Prof. Franco Taisch,

Lessons learnt?

Good corporate governance involves control, but must also leave room for entrepreneurial initiative. Various stakeholders have a role to play.

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Notenstein: Enron, Worldcom, Parmalat, Arthur Andersen, Swissair – these and many others stand for spectacular scandals, mismanagement and excessive pay packets over recent years. They triggered a broad discussion on corporate governance that continues to this day. The problem of false incentives, the conflict between the short-term thinking of managers and the long-term targets of owners, is nothing new, however. As long ago as 1494 the Medici bank went under because the family owners not only used the bank to finance their extravagant lifestyle, but also lost control over the managers they had employed. Professor Taisch, how is it with today's companies? Have they fully absorbed the fundamentals of good corporate governance? Have companies learnt their lessons from the recent scandals?

Franco Taisch: History teaches us that scandals, mismanagement and excesses are part of the human condition, and thus of the management of companies. But history also shows us that not everyone, not every politician, entrepreneur and manager, is incompetent, unethical or criminal. In the global economy far more companies contribute to our society with responsibility, integrity and enormous entrepreneurial energy than cause damage through corporate malfeasance and excess. It is of course necessary to react to abuses, and proper to do so with radical measures on occasion. But we should not suppose it necessary to regulate everyone equally. We should not criminalise whole sectors, nor should we, with the benefit of hindsight, apply criminal sanctions to the acceptance of entrepreneurial risk on the assumption that it represented corporate malfeasance.

Most companies contribute to our society with responsibility, integrity and enormous entrepreneurial energy.

Without entrepreneurial risk there can be no economic progress. Accidents will still happen in the 22nd century, and it is to be hoped that they will still be permitted. Otherwise, over time there will be no-one left prepared to take on entrepreneurial risk, whether as entrepreneur, director or manager, and – to be clear about this – without state support. We need to pay every bit as much regard to this entrepreneurial spirit as we do to absorbing the fundamentals of good corporate governance.
But what exactly is "corporate governance"? In academic circles, "governance" means the activities of planning, coordinating and controlling within organisations. This involves the direct and indirect influencing of behaviour in order to achieve goals. Governance was already a topic 4,000 years ago, in the Gilgamesh epic, in terms of making war and conducting business, and in particular with regard to important friendships (today's "trust"?) and adventures (today's

"risk"?). But the modern discussion on corporate governance has its origins in the 1930s, with the recognition for the first time of a discrepancy between the interests of the owners of an enterprise and the managers employed by them. The aim, then, is to minimise this latent conflict of interests.

> *There is as yet no global norm for "good", although there are many who believe they can preach the gospel on this.*

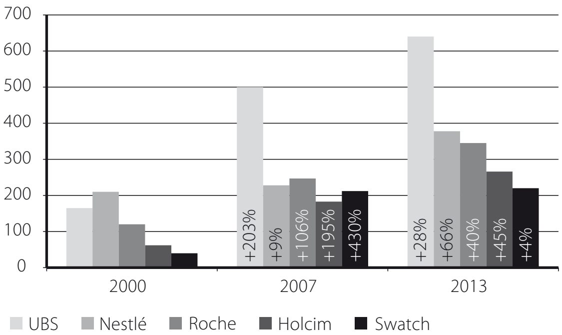
So, when is corporate governance "good"? There is as yet no global norm for "good", although there are many who believe they can preach the gospel on this. "Good" is not absolute; it changes over time and can vary between different societies at the same time. The corporate scandals of the 21st century have indeed served as a wake-up call, and helped (once again) to trigger a shift in values. From 2008 onward this development has been enormously accelerated by the financial and economic crisis. The issues today go far beyond the relationship between investor and manager. Nor is it simply a matter of how to encourage integrity and curb criminal activity. The fundamental issue is what kind of value-added should entrepreneurial activity generate in our society. The emerging global megatrends are indicators of what our society regards as good corporate governance. The ability to recognise them correctly and in good time, and react accordingly, is what distinguishes really successful businesses. So, have businesses absorbed all this? Have they learnt their lessons? Some have, others not. That was the case in the past and it will be no different in the future.

