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9B14M148

WHO WILL GUARD THE GUARDIANS?:[1] INTERNATIONAL CORPORATE GOVERNANCE

Business corporations are powerful organizations operating within societies. When that power is handled properly, customers obtain high-value products and services at a fair price, employees earn adequate compensation for meaningful work, investors receive returns on their investments as reward for their risk-taking, and material health and economic wealth are sustainably generated for the overall society. But when that power is handled improperly, some or all of the above parties suffer. Every country must balance the tension between releasing the creative power of corporations and constraining them to work for the overall well-being of society. This dilemma is one of today's most challenging issues confronting executives, nonexecutive directors, investors and policymakers.

Throughout the world, societies use institutions[2] to govern corporations, executive behavior and economic transactions. These institutions are the "rules of the game" established over time, and they represent the formal and informal norms within which corporations are expected to operate. Formal institutions, the codified guidelines for corporate behavior, include such principles as laws and regulations. Informal institutions are non-codified social norms and encompass values, beliefs and behavioral norms that define "proper" corporate behavior.

Governance, broadly understood, refers to the quality of institutions interacting to influence an overall society. Investors and policymakers become interested in governance when it applies to the economy, to society or to organizations that conduct business within a society. In such cases, governance is generally arbitrated and enforced by the government. World Bank researchers Kaufmann, Kraay and Mastruzzi[3] define governance as "the traditions and institutions by which authority in a country is exercised." Since 1996, they have performed research on more than 200 countries and have developed worldwide indicators of governance. For example, their *regulatory quality* indicator "captures the perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development."[4]

Embedded within the overall governance system is the corporate governance system, which focuses on how corporate power is channelled. Historically, corporate governance brought to mind sleepy directors on boards of publicly traded firms who did not demand accountability or transparency from their chief

executive officers (CEOs) and top management teams (TMTs). Yet, corporate governance is increasingly understood to not only entail corporate boards but also such matters as the laws, accounting standards and ethical norms that regulate corporate life and the majority of privately owned firms in the global economy.

In this technical note, we discuss what corporate governance is, how it is embedded in a larger governance system and who are its key actors. We then identify the different dimensions of corporate governance throughout the global economy. We simplify this complex reality by identifying the four different and salient models of capitalism currently operating around the world, and then discuss how those models influence corporate governance practices.

We do not claim that one model is better than the others, nor do we predict, as some observers do, that all models will converge to a common model. However, we underscore three main ideas: First, country-specific governance dimensions are historically determined by the economic, political and social development that firms and countries have experienced over time.[5] Second, governance practices are likely both to complement each other and to align with the national institutional environment in which firms are embedded.[6] Third, corporate governance is important for both domestic and multinational enterprises throughout the world.

THE WHO, WHAT AND HOW OF CORPORATE GOVERNANCE

Corporate governance was first studied in the United States. More specifically, the form of corporate governance that has been studied at length is that described by Berle and Means[7] — characterized by ownership of a large firm being separate from the control and management of the firm, and by the notion that shareholders (also referred to as owners outside the legal scholarship) and managers might differ in their views about what the firm should accomplish or how firm resources should be allocated.

With the principal-agent problem as background,[8] and with the United States providing a research setting of publicly traded firms and dispersed ownership, finance-oriented scholars define corporate governance as *shareholder-oriented governance*; i.e., as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[9] The main idea in this narrowly defined understanding of corporate governance is that when firms become so large that their owners can no longer manage them, the owners hire professional managers to run their firms. This practice has led to the emergence of U.S. managerial capitalism[10] and to the misalignment between managers and owners. For example, managers in a large firm might seek to quickly generate short-term and high-risk profits at the expense of increasing the firm's long-term value, while owners might be more concerned with sustaining long-term dividends and maintaining strong relationship with community stakeholders. The potential differences between the interests of managers and those of owners are acerbated by a series of agency costs (e.g., asymmetric information and rent-seeking behavior). The adoption of effective corporate governance practices can address these challenges and will, ideally, mitigate or extinguish them.

The board of directors is one of the core governance mechanisms that firms use to minimize agency costs. Specifically, the board of directors is responsible for aligning the interests of the financial owners and managers through governance practices. For example, the board might propose a compensation package that ties managerial compensation to the firm's long-term sustainable performance. Exhibit 1 depicts both some of the main concerns of owners, boards and managers and the relationships among these three governance actors in the *shareholder-oriented view of corporate governance*, which is predominant in the United States and the United Kingdom.

Unlike shareholder-centric business frameworks, governance practices in other countries attempt to balance shareholder needs with the needs of other important stakeholders.[11] In essence, this framework expands the notion of the "owner" of the corporation. A stakeholder comprises any group or individual that has an interest in its interaction with the firm and can be affected by the firm's actions, objectives, policies and its interactions with other stakeholders. Shareholders may be boards of directors, TMTs, employees, customers, suppliers, governments, the news media, competitors, trade associations, rating agencies, external auditors, communities, political activists or the general public. Not all stakeholders are equal in their relationships with the firm; some, such as shareholders, managers, employees and the board, have a more direct claim on the firm and its resources than others. However, the stakeholder view of corporate governance remains relevant because most firms around the world do not have dispersed ownership; instead, they fall mainly into the category of a firm ruled by a "controlling owner."[12] Therefore, to understand the corporate governance practices of different countries[13] that are joining the global economy, we need to take into account broader sets of stakeholders and their interests in the firm. We need to understand *stakeholder-oriented governance.*

HOW CORPORATE GOVERNANCE IS EMBEDDED IN THE ECONOMY

The 2004 Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance offer the following definition of a *stakeholder-oriented view of corporate governance*:

> Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.[14]

Such rights and responsibilities are extended to different groups, both within and outside of the firm, in an effort to ensure that they are pursuing the firm's goals. These goals may include maximizing shareholder value, sustaining high employment in a given municipality, assuring that a family firm is transferred to the next generation without a family quarrel or a combination of other goals. The broader stakeholder definition travels better around the world and is more relevant in countries that seek higher levels of cooperation between different stakeholders, in countries that believe firms have societal obligations beyond shareholder value and across different types of capitalisms.

Moreover, the effectiveness of different corporate governance practices is highly contingent on the institutional environment in which a firm operates. For example, a publicly traded firm in a country that has an active stock market may grant stock options to managers to help align the shareholders' value interests with managerial strategic behavior.[15] However, this same governance practice might be futile in Burma, which has no active stock market; in Thailand, where the culture is driven more by relationships than by personal profit or in China, where managers in state-owned firms do not feel it is in their best interest to exercise their vested stock options.

The advantage of the OECD's stakeholder governance definition is that it takes into greater account the broader national institutions in which firms are embedded, thereby reflecting and allowing for a more equitable distribution of power and resources within a society. The disadvantage of the OECD definition is that it focuses more on relationships than on purpose or intent and thus fails to account for how economic efficiency may suffer or how the firm's wealth may be distributed among stakeholders.

