FROM VALUE PROTECTION TO VALUE CREATION: RETHINKING CORPORATE GOVERNANCE STANDARDS FOR FIRM INNOVATION

Roger M. Barker and Iris H-Y Chiu***

ABSTRACT

A company's pro-innovation needs are often met by the exploitation of its resources, widely defined. The resource-based theory of the firm provides immense empirical insights into how a firm's corporate governance factors can contribute to promoting innovation. However, these implications may conflict with the prevailing standards of corporate governance imposed on many securities markets for listed companies, which have developed based on theoretical models supporting a shareholder-centered and agency-based theory of the firm. Although prevailing corporate governance standards can to an extent support firm innovation, tensions are created in some circumstances where companies pit their corporate governance compliance against resource-based needs that promote innovation. In the present context of steady internationalization and convergence in corporate governance standards in global securities markets towards a shareholder-centered agency-based model, we argue that there is a need to provide some room for accommodating the resource-based needs for companies in relation to promoting innovation. We explore a number of options and suggest that the most practicable option would be the development of recognized exceptions that deviate from prevailing corporate governance standards. We further suggest as to how an exceptions-based regime can be implemented in the U.K. and U.S., comparing the rules-based regime in the U.S. with the principles-based regime in the U.K.

* DPhil (Oxford); Managing Director, Barker & Associates Ltd., Honorary Associate, Centre for Ethics and Law, University College London.

** Professor of Corporate Law and Financial Regulation, University College London.

TABLE OF CONTENTS

INTRODUCTION

Firm innovation, which underpins new products and business models, is an important factor for sustained value creation by firms, bringing about their long-term success.[1] An enterprise that is able to innovate in a commercially-viable manner is well-placed to outperform its competitors and create value for investors, customers, and other stakeholders.[2] Increasingly, technological and scientific innovation is important to firms, as these are widely recognized as a major determinant of productivity growth and economic competitiveness.[3]

The innovative capacity, development, and harnessing of innovation in companies is shaped not only by market incentives but also by internal firm governance structures.[4] We survey the body of empirical literature that seeks to determine which corporate governance factors affect a company's investment or spending in research and development, and the level of innovation output (such as the number of patents filed). We find that successful companies that innovate well are often associated with all or some of the following characteristics:

(a) an entrepreneurial spirit in corporate leadership and the workforce, and an enterprising culture in the firm, including, a willingness to explore and take risks, and to dare to venture into the 'weird' and different;[5]

---

1. Federico Munari & Maurizio Sobrero, *Corporate Governance and Innovation*, *in* CORPORATE GOVERNANCE, MARKET STRUCTURE AND INNOVATION (Mario Calderini et al. eds., 2003); Gary P. Pisano, *You Need an Innovation Strategy*, HARV. BUS. REV., June 2015, at 44.

2. Kathryn M. Kelm et al., *Shareholder Value Creation During R&D Innovation and Commercialization Stages*, 38 ACAD. MGMT. REV. 770 (1995) (discussing how the different stages of innovation development and commercialization create shareholder value); Greg Statell, *Innovation is the Only True Way to Create Value*, FORBES (Nov. 29, 2015, 11:03 PM), https://www.forbes.com/sites/gregsatell/2015/11/29/innovation-is-the-only-true-way-to-create-value/#7186a77718e3 [https://perma.cc/4KJV-PWN4].

3. Nathan Rosenberg, Innovation and Economic Growth (2004) (unpublished manuscript), https://www.oecd.org/cfe/tourism/34267902.pdf [https://perma.cc/4KRU-8UUR].

4. Filippo Belloc, *Corporate Governance and Innovation: A Survey*, 26 J. ECON. SURVS. 835 (2012).

5. Charles M. Yablon, *Innovation, the State and Private Enterprise: A Corporate Lawyer's Perspective*, 40 DEL. J. CORP. L. 1017 (2016) (book review).

(b) a fluid internal work culture that prizes open-mindedness, flexibility, and a lack of hierarchy;[6]
(c) a dedication of investment into research and development, in terms of generally applying scientific and technological research but also in specific innovations[7] even if the immediate term returns are highly speculative;
(d) a long-termist approach to developing and growing the company;[8] and
(e) a willingness to access and tap into diverse and specialist skills that can be brought to the enterprise, such as having inclusive recruitment policies.[9]

These qualities suggest an intimate connection between firm-based factors and innovation in companies. However, the empirically accepted *firm-based* factors that promote innovation may not always be compatible with well-accepted corporate governance standards that are often upheld in major securities markets such as in the U.S. and the U.K. This is largely because conventional corporate governance standards tend to focus on 'value protection' for shareholders, and result in the institution of firm structures to further that objective. These structures can sometimes conflict with a firm's strategic need to innovate and engage in 'value creation' that will sustain its competitive advantage in the markets.[10]

Corporate governance standards have become increasingly convergent around a shareholder-centered model of accountability around

---

6. *Id.* at 1029.

7. Marianna Makri et al., *CEO Incentives, Innovation, and Performance in Technology-Intensive Firms: A Reconciliation of Outcome and Behavior-Based Incentive Schemes*, 27 STRATEGIC MGMT. J. 1057 (2006).

8. Nicolette C. Prugsamatz, In(Ex)ternal Corporate Governance and Innovation: A Review of the Empirical Evidence (Aug. 19, 2015) (unpublished manuscript) (on file with the Fordham Journal of Corporate & Financial Law) (recognizing that much of innovation is carried out with a view to long-term success).

9. FORBES INSIGHTS, GLOBAL DIVERSITY AND INCLUSION: FOSTERING INNOVATION THROUGH A DIVERSE WORKFORCE (July 2011), https://images.forbes.com/forbesinsights/StudyPDFs/Innovation_Through_Diversity.pdf [https://perma.cc/63QT-Z77E].

10. GUBERNA, Re-Designing Corporate Governance to Promote Innovation (Jan. 2016) (unpublished manuscript), http://www.guberna.be/sites/default/files/pubs/Redesigning%20corporate%20governance%20%20-%20position%20paper%2020%201%202016.pdf [https://perma.cc/LUE3-6YRC].

the world,[11] partly due to the theoretical appeal of the 'agency-based' perspective of economic relations[12] within the firm, and the practical financial interests of shareholders,[13] which champion this model of corporate governance. The globally dominant corporate governance standards are referred to in this Article as those established from a 'shareholder-centered agency-based' model. We argue that these standards insufficiently cater to the needs of firms in their strategic endeavors towards value creation. Therefore, we suggest modifications to these standards on the basis of a more robust account of corporate governance that consolidates insights from a *resource-based theory.*

Part I of this Article discusses the nature of 'shareholder-centered agency based' corporate governance standards and their rise in international capital markets. This part argues that although the key characteristics of such standards are not necessarily antagonistic to promoting innovation, the underlying theoretical model has little to contribute to promoting innovation.[14] This is because it focuses excessively on incentive-based individual economic behavior, while neglecting the enterprise context of the firm. This underlying theoretical model does not cater adequately to advancing the needs of coordination within the enterprise and the pursuit of collective enterprise success, ultimately affecting the usefulness of corporate governance standards based on such a model.

Part II argues that there is significant consistency between a resource-based theoretical perspective of the firm and empirical research findings on the corporate governance factors relevant for promoting innovation. We discuss the nature and key characteristics of this

---

11. Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1 (2011); *see also infra* Part III.

12. *See infra* Part II. The rationale for the theoretical appeal is explained in Allen Kaufman & Ernie Englander, *A Team Production Model of Corporate Governance*, 19 ACAD. MGMT. EXECUTIVE, Aug. 2005, at 9.

13. The rise of institutional investors and asset managers as major global shareholders is a key factor for influencing corporate governance standards maintained by many securities markets. Global securities markets have therefore been subject to competitive pressures in enhancing these standards and moving towards convergence in various degrees. *See, e.g.*, Mary O'Sullivan, *The Political Economy of Comparative Corporate Governance*, 10 REV. INT'L POL. ECON. 23 (2003); *see also infra* Part III.

14. EUROPEAN COMM'N, EU SOCIO-ECONOMIC RESEARCH: CORPORATE GOVERNANCE, INNOVATION AND ECONOMIC PERFORMANCE IN THE EU—CGEP 73 (William Lazonick & Mary O'Sullivan eds., 2004), http://cordis.europa.eu/docs/publications/7059/70595671-6_en.pdf [https://perma.cc/9QFV-MNNN].

theoretical perspective and how it practically supports the promotion of firm innovation. In this part, we highlight the tensions between the needs of firm innovation and the application of 'shareholder-centered agency-based' corporate governance standards.

Part III proceeds to discuss how the tensions between firm needs in innovation and adherence to conventional corporate governance standards may be addressed under two options. One is reliance on shareholders to play a greater role in 'stewardship' or 'engagement' to address each firm's needs. After all, conventional corporate governance standards are based on protecting shareholder value and mitigating the agency problem. Hence, shareholders can be placed back in the heart of the matter for establishing the nature and purpose of corporate governance standards. We highlight the regimes maintained by the key U.S. and U.K. securities markets and discuss the salience of shareholders in both markets. In particular, we discuss whether shareholder stewardship provides an adequate answer to the dilemma between upholding value-protection and value-creation priorities, but ultimately suggest that this option does not adequately meet firm innovation needs.

Second, we look into the possibility of refinement and adjustment of conventional corporate governance standards and suggest how 'shareholder-centered agency based' corporate governance standards may be adjusted to reflect the needs for promoting firm innovation. We argue that the resource-based theoretical perspective pursues the same ultimate objective as a 'shareholder-centered agency-based' corporate governance model, i.e. corporate success, but more accurately and holistically takes into account the productive activities and enterprise of the firm. Hence, subscribing to 'value creation' encompasses and goes beyond the objective of 'value protection' and is not inconsistent with the shareholder-centered agency-based model. We advocate that corporate governance standards should embody both individualistic and collective economic behavior to better cater to the needs of promoting firm innovation.

In Part IV, we provide suggestions for key adjustments in conventional corporate governance standards. Our stance is that boards, shareholders, and stakeholders can all be viewed differently from a resource-based perspective, giving us a new basis for the adjustment of prevailing corporate governance standards. Boards should ensure that companies have adequate access to a range of resources for innovation and also have a role to play in monitoring that such resources are harnessed and well-utilized. This part also reflects on the implications of our arguments for implementation in the U.K. and U.S. securities markets. We argue that implementation variations will feature different drawbacks in each jurisdiction due to the U.K.'s principle-based approach to corporate governance standards and the U.S.'s rule-based approach to corporate governance rules in the securities markets. Part V concludes.

I. CONVENTIONAL CORPORATE GOVERNANCE STANDARDS AND FIRM INNOVATION

Corporate governance models have been developed in theory since Berle and Means investigated in the 1930s the implications of the 'modern corporation' for the allocation of powers within a corporate structure.[15] As Moore and Petrin point out, although a number of theoretical models of corporate governance have been debated over the years in academia, across inter-disciplinary fields in economics, law, and organization, the model of corporate governance that has most profoundly influenced the modern development of corporate law and governance standards (which may be in Listing Rules of securities markets or 'soft law,' i.e. in non-binding codes of best practices) is the 'orthodox' contractarian model of corporate governance.[16]

The 'orthodox' contractarian model of corporate governance highlights corporate governance as essentially economic and contractual relations. In 1937, Coase's seminal work "The Nature of the Firm" provided the foundation upon which the contractarian conception of the corporation became a dominant intellectual paradigm.[17] The firm is characterized as a nexus of transactions that are 'internalized' because of the transaction cost-efficiencies of such arrangements as compared to market-based contracting.

The contractarian approach sees the firm as a nexus of contracts entered into by volition, and as a structure that internalizes a web of these arrangements. The individuality of these economic transactions remains paramount in relation to allocation of powers and rights and this model does not treat the firm as a collective institution of its own salience.

15. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1967).

16. MARC MOORE & MARTIN PETRIN, CORPORATE GOVERNANCE: LAW, REGULATION AND THEORY 23–45 (2017).

17. R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

Hence, the role of corporate law, boosted by the rise of the law and economics movement, deals with making such contractual relations efficacious. Staunch contractual theorists in corporate law support the role of corporate law as an enabling or facilitative framework so that contracting parties may decide how their relations may be governed.[18] Brudney and Bebchuk have pointed out that it is a myth that constituents in a corporation actively engage in contractual bilateralism to determine the substantive governance of their relations. However, theorists argue that the contractarian model can be supported on the basis of 'hypothetical bargains.'[19]

Hypothetical bargains are premised upon models of economic behavior on the part of the firm's constituents.[20] From the 1970s, theoretical milestones have been reached in establishing such models of economic behavior. Alchian and Demsetz analyze transactional behavior within the firm in terms of 'complete' and 'incomplete' contracts according to the efficiency needs of each constituent and conclude that shareholders are 'special' as they make open-ended contracts to invest their capital into a firm but bear the ultimate risk of the firm's insolvency.[21] Shareholders should thus be residual claimants of the firm's assets in insolvency. Jensen and Meckling further frame the residual claimant's position in the firm as subject to an 'agency' paradigm where managerial control of corporate assets could be adverse to residual claimants' interests, in cases where managers and shareholders are different persons.[22]

---

18. William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982); Fred S. McChesney, *Contractarianism Without Contracts? Yet Another Critique of Eisenberg*, 90 COLUM. L. REV. 1332 (1990); Manuel A. Utset, *Towards a Bargaining Theory of the Firm*, 80 CORNELL L. REV. 540 (1995).

19. Lucian Ayre Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); Lucian Ayre Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985).

20. David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815 (1991).

21. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

22. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

Hence, a key hypothetical bargain between shareholders and managers—as championed in Easterbrook and Fischel's influential thesis—is that the role of corporate law is to provide a default set of rules[23] that protect shareholders' residual claimant interests by having their interests form the objective for corporations. Shareholder primacy frames the corporate objective of the company, which as Easterbrook and Fischel argue, is 'shareholder wealth maximization' as the default and commonly accepted norm that most investors would subscribe to.[24] This objective provides a single-minded focus for managers and is an efficient axis for economic organization.[25] In this light, managers are disciplined, especially in publicly-traded corporations, by the share price of the company that embodies information signals as to financial performance—a proxy indicator for shareholders to determine whether managers are indeed effectively maximizing the value of the corporation.

The agency paradigm also frames corporate governance needs as revolving around controlling managerial 'agency' problems. This is realized through the allocation of powers in company law in favor of shareholders as well as the financial discipline of shareholder primacy upon directors. For example, in the U.K., shareholders are (a) the subjects of directors' accountability,[26] (b) the organ to exercise key powers in

---

23. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 23–25, 34–35 (1991).

24. *Id.* at 28–29.

25. Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197 (1984).

