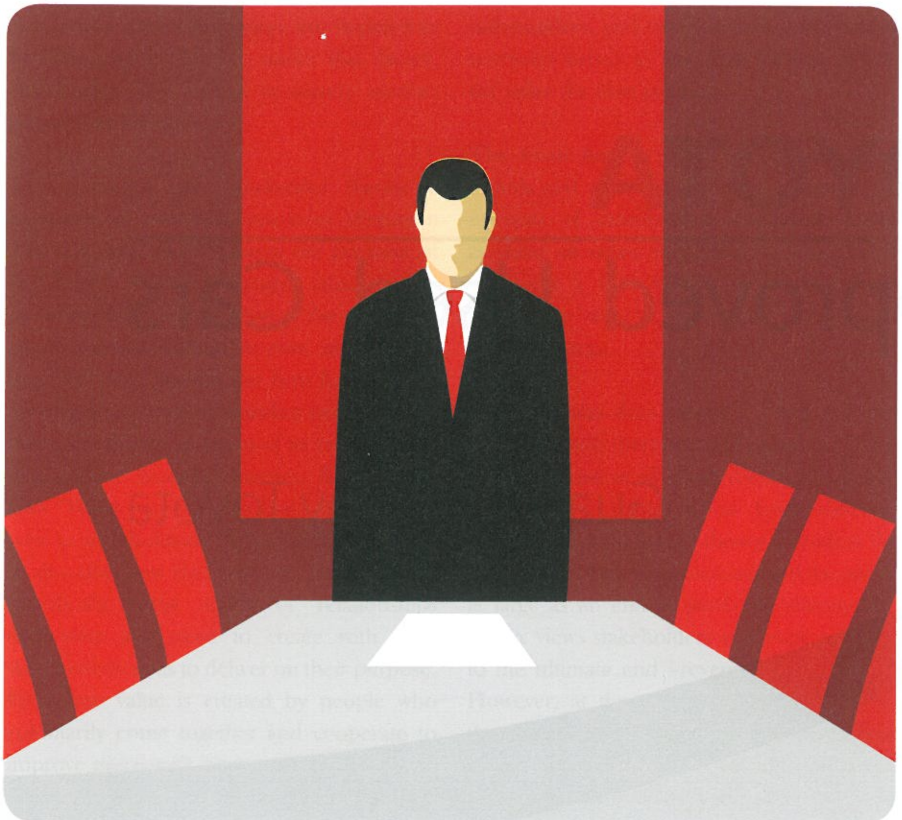

Corporate Governance: The Shareholders' & Stakeholders' Role

Maria Chetcuti Cauchi

Political tradition, culture and other social values of a society and its institutional structure determine the purpose of a society. Companies incorporated under different societies often have less in common that one would be inclined to think.

Traditionally the term corporate governance has always referred to a system whereby the board of directors administers the corporation and lays down business policy, executive officers act as agents of the board and execute its decisions and the owners of the corporation (shareholders) elect directors and vote in GMs on key business issues ranging from amendments to the company's statutes, to mergers and major corporate sales .

In the last issue of The Executive we have tackled the theme of corporate governance from a director's point of view. Nevertheless, in the light of today's relatively recent phenomenon, where more and more companies are resorting to finance from capital markets rather than through bank loans, a discussion on a "shareholder/stakeholder-oriented" model of management is inevitable. It is clear that the role of shareholders and other stakeholders in corporations is gaining more and more momentum. However, the question remains: where should management allegiance be focusing?

All stakeholders have become more significant in the corporate pyramid with the natural consequence that their rights need to be afforded more adequate protection. Employee representation on boards, effective redress for the violation of their rights, and strict disclosure requirements are indispensable measures to ensure proper stakeholder and investor protection.

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- *All stakeholders have become more significant in the corporate pyramid with the natural consequence that their rights need to be afforded more adequate protection.*
- *It has been argued that company boards have four principal functions, namely: to provide guidance to the head executive officer; approve main corporate strategies; provide a procedure for persons, who are not executives, to be represented in the company decision making process; and select, regularly evaluate, and, if necessary, replace the chief executive officer and other senior executives.*

THE 'SHAREHOLDER' THEORY

Traditionally, the shareholder view, which is the only one recognized in business law in most countries, provides that the shareholders or stockholders are the owners of the company, and the firm as represented by the directors has a binding fiduciary duty to put their needs first, to augment share value for them. In conventional input-output models, the company adapts the inputs of investors, employees, and suppliers into utilisable (profitable) outputs which consumers buy, thereby returning some wealth benefit to the firm. Accordingly, the main duty of management is the increase of shareholder value, i.e. profit maximisation.

THE 'STAKEHOLDER' THEORY

Originally presented by R. Edward Freeman, the stakeholder theory identifies groups in the corporate structure which qualify as stakeholders, and describes and recommends methods to be followed by management in giving due regard to such groups. In short, it attempts to address the "Principle of Who or What Really Counts".

The stakeholder theory argues that, besides investors, there are other parties involved in the corporate world which should benefit from it, and these include governmental bodies, political groups, trade associations, trade unions, communities, associated corporations, prospective employees, prospective customers, and the public at large. ▶

Sometimes even competitors are deemed to be stakeholders. Hence, under this theory, shareholders are viewed as merely another group of stakeholders.

