Corporate Governance & Complexity Theory

Seminar & Book Launch

13 December 2010 @ LSE

Welcome

The authors & their universities:

- Prof. Christine Mallin, Birmingham
- Prof. Marc Goergen, Cardiff
- Dr Ahmed Al-Hawamdeh, Jerash
- Dr Iris Chiu, UCL
- Prof. Eve Mitleton-Kelly, LSE

Programme

- **Four disciplines**: Corporate Governance, Finance, Law and Complexity Science
- **Chris Mallin**: Overview of the whole project
- **Marc Goergen**: Summary of the main findings on finance
- **Eve Mitleton-Kelly**: Insights from a complexity theory perspective
- General discussion
- 17.00 – 18.00 Reception in the Old Building, fourth Floor Reception Area

Overview of the Project

Prof. Chris Mallin
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University of Birmingham, UK

Overview of the Project

- **Origins**
- **Aims**
- **Timeliness**
- **Research approach**

Origins of the Project

- **The Corporate Governance Ideas Factory:** The project’s idea started at an ESRC/DTI/AIM Ideas Factory on Corporate Governance.
- The main aim of the Ideas Factory was to encourage participants “to think outside their traditional research areas, reassess the key issues which impact on the topic of corporate governance and interact with colleagues in distinct disciplines.”
- This book reflects the multidisciplinary approach to corporate governance research that the Ideas Factory aimed at encouraging.

Origins of the Project

- **Why corporate governance and complexity theory?**
- Despite the widespread adoption of corporate governance codes, financial scandals and collapses still occur. It seems that a rethinking of corporate governance frameworks is therefore overdue.
- Complexity theory explains the behaviour of complex adaptive systems. When we think of a governance framework, we think in terms of internal and external actors or participants interacting with each other. Internal actors in a company include the directors and employees, external actors include the shareholders and wider stakeholder groups, plus the legal, social, political influences and structures.

Origins of the Project

- **Why corporate governance and complexity theory?**
- Complexity theory emphasises the relationships, connectivity and inter-dependence between the internal and external actors, and the various structural influences on the environment in which they operate. By identifying, and analysing, the multiple elements that interact and influence each other, we will gain a deeper understanding of the evolution of governance frameworks, and reveal new insights regarding their effectiveness.
- Complexity theory is a way forward to visualise, describe and investigate the often complex relationships between a corporation on one side and its owners, stakeholders and gatekeepers on the other side.

Aims of the Book

- **Three aims of the book:**
- The first aim is to provide a review of the legal aspects of corporate governance with particular emphasis on the objective of the corporation. The literature review starts with a discussion of the division of powers in the corporation and the role of owners and management in corporate governance. It then proceeds by analysing the role of stakeholders as well as that of gatekeepers as actors in corporate governance.

Aims of the Book

- **Three aims of the book:**
- The second aim is to investigate whether corporate governance affects performance. Some of the current major challenges that researchers are facing are uncovered. One of these major challenges includes the potential endogeneity of corporate governance characteristics. Ownership is one of the corporate governance characteristics that may be endogenous.
- My colleague, Marc, will explain more about this area of our findings.

Aims of the Book

- **Three aims of the book:**
- The third aim is to introduce complexity theory and to explain how its concepts may be used to fill in the gaps in the existing corporate governance literature. In particular, complexity theory may provide a way forward to deal with the frequently complex relationships between the corporation on one hand, and its stakeholders and gatekeepers on the other hand.
- We do not claim to provide a solution to all the unsolved key problems in corporate governance research but we hope that this book will provide a way forward to address some of the more complex issues with the help of complexity theory as a lens.

Timeliness of the book

- **Recent financial crisis and corporate collapses:** Banks over the last few years have not only failed their shareholders, but also their customers, the tax payer and society at large. The fact that bank failures have to a large degree been concentrated in Anglo-Saxon countries also suggests that no one corporate governance system is superior, despite the widely accepted view in the academic literature claiming that investor protection is higher in common-law countries (such as the UK and the US) than in civil-law countries (such as France and Germany).