26. Companies Act 2006, c. 46, § 172 (UK), explicitly provides that directors' duties are to promote the long-term success of the company for the benefit of the members as a whole. This has come to be coined as 'enlightened shareholder value,' a long-termist and more inclusive perspective for corporate performance, but revolving around shareholders. However, many commentators are of the view that the focus on shareholder value will unlikely introduce any revolutionary move in directors' conduct towards stakeholders. *See, e.g.*, Paul L. Davies, Cassel Professor of Commercial L., London Sch. of Econ. & Political Sci., W.E. Hearn Lecture at the University of Melbourne Law School: Enlightened Shareholder Value and the New Responsibilities of Directors (Oct. 4, 2005), http://law.unimelb.edu.au/__data/assets/pdf_file/0014/1710014/94-Enlightened_Shareholder_Value_and_the_New_Responsibilities_of_Directors1.pdf [https://perma.cc/H49P-AU3T]; *see also* Andrew Keay, *Section 172(1) of the Companies Act 2006: An Interpretation and Assessment*, 28 COMPANY LAW. 106 (2007); Elaine Lynch, *Section 172: A Ground-Breaking Reform of Director's Duties, or the Emperor's New Clothes?*, 33 COMPANY LAW. 196 (2012); Richard Williams, *Enlightened Shareholder Value in UK Company Law*, 35 U.N.S.W. L.J. 360 (2012).

certain aspects of decision-making in the company,[27] and (c) the constituents whose capital return interests should form the basis for corporate management.[28]

The shareholder-centered agency-based model of corporate governance is most closely reflected in Anglo-American corporate law and corporate governance standards maintained by the U.S. and U.K. securities markets. Although Bruner argues that the extent of shareholder powers enjoyed in the U.K. is more extensive than in the U.S.,[29] the U.S. corporate sector accepts the legitimacy of 'shareholder value' as a key corporate objective,[30] and accountability lies with shareholders for the

27. Such key aspects include: the appointment and removal of directors, Companies Act 2006, c. 46, § 168 (UK); the power to approve of certain transactions such as loans and guarantees to directors or substantial transactions to directors, long-term incentive arrangements and payments for loss of office, *id.* at § 188ff; the power to ratify directors' breaches of duties or defaults, *id.* at § 239; the power to direct management in a specific matter by special resolution, The Companies (Model Articles) Regulations 2008, SI 2008/3229, art. 4 (UK); and a power to approve (or otherwise) directors' remuneration packages on a three-year basis, Companies Act 2006, c. 46, § 439A (UK). Shareholders also have extensive powers to determine capital restructuring, such as approval of capital reduction or redemption of shares, *id.* §§ 641, 659; and are the key organ to determine if a takeover of the company is approved, *see* John Armour et al., *Shareholder Primacy and the Trajectory of UK Corporate Governance* (Univ. of Cambridge, Econ. & Soc. Research Council, Ctr. for Bus. Research, Working Paper No. 266, 2003), http://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp266.pdf [https://perma.cc/H7TG-79XG].

28. Shareholders are treated by economists as 'residual claimants,' meaning that their supply of capital to the company is under an open-ended arrangement which renders them liable to be ultimate losers if the company should fail. The 'residual claimant' status of the shareholders therefore requires protection so that managers do not abuse the privilege of being in control of the use and application of capital. *See* Alchian & Demsetz, *supra* note 21; Williamson, *supra* note 25.

29. CHRISTOPHER M. BRUNER, CORPORATE GOVERNANCE IN THE COMMON LAW WORLD: THE POLITICAL FOUNDATIONS OF SHAREHOLDER POWER (2013).

30. Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135 (2012); Leo E. Strine, Jr., *Corporate Power is Corporate Purpose I: Evidence from My Hometown* (Univ. of Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 16-34, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2906875 [https://perma.cc/BPC2-PU5S].

exercise of managerial powers.[31] Indeed, shareholders' formal powers[32] and their activism is on the rise in the U.S.,[33] with the growth of institutional shareholder influence in global capital markets.

The shareholder-centered agency-based model of corporate governance has found international admiration, as by the end of the 1990s[34]—the success of the American economy drew attention to the successes of its corporate governance model. Further, studies of incidents of corporate failure highlight that poor corporate governance can often be a significant factor in firm failures.[35] It may be too simplistic to say that adhering to the conventionally accepted standards of corporate governance in accordance with the shareholder-centered agency-based model is a panacea for boosting corporate performance,[36] but empirical

---

31. Reflected in the investor-focused accountability regimes for corporations such as in securities regulation; *see also* sources cited *supra* note 30.

32. Thomas and Tricker's empirical research on shareholder voting in the U.S. concludes that shareholders' powers are more nuanced than thought, and significant influence can be exerted in proxy contests. *See* Randall S. Thomas & Patrick C. Tricker, *Shareholder Voting in Proxy Contests for Corporate Control, Uncontested Director Elections and Management Proposals: A Review of the Empirical Literature*, 70 OKLA. L. REV. 9 (2017).

33. From the model of 'fiduciary capitalism' and 'universal owners' championed in relation to pension funds, *see* JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC (2000); ROBERT A.G. MONKS, THE NEW GLOBAL INVESTORS: HOW SHAREHOLDERS CAN UNLOCK SUSTAINABLE PROSPERITY WORLDWIDE (2001); to modern forms of shareholder activism carried out by hedge funds, *see* John Armour & Brian Cheffins, *The Rise and Fall (?) of Shareholder Activism by Hedge Funds*, 14 J. ALTERNATIVE INV. 17 (2012); Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459 (2013).

34. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

35. Abe de Jong et al., *Investor Relations, Reputational Bonding, and Corporate Governance: The Case of Royal Ahold*, 26 J. ACCT. & PUB. POL'Y 328 (2007); Robert Eli Rosen, *Risk Management and Corporate Governance: The Case of Enron*, 35 CONN. L. REV. 1157 (2003).

36. Rob Bauer et al., *Empirical Evidence on Corporate Governance in Europe: The Effect on Stock Returns, Firm Value and Performance*, 5 J. ASSET MGMT. 91 (2004); Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009); Sanjai Bhagat & Brian Bolton, *Corporate Governance and Firm Performance*, 14 J. CORP. FIN. (2008); Andreas Bermig & Bernd Frick, Board Size, Board Composition and Firm Performance: Empirical Evidence from Germany (May 2010) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1623103 [https://per

research consistently finds that returns on investment may be higher where companies implement such standards.[37] Hence, corporate governance standards have become increasingly integral to global securities regulation since they are perceived in capital markets to be important contributors to corporate success and performance. Capital markets promote these standards through increasing prescription or legalization for their listed companies' adoption, in order to promote the appeal of their markets to investors.[38]

Shareholder-centered agency-based corporate governance standards appeal to institutional investors, who have become the most important type of investor in global corporate equity.[39] According to a survey carried out by PwC, global assets under management total $64 trillion and are predicted to increase to $102 trillion by 2020.[40] As institutions are also minority investors in corporate equity, they rely on the existence of good

---

ma.cc/UYA4-LBKH]; Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance (Dec. 7, 2004) (unpublished manuscript), http://ssrn.com/abstract=586423 [https://perma.cc/Y3WA-NXD4]; N. K. Chidambaran et al., Corporate Governance and Firm Performance: Evidence from Large Governance Changes (Jan. 2008) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108497 [https://perma.cc/79VX-NZGS]; Charles Weir et al., An Empirical Analysis of the Impact of Corporate Governance Mechanisms on the Performance of UK Firms (Oct. 10, 2001) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=286440 [https://perma.cc/EEX3-BL4T].

37. Brown & Caylor, *supra* note 36; David F. Larcker et al., How Important is Corporate Governance? (May 2005) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=595821 [https://perma.cc/6N53-GBCN]; R. Madhumathi & M. Ranganatham, Earnings Quality, Corporate Governance and Firm Performance (June 22, 2011) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1867869 [https://perma.cc/4VE2-G4K2]; Carol Padgett & Amama Shabbir, *The UK Code of Corporate Governance: Link Between Compliance and Firm Performance* (ICMA Ctr. Discussion Papers in Fin., No. DP2005-17, 2005), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=934313 [https://perma.cc/48L3-EPUT].

38. Tobias H. Tröger, *Corporate Governance in a Viable Market for Secondary Listings*, 10 U. PA. J. BUS. & EMP. L. 89 (2007) (arguing that securities regulation has come to brand the U.S. listed markets).

39. ROGER M. BARKER & IRIS H.-Y. CHIU, CORPORATE GOVERNANCE AND INVESTMENT MANAGEMENT: THE PROMISES AND LIMITATIONS OF THE NEW FINANCIAL ECONOMY 10–61 (2017).

40. PWC, ASSET MANAGEMENT 2020: A BRAVE NEW WORLD (2014), https://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf [https://perma.cc/4VXC-HUHH].

corporate governance standards adopted by firms as being essential to protecting their investment interests.[41] With increasing global assets under management, the investment management sector is becoming more influential in regards to the terms that govern investments made in securities markets. Anglo-American institutions are a significant institutional sector and they continue to demand robustly implemented corporate governance standards in listed issuers,[42] many of which reflect the shareholder-centered agency-based model of corporate governance, focusing on subjecting directors to adequate monitoring and accountability, and empowering shareholders to exercise powers in engagement and scrutiny.

We observe the internationalization of corporate governance standards that meet the needs of regulatory competition in globally competitive securities markets.[43] Broad patterns of international

---

41. Stuart L. Gillan & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, 13 J. APPLIED FIN., Fall/Winter 2003, at 4; James P. Hawley & Andrew T. Williams, *Shifting Ground: Emerging Global Corporate-Governance Standards and the Rise of Fiduciary Capitalism*, 37 ENV'T & PLAN. 1995 (2005).

42. There is much empirical evidence on the increased valuation of companies on securities markets driven by investor preferences where good corporate governance is instituted. *See* Fabio Bertoni et al., *Board Independence, Ownership Structure and the Valuation of IPOs in Continental Europe*, 22 CORP. GOVERNANCE: INT'L REV. 116 (2014); Kee H. Chung & Hao Zhang, *Corporate Governance and Institutional Ownership*, 46 J. FIN. & QUANTITATIVE ANALYSIS 247 (2011); Armand Picou & Michael J. Rubach, *Does Good Governance Matter to Institutional Investors? Evidence from the Enactment of Corporate Governance Guidelines*, 65 J. BUS. ETHICS 55 (2006); Brown & Caylor, *supra* note 36 (arguing that there are only a few cherished corporate governance notions that make a difference, for example, independent directors).

43. Earlier literature on convergence driven by institutions are more broad-brush and optimistic. *See* MICHAEL USEEM, INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA (1996). Also see the strand of literature on nuanced forms of and drivers for convergence in corporate governance standards. WEIL, GOTSHAL & MANGES LLP, COMPARATIVE STUDY OF CORPORATE GOVERNANCE CODES RELEVANT TO THE EUROPEAN UNION AND ITS MEMBER STATES (2002), http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf [https://perma.cc/AD3H-JMUU] (pointing out significant convergence in codes although not in company law); Ilir Haxhi & Ruth V. Aguilera, *Are Codes Fostering Convergence in Corporate Governance? An Institutional Perspective*, *in* THE CONVERGENCE OF CORPORATE GOVERNANCE: PROMISE AND PROSPECTS 234 (Abdul A. Rasheed & Toru Yoshikawa eds., 2012); Toru Yoshikawa & Abdul A. Rasheed, *Convergence of Corporate Governance: Critical Review and Future Directions*, 17

convergence[44] can be found in corporate governance standards that address the agency problem of overly-powerful management in widely-held companies.[45] In particular, independent board representation has become a key building block in corporate governance standards. Empirical literature has measured convergence in corporate governance standards internationally and records that notable convergence has taken place in standards that are particularly valued for minority shareholder protection.[46] However, regional fragmentations in corporate governance standards[47] show that the dialectics of contention between issuers, investors, and policy-makers will continue to sustain some of the unique differences in corporate governance standards upheld in each securities market.[48]

The dominance of the agency-based perspective of corporate governance in the leading global securities markets—such as New York, London, and Hong Kong—has shaped both the content of corporate governance standards as well as international standardization to some extent. Even countries that have adopted stakeholder models of corporate governance such as Japan are driving greater shareholder empowerment[49]

CORP. GOVERNANCE: INT'L REV. 388 (2009); Gerald Davis & Christopher Marquis, *The Globalization of Stock Markets and Convergence in Corporate Governance* (Ctr. for the Study of Econ. & Soc'y, Working Paper No. 7, 2003), http://www.economyandsociety.org/wp-content/uploads/2013/08/wp7.pdf [https://perma.cc/48H8-VSXP].

44. Hopt, *supra* note 11; O'Sullivan, *supra* note 13.

45. Such as the institutionalization of independent board representation and the independent audit committee of the board. *See* Paul L. Davies & Klaus J. Hopt, *Boards in Europe—Accountability and Convergence*, 61 AM. J. COMP. L. 301 (2013).

46. Mathias M. Siems, *Convergence in Corporate Governance: A Leximetric Approach*, 35 J. CORP. L. 729 (2010); Carsten Gerner-Beuerle, *Diffusion of Regulatory Innovations: The Case of Corporate Governance Codes*, 13 J. INSTITUTIONAL ECON. 271 (2017).

47. Gerner-Beuerle, *supra* note 46.

48. Detailed studies can be found in THE CONVERGENCE OF CORPORATE GOVERNANCE: PROMISE AND PROSPECTS 234 (Abdul A. Rasheed & Toru Yoshikawa eds., 2012).

49. See the Japanese Stewardship Code which is intended to encourage greater shareholder engagement with their investee companies. Principles for Responsible Institutional Investors [Japan's Stewardship Code], 2014 (Japan), http://www.fsa.go.jp/en/refer/councils/stewardship/20140407/01.pdf [https://perma.cc/2553-2MML].

in a bid to reinvigorate the corporate sector and weed out the malaises of executive entrenchment.[50]

Although the shareholder-centered agency-based model of corporate governance has influenced global standards and standardization, it is fundamentally a model based on individualistic economic behavior within the firm, premised upon opportunistic assumptions of human behavior. It does not take into account whether economic behavior adjusts in relation to the context of the 'collective enterprise' that is being pursued by constituents of the firm.[51] The behavior of individual economic constituents that are brought together for the common purpose of the enterprise of the firm can be shaped by the sociological dimension of their interactions and the sense of collective purpose in the common enterprise. The shareholder-centered agency-based model of corporate governance has little to say about how economic constituents engage in and organize productive activities for the purpose of enterprise, hence its relation to firm innovation is remote and skeletal at best.

Shareholder-centered agency-based corporate governance standards may hinder firm innovation[52] in the following ways:

(a) As the key tenet of such a corporate governance model is based on 'monitoring'—i.e. boards to monitor CEOs and executives, and shareholders to monitor boards, so that controlling constituents of corporate assets do not use them for selfish purposes—the 'monitoring' ethos creates a culture of critical scrutiny and risk aversion, which can be disincentivizing for fostering an entrepreneurial spirit or culture.[53]

(b) A 'monitoring' model of corporate governance focuses on financial performance monitoring as a key means to monitor. This is because financial performance provides a proxy for general well-being, and monitoring at 'arm's length' requires reliance upon such proxy indicators. This approach is taken by independent directors 'monitoring' the rest of the board without

50. Bruce E. Aronson, *The Olympus Scandal and Corporate Governance Reform: Can Japan Find a Middle Ground between the Board Monitoring Model and Management Model?*, 30 UCLA PAC. BASIN L.J. 93 (2012).

51. Kathleen R. Conner & C. K. Prahalad, *A Resource-based Theory of the Firm: Knowledge Versus Opportunism*, 7 ORG. SCI. 477 (1996).

52. Position taken in GUBERNA, *supra* note 10.

53. Yablon, *supra* note 5.

necessary inside knowledge[54] and by shareholders 'monitoring' the board. An emphasis on financial performance monitoring creates incentives towards minimizing expenditure, and investment in research and development could be regarded as costly without bringing in sure and quick returns.[55]

(c) A 'monitoring' model of corporate governance that focuses on financial performance monitoring is likely to tend towards managerial short-termism as financial performance is scrutinized quarterly by shareholders.[56] Short-termism has been highlighted to be a malaise for the corporate sector as it may damage the sector's long-term success and its socially beneficial role in value creation for savers and investors.[57] Shareholders focused upon short-termist 'monitoring' may be seen to 'protect value' in the short-term, but this may indeed hinder corporations from engaging in long-termist expenditures and development that may not quickly generate returns in the short-term.

It may however be argued that the shareholder-centered agency-based model of corporate governance is relevant to innovation as a 'monitoring' model is able to check the exercise of corporate powers over assets.[58] The aim is to ensure that corporate assets are used to secure the company's financial performance, which protects and enhances shareholders' wealth. Where promoting innovation is relevant to the financial success of the company, a 'monitoring' model could in theory

---

54. Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV. 72 (1990).

