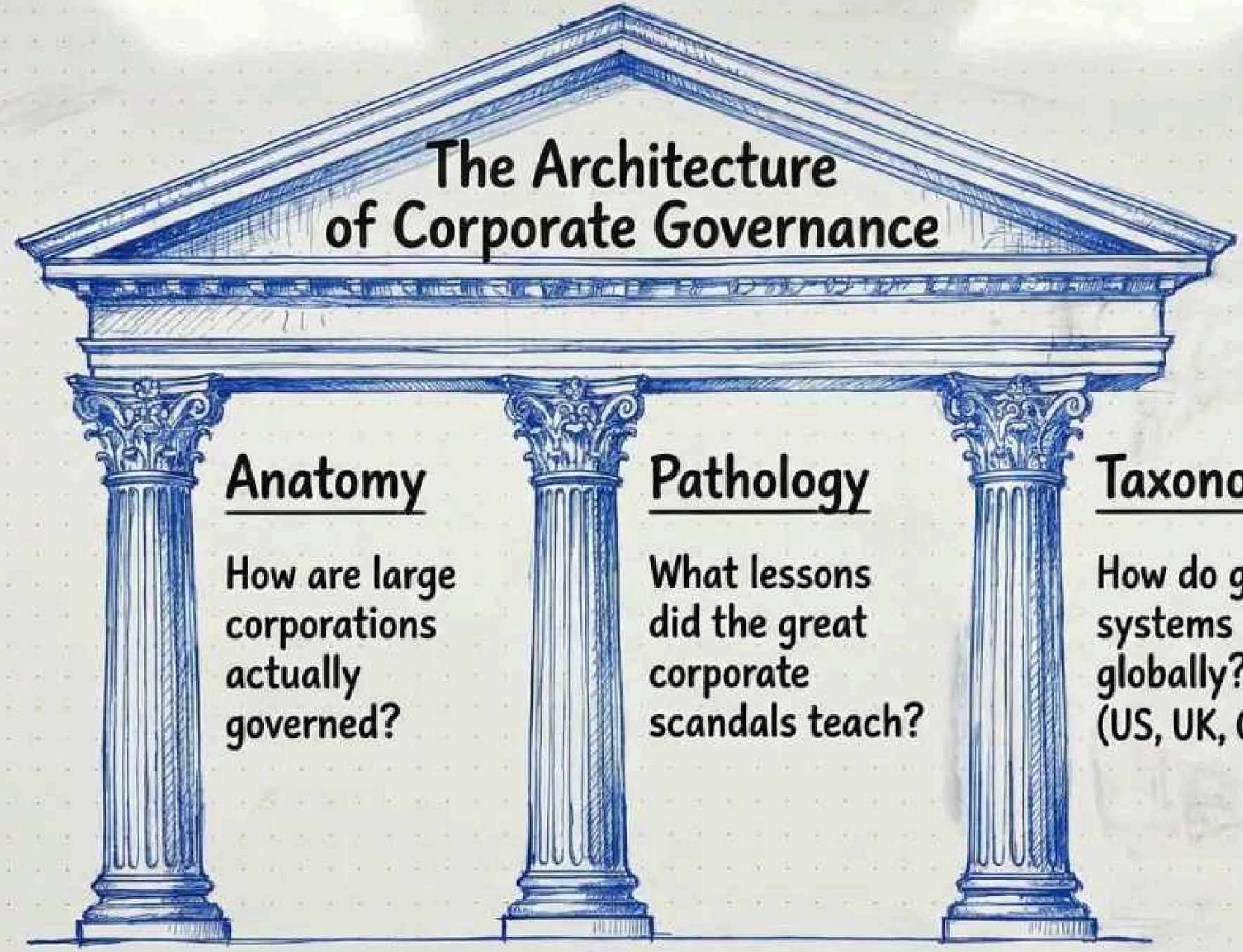
¶ 4.1

The Architecture of Corporate Governance



Anatomy

How are large corporations actually governed?