Timeliness of the book

- **Problems with focusing on the supremacy of shareholders:** The fact that no one corporate governance system is infallible is an important lesson. This lesson is particularly important in the light that much of the cross-national regulatory reform over the last decades – such as that undertaken by the European Union – has been heavily influenced by the Anglo-American view of corporate governance, including the supremacy of shareholders.
- While the definition of corporate governance in some countries (such as Germany) explicitly states that managers should look after the interests of shareholders and stakeholders alike, Anglo-American legislation is firmly based on the principle of shareholders' supremacy.

Timeliness of the book

- **Benefits of a stakeholder approach:** Looking after one's stakeholders is likely to be in the long-term interest of companies.
- Indeed, one of the possible reasons for the latest series of corporate scandals may have been managerial remuneration packages that focused too much on short-term profits without any regard for the long-term future and survival of the organisation and ignoring the basics of proper risk management. One may argue that, by enabling directors to consider stakeholders' interests and allowing them to depart from the principle of shareholders' primacy in the short run, shareholders' interests may end up being better served in the long run.'

Research Approach

- **The research approach is to:**
- Identify how insights from complexity theory may be used by individual organisations as well as entire industries and economies to create enabling environments that facilitate good corporate governance. These insights are illustrated via (and to some extent derived from) the study of a case company, a large UK multinational.
- Analyse the legal aspects of corporate governance; and of corporate governance and corporate performance.

Corporate Governance and Corporate Performance

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Corporate Governance and Corporate Performance

1. What is the impact of corporate governance on firm value and performance?
2. How can bad corporate governance be corrected?

Before we can answer these questions, we need to define corporate performance

Corporate Performance

- There are three main types of corporate performance measures
  - Accounting measures of performance
  - Stock performance
  - Measures of value creation for other stakeholders

Accounting Measures of Performance

- They measure *actual* performance whereas share prices include investors' expectations about future cash flows

- They can also be used to measure performance at lower levels of the organisation

Accounting Measures of Performance

However:

1. They can be manipulated and increased artificially

2. They do not necessarily measure shareholder wealth creation

3. They may be biased and differ from true, economic performance

Stock Performance

- Thought to be more objective, i.e. more difficult to manipulate than accounting profits
- Stock prices also take into account
  - The cost of capital
  - The company's relative performance
- However:
  - Increases or decreases in the stock price may be due to external factors
  - Stock markets may not always be efficient

So What Measure(s) Should One Use?

- Neither accounting nor stock performance may necessarily give a true and objective view of corporate performance
- Even if stock markets are efficient, it may still be a challenge to distinguish between price changes caused by the management and those caused by external factors

So What Measure(s) Should One Use?

- It is therefore best to use a range of performance measures
- Should performance be measured over the short term or the long run?
  - As most corporations have both long-term and short-term shareholders, the answer is not straightforward
  - Stock markets have been accused of being (too) short-termist

Measures of Value Creation for Other Stakeholders

- Various commercial providers such as KLD and Dow Jones score firms in terms of how they treat various stakeholder groups (CSR)
- For example, KLD rank firms according to their strengths and weaknesses in 7 different areas such as
  - Community
  - Employee relations
  - Environment
  - …

Measures of Value Creation for Other Stakeholders

- The academic literature suggests that it is important to consider the type of CSR when judging its impact on financial performance
  - CSR that improves relations with *primary* stakeholders seems to improve firm performance
  - CSR targeted at other stakeholders does not

Impact of Corporate Governance on Financial Performance

- Theories, on the effect of ownership on firm value, suggest that there is an optimal level of
  - Managerial stock ownership (entrenchment versus incentives)
  - Ownership by a large shareholder (toe-hold for value-creating takeovers; monitoring incentives versus managerial discretion)

Impact of Corporate Governance on Financial Performance

- Results from empirical studies are not consistent as to the effect of ownership

- Some studies assume ownership is exogenous and then tend to find a link between the two

- Those studies that assume ownership to be endogenous do not normally find a link

Impact of Corporate Governance on Financial Performance

- Studies analysing the effects of other corporate governance mechanisms such as
  - The composition of the board of directors
  - Dividend policy
  - Type of large shareholder

  do not find consistent results either

Conclusions

- There is no single way of measuring and assessing a company's performance
- Investors need to consider a range of performance measures
  - Complexity theory (CT) supports the idea of exploring the space of possibilities and the idea that there is no single universally applicable solution
- Companies need to be aware of their investors' profiles
  - All 'agents' interacting in a social complex system are different and heterogeneity is an integral aspect
  - Investors in this case, will have different profiles and requirements and treating them as a homogeneous whole would be seriously counterproductive.

