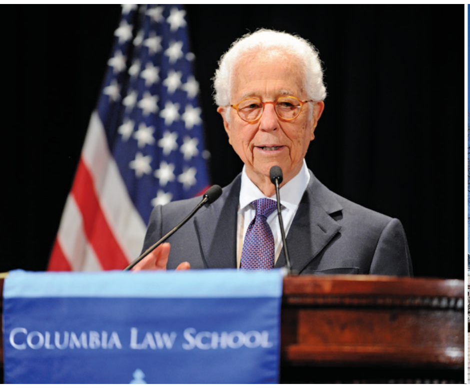
MILLSTEIN CENTER FOR GLOBAL MARKETS AND CORPORATE OWNERSHIP



10th Year Anniversary Essay

"Adapting Global Standards to a Changing World"

COLUMBIA LAW SCHOOL

About the Essay

This essay is part of a series written for the Millstein Center's 10-year anniversary. Each of the essays explores a topic or issue that the Center has addressed over its past decade of work. The essays' authors have all been on the front lines of the changes addressed and were often directly engaged in the Center's activities.

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Adapting Global Standards to a Changing World

By Serdar Çelik and Mats Isaksson*

From Ira Millstein to OECD

In 1996, Ira Millstein received a phone call from Paris. It came from the Organization for Economic Co-operation and Development (OECD) asking him to head a small international group of distinguished businesspeople, including Sir Adrian Cadbury. Their assignment would be to provide economists and policy makers with advice for future work in the area of corporate governance. At the time, the topic was little understood among policy makers and its wider economic implications were rarely discussed. But OECD, already well known for its analysis of both macroeconomics and structural policies, wanted to change that. They looked at corporate governance as an increasingly important field of economic reform and believed that the experiences of business, legal scholars and economists could help in shaping better policies and advice.

Ira Millstein accepted the challenge and the group's report *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*[1] that was released in 1998, attracted a lot of attention and made headlines in all the major business papers around the world. The report also provided important input to the groundbreaking *OECD Principles of Corporate Governance* that were issued the following year.

From OECD to the G20

Together, the "*Millstein report*" and the OECD Principles paved the way for a large number of national and regional corporate governance initiatives around the world. The OECD Principles were also adopted by other global institutions such as the World Bank and the Financial Stability Board that continue to work closely with the OECD to raise awareness and monitor their implementation. As a result, numerous countries and private sector bodies stepped up their act with the ambition to align corporate governance policies and private practices with the recommendations of the OECD Principles.

Fast-forward to 2015 and the annual summit of the G20 Leaders, which became another important milestone in international corporate governance. Following several years of research and analysis by the OECD, the G20 Leaders in November 2015 agreed to endorse a revised version of the original OECD Principles; now as the *G20/OECD Principles of Corporate Governance*.[2] This endorsement demonstrated the commitment to the Principles by an even wider circle of important countries, including the world's largest emerging markets, such as the People's Republic of China, India and Brazil. Moreover, the endorsement also sent the message that corporate governance as an area of public policy can play an important role in supporting investment, sustainable growth and financial stability. Making this link between corporate governance policies and the overall functioning of the economy was a major step.

Formulating the public policy perspective

To avoid confusion about the role of public policy, it is important to understand that the term corporate governance in itself means different things to different people and in different contexts. For many, if

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not most, it refers mainly to the daily interactions, responsibilities, and decisions in a specific company: things like board dynamics, selection of top executives, and the formulation of strategic company objectives. The specifics of these day-to-day decisions are hardly a matter for public policy. They belong to the domain of private interactions influenced by individual economic interests, diversity in terms of personal talent, and differences in terms of business judgment. The role of public policy is to provide a purposeful legal and regulatory framework that gives everyone involved the right incentives to work towards an outcome that is in society's long-term interest. Differences of opinions; winners and losers; contractual innovations and the development of new corporate forms are all ingredients of that process. From policy perspective, corporate governance is not a zero-sum game about different parties fighting how to split a set of given assets or a given result at a given time. Rather it is about how to best support and increase the very creation of these assets and results.