55. Bengt Holmstrom, *Agency Costs and Innovation*, 12 J. ECON. BEHAV. & ORG. 305 (1989).

56. Emeka Duruigbo, *Tackling Shareholder Short-Termism and Managerial Myopia*, 100 KY. L.J. 531 (2011); Caitlin Helms et al., *Corporate Short-Termism: Causes and Remedies*, 23 INT'L COMPANY & COM. L. REV. 45 (2012).

57. ASPEN INST.: BUS. & SOC'Y PROGRAM, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT (2009), https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/overcome_short_state0909_0.pdf [https://perma.cc/3CC9-WSRA]; DEP'T FOR BUS., INNOVATION & SKILLS, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING (July 2012), http://www.ecgi.org/conferences/eu_actionplan2013/documents/kay_review_final_report.pdf [https://perma.cc/R68J-LS5R].

58. Matthew O'Connor & Matthew Rafferty, *Corporate Governance and Innovation*, 47 J. FIN. & QUANTITATIVE ANALYSIS 397 (2012).

prevent corporate powers from being exercised in ways that diminish a company's success. In this way, the shareholder-centered agency-based corporate governance model can promote innovation in relation to providing the boundaries for legitimate exercises of managerial power. The 'protective' element in the 'monitoring' model therefore is arguably able to facilitate value creation through its protection. For example, a key tenet of the 'monitoring' model of corporate governance is the institution of independent directors on the board.[59] These are regarded as well-placed to ensure that executive directors are not self-serving in their pursuits. In one sense, they could be regarded as adverse to innovation as their monitoring emphasis could distract the board from focusing on innovative and strategic directions.[60] However, different commentators have also found in empirical research that independent directors are pro-innovation from *both* the agency-based perspective of corporate governance and the resource-based perspective discussed below. Kor finds that a significant level of board independence, such as the separation of the CEO from the Chairman of the board, is positively correlated with higher levels of Research and Development (R&D) investments.[61] Independence on the board can promote strategic views towards the long-term good of the company and mitigates the self-serving tendencies on the board. That said, some commentators are skeptical that director independence is a factor that promotes innovation, as independent directors do not have sufficient proximity to the business to be strategically useful in promoting innovation.[62]

As we have pointed out in (c) above, 'value protection' is not necessarily synonymous with 'value creation.' This is because 'value protection' can be excessively perceived through the lens of short-term

---

59. Haxi & Aguilera, *supra* note 43; Yoshikawa & Rasheed, *supra* note 43; Davis & Marquis, *supra* note 43.

60. Erik P.M. Vermeulen et al., *Intelligent Cars Inc. - Governance Principles to Build a Disruptive Company* (Lex Research Topics in Corp. L. & Econ., Working Paper No. 2016-6, 2016), http://ssrn.com/abstract=2823006 [https://perma.cc/YHF4-Z5H6].

61. Yasemin Y. Kor, *Direct and Interaction Effects of Top Management Team and Board Compositions on R&D Investment Strategy*, 27 STRATEGIC MGMT. J. 1081, 1093 (2006).

62. Barry D. Baysinger et al., *Effects of Board and Ownership Structure on Corporate R&D Strategy*, 34 ACAD. MGMT. J. 205 (1991); Krishnamurti Chandrasekar & Haiyun Ren, *Review of Relationship Between Corporate Governance and R&D Input*, 2 J. APPLIED FIN. RES. 37 (2012).

financial performance, and risks of expenditure taken towards longer-term 'value creation' may not always be valued by shareholders.

Nevertheless, from the corporate finance perspective of shareholder primacy, access to stock market financing can be improved if firms demonstrate optimal shareholder-friendly standards.[63] As access to stock market financing can improve a company's capacity to invest in innovation, adhering to agency-based corporate governance standards that promote shareholder rights and protection is arguably not in conflict with a pro-innovation strategy.[64] This seems to be especially important where stock markets are not already highly developed,[65] especially in emerging countries.[66] Lazonick and Sullivan critically opine that stock market financing is not a major source of finance for innovation.[67] That said, the ready access to a stock market can incentivize support for innovation in other ways. For example, venture capitalists may be more willing to invest as they eventually look to stock markets for exit, and employee stock options can be used to motivate a greater sense of employee commitment and productivity.

Finally, empirical research has not found an adverse impact between institutional shareholdings and the level or commitment to innovation in companies. Indeed, to the contrary, institutional shareholding seems positively related to promoting innovation. The relevance of investigating into the influence of institutional shareholding is that such shareholders are often regarded to be short-termist and excessively concerned with

---

63. Soo H. Lee & Taeyoung Yoo, *Competing Rationales for Corporate Governance in France: Institutional Complementarities between Financial Markets and Innovation Systems*, 16 CORP. GOVERNANCE: INT'L REV. 63 (2008).

64. David Hillier et al., *The Impact of Country-Level Corporate Governance on Research and Development*, 42 J. INT'L BUS. STUD. 76 (2011); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

65. Stéphane Lhuillery, *The Impact of Corporate Governance Practices on R&D Intensities of Firms: An Econometric Study on French Largest Companies*, (École Polytechnique Fédérale de Lausanne, CEMI Working Paper No. 2009-006, 2009), http://ssrn.com/abstract=1426089 [https://perma.cc/UM7D-724R].

66. Domagoj Račić et al., *The Effects of the Corporate Governance System on Innovation Activities in Croatia*, 39 REVIJA ZA SOCIOLOGIJU 101 (2008); Hui He et al., Does Stock Market Boost Firm Innovation? Evidence from Chinese Firms (Apr. 9, 2016) (unpublished manuscript), http://ssrn.com/abstract=2759516 [https://perma.cc/3CBF-4SXT].

67. EUROPEAN COMM'N, *supra* note 14.

value protection.[68] Their regular legal duties of accountability to their beneficiaries in terms of financial performance in their investments make them susceptible to these tendencies. Brossard et al. examine the relationship between ownership structures in a sample of 234 large European companies and their innovative activity in terms of R&D spending.[69] They found that institutional investors have a positive impact on companies' R&D spending. However, different institutional investors seem to create different influences, with impatient investors being antithetical to promoting innovation. Pension funds are regarded as long-termist and positive influencers, while mutual funds are short-termist and impatient. Aghion et al. have also arrived at a similar conclusion.[70] They assembled a dataset of 800 major U.S. firms over the 1990s containing time-varying information on patent citations, ownership, R&D, and governance. They found a robust positive association between innovation and institutional ownership. Their findings provide support for the validity of the agency-based perspective of corporate governance in relation to promoting innovation in companies—that the disciplinary effect of institutional share ownership, despite its short-termist tendencies, motivates the 'lazy manager' to engage in innovation in order to improve corporate performance.

The empirical literature discussed above does not point to the complete incompatibility of shareholder-centered agency-based corporate governance standards with the needs of corporate innovation. However, it may be argued that the connection between protecting shareholders and creating value through promoting innovation is still remote. The limitations of the model fails to take into account the holistic perspectives regarding the organization of collective productive activity by constituents of the firm, and may reinforce certain incentives that undercut such productive activity.

In the next part, we discuss findings from empirical research regarding what firm-based factors matter for firm innovation. These

---

68. Paul Frentrop, Lecture at Nyenrode Business University: Short-termism of Institutional Investors and the Double Agency Problem (June 25, 2012), http://ssrn.com/abstract=2249872 [https://perma.cc/5H8J-8DPE].

69. Olivier Brossard et al., Ownership Structures and R&D in Europe: The Good Institutional Investors, the Bad and Ugly Impatient Shareholders (July 15, 2013) (unpublished manuscript), https://halshs.archives-ouvertes.fr/halshs-00843984/document [https://perma.cc/TN9G-C3UX].

70. Philippe Aghion et al., *Innovation and Institutional Ownership*, 103 AM. ECON. REV. 277 (2013).

results demonstrate that adopting a resource-based theory of corporate governance is better aligned with promoting innovation, but this theory has implications for how corporate governance should be conceived of as a model, and consequently, the corporate governance standards that should be regarded as optimal. These implications create tension with the shareholder-centered agency-based model of corporate governance, which we explore.

II. FIRM-BASED FACTORS SUPPORTING INNOVATION AND THE RESOURCE-BASED THEORY OF CORPORATE GOVERNANCE

Empirical literature has provided a variety of insights into the firm-based factors that support innovation. Our survey of such literature shows that a resource-based theory of the firm most closely explains the salience of these factors.

The resource-based theory of the firm was first developed by commentators in business management literature who sought to shed light on why certain firms maintain a sustained competitive advantage over other firms and are therefore successful in value creation over the long term. Commentators are of the view that firms sustain a competitive advantage because they are able to exploit resources that are rare, valuable, and not easily imitable or substitutable.[71] These resources may range from a firm's internal resources or external resources that the firm is able to exploit successfully. Such resources may be 'sticky' to the firm due to the firm's unique connections with them, or their lack of mobility or homogeneity in the market.[72] The resource-based theory of the firm has been developed intensely since the 1990s, offering an alternative account of the firm other than contractarianism,[73] and can now be considered a

71. As an example of other similarly themed works by Barney, see Jay B. Barney, *Firm Resources and Sustained Competitive Advantage*, *in* 17 ECONOMICS MEETS SOCIOLOGY IN STRATEGIC MANAGEMENT 203 (Joel A.C. Baum & Frank Dobbin eds., 2000). *See also* Birger Wernerfelt, *A Resource-Based View of the Firm*, 5 STRATEGIC MGMT. J. 171 (1984). The resource-based view is often traced back to EDITH PENROSE, THE THEORY OF THE GROWTH OF THE FIRM (1958).

72. Margaret A. Peteraf, *The Cornerstones of Competitive Advantage: A Resource-Based View*, 14 STRATEGIC MGMT. J. 179 (1993).

73. Conner & Prahalad, *supra* note 51.

relatively mature theory[74] of interdisciplinary import, connecting with business management, organization science, economic theories of the firm, and corporate governance and law.[75]

Innovation is promoted in a firm when resources with innovative potential are perceived and developed.[76] As our survey from empirical research suggests, the corporate governance of a firm is intimately connected with the perception and development of such innovative potential. Corporate governance is the system in a firm that organizes the exercise of managerial leadership and power, structures the functions and responsibilities within the firm, and mobilizes human capital for corporate objectives.[77] Corporate governance affects the level and quality of firm innovation in three ways. The first is related to the firm's access to resources at all levels in the firm; the second relates to incentives (affecting all levels of individuals, especially senior management) to pursue innovation; and the third relates to structures for governing innovation in firms.

A. ACCESS TO RESOURCES AND INCENTIVIZING THE DEVELOPMENT OF SUCH RESOURCES

Our survey shows that access to resources in terms of human, social, stakeholder, and financial capital is important in facilitating innovation in firms. Firms that promote such access are likely to harness more innovative potential than firms that are hamstrung in pursuing such

---

74. Jay B. Barney et al., *The Future of Resource-Based Theory: Revitalization or Decline?*, 37 J. MGMT. 1299 (2011).

75. Barney et al., *supra* note 74; Francisco José Acedo et al., *The Resource-Based Theory: Dissemination and Main Trends*, 27 STRATEGIC MGMT. J. 621 (2006).

76. Reginald A. Litz, *A Resource-based-view of the Socially Responsible Firm: Stakeholder Interdependence, Ethical Awareness, and Issue Responsiveness as Strategic Assets*, 15 J. BUS. ETHICS 1355 (1996).

77. The Organisation for Economic Co-operation and Development (OECD) Corporate Governance Principles defines corporate governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." ORG. FOR ECON. CO-OPERATION & DEV., G20/OECD PRINCIPLES OF CORPORATE GOVERNANCE (2015), http://www.oecd-ilibrary.org/docserver/download/2615021e.pdf?expires=1511800123&id=id&accname=guest&checksum=C3754AE47D70883CB900294DD6F05F3F [https://perma.cc/E6ZK-7HS9].

access. The shareholder-centered agency-based corporate governance standards could be a basis for hindering some forms of 'access,' and creates tensions between a firm's need to promote innovation and to comply with prevailing standards in order to demonstrate an appealing system of corporate governance to securities markets.

B. BOARDS AS RESOURCES

First, board members are viewed as key resources for the firm's success. From a resource-based perspective, board members bring expertise and skills that the company can draw upon for innovative strategies. Empirical research demonstrates that 'inside' directors—i.e. executive directors who have knowledge of the company's business position and needs—are more important for corporate innovation than outside or independent directors.[78] This may create tension with the convention in agency-based corporate governance that prizes independent directors as a monitoring force on boards. Indeed, the U.K.'s Corporate Governance Code requires premium-listed companies on the London Stock Exchange to fill at least half their boards with independent directors.[79] Moreover, empirical research demonstrates that independent directors only bring about pro-innovation influence if they are appointed for their complementary expertise and skills,[80] affirming a resource-based view of the importance of boards to corporate innovation. The resource-based view of board composition would entail different outcomes for board appointments from the shareholder-centered agency-based perspective, which emphasizes independence and directors' ability to critically scrutinize and hold to account executive decisions.[81]

---

78. Baysinger et al., *supra* note 62; Houman B. Shadab, *Innovation and Corporate Governance: The Impact of Sarbanes-Oxley*, 10 U. PA. J. BUS. & EMP. L. 955 (2008).

79. FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE § B.1.2 (Apr. 2006), https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf [https://perma.cc/P896-CBJM].

80. Benjamin Balsmeier et al., *Outside Directors on the Board and Innovative Firm Performance*, 43 RES. POL'Y 1800 (2011); Jun-Koo Kang et al., *Friendly Boards and Innovation*, 45 J. EMPIRICAL FIN. 1 (2018).

81. The importance of independent directors is discussed as a point of international convergence *infra* Part I in relation to the dominance of shareholder-centered agency-based corporate governance standards.

Further, empirical research has found that the social capital brought in by board members is extremely useful for corporate innovation. Chen and Kang et al. find that directors' social connections and interlocking directorates allow them to bring beneficial industry knowledge and ideas to the board, generally contributing to corporate innovation.[82] Helmers et al. also find that business group affiliations and the sharing of board members across a group of related companies is positively related to corporate innovation as cross-fertilization of knowledge and expertise takes place between the companies.[83] However, the agency-based perspective of corporate governance would unlikely support the promotion of interlocking directorates as cross-appointments on a number of boards may be seen to adversely affect the quality of directorial independence. If a board has to choose between an interlocking director with the potential to promote innovation and a completely 'outside' candidate, the board could face a conflict between the resource-based view of corporate governance that supports the promotion of innovation and adherence to the standards preferred by the conventional model of corporate governance.

There is also empirical research on incentivizing corporate leadership with appropriate remuneration and tenure packages in order to promote innovation leadership. Empirical research has found that incentivizing CEOs with a pay-for-performance package over the long-term with longer periods of vesting improves corporate innovation[84] such as in relation to CEOs' willingness to make corporate investments for the long-term. However, this may conflict with the agency-based perspective of corporate governance that ties pay-for-performance to shorter term financial benchmarks.[85] Nonetheless, with respect to CEO tenure, the two

82. Hsiang-Lan Chen, *Board Capital, CEO Power and R&D Investment in Electronics Firms*, 22 CORP. GOVERNANCE: INT'L REV. 422 (2014); Kang et al., *supra* note 80.

83. Christian Helmers et al., *Do Board Interlocks Increase Innovation? Evidence from a Corporate Governance Reform in India*, 80 J. BANKING & FIN. 51 (2017).

