION AND MODELS

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INTRODUCTION TO COMPARATIVE CORPORATE GOVERNANCE

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Corporate governance endures as an important and popular field of study, but one which is also complicated by multiple definitions, an uncertain relationship with economic growth and development, and the difficulties in formulating a consistent approach that goes beyond current perceptions but is grounded in the real world. This book takes a comparative approach to corporate governance to analyze the leading markets in Asia. It pays heed to the challenge of applying largely Western-based general theory to a variety of dynamic jurisdictions in Asia that differ materially from the countries from which such theory originated. At the same time, it seeks to examine actual practice from local Asian contexts to provide a deeper understanding of corporate governance issues from a comparative perspective.

1.1 Basic Issues in Corporate Governance

1.1.1 What Is Corporate Governance?

Two definitions:

> means of decision-making and power allocation among shareholders, senior managers, and boards of directors.[1]
>
> [M]ore broadly defined, corporate governance can encompass the combination of laws, regulations, listing rules and voluntary private sector practices that enable the corporation to: attract capital, perform efficiently, achieve the corporate objective, [and] meet both legal obligations and general societal expectations.[2]

And the most famous definition:

> Corporate governance is the system by which companies are directed and controlled.[3]

[1] Mark Roe, 'Comparative Corporate Governance,' in Paul Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (London: Macmillan, 1998), vol. I, p. 339

[2] Holly Gregory, 'The Globalization of Corporate Governance' (September 2000) 5 *Global Counsel* 52–65, at 55.

[3] *Report of the Committee on the Financial Aspects of Corporate Governance* (1992) (the "Cadbury Report").

Notes and Questions

1. What is corporate governance? If there is more than one definition (e.g. narrow view versus broad view or shareholder-oriented system versus stakeholder-oriented system), does it matter which definition we use? Are there real-world consequences?
2. Corporate governance is a multidisciplinary field that includes not only a combination of law, finance, business, and economics, but may also include political science, international relations, history, and sociology, among others.

1.1.2 Comparative Corporate Governance

1.1.2.1 Overview

Arthur R. Pinto, 'Globalization and the Study of Comparative Corporate Governance' (2005) 23 *Wisconsin International Law Journal* 477–504, at 477–9, 484–5, 491–2

The particular comparative corporate governance scholarship that is part of the globalization debate involves two significant issues: first, whether the model of corporate governance should include a role for stakeholders other than shareholders (hereinafter 'the stakeholder model'); and second, how and why two particular ownership patterns for publicly traded corporations, that of either widely dispersed shareholders or concentrated shareholdings (hereinafter 'ownership models'), developed in certain countries and whether one ownership model will prevail … While the role of stakeholders and the ownership structure can be viewed as separate and distinct issues, there is a connection between them. Arguments for a stakeholder model of corporate governance seem more prevalent in countries where there is concentrated ownership. Thus, if dispersed ownership ultimately means shareholder primacy, then the extent to which it becomes the standard model could have an impact on the future role of stakeholders …

The publicly held corporation can be viewed in purely economic terms as a means by which capital is raised from a large number of public savers and used by businesses. Under that focus, corporate governance may concentrate on the suppliers of capital (creditors and shareholders) and the managers or those who control management. Since shareholders are owners, this view usually gives them primacy. Given the economic significance that many of these corporations have in different countries, however, a broader view has long been advocated by some because the governance of these large economic units has an impact on other interests who do not supply capital to the business. In some countries, these interests, including labor (which invests human capital) and other interests in the society where the business operates, have a role to play in corporate governance.

… Unlike traditional comparative law, financial economists have looked to see if a particular model is better or optimal. The financial economists' influence has both broadened and narrowed the study. It has broadened the study by showing corporate governance in the larger context of financing business and economic performance. It has narrowed the study by using the agency perspective to exclude non-finance issues such as the role of the corporation in society and other non-financial stakeholders. In addition, empirical research does not tell a complete story of a complex issue because it is difficult to consider non-economic factors, such as culture or societal norms, that may be significant for certain governance issues …

Within comparative corporate governance scholarship, significant theoretical and empirical work has been designed to explain the outcome of dispersed and concentrated ownership. The widely dispersed ownership model usually relies more on market financing while the concentrated ownership model looks more to private financing. Because concentrated ownership seems connected with the stakeholder model, studies on concentrated ownership also relate to that model. A number of different stories have tried to explain the reasons for the different ownership patterns, and some have concluded that dispersed ownership has advantages over concentrated ownership …

A traditional classification of corporate governance systems between shareholder-oriented and stakeholder-oriented systems is summarized in the first two columns of Table 1.1. The classification here is based on widely used factors of purpose, ownership structure, and monitoring, as well as the problem each corporate governance system is designed to ameliorate.

