HARCOURT BOARDROOM RESOURCES

GROUP GOVERNANCE

Group governance is emerging as one the key topics in the theory and practice of corporate governance, yet very few best practice principles have been developed in this important realm. Much has been written about the application of good corporate governance at the helm of an organization but the reality is that corporate governance challenges are far wider and more complex in most corporations with subsidiary networks. It is no longer sufficient to view corporate governance as simply the way in which the board at headquarters operates.

Subsidiaries are a common feature of modern-day business structures and as recent scandals, such as those involving the Swiss subsidiaries of global banks and the BP oil spill in the Gulf of Mexico (which occurred in a subsidiary seven layers below the parent company), clearly demonstrate that if group governance is not adequately addressed, it can have a disproportionate impact on the group as a whole in terms of tarnished reputation, drop in share price, litigation and changes in management. In some cases, the consequences may be even more extreme. One of the most famous examples of this, dating back decades, is Barings Bank where inadequate controls in its Singapore subsidiary allowed risky trading by one individual which ultimately led to the bank's collapse. The more recent bank crises have many elements of failed group governance.

In simple terms, group governance relates to how corporate governance principles can be cascaded, consistently and effectively, down to the level of subsidiaries. It is also about balancing group business objectives while recognizing the legal independence of subsidiaries.

Subsidiaries come into being (through formation, investment or acquisition) for a number of reasons including commercial reasons, tax reasons, risk management reasons, fiscal reasons, group operational reasons, and etc, and all subsidiaries are separate legal entities. Only a handful of legal frameworks such as the company law of Germany recognize the concept of group companies, and in most jurisdictions, the legal duty of company boards is to act in interests of that legal entity as opposed to the group/owner(s). The implication of this is that there is no prima facie reason why subsidiaries in a corporate group should act in a coordinated manner at all.

The ability of parent companies to control or influence decision making within their subsidiaries depends on a number of factors such as the level and structure of ownership (wholly-owned, majority, minority), shareholder rights (e.g., number of board seat and who has the right to appoint the CEO), the nature of the relationship between the shareholders, the regulatory environment (subsidiaries may have to answer to powerful regulators in their own jurisdictions such as local central banks or conversely, in lax regimes, legal documents such as shareholder agreements may not be enforceable), their maturity and resources (large and long-established subsidiaries are often inclined to follow their own processes and systems), and the activities they conduct as well as the subsidiary's geographical and cultural proximity to the parent.

There are a number of ways to govern group companies, but the key is for the parent to define its ownership policy. The governance models range from a pure financial holding to integrated group model.

The financial model is one where the parent is a mere shareholder focusing primarily on financial returns. The parent, especially if it is a majority owner, will have a significant say in the board composition, in the CEO appointment, in the overall vision for the company and etc. But the idea behind this model is that the company is run on commercial basis and the owner's role is not to second guess the management, but it should focus on whether certain processes (such as those relating to audit, risk management, ethics & compliance, etc.) are in place to ensure that the company operates effectively and that the management's interests are aligned with those of the owners.

The concern, often witnessed in the case of state-owned enterprises, is that the owner will interfere in the business to advance political goals. The best practice calls for the state to adopt a clear and consistent ownership policy setting out its overall objectives for the ownership and that the ownership be structured under a single entity such as a sovereign wealth fund or a sectoral holding company under a ministry as a way of limiting political interference. Similarly, family groups are advised to set up family councils to act as buffers between the family and the board to ensure that the company operates in the interest of all family owners as opposed to various family interests.

Minority owners under the financial holding model will have limited degree of influence on the subsidiary, and this is often restricted to annual general meetings. In case, the minority's concerns are not addressed, they will vote with their feet and sell their shares (if practically viable) or demand a seat at the board table.

This model is also one where the parent seeks to influence decision making at the subsidiary through board representation. Private Equity firms often adopt this model given that they tend to oversee a number of portfolio companies operating in numerous sectors. This model does not sit easily with the law in the sense that nominee directors, i.e., the directors appointed by the parent as its representatives, owe a legal duty to serve the interests of the subsidiary and not the party who appointed them, which may put the directors between a rock and a hard place. Enlightened parent companies take steps to limit potential conflicts of interests of their nominee directors and encourage them to fulfill their duties as effective board members.

This success of this model is largely dependent on the quality of the directors. The individuals appointed by the parent are often functional heads at the parent company and experts in their own area. However, as board members they cannot practice a single lens approach focusing on their own area of expertise as they need to become generalists and involved in all areas that fall within the remit of the board ranging from strategy to audit. It also must be ensured that the board members have adequate time to commit to their role. But it should not be forgotten that board members need to be supported which means that they are provided with induction upon joining the board as well as with ongoing professional development during the directorship. A good company secretary can also assist the board in developing annual work plans for the board and its committees and setting agendas accordingly.

The integrated model is one where the parent is directly involved in the running of the subsidiary through group functions such as finance, HR, compliance, legal, etc. In some cases, the subsidiary is treated as a division rather than a legally independent entity. This implies that the parent needs to have the resources to do so and that it understands the business of the subsidiary well (e.g., that they operate in similar sectors). The legal concern under this model is that members of management at the parent level may be deemed to be “shadow directors”, or de facto directors, at the subsidiary by the courts and therefore jointly and severally liable for the subsidiary if something goes wrong.

In reality, groups tend to exercise group governance through hybrid models (e.g. board representation while the group functions oversee the implementation of their respective areas), and these are often based on both formal and informal practices which include legal agreements between the companies, service level agreements, transfer pricing, board appointments, entity based investment and business planning, contractual arrangements to ensure subsidiaries follow group policies e.g. financial policies. Other elements include compliance and audit/assurance functions, information systems, compensation, ethics and culture.

All these elements introduce a high degree of complexity into group governance, and this complexity increases with the number of subsidiaries in a group and multiplied by the number of subsidiaries they have. The hybrid models also introduce vacuums in the sense that it is not always clear who does what – what falls under the remit of the subsidiary board, subsidiary management and the various group functions. In addition, group functions often step into the natural territory of boards and subsidiary boards, which are by-passed by the group functions in important areas such as strategy formulation, may develop a sense of not being “real” boards, which often undermines their sense of ownership in overseeing the company.

Parent-subsidiary relationships are seldom static, which adds an extra layer of complexity. The parent’s ownership policy may change over time as may the strategic importance of the subsidiary. Subsidiaries themselves evolve: whereas a newly formed subsidiary may look to the parent for support, a more mature company is likely to be less reliant on the parent. Changes in ownership structures will also result in new realities.

It is no accident that some companies are better at group governance than others. The more successful companies keep group governance under regular review – what are our subsidiaries, why were they formed, where do they operate, what are their risk profiles, what are the group's expectations from the subsidiary – and some companies have established board committees to monitor their group governance. Much emphasis is placed on clarity over the various roles between the subsidiary management, subsidiary board and the parent and any centrally overseen policies and procedures are clearly articulated and their implementation reviewed. Particular emphasis is placed on board effectiveness at the subsidiary level to ensure that these boards take ownership of governing the subsidiary.

Group governance is complex, multifaceted and often people-dependent, rather than document-dependent. In today's world, the complexities are not an excuse for not addressing group governance head on. As one Barclays Bank insider noted, when the bank announced its pull out from the African markets due its concerns over compliance and monitoring costs to prevent potential corruption and misconduct in its subsidiaries, "Barclays does not own all of the equity, but it owns 100 per cent of the risk if something goes wrong."

Harcourt IGN

April 2016