1. Introduction

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1.1 INNOVATIONS IN CORPORATE GOVERNANCE: AN OVERVIEW

Why is there a need for corporate governance? Many academics and financiers argue that the disciplines of the capital markets on their own will cause corporate managers to take corrective action to improve performance.[1] As early as 1992, Martin Lipton, the founding partner of the famous New York mergers and acquisitions law firm Wachtell, Lipton, Rosen & Katz, critiqued the argument saying it would ultimately be up to history to judge whether the argument had validity (Lipton and Lorsch 1992, 59–60).

History has finally spoken. The catalyst has probably been the Global Financial Crisis (GFC) of 2008, although it has taken some time for the alchemy of change to take hold. This book is the third collection that we have co-edited. The first, *Corporate Governance after the Financial Crisis* (Vasudev and Watson 2012), addressed the immediate aftermath of the GFC of 2008–09 where early hopes of a fundamental reconsideration of the tenets of the economic system seemed to have been dashed by 2010. The world looked much the same at that time. Ultimately though, states and governments recognized that old certainties had been swept away and were now grappling with the implications of new thinking about the ways in which the role and nature of corporations should be viewed and, therefore, regulated.

Corporate governance is suddenly fashionable after long being associated with, at best, compliance and the dull end of the law and, at worst, with state-imposed requirements around how corporations must

[1] Some representative examples cited by Lipton and Lorsch (1992, 59) are Easterbrook FH and Fischel DR, 'The Proper Role of a Target's Management in Responding to a Tender Offer' 94 Harvard Law Review 1161, 1169; Gilson RJ, 'A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers' (1981) 33 Stanford Law Review 819.

be internally governed and therefore, as intrusions into free enterprise tantamount to socialism. It is surprising, therefore, to see that change—in some jurisdictions at least—is being driven by the political right. Theresa May, the British Prime Minister, is from the Conservative Party. In her 2016 pitch for the leadership she focused in part on corporate governance, calling for measures like worker representation on boards (as in Germany), board diversity and executive director remuneration being pegged to employee salaries. Across the political spectrum, therefore, the state increasingly sees a role for itself in determining how Britain's largest companies ought to be governed.

Corporate governance has moved into the political zeitgeist as part of an emerging shift in economic thinking, as well as a reaction to corporate scandals like the Volkswagen emissions saga and the collapse, after 88 years of trading, of the BHS high street chain of stores in the United Kingdom (UK). British MPs in a report described the BHS collapse as 'the unacceptable face of capitalism' (Work and Pensions and Business, Innovation and Skills Committees 2016, [168]). Founder and former owner Sir Philip Green 'made a fortune beyond the dreams of avarice' in part by using complex offshore structures in the name of his wife, Lady Tina Green, to avoid paying tax in the UK (Field 2016). The media now consider the Greens fair game, lambasting them not only in the tabloids, for which paparazzi vie for unflattering shots of Sir Philip and Lady Tina sunning themselves on their £100 million super yacht, but also in the broadsheets.[2]

The extreme reaction may be surprising to some. The Greens were no longer owners of BHS when it failed and had not been for a year. It might be questioned what possible responsibility Sir Philip had once he divested himself of his shares. But the disquiet centres on emerging beliefs that corporate controllers have not only legal but also moral obligations to stakeholders such as employees and investors in superannuation funds, all of whom lost out in the collapse.

Morality in corporate law: what is going on? The change in economic thinking is influencing how we view modern corporations. For a long time, listed companies were regarded as no more than private vehicles for aggregation of shareholder capital. Directors were regarded as agents for shareholding owners with the role of corporate governance largely confined to ensuring the interests of directors and shareholder owners were aligned. With a board's mandated focus considered to be on maximizing profits for shareholders, strategies such as incentive pay pegged to share price and profitability were adopted.

[2] For example, see Adams and Boshoff 2016; Quinn 2016.

Then the wheels fell off: first with corporate scandals such as Enron early in the millennium and then the GFC of 2008–09. Executive remuneration had spiraled out of control and corporate risk-taking increased with directors incentivized to put short-term profits first. The recent inequality discourse revealed that corporations, as effective aggregators of capital, are in fact big contributors to inequality, enormously benefiting corporate managements and shareholders to the detriment of employees and consumers. The attention currently paid to corporate governance is, therefore, not just an outcome of corporate governance failures, but also of a new understanding that what really matters in companies is control of the corporate entity. As the body statutorily charged with managing the resources of corporations, boards are best placed to carry the responsibility for sustaining and growing the company as an entity and, in doing so, balancing the competing interests of stakeholders such as employees, creditors and consumers against the interests of corporate managements and shareholders.