Pathology

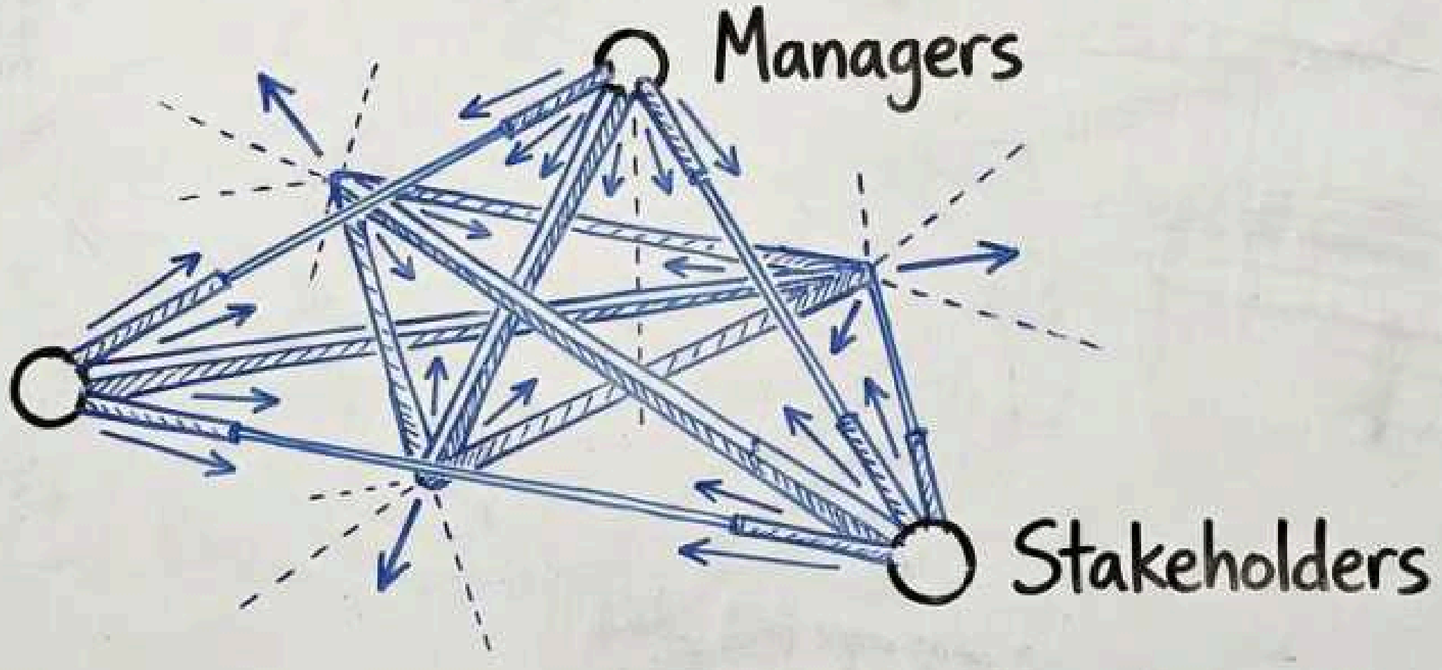
What lessons did the great corporate scandals teach?

Taxonomy

How do governance systems differ globally?
(US, UK, Germany, Japan)

$$\text{Corporate Governance} = f(\text{Direction, Control, Accountability})$$

Cadbury Report (UK, 1992)
— Born from the ashes of the Maxwell empire collapse.



¶4.3

The Board of Directors (Executives + Non-Executives)

Appoint, pay, or dismiss the CEO



Plan for succession



Approve strategy & major transactions



Oversee risk & financial reporting



Approve strategy & major transactions

¶ 4.4

Past State: Rubber Stamp Board

Heavy with the CEO's friends and insiders.

