Corporate Governance and Stock Structure Corporate Governance and Stock Structure

What is corporate governance?

"Corporate governance can be defined as the set of institutional and market mechanisms that induce self-interested managers to maximize the value of the residual cash flows of the firm on behalf of its shareholders (the owners)." This view of corporate governance is known as the "shareholder governance."

In simpler words, corporate governance is the approach an economy takes toward getting managers to maximize firm value for the owners of the firm. Corporate governance focuses on reducing agency conflicts between the managers and the shareholders of the firm, including the protection of the interests of minority shareholders.

Corporate governance in the U.S. mostly adopts the capital market-based system, which is characterized by large independent publicly-traded companies. These companies have many shareholders who each own a small amount of stock. Firms in this system rely more on capital markets and less on financial intermediaries, relative to other corporate governance systems, when they need external capital. Public firms are required to disclose lots of information to the public and information is widely available to investors. Most large public companies are professionally-managed, as opposed to owner-managed, and the managers are compensated partially with equity. There is an active takeover market in this system.

Two Broad Classifications of Corporate Governance

The following sections are adapted from Stuart L. Gillan's "Recent Developments in Corporate Governance: An Overview" published in Journal of Corporate Finance, 2006 (JCF06).

I. Internal Governance is composed of five basic categories:

- The Board of Directors (their roles, structure, and incentives)
- Managerial Incentives (equity-based compensation package)
- Capital Structure (share structure, i.e., single vs multiple classes of stock)
- Bylaw and Charter Provisions (i.e., anti-takeover measures)
- Internal Control Systems

Though each component of internal governance is intended for achieving the goal of corporate governance, there are always imperfections and challenges in the execution. For instance, the Board of directors, which are elected by the shareholders, supervises management in public U.S. companies. Firms have inside directors and outside directors. Top managers who serve on the Board are inside directors. People from outside the firm are outside directors that are supposed to be independent and play a critical role in aligning the interests of managment with those of the shareholders in major decisions. Hoever, outside directors connect to top management through consulting contracts, common bonds with charities, and common memberships on the boards of other firms, etc. Such relationships may compromise the independence of outside directors.

II. External Governance is also composed of five groups:

- Laws and Regulations
- Key Markets, i.e., capital, labor, and product markets, and market for corporate control
- Professional Analysts as information providers and monitors
- Professional Services Providers such as auditing and investment banking
- Private sources of external oversight such as media

Financial institutions, such as pension funds and insurance companies, own blocks of stock in large corporations. These institutional investors may be activist shareholders, pressuring managers and directors to take actions that they believe will improve share price. CALPERS, the California Public Employees Retirement System, is a huge institutional investor. CALPERS is well-known as an activist investor, pressuring managers to take actions such as pay out more cash to investors when a firm has few investment opportunities. Look for the core principles of corporate governance for U.S. corporations. Issues such as director independence, director qualifications, and separation of the CEO and Chairman of the Board positions are addressed from the investor perspective.

Multiple Classes of Common Stock

In the previous sections, we learn about voting right being the important feature that is unique to common stock. The voting right allows shareholders to exercise their control of the firm that they own. We also learn how cumulative voting helps protect the interests of minority shareholders that have a small ownership fraction of the firm. Thus far, we implicilty assume a single class common stock system under which one vote is assigned to each share of common stock.

However, some companies chose to establish a multiple classes common stock struture when they went public. When more than one class of common stock exists, they are usually created with unequal voting rights. Typically, the founder(s) and/or other major investors of the private company before it went public hold the class of common stock that has super voting power, i.e., super-voting stock, while the public can only invest in the "regular" class of common stock. Many companies such as Ford Motor, FaceBook, Fitbit, UPS, etc. issue dual classes of common stock. The reason has to do with the control of the firm! For instance, Ford Motor's super-voting stock - Class B: always controls 40% of the votes regardless of the total number of shares outstanding. For interested students, you will find the website of "Council of Institutional Investors" offers great information on this topic.

Since dual-class common stock structure imposes challenges to the main goal of corproate governance that serves the interests of (all) shareholders, it worths further learning efforts on this topic. The individual assignemnt - Dual Class Stock Structure and Corporate Governance is designed for such.