Conclusions

- Stakeholder management seems to create value, but only if it targets primary stakeholders

- Testing the effects of corporate governance on financial performance is challenging given the likely endogeneity of individual corporate governance mechanisms

Conclusions

- Individual corporate governance mechanisms should not be considered in isolation
  - Not only do they co-exist they also influence each other
  - They co-evolve through powerful dynamics
  - Corporate Governance mechanisms cannot be considered in isolation as they are part of a larger complex system

Conclusions

- Diversity of responses depends on the local context
- Universally applicable standards may not be the way forward
- Because local contexts differ it is absolutely essential that there is a diversity of responses that address the requirements of the local context
- Multiple micro-strategies are a relatively safe way of ‘experimenting’ with different solutions. If they fail they do not affect the entire system and if they succeed others can learn from them

Insights from Complexity Theory

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3 Key Insights from Complexity Theory

- 1. It is not enough to focus on the relationship between the board and the shareholders
- 2. Most effective approach is both bottom-up and top-down
- 3. Good corporate governance is more likely to emerge if there is a supportive enabling environment (EE) in a company and an industry

1. Multiple Relationships Within the Corporate Governance Social Ecosystem

- Not just shareholders but multiple stakeholders

- Regulators; institutional investors; listed companies, their employees, customers and suppliers; the financial press and analysts; and other corporate governance actors, are intimately *inter-connected*

- Through positive and negative *feedback* processes

- They influence each other through formal and informal relationships in such a way that they change each other's behaviour – i.e. they ***co-evolve***

Definition of Co-evolution in a Social Context

- ***Reciprocal influence which changes the behaviour of the interacting entities*** (individuals, organisations, industries, economies, etc.)
- Co-evolution takes place within a social ecosystem
- If influence and change are entirely in one direction: 'adaptation to' a changing environment
- Short-term adaptation may result in long-term co-evolution

- No set of relationships exists in isolation
- Focussing on the relationship between the board and the shareholders, provides only a partial view of the relevant dynamics that influence corporate governance
- Therefore essential to look at **all the related actors within the whole *corporate governance social ecosystem***

Multiple Elements within a CG Social Ecosystem

- Government policy
- The strategies and actions of individual firms
- Institutional and other shareholders
- The financial press and analysts
- Regulation such as the US Sarbanes-Oxley Act of 2002 (Sarbox)
- EU regulation
- Etc.

- These elements/institutions do not exist in isolation, they influence each other and are part of a multidimensional corporate governance *social ecosystem* within which single organisations, industries, national governments and the legal frameworks operate – these institutions also co-evolve

Corporate Governance Social Ecosystem

- Each organisation is therefore influenced by *exogenous* conditions
- Organisations exist within a specific political, legal, physical, geographic and economic environment
- Each organisation will also have a set of *endogenous* conditions: its culture, organisational and power structures and organisational norms that influence each other
- Both the endogenous and exogenous conditions are in constant flux, as they influence each other and *co-create the corporate governance social ecosystem*
- By being an active member of its social ecosystem, a company can influence its industry (case study example)

1. Board-Shareholder Relationship: Conclusions

- The recent “credit crunch” is a reminder that CG at company and industry level, as well as regulation on corporate governance more widely, is deficient

- It does not properly deal with the complex nature of these relationships and the potential conflicts of interests

- Banks have not only failed their shareholders, but also their customers, the tax payer and society at large

- By considering stakeholders’ interests and departing from the principle of shareholders’ primacy in the short run, shareholders’ interests may end up being better served in the long run

2. Most effective approach is both bottom-up and top-down

- Not just through government regulation
- But at multiple micro and macro levels of interaction
  - with involvement & engagement at multiple scales
- In line with current Government policy & subsidiarity
- In line with the UK's principles-based approach
  - in conjunction with rigorous company and industry level self-regulation

- The case study showed a good example of self-regulation at multiple levels

The Case Study

- The study included in depth interviews with employees of the case study organisation
- With representatives from the corporate governance social ecosystem in the UK:
  - Trades Union Congress (TUC)
  - Financial Reporting Council (FRC)
  - Department of Trade and Industry (DTI)
  - Her Majesty’s Treasury (HMT)
  - Financial Services Authority (FSA)
  - the London Stock Exchange
  - several institutional shareholders
- The findings were validated at several workshops