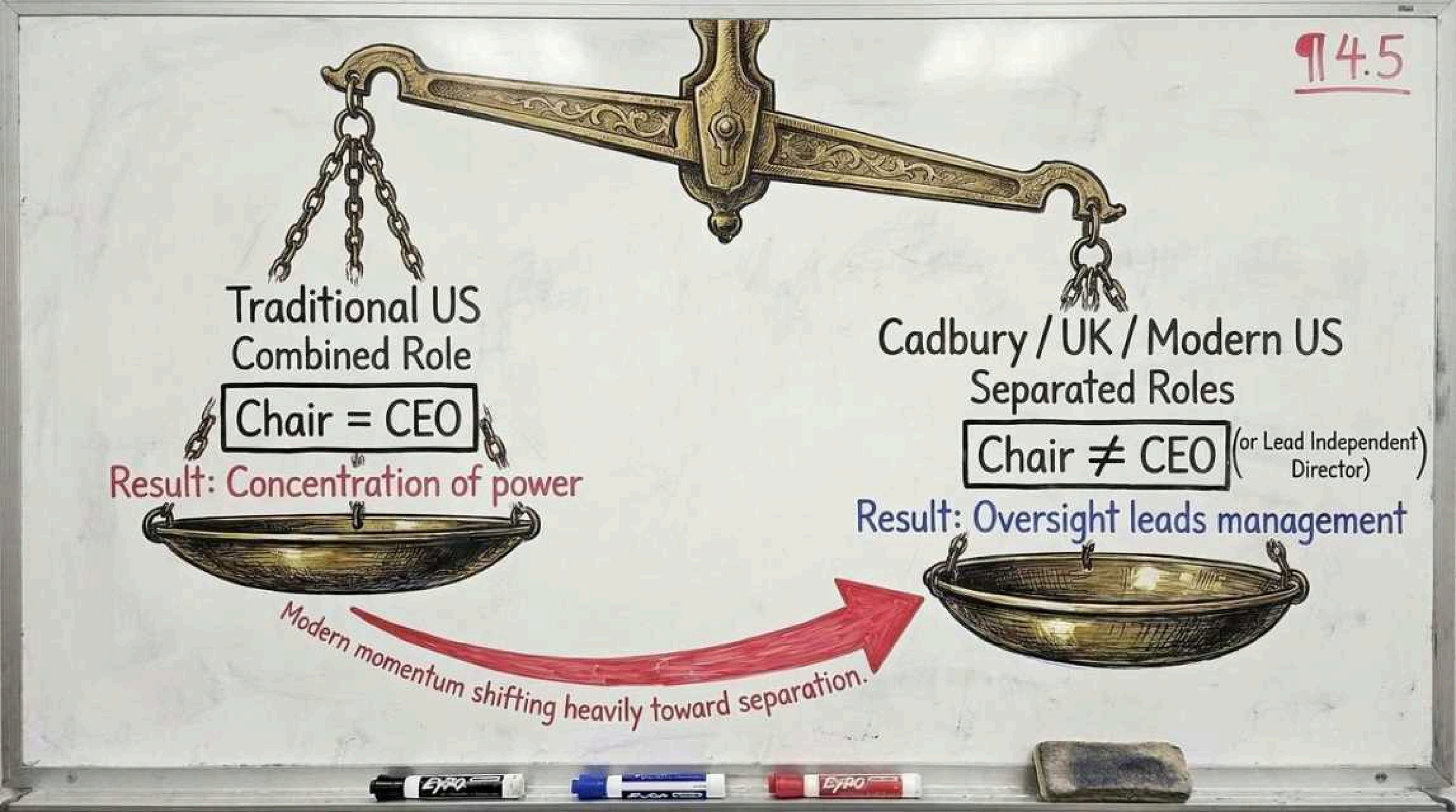


Current State: Independent Majority

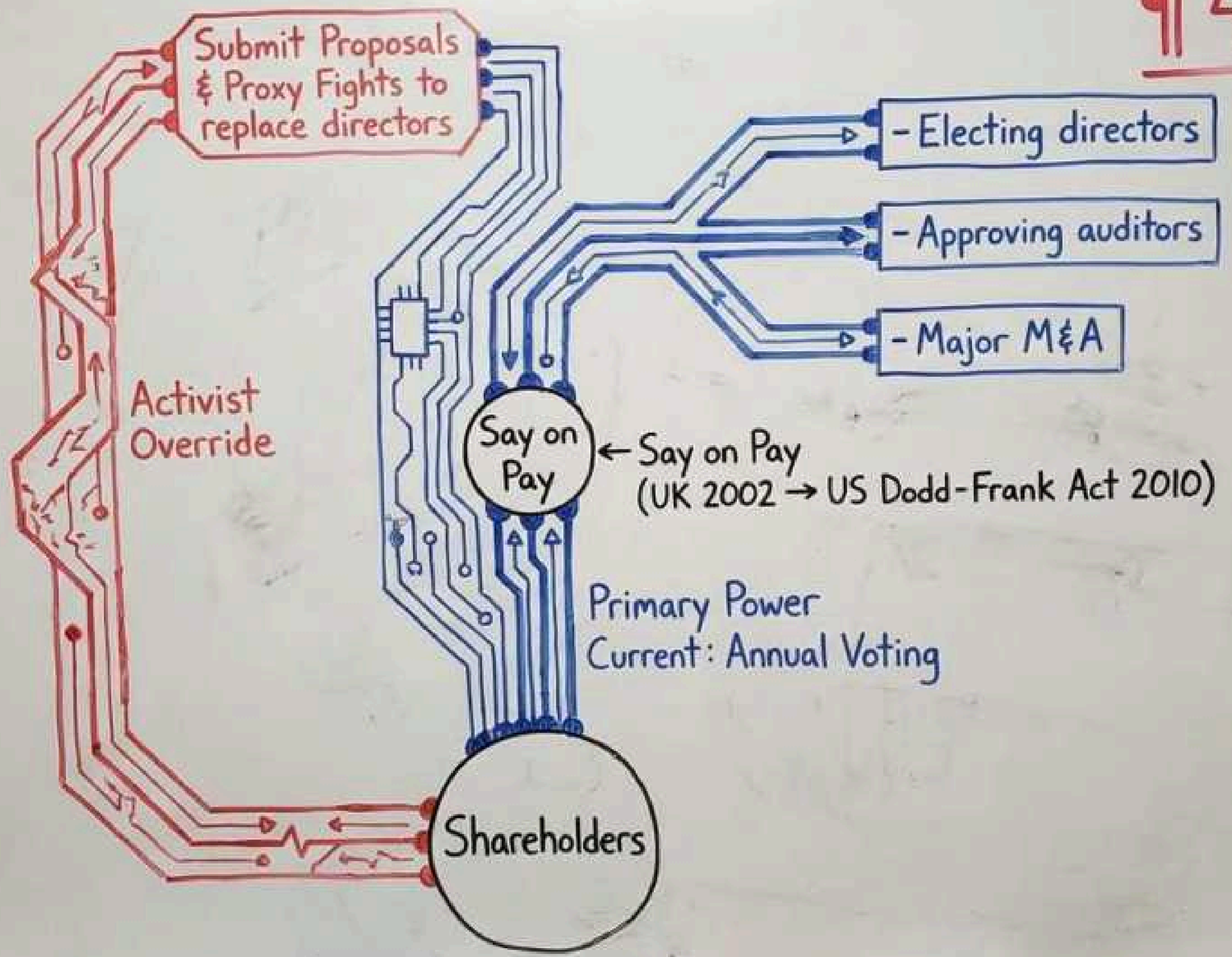
Definition: Ø Employment Ties + Ø Business Ties