> *The belief in universally applicable principles for good corporate governance seriously restricts listed companies' room for manoeuvre – perhaps too seriously.*

Notenstein: So, corporate malfeasance is an aspect of the human condition – it was ever thus, and so it will remain. Entirely avoiding accidents would involve nipping all entrepreneurial activity in the bud. Nevertheless, efforts to regulate everything are far advanced. Companies today must account for anything and everything. As the figure shows, the annual reports of large listed companies now run to hundreds of pages, and are set to get even longer. They teem with positions open to interpretation: contingency reserves, deferred taxes, contingent liabilities, holdings – all annotated in detail. The effort involved is extensive; the benefit for shareholders, analysts or journalists, minimal. Further, Anglo-Saxon corporate-governance principles are usually applied tel quel to companies in other countries, without any consideration of country-specific characteristics. Thus, employee representatives on German supervisory boards are "not independent"; founding families with majority holdings are "dominant investors". The ever-growing forest of legally-binding regulations is supplemented by non-binding guidelines – so-called "soft law". The bulky handbooks of professional proxies define their own guidelines and are then regarded as "gospel" for listed companies. In short, the belief in universally applicable principles for good corporate governance seriously restricts listed companies' room for manoeuvre – perhaps too seriously.

Higher transparency = increased complexity?

Number of pages of annual reports of various companies



The percentages indicate year-on-year increases
Source: annual reports

As we know, the business world is not made up of stock corporations only. There are other forms of company, including cooperatives. The goal of any enterprise is to create value-added, from the perspective of its owners. This goal is only achievable in the long term, however, if it is not at the cost of other stakeholders. Are there legal forms of organisation that offer better prospects here than others?

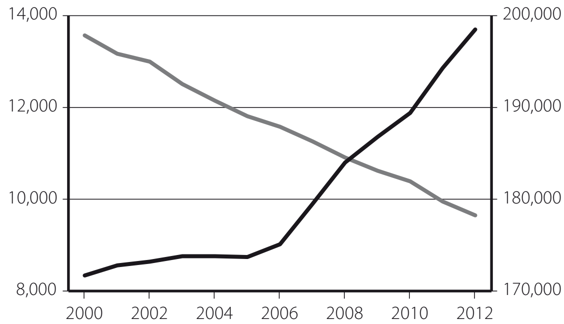
> *It may come as a surprise that the DNA of an old business structure, the cooperative, fits fairly well with the current situation.*

Franco Taisch: All entrepreneurial activity takes place within given legal platforms. Each of these platforms has a specific DNA. Entrepreneurs must always consider whether, in any given environment and at any given phase of development of their business, they (still) have the appropriate legal form for their business model. So, it's not a question of good or bad platforms. Much has changed over the last 20 years, and it may come as a surprise that the DNA of an old business structure, the cooperative, fits fairly well with the current situation. What is particularly noteworthy here is that a business with a cooperative structure is oriented not on one-dimensional value generation for the benefit of a single stakeholder group, but on the generation of multi-dimensional benefits for multiple stakeholder groups: members, customers, employees, suppliers, investors, the general public. Cooperatives unite what often appears irreconcilable. The cooperative business model is locally anchored and at the same time supra-regionally networked. It facilitates the recognition of customer needs and creates sustainable business relationships. At the same time, it enables use to be made of multiplier effects and economies of scale. Cooperatives are managed on the basis of democratic decision-making processes: "one person, one vote". That creates trust, reflects the social need for participation, encourages long-term stability and reputation, and enables more effective involvement of its members in the innovation process. Furthermore, cooperatives are oriented on the key driver of the real economy; primacy is given to value creation for all stakeholders, without recourse to the financial markets. That too creates confidence. Lastly, cooperatives' DNA is characterised by sustainable finances. This means profit optimisation, not profit maximisation for the payment of dividends, retained earnings rather than share buy-backs and debt financing. Risks are also limited as investments are mostly local and under democratic control. Not only cooperatives themselves, but also other entrepreneurial platforms have realised in recent years that all these points together offer interesting potential for differentiation of great strategic relevance. Stock corporations in particular have reacted with sustainability reporting, corporate social responsibility departments, good corporate citizenship programmes, or a move from social sponsoring (the donation of money previously earned through profit maximisation) to the creation of multi-dimensional benefit. This requires some degree of genetic modification to the original DNA, and cooperative elements can offer valuable enrichment here.