Example: Ethics Project

- Company Z was instrumental in initiating a rigorous set of ethical standards for its industry that exceeded those expected by national regulation
- The industry association includes all its major companies and acts as a self-regulating body
- Company Z through its chairmanship of the association and its initiation of the industry ethical code of conduct influenced and affected the other companies in that industry
- At the same time, those changes influenced its own operations
- It set up an internal ethics project and its own ethical code of conduct, which affected its own employees as well as their customers

Company Z's Ethics Project

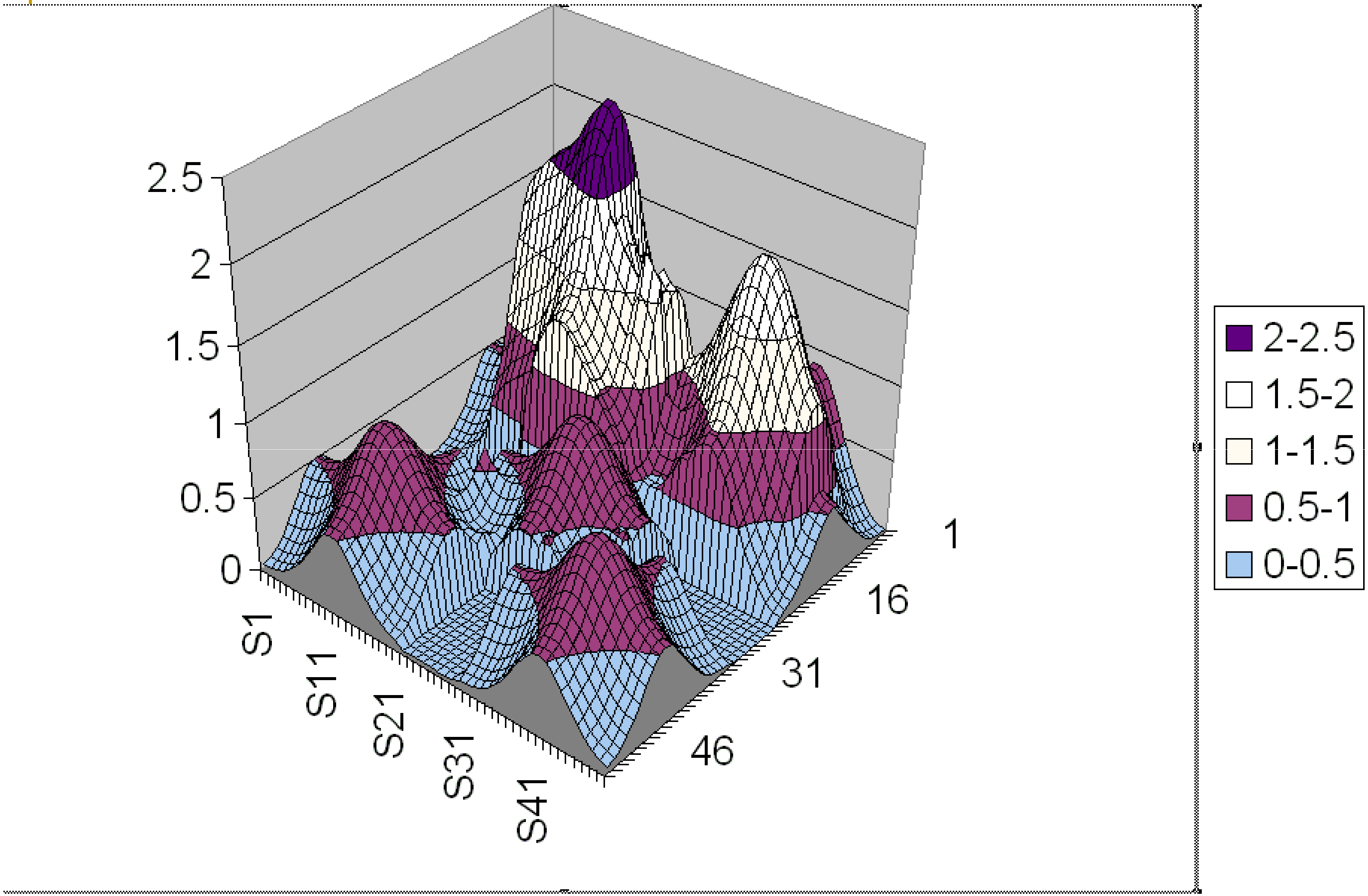
- The sales representatives were required to change their relationship with their customers
- Well established practices had to change, as some could potentially lead to unethical behaviours
- To help the sales reps to change these relationships and behaviours they were given a day on the road (not selling) called Code Day, to visit their customers to explain the new ethical basis
- Company Z also offered the reps workshops to train them in presenting the new ethical code
- Plus, guidelines to understand the code, by describing its requirements in simple terms