84. I-Ju Chen & Shin-Hung Lin, *Managerial Optimism, Investment Efficiency, and Firm Valuation*, 18 MULTINATIONAL FIN. J. 341 (2014); Radhakrishnan Gopalan et al., *Duration of Executive Compensation*, 69 J. FIN. 2777 (2014); Josh Lerner & Julie Wulf, *Innovation and Incentives: Evidence from Corporate R&D*, 89 REV. ECON. & STAT. 634 (2007); Makri et al., *supra* note 7.

85. Benjamin Bennett et al., *Compensation Goals and Firm Performance*, 124 J. FIN. ECON. 307 (2017); David I. Walker, *The Challenge of Improving the Long-Term Focus*

corporate governance perspectives agree that entrenchment should not be encouraged via long tenures because entrenchment does not incentivize leadership in innovation.[86] Yet, there are mixed results as to whether CEO turnover, which reflects the effectiveness of an agency-based model of corporate governance, is good for corporate innovation. Bereskin and Hsu find that CEO turnover improves levels of corporate innovation,[87] but Manso finds that tolerance for failures in innovative projects and retaining the CEO could help improve subsequent corporate innovation.[88]

C. SHAREHOLDERS AS RESOURCES

A resource-based view of the firm also departs from the shareholder-centered agency-based model in relation to the salience of shareholders, especially controlling ones.

Major shareholders who have controlling powers are often seen as important resources for firm innovation. As concentrated owners they are likely to have a long-term commitment to the success of the company and a willingness to make R&D investments and promote innovation.[89] The stability factor that major and long-term shareholders bring is found to be positively related to innovation. Evidence of this has been found even in relation to bank shareholdings, important in jurisdictions reliant on bank-based finance,[90] and in relation to friendly corporate shareholders, such as

---

of Executive Pay, 51 B.C. L. REV. 435 (2010). Forbes reports research that associates shorter-term pay benchmarks with higher pay and worse performance over the long-term. Monica Wang, *Time to Rethink CEO Compensation: Those with Higher Pay and Equity Lead Worse-Performing Companies*, FORBES (Aug. 1, 2016, 11:43 AM), https://www.forbes.com/sites/monicawang/2016/08/01/time-to-rethink-ceo-compensation-those-with-higher-pay-and-equity-lead-worse-performing-companies/#4ba14daf5d3b [https://perma.cc/ND9Z-DP55].

86. Nina Baranchuk et al., *Motivating Innovation in Newly Public Firms*, 111 J. FIN. ECON. 578 (2014); Kor, *supra* note 61.

87. Frederick L. Bereskin & Po-Hsuan Hsu, Bringing in Changes: The Effect of New CEOs on Innovation (Oct. 24, 2013) (unpublished manuscript), http://ssrn.com/abstract=1944047 [https://perma.cc/65P3-U47X].

88. Gustavo Manso, *Motivating Innovation*, 66 J. FIN. 1823 (2011).

89. Charles W. L. Hill & Scott A. Snell, *Effects of Ownership Structure and Control on Corporate Productivity*, 32 ACAD. MGMT. J. 25 (1989); Munjae Lee, *Impact of Corporate Governance on Research and Development Investment in the Pharmaceutical Industry in South Korea*, 6 OSONG PUB. HEALTH RES. PERSP. 249 (2015).

90. Hillier et al., *supra* note 64.

the Japanese Keiretsu.[91] Further, major shareholders, such as founder families, bring social capital to the company to support the company's business, for example by expanding the company's networks.[92]

Concentrated ownership is however viewed with suspicion under the conventional model of corporate governance, as controlling shareholders could pose agency problems to minority shareholders.[93] A number of commentators warn that since controlling shareholders are in a position to benefit themselves by tunneling and appropriating corporate assets, they may not be dedicated to investing corporate resources in R&D and optimally promoting innovation.[94] Perhaps it is not unequivocal that controlling shareholders are good for firm innovation and long-term success, and much depends on the incentives at play in the market and firm contexts. However, it would be important not to disincentivize controlling owners from bringing a beneficial form of long-termism and stability that can facilitate innovation. In this respect, certain incentives for long-term controlling shareholders may promote innovation even if these notions are seen as offensive against standards safeguarded under the agency-based corporate governance model. For example, commentators discuss the use of unequal shareholder rights and some

---

91. Kaoru Hosono et al., *Corporate Governance and Research and Development: Evidence from Japan*, 13 ECON. INNOVATION & NEW TECHS. 141 (2004).

92. Suman Lodh et al., *Innovation and Family Ownership: Empirical Evidence from India*, 22 CORP. GOVERNANCE: INT'L REV. 4 (2014).

93. *See* Fin. Servs. Auth., *Enhancing the Effectiveness of the Listing Regime and Feedback on CP12/2* (Consultation Paper No. CP12/25, Oct. 2012), https://www.fca.org.uk/publication/consultation/cp12-25.pdf [https://perma.cc/Q6BF-EA5P]; Fin. Conduct Auth., *Feedback on CP12/15: Enhancing the Effectiveness of the Listing Regime and Further Consultation* (Consultation Paper No. CP13/15, Nov. 2013), https://www.fca.org.uk/publication/consultation/cp13-15.pdf [https://perma.cc/2HD2-JJU2]; Fin. Conduct Auth., *Response to CP13/15—Enhancing the Effectiveness of the Listing Regime* (Policy Statement No. PS14/8, May 2014), https://www.fca.org.uk/publication/policy/ps14-08.pdf [https://perma.cc/K2VT-S79D], which form the background to listing rules reform in the U.K. for listed companies with controlling shareholders. *See also* Roger M. Barker & Iris H.-Y. Chiu, *Protecting Minority Shareholders in Blockholder-Controlled Companies—Evaluating the UK's Enhanced Listing Regime in Comparison with Investor Protection Regimes in New York and Hong Kong*, 10 CAP. MKTS. L.J. 98 (2015).

94. Filippo Belloc et al., *Corporate Governance Effects on Innovation when both Agency Costs and Asset Specificity Matter*, 25 INDUS. & CORP. CHANGE 977 (2016); Suk Bong Choi et al., *Does Ownership Structure Matter for Firm Technological Innovation Performance? The Case of Korean Firms*, 20 CORP. GOVERNANCE: INT'L REV. 267 (2012).

forms of takeover protection that may be beneficial for a company's long-term success.[95]

One of the key incentives for promoting innovation lies in the sense of 'ownership' and commitment that founder-controllers have for their firms. Empirical research supports the idea that founder-controllers often bring with them innovative visions and a long-term commitment to making the enterprise successful, and are thus a highly valuable resource.[96] In particular, there is a growing trend for founders of Silicon Valley technology companies to retain control through a dual-class share structure in which voting rights exceed cash flow rights. Founder shareholders may be motivated to insist on such voting structures due to concerns about the potential risk of short-termism in widely-held corporations. For example, Google founders, Larry Page and Sergey Brin, retained 51% of the voting control despite having only 11% of the cash flow rights in Google's holding company.[97] They cite their long-term perspective as rationale for supporting the issue of a class of non-voting shares, which controversially started trading in April 2014.[98] Successful companies, such as Facebook and Alibaba, are also intensely controlled by their founders.[99] The commitment of founder-controllers is secured at a 'corporate governance price,' such as greater or weighted voting rights

95. Marc T. Moore & Edward Walker-Arnott, *A Fresh Look at Stock Market Short-Termism*, 41 J. L. & SOC'Y 416 (2014).

96. Kor, *supra* note 61; Yongwook Paik & Heejin Woo, The Effects of Corporate Venture Capital, Founder Incumbency, and Their Interaction on Entrepreneurial Firms' R&D Investment Strategy (Feb. 10, 2017) (unpublished manuscript), http://ssrn.com/abstract=2340900 [https://perma.cc/QZD3-3V47].

97. *How Tech Giants are Ruled by Control Freaks*, ECONOMIST (Nov. 23, 2017), https://www.economist.com/news/business/21731648-facebook-google-alibaba-et-al-offer-lessons-dark-arts-corporate-control-how-tech [https://perma.cc/J7LX-CQHM].

98. Richard Waters, *Google Founders Look to Cement Control with Novel Share Split*, FIN. TIMES (Apr. 2, 2014), https://www.ft.com/content/5ba9a078-b9f2-11e3-a3ef-00144feabdc0 [https://perma.cc/2U5R-8A9P].

99. *How Tech Giants are Ruled by Control Freaks*, *supra* note 97. There is contrary empirical evidence that shows worse long-term performance by firms that have used dual-class shares. *See* Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051 (2010); *The Cost of Control*, ECONOMIST (July 21, 2011), http://www.economist.com/node/18988938 [https://perma.cc/6VWR-E3CC]. However, the empirical surveys are performed on firms between 1994 and 2002, that is, before the advent of more recently successful technology giants such as Google and Facebook.

for such founders even if this is mismatched with cash flow rights.[100] The common use of dual-class voting shares—or in Snapchat's case, the issuance of non-voting shares to outside shareholders—are means of ensuring that founders remain in control of the firm's innovative vision and that the company is relatively insulated from outside shareholders' 'short-termism.'[101] Minority outside shareholders view this with great skepticism as unequal shareholder rights can entail agency problems.[102] There is however a resource-based justification for incentivizing such founder-controllers' commitments by allowing them to maintain control.

Although some jurisdictions have resisted dual-class shares, such as Hong Kong,[103] the key U.S. stock exchanges and the London Stock Exchange have allowed dual-class shares for some time now. The New York Stock Exchange (NYSE) Listing Rules provide some safeguards for minority shareholders of listed companies that feature dual-class voting or concentrated ownership. The Listing Manual contains general principles to prohibit conflicts of interest, misappropriation of corporate opportunities,[104] and director/officer share transactions surrounding corporate communications.[105] Related-party transactions, however, do not require shareholder voting except where there are issues of securities to the effect of increasing voting power by at least one percent.[106] These transactions may be effected after scrutiny by the audit committee.[107] Given the traditional U.S. context of corporate resistance towards

---

100. *See, e.g.*, Waters, *supra* note 98.

101. Joseph A. McCahery & Erik P.M. Vermeulen, *Venture Capital, IPOs and Corporate Innovation* (Lex Research Topics in Corp. L. & Econ., Working Paper No. 2013-4, 2013), http://ssrn.com/abstract=2298315 [https://perma.cc/69W7-VXHX].

102. Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988); Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687 (1986).

103. Alison Smith et al., *Exchanges Divided by Dual-Class Shares*, FIN. TIMES (Oct. 3, 2013), https://www.ft.com/content/e18a6138-2b49-11e3-a1b7-00144feab7de [https://perma.cc/VJQ2-W2J7].

104. Under the requirement imposed on listed companies to maintain a Code of Business Conduct and Ethics. *See* N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303A.10, http://wallstreet.cch.com/LCM/ [https://perma.cc/FW8N-WJEZ].

105. *Id.* § 309.00.

106. *Id.* § 312.03.

107. *Id.* § 314.00.

increasing shareholder rights,[108] it is perhaps not surprising that the NYSE Listing Rules do not feature many specific shareholder protections, particularly in relation to companies with a dual-class voting structure. That said, empirical research[109] in the U.S. shows that many companies featuring dual-class voting structures have voluntarily installed mechanisms, such as increased independent board representation, to assuage minority concerns. NASDAQ, for example, requires its listed companies to undertake certain corporate governance safeguards.[110]

Where the London Stock Exchange is concerned, special listing rules apply to companies that feature a controlling shareholder in terms of voting rights.[111] Such a controlling shareholder is required to enter into a relationship agreement with the company to preserve the company's business independence. An independent director on the board may determine if this is breached and call for all related-party transactions to be subject to minority shareholders' veto. In practice, this power is rarely used[112] as there is a lack of further dispute resolution between independent directors and their companies if this power is exercised. Minority shareholders are also allowed to vote as a separate class on all appointments of independent directors and in the event a change in listing status is proposed.

The measures above seem to reflect the compromises struck by listing authorities in adhering to minority shareholders' preference for agency-based standards of corporate governance as well as accommodating the needs of companies that perceive key shareholders as important resources for the company's continued innovative success. This

108. In particular the Business Roundtable's aggressive lobbying efforts on behalf of the management sector and its successes in court in invalidating pro-shareholder rules enacted by the SEC.

109. R. Charles Moyer et al., *Substitutes for Voting Rights: Evidence from Dual Class Recapitalizations*, FIN. MGMT., Autumn 1992, at 35.

110. Especially in relation to the composition of the board where independent directors are concerned. *See infra* Part IV.

111. FIN. CONDUCT AUTH., LISTING RULES § 6.5.4 (Feb. 2018), https://www.handbook.fca.org.uk/handbook/LR.pdf [https://perma.cc/P7M4-K7HM].

112. The regime is discussed in Barker & Chiu, *supra* note 93 and Bobby V. Reddy, *The Fat Controller—Slimming Down the Excesses of Controlling Shareholders in UK Listed Companies*, (Univ. of Cambridge Legal Studies Research Paper Series, Paper No. 47/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3056999 [https://perma.cc/6VQN-WEP3].

area, however, is by no means settled[113] and continues to draw out the tensions between the resource-based and agency-based theories of corporate governance.

Distrust of significant control is pitted against the advantages of keeping founder-controllers incentivized. Choi argues that the disadvantages of agency (i.e. extraction of private benefits by controllers) are outweighed by the advantages of long-term corporate success.[114] This is supported by other recent empirical research.[115] Dallas and Barry find that where companies implement time-phased voting, a milder form of dual-class structure that rewards longer term shareholders with more voting rights, such firms have not only outperformed financially in the long-term but have also diversified their shareholder base, ensuring that there is little risk of entrenchment of insiders.[116] However, opposing empirical research indicates that dual-class voting structures can reduce trust in companies and may be avoided by some investors.[117] Gompers et al. also find that listed companies with dual-class structures have generally performed worse over the long term than those without a controlling shareholder.[118]

Next, insulation from takeover threats, or takeover protection, may be useful in fostering innovation in companies. A number of commentators have found that innovation can be better nurtured in an environment not subject to the disruptions of takeover threats,[119] hence

113. *See, e.g.*, Marissa Lee & Wong Wei Han, *HKEX Mulls Over Plan for Dual-Class Shares Again*, STRAITS TIMES (Jan. 20, 2017), http://www.straitstimes.com/business/hkex-mulls-over-plan-for-dual-class-shares-again [https://perma.cc/NFS5-JPMP], after giving up on it after consultation in 2015.

114. Albert Choi, *Concentrated Ownership and Long-Term Shareholder Value*, HARV. BUS. L. REV. (forthcoming).

115. Stephan Nüesch, *Dual-Class Shares, External Financing Needs, and Firm Performance*, 20 J. MGMT. & GOVERNANCE 525 (2016) (arguing that dual-class structured firms perform better financially if equity financing is also sought on open markets, as the inherent concerns with agency problems will moderate the expropriation risks of dual-class voting structures).

116. Lynne L. Dallas & Jordan M Barry, *Long-Term Shareholders and Time-Phased Voting*, 40 DEL. J. CORP. L. 541 (2016).

117. *See also* Vijay M. Jog & Allan L. Riding, *Price Effects of Dual-class Shares*, FIN. ANALYSTS J., Jan.–Feb. 1986, at 58.