Corporate governance is often thought of as an approach to address and reduce potential problems of "agency costs." An agency relationship exists when a principal hires an agent to work for him and represent his interests. The agent may be obligated to work on behalf of the principal, but there is also an inherent conflict of interest: the agent controls the actual work and may develop an incentive to work in his own interest rather than on behalf of the principal, particularly when the principal has limited ability to effectively supervise the agent.

In the corporate context, the interests of those in effective control of the corporation (management) can differ from those who are external providers of capital (shareholders). Under a system with dispersed shareholders who have difficulty acting in concert, this conflict of interest is often described as an agency problem

Table 1.1 Simplified classification of corporate governance systems

Type of system	Shareholder system (US/UK)	Stakeholder system (Japan/ Germany)	Controlling shareholder system (family or government) (much of Asia)
Purpose	Maximization of shareholder wealth	Maximization of benefit for stakeholders and society	Maximization of benefit for controlling shareholder
Ownership structure	Widely dispersed	Relatively concentrated with block shareholder(s)	Highly concentrated
Monitoring	1950: shareholders generally today: independent directors/ institutional investors/market for corporate control	1950: replace corporate auditors with shareholders generally (Japan); supervisory board (Germany) Today: banks/ financial institutions Institutional investors Employees	Controlling shareholder? Government control: separate monitoring organization (e.g. Temasek); family control: "trusted" independent directors as facilitators
Main problem	Agency costs – management will act in own self-interest, not in best interests of shareholders	Oppression of minority shareholders – management will act on behalf of block shareholder(s) and against interests of minority shareholders	Oppression of minority shareholders – controlling shareholder will obtain private benefits of control
Solution to main problem	Reduce agency costs (protect shareholders generally from management) through legal rules and economic incentives	Protect minority shareholders from block shareholder(s) through legal rules and economic incentives	Protect minority shareholders from controlling shareholder through legal rules and economic incentives

between shareholders and management. Management is hired to work on behalf of shareholders, but may also have an incentive to act in its own interest by, for example, paying itself high compensation or reveling in the perks of privilege. In other systems with more concentrated shareholding, a large individual shareholder may be in a position to influence company management to act in a way that benefits that particular large shareholder. In such case, the conflict of interest may be characterized as being between such large shareholders and other smaller minority shareholders who are unable to influence company management.

Agency costs have been compared to friction in a gasoline-powered automobile engine. In an engine, friction is inevitable. Measures are taken, such as the use of lubricating oil, to reduce friction to a manageable level that does not interfere with the car's operation. Similarly, once you hire someone else to represent your interests, potentially your agent will not perform the same way that you would or in a way that you believe best represents your interests. While potential conflicts of interest cannot be eliminated, agency costs can be reduced to a manageable level through corporate governance. Laws, institutions, and procedures both inside and outside a corporation will seek to make certain actions illegal, require potential conflicts of interest to follow prescribed procedures and provide incentives that help to ensure that the agent's conduct will align with the interests of the principal.

1.1.2.2 The Role of the Board of Directors

In all modern corporate law statutes, the board of directors serves as the highest decision-making body of the corporation except for limited rights specifically provided to shareholders. The board of directors has two somewhat contradictory functions: advising management and monitoring management. Depending on the country, management is typically led by a chief executive officer (CEO) who may also be the president or managing director and other officers such as the chief financial officer (CFO), chief operating officer (COO), chief information officer (CIO), and other senior managers, including the executive vice president or treasurer.