The core objective is to make sure that all that capital that ultimately comes from hard earned household savings is put to productive use in the real sector. And in this transformation of savings into real investments, corporate governance rules and regulations play a critical role by influencing both the formation and the allocation of capital. They determine the conditions under which corporations are allowed to access public equity markets and the terms on which savers are able to invest and participate in the value-creation process of the corporation.

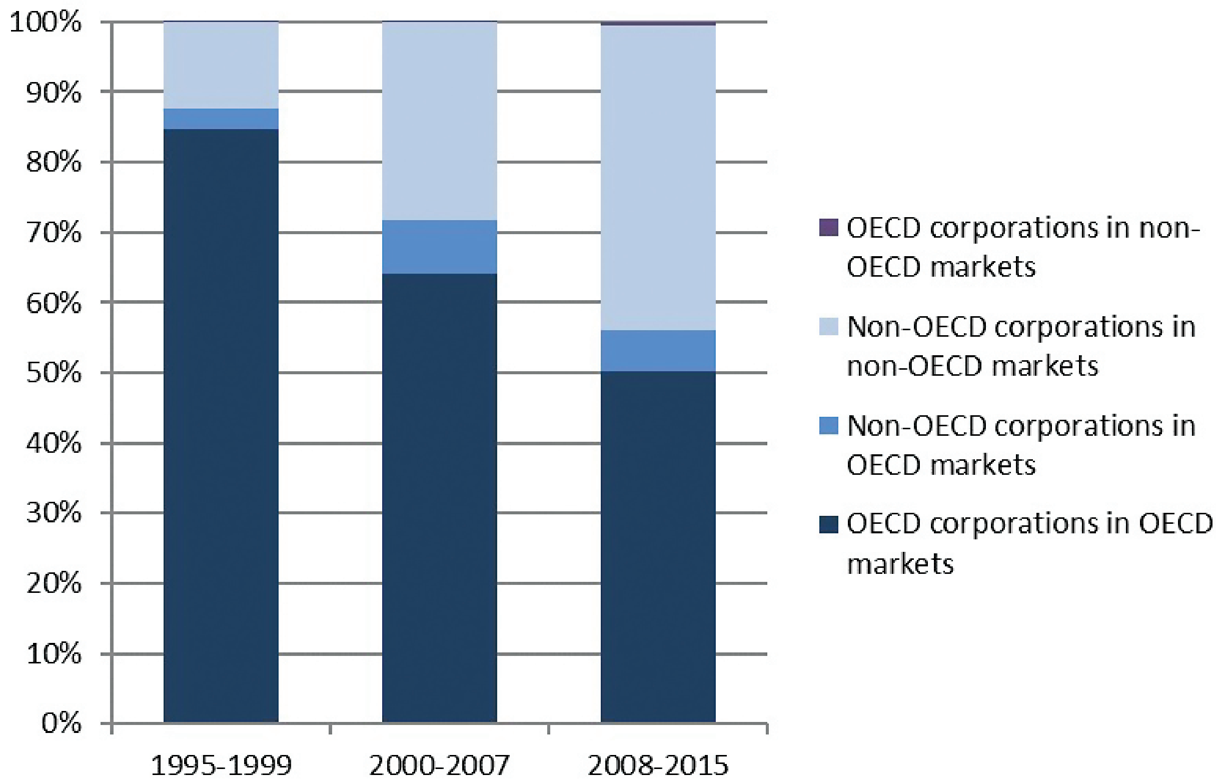
This is why the G20/OECD Principles was supported by an extensive mapping of developments in capital markets and how these changes in the functioning of capital markets may influence how we design and re-design corporate governance related laws and regulations.

The changing landscape of listed companies

An important but often neglected development in capital markets that may affect the way that we approach corporate governance is the change in the number and character of publicly listed companies worldwide. The US and some European stock markets today have 30-40% fewer publicly traded companies than they had at the turn of the century.[3] This decline is to a large part explained by a structural decline in the number of initial public offerings. As a matter of fact, the annual average number of IPOs by non-financial companies in advanced economies fell from about 1,100 during the second half of the 1990s to 691 during the period 2000-2015. Also the total amount of money raised through IPOs decreased, from USD 140 billion annually to 86 billion.