It is appealing to think that governments and legislation might require boards to drive corporations in a direction that compels them to look at sustainability in the long term and the benefit of all stakeholders. But why should the financial interests of shareholders as owners yield in any way to other stakeholders? What right do governments have to interfere with private property rights? The answer lies in the role of states in ensuring the success of the corporate form. Limited liability companies are remarkably effective aggregators of capital and therefore facilitators of growth. Yet their success was not inevitable or even predicted. Adam Smith (1776, 254), the father of modern economics, considered that joint stock companies could never compete effectively with other forms of business. What Smith could not have predicted was that by the mid-nineteenth century, incorporation as a right would be coupled with limited liability sanctioned by legislation and public policy. More than anything else, limited liability combined with the company as an entity separate from its shareholders and the status of a legal person led to the success of the form.

So, why would governments kill or even interfere with the golden goose? The answer must be that the corporate form is a success only because the state permits limited liability and gives the entities the status of legal persons: enormous benefits for corporations, and therefore for shareholders, are derived from the state. In return, it can be argued, governments are justified in regulating the internal governance of companies to ensure that the long-term interests of companies as entities are paramount in boardroom decision-making. Granted, many boards already prioritize the long-term interests of companies as entities, but they are often forced to use the fig leaf of long-term shareholder interests. It ought to be more overtly acknowledged that limited liability companies are not completely private: they are entities legally separate from people and sit at the interface of the public and private realms. At a time when privilege is increasingly questioned, it is in the interests of sustainability, not just of their own companies but of the corporate form itself, that boards should not be afraid to base decisions on the long-term interests of corporations as entities and should be explicitly protected from shareholder challenge if they do so. Innovative and creative thinking in corporate governance is long overdue.

This collection of chapters written by scholars from around the world highlights and critically analyses innovations in corporate governance adopted in a range of jurisdictions, both mature and developing. One section of the collection focuses on the governance of banks due to their primary importance.

The book maps recent global trends in corporate governance, with a special focus on identifying any commonalities or convergences. The chapters included in the book fall under the following three specific categories:

1. Perspectives on corporate governance (Part I);
2. Regulatory techniques (Part II);
3. Governance in banks (Part III).

The book has nine chapters. Chapter 1 is an introductory chapter. The chapter outlines for Chapters 2–9 are presented below.

1.2 PART I: PERSPECTIVES ON CORPORATE GOVERNANCE

The first part, containing three chapters, provides perspectives on corporate governance. The first two chapters deal, respectively, with globalizing corporate law and the governance of state-owned enterprises in China. The third argues for a new conception of modern corporations that can facilitate better governance.

1.2.1 Chapter 2: Franklin A. Gevurtz—Globalizing Up Corporate Law

A frequent criticism of globalization is that it produces a 'race to the bottom' as multinational corporations engage in regulatory arbitrage by moving activities to nations with less legal protections accorded to workers, the environment, and so on. Others have argued that globalization may actually lead to an increase in legal protection—trading or globalizing up. One example is the 'California effect' that occurs when multinational corporations find it more efficient to produce products meeting the standards imposed by the most demanding jurisdiction, rather than tailor products to differing standards. This chapter contributes to the dialogue by looking at globalizing up in the corporate law context and specifically at examples in which globalization led to greater legal protections for minority shareholders against self-enriching conduct by controlling parties or large shareholders.

Franklin A. Gevurtz examines the phenomenon of globalizing up in a corporate law context, where the globalization of companies effectively increases minority shareholder protections against 'self-enriching conduct by controlling parties'. This occurs when, 'as a result of international capital flows, foreigners become subject to a different nation's more demanding corporate law'.

Gevurtz examines three cases that illustrate this phenomenon. First is *Southern Peru Copper* (2011), in which a Mexican corporation diversified into the United States (US) market via a leveraged buyout of a US company, Asarco. It later tried to take advantage of Asarco's majority voting ownership in a Delaware company, Southern Peru Copper (SPC), by selling itself SPC's shares for gross undervalue. This resulted in a Delaware court ruling against it for over $2 billion in a derivative lawsuit brought by SPC's minority shareholders. Second is *Puda Coal* (2013), an example of a Chinese 'reverse merger' where a Chinese company enters the US capital market by merging with a 'moribund' corporation that had previously been on the US market. This method helps in avoiding IPO regulations and expenses. Here, the company's outside directors in Delaware found themselves liable for breach of directors' duties for failing to stop the managing director/CEO from self-dealing in China, and then resigning, rather than have the company sue the managing director. Thirdly, Gevurtz discusses Greenlight Capital, where UK insider-trading rules were enforced against a US hedge fund for transactions involving a UK company's shares (Financial Services Authority 2012). The transactions would otherwise have been legal in the US.

Gevurtz contrasts globalizing up by 'moving capital' (the chapter's focus, where foreign corporations are subjected to more demanding corporate law when diversifying into other countries) and globalizing up by 'moving law' (where countries with fewer legal protections adopt more protective corporate law to attract foreign capital). Moving capital is more limited than moving law, as it only applies to corporations that diversify by buying 'large blocks of shares' in corporations formed in foreign countries. However, Gevurtz argues that a corporation's failure to do this could be seen as evidence of its controlling parties' bad intentions, thereby attracting fewer prospective minority shareholders. Furthermore, moving law is limited to laws that are 'easy' to import. This means that many countries lack the protection of laws that might be harder to import. For example, the requirement to have independent directors has been adopted worldwide, but the judicial enforcement of directors' fiduciary duties has not. For several reasons, moving law can also be difficult to achieve. It can face 'vigorous opposition'. Procedural barriers (such as availability of shareholder actions) also remain. There may, too, in some countries be less jurisprudence on such matters and a judiciary that is less sophisticated in dealing with them.