FOUR MODELS OF CAPITALISM

The goals of the firm and the characteristics of its stakeholders (i.e., its governance actors) vary across countries, so it is very useful to understand how differing country characteristics affect the design and execution of corporate governance systems. We begin this analysis by first identifying different types of economies based on their salient institutions, which we refer to as the four models of capitalism (MOCs). We then discuss the primary characteristics of key governance actors in each type of capitalism. Finally, we illustrate how corporate governance actors utilize distinct internal and external corporate governance mechanisms, depending on the MOCs in which they operate.

Capitalism is an economic system that is based on the private ownership of capital goods as the means of production, using the creation of goods and services for profit.[16] In the United States, capitalism is sometimes considered to be a practice of democratic governments, but most countries' economies include some element of capitalism. Thus, the question is not whether an economy is capitalistic but what form of capitalism it represents and to what degree.[17]

In fact, capitalism can take many forms, such as welfare capitalism, post-socialist capitalism, state capitalism, laissez-faire capitalism and crony capitalism. Researchers of MOCs have categorized capitalism into *shareholder-oriented*, or market-based, countries (that have liberal market economies), and *stakeholder-oriented*, or bank-based, countries (that have coordinated market economies). Most of the identified business systems worldwide are based on concepts prevalent in Western industrialized countries,[18] and the most commonly identified elements are capital accumulation, competitive markets and a price system.

Exhibit 2 extends Exhibit 1 by identifying some concerns of the key governance actors and some characteristics of the institutional environment. We highlight four institutional domains related to corporate governance: capital markets, labor markets, legal systems and social norms (see Exhibit 2).[19]

The nature of a firm's institutional environment is determined by the MOC that exists in the corresponding country. We have identified four stylized MOCs based on how economic life is organized and how corporate governance is practised. Keep in mind that this typology is theoretical in nature because no two countries have the same historical background or operate in the same way, and no country's institutional environment is static.

The four MOCs are liberal market economies (LMEs), coordinated market economies (CMEs), family-led market economies (FLMEs) and state-led market economies (SLMEs).[20] While this typology aids our understanding, two primary complications emerge when creating such "pure types." First, several types of capitalism may exist in a large and heterogeneous country, such as the United States or a BRIC (Brazil, Russia, India and China) country. For instance, India is characterized primarily by the presence of both state- and family-owned firms.[21] Second, it is possible to find "swappers," that is, firms that operate in one of the four capitalist environments but whose firm characteristics are typical of another model. For example, Spain's Telefónica Móviles is hosted in a CME but exhibits LME practices.[22]

Liberal Market Economies (LMEs)

Liberal market economies (LMEs) are characterized by the predominance of markets (as opposed to direct or indirect governmental control), managerial and investor opportunism (as opposed to cooperation), well-defined property rights, and relatively individualistic and low-power distance social

norms. According to Hall and Soskice, "firms [in LMEs] coordinate their activities primarily via hierarchies and competitive market arrangements."[23]

Examples of LME countries include the United States, the United Kingdom, Canada and Australia. The capital market of LME countries is mostly grounded around a stock market that tends to be large, global, highly developed, relatively transparent and financially sophisticated. Most LME firms raise capital through stock or private equity markets. Commercial banks are not as central to their economic life as they are in other economic systems. The legal system is mostly based on common law, or jurisprudence-based, where shareholder rights and property rights tend to be strongly protected; also likely are a high level of litigation and a sophisticated and costly system to bring class-action lawsuits against corporate officers, directors and managers. The LME labor market is characterized by an open labor market where employees and managers tend to move from company to company, compensation is generally based on short-term performance, in-company employee training tends to be minimal and the overall education system is generalist (as opposed to vocational or in-company). Formal employee representation and rights are relatively weak compared with the type of capitalism practised by other economies, and employment at will is the predominant labor contract. This type of economy, which emphasizes individual rights and individual initiative, relies on a relatively low power distance; authority can be challenged and questioned by subordinates.

Coordinated Market Economies (CMEs)

Coordinated market economics (CMEs) are characterized by non-market relationships orchestrated through relatively high levels of corporatism — "various types of institutional arrangements whereby important political-economic decisions are reached via negotiation between or in consultation with peak-level representatives of employees and employers (or another interest groups and the state)."[24]

Classic examples of CME countries include Germany, Japan and the Scandinavian countries. Corporatist societies are based on the ideology of using consensus building and cooperation to maintain an organic (as opposed to atomistic) society and long-term views of firms and the economy. Governance practices that result from corporatism are, for example, inter-organizational networks such as vocational training, business confederations, industry-wide wage-setting coordination and cooperation between labor and management when making firm-level strategic decisions. The capital market traditionally relies heavily on commercial banks that are also investment banks; for instance, Deutsche Bank could be considered both a lender and a shareholder of Daimler-Benz. In addition to their ownership ties, banks and corporations develop a tight network of directorship interlocks.[25] The stock market is not as developed as in LMEs, and investments are mostly domestic with limited free-floating capital. Family members and state agencies also provide some lending opportunities, but the banks are at the core of their economic development. The CME legal system is based on civil law, entailing a reliance on codes, laws and norms that are difficult to change, and where the state has a major role in determining outcomes.

Although according to one belief, civil law does not generally offer extensive protection to minority shareholders,[26] the reality is more complex. In common-law systems, judges issue decisions on the basis of precedent (jurisprudence), which draws from general principles such as fiduciary duty. Contrarily, judicial rulings in civil law countries are made based largely on legal statutes. This discrepancy results in significant variations in the legal protection of minority shareholders across civil law countries; creative insiders or majority shareholders can undertake corporate actions that are not explicitly prohibited by legal statutes but clearly damage the interests of outsiders or minority shareholders.[27] In addition, soft laws, such as codes of good governance that are based on "comply or explain" principles, are highly

engrained in this economic system.[28] Overall, litigation is lower in CME system than in the LME system in part because CMEs lack an easy system in which to bring claims. The labor market is highly coordinated in terms of both collective bargaining and employees having a strong voice within the firm. The labor market tends to be more internal, whereby employees and managers generally pursue careers within a firm as opposed to hopping from firm to firm. Moreover, employees have incentives to develop firm-specific skills, and corporate executives have opportunities to take a long-term perspective because of the presence of vocational and continuous in-firm training, the coordination of wage bargaining across companies and the rigidities of procedures regarding employee dismissals.

The traditional dichotomy in economic typology is between LMEs and CMEs; this comparison has become incomplete because it fails to capture many institutional idiosyncrasies. For example, fast-growing emerging economies, such as the BRIC countries, are increasingly important members of the world economy. Rapidly developing economies, such as Mexico, Thailand, and Turkey, typically host firms that are known as global challengers.[29] The diverse African, Asian and Latin America regions include emerging countries, such as Taiwan, South Africa and Chile, which are key contributors to global gross domestic product. In looking into models of capitalism, Witt and Redding[30] divide the 13 major Asian countries into five types of business systems;[31] Chironga, Leke, Lund and van Wamelen[32] categorize African capitalism by their level of exports and economic diversification (dependence on natural resources) into four types;[33] and Schneider[34] discusses the complexities of fitting Latin American countries into MOC categories since their economies are diversified by business groups, multinational corporations, low-skilled labor and atomistic labor relations. Clearly, the LME and CME dichotomy is insufficient; therefore, we have identified and will explore two additional ideal types of capitalisms (FLMEs and SLMEs).