Notenstein: Let's stay with the image of DNA for a minute. In strict evolutionary terms, an advantageous genetic disposition should increase the chances of survival – "survival of the fittest" in the business world too. While it is true that individual exponents of the cooperative legal structure have proved highly successful, adaptable and thus capable of survival, this does not apply to the legal structure in general.

Declining importance of cooperatives

Number of of companies per legal form in Switzerland



Cooperatives (left-hand scale)
Companies and partnerships limited by shares (right-hand scale)

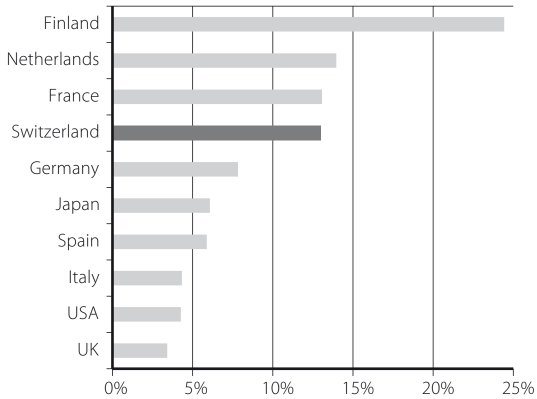
Source: Swiss commercial register

In Switzerland in 2011 cooperatives employed something over 110,000 people, a mere 3 percent of the total. Stock corporations employed 20 times as many. And, as shown in our figure, the importance of cooperatives has declined continually over recent years. From this perspective, cooperatives are a dying breed. Are they at all still in keeping with the times?

Franco Taisch: That certainly sounds like an evolutionary death sentence for businesses with cooperative structures. Over the last 30 years cooperatives have gathered a lot of dust, and no other business structure in history has been so seriously taken hostage by ideologists of various colours. That is both distorting and damaging. What is not damaging, however, is the fact that cooperatives are not suitable for every purpose. The cooperative is only one of many alternatives for entrepreneurial activity. At a time when investor-oriented business models are favoured, the stock corporation is a clearly more suitable option. And that's fine: the business world needs diversity. At a time like today, when the focus is increasingly on a broader spread of benefit creation, cooperatives suddenly appear highly modern. Nor should we forget that for every statement there's a statistic. If we broaden the statistical picture, it reveals that cooperatives have a membership of around a billion people in over 1,200 countries, and generate between 3 and 5 percent of global GDP. In the USA one-quarter of the population belongs to a cooperative. In Brazil, 72 percent of cereal production is marketed by cooperatives, as is practically 100 percent of milk production in Norway.

How important are cooperatives in various countries?

Contribution of cooperatives to nominal GDP
(As at 2011)



Source: The World Cooperative Monitor 2013, World Bank

Germany has experienced a renaissance in cooperative start-ups in recent years: there are now 20 million members and 4.3 million shareholders. In Switzerland, as shown on the figure, cooperatives contribute 13 percent of GDP. Start-ups are not particularly numerous, but there are also hardly any liquidations. The decline in numbers mentioned is strongly influenced by mergers. According to a study by gfs.bern, a research institute, society shows the greatest trust in family firms, closely followed by cooperatives. Listed stock corporations come last. Cooperative business models are certainly in keeping with the times, and their DNA is interesting for other forms of company today.

So, why are there in general so few cooperative start-ups?

I think there are three main reasons. Firstly, the cooperative business model is too little known, if at all, in the start-up scene. Secondly, in some countries, including Switzerland, the large number of founders required is prohibitive. Thirdly, as a model for a start-up the cooperative is promising in the long term, but, on account of its participative character, highly challenging.

Globally, cooperative start-ups are to be found today above all in the energy, foodstuffs, transport and healthcare sectors.