Finally, using the example of insider-trading prohibitions, Gevurtz discusses how moving law and moving capital can mutually interact, such as through a California effect, where multinational corporations 'comply with the most demanding jurisdiction's law'.

1.2.2 Chapter 3: Li-Wen Lin—China's National Champions: Governance Change Through Globalization?

China is regarded as the world's leading practitioner of state capitalism. About 100 large state-owned enterprises (SOEs), controlled by organs of the central government, are major actors in critical industries such as oil, telecom and transportation. They are not only important players in China's domestic economy but also major contributors to China's global investment. Their global expansion is hindered partly because SOEs' corporate governance practices are often opaque and deviate from international standards.

Prevailing theories suggest that political and regulatory pressure in host countries (particularly advanced economies such as the US) may be effective in forcing SOE governance change. Empirical findings presented in the chapter, however, indicate that global equity connections and foreign institutional pressure seem to be virtually irrelevant to the reform of non-financial SOEs in China. This could be related to investment structure and geography, investment motives and, importantly, China's domestic political institutions. In 'China's national champions: Governance change through globalization?' Li-Wen Lin, who teaches at the University of British Columbia, Canada, explores the future of national corporate governance systems in the globalization setting and offers recommendations for Chinese and international policymakers.

China has become a major source of foreign direct investment into both developing and developed countries. Investment by Chinese SOEs in Western countries has given rise to controversy in those countries. This includes concerns around the transparency and corporate governance practices of Chinese SOEs. Regulators have sometimes approved investment deals conditional upon the adoption of international corporate governance standards. The question is whether this level of scrutiny, and indeed the process of overseas investment in general, will cause Chinese SOEs to modernize their domestic governance practices.

In other words, will global investment cause a ‘diffusion’ of positive governance benefits back to the parent companies in Beijing, as some theories predict? This chapter finds that, so far, there is little empirical evidence to indicate this diffusion is, in fact, occurring. Lin suggests that the investment structures used by Chinese SOEs investing offshore, along with the dominant role of central planning in Chinese SOE governance, may explain why the reality does not match theoretical preditions.

China’s largest nonfinancial SOEs are controlled by a central agency, the State-Owned Assets Supervision and Administration Commission (SASAC). Each of these SOEs is structured as a vertically integrated group, with a holding company at the top owned wholly by the SASAC. These holding companies are governed very differently from international best practice. Some still do not have boards of directors, while others adopted the board model only recently. Top managers are appointed by the central government, with party loyalty as an important criterion. This model has caused concern in Western states that have been targeted for investment by Chinese SOEs.

When investing in developed countries, Chinese SOEs employ several strategies to avoid obstruction from concerned regulators. One is to enter into joint ventures rather than make acquisitions, as the former model tends to attract fewer regulatory hurdles. Another is to operate through subsidiaries which increase the distance between the investing vehicle and the holding company in China. Both strategies may tend to weaken any positive governance benefits flowing back to the parent company in Beijing.

Where a chain of subsidiaries is used, weak monitoring by the parent SOE can limit the flow of information and hence, the diffusion of governance practices, up the ownership chain. This effect may, perhaps ironically, be exarcerbated by Western concerns about Chinese government influence, leading to demands that investing subsidiaries operate independently from their state-owned parents in Beijing.

As a result, improvements in governance seem to be limited to overseas subsidiaries, rather than diffused back to the parent companies. Although there has been governance reform among the parent SOEs, the degree of reform has been uneven, and exposure to international corporate governance standards seems to be virtually irrelevant to the pattern. Instead, domestic political affairs appear to have more impact on the extent to which an SOE reforms its governance practices.

1.2.3 Chapter 4: Susan Watson—The Taxonomy of the Modern Company

Susan Watson discusses normative conceptions of the corporation and their effects on corporate governance. Her chapter sets out a new model of the business corporation. In terms of form, in modern corporations the capital contributed by shareholders is severed from them in the corporate entity. Shareholders hold shares that have rights attached to them but do not own the company. The corporation contains the joint stock: a capital fund that is under the control, at least in a normative sense, of the board of directors. The chapter shows that the severing of capital from the holders of shares took place with the advent of the general incorporation statutes in mid-nineteenth-century Britain. The severance was brought about by the combination of two earlier forms together with the statutory enablement of limited liability and the requirement that corporate accounts distinguish between capital and income.