Family-Led Market Economies (FLMEs)

Family-led market economies (FLMEs) tend to be latecomers to economic development; the economy is sustained in great part by family businesses, and their businesses are often sheltered by the state. Examples of FLMEs are the Agnelli family pyramidal group in Italy, large Korean conglomerate *chaebols* such as Samsung and Hyundai, family-owned firms from Taiwan such as Foxconn and family-owned firms from Brazil such as Odebrecht or Friboi. Family-led capitalism tends to be embedded in weak institutional environments where legal protection for investors is poor, the labor market is inefficient and the financial market is underdeveloped. Thus, "when formal legal and regulatory institutions are dysfunctional, founding families *must* run their firms directly."[35]

Italy is an example of a family-led capitalistic country within a developed economy, as neither financial markets nor banks are highly developed; as a result, many firms have historically relied on family capital. Among the largest listed Italian firms in the period from 1985 to 2005, 72 per cent had a family owner as the ultimate blockholder,[36] and this majority family owner tended to hold an average of 45 per cent of the firm.[37] Similarly, according to Schneider, "in the early 2000 over 90 percent of 33 largest groups in Latin America were family-owned and managed."[38] Family capitalism is also prevalent in Asia where, for example, "the ten largest families in Indonesia, the Philippines, and Thailand control half of the corporate assets."[39] "Korea has exhibited the largest increase in the average number of the nation's largest firms that are in the hands of a single family," up to a 10.1 per cent increase from the 200 largest publicly traded firms in 2008.[40]

The challenges in this form of capitalism tend to be between family owners and non-family owners, family managers and non-family managers, and the long-term goals of family firms versus the

shareholder value.[41] Capital markets tend to be less developed than in LMEs, and they comprise stable family-owned businesses. Dual-class share structures, syndicate agreements and the strong presence of pyramidal groups combine with a predominantly civil law legal system to result in little protection for investors. The labor market tends to be internal and to have scarce employee rights, although the specifics are difficult to generalize. Top managers are typically related to the owners and are not necessarily professional managers. The social norms are based on consensual and collectivist societies.

State-Led Market Economies (SLMEs)

State-led market economies (SLMEs), such as China, Hungary and Malaysia, exist in countries where the state plays a salient role in economic life. Sometimes, the state directly controls a firm through full or partial ownership and management; other times, the state controls a firm indirectly through state subsidies or state lending.[42] We discuss this MOC through the quintessential state capitalist system, wherein the state has control over the largest firms in national strategic sectors: China.[43] Large firms tend to be state-owned enterprises (SOEs) dominating two not-so-transparent domestic stock markets.

Some SOEs agree to improve their firms' corporate governance practices and engage in institutional bonding; i.e., they list in the Hong Kong or Anglo-American stock markets, which have much higher requirements for transparency and accountability. Corporate financing happens mostly through a system of "administrative credit" whereby state-owned banks lend to SOEs at low or zero interest rates.[44] The Chinese state also exercises strong control over the labor force by having a single party–controlled union that lacks collective bargaining rights.[45] The internal labor market is based mostly on seniority and on political affiliations with the People's Communist party; typically, "government bureaucrats exert control over SOEs."[46] The legal system is based on civil law; however, enforcement faces a clear challenge and, as has often been said, the rule of man overtakes the rule of law. Social norms entail a low level of individualism and a strong legacy of communist values.

Governance Actors across Models of Capitalism

Exhibit 3 identifies the main traits of governance actors across these four MOCs, which are practised throughout the world. The role of specific governance actors varies considerably within each MOC, and indices measure firm-level corporate governance practices across countries (see Exhibit 3).[47]

As we highlighted above, each MOC is characterized by the dominance of a unique type of primary owner. When we discuss ownership, it is important to look at three factors: (1) the concentration of ownership, (2) the type of primary owners and (3) the separation of voting and cash flow rights (i.e., dual-class shares and other non-one-vote-one-share structures). A unique trait of shareholders in LMEs, unlike in other MOCs, is that ownership tends to be highly dispersed. The most salient owners are institutional investors (i.e., pension funds, mutual funds, hedge funds) and wealthy individuals (i.e., private equity). In CMEs, firms have less dispersed ownership than is held by other industrial corporations and large universal banks. FLMEs and SLMEs are characterized by high concentrations of ownership in the hands of families and the state, respectively.

Regardless of the MOC, ownership does matter in corporate governance for at least two reasons. First, the nature of ownership determines the incentives and capabilities that define both how the performance of a firm will be monitored and measured and how the daily operations of the firm will be managed. For example, a minority shareholder in a widely dispersed firm will have few tools to discern the strategy of a

firm and little incentive to do so, whereas a majority owner in a family firm is likely to also hold a managerial position. Second, the nature of ownership shapes the goals of the firm. For example, state-owned firms are driven by regulatory or policy considerations rather than, or in addition to, economic objectives; thus, the state is a very different kind of shareholder from profit-driven investment firms.[48]

The board of directors (BoD), in theory, represents primary stakeholders in the role of monitoring and advising the firm's top management team.[49] When assessing a board, its modus operandi can be revealed through different dimensions: single- or dual-tier boards,[50] the presence and percentage of independent directors, dual leadership (i.e., CEO and chairman positions are held by different individuals), how directors are elected (the nominations committee), how the board decides CEO and managerial compensation (the compensation committee), how the board exercises internal controls and complies with regulations (the audit committee), board diversity (the members' gender, race, age and functional experience), board interlocks and the turnover of members of the board.

In practice, BoDs vary considerably across MOCs.[51] In LMEs, boards are set up to be independent and to be increasingly more active and responsible. They are governed by the principles of fiduciary duty, duty of care and duty of loyalty. In the United States, recent regulation has brought needed nuances to board practices. The 2002 Sarbanes–Oxley Act demanded higher controls from the board, and the 2011 Dodd-Frank Act introduced "say-on-pay" policies and proxy access. CME boards are often "dual tier," which implies that labor has a significant voice in the strategy of the firm. CME boards also tend to have a majority of insiders instead of independent directors, and major shareholders such as banks or other corporations are typically represented via a director on the board. Board structures such as staggered boards and directorship interlocks are used as anti-takeover mechanisms in both CMEs and LMEs.

FLME boards tend to be composed of insider directors or family owners. Boards are largely symbolic since most of the decision-making takes place at the family dinner table and not in the boardroom.[52] There is some debate about how to better incorporate non-family owners and managers into family firms as a means to improve corporate governance.

SLME directors tend to be nominated and/or approved by the state; therefore, there are few if any independent directors. Directorship interlocks are very common, meaning that directors serve on boards for several different firms. In general, the mission of a board in an SLME is to help the firm fulfill its state goals. Interestingly, Chinese BoDs follow the dual-tier structure common in CMEs; however, Chinese boards are not known for their responsiveness to employee concerns to the same degree as boards within CMEs.