Why?

- Company Z and all the other companies in that industry wished to avoid stricter regulation in the UK (principles-based) such as Sarbox in the USA (rules-based)
- They wanted to **prevent an undesirable adaptive response from the regulators**
- They therefore *self organised* and by *exploring the space of possibilities* they developed an alternative model with unpredictable *emergent* properties

Exploring the space of possibilities

- As the external environment changes, what may have been an optimal strategy under one set of conditions, may become totally inappropriate when these conditions change
- If different options or solutions are being tried, some of those solutions will fit the new conditions in the changed environment
- Local experiments, can take risks without damaging the whole system, if they fail - they are contained locally
- If they do succeed, then others can learn from such good practice and adapt it to their local conditions
- 'Best practice', cannot be copied
  - Not 'what' and 'how'
  - But 'why' it worked within that particular context and what would have stopped it working
  - underlying principles can then be adapted to a new context
- Diversity enables a complex system to survive under turbulent conditions


2.5
2
1.5
1
0.5
0
S1
S11
S21
S31
S41
1
16
31
46
2-2.5
1.5-2
1-1.5
0.5-1
0-0.5

Emergent Process

- The evolving culture of company Z, with increased awareness of good corporate governance, through the ethics project was emergent in that
  - its specific characteristics could not have been fully predicted at the outset
  - it was an outcome of multiple interactions, hence a product of the whole system

Emergent Process

- e.g. the pride employees felt in working for an ethical company;
- this sense of pride had emerged as part of the overall culture;
- once it was in being as an *emergent*, it affected the employees in two different ways
  - it allowed them to explore a different relationship with their customers
  - while at the same time it constrained and limited earlier behaviours, which the new emergent culture had made unacceptable

3. An Enabling Environment (EE)

- They created an *enabling environment* to support the new way of working, which was supported at two levels
  - at industry level, the different companies supported each other through their industry association
  - at individual company level, company Z supported its own employees in addition to the industry support
- Together they created an *enabling environment* that facilitated the change in relationships and behaviours towards a more ethical standard
- Once this process started, it initiated a new way of working and relating, which the sales reps themselves continued to develop.

Bringing all 3 insights together

- Not just top down, but principles based approach with rigorous self-regulation

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- Enabling Support Environment at multiple scales

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- Focus on relationships
  - stakeholders not just shareholders
  - within industry
  - within each individual company

One More Insight: Creation of New Order

- When exploring alternatives, some attempts are bound to fail
- A good corporate governance framework does not preclude things going wrong and corporate failures may be seen as a sign of health
  - *"…because that is the way that the capital markets discipline both companies and investors …".*
- The regulators and the government should therefore resist the temptation to tighten regulation in the hope of eliminating the odd failure
- Instead, the corporate governance ecosystem as a whole needs to be supported (EE) to become robust enough to adjust itself, to *self-organise*, *explore the space of possibilities*, *co-evolve* and to create a *new order* or way of working that will reduce such risks in future

Finally

- Have brought together experts in corporate governance, law, finance and complexity science
- To look at a critical institution, whose failure has had a devastating effect on the world economy
- Using complexity science to offer a fresh and practical perspective
- We would like to thank:
  - ESRC, BIS (DTI) & AIM for being far sighted and funding the project
  - All the interviewees who contributed their expertise and time and the Case Study company
  - Edward Elgar for publishing the book

Thank you …

Corporate Governance Report:

www.lse.ac.uk/complexity

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