Globally, cooperative start-ups are to be found today above all in the energy, foodstuffs, transport and healthcare sectors. A most exciting recent project that I have been supporting is the healthbank. The healthbank, set up by an international group of entrepreneurs and academics, is the first health data platform in the world to be owned by consumers. It combines data sources from all segments of the healthcare system and rewards participation. The cooperative elements are evident: only the users can manage their data, and only they decide whether or not to share these data with service providers, researchers or other players. The platform is a neutral intermediary, secure and transparent. It is not only the participants themselves who profit (via remuneration for the provision of their own health data), but also the general public, through improvements to the quality of healthcare provision and reduced costs.

Notenstein: From your perspective, then, cooperatives are more strongly oriented towards benefits, and stock corporations more strongly towards investors. Let’s try to define the specific characteristics of cooperatives more precisely. For many may not perceive any very great difference between cooperatives and stock corporations. There are certainly stock corporations focused on their customers! And there are also cooperatives focused on profit. At least, that’s the impression we get with regard to prominent exponents of this legal structure, such as Migros and Coop in Switzerland, who have a significant influence on the cooperative image. Simply in terms of numbers, however, non-commercial cooperatives, founded quasi as “self-help” organisations, for instance in the agricultural and construction sectors, are far more significant.

There are certainly stock corporations focused on their customers! And there are also cooperatives focused on profit.

In terms of corporate governance, differences in the management and control structures appear particularly interesting. The grass-roots democracy inherent in the design of cooperatives’ co-determination rights is conspicuous. Statutes are determined or adjusted at general assemblies or by ballot. Either there are binding regulations governing the appropriation of profits or, if nothing else is defined, profits are retained as assets of the cooperative. The focus on people is also reflected in the capital structure. Share certificates do exist, but are generally not transferable and in particular not tradeable. This protects against take-overs, but also restricts possibilities for raising capital. Further, cooperative members are simultaneously owners and users of “their” cooperative. As customers, they experience directly whether or not the cooperative achieves its aims. But there is also further control of business activity, as with stock corporations, through delegation to a board of directors.

There may also be differences in management and control structures because cooperatives are – or so we assume – organised more decentrally than stock corporations. Where do you see differences between the management and control structures of cooperatives and stock corporations? For these play a key role in the prevention of scandals, mismanagement and excesses. But – as we have already determined – there is a state of tension between control and entrepreneurial energy. So it is also interesting to see what impact these differences have on the ability to innovate.

Franco Taisch: Regardless of size or sector, stock corporations and cooperatives are both oriented on some commercial activity; they are both involved in competition; they are both subject to the same business mechanisms; and they should both make a profit. Stock corporations do this by maximising profits to the benefit of their investors; cooperatives by optimising profits and balancing the benefits across several stakeholder groups. That is the difference. The capital may well take the form of tradeable (non-voting) share certificates. The notion that cooperatives are non-commercial or charitable organisations is simply wrong. Entirely non-commercial cooperatives do not correspond to the cooperative DNA. They are tolerated in practice; no more and no less. There are other platforms whose DNA is better suited to charitable or non-commercial activities, such as associations or foundations. Self-help is not public utility; today it is simply modern entrepreneurship.

Over and over again, we believe we must, and can, control everything: technology, nature, love, business.

That is the context in which to discuss the management and control structures of stock corporations and cooperatives. For both, it is the case that control is part of management. And both are today expected to control anything and everything, in triplicate or quintuplicate. Anyone failing to comply, continually and comprehensively, with his or her control obligations is negligent, liable, if not criminal. Trust is good; control is far better. Control thus often becomes an end in itself, and a tool of our insurance-based society. But control is no guarantee of success. Properly understood, control as part of management generates trust. No business can be successful if it functions in an atmosphere of continuous mistrust between owners, directors and management, with a corresponding blanket of mutual control. The generation of trust must be an essential part of any corporate governance system. Over and over again, we make the capital error of believing that we must, and can, control everything: technology, nature, love, business. Thank God, we cannot, and it is to be hoped that we never shall, for otherwise there would be no more innovation. And here precisely is the nexus between control and innovation.

