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KHEZRI: Improving corporate governance - before the next market crisis

Photo by: Mark Lennihan

An American flag flies in front of the New York Stock Exchange, Wednesday, Oct. 8, 2014 in New York. Stocks are moving between gains and losses in early trading as traders digest the latest corporate earnings news. Later Wednesday the Federal Reserve releases minutes from its latest policy meeting last month. (AP Photo/Mark Lennihan)

By Bijan Khezri - - Friday, October 10, 2014

October is no stranger to market volatility. So far, volatility is up 80% this month over June's all-time low. Quite apart from geopolitics and a looming change in the yield curve, we have over-leveraged corporate loans close to 2007 peak levels, an IPO boom, and a succession of debt-fuelled M&A and share-buy-back transactions. The scene is set for another wave of corporate governance failures. Once the current market tide goes out, weaknesses will be laid bare.

Since the burst of the dot-com bubble in 2001, the standard response to financial crises has been to tighten corporate governance rules. Heavy acts such as Sarbanes-Oxley and Dodd-Frank have taken centre-stage. As a result, today's blue-chip corporations are led by perfectly compliant boards that put directors' independence and a 'nose in, hands off' supervision at the heart of their mission.

There is a danger, however, that the compliant board is breeding formalism, group-think and risk-aversion at the expense of operational understanding, strategic focus and independent thinking. "How can a team of committed board members with individual IQs above 120 have a collective IQ of 60?" questioned MIT's Peter Senge. The financial performance of publicly listed companies is at stake.

Warren Buffet lost close to a $1billion in Tesco, Europe's leading supermarket chain, this October when its

Chairman asserted that a $400 million downward revision for first-half-year revenues was “not a failure of financial oversight, [but] something out of the ordinary course”. It took an individual whistleblower’s report on a Friday to put the Tesco Board into a state of emergency over the weekend: a perfectly compliant board, but apparently ‘out-of-touch’ and certainly taken by surprise. Get prepared for more surprises.

In an environment where ‘best practices’ compliance is the gold standard, normative thinking is the rule. Stock exchange regulations further exhibit our over-reliance on rules-based governance. Requests for dual-class listings from Google and Facebook, for example, paved the way to violate a sacrosanct ‘one share, one vote’ principle of U.S. governance. As a matter of regulatory arbitrage, this is attracting foreign issuers such as China’s Alibaba record-breaking IPO this September. The market for corporate control may become distorted.

To improve the effectiveness of a board, the concept of diversity in board composition has been increasingly embraced by policy makers and business leaders alike. Board gender quotas, for example, which are legally enforceable in Europe’s Nordic countries and have been recently introduced in Germany, however, are likely to have limited impact on financial performance. Unless “board members and top managers possess diversity competence and are aware of each other’s strengths and weaknesses beyond the stereotypes attached to their roles and identities” diversity is an empty shell, according to international governance experts Professors Martin Hilb and Nils Jent of University of St. Gallen in Switzerland.

American neuroscientist Stephen Kosslyn’s theory of four dominant thinking modes, summarised in his recent publication ‘Top Brain, Bottom Brain’, provides new insights which could be relevant for board composition. According to the pattern of interaction amongst certain parts of the brain, an individual’s dominant thinking mode can be profiled: mover, perceiver, stimulator or adaptor. Group effectiveness requires a balanced mix of all four modes. Neither too many alpha-movers nor too many compliance-adaptors are desirable.

To date, boards have been predominantly populated with CEO-type movers recruited from within a trusted circle. But there is a risk that regulations are pushing the pendulum to the opposite extreme. Neuroscience has made significant advances to empower the business world with insights and suitable testing methods to optimize group effectiveness. While those methods have been applied to executive teams, boards have been traditionally ring-fenced from behavioural scrutiny and profiling.

Eventually, market volatility is determined by how effectively boards and senior management anticipate, manage and communicate change and disruptions. Public companies could do better in aligning the board with shareholders, and the latter deserve their fair share of blame. The annual shareholders’ meeting as well as the rather obsolete annual report and a generally introverted board selection process seem outdated in an age where transparency and real-time engagement are the norm.

The next market crisis should make an end to the regulatory overdrive in corporate governance. We must avoid the mental trap of regulatory compliance, which is prone to instill a false sense of security and potentially distances the board from understanding the very business they are asked to supervise. More authentic, diverse and dynamic governance approaches responding to a company’s specific needs at a given time - that’s the future.

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