The role of managers also varies across countries, in part determined by the labor market structure and the nature of the firm in each of these MOCs. Managers, particularly those with a strong financial orientation, exercise a dominant role in LME firms. Managers can access an active and open labor market, and incentives encourage managers to move to new firms. Executive-level managers in LMEs often have contingency pay options tied to the firm's value and productivity; their aim is to help align management interests with those of the firm and the owners, and minimize private benefits of control.

Traditionally, CME managers tend to have technical or even scholarly skills (such as doctorates) as opposed to managerial or financial skills. The labor market is internal in the sense that the mobility of managerial jobs is limited and pay incentives are understated. Similar to BoD appointments, executive-level managers in both FLME and SLME companies are appointed by their respective owners, family or state, and they tend to be family members or state representatives. These two MOCs are currently experiencing an increase of professionalization of their managerial cadres.

The nature of employees is tied to the nature of both the labor market and the country's educational system. Typically, employees in LMEs receive a general education and little company-specific training compared with CME employees who are more likely to receive vocational and in-company training. As a result, CME employees typically enjoy a greater level of job protection and develop higher-level skills. Traditionally, trade apprenticeships and in-company training are also common among FLME employees. In SLMEs, employees' education is very much determined by the official geographic "household registration" or *hukou* and by the highly competitive educational system. Moreover, employee promotions are often contingent on political affiliations.

Corporate Governance Mechanisms across Models of Capitalisms

Corporate governance mechanisms are the formal and informal devices for channelling corporate power to deploy, influence and/or control a firm's strategy, management and profitability. These mechanisms are typically divided into *internal* mechanisms (operating within the firm) and *external* mechanisms (operating outside the firm).[53] We discuss some of these mechanisms to illustrate their capabilities across MOCs, which are summarized in Exhibit 4.

As mentioned above, boards can act as an internal mechanism to control managers when they are independent boards and have the power and incentives to monitor management. This situation is typically the case in LMEs and when directors directly represent stakeholder voices such as in the codetermined boards in Germany under the CME. Conversely, boards are not very effective as an internal mechanism in the FLME or SLME because they are, essentially, functionally equivalent to the dominant owner.

Executive compensation is an important internal mechanism for corporate control in open labor markets when it can be activated via contingent pay, such as in LMEs, and, to a lesser extent, in CMEs. In FLMEs, managers are closely linked to the family, and this mechanism of executive compensation is more aligned with emotional wealth. In SLME firms, executive compensation is typically not contingent on profitability, and promotions are decided largely based on seniority and party affiliations. Finally, public disclosure of information is an internal control mechanism because it measures how much a company is willing to disclose its strategic decisions (including any information related to its triple bottom line); public disclosure of information opens the door to external evaluations. The flip side of disclosure is accountability; the more information a firm discloses, the more its stakeholders can hold the firm accountable (see Exhibit 4).

External governance mechanisms are those that are imposed on the firm from outside. The market for corporate control through takeovers is common in LMEs and, to a lesser extent, in CMEs. Another external mechanism is the regulatory system; in particular, whether regulations are in the form of hard law (i.e., where compliance is mandatory) or soft law (i.e., comply or explain). Examples of hard and soft laws are the 2012 Dodd-Frank Act and the 2011 UK Combined Code, respectively.

Non-LME societies, which are less legalistic, tend to follow soft laws that are enforced by social expectations and pressure. FLMEs and SLMEs commonly provide less than effective legal enforcement of existing laws. Finally, some economies are experimenting with informal cultural norms and trust-based social networks to guide and direct corporate behavior. For example, many Scandinavian economies rely on their unique social culture to ensure that wealth is not overly concentrated in too few hands, and that everyone in the society benefits from corporate success. Hence, egalitarian "small worlds" social norms are used to guide and constrain their corporate behavior.[54]

CORPORATE GOVERNANCE IN MULTINATIONAL FIRMS

As trade barriers fall and corporations invest in foreign economies, multinational firms face a unique challenge in governing themselves, which domestically focused firms do not have. For example, Coca-Cola (an LME) is headquartered in the United States, but its foreign subsidiaries operate in many non-LME–oriented economies. Similarly, Lenovo (an SLME) is headquartered in China, but it has foreign subsidiaries in many non-SLME economies. In the absence of any absolute transnational governing body, multinational firms must attempt to reconcile the sometimes conflicting governance rules and expectations that their far-flung operations confront.

Some multinational firms govern their firm one way in one economy, and adjust their governance practices to norms practised in other economies. This approach follows the adage "when in Rome, do as the Romans do." For example, it is unfortunately common for multinational firms to drop their ethical standards in host countries when the standards for corruption and bribery are lower than in their home country.[55] The advantage of this approach is that corporate governance is locally optimized, and conflicts with the host nation's government are likely to be minimized. The disadvantage of this approach is that governance standards vary widely throughout the world, which can perpetuate problems in the home country and degrade corporate-wide norms of integrity. Furthermore, multinational firms can be accused of "moral muteness" when immoral practices are taken for granted within an economy and/or global problems that transcend national boundaries are ignored.[56] For example, global climate change is not limited to any one country's national boundaries, but national governance standards seeking to curtail carbon emissions vary widely. Finally, a firm can experience legal problems in its home country by taking this approach, such as U.S. firms' experience with the Foreign Corrupt Practices Act, which, in foreign markets, governs U.S. firm behavior (and increasingly all firms operating within the OECD).[57]

As a result, some multinational firms seek to govern all of their operations in a globally consistent fashion, regardless of variations in governance practices throughout the world. The advantage of this approach is that best practices can be adopted and enforced, and the global economy can benefit while the multinational firm protects its legitimacy and integrity. The disadvantage of this approach is that it often brings multinational firms into conflict with national and local governmental agencies. Furthermore, a multinational firm can be accused of "cultural imperialism" by attempting to force its values and beliefs on another country.[58]

There are several ways that multinational firms can govern their foreign subsidiaries well. First, effective multinational corporate governance starts with the board of directors of the parent corporation in the home country; this governing body establishes and coordinates the degree to which foreign subsidiaries are permitted to deviate from corporate norms and values. Second, the board of a foreign subsidiary in a host country can play an important role; to be globally consistent but also locally responsive, the foreign subsidiary board would be composed of knowledgeable and engaged directors who understand the parent company's norms and values, and who also understand the host country's formal and informal governance institutions; as such, the foreign subsidiary board can act as an arbitrator of all conflicts between local customs and corporate standards. Third, expatriate representation within the top management team can ensure that the foreign subsidiary is properly governed; for example, expatriate managers can help provide a parent company with perspective on local company issues that may arise. Fourth, human resource practices and systems can be standardized and customized to local norms to ensure governance standards are met; for example, minimum-wage practices may or may not match host country norms. Fifth, the firm can fully adopt international accounting standards, regardless of the accounting norms enforced in host countries.[59] Finally, global supply chain oversight is an increasingly important governance task for multinational firms and its foreign subsidiaries. For example, child labor

practices may not be established or enforced in some economies; thus, it may be up to the multinational firm to ensure that children are not taken advantage of by some of the firm's suppliers.