An implicit severance of shareholders from capital underpins *Salomon v Salomon* (1897) and this is a reason why it is the seminal corporate law case in many jurisdictions. The consequences and advantages of the modern corporate form were not fully recognized or exploited until later in the nineteenth century leading to the inevitable concentration of economic power in companies. This was identified and predicted to intensify by Berle and Means (1933). Their attributing its cause to a separation of ownership in shareholders from control in management, however, led to a shift in the focus of modern corporate law to solving perceived agency problems between shareholders as owners and managements as agents. The chapter argues that the primary focus for corporate law should instead be on regulating the control of the corporate capital fund.

In doing so it attempts to identify what a 'company' is, and introduces three main theories: concession theory (the state 'grants' companies the right to exist; the company is a *universitas*), participant theory (a company's existence stems from the individuals who comprise it; it is a *societas*) and institutional theory (an intermediate view: the company is an institution that is both formed according to legal rules and organized and run by individual people).

Before general incorporation statutes were enacted, concession theory prevailed as incorporation could only be obtained via a concession from the Crown or state. Independently, the joint stock company emerged as double-entry bookkeeping developed to allow partners to contribute capital to a venture, while not actively taking part.

By 1844, companies could be incorporated by registration, not just concession, and the chapter examines the three theories that followed, each favoured in turn during the nineteenth century. The first was the associational view, which saw the firm as an association of individuals. Many ideas were drawn from partnership law, and the company was regarded as a direct descendant of the joint stock company. Next, with the introduction of limited liability and gradual realization of its benefits came the fictional view, which saw the company as a legal fiction separate from, rather than an association of, its shareholders. Finally came the real entity theory, which saw a company as a legal entity separate from its incorporators and shareholders. An organization of people was seen as a 'real person' with its own 'real' will. The term 'entity' was favoured over the term 'fiction' due to the company's size and reality. But Watson argues that the company's existence does not depend on it being 'real', for example in the case of a company remaining as a shelf company.

Watson concludes that concession theory in its historical terms can no longer apply to modern companies, but the fictional view may survive, in that at inception a company is a creation/fiction of the law that can only be bestowed by the state, albeit by following the statutory steps rather than by concession.

Susan Watson also argues that real entity theory and institutional theories can apply once a company comes into existence. In particular, the real entity theory can explain the nature of a company's 'core', being its fund, which changes over the company's lifetime, acquiring tangible and intangible assets throughout its course. The actions of individuals in the company affect this fund, but do not affect the company's legal structure.

Within a legal institutionalism framework, the company is an example of both public and private ordering. The public aspect is illustrated through the statutory requirements for incorporation, default limited liability and recognition of the fund as a legal person. Watson examines the private 'participant aspect' of the company through participant theory, but shows that it places insufficient weight on the significance of corporate legal personality and its distinctions (other than asset partitioning strength) within partnerships. Her chapter sees companies and partnerships as fundamentally different, the former being a modern form of the *universitas* and the latter a modern form of *societas*. While individuals create the company, the steps for creation and the characteristics of the company can be bestowed only by the state. The company is still a legal fiction—a legal person that is both an entity and a fund.

1.3 PART II: REGULATORY TECHNIQUES

The second part presents three chapters that explore major regulatory techniques applied in corporate governance—namely, governance codes, board committees and shareholder 'say on pay'.

1.3.1 Chapter 5: Brigitte Haar—Corporate Governance Codes as Regulatory Tools to Advance Stakeholder Concerns in the Corporation

Shareholder wealth or stakeholder interests? The alignment of these two priorities has been at the centre of self-regulation under corporate governance codes, which are increasing in number. Yet what drives compliance with these codes? 'Comply or explain' is a principal method in implementing corporate governance codes in Europe. It implies flexibility and voluntary compliance with code recommendations and motivates compliance. The model is based on the self-regulatory, capital market-based mechanism, which is aligned to the law-and-economics paradigm.

In Germany, the goal was to instil investor trust through disclosure under corporate governance rules. This was attempted through the comply or explain rules in the German Stock Corporation Act in 2002, to open the German capital market to international investors in the aftermath of the Mannesmann takeover. Evaluating the efficacy of the regime, the chapter provides an overview of its significance and underlying enforcement mechanisms, before looking at the compliance rates under the German Corporate Governance Code (2002) in recent years. The survey identifies companies' reasons for following the Code on specific issues such as regulating incentive pay, severance pay caps and gender diversity on supervisory boards. The study lays the foundation for a more differentiated analysis of compliance and legitimacy questions.

The last two decades have seen a proliferation of corporate governance codes in Continental Europe, following the model first developed in Britain. One of the key tools these codes employ is the comply or explain principle, under which compliance with code norms is not mandatory. However, when companies decide not to comply with a particular recommendation, they must publicly explain their reasons for non-compliance. The theory is that shareholders and capital markets, once informed of these reasons, will pressure companies to comply with the code, except where non-compliance is somehow advantageous. Under this model, the market (rather than government) enforces compliance, while still allowing enough flexibility to suit the particular circumstances of individual companies.

