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Corporate Fraud and Corruption: What governance can and cannot do

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The articles reviewed in this month's digest raise some very important issues about corporate engagement by large institutional investors (and perhaps smaller ones as well) in general, and specifically raise issues about monitoring and information that is a prerequisite to any type of effective engagement. Thus, these articles open up a larger discussion of the limits of monitoring, even by the largest institutional owners, either individually or working in coalitions. As well, the article by Dyck, Morse and Zingales on whistle blowing (who does it, will do it and why?) in particular opens up an important topic about what should institutional owners do vis à vis government regulation when arguably critical sources of information are unavailable to them. Moreover, this article implicitly suggests that employees are the single most important potential whistle blowers in the case of corporate fraud and should perhaps be brought into the larger circles of corporate governance. This is often but not always the case even when investigative reporters 'break' a story since often insider employees are their sources.

In the ESG framework, governance is the critical means to not only impacting the environmental and social behavior of firms but critical as well to effect firms' financial performance. This has been a tenet of governance activism since the late 1980's, and predates ESG terminology. Indeed, one weakness of the ESG formulation is that it implicitly leaves out, or at minimum does not emphasize, equal to the E and the S the centrality of the financial and more broadly, the economic elements of the firm.

Implicit in governance is a focus on financial and economic performance, whether at a single firm or at a portfolio level (as in universal owner analysis). While E and S are considered potentially material as they impact firm or portfolio-wide performance, the financial and economic elements of governance are the focus of these two articles. Both suggest that non-traditional governance actors (e.g. media, employees, governmental industry regulators) play an outsized and typically ignored role in exposing corruption and fraud in a variety of circumstances. These critical players are not recognized in standard formulations of governance such as the legal or financial view.

The implications for large and small institutional investors alike, especially those with an ESG focus, is that it may well be necessary to expand governance horizons beyond institutional investor coalitions in order to achieve effective monitoring and to have greater access to critical information. The two articles focus on financial information and fraud in particular, but one could as well likely include a variety of environmental and social issues, that are best known to employees and communities impacted in regard to these issues. For example, it was insider employees who blew the whistle on the U.S. space shuttle disaster in the 1980's, focusing on quality control issues, with obvious human and financial implications in defective 'O' ring manufacturing.

Too often monitoring by institutional investors relies on the media, on specialized sources of information providers on diverse issues, e.g. human rights, environmental hazards. In turn these organizations are often in touch with NGO's who may have access to sources of non-traditional information, including employees who are potential whistle blowers. Yet there is a sound basis to consider whether employees in particular should in a variety of possible ways be brought into a more formal governance role.

This is not as far-fetched as it might first appear. There is a stream of corporate governance work that suggests that employees are what can be called privileged stakeholders. Margaret Blair and Lynn Stout in particular have argued this perspective, albeit in a different context, suggesting that employees bring firms (or perhaps industry) specific human capital, akin to shareowner's capital, and should for that reason alone have some formalized role in governance. (Similar arguments are the basis for Germany's Mitbestimmung, or co-determination, between employees and capital.) While this particular form (and somewhat similar forms in other European countries and the U.K., e.g. employee councils) have been established for different purposes, institutional owners might consider whether it is desirable and possible to establish various institutionalized links with employees and employee organization in order to at least open up channels for communication, especially where their interests might coincide as in the case of financial fraud, quality control and other issues.

As the authors of these articles suggest or imply, government regulation and standards need also to attract the attention of institutional owners, either in defense of, for example, current whistle blowing legislation in the U.S. (both under Sarbanes-Oxley and more recently under Dodd-Frank legislation) or in possible expansion of protection and/or increase of monetary compensation for whistle blowers. In general the logic of corporate governance would imply that if significant coalitions of institutional owners cannot affect changes in corporate behavior that is in the interests of the owners, it may be necessary to turn to government as a means to a necessary end that they alone cannot achieve. Indeed, there are many examples of this in the recent financial crisis where owners lobbied legislatures and regulators on issues of financial reform. It might well be necessary to take similar actions regarding issues raised in these two articles and similar issue. It is not to far afield to suggest that if fiduciary duty on financial, economic, social and environmental issues compels firms to consider or act on engagement with firms they own and yet such engagement does not achieve desired results, then a turn to government may well be necessary.