CONCLUSION

Corporate governance practices vary significantly around the world because they are contingent on the type of economic system in which they are embedded. These economic systems represent the formal and informal institutions that have evolved over time to yield the rules by which corporations are expected to operate. While no governance practice or structure is costless, to fail to understand what society considers to be legitimate behavior or to ignore it is also not costless.

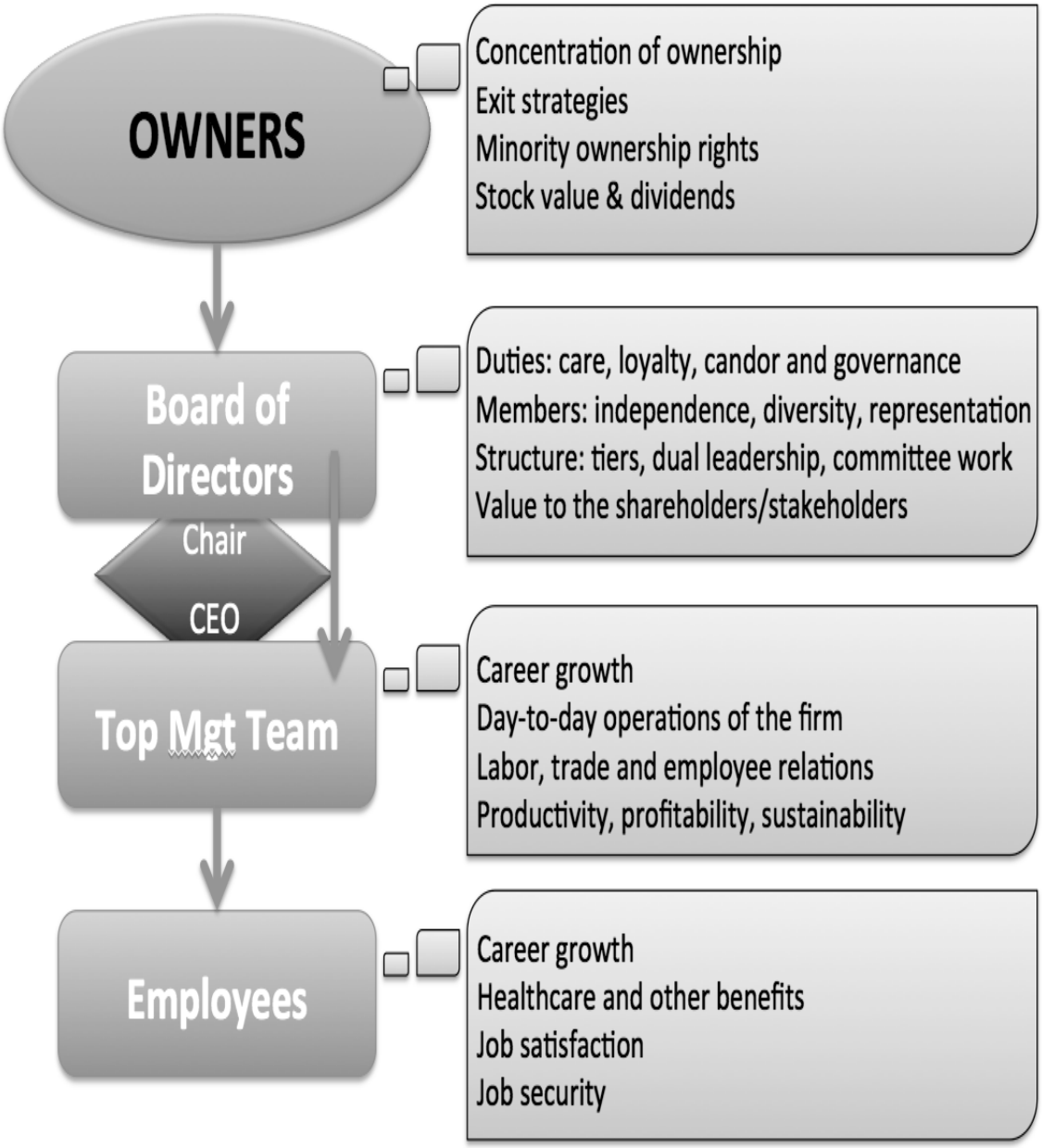
However, all corporations within the same economy are *not* governed in the same way. All societies grant considerable latitude, within which firms can govern themselves. As we discussed, some societies, such as those within CMEs, ask their firms to comply or explain why they govern themselves one way or the other. Other societies, such as those within LMEs, tightly prescribe certain structures and behaviors through specific laws, but permit firms to have considerable freedom to operate outside of those specifications. And other societies, such as those within FLMEs and SLMEs, demand allegiance to the family patriarch or state while permitting considerable discretion in those areas that are less important to the state or family.

In addition to this society-granted discretion are transnational pressures for deviation from societal governance standards. For example, multinational institutional investors sometimes attempt to change the governance practices of firms in which they have invested, even though those practices conform to society's norms, such as was attempted by CalPERS, the Japanese public pension fund.[60] In response, some firms adopt the foreign-imposed structure, such as boards composed of directors that are independent of management (and attempt to make this structure work), or, more frequently, the new structure or practice is adopted but it isn't used to actually govern the firm.

Ultimately, however, firms are granted their right to exist by the societies in which they operate. When that right is handled responsibly from the perspective of society, the firm is viewed as being legitimate, and power accrues to it. When that right is handled irresponsibly from the perspective of society, the firm is viewed as being illegitimate, and power is constrained or, in extreme circumstance, the firm is no longer allowed to function. This effect is known as the "iron law of responsibility," which simply argues that with power comes responsibility, and those firms that fail to behave responsibly will lose their power.[61]