1. Audit Committee
2. Compensation Committee
3. Nominating Committee

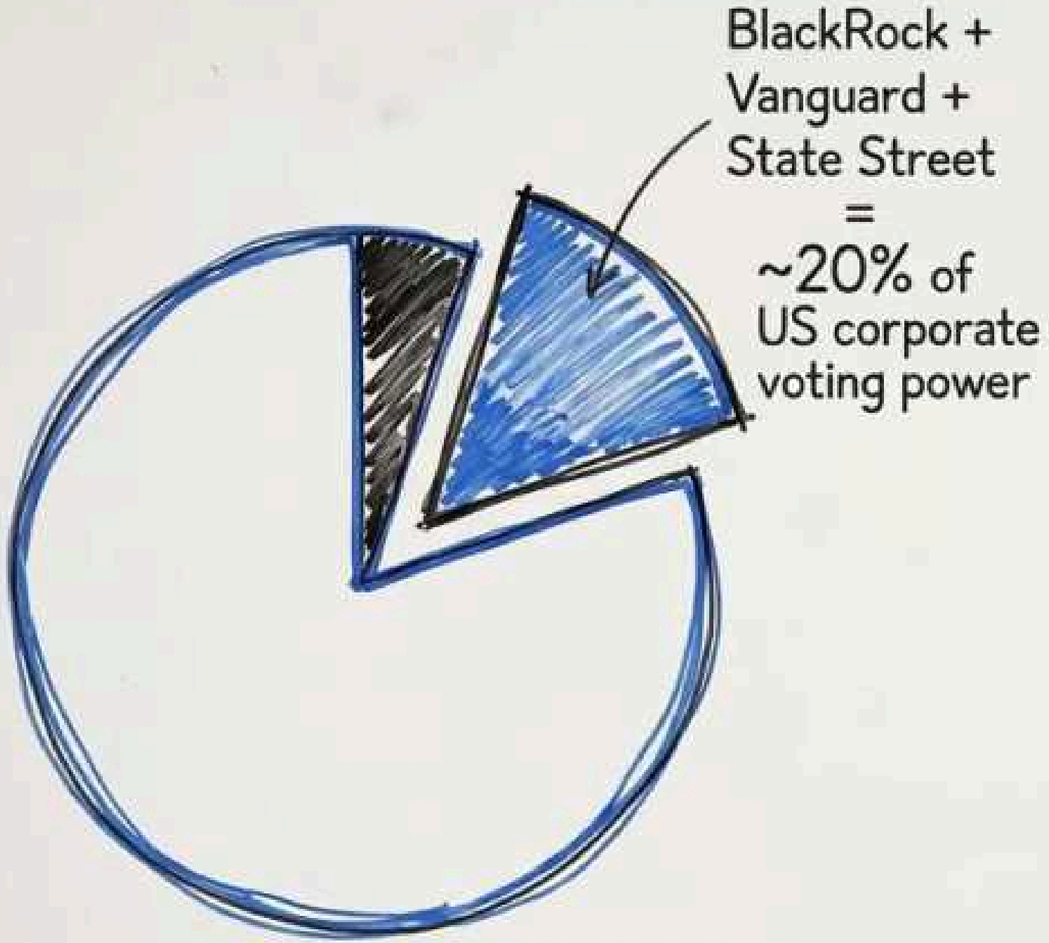
¶4.5


Traditional US
Combined Role
Chair = CEO
Result: Concentration of power
Cadbury / UK / Modern US
Separated Roles
Chair ≠ CEO (or Lead Independent Director)
Result: Oversight leads management
Modern momentum shifting heavily toward separation.