This trend in advanced economies stands in sharp contrast to developments in emerging markets, particularly in China. In the period 1995-2000 only 12 percent of all equity capital that was raised through IPOs in the world went to companies in non-OECD countries who listed in a non-OECD country. About 90 percent of all equity that was raised worldwide through an IPO was raised on a stock exchange in an OECD country. A decade later, this had all changed. During the period 2008-2015 nearly 45% of all equity raised in the world was by non-OECD companies that listed on a stock exchange in a non-OECD country.[4]

Figure 1. **The Global Shift in Initial Public Offerings (IPOs)**



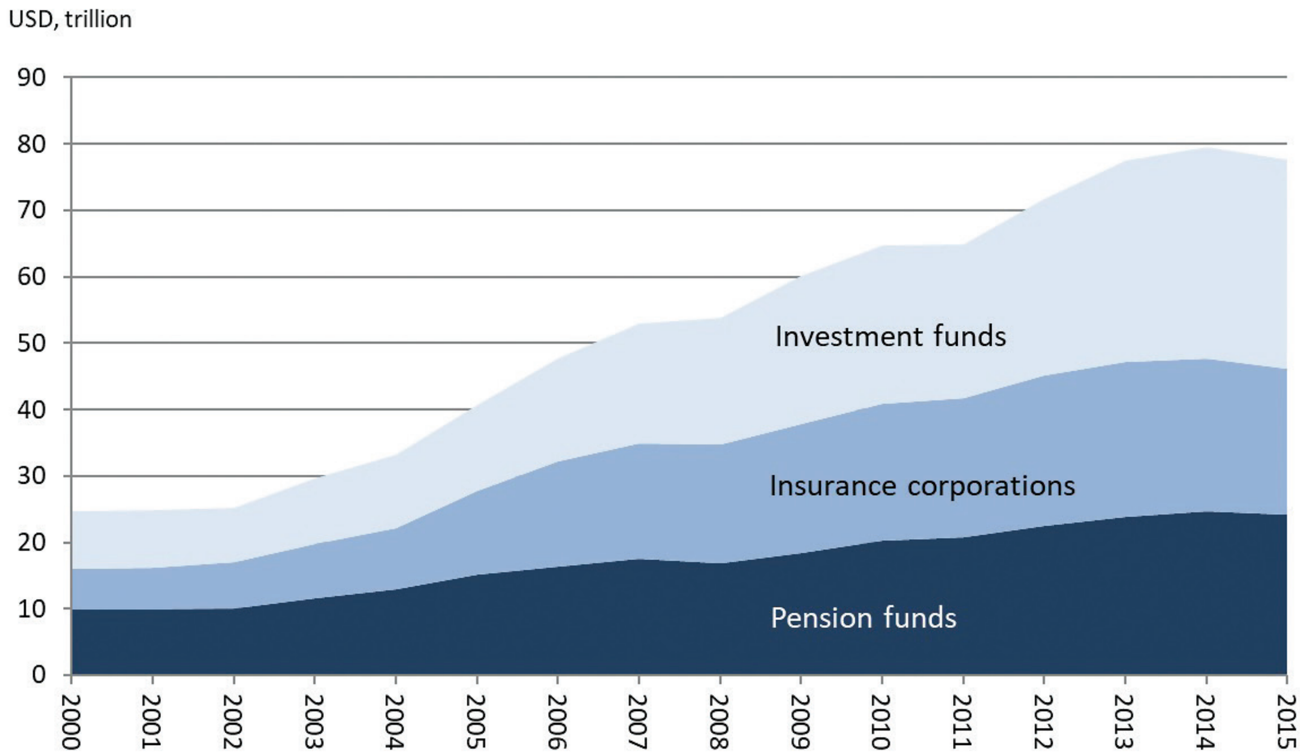
Source: Authors' calculations based on data from Thomson Reuters New Issues Database.

