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Unblocking Corporate Governance Reform

By Lucian Bebchuk

When they met earlier this month, G-20 finance ministers and central bankers called for global improvements in corporate governance. Such appeals are often heard, but powerful vested interests make it hard for governments to follow through. So, if serious reforms are to be implemented, strong and persistent public pressure will be needed.

Many countries provide investors in publicly traded firms with levels of protection that are patently inadequate. Even in countries with well-developed systems of corporate governance, arrangements that are excessively lax on corporate insiders persist. In the United States, for example, insiders enjoy protections from takeovers that, according to a substantial body of empirical evidence, actually decrease company value.

Lax corporate governance rules are not generally the result of a lack of knowledge by public officials. Political impediments often enable lax arrangements to linger even after they are recognized as inefficient.

Ordinarily, corporate governance issues are not followed by most citizens. As a result, politicians expect that their decisions on investor protection will have little direct effect on citizens' voting decisions. By contrast, interest groups with big stakes in the rules follow corporate governance issues closely, and they lobby politicians to get favorable regulations.

The group that, in normal times, can be expected to have the most influence is that which consists of insiders within publicly-traded companies. Corporate insiders are an especially powerful lobbying group because of their ability to use some of the resources of the companies under their control. They have the power to direct their firms' campaign contributions, to offer positions or business to politicians' relatives or associates (or to politicians upon retirement), and to use their businesses to support issues and causes that politicians seek to advance.

Because insiders gain the full benefits that arise through lobbying for lax corporate governance rules, while their firms bear most of the costs of such lobbying, insiders have an advantage in the competition for influence over politicians. Their lobbying, which is carried out at the expense of their companies, is subsidized by their shareholders.

While individual investors cannot be expected to invest in lobbying for stronger investor protection, it might be hoped that institutional investors – mutual funds, banks, insurance companies, and so forth – will do so. Institutional investors receive funds from individuals and invest them in publicly traded companies. Because institutional investors invest substantial amounts in such companies, they should be well informed about corporate governance issues.

But institutional investors usually do not provide a sufficient counter-weight to lobbying by corporate insiders. In contrast to corporate insiders, institutional investors cannot charge the costs of lobbying to the publicly traded companies whose investor protection is at stake. In addition, depending on their relationship with their own investors, some institutional investors (for example, mutual fund managers) may capture only a limited fraction of the increase in value of their portfolios as a result of governance reforms. This reduces the willingness of institutional investors to invest in counteracting insider lobbying.

Moreover, those who make decisions for institutional investors often have interests that discourage lobbying for stronger constraints on corporate insiders. Some institutional investors are part of publicly traded firms, and are consequently under the control of corporate insiders whose interests are not served by new constraints. And even those institutional investors that are not affiliated with publicly traded companies may have an interest in getting business from such companies, making these institutional investors reluctant to push for reforms that corporate insiders oppose.

So, interest-group politics commonly produce substantial obstacles to reform of corporate governance. However, some events – such as a wave of corporate scandals or a stock market crash – can interrupt the ordinary pro-insider operations of interest-group politics by leading ordinary citizens to pay attention corporate governance failures.

When citizens become so outraged that their voting decisions may be affected by politicians' failure to improve investor protection, public demand for governance reform can overcome the power of vested interests. Indeed, most major governance reforms occur in such circumstances. In the US, for example, new securities laws were passed following the stock market crash of 1929, and the Sarbanes-Oxley Act was adopted in 2002, in the immediate aftermath of the collapse of the Internet bubble and the Enron and WorldCom scandals.

By creating a large public demand for reforms, the current crisis offers another opportunity to improve governance arrangements. This opportunity should not be missed.

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