Important differences exist in the role of the board in various corporate governance systems: should the board focus more on its management role and become involved in day-to-day decisions, or should it focus primarily on monitoring management and limit its decision-making to significant, strategic decisions? Although an oversimplification, shareholder-oriented systems are generally associated with a "monitoring board" that emphasizes the role of independent directors and acts to reduce agency costs by monitoring management on behalf of widely dispersed shareholders. In contrast, stakeholder systems typically involve a "management board" that emphasizes the role of experienced inside directors and focuses more

Cambridge University Press
978-1-108-42077-8 — Corporate Governance in Asia
Edited by Bruce Aronson , Joongi Kim
Excerpt
More Information

on operational performance and benefits for a wider group of stakeholders. The relative strengths and weaknesses of an insider-oriented management board system and an outsider-oriented monitoring board system differ substantially.

1.1.2.3 What Is "Internal" versus "External" Corporate Governance?

"Internal" governance generally refers to the narrow definition of corporate governance discussed above. It focuses on relationships among the board of directors, management, and shareholders. "External" governance generally refers to outside forces, including legal and market mechanisms, that aid in the monitoring of management and enforcement of governance. These external forces would include both market forces such as product market competition and a market for corporate control, government regulation, gatekeepers, and the media. An example of legal and market-oriented monitoring mechanisms and an accompanying discussion are provided in Table 2.2.

Notes and Questions

1. Independent directors. The US and the UK rely on the use of independent directors within the board to monitor management on behalf of shareholders and thereby reduce the agency problem of management versus shareholders. How do you ensure that an "independent" director is truly independent? Legal definitions usually focus on a series of prohibitions: an independent director cannot have a substantial economic or financial relationship with the company, be a family member of the CEO, etc. This does not address the common situation where a new director could be influenced by social or personal ties with company management. The Organisation for Economic Co-operation and Development (OECD) has essentially given up on formulating an effective definition of independence and has merely stated that independent directors should be "independently minded." Legal definitions of independence vary considerably among countries.
2. Global spread of independent directors. Global institutional investors based primarily in the US and the UK have promoted the use of independent directors in all corporate governance systems, even though outside of the US and the UK the agency problem typically concerns controlling shareholders and minority shareholders. One question raised throughout the book is the role of independent directors in corporate governance in Asia, particularly where controlling shareholders prevail. Can their role be the same as in the US or UK? Can they work effectively? A few jurisdictions have attempted to create substitutes for independent directors in the monitoring of management (see the discussion of corporate auditors, or *kansayaku*, in Chapter 10 on Japan).

3. Enforcement. Enforcement of laws, regulations, and codes related to corporate governance is important, since actual corporate governance practices are more important than "law on the books." The US is known for active private enforcement through lawsuits by shareholders against corporate actors and public enforcement by regulators and prosecutors, while many countries remain hesitant about the economic and social costs of litigiousness. Several innovative countries in Asia have established a separate foundation or entity to pursue enforcement actions on behalf of shareholders. See discussions in Chapter 2 (US/UK), Chapter 5 (Australia), and Chapter 12 (Taiwan).
4. Gatekeepers. Monitoring and enforcement may also be aided by gatekeepers such as external auditors, credit agencies and analysts, who are professional service providers monitoring corporations as reputational agents. Substantial additional regulation of auditors in the US followed the passage of the Sarbanes–Oxley Act in 2002. Gatekeepers have generally not played a strong role in Asian jurisdictions. See Chapter 2.
5. Globalization. As globalization makes markets more accessible and integrated, including both product markets and financial markets, what effect will market competition and integration have on corporate governance? Will an efficient corporate governance system give some countries a competitive advantage? See the discussion in Chapter 4.

1.1.3 What Is the Purpose of Corporate Governance?

Presumably corporate governance is a means to achieve some broader goal, whether economic, social, or political and whether for the company or for society as a whole. General principles, like the OECD Principles, often refer simply to the "corporate objective" which is, however, defined by the corporation (and by law and society). But what is the goal that corporate governance is trying to achieve?

1.1.3.1 "Good" Corporate Governance

OECD, website (www.oecd.org/corporate/principles-corporate-governance.htm) and *G20/OECD Principles of Corporate Governance* (2015) at 9, 10, 18, 34

About the Principles

Good corporate governance is not an end in itself. It is a means to support economic efficiency, sustainable growth, and financial stability. It facilitates companies' access to capital for long-term investment and helps ensure that shareholders and