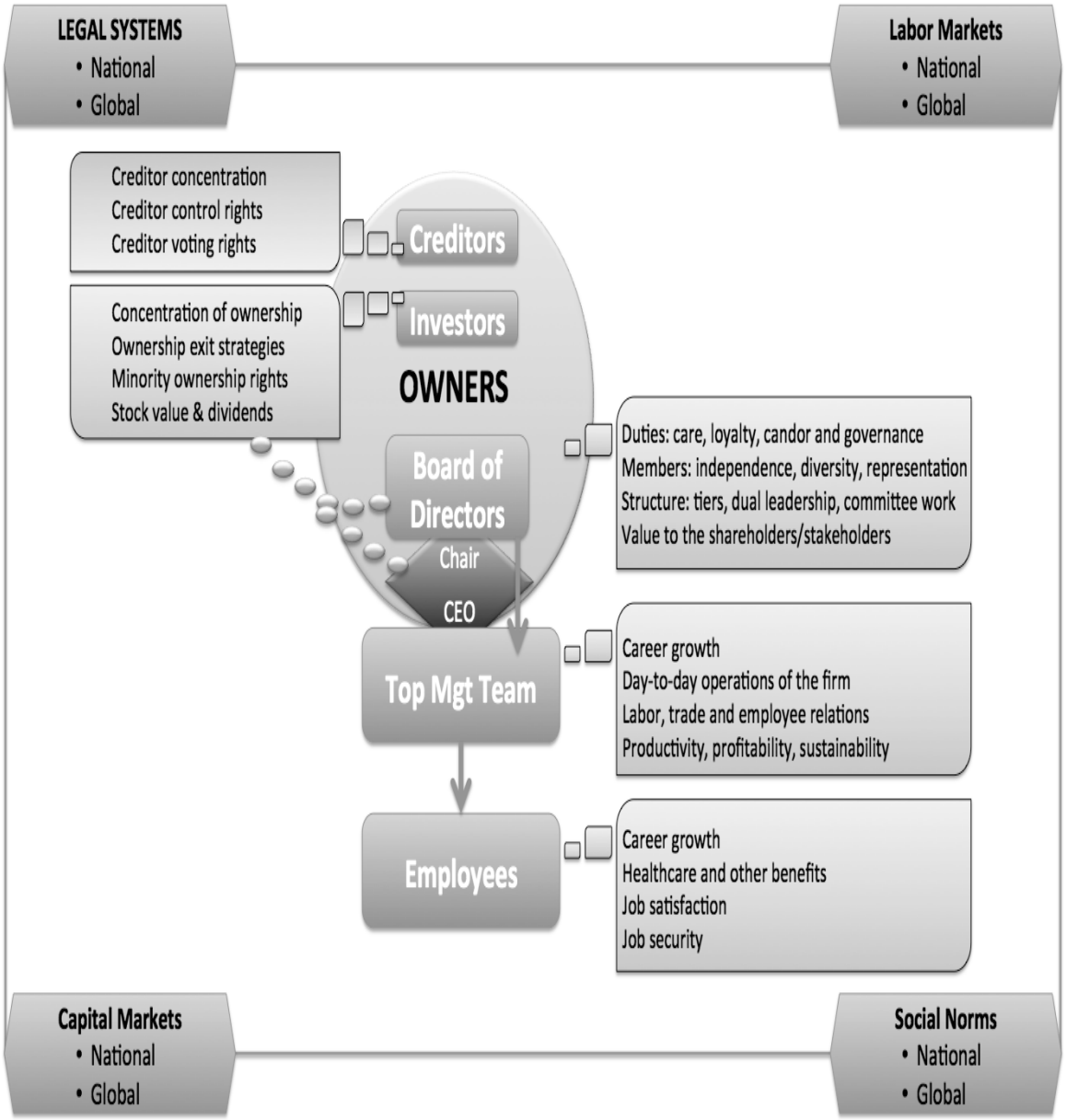
Overall, society provides many checks and balances — i.e., guards — to guide and constrain corporate power. This system requires the corporation to install internal checks and balances — i.e., guardians — to guide and constrain corporate power. International corporate governance, therefore, can be viewed as a system that consists of layers of checks and balances — i.e., guards guarding the guardians — to assure that corporate power is wielded appropriately. This system starts at the individual level, which is embedded within a firm, which is embedded within an industry, which is embedded within a society, which ultimately is influenced by external actors and societies. This system of domestic and transnational governance is constantly evolving along with the weight of history, developing along with social norms and emerging along with international changes in personal and corporate values and practices.

EXHIBIT 1: THE SHAREHOLDER-ORIENTED MODEL OF THE FIRM: CORPORATE GOVERNANCE ACTORS AND THEIR PRIMARY CONCERNS



Source: Created by the case writers.

EXHIBIT 2: THE INSTITUTIONAL MODEL OF CORPORATE GOVERNANCE ACTORS: CONSIDERATION OF THE EMBEDDED NATURE OF CORPORATE GOVERNANCE MECHANISMS



Source: Created by the case writers.

EXHIBIT 3: THE KEY CORPORATE GOVERNANCE ACTORS ACROSS MODELS OF CAPITALISM

	Models of Capitalism			
	LME	CME	FLME	SLME
Nature	Liberal Market Economy	Coordinated Market Economy	Family Market Economy	State-Led Market Economy
Exemplar countries	United States United Kingdom Australia	Germany Japan Sweden	Italy Korea Brazil	China Hungary Malaysia
Primary Owners	Institutional investors, Individual investors	Industrial corporations, Universal banks	Family, Business groups	State, State-owned banks
Managers	Act as agents for shareholder interests	Act as agents for stakeholder interests	Act as agents for family interests	Act as agents for state interests
Employees	Beholden to the marketplace	Beholden to the firm or industry	Beholden to the family patriarch	Beholden to the state
Board of Directors	Actively monitor and advise managers	Balance various demands	Represent family interests	Largely symbolic, politically affiliated

Source: Created by the case writers.

EXHIBIT 4: CORPORATE GOVERNANCE MECHANISMS ACROSS THE FOUR MODELS OF CAPITALISMS

	Model of Capitalism			
Corporate Governance Mechanism	Liberal Market Economy (LME)	Coordinated Market Economy (CME)	Family-Led Market Economy (FLME)	State-Led Market Economy (SLME)
Internal				
Boards of Directors	Independent, activist	Co-opted, corporatist	Dinner table boards, duplicate	Politically appointed boards
Executive Compensation	Relatively high and variable	Moderate	Relatively low, but many perquisites	Relatively low, but many perquisites
Information Disclosure	Extensive & transparent	Moderately transparent	Limited to insiders	Opaque
External				
Market for Corporate Control	Active	Minimal	Non-existent	Non-existent
Legal & Regulatory System	Common Law Hard law High enforcement	Civil Law Soft Law High enforcement	Civil Law Family law Little enforcement	Civil Law State policies No enforcement
Corporate Governance Codes	Inconsequential	Comply or explain	Comply or explain	Inconsequential
Informal Cultural Norms	Low Power Distance, High Individualism	Low Power Distance, Moderate Individualism	High Power Distance, Low Individualism	High Power Distance, Low Individualism

Source: created by the case writers.

