How should we think about corporate governance regulation?

Speech held by SCGI Director Mats Isaksson[*] at the Corporate Governance Board Annual Conference on October 11, 2022.

The basic building blocks of corporate governance regulation –company law and securities regulation – have served our societies well by making the corporate form a prominent means to raise capital and organise production.

Hence, it is not surprising that this formidable engine of innovation, investment and production that we call the joint stock company, has been subject to much attention and admiration.

But sometimes I think, that the corporation is at risk of becoming a victim of its own success. The reason is that the increased public interest in corporate governance has been accompanied by increased confusion, misunderstanding and ignorance about the core purpose of the regulation. Namely, to facilitate the supply and use of equity capital that is willing to assume risk and engage in long-term investment.

Instead the corporation has increasingly been seen by politicians and special interest groups as a convenient vehicle to advance a whole range of unrelated objectives.

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The unfortunate result of this tendency is the creation of unfounded and unrealistic public expectations of what corporations actually can and should be obliged to deliver.

As a matter of fact I believe that the European Union (to which the faith of Swedish regulation is closely tied) is at an important crossroads when it comes to what basic principles it should follow when shaping tomorrow's corporate governance rules and regulations.

Based on global experiences and the challenges that are facing the EU, my own humble opinion is that we should rely on two simple principles.

The **first** principle should be to encourage pluralism and flexibility: between companies, between countries and over time. The **second** guiding principle should be to design a regulatory framework where provisions and incentives are focused on facilitating the supply and use of equity capital.

The rationale behind these two principles is simply that we should allow and encourage business to focus on what they are good at. Namely to innovate, invest and in competition produce, as effectively as they can.

With respect to the first principle of flexibility and pluralism, it is not only about accepting differences and deviations from a common norm. It is also about having a regulatory framework that beyond certain mandatory standards can accommodate innovation and evolution in corporate governance practices.

The reason is not only the obvious fact that companies and countries differ. Equally important is that financial and technological innovations often require innovations with respect to contractual and organisational practices. One is needed for the other and the corporate governance of a company or industry needs to be adapted in order to embrace change.

It is important to underline that the principle of flexibility and pluralism doesn't come without demands. On the contrary, it requires that we have an efficient judiciary and competent self-regulatory bodies. We are not talking about a laissez-faire system, but a system of contractual freedom that relies on sophisticated institutions that protect private property rights and the rule of law.

When it comes to the second guiding principle, which should be to promote the supply and use of equity capital, the rational is a return to the core purpose of corporate governance and an adaption to current circumstances of regulations that has served us so well for more than a century.

Today, the importance of this principle is further underlined by the many structural and economic challenges facing Europe. Including the ambition to develop leading businesses in everything from artificial intelligence and life sciences to green technology and infrastructure. None of this will happen without innovation, risk-taking and long-term investment, which in turn call for more and better use of equity capital.

Let us take green technology as an example. The objectives of EUs Green Deal is to make EU climate neutral by 2050 and to decouple economic growth from the use of resources.[1] Navigating towards these goals is obviously a journey in unchartered territory. But the one thing that we do know is that it will require a lot of innovation and investment. Which in turn will require a lot of capital.

The International Energy Agency (IEA) has together with IMF estimated that in order to reach zero net emissions by 2050 the annual investments in the energy sector alone must more than double to 5 trillion USD by 2030. The IEA also predicts that most of the capital required for the transition to carbon neutrality will have to come from the private sector, and that it can only be mobilized through proper incentives and a sound regulatory framework.[2] And since we are talking about the supply and use of risk capital, one of the most important regulatory frameworks to get right is the domain of corporate governance.

The obvious reason is that equity capital has unique properties when it comes to supporting innovation and risk taking. Studies from the OECD for example has shown that an increased share of debt financing in an economy can slow down economic growth while increased equity financing through the stock market increases growth.[3] A study by the ECB staff also indicates that this positive role

[1] See COM(2019) 640 final, COMMUNICATION FROM THE COMMISSION on the The European Green Deal, Brussels 11.12.2019.

[2] See the report by IEA and IMF *Net Zero by 2050: A Roadmap for the Global Energy Sector*. Available at https://www.iea.org/reports/net-zero-by-2050.

[3] Cournède & Denk, *Finance and economic growth in OECD and G20 countries*, OECD Economics Department Working Papers 1223, OECD Publishing 2015

of equity is not only true for economic progress in general but also when it comes to our ability to meet the climate goals.[4]

These findings may be hard to appreciate for those who routinely tend to claim that stock markets and companies are short term and notorious sources of misallocation. Claims that was somewhat of a theme in the background report that the European Commission used when developing the Sustainable Corporate Governance Directive.[5] A worrying example of how unfounded assumptions can be allowed to guide important policy proposals.

So in order to avoid this and to put the discussion on a more realistic, some basic principles based on a proper understanding of the relationship between law and economics can not only guide the direction of reforms but also serve as a litmus test to sort out irrelevant or even counterproductive reform initiatives at an early stage.

For this purpose I am very glad that also the OECD is present here today.[**] Because I hope that the OECD with its "law and economics" approach and deep understanding of the interplay between corporate governance, capital markets, innovation and economic growth will be of great assistance.

From what I see of OECD work and the G20/OECD Principles of Corporate Governance I believe the Organisation is very well positioned to play an increasingly important role in informing the European corporate governance agenda. For the EU to get it right will require a truly economic perspective and a global outlook. OECD has both.

Thank you very much.

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[4] See Ralph De Haas and Alexander Popov, *Finance and carbon emissions*, ECB Working Paper 2019 no. 2318.

[5] See the study carried out by EY Italy in 2020, *Study on directors' duties and sustainable corporate governance*, available at: https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en

[**] Professor Carmine Di Noia, Director of the OECD Directorate for Financial and Enterprise Affairs was another speaker at the Corporate Governance Board Annual Conference on October 11, 2022.