¶ 4.6


Submit Proposals & Proxy Fights to replace directors
- Electing directors
- Approving auditors
- Major M&A
Activist Override
Say on Pay
← Say on Pay (UK 2002 → US Dodd-Frank Act 2010)
Primary Power
Current: Annual Voting
Shareholders

¶ 4.7



IF Fund ∈ Index

THEN Cannot Sell Poorly Governed Firm

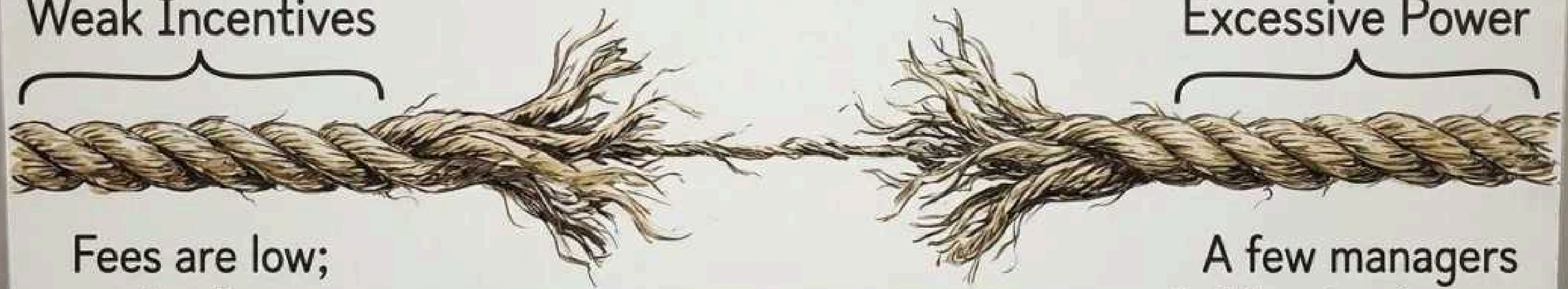
∴ Strategy must be VOICE (influence), not ~~EXIT~~ (selling)

The Index Fund Debate

¶ 4.8

Weak Incentives

Fees are low; gains from monitoring are shared with rivals. (Risk of apathy)



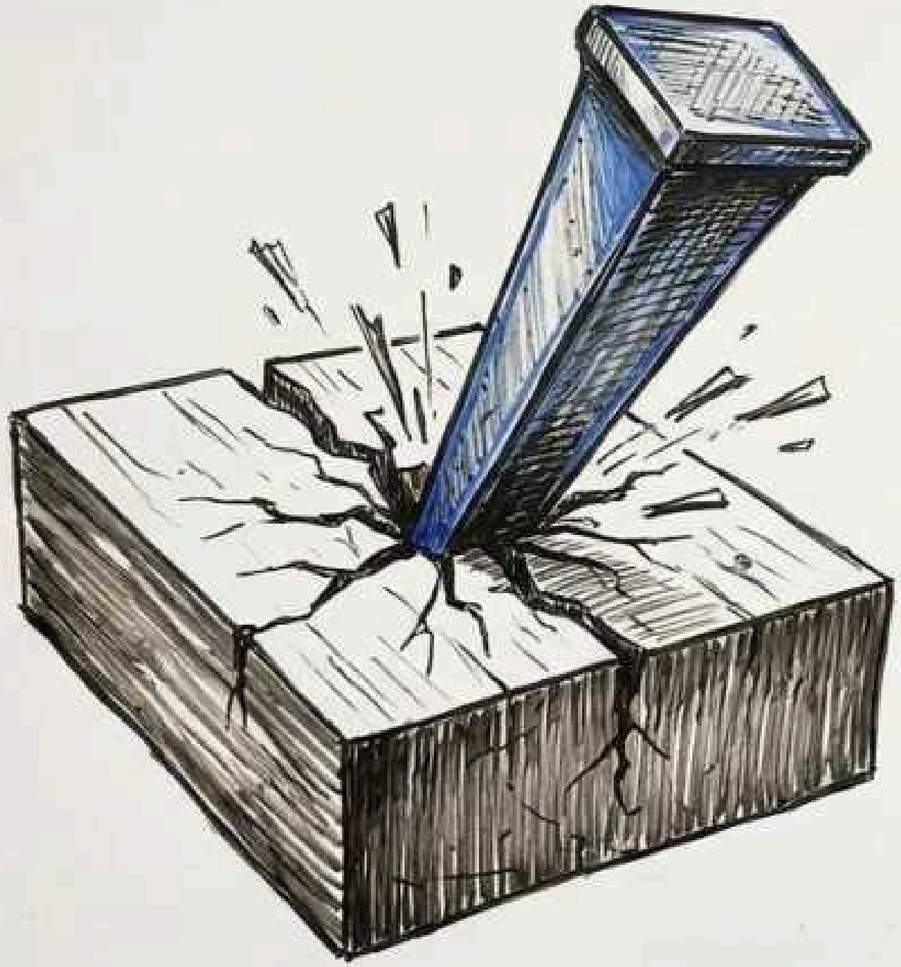
Excessive Power

A few managers hold systemic power across entire industries. (Risk of oligopoly)

Proposed Solution:
Pass-through voting
(Giving the vote directly to the funds' individual investors)

Activist Hedge Funds

¶ 4.9



Buy stakes in underperforming firms

→ Campaign for change (new directors, spending cuts, sale)

Supporters
↑ Corrects managerial slack. (Often backed by index funds)
Critics
↓ Forces short-term gains at the expense of long-term investment.