ENDNOTES

[1] *Quis custodiet ipsos custodes? is a Latin phrase traditionally attributed to the Roman poet Juvenal from his Satires (Satire VI, lines 347–348), which is literally translated as "Who will guard the guards themselves?"*

[2] *"Institution" is used here in the sense of a societal rules and norms.*

[3] *The Worldwide Governance Indicators provide comprehensive cross-national data in terms of three main categories: (1) the process by which governments are selected, monitored and replaced; (2) the capacity of the government to effectively formulate and implement sound policies and (3) the capacity of the government to effectively formulate and implement sound policies. Source: Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, "The Worldwide Governance Indicators: Methodology and Analytical Issues," Hague Journal on the Rule of Law, 2011, 3(2), pp. 220–246. These data are publicly available at: http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/EXTMNAREGTOPGOVERNANCE/0,, contentMDK:20513159~pagePK:34004173~piPK:34003707~theSitePK:497024,00.html. The World Values Survey at the University of Michigan has compiled a longitudinal survey capturing national values across countries: www.worldvaluessurvey.org/, accessed November 19, 2014.*

[4] *http://web.worldbank.org/governance/wgi/resources.htm, accessed April 5, 2013.*

[5] *Mark J. Roe, "Political Preconditions to Separating Ownership from Corporate Control," Stanford Law Review, 2000, 53, pp. 539–606.*

[6] *See Ruth V. Aguilera and Gregory Jackson, "The Cross-National Diversity of Corporate Governance: Dimensions and Determinants," Academy of Management Journal, 2003, 28, pp. 447–465; and Ruth Aguilera, Igor Filatotchev, Howard Gospel and Gregory Jackson, "Contingencies, Complementarities, and Costs in Corporate Governance Models," Organization Science, 2008, 19, 475–492.*

[7] *Adolf Berle and Gardiner Means, The Modern Corporation, Macmillan, New York, 1932.*

[8] *Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure," Journal of Financial Economics, 1976, 3 (October), pp. 305–360.*

[9] *Andrei Shleifer and Robert Vishny, "A Survey on Corporate Governance," Journal of Finance, 1997, 2, p. 737.*

[10] *See Alfred Chandler, The Visible Hand: The Managerial Revolution in American Business, Harvard University Press, Cambridge, MA, 1977; Mark Roe, Strong Managers and Weak Owners: The Political Roots of American Corporate Finance, Princeton University Press, Princeton, NJ, 1994.*

[11] *R. Edward Freeman, Strategic Management: A Stakeholder Approach, Prentice Hall, Englewood Cliffs, NJ, 1984.*

[12] *Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, "Corporate Ownership around the World," Journal of Finance, 1999, 54(2), pp. 471–517. This work was the first empirical article to show, using a small sample of firms around the world, that the dispersed ownership prominent in the United States was not common in the rest of the world. Others have corroborated this claim: Thomsen & Pedersen (2000); Claessens, Djankov & Lang (2000); Faccio & Lang (2002); Lubatkin, Lane, Collin & Very (2005); Alberto Chong and Florencio López-de-Silanes (eds.), Investor Protection and Corporate Governance: Firm-Level Evidence across Latin America, World Bank, Washington, DC, 2007; Richard Carney and Travers Child, "Changes to the Ownership and Control of East Asian Corporations between 1996 and 2008: The Primacy of Politics," Journal of Financial Economics, 2012, 107(2), pp. 494–513; and Kabbach de Castro, Aguilera & Crespí-Cladera (2013).*

[13] *For example, Francesca Cuomo, Alessandro Zattoni and Giovanni Valenti, "The Effects of Legal Reforms on the Ownership Structure of Listed Companies," Industrial and Corporate Change, 2012, 2(22), pp. 427–458 state that "(i) outside the U.S. and the U.K., large companies have ultimate controlling owners, (ii) controlling shareholders are usually wealthy families or the State, and (iii) dominant shareholders use control enhancing mechanisms to acquire and maintain the control of large firms" (p. 428).*

[14] *OECD Principles of Corporate Governance, OECD Publishing Services, Paris, 2004, p. 11. These principles were originally signed in 1999 and "have become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide." (p. 3) They include six sections: (1) ensuring the basis for an effective corporate governance framework, (2) the rights of shareholders and key ownership functions, (3) the equitable treatment of shareholders, (4) the role of stakeholders in corporate governance, (5) disclosure and transparency and (6) the responsibilities of the board. See: www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf, accessed November 19, 2014.*

[15] *William Q. Judge, Ajai Gaur and Maureen Muller-Kahle, "Antecedents of Shareholder Activism in Target Firms: Evidence from a Multi-Country Study," Corporate Governance: An International Review, 2010, 18(4), pp. 258–273.*

[16] *Oxford Dictionaries. See also Charles Tilly, Gabriel Ardant and Social Science Research Council (U.S.) Committee on Comparative Politics, Formation of National States in Western Europe, Princeton University Press, Princeton, NJ, 1975.*

[17] *See William Q. Judge, Stav Fainshmidt and J. Lee Brown, "Which Model of Capitalism Best Delivers Wealth and Equality?" Journal of International Business Studies, 2014, 45, pp. 363–386.*

[18] *For conceptual developments of the varieties of capitalism (VoC) theory, see Whitley (1999); Peter A. Hall and David Soskice, Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press, Oxford, UK, 2001; Amable (2003); Redding (2005) and Hancké, Rhodes and Tatcher (2007); for empirical testing of the VoC theory, see Schneider & Paunescu (2012) and, for empirical testing of the VoC theory, see Peter A. Hall and Daniel W. Gingerich, "Varieties of Capitalism and Institutional Complementarities in the Macroeconomy," British Journal of Political Science, 2009, 39, pp. 449–482.*

[19] *Additional domains could be those used in Michael A. Witt and Gordon Redding, "Asian Business Systems: Institutional Comparison, Clusters and Implications for Varieties of Capitalism and Business Systems Theory," Socio-economic Review, 2013, 11, pp. 265–300: internal firm structure, social capital, educational skills and inter-firm relations.*

[20] *Our categorization of SLME is based on recent refinements by Nahee Kang and Jeremy Moon, "Institutional Complementarity between Corporate Governance and Corporate Social Responsibility: A Comparative Institutional Analysis of Three Capitalisms," Socio-Economic Review, 2012, 10, pp. 85–108; and Witt and Redding, op. cit.*

[21] *Witt and Redding, op. cit., p. 272.*

[22] *Roberto Garcia-Castro, Ruth V. Aguilera and Miguel Angel Ariño, "Bundles of Firm Corporate Governance Practices: A Fuzzy Set Analysis," Corporate Governance: An International Review, 2013, 21(4), pp. 390–407.*

[23] *Hall and Soskice (1992); Hall and Soskice, Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, op. cit., p. 8.*

[24] *Lane Kenworthy, "Quantitative Indicators of Corporatism," International Journal of Sociology, 2003, 33(3), p. 11. For more background on corporatism, see Alexander Hicks and Lane Kenworthy, "Cooperation and Political Economic Performance in Affluent Democratic Capitalism," American Journal of Sociology, 1998, 103(6), pp. 1631–1672. The Hicks-Kenworthy scale of corporatism is available at www.u.arizona.edu/~lkenwor/ajs98.htm, accessed November 19, 2014.*

[25] *Paul Windölf, Corporate Networks in Europe and the United States, Oxford University Press, Oxford, UK, 1992.*

[26] *Rafael La Porta, Florencia López-de-Silanes, Andrei Shleifer and Robert Vishny, "Investor Protection and Corporate Governance," Journal of Financial Economics, 2000, 58, pp. 3–27.*

[27] *John Coffee, "Privatization and Corporate Governance: The Lessons from Securities Market Failure," Journal of Corporation Law, 1999, 25, pp. 1–39.*

[28] *Ruth V. Aguilera and Alvaro Cuervo-Cazurra, "Codes of Good Governance," Corporate Governance: An International Review, 2009, 17(3), pp. 376–387.*