Brigitte Haar investigates what really drives companies to comply (or not comply) with governance codes, using the compliance rates for the German Corporate Governance Code as a measure. Examining high-profile provisions dealing with incentive pay, severance pay and age limits for supervisory board members, she analyses the rates of compliance by German companies, as well as the reasons given for non-compliance. Haar suggests that compliance or non-compliance with particular provisions is driven by a complex mixture of economic and reputational factors, resulting from both insider and outsider interests.

German companies must declare, annually, with which provisions of the Code they will or will not comply, and give reasons for the latter. The idea is to make their corporate governance practices transparent to investors and, by doing so, both instil market confidence in German companies and allow the capital market to 'punish' companies that deviate from best practice. This model resembles the theory in which stocks and bonds are seen as contractual solutions to the principal–agent problem in corporate governance, and financial markets reward the most effective solutions by pricing those stocks higher. The difference is that in the German model, government designs solutions by writing the Code, leaving it to the market to price them.

The empirical evidence is unclear as to the relationship between Code compliance and market performance. Investors may tolerate non-compliance if a company's financial performance is sufficiently good. Another question is whether non-economic factors also affect compliance. A survey of German board chairmen reveals that proxy advisors and the media are considered the two most important drivers of compliance. Interviewees were asked which Code provisions they considered useful in improving corporate governance. The responses revealed that perceived usefulness does not predict compliance, further indicating that economic considerations alone cannot fully explain compliance.

One of the most negatively assessed recommendations is a call for supervisory board members to receive incentive pay alongside fixed compensation. Principal–agent theory favours this as a means to align management and shareholder interests, which implies that capital markets should be supportive of the method. Countervailing factors, however, explain the apparent reluctance to comply. An often-suggested factor is the so-called 'outrage constraint' imposed by the unpopularity of incentive pay among the wider public.

Haar argues, however, that a more crucial factor was the German Federal Court of Justice decision in *Mobilcom* (2004). It noted the lack of explicit provision in the German Stock Corporation Act for granting stock-option pay to supervisory boards and criticized such pay as undermining the board's risk-management role. This decision led to a decrease in compliance, and indeed to a Code amendment that made incentive pay optional. Thus, argues Haar, hard law in the German Stock Corporation Act radiated, by way of judicial interpretation, into the soft law of the Governance Code. This change was reinforced by suggestions, made after the GFC, that incentive-based compensation was a factor leading to the Crisis. In any case legal developments, rather than capital markets, drove patterns of compliance.

A recommendation that received fewer negative assessments prescribed caps on severance pay for supervisory board members. Yet there has been relatively low compliance with this recommendation. The reports of DAX-listed companies show that these companies gave strikingly similar reasons for non-compliance. Haar suggests that high-profile companies that choose not to impose severance-pay caps face the pressure of explaining this to the public. It is understandable that they would copy the explanations of their peers, so as to increase the credibility of their non-compliance and avoid the 'outrage constraint'. Supporting this theory is the fact that less-visible companies, facing less public pressure, tend to give more diverse explanations for non-compliance.

The recommendation on age limits for supervisory boards attracted both low compliance and low rating by the chairmen who were surveyed. Evidence suggests that capital markets actually value non-compliance with this recommendation, seemingly not sharing the underlying assumption that performance decreases with age. In this light, it seems surprising that DAX-listed companies comply with the recommendation at much higher rates than companies overall. Haar suggests that wider social values may point in the opposite direction from those of the market and there may additionally be internal stakeholders pushing in the direction of compliance. Finally, board members themselves may prefer to leave office through a regulated procedure, rather than have their departure triggered by observable declines in performance.

1.3.2 Chapter 6: Brenda Hannigan—Empire-building: The Rise of the Audit Committee

Brenda Hannigan explores the efficacy of audit committees in public company boards. In particular, her chapter examines the requirements of the UK Corporate Governance Code (2014) and the new EU Directive (2006) and Regulation (2014) on audits that significantly enhance the role of audit committees. These came into force in June 2016.

Opening by examining the legal basis and composition of audit committees, Hannigan identifies the wide-ranging responsibilities now assumed by and imposed upon audit committees. These include their role in addressing 'going-concern', liquidity and sustainability issues as well as their expanded role in the appointment of external auditors. She next evaluates the duty of care owed by audit committee members and by boards in the context of the division of power now emerging. She asks whether audit committee members are now at a greater risk of being sued for negligence than before. In conclusion, Hannigan considers whether the law on directors' duty of care and skill has kept pace with the changing responsibilities of audit committee members. An important question is whether the developing role of audit committees is undermining in some way the strength of the unitary board.

As the governance of large companies has become more complex, boards have increasingly delegated some of their functions to specialist committees, typically composed of independent, non-executive board members. One of the most frequently seen committees is the audit committee. This is so, partly because many corporate governance codes require their use and, in the EU and US, audit committees are now mandatory for listed companies. This chapter examines the expanding role of audit committees under the UK Corporate Governance Code and EU regulations, and discusses its implications for committee members, their relationships with other corporate actors and the legal future of the audit committee.