¶ 4.10



Subject: Enron (2001)
(Energy trading, celebrated innovator)

The Failure:

Hidden debts in off-balance-sheet entities + inflated profits.

Collateral Damage:

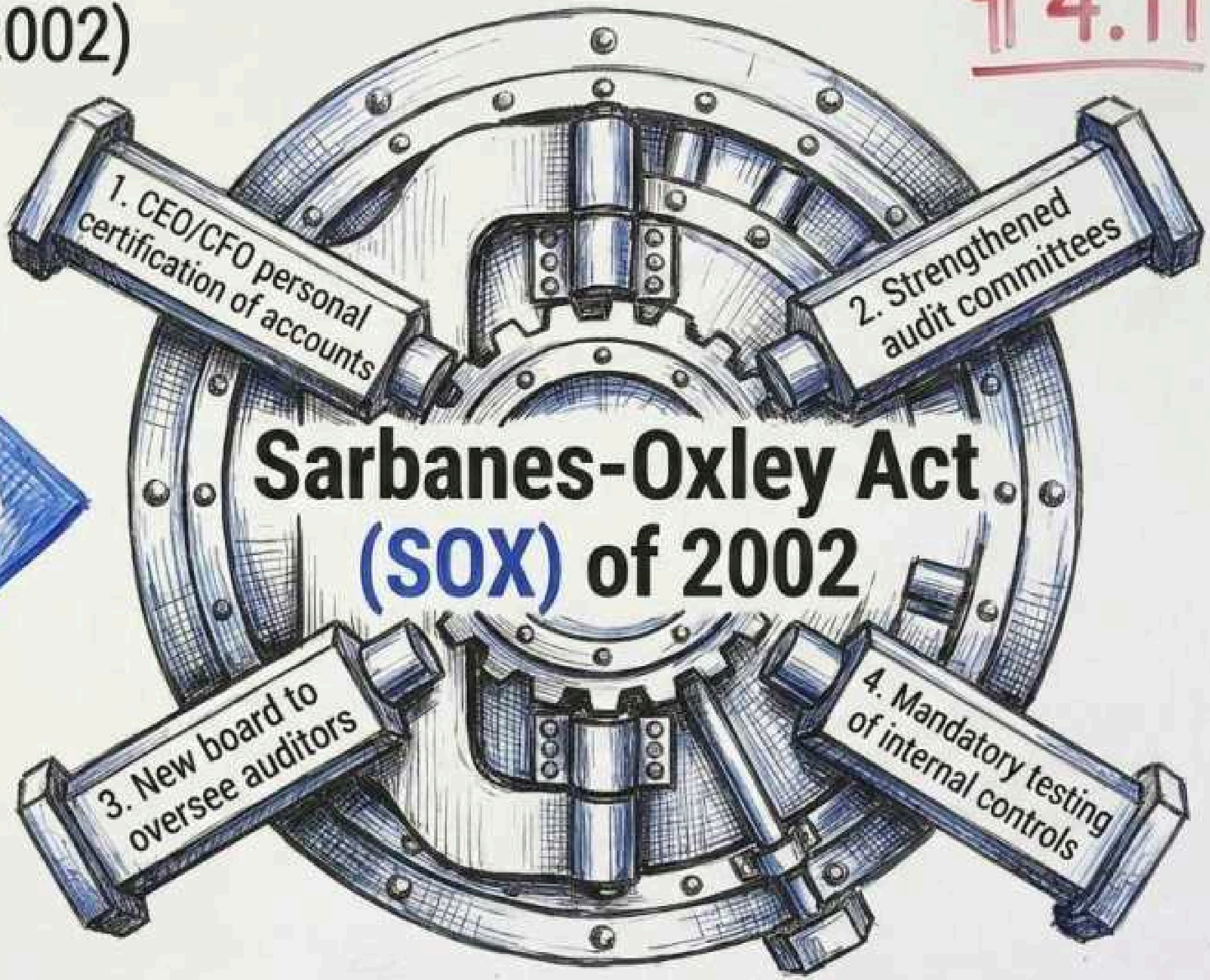
Arthur Andersen (Big 5 Auditor) convicted of obstruction, destroyed.
(Conviction later overturned)