How the processes of control and innovation are designed in stock corporations and cooperatives is determined by their differing DNA structures. In cooperatives these processes are characterised by the principles of multi-dimensional benefit generation and an open door, which enable a highly heterogeneous group to exercise influence. Of particular interest in this context is the identity between various stakeholder groups typical of cooperatives (identity between members and customers, members and suppliers, members and employees, etc.). This creates a remarkable engine, both multi-faceted and robust, as right from the start all parties are in equilibrium, that drives innovation. Further, the "one person one vote" principle hinders the development of over-powerful interest groups. These can hinder effective control and innovation. Such concentrations of influence can occur in stock corporations, but that may also be desirable. Giving priority to generating benefit directly down the value-added chain simplifies control, as it is easier to monitor what one knows, and it encourages innovation directly on the product. And being locally anchored provides an immediate link to the customer, and hence strong social control.

The federal, decentral organisation typical of cooperatives, with as much entrepreneurial management (including control) at local level as possible, and communication platforms at every level, enables the development of a real network of innovation clusters and "checks and balances". Stock corporations tend to have centralised hierarchical structures that can be highly authoritarian and permit only limited heterogeneity. Furthermore, it is possible for a very interesting circle of innovation and control to develop within a cooperative, in which the central organisational unit steers its members, while the members simultaneously control the central organisational unit. Here too, the control process in stock corporations is more unidimensional, but possibly simpler. Lastly, in large cooperatives the principle of indirect democratic control by an assembly of delegates leads to a strengthening of powers and competences of control vis-à-vis the board and the management. This might, incidentally, be one approach to overcoming the problem of control in large stock corporations with a highly fragmented group of shareholders.

Notenstein: From the perspective of an asset management bank the question of investment suitability is of course crucial. Lastly, then, let's focus on the stock corporation. In selecting the companies we invest in, at Notenstein we consider various criteria. Corporate governance is an important aspect of our comprehensive sustainability analysis (in addition to a convincing business model, sound balance-sheet indicators and an attractive valuation).

In our title selection, corporate governance is an important aspect of the overall sustainability analysis.

We assess the design of the management and control structures and check, among other things, whether there are any restrictions on voting rights, whether the CEO is also on the board, or whether the board reveals any dependencies on the management. Our catalogue of criteria contains some 50 points. Additionally, we review the business from ethical, social and ecological perspectives. We do this not from purely idealistic motives, but as a matter of rational calculation. Businesses that operate in accord with their environment pay less in damages and legal costs, have fewer labour conflicts, spend less on environmental remediation, and have fewer reputation issues to resolve. A good example here is the accident on the Deepwater Horizon oil platform in the Gulf of Mexico in 2010. The accident involved the platform's operator, the British oil company BP, in immense costs for making good the environmental damage, as well as financial penalties and damages. The company had to make provisions of some USD 42 billion – a multiple of the 2012 net profit. Shareholders were hit with a drop of over 40 percent in the share price, and the shares have still not fully recovered. If we can identify those companies that face such risks, and whose management do not try hard enough to avoid serious accidents of whatever kind, this generates value-added for our clients. What do you think of our approach to stock analysis? Are there other, more important, criteria?

Franco Taisch: Notenstein's approach is undoubtedly correct, regardless of whether the investment is in a stock corporation or some other entrepreneurial platform. But investors should not be under the illusion that with such carefully selected businesses an event like Deepwater Horizon becomes impossible. Companies are managed by people. People make mistakes, and from time to time take on entrepreneurial risks that lead to failure. On the other hand, good governance can contribute to striking the right balance between too much and too little (there is that too!) risk-taking by the management, and to identifying errors at an early stage and taking counter-measures. This certainly generates value-added for Notenstein's clients. With an impressive criteria catalogue of 50 points, however, there is a danger that assessment becomes too formalised, and degenerates into a simple tick-the-box exercise. For example, is a double mandate per se the devil's work? Or might it be absolutely appropriate for the stage of development of the company concerned? Reflective, differentiated assessment is required here.