The traditional role of the audit committee was to review the integrity of financial statements and oversee the appointment and work of independent auditors. In the wake of the GFC of 2008–09, concerns that companies were not properly assessing and managing risk led to expansion of this limited role. In the UK, the 2012 Sharman Inquiry recommended ongoing reporting on company viability and sustainability, and board stewardship. As a result, the 2014 Corporate Governance Code places heavier risk-identification and management requirements on boards. It has typically fallen to the audit committee to carry out the requirements.

As a result, audit committees' remit now includes much greater continuous review of company operations than before. That this requires committee members to work closely with management is a mixed blessing. On the one hand, non-executive directors are drawn deeper into a company's business; on the other hand, this may bring their independence into question. The committee also works closely with auditors. It has thus become a vital hub that is independent from the board as a whole; the main pathway through which company information travels and is scrutinized.

It seems likely that audit committees' remit will continue to expand as further non-financial reporting requirements are imposed upon companies. Even within its traditional role of supervising external auditors, the audit committee's job has become more complex, as EU regulations now require companies periodically to put audit contracts out to tender whereas previously, many companies retained the same auditor for many decades.

Expanded duties demand greater competence and experience from non-executive directors, with a concomitant greater time commitment. That, in turn, entails higher remuneration; this combination of factors again calls into question just how independent non-executive directors are likely to be. The audit committee's new role also calls into question its relationship with the board. As the committee's remit grows, the board's role must necessarily shrink if wasteful duplication is to be avoided. Although the board has a duty to supervise delegated functions, as the expertize and resources of audit committees improve, board supervision must be minimal if overall governance efficiency is to be preserved.

Audit committees are also now required to have greater engagement with shareholders. Disclosure requirements have increased in recent years, and the UK Financial Reporting Council (FRC) now suggests that audit committees should be prepared to meet with investors—a shift from the previous model of liaison via the board or committee chair. The FRC itself is now active in monitoring the performance of audit committees.

If the developments continue, Hannigan suggests that several matters should be addressed by legislation. First, the level of skill and care expected of non-executive directors should be set down in statute, including the extent to which directors can rely on outside advice. Second, consideration should be given to allowing shareholders to appoint the audit committee from the pool of directors. Finally, the respective responsibilities of boards and audit committees should be clearly delineated, with the board focusing on overall strategy and promoting the long-term success of the business.

1.3.3 Chapter 7: Christoph Van der Elst—Answering the Say For No Pay

Traditionally, executive remuneration was decided exclusively by boards of directors. But in recent years, concerns about excessive remuneration have led to a wave of 'say on pay' legislation, giving shareholders a vote on executive pay packages. The Netherlands adopted shareholders' say on pay over a decade ago. Shareholders must approve the remuneration policy and any amendments.

The Dutch approach offers insights on how say on pay works in practice. In the light of the recent European proposal to introduce a uniform say on pay, here Christoph Van der Elst examines the Dutch say on pay system. After first describing the legal framework of the Dutch say on pay and its background, he then uses hand-collected voting data, information from the minutes of general meetings and ownership data for the entire Dutch say on pay period (2004–14) to address and discuss its direct as well as indirect effects. He shows that although remuneration proposals are seldom rejected, the influence of shareholders on the remuneration policy of companies is considerable. Furthermore, the Dutch approach of say on pay stimulates shareholder dialogue and increases pressure on boards regarding remuneration matters, even when large insider shareholders are present. The chapter recommends a similar approach for Europe.

In countries that have enacted say on pay legislation, the issue of remuneration has become one of the most discussed agenda items at shareholder meetings, and shareholders have often refused to approve remuneration packages. Van der Elst analyses patterns of such refusals in the UK and Belgium. Where a refusal occurs, it should send a signal to companies that their shareholders are unhappy with the high level of executive remuneration. Yet while some companies have adjusted their policies (or at least improved their transparency) in the aftermath of a 'no' vote, others have done little or nothing to change course in the face of shareholder rejection.

Part of the reason for this may be the fact that say on pay legislation often provides for an advisory vote only, which boards can, if they choose, simply ignore. The UK and Belgian laws are of this type. Although they require a shareholder vote on the company's remuneration report at the annual general meeting, the vote is only advisory.

In Belgium, shareholder approval is required for some remuneration features, such as generous severance pay or high proportions of short term performance pay. In Britain, studies found that some companies failed to make any changes in response to a negative shareholder vote on the remuneration report. This led to further reforms which require that where a 'significant proportion' of shareholders of a company vote against the report, the company must disclose the cause of shareholder discontent (if known) as well as the actions it intends to take in response. In addition, companies must set out their overall remuneration policy, which must be submitted to a binding vote.

Compared to Belgian companies, UK companies now tend to be more responsive to shareholder dissent. The former are, so far, less likely to disclose reasons for a no vote. One prominent company even complained that shareholders were blindly following the opinions of proxy advisors. As a result, Belgian companies have been less successful in gaining shareholder approval for subsequent remuneration reports.