¶ 4.11

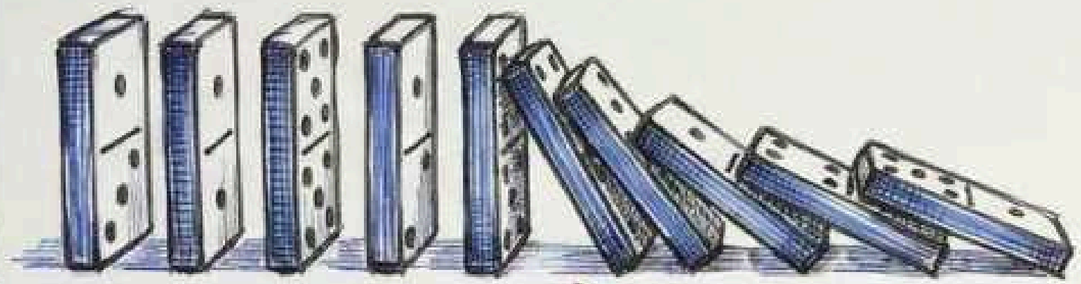
The Catalyst: WorldCom (2002)

Disguised billions in ordinary expenses as investments.

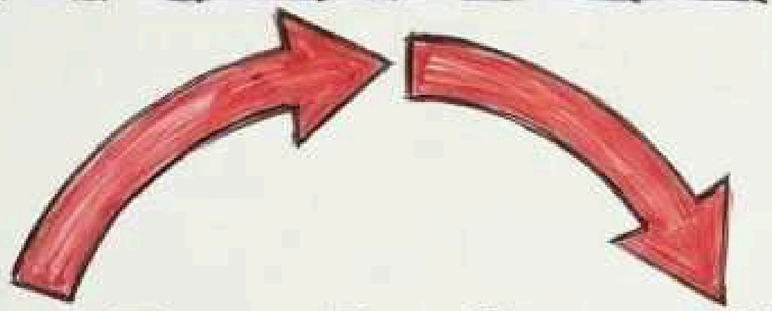
The Response



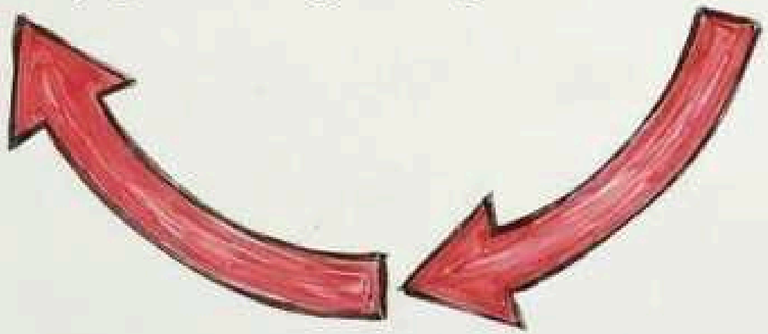
¶ 4.12



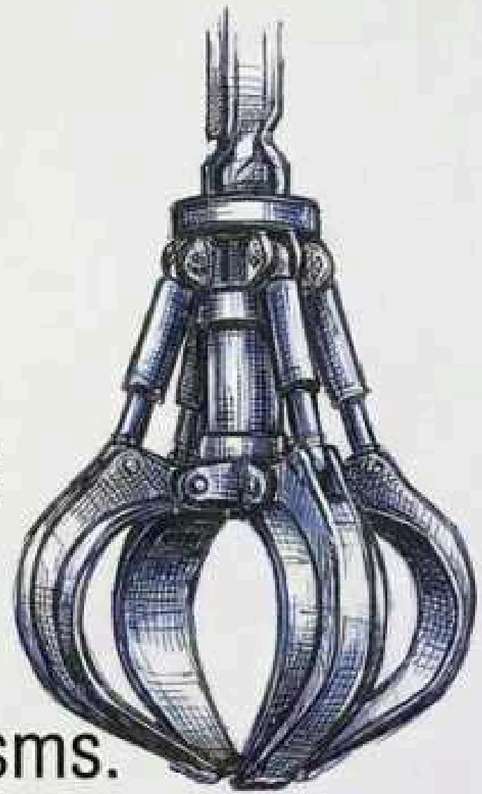
The Failure (Lehman Bros et al., 2008):
Enormous risks taken with borrowed money
+ boards failing to understand or limit risk.



Short Term Profits = High Pay
(Ignoring long-term risk)



The Reforms (Post-2008):
- Stronger capital rules.
- Bonus limits (EU).
- Pay clawback mechanisms.



¶ 4.13

The British Model: Flexibility via Code

Origin: Cadbury Report

Mechanism: A Governance Code, not rigid statutory law.