Since the ownership structure of publicly traded companies in most emerging markets is typically characterized by concentrated ownership, listed companies with a controlling owner have, globally, become the norm rather than the exception. At the same time, as described in the pioneering works of the Millstein Center's co-director Professor Jeffrey Gordon and his collaborator Professor Ronald Gilson, we also see a "re-concentration" of ownership in the hands of institutional investors in the US and other advanced economies.[5] These developments and the frequent affiliations within a company group have increased the focus on corporate governance issues, such as related party transactions, takeover regulations and minority rights, which were further elaborated in the G20/OECD Principles.

The changing landscape of intermediation

A second key trend in capital markets that has profound implications for corporate governance is an ever longer and more complex investment chain. Instead of the textbook economic assumption of direct physical shareholders that act in their own immediate interest to monitor and support corporate performance, the "ownership" functions are now exercised by a large number of different intermediaries. Since year 2000, the total amount of assets under management by traditional institutional investors, such as pension funds, insurance companies and investment funds has increased from USD 25 trillion to more than 75 trillion. On top of that we have a range of new intermediaries, such as hedge funds, exchange-traded funds, sovereign wealth funds, advisers, and other service providers.

Figure 2. Assets Under Management by Institutional Investors



Source: OECD Institutional Investors Statistics

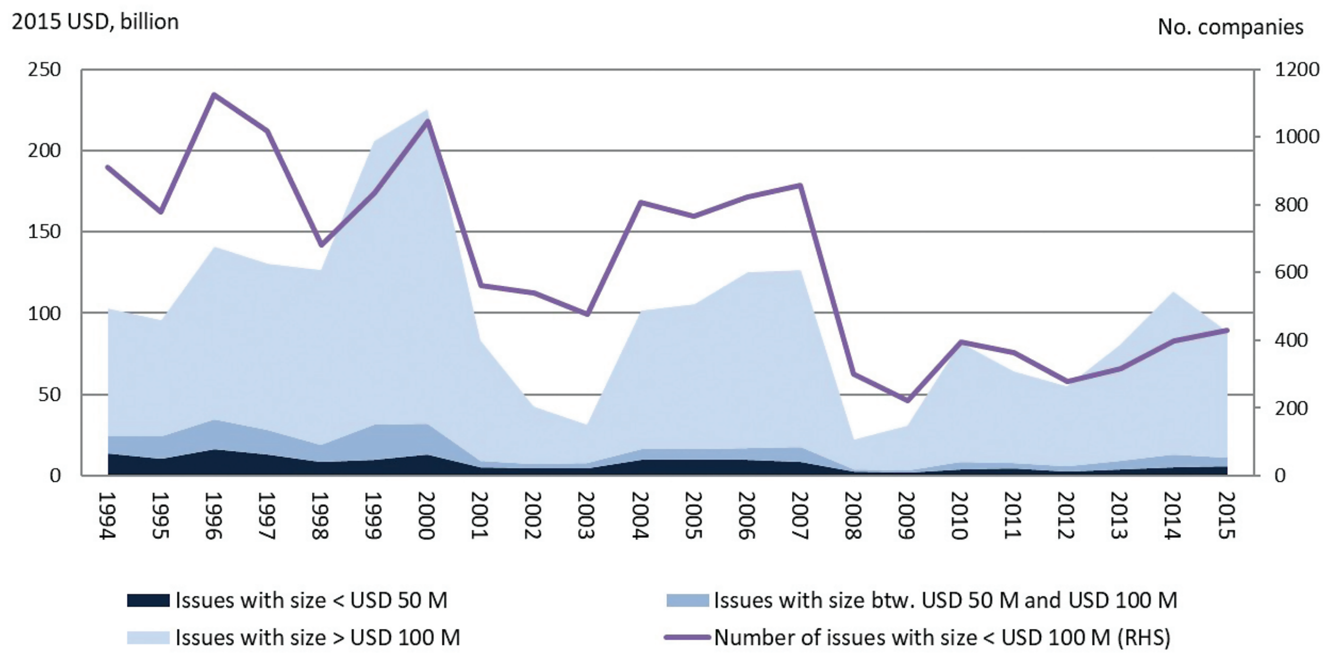
Most of these intermediaries and service providers are themselves profit maximizing enterprises. They all have their own business models with respect to fee structures, investment strategies and trading techniques. And as a consequence of these differences in business models they also have different incentives to exercise their corporate governance functions. For certain institutions, like some hedge funds, ownership engagement is a vital component of the business model. For others, like some indexed passive funds, ownership engagement has no role at all in the business model and is seen as nothing but a net cost. Based on a taxonomy for identifying an institution's appetite for ownership engagement, an OECD study from 2013 suggested that when ownership engagement is not a central part of the institution's business model, public policies and voluntary standards aiming to mandate ownership engagement are likely to have limited real effect on the quality of corporate governance.[6] The G20/OECD Principles also cautioned that stewardship codes may lead to standardized cost minimizing box ticking at the expense of truly informed ownership engagement.