Van der Elst suggests that the Belgian legislature should provide more detailed guidelines for companies' responses to a negative vote, in line with the UK model. He also recommends a two-strike system: if a company's remuneration report fails the advisory shareholder vote, the next vote should be binding, meaning that the company must then amend remuneration practices to address shareholder concerns. These reforms would strengthen the say on pay device, improve relations between boards and shareholders and better align company policies with shareholders' interests.

1.4 PART III: GOVERNANCE IN BANKS

Focusing on the governance of banks, the final part of the book, containing two chapters, is more specialized in content. The first chapter explores the benefits of appointing public interest directors to the boards of large Canadian banks. And the second chapter argues for alternative business structures for banks considering the experience with their governance, particularly in the context of the GFC.

1.4.1 Chapter 8: Gail E. Henderson—Banks, Corporate Governance and the Public Interest: The Potential Role of Public Interest Directors

Typically, debates about corporate governance start with the question what is the appropriate goal of the corporation: is it solely to maximize returns to shareholders, or is it to generate returns, coupled with some broader social responsibility or duty to stakeholders? In Canada, in the case of 'systemically important' banks, that question has been answered. Although Canada's 'big six' domestic banks are publicly traded, for-profit corporations, their central role in the Canadian economy means that directors and officers are expected to concern themselves with the 'safety and soundness' of the banks, as well as profits. This broader social goal is incorporated, expressly and implicitly, in the regulatory structure of the Canadian banks. The question is how this regulatory structure, particularly as it relates to corporate governance, can best realize both of these goals.

The chapter explores the merits of appointing to the boards of directors of systemically important banks 'public interest directors' whose role would be to safeguard the public interest in the stability of the banks, and check excessive risk-taking in pursuit of higher profits. The analysis draws on both academic literature and the recent use of public interest directors in Ireland, in response to the Irish banking crisis.

Gail Henderson explores the potential role of public interest directors in protecting the public interest in banks. Banks have a social responsibility that is broader than just maximizing shareholder return. Banks encourage economic development, provide a payment clearance and settlement system, and promote development of natural resources.

Stability is especially important in banks because one insolvent bank can take other solvent banks down with it. Further, banks' inability to lend will halt credit flow and contribute to a faltering economy. Finally, Canada's 'Big Six' banks dominate Canada's financial market—their size creating benefits but also risks. Banks' inherent fragility is due partly to the mismatch between their short term liabilities (ie deposits) against long term assets (ie loans), and partly to the difficulty in assessing the 'quality' of the banks' assets, as opposed to more solid/stable assets of non-bank corporations.

Profitability is also important to banks, not just for liquidity and credit reasons, but also for their large numbers of employees and shareholders. However, a bank's profitability depends on it accepting more risk, which threatens stability. Greater risk appetite is fuelled by the fact that banks put other people's money at risk.

Finally, banks provide credit access and basic banking services to the community. This is important for alleviating poverty.

The primary Canadian legislation is the Bank Act (1991), and Henderson outlines the relevant regulatory agencies and their roles. Public interest is currently protected in two ways: a mandatory insurance regime over bank accounts, and capital adequacy requirements. Both guard against a liquidity crisis. However, Henderson argues that this is insufficient. Insurance encourages banks to accept more risk as they know the deposits are insured. The capital adequacy requirements alone are insufficient, and encourage banks to 'game' the rules to accept more risk. Some other way to control risk-taking is required. Corporate governance rules for banks are similar to those for non-bank corporations. Outlining the main differences, Henderson argues that private stakeholders cannot be relied on to fill in the regulatory gaps, due to the informational disadvantage of customers and creditors, and the difficulty in deciding when stability should be valued over profitability.

Public interest directors could raise questions in the boardroom that would not otherwise be raised by other directors. Once the issues are raised, they are difficult to dismiss. Henderson examines the North American and Irish experiences. One advantage of public interest directors is their specific mandate to 'advocate' public interest over profitability. Public interest directors can also help prevent risk managers being 'marginalized' in times of 'market euphoria'. They would help encourage, too, a culture of regulatory compliance. Issues raised over public interest directors are whether they would be able to influence the board, hostility from other board members, balancing boardroom confidentiality with their public mandate, whether they have sufficient expertize and independence, and defining their mandate. Henderson offers solutions or counter-arguments to each issue.

1.4.2 Chapter 9: Michael Marin—Organizational Form and Financial Stability: Lessons from Cooperative Banks in the US and UK

In the aftermath of the GFC, sweeping changes were made to the regulation of banks in order to promote stability and prevent the widespread costs associated with collapse. In the US and UK, two countries heavily affected by the GFC, these reforms were particularly extensive, resulting in the establishment of new regulatory bodies, expansion of governmental authority and evolution of governance norms. At the same time, the reform programme suggests a lack of focus by policymakers on the root cause of the destabilizing behaviour.