118. Gompers et al., *supra* note 99; *The Cost of Control*, *supra* note 99.

119. Baranchuk, *supra* note 86; John R. Becker-Blease, *Governance and Innovation*, 17 J. CORP. FIN. 947 (2011); Haresh Sapra et al., *Corporate Governance and Innovation:*

suggesting that anti-takeover regimes may be regarded as a pro-innovation factor. This is in conflict with agency-based corporate governance standards that tend to regard the market for corporate control as a form of discipline for management and as a key form of shareholder protection. Lhuillery finds a positive correlation between less anti-takeover provisions and the promotion of innovation in French companies, but is of the view that one should not regard shareholder-friendly rules as unequivocally pro-innovation.[120] His research is highly context-specific and shareholder-friendly rules could be regarded as much-needed relief from prevailing protectionist corporate governance practices in the French corporate sector. Such mixed results perhaps suggest that some extent of takeover protection may benefit companies in highly open markets for corporate control, such as the U.K., where the dominance of the agency-based corporate governance model has already produced concerns with regard to short-termism in the listed corporate sector.[121] Executives could be disincentivized from committing to long-term investments in R&D or taking risks in pro-innovation strategies. That said, the U.K. has maintained a top five position in the Global Innovation Index for the last five years, although slipping since 2013.[122]

Theory and Evidence, 49 J. FIN. & QUANTITATIVE ANALYSIS 957 (2014); Miroslava Straska & Gregory Waller, *Do Antitakeover Provisions Harm Shareholders?*, 16 J. CORP. FIN. 487 (2010). *See also* Mehmet Ugur & Nawar Hashem, Market Concentration, Corporate Governance and Innovation: Partial and Combined Effects in US-Listed Firms (Sept. 17, 2012) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2210928 [https://perma.cc/9WBB-LUEK] (reporting that takeover protection can incentivize increased R&D spend but may not correlate with more valuable brands or patents).

120. Lhuillery, *supra* note 65.

121. DEP'T FOR BUS., INNOVATION & SKILLS, *supra* note 57.

122. CORNELL UNIV. ET AL., THE GLOBAL INNOVATION INDEX 2017: INNOVATION FEEDING THE WORLD xviii (Soumitra Dutta et al. eds., 2017), https://www.globalinnovationindex.org/gii-2017-report [https://perma.cc/CK6A-P5P8]; CORNELL UNIV. ET AL., THE GLOBAL INNOVATION INDEX 2016: WINNING WITH GLOBAL INNOVATION xviii (Soumitra Dutta et al. eds., 2016), https://www.globalinnovationindex.org/userfiles/file/reportpdf/gii-full-report-2016-v1.pdf [https://perma.cc/6XP6-V27Z]; CORNELL UNIV. ET AL., THE GLOBAL INNOVATION INDEX 2015: EFFECTIVE INNOVATION POLICIES FOR DEVELOPMENT xxx (Soumitra Dutta et al. eds., 2015), https://www.globalinnovationindex.org/userfiles/file/reportpdf/gii-full-report-2015-v6.pdf [https://perma.cc/J4QQ-52JG]; CORNELL UNIV. ET AL., THE GLOBAL INNOVATION INDEX 2014: THE HUMAN FACTOR IN INNOVATION xxiv (Soumitra Dutta et al. eds., 2014), https://www.globalinnovationindex.org/userfiles/file/reportpdf/GII-2014-v5.pdf [https://perma.cc/A5PJ-FKH7];

D. STAKEHOLDERS AND SOCIAL CAPITAL AS RESOURCES

Next, empirical research suggests that corporate innovation can be promoted if a company engages more intensely with stakeholders and gains useful knowledge, ideas, and feedback for its strategic development in innovation.[123] Greater employee participation, such as in the German co-determination system of corporate governance[124] and a flatter working structure,[125] also facilitate corporate innovation; as human capital in the company is made more engaged with corporate purposes and success, and therefore becomes more committed and productive. These findings have implications for the shareholder-centered agency-based model of corporate governance, as promoting innovation may require the elevation of stakeholders in relation to representation and participation in corporate governance.

The resource-based theory of the firm focuses on different locations of innovative potential in resources in order to mobilize and galvanize them towards the collective enterprise of the firm. Hence, it is not necessarily supportive of shareholder primacy. Indeed, it can be argued that the resource-based theory of the firm resonates with alternative theories of corporate governance such as director primacy, director stewardship, stakeholder theory, and social theories of the company.

The resource-based theory of the firm arguably finds resonance with the perspective that the company is a 'team' of corporate constituents[126] contributing inputs into the collective enterprise of the company. As such, directors' roles are to organize the mobilization and deployment of such inputs in a coherent manner, and the exercise of their powers is for such purpose and not necessarily focused only on shareholder wealth

---

CORNELL UNIV. ET AL., THE GLOBAL INNOVATION INDEX 2013: THE LOCAL DYNAMICS OF INNOVATION xx (Soumitra Dutta & Bruno Lanvin eds., 2013), https://www.globalinnovationindex.org/userfiles/file/reportpdf/GII-2013.pdf [https://perma.cc/9AGU-P6NS].

123. Silvia Ayuso et al., *Using Stakeholder Dialogue as a Source for New Ideas: A Dynamic Capability Underlying Sustainable Innovation*, 6 CORP. GOVERNANCE: INT'L J. EFFECTIVE BOARD PERFORMANCE 475 (2006); Vermeulen et al., *supra* note 60.

124. Belloc, *supra* note 4.

125. Vermeulen et al., *supra* note 60.

126. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Kaufman & Englander, *supra* note 12.

maximization.[127] Further, this director primacy theory accords well with the 'stewardship' perspective of directors' roles,[128] which offers a view of directors as stewards of corporate resources for the success of the collective enterprise of the company. They should not merely be seen as self-interested 'agents,' who may serve their own purposes or shirk their responsibilities. To an extent, this theory parallels the position in both U.S. and U.K. corporate law as directors owe their duties to the company as a distinct legal personality from shareholders or groups of shareholders.[129] However, as the company is a legal fiction, even U.K. law accepts that the corporate objective is the 'hypothetical' collective bargain of shareholders as a whole—which is understood as wealth creation in shareholders' interests over the long term.[130] Keay has since argued for the corporate objective to be understood as distinct and separate from shareholders' interests, and his view of long-term corporate survival and success is capable of forming the practical basis for directors' powers and duties under company law.[131]

Further, it can also be argued that where stakeholders are important locations of resource for innovation, a model of corporate governance that incorporates stakeholder theory could be highly beneficial to the company. Namely, stakeholder connections with firms could be intangible assets exploitable by firms for their competitive advantage,[132] such as employees[133] and human capital connected with the firm, as well as stakeholders such as users and customers that bring network effects and positive reputational effects to firms. For example, a company like

---

127. The director primacy theory is also supported by Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

128. Catherine M. Daily et al., *Corporate Governance: Decades of Dialogue and Data*, 28 ACAD. MGMT. REV. 371 (2003); James H. Davis et al., *Davis, Schoorman, and Donaldson Reply: The Distinctiveness of Agency Theory and Stewardship Theory*, 22 ACAD. MGMT. REV. 611 (1997).

129. Companies Act 2006, c. 46, § 170 (UK). For an example in the U.S., see Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

130. Companies Act 2006, c. 46, § 172 (UK).

131. ANDREW KEAY, THE CORPORATE OBJECTIVE (2011).

132. Arturo Capasso, Stakeholder Theory and Corporate Governance: The Role of Intangible Assets (Oct. 29, 2004) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=610661 [https://perma.cc/T8FA-GHEN].

133. Frank Mueller, *Human Resources as Strategic Assets: An Evolutionary Resource-Based Theory*, 33 J. MGMT. STUD. 757 (1996).

Facebook builds its success upon the trust and proliferation of use among its user communities, and its user base is therefore a massive resource for the company's innovative developments.[134] Amazon also relies on its customers to build up its increasingly trusted 'feedback' system that encourages network effects and builds up reputational reliability, further enhancing its core business in sales.[135]

Extending the stakeholder mapping of companies would also allow us to consider more broadly 'social capital' or 'natural capital' as being locations of resources for firms to exploit in terms of innovation, and such a perspective may fundamentally change our view of what an appropriate corporate governance model for a firm *should be.* Hart proposes that we should see natural resources and their sustainability as part of the resource-based theory of the firm, so that firms treat not only the use or exploitation of natural resources as important to their enterprise, but the protection and sustainability of such resources and the avoidance of externalities (such as pollution) as the essential counterpart to their enterprise too.[136] This is because protecting sustainability and avoiding externalities address not only long-term sourcing for firms, but also helps to preserve firm-community relations in a positive manner, in order to sustain the firm's legitimacy of its enterprise.[137] Further, Branco and Rodrigues support the view that a firm's social capital—i.e. its community relations, its influence, reputation, and legitimacy—are

---

134. For example, users' privacy demands incentivizes Facebook to develop user settings in terms of visibility of their profiles and information, and users' information continues to provide Facebook with fertile ground for marketing and advertising ideas and development. YUVAL KARNIEL & AMIT LEVI-DINUR, PRIVACY AND FAME: HOW WE EXPOSE OURSELVES ACROSS MEDIA PLATFORMS 62 (2015).

135. The importance of consumer reviews to customer perception of 'usefulness' and to customers' increased social presence on the website is discussed in Nanda Kumar & Izak Benbasat, *The Influence of Recommendations and Consumer Reviews on Evaluations of Websites*, 17 INFO. SYS. RES. 425 (2006). The study is based on Amazon.com customer reviews.

136. Stuart L. Hart, *A Natural-Resource-Based View of the Firm*, 20 ACAD. MGMT. REV. 996 (1995).

137. Referred to as the 'social license' to operate. *See, e.g.*, Karin Buhmann, *Public Regulators and CSR: The 'Social Licence to Operate' in Recent United Nations Instruments on Business and Human Rights and the Juridification of CSR*, 136 J. BUS. ETHICS 699 (2016).

extremely important resources for the firm.[138] Hence, firms may find it essential to develop social responsibility to protect and preserve its 'social capital' resources. These aspects are relevant to firm innovation, as inspiration for innovation can be derived from social capital resources. Further, such resources may also be important in amplifying the positive effects of innovation in terms of 'spreading the word' or boosting the social and market appeal of firms' innovative products and processes.

If the resource-based view of the salience of stakeholders and social capital is mapped onto an optimal model of corporate governance, then each firm's model of corporate governance, depending on its resources needs, could be very different from that standardized under the shareholder-centered agency-based model. There may be a case for the relevant firm to accommodate stakeholders in representation or participation in corporate governance[139] or even consider embracing elements of social and public accountability.[140] This would give rise to questions of new matrices of power allocations among shareholders, stakeholders, and boards.[141] Chiu argues that in attempting to actualize or operationalize a stakeholder theory of corporate governance in company law, heavy lifting is required as power is required to be distributed away

---

138. Manuel Castelo Branco & Lúcia Lima Rodrigues, *Corporate Social Responsibility and Resource-Based Perspectives*, 69 J. BUS. ETHICS 111 (2006).

139. Andrew Crane & Trish Ruebottom, *Stakeholder Theory and Social Identity: Rethinking Stakeholder Identification*, 102 J. BUS. ETHICS 77 (2011); Thomas Donaldson, *Two Stories*, *in* Bradley R. Agle et al., *Towards Superior Stakeholder Theory*, 18 BUS. ETHICS Q. 153, 172 (2008); Donna J. Wood, *Corporate Responsibility and Stakeholder Theory: Challenging the Neoclassical Paradigm*, *in* Bradley R. Agle et al., *Towards Superior Stakeholder Theory*, 18 BUS. ETHICS Q. 153, 159 (2008); James A. Stieb, *Assessing Freeman's Stakeholder Theory*, 87 J. BUS. ETHICS 401 (2009).

140. *See, e.g.*, JOHN E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW (1993); Carl Kaysen, *The Corporation: How Much Power? What Scope?*, *in* THE CORPORATION IN MODERN SOCIETY 85 (Edward S. Mason ed., 1970); Philip I. Blumberg, *The Politicization of the Corporation*, 26 BUS. LAW. 1551 (1971); Lawrence E. Mitchell, *Groundwork of the Metaphysics Of Corporate Law*, 50 WASH. & LEE L. REV. 1477 (1993). Also see writings aimed at encouraging the corporation to take up responsible citizenship. *See, e.g.*, KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS & PROGRESSIVE POSSIBILITIES (2006); LAWRENCE E. MITCHELL, PROGRESSIVE CORPORATE LAW (1995); SALLY WHEELER, CORPORATIONS AND THE THIRD WAY (2002); Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87 (2005).

141. Iris H-Y Chiu, *Operationalising a Stakeholder Conception in Company Law*, 10 L. & FIN. MKTS. REV. 173 (2016).

from shareholders under the shareholder-centered agency-based model, in favor of stakeholders in an organized and coherent manner.[142] Further, directors' powers to undertake such coordination and organization need to be enhanced. These implications would likely create much resistance in the current institutional shareholder community which largely supports the prevailing shareholder-centered agency-based corporate governance standards.

E. STRUCTURES FOR GOVERNING INNOVATION IN COMPANIES

Deschamps and Nelson discuss the importance of having a governance structure in firms for innovation.[143] This ensures that personal leadership and responsibility is directed towards stimulating, overseeing, and implementing innovation. The CEO is often seen as a strategic lead for innovation[144] and indeed in many innovative technology companies, the combination of CEO and founder-controller as strategic innovation lead has proved highly effective.[145] However, firms can innovate effectively even with different types of structures in place for governing innovation, so long as there is a credible structure. In some firms, a Chief Technical Officer may be the strategic lead for corporate innovation, in others a steering group of executives or business leaders could take the lead.[146]

The agency-based perspective of corporate governance emphasizes governing structures that focus on monitoring, hence the development of audit committees on the board after corporate reporting scandals in the

142. *Id.*

143. JEAN-PHILIPPE DESCHAMPS & BEEBE NELSON, INNOVATION GOVERNANCE: HOW TOP MANAGEMENT ORGANIZES AND MOBILIZES FOR INNOVATION 87 (2014).

144. *Id.*

145. For example, Jeff Bezos as the CEO, founder-controller, and innovative lead of Amazon, Mark Zuckerberg as the equivalent in Facebook, and Jack Ma having an equivalent position in Alibaba. *See How Tech Giants are Ruled by Control Freaks*, *supra* note 97.

146. DESCHAMPS & NELSON, *supra* note 143.

U.K.[147] and U.S.,[148] and the development of risk committees on the board after the global financial crisis of 2007–2009.[149] As Lazonick and O'Sullivan point out, there is no theory of innovation in this corporate governance model and no recommended structural standards for companies in promoting and governing innovation.[150] Further, there may be tension between pursuing innovation and instituting a corporate culture that meets the standards of the agency-based corporate governance model. Moore points out that corporate governance standards are evolving towards a 'risk moderation' role for boards after the global financial crisis, in order to protect shareholder value from excessive risk-taking, and this may be antagonistic to developing pro-innovation and risk-taking leadership on boards.[151] Mendoza et al. also point out that the procedural compliance required to maintain the corporate governance standards in the prevailing agency-based model fosters defensive and box-ticking behavior on boards, and this may do little in stimulating innovative leadership.[152] Perhaps this is why McCahery et al. argue that innovative firms avoid being subject to securities markets pressures as conformity with agency-based corporate governance standards is often expected in securities markets.[153]

Although we have presented both sides of the empirical research on what matters in corporate governance for firm innovation, we find that (a)

---

147. After the fall of Polly Peck and BCCI in the early 1990s, the audit committee was a best practice in corporate governance recommended in the Cadbury Code of Corporate Governance of 1992. *See* ADRIAN CADBURY, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (Dec. 1, 1992), https://www.icaew.com/-/media/corporate/files/library/subjects/corporate-governance/financial-aspects-of-corporate-governance.ashx?la=en [https://perma.cc/B2QH-N2UX].

148. This change was brought about by section 301 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (2002) (codified at 18 U.S.C. § 1514A (2012)), introduced after the fall of Enron in 2000, and implemented by national stock exchanges in their listing rules relating to corporate governance.

149. For an example of reforms in Article 88(1)(a), see Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, 2013 O.J. (L 176) 338.

150. EUROPEAN COMM'N, *supra* note 14.

151. Marc T. Moore, *The Evolving Contours of the Board's Risk Management Function in UK Corporate Governance*, 10 J. CORP. L. STUD. 279 (2010).