The need for flexibility and proportionality

A development that is of particular concern for long-term economic growth is the decrease in the listings of smaller growth companies. These companies rely heavily on short-term debt as a source of funding and would in general benefit from access to public equity, which could boost their risk taking, long-termism, and innovation. However, since the early 2000s, the number of small company IPOs in advanced markets has declined even more than the general decline in IPOs. And there is nothing to indicate that this decline has been compensated for by an increase in various forms of private equity supply.

Between 1994 and 2000 there were 6,397 IPOs in advanced economies with a size less than USD 100 million in real terms. This fell to 4,835 in the period 2001-2007 and further to just 2,269 during the period 2008 to 2014. But small company IPOs have not only decreased in absolute numbers. They also receive a shrinking share of all the equity raised in public equity markets. In the period 1994-2000 about 20% of all public equity raised in advanced economies went to support smaller companies. In 2015 that share had decreased to only 12 percent.[7]

Figure 3. **The Decline in Small Company IPOs in Advanced Economies**



Source: Authors' calculations based on data from Thomson Reuters New Issues Database.

There are probably several explanations for this decline in small company IPOs and some of them may relate to the design of the corporate governance framework. In light of this, the G20/OECD Principles point to the need to put in place a policy framework that is flexible enough to meet the needs of companies operating under widely different circumstances. The corporate governance framework, including listing rules, should therefore allow for proportionality, particularly with respect to the size of listed companies and the company's stage of development.

The changing business models of stock exchanges

In parallel to a changing global landscape of listed companies and the emergence of a more complex ecosystem of intermediary ownership, the last decade has also seen profound structural changes in the stock markets themselves, notably with respect to the structure and business models of stock exchanges. Since the turn of the century, most traditional stock exchanges in advanced economies have either been acquired by another entity or become subsidiaries of an upstream parent company. Moreover, that parent company is itself often a profit maximizing corporation with its own shares traded on one or more of its own exchanges.

A recent OECD report identified 169 buy-side deals in the stock exchange industry between 2000-2014, with a marked increase in the number of deals after 2006.[8] The report also noted a shift in the revenue structure of stock exchanges with listing and issuer services today accounting for a much smaller part of revenues than they did ten years ago. Instead, revenue from derivatives and OTC trading has increased as a source of stock exchange earnings.

The restructuring of the stock exchange industry has also been characterized by fragmentation in two dimensions. First there is extensive fragmentation between stock-exchange and off-exchange trading, such as alternative trading systems. Today, about one third of all trading in the US and about half of the trading in Europe takes place on an off-exchange trading venue. Second, there is a marked fragmentation between transactions where investors have access to pre-trade information about buying and selling interests (lit trading) and transactions where pre-trade information is not made available (often referred to as dark trading). It the US, 42 percent of all trading is in the form of dark trading and on the largest European stock markets dark trading varies between 35 and 48% of all trading.[9]

Also these developments are recognized in the G20/OECD Principles, which recommend that the role of stock exchanges and trading venues in standard setting, supervision, and enforcement in corporate governance should be assessed with a view to their business models, their incentives, and their ability to carry out such functions. The Principles also underline the importance of fair and efficient price discovery as a means to promote effective corporate governance.