The Formula

[COMPLY with principle]

OR

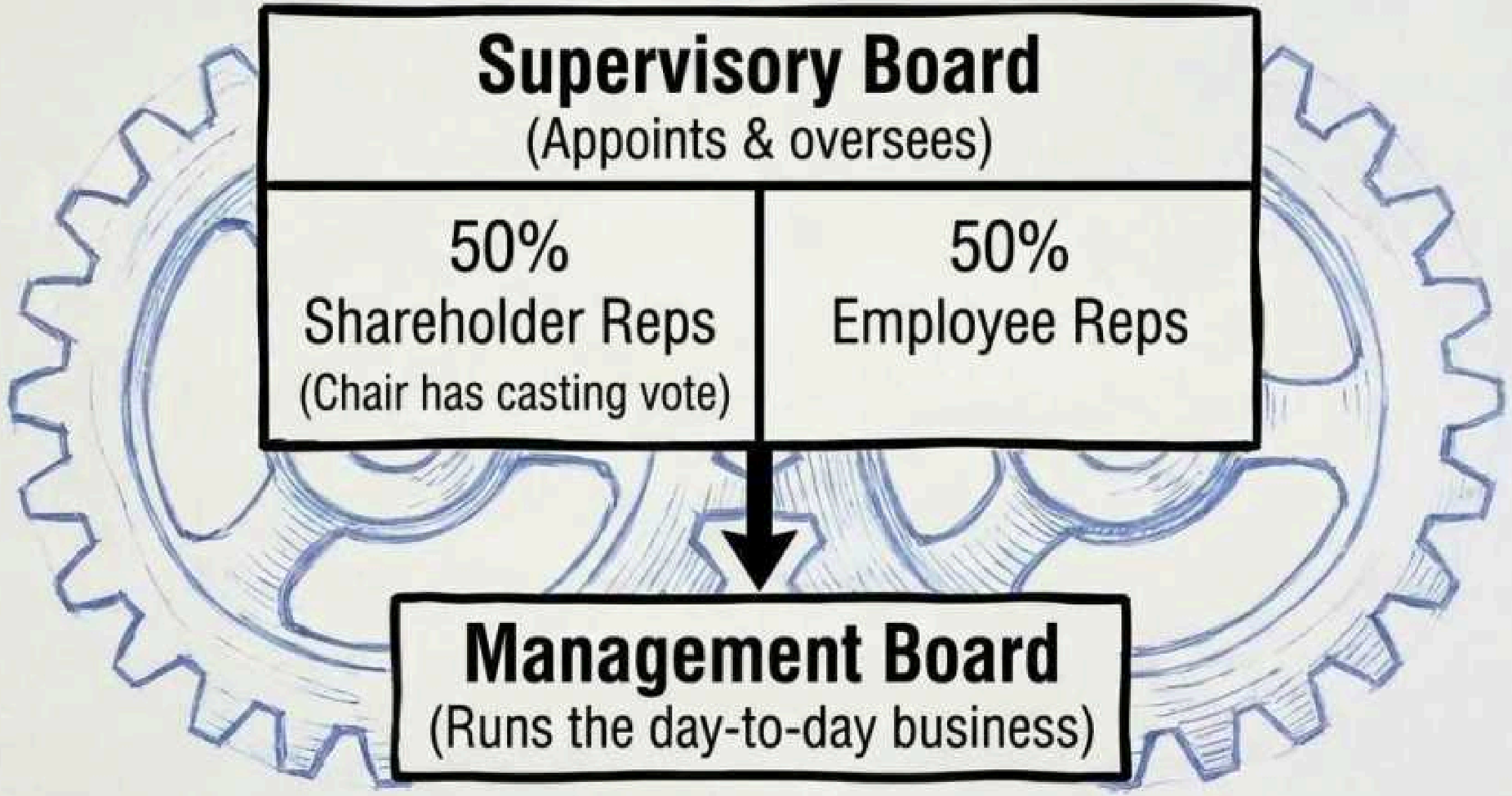
[EXPLAIN publicly why not]



This system only works if investors actively read the explanations and act on them.

The German Model: Codetermination (1976 Law)

¶ 4.14



Applies to companies with >2,000 employees.

The Japanese Model

¶ 4.15



Traditional Keiretsu

- Linked by cross-shareholdings
- Centered on a main bank
- Friendly partner shareholders
- Insider managers & lifetime employment

Modern Evolution (2010s →)

Stewardship & governance codes introduced to force ↑ independent directors and ↑ shareholder returns.

¶ 4.16

American System	German/Japanese Systems
(+) Strengths: Funding new firms, replacing failing managers.	(+) Strengths: Long-term relationships, investment in human skills.
(–) Critiques: Short-termism, excessive executive pay.	(–) Critiques: Protects weak managers, slows down change.

Conclusion: Governance systems reflect a country's unique history, law, and politics.

¶ 4.17



Closing Diagnostic Exercise

Prompt: Read the governance section of a large company's annual report.

- ☐ How many directors are independent?
- ☐ Are the Chair and CEO roles separate?
- ☐ What committees exist?

If the CEO makes a serious mistake: Who notices? Who acts?

Next: Lecture 5 — What are corporations for?