The focus of the stakeholder theory is expressed in two core questions (Freeman 1994). It first asks "What is the purpose of the firm?" This encourages managers to understand the shared sense of the value they create and what brings its core stakeholders together. This propels the firm forward and allows it to generate outstanding performance, determined both in terms of its purpose and marketplace financial metrics. Secondly, it asks "What responsibility does management have to stakeholders?" This pushes managers to describe how they want to do business–specifically, what kinds of relationships they want and need to create with their stakeholders so as to deliver on their purpose. Economic value is created by people who voluntarily come together and cooperate to improve everyone's circumstances. Managers must develop relationships, inspire their stakeholders, and create communities where everyone strives to give their best to deliver the value the firm promises.

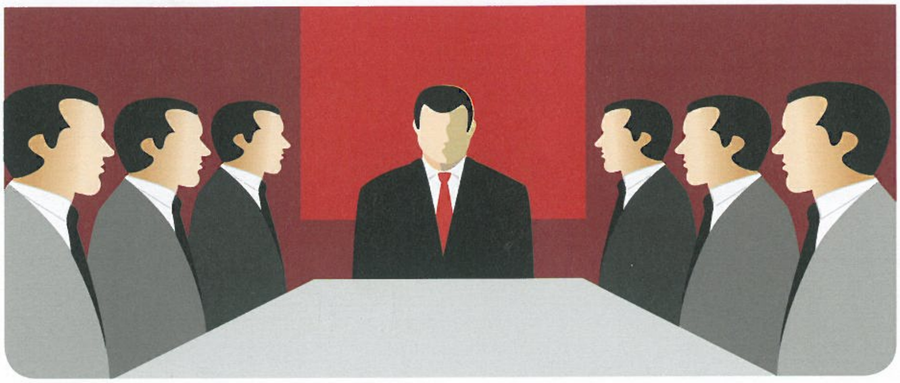
The focus here is more on the principles, morals and ethics of a company, where the interests of shareholders ranked as highly as those of other stakeholders. This theory promotes a view where no single group's interest or 'stake' ranks higher than that of another group.

The question thus looms - "Are the two theories totally divergent and opposed?" This is not the case at all. Both theories look into stakeholders' rights, albeit from different angles. The stakeholder theory considers the rights of employees, consumers and the public at large as an end in itself; the shareholder theory views stakeholders as merely a means to the ultimate end -revenue maximisation. However, at the end of the day, the latter theory does recognise that shareholder welfare cannot be secured unless a healthy affiliation with other stakeholders is nurtured.

PRACTICAL ASPECTS

Different national laws provide diverse methods of dealing with these management and control functions of a corporation. The importance of the role of directors under company law has its inception in the 20th century era, when the phenomenon of the managerial revolution took place. This phenomenon has been described as the "separation of ownership and function of capital" or as the "separation of ownership and control of wealth". It has been argued that company boards have four principal functions, namely: to provide guidance to the head executive officer; approve main corporate strategies; provide a procedure for persons, who are not executives, to be represented in the company decision making process; and select, regularly evaluate, and, if necessary, replace the chief executive officer and other senior executives.

Subsequently the 1990s have witnessed a persisting discussion about the extent of shareholders' rights under national company ▶



law systems. These rights vary from public to private companies and listed and non-listed companies. Indeed some jurisdictions embody shareholders' rights through the supervisory board, as the latter is deemed to be the body which acts in the shareholders' interests, to check, supervise and correct the active management. Other systems resort to legislation such as the statutory right to call for an extraordinary GM. However, under all systems of governance, shareholders are excluded from the performance of any managing or representative function.

Since 1993 the United Kingdom has pioneered a flexible model of regulation of corporate governance, known as the "comply or explain" code of governance. The system has so far worked reasonably well and in effect is often labelled as a benchmark, followed by several countries. This code lists recommended practices, inter alia the separation of the CEO and the Chairman of the Board, the introduction of a cut-off date for CEOs' contracts and the introduction of a minimum number of non-executive Directors on the Board.

Publicly listed companies in the U.K. have to either apply these principles or give details in a designated part of their annual reports if they choose to not comply. Supervision of explanations is left to shareholders themselves. The tenet of the regulations is that there is no single rule which fits all in the ambit of corporate governance and that, instead of adopting a statuary regime similar to the Sarbanes-Oxley Act in the U.S., it is best to leave some flexibility to corporations permitting them to make choices most apt to their particular circumstances. If they have valid reasons to move away from the recommended rule, they should be in a position to realistically clarify those to their shareholders.

In July 2006, the Malta Financial Services Authority (MFSA) issued new corporate governance rules for listed companies and for public interest companies. The model adopted is similar to that of the UK in that it has made an audit committee mandatory for listed companies but has left most of the other provisions as guidelines. During the public consultation phase the MFSA had proposed principles which would have included a number of obligatory clauses, such as having a separate chairman and CEO and non-executive directors on the board. The reaction at the time had been mixed, some saying that mandatory provisions were better than relying on self-regulation but others insisting that the burden they posed might discourage companies from listing.

In the end, except for the compulsory requirement of an audit committee, the published rules were non-mandatory. The rules set standards of corporate conduct in very essential matters such as the role and responsibilities of the board, the directors and officials of the company and institutional investors; relations with shareholders and the market and corporate social responsibility. By adopting this "comply and explain" approach, companies are not bundled in a single basket where rules would be applicable to all, despite diversity in size and area of operation. This approach presents flexibility whilst at the same time bestowing a clear general framework and enterprise-wide benchmarks.

These guidelines definitely improve the level of trust between the business community and the public by creating a fusion of good practice in the control and operation of companies that respects shareholders, stakeholders and the general public alike. ■

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