The message from Millstein has not been lost

To conclude, the endorsement of the G20/OECD Principles of Corporate Governance was not only a major event in global corporate governance by signaling the commitment by Leaders from all of the world's most important economies. It was also a recognition of the economy wide implications of public policy in the field of corporate governance. In particular, it illuminated its impact on corporate competitiveness, access to capital, and investment in a global and constantly changing business environment.

So, it should come as no surprise, that the development of the G20/OECD Principles was well served and received constant guidance by the wisdom of the Millstein report from 1998 and its ultimate message that capital markets are there to serve the real economy.

ENDNOTES

[1] OECD (1998), *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*, A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, Ira M. Millstein (Chairman), April

[2] OECD (2015), *G20/OECD Principles of Corporate Governance*

[3] World Bank World Development Indicators, Number of listed domestic companies, United States 2000: 6917, 2015:4381; France 2000: 1185, 2015:490; Germany 2000:744, 2015: 555.

[4] Isaksson, M. and S. Çelik (2013), "Who Cares? Corporate Governance in Today's Equity Markets", *OECD Corporate Governance Working Papers*, No. 8, OECD Publishing

[5] Gilson, R. J. and. Gordon, J. N (2013), "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights", 113 *Columbia Law Review* 863

[6] Çelik, S. and M. Isaksson (2013), "Institutional Investors as Owners: Who Are They and What Do They Do?", *OECD Corporate Governance Working Papers*, No. 11, OECD Publishing

[7] OECD (2015), *Growth Companies, Access to Capital Markets and Corporate Governance*, OECD Report to G20 Finance Ministers and Central Bank Governors, September

[8] OECD (2016), "Changing business models of stock exchanges and stock market fragmentation", *OECD Business and Finance Outlook 2016*

[9] Ibid.

About the Authors

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Serdar is currently managing the OECD's project on Corporate Governance, Value Creation and Growth which aims to analyze developments in capital markets that are relevant for the design of corporate governance policies. This initiative was key in the 2015 update of the G20/OECD Principles of Corporate Governance. A Turkish national, he holds a Business Administration degree and a graduate degree in Public Economics from Ankara University, Turkey.

Mats Isaksson: Mats Isaksson is Head of the Corporate Affairs division at the Organisation for Economic Co-operation and Development (OECD). His responsibilities include corporate governance, state-owned enterprises, equity markets, company law, corporate finance, privatization and other policy areas of importance to well-functioning capital markets and a dynamic business environment. Mats initiated the development of the OECD Principles of Corporate Governance and was in charge of the 2015 review of the Principles, which in September 2015 resulted in the endorsement of the G20/OECD Principles of Corporate Governance. He also led the work to develop the OECD Guidelines for Corporate Governance of State Owned Enterprises and initiated the OECD's work on The State in the Market Place. Mats has extensive experience from working with both OECD and Partner countries and most recently served as international advisor to the government of Japan. He regularly participates in the works of other international organizations, notably the Financial Stability Board. In recent years, he has written extensively on the relationship between corporate governance, value creation and growth addressing issues such the functioning of modern equity, the role of institutional investors, the use of corporate bonds and the conditions for growth companies to access market based finance. Mats serves on the Advisory Board of the Ira Millstein Centre for Global Markets and Corporate Ownership at Columbia University, and is Senior Visiting Fellow at the Stockholm Centre for Commercial Law. He is a founding Director of the Swedish Corporate Governance Forum and a member of the European Corporate Governance Institute. Writings and related material can be found at **www.oecd.org/corporate/ca/**.

About the Millstein Center for Global Markets and Corporate Ownership

The mission of the Millstein Center for Global Markets and Corporate Ownership is to bring world class scholarship, research and academic rigor to the vital task of restoring and strengthening long-term financing of innovative and durable public corporations, which are the underpinning of economic growth.

For more information, please visit **www.law.columbia.edu/millsteincenter**.

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