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The additional review of the company from ethical, social and ecological perspectives reflects investors' stronger sensibilities in these areas. And the investment world will change further in this direction. Investments should bring investors financial rewards, but also be acceptable ethically, socially and ecologically. This reflects a broadly based expectation of entrepreneurial activity. In earlier times too, though, honourable businessmen were expected to take the needs of urban society into account. The current values-based discussion on the benefits of entrepreneurial activity goes deeper, however, as already mentioned. It affects the business model itself, and requires multiple value generation for the benefit of various stakeholder groups. It is no longer enough to keep one or other interest more or less satisfied; it is a matter of bringing together a wide range of interests at the core of the business model. The cooperative DNA we have discussed may offer interesting insights here. Whether a company orients its operations on it, and how successful the management is in navigating though these tensions, could offer an additional indicator that might in future generate significant value-added for Notenstein's clients.

Notenstein: Many thanks indeed for this discussion.

The Notenstein view

The title of our dialogue, "Lessons learnt?" almost makes it sound as if the epic discussion about corporate scandals and mismanagement could be resolved with one powerful lesson, and then everything would be alright again. After the dialogue, it is (naturally enough) clear that things are not so simple. The tension between risk management and entrepreneurial freedom is just as long-standing as the divergence between the interests of owners and managers. So, this is a discussion that will continue into the future. It is, however, cause for concern that, in our "comprehensive-insurance society", the pendulum seems to be swinging far out in the direction of control. Control is, though, and we entirely agree with Franco Taisch on this, no guarantee of success. Without entrepreneurial risk there can be no economic progress. And risk explicitly involves trust. This should – here too, we entirely agree – be an intrinsic element of any corporate governance system. Companies successful in the long term not only take on risk and generate economic value-added, they also operate in accord with their environment – ethically, socially and ecologically. In this context, the question arises of whether there are legal forms that are particularly suited for companies. The answer is clear: there are neither "good" nor "bad" forms of company; excellent companies may operate with various legal forms. It does, however, seem that cooperatives are very much in tune with the spirit of the present times.

Their "one person, one vote" principle helps prevent any potentially damaging concentration of power, and with their federal, decentral DNA, cooperatives can develop networks of innovation clusters. The associated "checks and balances" and their local anchoring result not least in sound control structures. All this looks like a good basis for sustainable operations. What does this mean for investors? Investors are principally interested in the maximisation of corporate value – "shareholder value" – and this will not change. We take the view that corporate value can only be increased – maximised – over the long term if management keeps its eye continually on the sustainability of the business. This is why we devote a good deal of time and resources to including these aspects in our analyses – quantitatively, but also, and deliberately, qualitatively.

Our Dialogue partner

Prof. Franco Taisch is an entrepreneur across a range of industry sectors, and a director of various companies. He is a director and member of the Audit and Risk Committee of the Raiffeisen Group, and Chairman and founding partner of kreisquadrat gmbh, the decision network. He also teaches (part-time) at the University of Lucerne, with Corporate Governance as one of his subjects. Franco Taisch held leading positions in global, medium-sized and smaller enterprises at home and abroad for over 25 years. He studied in Zurich, New York and Lausanne.

Speaking for Notenstein

The Notenstein Dialogue was led by Dr Michael Zurkinden, together with Dr Ivan Adamovich, Member of the Executive Board, Dr Eckhard Plinke, Member of the Executive Management and Head of Sustainability Research, Sascha Liniger, Macro Research, and Lotti Gerber, Communications.

The Notenstein Dialogue

The Notenstein Dialogue aims to encourage discussion and thinking around the key social and economic trends, and to identify potential consequences for investors. On a bi-monthly basis, Notenstein's experts conduct a dialogue with a leading figure from business or academia. The aim is to challenge our partner in the dialogue with our own views and theories, and thus to generate insights that can ultimately be put into practice. We are open to controversial opinions that encourage a lively dialogue. The Notenstein Dialogue takes place over several days, in written form. This form of interaction enables the calm and considered analysis of arguments – in an era often characterised by a breathless flood of information.

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General Stanley McChrystal,
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William R. White, former Economic Adviser of the BIS
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Peter Voser, former CEO of Royal Dutch Shell
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