152. Jose Miguel Mendoza et al., *Entrepreneurship and Innovation: The Hidden Costs of Corporate Governance in Europe*, 7 S.C. J. INT'L L. & BUS. 1 (2010).

153. McCahery & Vermeulen, *supra* note 101.

tensions remain between adhering to the prevailing agency-based corporate governance standards and the corporate governance needs of firms that facilitate innovation; but (b) the shareholder-centered agency-based model of corporate governance is not irrelevant to and could contribute to an extent to firm innovation. We highlight certain implications in Part III. Further, Part III proposes that prevailing corporate governance standards should be adjusted if such standards are adverse to the resources, structures, or incentive designs that promote corporate innovation. Indeed, excessive prescriptions in corporate governance standards are probably sub-optimal for promoting innovation. However, securities markets do not seem to favor excessive levels of flexibility or open-endedness in corporate governance standards. In view of the need to create a balance between predictability and flexibility in investors' expectations of today's listed companies, Part III proposes a 'middle way' that preserves the prevailing standards of corporate governance but allows for coherently and justifiably developed exceptions that can be derived from the resource-based needs of firms in relation to innovation. In light of this proposal, Part III urges caution in respect to the indefatigable movement of international standardization and convergence around shareholder-centered agency-based corporate governance standards.

II. PROMOTING CORPORATE GOVERNANCE THAT RECONCILES VALUE PROTECTION NEEDS AND INNOVATION NEEDS FOR VALUE CREATION

The rise of corporate governance standards in the U.K. and in many leading securities markets jurisdictions feature the common focus of addressing the agency problem in corporate governance. These standards revolve around protecting shareholder value in the corporation, upholding minority shareholder rights, ensuring that boards monitor executives, and that the board is itself monitored by independent directors. However, the nature of such standards and their enforcement may differ between jurisdictions. The U.S. in particular is often described as a 'rules-based' regime for corporate governance,[154] even if the mandatory rules, such as

154. Erinn B. Broshko & Kai Li, Corporate Governance Requirements in Canada and the United States: A Legal and Empirical Comparison of the Principles-based and Rules-based Approaches (Feb. 2006) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=892708 [https://perma.cc/ZGQ2-Y2KX].

the definition of directorial independence, and rules on board composition or board committees,[155] are rules made by securities markets.[156] The U.K. leads in adopting a 'principles-based' approach instead.[157]

In the U.K., corporate governance standards are largely maintained as 'soft law.'[158] Listed issuers on the London Stock Exchange only have to 'comply or explain' in relation to the U.K. Corporate Governance Code. This means companies can explain any deviations from the Code and it is up to their shareholders to determine if explanations for deviation are acceptable. The comply-or-explain approach seems to be the prevailing approach for many jurisdictions and stock markets that have adopted a corporate governance code.[159]

A. LET SHAREHOLDERS DECIDE ON A CASE-BY-CASE BASIS?

In jurisdictions where a principles-based approach prevails, in theory, companies could adapt the relevant Corporate Governance Code to their unique needs and explain to investors if they deviate from the Code. It is then up to investors to judge if such deviation is likely to secure value for the company or otherwise. As corporate governance codes are 'soft law' in nature, there is inherent flexibility for companies to adapt the standards in the codes to their pro-innovation needs. Hence, it can be argued that the tensions between prevailing standards based on a shareholder-centered agency-based model and firm innovation needs should not be exaggerated as companies can make appropriate governance choices and explain those choices to their shareholders.

---

155. *See, e.g.*, NASDAQ, STOCK MARKET RULES § 5600, http://nasdaq.cchwallstreet.com/ [https://perma.cc/6HJ2-US7D] (Corporate Governance Requirements); N.Y. STOCK EXCH., CORPORATE GOVERNANCE GUIDE (2014), https://www.nyse.com/publicdocs/nyse/listing/NYSE_Corporate_Governance_Guide.pdf [https://perma.cc/K2WD-VV4V].

156. The increasingly important role of securities markets in making corporate governance rules is discussed in Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961 (2003), reflecting collaboration between the markets and the SEC in particular.

157. Similar to the Canadian approach discussed in Broshko & Li, *supra* note 154.

158. Some aspects are 'legalized' such as the binding shareholder vote on executive remuneration under Companies Act 2006, c. 46, § 439 (UK), but many matters such as board composition or committees are left to the Code.

159. Hopt, *supra* note 11.

Rules-based regimes would not be able to accommodate this approach, as they are more *ex ante* in nature. Corporate governance in the U.S. is subject to state law, federal securities regulation, and increasingly stock exchange rules that are made in close collaboration with the Securities and Exchange Commission (SEC).[160] The different sources of law reflect the often contesting interests and ideologies that shape U.S. corporate governance law and standards—from favoring director primacy to shareholder primacy.[161] SEC regulation and securities market rules have of late been the key sources of law for developing shareholder interests and power.[162] The rules-based regime in the U.S. securities markets therefore reflects a broader context of power and interest dynamics underlying corporate law, which gives rise to rules as *ex ante* determinants of rights and roles in corporate governance. In the face of pressure to accommodate firm innovation needs that are contrary to the

---

160. Thompson, *supra* note 156.

161. Romano argues that state law has developed in response to the competition for corporate charters. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993). One of the most successful incorporation states, Delaware, has in particular developed corporate law jurisprudence that protects directors' business judgments and board centricity in corporate governance for the interests of the company. *See* Bainbridge, *supra* note 127; *cf.* Sabrina Bruno, *Directors' Versus Shareholders' Primacy in U.S. Corporations Through the Eyes of History: Is Directors' Power "Inherent"?*, 9 EUR. COMPANY & FIN. L. REV. 421 (2012) (arguing that corporate law in the U.S. is not inherently pro-director, and that it shared similar roots with U.K. and European law). Arguably the rise of powerful CEOs who are in principle, directorial 'delegates,' but who have not been effectively controlled by the board, is a key reason for the rise of the need for shareholder monitoring and the exercise of countervailing power. *See* George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOUS. L. REV. 1213 (2008) (discussing the rise of CEO power in U.S. corporations).

162. This is in no small part accelerated by the Enron scandal and the regulatory advancement achieved under the Sarbanes-Oxley Act. *See* Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189 (2003); *cf.* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005). However, as discussed *supra* Part I, the importance of institutional investors' demands for global securities markets to list well-governed companies plays a key part in the indefatigable global adoption of shareholder-centered agency-based corporate governance standards. *See* Luigi Zingales, *The Future of Securities Regulation*, (Univ. of Chi. Booth Sch. of Bus., Working Paper No. 08-27, 2009), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319648 [https://perma.cc/Q2DC-GW4E]; Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1 (2006).

requirements of corporate governance standards, rules-based regimes would have to grapple with rule or enforcement changes. This is not necessarily a handicap of rules-based regimes. Rules-based regimes are not inferior to principles-based regimes like the U.K., which, though apparently accommodates flexibility in the development of corporate governance standards, is in fact dominated by the ideology of shareholder primacy. The diverse system of sources for corporate law in a rules-based regime can accommodate dialectical processes and be well-positioned to generate reforms, a point to which we return shortly.

Although the principles-based approach of comply-or-explain is adopted for listed issuers' compliance with corporate governance standards, the reality of shareholder 'tyranny' exists. In reality, there is considerable market pressure that Moore has described as undermining the 'comply or explain' regime.[163] This is because the standards reflect what institutional shareholders largely prefer, and there is significant market pressure not to deviate from these. It may be argued that listed issuers have not done themselves a favor as early implementation of comply-or-explain generated boilerplate and routine explanations that were opaque and not meaningful, making the 'explain' strategy discreditable.[164] Subsequent efforts at enhancing explanations, such as in the case of Marks & Spencer Plc discussed in Moore,[165] especially where companies desired a unique deviation, were not welcomed in capital markets. Investors suffer from information asymmetry in determining if unique explanations are beneficial and tend to trust standardized practices that are in compliance. The role of proxy advisory agencies in standardizing expectations of what is 'good' corporate governance is also of significant influence.[166]

We are skeptical that leaving firms to explain their innovation needs and corporate governance deviations to the market is the optimal way of addressing the tensions caused by conventional corporate governance standards for firms' innovation needs. Policy-makers in the U.K. encourage shareholders to meaningfully 'engage' with their investee

---

163. Marc T. Moore, *"Whispering Sweet Nothings": The Limitations of Informal Conformance in UK Corporate Governance*, 9 J. CORP. L. STUD. 95 (2009).

164. Iain MacNeil & Xiao Li, *"Comply or Explain": Market Discipline and Non-compliance with the Combined Code*, 14 CORP. GOVERNANCE 486 (2006).

165. Moore, *supra* note 163.

166. Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887 (2007).

companies, within the framework of 'stewardship.' Shareholder engagement is meant to bring about an organic process for developing optimal corporate governance practices for firms, as standards are not meant to be mere shackles that bind companies to a 'one size fits all' framework. Shareholder stewardship was pioneered in the U.K. and has become an international model.[167] However, we are skeptical that shareholders' engagement is substantively meaningful and are concerned about the implications of 'shareholder tyranny.'[168]

The notion of "stewardship" in relation to institutional shareholders, may be defined as "... the process through which institutional shareholders, directors and others seek to influence companies in the direction of long-term, sustainable performance that derives from contributing to human progress and the well-being of the environment and society."[169] The key notions in "stewardship" seem to be long termism, and taking a more holistic view of the well-being and performance of the company. The genesis of the Code can be traced to the aftermath of the global financial crisis. In the U.K., the role of institutional shareholders was criticized by the Walker Review of 2009 in the wake of the failure of two U.K. banks.[170] The critique is that institutional shareholders have been uncritical of risky business practices in their investee banks[171] and

---

167. Iris H-Y Chiu, *Learning from the UK in the Proposed Shareholders' Rights Directive 2014? European Corporate Governance Regulation from a UK Perspective*, 114 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFT [ZVGLRWISS] 1 (2015).

168. We examine the incentives and structures for institutional investors, and survey the stewardship landscape in our recent book. *See* BARKER & CHIU, *supra* note 39. We argue that one should be very careful of relying on shareholder engagement to monitor companies for the purposes of public interest objectives such as the social good of a well-performing corporate sector over the long term. *Id.* at 10–198.

169. Arad Reisberg, *The Notion of Stewardship from a Company Law Perspective: Re-Defined and Re-Assessed in Light of the Recent Financial Crisis?*, 18 J. FIN. CRIME 126 (2011).

170. DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS (2009), http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf [https://perma.cc/BR9J-F62K].

171. Kate Burgess, *Myners Lashes Out at Landlord Shareholders*, FIN. TIMES (Apr. 21, 2009), https://www.ft.com/content/c0217c20-2eaf-11de-b7d3-00144feabdc0 [https://perma.cc/V6H7-LBYD]; Jennifer Hughes, *FSA Chief Lambasts Uncritical Investors*, FIN. TIMES (Mar. 11, 2009), https://www.ft.com/content/9edc7548-0e8d-11de-b099-0000779fd2ac [https://perma.cc/8BCZ-V4B7]. *See also* Helia Ebrahimi, *Institutional Shareholders Admit Oversight Failure on Banks*, TELEGRAPH (Jan. 27, 2009, 9:00 PM),

should have monitored board risk management. Although institutional shareholder apathy is not regarded as the key cause of the U.K. banking crisis, the Walker Review on corporate governance in banks and financial institutions is of the view that such institutional shareholder apathy has provided a tolerant context for misjudgments of risk made at the board level of the failed U.K. banks. In response, the Institutional Shareholders Committee, the trade association representing institutions, developed a broadly framed Code to encourage institutions to be more active.[172] Such 'activeness' extends beyond attendance at general meetings and voting, and entails informal dialogue and monitoring, as well as intervention by shareholders where relevant. As this Code has received bottom-up acceptance among institutions, the Financial Reporting Council in the U.K. adopted this formally as a 'Stewardship Code' in 2010,[173] to reflect the expectations for institutions —that to engage with their investee companies is a matter of 'stewardship.' The Code is subject to a comply-or-explain regime, and only applies to voluntary signatories.[174]

Under the U.K. Stewardship Code, institutions are required to establish certain policies to guide their engagement behavior with investee companies. Principle 1 requires that institutions develop stewardship policies to explain how they intend to integrate stewardship into their investment management and discharge those responsibilities, and publicly disclose the policies.[175] Principle 2 requires institutions to supplement the abovementioned stewardship policy, which is of an overarching nature, with specific policies that show how institutions manage conflicts of interest that may affect their stewardship.[176] Principle

---

http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/4363635/Institutional-shareholders-admit-oversight-failure-on-banks.html [https://perma.cc/63SE-CTHG].

172. INSTITUTIONAL S'HOLDERS' COMM., CODE ON THE RESPONSIBILITIES OF INSTITUTIONAL INVESTORS (2010), https://www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=industry-guidance/isc-01.pdf [https://perma.cc/BJ53-DHSY].

173. FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE (Sept. 2012), https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx [https://perma.cc/QM58-U9CV].

174. John Parkinson & Gavin Kelly, *The Combined Code of Corporate Governance*, 70 POL. Q. 101 (1999).

175. FIN. REPORTING COUNCIL, *supra* note 173, at 6 (Principle 1).

176. *Id.* (Principle 2).

6 also requires institutions to develop a policy for voting and disclosure of voting behavior.[177]

Further, the Code provides guidance on best or optimal practices in engagement behavior. Stewardship involves "monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration" through voting and the development of a "purposeful dialogue" with the investee companies on these matters.[178] Principle 3 requires institutions to "monitor" their companies.[179] This Principle illustrates examples of monitoring activities, such as keeping abreast of corporate disclosures, considering the quality and implications of corporate disclosure and meeting company representatives, and attending general meetings.[180] Such monitoring need not be interactive with the company management as 'monitoring' includes becoming prepared for interaction and it generally refers to being sufficiently informed. Principle 4 then provides for the development of an appropriate escalation and intervention policy.[181] It emphasizes that the pursuit of passive investment strategies and/ or being underweight in any particular stock should not prevent the undertaking of appropriate escalation and intervention activities.[182] The illustrations of escalation and intervention activities, including meeting company representatives, making public statements, submitting proposals for general meetings and requisitioning general meetings,[183] are of a nature that is more interactive with company management or at least compels company management to respond. Principle 5 then envisages that institutions may step up engagement in collective terms especially "at times of significant corporate or wider economic stress, or when the risks posed threaten the ability of the company to continue."[184]

---

177. *Id.* at 9 (Principle 6).
178. *Id.* at 6 (Principle 1).
179. *Id.* at 7 (Principle 3).
180. *Id.*
181. *Id.* at 8 (Principle 4).
182. *Id.*
183. *Id.*
184. *Id.* at 8–9 (Principle 5); *see also* DEP'T FOR BUS., INNOVATION & SKILLS, *supra* note 57 § 7.8.

In our survey of institutional shareholders' corporate governance roles,[185] we observe a diverse range of engagement behavior, from cosmetic engagement to using shareholder rights in an instrumental manner to further shareholders' own interests. As 'stewardship' is not defined for the purposes of achieving particular ends, it becomes merely a paradigm for justifying or legitimating the demonstration of shareholders' corporate governance rights and roles in a visible manner. The exercise of shareholders' rights and roles cannot be assumed to be *certainly* in the interests of the company as shareholders do not normally owe duties of loyalty to the company.[186] We do not see how shareholder stewardship could become the paradigm in which conflicts between corporations' innovation and governance needs are resolved, as, in the absence of normative standards of shareholder conduct, shareholder stewardship merely legitimizes the exercise of shareholders' powers, whether formally or informally. We are unable to see how shareholder stewardship, in a model of shareholder primacy, would be well-placed to work with firms towards adjustment of corporate governance compliance that may facilitate firm innovation.