[29] *Global Challengers are "companies based in RDEs that are shaking up the established economic order," such as América Móvil from Mexico, Sappi from South Africa or Koç Holding from Turkey. Source: Boston Consulting Group, 2011 BCG Global Challengers: Companies on the Move—Rising Stars from Rapidly Developing Economies Are Reshaping Global Industries, The Boston Consulting Group, Boston, p. 1-1, at www.bcg.com/documents/file70055.pdf, accessed November 19, 2014.*

[30] *Witt and Redding, op. cit. They demonstrate that Asian countries cannot be understood within the VoC dichotomy and suggest the need to incorporate social capital, cultural elements and informality.*

[31] *The five types of business systems include the following: (post-) socialist systems (China, Vietnam, Laos and India), advanced city economies (Hong Kong and Singapore), emerging Southeast Asian systems (Indonesia, Malaysia, the Philippines and Thailand), advanced Northeast Asian (Korea and Taiwan) and Japanese systems.*

[32] *Mutsa Chironga, Acha Leke, Susan Lund and Arend van Wamelen, "Cracking the Next Growth Market: Africa," Harvard Business Review, 2011, 89(5), pp. 117–122.*

[33] *The four types are diversified economies (e.g., Egypt, Morocco, South Africa and Tunisia), oil exporters (e.g., Algeria, Angola and Nigeria), transition economies (e.g., Ghana, Kenya, Uganda and Senegal) and pre-transition economies (e.g., Democratic Republic of Congo, Ethiopia and Mali).*

[34] *Ben Ross Schneider, "Hierarchical Market Economies and Varieties of Capitalism in Latin America," Journal of Latin American Studies, 2009, 41(3), pp. 553–575.*

[35] *Mike W. Peng and Yi Jiang, "Institutions behind Family Ownership and Control in Large Firms," Journal of Management Studies, 2010, 47(2), p. 256.*

[36] *Cuomo, Zattoni and Valentini, 2012, op. cit., p. 433.*

[37] *Marc Van Essen, Peter-Jan Engelen and Michael Carney, "Does 'Good' Corporate Governance Help in a Crisis? The Impact of Country- and Firm-Level Governance Mechanisms in the European Financial Crisis," working paper, 2012, p. 48.*

[38] *Schneider, op. cit., p. 559. Moreover, approximately 75 per cent of the business groups in Brazil are family owned. Source: Chong and López-de-Silanes, op. cit.; Dante Aldrighi and Fernando Postali, "Business Groups in Brazil," in Asli Colpan, Takashi Hikino and James Lincoln, eds., The Oxford Handbook of Business Groups, Oxford University Press, Oxford, UK, 2010.*

[39] *Steven Globerman, Mike Peng and Daniel Shapiro, "Corporate Governance in Asian Companies," Asia Pacific Journal of Management, 2011, 28, p. 5, data from Claessens (2000).*

[40] *Carney and Child, op cit., p. 13.*

[41] *Michael N. Young, Mike W. Peng, David Ahlstrom, Garry Bruton and Yi Jiang, "Corporate Governance in Emerging Economies: A Review of the Principal-Principal Perspective," Journal of Management Studies, 2008, 45(1), pp. 196–220.*

[42] *Kang and Moon, op.cit., have developed this typology extensively for corporate governance and corporate social responsibility, and this section draws heavily from these authors. See also Aldo Musacchio and Sergio Lazzarini, "Leviathan in Business: Varieties of Capitalism and their Implications for Economic Performance," working paper, 2012.*

[43] *Globerman et al., op. cit.*

[44] *Kang and Moon, op. cit., p. 93.*

[45] *Witt and Redding, op. cit., p. 271.*

[46] *Globerman et al., op. cit., p. 5.*

[47] *For a review of all the current indices available and their strengths and limitations, see Ruth Aguilera and Kurt Desender, "Challenges in the Measuring of Comparative Corporate Governance: A Review of the Main Indices," Research Methodology in Strategy and Management, 2012, 7, pp. 289–322.*

[48] *According to Van Essen, Engelen and Carney (op. cit., p. 7), "Most studies show that government ownership is associated with inefficiency and financial underperformance compared with private firms (Boardman and Vining, 1989; Megginson and Netter, 2001)." We think the jury is still out.*

[49] *For more discussion on current challenges in boards, see Jay Lorsch, (ed.), The Future of Boards. Meeting Governance Challenges of the Twenty-First Century, Harvard Business Review Press, Cambridge, MA, 2012.*

[50] *German corporation law, the Aktiengesetz, requires all public companies (Aktiengesellschaften) to have two boards: a management board, called a Vorstand, and a supervisory board, called an Aufsichtsrat. Half of the supervisory board (the key decision-making body) is composed of representatives of the employees who have as much voting power as their peer directors. This composition structure has been referred to as "codetermination." For further discussion on this topic, see Gregory Jackson, "Stakeholders under Pressure: Corporate Governance Reform and Labour Management in Germany and Japan," Corporate Governance: An International Review, 2005, 13(3), pp. 419–428.*

[51] *Ruth V. Aguilera, "Corporate Governance and Director Accountability: An Institutional Comparative Perspective," British Journal of Management, 2005, 16, pp. 1–15.*

[52] *Daniel Denison, Colleen Lief and John Ward, "Culture in Family-owned Enterprises: Recognizing and Leveraging Unique Strengths," Family Business Review, 2004, 17(1), pp. 61–70.*

[53] *Diane Denis and John McConnell, "International Corporate Governance," Journal of Finance & Quantitative Analysis, 2003, 38, pp. 1–36.*

[54] *Evis Sinani, Anna Staffsudd, Steen Thomsen, Christofer Edling and Trond Randoy, "Corporate Governance in Scandinavia: Comparing Networks and Formal Institutions," European Management Review, 2008, 5, pp. 27–40.*

[55] *Maria Halter, Maria de Arruda and Ross Halter, Transparency to reduce corruption? Journal of Business Ethics, 2009, 84, 373–385.*

[56] *Peter Verhezen, "Giving Voice in a Culture of Silence: From a Culture of Compliance to a Culture of Integrity," Journal of Business Ethics, 2010, 96, pp. 187–206.*

[57] *Masako Darrough, "The FCPA and the OECD Convention: Some Lessons from the U.S. Experience," Journal of Business Ethics, 2010, 93, pp. 255–276.*

[58] *Verhezen, op. cit.*

[59] *William Q. Judge, Shaomin Li and Robert Pinsker, "National Adoption of International Accounting Standards: An Institutional Perspective," Corporate Governance: An International Review, 2010, 18(3), pp. 161–174.*

[60] *Sanford Jacoby, "Principles and Agents: CalPERS and Corporate Governance in Japan," Corporate Governance: An International Review, 2007, 15, pp. 5–15.*

[61] *Archie Carroll and Ann Buchholtz, Business and Society: Ethics and Stakeholder Management, 7th ed., Southwest Publishing, New York, 2008, p. 30.*