The analysis in Michael Marin's chapter is based on the premise that the drive to maximize profit is the source of instability at both the institutional and systemic levels. While many of the post-GFC reforms are meant to weaken this objective, it remains embedded in the organizational form that dominates the banking industry—namely the Anglo-American corporation and the emphasis on shareholder value. This model is inherently destabilizing because its governance structure pushes banks to maximize profit. Reform fails to confront the impact the corporate form has on financial stability and, therefore, it rests on a shaky foundation.

The chapter examines the cooperative model as applied in the banking sector. It explains how US/UK laws governing cooperative banks promote stability. It points out that many of the post-GFC reforms are already embedded in the governance structure of cooperative banks. These include internal limits on growth and investment, mechanisms to ensure that managements act in customers' best interests, democratic governance, strict conflict of interest rules, independent oversight committees and restrictions on compensation. These features go much further and address the root causes more directly than the post-GFC reforms. The chapter argues for cooperative banks as an alternative business structure for banks.

During the GFC, cooperative banks proved to be considerably more stable than those organized as shareholder corporations. Moreover, countries where cooperatives held a larger share of the banking market were hit less hard by the crisis.

Marin argues that because the cooperative model leads banks to operate in the interests of customers rather than investors, cooperative banks are not tied to the profit maximization imperative that led corporate banks to engage in risky lending. Reforms that seek merely to temper the profit maximization drive will not eliminate the systemic risk. If governments sought instead to diversify organizational form in the banking sector, particularly by increasing the market share of cooperative banks, this might be more effective at building stability into the system.

Marin examines cooperative banks in the US and the UK, two of the countries hardest hit by the financial crisis, which both have well-established cooperative banking sectors governed by mature laws. He suggests that many of the reforms imposed on commercial banks in the wake of the GFC were already embodied in the governance structure of cooperative banks. In particular, the cooperative model aligns the interests of a bank's shareholders (or members) with those of its customers.

Commercial banks derive profit from the spread between the interest rate they pay when they borrow and the rate they charge when they lend. Shareholders thus reap profits derived from the bank's customers. Banks can maximise their profits by widening the spread, and as seen prior to the GFC, this can sometimes lead them into lending to riskier customers at higher rates of interest. Cooperative banks, the most common forms of which are credit unions and building societies, are controlled by their members, who are customers rather than outside shareholders. As such, there is less incentive to maximize profits, as increased profit can only come at the expense of the very people who control the bank (the customers).

US credit union rules require that membership be restricted to persons with a common bond of occupation or association, or who share a particular geographic area. This protects credit unions from the type of radical consolidation seen in the corporate banking sector, but also means that members have shared interests, such as local economic development, which may rival or even outrank profit maximization. It also prevents the bank engaging in 'subprime lending' to high-risk outsiders. US law also holds that credit union directors and managements owe fiduciary duties to the entire membership—in other words, to the customer base—in contrast to the corporate model where duties are owed only to shareholders.

Prudence is thus at the heart of management's legal duties in a credit union, as decisions which would undermine the safety of deposits or amount to predatory lending would likely give rise to a fiduciary breach, exposing management to personal liability. While the UK law is less restrictive than in the US, it shares similar features, including democratic control by members, a restricted field of membership and fiduciary obligations that incentivize prudence.

While Marin recognizes that corporate banks will likely continue to dominate the US and UK financial sectors, he suggests that governments should at least consider working towards the goal of a more diversified banking sector. After all, placing complex regulatory restraints on the inherently unstable corporate form is an inefficient way to build stability into the system when other, more stable forms are available. One way to increase the market share of cooperatives might be to restructure failed corporate banks along a cooperative model. The point is not that cooperative banks are infallible. Rather, it is that they have certain stability advantages built into their organizational form, and these should not be overlooked when governments consider strategies to avert future crises.

1.5 CONCLUSION

Corporate governance matters because corporations matter. About 70 per cent of world trade is controlled by 500 corporations. Every year around three million new limited liability companies are registered. These statistics are derived from *The Purpose of the Corporation Project*, a global round-table series that pulls together experts from business, academia, regulators and civil society from around the world and across disciplines who are united in questioning the old assumptions about corporate law and corporate governance, which they say are not supported by law and empirical evidence.[3] Projects of this scale testing longstanding tenets such as shareholder primacy were unheard of a decade ago.

Alongside, complaints about companies continue to grow. The range of misconduct seen in the financial sector after the GFC was shocking—ranging from manipulation of interest benchmarks (LIBOR) and forex rates to hoarding of commodities and profiteering,[4] and there are reports of egregious behaviour at leading corporations such as Volkswagen (cheating on emissions tests) and Wells Fargo (creating fake customer accounts).[5] These trends underscore the importance of continued scholarly and public attention to corporate governance. This book is an effort to contribute to that discourse and to the campaign to promote better alignment between corporate and larger societal interests.

[3] See 'The Purpose of the Corporation Project' <www.purposeofcorporation.org> accessed 6 December 2016.

[4] See generally Vasudev 2015.

[5] For example, see Topham et al. 2015; Price 2016.

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