As shareholder primacy ideologically dominates U.K. corporate law and governance, the principles-based approach of apparent flexibility in designing corporate governance standards does not necessarily produce a range of diverse outcomes for firms. In contrast, the rules-based system in the U.S. may offer opportunities for the refinement of corporate governance standards. As the development of corporate governance rules in the U.S. is shaped by contests in pro-management and pro-shareholder debates,[187] the articulation of rules takes place in an arena for

---

185. BARKER & CHIU, *supra* note 39; *see also* Jennifer G. Hill, *Images of the Shareholder—Shareholder Power and Shareholder Powerlessness* (N.Y. Univ. Law & Econ. Research Paper Series, Working Paper No. 15-23, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2664430 [https://perma.cc/A2NB-SS7C].

186. Robert Flannigan, *The Economics of Fiduciary Accountability*, 32 DEL. J. CORP. L. 393 (2007). This is in marked contrast with the U.S. legal regime, which imposes fiduciary duties on majority controlling shareholders and in closely held private companies. *See* Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 HOFSTRA L. REV. 175 (2004); Jens Dammann, *The Controlling Shareholder's General Duty of Care: A Dogma That Should Be Abandoned*, 2015 U. ILL. L. REV. 479 (2015).

187. Such as exemplified by Business Roundtable v. SEC, where the SEC lost in relation to a one-share-one vote policy, 905 F.2d 406 (D.C. Cir. 1990), and in relation to

compromises to be made. In the U.S., formal shareholder powers whether in corporate or securities law are more limited than in the U.K.,[188] but minority shareholder activists can make visible demonstrations and overtures that demand boards' attention.[189] Such activism is however not governed by *ex ante* standards of conduct either in corporate or securities law. Instead of assuming that shareholders are the optimal port of call to determine a company's governance, we suggest the contested landscape in the U.S. provides ample opportunities for debate and future rule development, to achieve balances between the demands of investors in securities markets and the need to meet firms' longer-term resource-based needs for value creation. The less pronounced bias in the U.S. towards shareholder power in the total mix of corporate and securities law provides a context for dynamic forces to shape corporate governance expectations and standards, which is not at all disadvantageous to the U.S.

This context may also explain the lack of an accepted Stewardship Code by the SEC or by leading securities markets.[190] The lack of an assumption that shareholders are the ultimate port of call to determine optimal corporate governance could indeed be a beneficial context for the negotiation of corporate governance standards in a dynamic and organic manner. We see firm innovation needs as capable of being explicitly addressed through rule adjustments, such adjustments being the

---

Rule 14a-11 which provides for enhanced shareholder power to nominate directors for appointment, 647 F.3d 1144 (D.C. Cir. 2011).

188. For a general discussion in a historical view, see Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033 (2015).

189. Hedge funds have greatly shaken up the landscape for corporate influence, and commentators are mixed in their perspectives of the impact of such activism on corporations. On skeptical pieces, see John C. Coffee, Jr. & Darius Palia, *The Impact of Hedge Fund Activism: Evidence and Implications* (European Corp. Governance Inst. Working Paper Series in Law, Working Paper No. 266/2014, 2014), http://ssrn.com/abstract=2496518 [https://perma.cc/E9Q7-QFZ5]; Frank Partnoy, *U.S. Hedge Fund Activism*, (Univ. of San Diego, Legal Studies Research Paper Series, Research Paper No. 15-187, 2015) (on file with the Fordham Journal of Corporate & Financial Law). On more optimistic pieces, see Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015); Shane Goodwin, Corporate Governance and Hedge Fund Activism (Sept. 2015) (unpublished manuscript), http://ssrn.com/abstract=2646293 [https://perma.cc/N5DT-CMV7].

190. Discussed in Jennifer G. Hill, *Good Activist/Bad Activist: The Rise of International Stewardship Codes*, 41 SEATTLE U. L. REV. (forthcoming 2018).

culmination of processes of debate, therefore likely to be more acceptable to firms and markets and would not adversely impact the attractiveness of securities markets to investors. Although the recently established Investor Stewardship Group in the U.S. is attempting to lead the way by promulgating a Code for Corporate Governance and for Stewardship,[191] such Codes are distinctly shareholder-centric, directing board accountability exclusively to shareholders and promoting increased shareholder influence and power.[192] We do not see such Codes as likely to be adopted yet by the SEC or securities markets in the face of the complex forces that drive the development of corporate and securities laws in the U.S. We will explore rule adjustment in rules-based regimes as compared to principles-based regimes for corporate governance shortly. We turn first to an overview of the options for rule adjustment to be made.

Rule adjustment may be achieved in a number of ways. First, there is a case to consider adjusting prevailing corporate governance standards (or rules) in order not to disincentivize innovation. In the alternative, we could consider establishing a different set of corporate governance standards (or an alternative Code or set of rules) for innovative companies.

B. ADJUSTING CORPORATE GOVERNANCE STANDARDS/RULES?

Explicit adjustments to established corporate governance codes such as the NYSE, NASDAQ corporate governance rules, or the U.K. Corporate Governance Code would likely face many challenges, even if framed towards the purposes of promoting firm innovation for long-term value creation. The U.K. Corporate Governance Code, for example, is a product of influences increasingly dominated by the investment sector.[193] This sector has every incentive to shape a shareholder-centered set of

191. *About the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance*, INV. STEWARDSHIP GROUP, https://www.isgframework.org/ [https://perma.cc/T9GM-B9SL] (last visited Feb. 21, 2018).

192. *Corporate Governance Principles for US Listed Companies*, INV. STEWARDSHIP GROUP, https://www.isgframework.org/corporate-governance-principles/ [https://perma.cc/37QZ-A3W6] (last visited Feb. 19, 2018) (Principles 1–3).

193. FIN. REPORTING COUNCIL, *supra* note 173. The success of exporting the U.K.'s principles-based corporate governance and stewardship codes is discussed in Chiu, *supra* note 167.

corporate governance standards that protect investment value and minority shareholder rights. Policy-makers also continue to affirm the primacy of shareholder stewardship as they desire the investment sector to facilitate market-based governance for the corporate sector and minimize the need for state intervention and regulation.[194] In this light, Code standards that are consonant with shareholders' preferences are unlikely to be pared down. Institutional investors also exert considerable market pressure in global securities markets, as discussed in Part I, accounting for increasing observation of international adoption of both corporate governance and stewardship codes.[195] In terms of adjusting corporate governance rules on U.S. securities markets, we see that the SEC may potentially not be supportive if the perception is that such adjustments in favor of firm innovation needs would result in paring down investors' rights or level of protection.

Corporate governance standards or rules have become key indicators in global securities markets, providing a 'branding' effect for listed companies as being well-governed and promising. Their 'branding role' in boosting the appeal of securities markets to investors,[196] especially institutional investors, is likely to be protected by securities markets and listing authorities. There is likely to be a degree of anxiety and reluctance to adjust code standards or rules in a manner that is seen to deviate from investors' preference for the shareholder-centered agency-based model. Pressures from international convergence would also make such adjustments unlikely to be pursued. The adoption of similar corporate governance standards or rules in many securities markets around the world has led to the general acceptance of them as being essential capital markets institutions.[197] Global competitive pressures tend towards sustaining or encouraging more convergence of corporate governance standards.

In light of the significant challenges to adjusting codes or rules, we propose adjustment by way of an 'exceptions-based' regime and not by way of frontal challenge to the established codes and rules. This regime is discussed shortly, but before that, we turn to exploring whether an alternative set of corporate governance standards can be introduced for innovative companies as a means of rule adjustment.

---

194. BARKER & CHIU, *supra* note 39, at 1–10, 122–198.

195. Hopt, *supra* note 11; O'Sullivan, *supra* note 13.

196. La Porta et al., *supra* note 162.

197. ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 77, at 10–18.

C. An Alternative Set of Corporate Governance Standards for Innovative Companies?

McCahery and Vermeulen posit that an alternative set of corporate governance standards could be established for innovative companies.[198] It can be argued that having a set of alternative corporate governance standards is superior to the situation of open-ended flexibility in deviation from prevailing standards. Recognition for *different* standards that may be useful for companies that engage in significant amounts of innovation, such as in technology, *and* formalization into a different code give such *different* standards an appeal of legitimacy. This is also important for companies in their interface with capital markets as the existence of formalized governance rules or standards fosters investor trust. However, developing such an alternative set of rules or standards altogether would also entail defining the scope of application of such standards or rules, and justifying why carving out 'innovative companies' as a sector distinguished from the listed corporate sector is appropriate. Would technology, automotive, or pharmaceutical companies be regarded as innovative while retail companies may not? Establishing an alternative set of rules or standards for a yet-to-be-defined alternative sector raises boundary issues, and also arbitrage issues, although it can be argued that competition between different sets of rules and codes can lead to greater market choice in optimal governance models for listed companies.

For now, we argue that an immediately practicable and incremental approach lies in adding to prevailing corporate governance standards, a set of recognized exceptions to the existing rules or standards on the grounds of 'resource-based justifications.' An exceptions-based regime would implicitly recognize the default status of existing rules and standards, and would also put the onus on companies to show that they are eligible for the exceptions. Such accountability is in our view a necessary trade-off in order to secure market support for a firms' value-creation strategy.

Where the U.K. is concerned, an exceptions-based regime would be a refinement of the 'comply-or-explain' model that suffers from the perception problem that 'comply' is ideal, while 'explain,' which relates

198. Joseph A. McCahery & Erik P.M. Vermeulen, *Corporate Governance and Innovation: Venture Capital, Joint Ventures, and Family Businesses* (European Corp. Governance Inst., Law Working Paper No. 65/2006, 2006), http://ssrn.com/abstract=894785 [https://perma.cc/T7TU-H687].

to an uncharted territory, raises investor risk. We are of the view that by formally carving out exceptions, such exceptions can more clearly articulate companies' resource-based needs that promote innovation. This provides more transparency and predictability for investors, enhancing the acceptability and legitimacy of the exceptions. The formality of having clearly articulated exceptions and companies to demonstrate that they fall within these would in less likelihood adversely affect company-investor relations, as investors continue to be relevant to scrutinizing the company's case for adopting exceptions. We are indeed of the view that developing such a formalized exceptions-based regime for companies' deviation from conventional corporate governance standards forces investors to engage more meaningfully with corporate communications and explanations, therefore making 'stewardship' more substantive in nature. Investors and indeed their proxy advisers should not merely rely on compliance as a sign of 'good governance' and should demonstrate that they are worthy of the stewardship call to understand individual company characteristics and needs, and to engage accordingly.

Where the U.S. is concerned, we propose that securities markets should consider developing an 'exceptions-based' regime with a clear justificatory criteria based on resource-based principles. A danger is that the exploration of such a regime could ignite the long-standing contesting forces between businesses (or the Business Roundtable, which may support pro-innovation initiatives) and investors (and championed by the SEC[199]). However, it can be argued that refinement to corporate governance rules are a reflection of changing needs in the corporate sector and securities markets, and so there should not be a resistance to engage in this dialectical process. The body of empirical findings that support a resource-based perspective of corporate governance and its role in promoting firm innovation can provide guidance as to how exceptions should be developed. This allows an important conceptual development in corporate governance to be debated on and gain recognition. Ultimately, the promotion of the importance of the resource-based perspective will not only enrich conceptual discussion and development,

199. For example, the SEC's attempt to improve investor protection under the challenged Rule 14a-11 that allowed investors to more easily access the proxy process for nominating board candidates. This was ultimately defeated in judicial review. *See* Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011); *see also* Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Seeing Capital Markets Through Investor Eyes (Dec. 5, 2013), https://www.sec.gov/news/speech/2013-spch120513-2laa [https://perma.cc/7YXC-5QBK] (indicating an "investor protection"-first approach).

but also practically supports the building of key institutions of capital markets. However, we are fully cognizant that dialectical processes can be weighed down by their time-consuming nature and opposition in interests represented. The proposals in Part IV below sketch the contours of a few key features of our exceptions-based regime, which hopefully feed into such dialectical processes.

III. ESTABLISHING A RESOURCE-BASED EXCEPTIONS REGIME TO CONVENTIONAL CORPORATE GOVERNANCE STANDARDS

The key features of many corporate governance codes deal with boards and emphasize a board's roles in effective monitoring and 'value protection.' The excessive prioritization of 'value protection' may cause boards to make strategic trade-offs between value protection priorities and 'value creation' strategies. We suggest that the key features of the proposed exceptions-based regime would revolve around boards, such as relating to board appointments, design of executive remuneration, and board responsibilities in order to accommodate pro-innovation needs that would benefit from a resource-based perspective. These are not exhaustive but we focus on boards as we are of the view that rule development such as in galvanizing shareholders as a resource have already progressed much further, such as in the rules providing for dual class listing. The proposals below embody the ideas distilled from the adoption of a resource-based account of corporate governance, and should be regarded as starting points for policy development in corporate governance standards and rules.

A. BALANCING 'MONITORING' APPOINTMENTS WITH 'RESOURCE-BASED' APPOINTMENTS

In both the U.S. and U.K., the appointment of non-executive and independent directors has been accepted as a key standard in good corporate governance, in order to promote 'monitoring' on the board. Non-executive or independent directors are perceived to be able to moderate self-serving executive behavior or even detect misbehavior by executive members.[200]

200. *See, e.g.*, Richard C. Nolan, *The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report*, 6 THEORETICAL INQUIRIES L. 413 (2005).

The monitoring role is explicitly articulated in the U.K. Corporate Governance Code, as being consistent with the shareholder-centered agency-based model of corporate governance-non-executive directors are to be appointed to U.K. boards to serve primarily in the capacity of 'financial monitor.'[201] They are responsible for scrutinizing financial performance, the "integrity of financial information and that financial controls and systems of risk management."[202] Such responsibilities are clearly in the vein of chiefly 'defensive' or 'value protecting' purposes. In the U.S., the role of 'independent' directors includes a monitoring purpose, to keep powerful management in check by virtue of 'non-management' or 'disinterested' (therefore more objective) attributes.[203]

In order to boost 'monitoring' power on boards, the composition of non-executive or independent directors is often prescribed. The U.K. Corporate Governance Code recommends at least half of the board to be non-executive and independent.[204] Independence requirements are also applied for the membership of the nomination committee and the majority of membership of the remuneration or audit committees of the board.[205] The NYSE and NASDAQ rules on corporate governance feature a similar prescription in terms of board composition. The NASDAQ rules require independent membership of the nomination, compensation, and audit committees, while the NYSE rules prescribe at least one independent member to serve on board committees.[206] Further, the U.K. Corporate Governance Code also designates the senior independent director to be the 'monitoring' lead and to interact with shareholders.[207]

We argue that first, the prescriptive composition requirements could be subject to exceptions where resource-based justifications exist. Part II has pointed out how boards are an important resource, and at times, higher levels of executive appointments or even certain interlocking directorial appointments could be important resources for the firm. Perhaps an exception can be created to moderate the requirement of 50%

---

201. FIN. REPORTING COUNCIL, *supra* note 79 § A.4.

202. *Id.*

203. Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73 (2007).

204. FIN. REPORTING COUNCIL, *supra* note 79 § B.1.2.

205. *Id.* §§ B.2.1, C.3.1, D.2.1.

206. N.Y. STOCK EXCH., *supra* note 104 § 303A (requiring at least 1 independent director on board committees); NASDAQ, *supra* note 155 § 5600 (providing that all board committee members should be independent).

207. FIN. REPORTING COUNCIL, *supra* note 79 § A.4.1.

independence to 'at least 25%,' so that room can be made for resource-based appointments that can be explained.

Under the principles-based approach taken in the U.K. Corporate Governance Code, the exception can be stipulated in the Code subject to companies' disclosure and justification. The principles-based approach is predominantly an *ex post* regime, thus companies would need to convince shareholders that their appointments for resource-based purposes are warranted.

In the U.S., as the majority independent requirement is cast as a market rule, adjustment to this requires an explicit addition to the rules that exceptions can be admitted. The NYSE and NASDAQ could continue to uphold a default of 'majority independent,' unless clearly-articulated exceptions that are based on resource-based criteria are applied. This requires the market to take on the additional role of approving the exception. We believe that markets are well-placed to do so. The NYSE has, as discussed in Part II, upheld dual-class voting shares in its balanced consideration for firm needs and investors' preferences. In recognizing the cogency of resource-based corporate governance needs on the part of companies, a range of debatable issues will arise for securities markets, beyond just the dual-class shares debate. Hence, securities markets should engage with these instead of shutting them out with a dogmatic insistence on the agency-based perspective of corporate governance. A note of caution is that reducing the proportion of independent directors in favor of 'resource-based' appointments may become a back door by which powerful CEOs on American company boards bring in their friends and cronies. Securities markets should therefore be vigilant about the ties between CEOs and resource-based directorial appointees in considering the balance of the board and whether the exceptions should apply. Further, as we see that both exchanges already misapply the board composition rule where companies feature controlling shareholders, the possibility of additional exceptions being introduced is not impracticable.

Next, we suggest that it would be a missed opportunity for appointments of non-executive or independent directors to only focus on their financial monitoring roles, as empirical research has found that non-executive directors, especially those with 'social capital,' can bring new ideas and strategic input[208] that is useful for the company's promotion of

208. Strategic contribution by non-executive directors was highlighted in DEREK HIGGS, REVIEW ON THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS (Jan.

innovation.[209] The purpose of non-executive or independent directors is more clearly articulated to be in relation to monitoring roles in the U.K. than under the NYSE or NASDAQ's manuals in the U.S.[210] Hence, we see adjustment needed particularly in relation to the U.K. position.

We argue that in the U.K., with the role of the senior independent director being defined to align with the company's accountability to shareholders, perhaps the role of 'non-executive' director should be left more open and welcome to a resource-based perspective of their relevance. The U.K. Corporate Governance Code sets out that appointments to the board are to be evaluated in terms of the balance of skills, knowledge, independence, and experience.[211] We urge that appointments to the board, whether executive or non-executive, should take into account the resource-based profile of the candidate, and that board responsibilities be defined more holistically, including the needs of advancing the collective enterprise of the company for 'value creation,' besides 'value protection' responsibilities. This would mean explicitly widening the scope of non-executive and independent director's scope of oversight, and requires adjustment on the part of the nomination committee's selection processes.

The nomination committee is normally tasked with selecting suitable executive and non-executive directors.[212] Empirical research shows that the characteristics of the nomination committee members affect their selection.[213] The independence quotient on the nomination committee is likely to affect the committee's determination, such as in favor of candidates' 'monitoring' qualities, possibly playing down the importance of strategic capabilities. We urge a more broad-minded application of appointment criteria to non-executive and independent directors, looking

---

2003), http://www.ecgi.org/codes/documents/higgsreport.pdf [https://perma.cc/E6DS-ZT5M], but over the years and across corporate scandals, the 'monitoring' role of non-executive and independent directors has become more pronounced.

209. *See* Balsmeier et al., *supra* note 80; Kang et al., *supra* note 80.

210. Clarke, *supra* note 203, indeed argues for more clarification of their roles, but in this Article we see the open-endedness of the purpose of such directors as being beneficial and can accommodate resource-based needs for promoting innovation.

211. FIN. REPORTING COUNCIL, *supra* note 79 § B.6.

212. *Id.* § B.2.1; N.Y. STOCK EXCH., *supra* note 104 § 303A.04; NASDAQ, *supra* note 155 § 5600.

213. Szymon Kaczmarek et al., *Antecedents of Board Composition: The Role of Nomination Committees*, 20 CORP. GOVERNANCE: INT'L REV. 474 (2012).

conjunctively at their strategic abilities and the 'resources' they can contribute to the company. The nomination committee should be required to report on both the agency-based as well as resource-based justifications for board appointments in the company's annual report.

One of the implications of widening the scope of non-executive or independent directors' responsibilities is that perhaps such directors could be awarded performance-linked remuneration in order to incentivize them to bring their 'resources' to contribute to the strategic needs of the company. At present under the U.K. Code, non-executive directors are tied to a monitoring role and cannot be remunerated in a manner linked to the company's performance.[214] The Code is antagonistic to this suggestion as such remuneration is perceived to likely jeopardize non-executive directors' independence or objectivity. Although such a clear prohibition is not present in either the NYSE or NASDAQ Manuals, the receipt of performance-linked compensation may affect a director's 'independence.'

It may be argued that if resource-based board appointments are to contribute to the strategy of the company's business, they should not be put up for non-executive appointments in the first place. However, being an executive director is demanding, and suitable or talented people may not wish to make that commitment if tied up elsewhere. It can be useful to have a non-executive director on board who needs to be appointed in that capacity only perhaps because s/he holds an executive directorship elsewhere. If we take a resource-based perspective of corporate governance, there is no reason why non-executive directors who contribute to the company's success should not be rewarded in a form of performance-linked remuneration.[215] It would be necessary to ensure that the remuneration committee sets out, from the start, clear criteria for assessing such directors' performance and to ensure that pay policies do not reward non-performance or failure.

In relation to the U.K. Corporate Governance Code, we suggest an exception to be articulated with respect to the remuneration of a resource-based non-executive appointment. The nomination and remuneration committees should be tasked with considering appointments based on resource-based purposes and whether and why performance-linked remuneration should be appropriate. We suggest that such determinations should be clearly disclosed to markets, and the award of remuneration

214. FIN. REPORTING COUNCIL, *supra* note 79 § D.1.3.
215. GUBERNA, *supra* note 10.

should be subject to the same controls as those existing in the U.K.—i.e. shareholder approval on a three-year basis, and in addition, a yearly shareholder advisory vote on compliance with the earlier-obtained approval.[216] In this manner, the exceptions regime to established conventional standards can strike a balance between catering to firms' resource-based needs in innovation and being accountable to securities markets.

The NYSE and NASDAQ manuals do not expressly prohibit independent directors from receiving performance-based compensation but such receipt may bring into question their 'independence' and hence affect the company's board composition compliance. The NYSE corporate governance rules require that independent directors do not have a material relationship with the company, and compensation could be a factor in determining if the relationship is material.[217] If compensation is linked to performance, it can be argued that the lack of a 'material' relationship may not be found. However, as the compensation committee has the discretion to make its determinations and justify them, the committee can achieve a balance between establishing a compensation policy sufficient to incentivize the resource-based appointment while setting the level of compensation to be proportionate to the non-executive profile of such an appointment, so that the level of award may not become material. The NASDAQ rules regard previous employment and a compensation relationship in excess of $120,000 for the previous three years as not satisfying the independence criteria, but if a board member has received in excess of $120,000 for board or committee service, the quantitative threshold does not apply to disqualify such a person from being regarded as 'independent.'[218] It seems that board members can be remunerated in significant levels but related to 'board service' as such. We do not think performance-linked compensation is inconsistent with the NASDAQ rules but the compensation committee should be vigilant to define the performance criteria for the board service such resource-based directors bring and apply them stringently. Further, both securities markets should monitor how the use of such compensation is justified, in

216. Companies Act 2006, c. 46, § 439A (UK); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 951, 124 Stat. 1376, 1899–1900 (2010) (codified at 15 U.S.C. § 78n-1 (2012)).

217. N.Y. STOCK EXCH., *supra* note 104 § 303A.02.

218. NASDAQ, *supra* note 155 § 5605.

particular to prevent rewarding appointees to the board who may be cronies and friends of CEOs, as this could have the effect of reinforcing each other's high pay packages.[219]

B. A DIFFERENT LOOK AT BOARD DIVERSITY

Board appointments are now affected by policy initiatives that seek to encourage greater diversity, especially gender diversity.[220] Although appointments are made on a merit basis, there is a need to ensure that there is adequate diversity to meet the requirements of 'balance.' The debate on gender diversity that exploded after the global financial crisis focused on the likelihood of women's risk moderation role on boards, seen as essential to curb excessive risk-taking in business strategy.[221] The impetus behind this initiative, and other forms of diversity are likely to be more socially-motivated as empirical findings on the performance relation to diverse boards are mixed.[222] One could view gender diversity as bringing about a change in dynamics that could benefit the board's decision-making process.[223] However such arguments are also causally flimsy and could be based on stereotyping the qualities women bring to

---

219. Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 403 (2006).

220. *See, e.g.*, EUROPEAN WOMEN ON BOARDS, GENDER DIVERSITY ON EUROPEAN BOARDS: REALIZING EUROPE'S POTENTIAL: PROGRESS AND CHALLENGES (Apr. 2016), http://european.ewob-network.eu/wp-content/uploads/2016/04/EWoB-quant-report-WEB-spreads.pdf [https://perma.cc/TN2K-JXMV].

221. Mohamed Azzim Gulamhussen & Sílvia Fonte Santa, *Female Directors in Bank Boardrooms and Their Influence on Performance and Risk-Taking*, 28 GLOBAL FIN. J. 10 (2015) (arguing that gender diversity on bank boards improves risk moderation); Melsa Ararat et al., Impact of Board Diversity on Boards' Monitoring Intensity and Firm Performance: Evidence from the Istanbul Stock Exchange (Apr. 2010) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572283 [https://perma.cc/69LU-QGTP] (on Turkish banks).

222. Renée B. Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. FIN. ECON. 291 (2009); Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference Does Difference Make?*, 39 DEL. J. CORP. L. 377 (2014). For more positive findings, see Jie Chen et al., Board Gender Diversity, Innovation and Firm Performance (Nov. 30, 2015) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2607295 [https://perma.cc/3HZJ-BZT8].

223. Barnali Choudhury, *New Rationales for Women on Boards*, 34 OXFORD J. LEGAL STUD. 511 (2014).

boards.[224] The call for more diversity on boards is curiously not connected to a more resource-based rhetoric. Indeed, such a view may make diversity arguments (and not just gender diversity) more legitimate and convincing, especially since empirical research supports the link between diversity on boards, the promotion of new strategic thinking, and increased corporate innovation.[225] It is also opined that from a resource-based perspective, diversity on boards also improves social and stakeholder legitimacy, as well as engagement, if these are important to the company's needs.[226]

C. A STRATEGY AND INNOVATION COMMITTEE OF THE BOARD

We are concerned that the functions of the board, especially in relation to its dedicated committees, are not susceptible to the promotion of corporate innovation for long-term development and success. This is because important committees such as the audit committee and remuneration committee are focused on 'value protection' in respect of their roles. It is queried whether the board is sufficiently directed or incentivized to focus on 'value creation' priorities.

Under the U.K. Corporate Governance Code, the audit committee has oversight of the integrity of financial reporting, the role of internal control, and the appointment or removal of external auditors, while the remuneration committee is to ensure appropriate executive remuneration design that promotes pay-for-performance and no rewards for failure.[227] In general, the remit of committees on the board in NYSE and NASDAQ listed companies are also focused on monitoring. Under both the NYSE and NASDAQ rules, compensation committee provides the essential 'objective' check on how the CEO is rewarded,[228] as significant levels of CEO pay are a key issue in U.S. corporate governance. The NYSE rules

224. Renée B. Adams, *Women on Boards: The Superheroes of Tomorrow?*, 27 LEADERSHIP Q. 371 (2016).

225. FORBES INSIGHTS, *supra* note 9 (discussing the advantages of diversity at all levels of the firm); *see also* Chen et al., *supra* note 222.

226. Mijntje Lückerath-Rovers, *Female Directors on Corporate Boards Provide Legitimacy to a Company: A Resource Dependency Perspective*, MGMT. ONLINE REV., June 2009, at 1.

227. FIN. REPORTING COUNCIL, *supra* note 79 §§ C, D.

228. N.Y. STOCK EXCH., *supra* note 104 § 303A.05; NASDAQ, *supra* note 155 § 5605(d).

require the compensation committee is to effectively check that CEOs have met their performance criteria and should act as performance/financial monitors of the company.[229] Both the NYSE and NASDAQ rules see the audit committee as having oversight of companies' internal reporting systems and playing a crucial role in determining the independence of the external auditor.[230] Further, the NYSE rules expect the audit committee to act as gatekeeper for compliance purposes.[231] In general, board committee work is excessively focused on agency-based issues and the monitoring priorities, and Vermeulen et al. perceive that corporate boards are too focused on compliance and monitoring issues today instead of providing strategic leadership, which is a resource-loss for companies.[232] We propose that a balancing institution can be introduced on boards in order to focus on its strategic priorities for innovation and value creation. We also believe that this institution can improve board engagement with strategic matters so that such matters are not dominated by the CEO. Board engagement with value-creation, which is at the heart of the business enterprise of the company, can in general help improve board scrutiny and oversight of powerful CEOs.

We propose that boards may consider establishing a Strategy and Innovation Committee in order to provide balance *vis a vis* the other board responsibilities and committees. Such a Committee could then be responsible for instituting a corporate-wide innovation strategy and its oversight. Such a Committee does not replace the board in strategic contributions as every director can bring a 'resource-based' contribution to the board. Many boards are not inordinately large,[233] and the Committee's role could be to coordinate the 'resource' profiles of all board members,[234] while some focus on 'monitoring' type functions in relation to the audit or remuneration committees. Such a Committee would be different in composition from the Committees dedicated to value-protection, and could indeed be comprised of a balanced slate of

229. N.Y. STOCK EXCH., *supra* note 104 § 303A.05.

230. *Id.* § 303A.06, NASDAQ, *supra* note 155 § 5605(c).

231. N.Y. STOCK EXCH., *supra* note 104 § 303A.07.

232. Vermeulen et al., *supra* note 60.

233. Large boards may function less well in decision-making and affect firm performance. *See* Paul M. Guest, *The Impact of Board Size on Firm Performance: Evidence from the UK*, 15 EUR. J. FIN. 385 (2009).

234. Kaufman & Englander, *supra* note 12.

executive and non-executive directors committed to exploring the exploitation of innovation by the company. The Committee can also be positioned to develop an enterprise-wide strategy and investigate all levels of the firm in order to encourage and motivate innovation. Articulating the separate importance of 'strategy and innovation,' which some may take for granted as an inherent board task, can contribute towards reinstating the importance of 'entrepreneurial' leadership on the board, a task which Vermeulen et al. critically opine has been left by the wayside in many companies.[235]

We also propose that the Strategy and Innovation Committee could be responsible for developing stakeholder engagement and channels for representation or participation if this is warranted from a resource-based perspective. Where the network effects of stakeholders, reputational maintenance, or matters of feedback by stakeholders are important to the company as 'resources'(as discussed in Part II), the Committee could develop strategies for stakeholder engagement that may create new avenues of participation and/or accountability.

The proposals above add formalized and resource-based exceptions to existing corporate governance rules and standards. They are not uncontroversial as investors can perceive a moderation of 'monitoring' emphases to be detrimental to their interests, or stakeholder engagement to be a dilution of shareholder primacy. This Article does not set out to present a perfect reconciliation, as Parts I and II have already explored the context of tensions and dilemmas between the shareholder-centered agency-based corporate governance standards favored by investors and deviations from those standards for pro-innovation needs in companies. We believe that the proposed adjustments are ultimately moderations of existing standards that seek to mitigate the straitjacketing effects of prevailing corporate governance standards perceived by some companies in accessing or deploying resources to develop innovation. Prevailing corporate governance standards have developed such a strong leaning towards agency-based corporate governance and investor interests that some balance towards the other constituents in corporate governance may not be unwarranted.

---

235. Vermeulen et al., *supra* note 60.

D. RETHINKING CORPORATE GOVERNANCE STANDARDIZATION

In light of our approach to establishing formalized exceptions to prevailing corporate governance standards, it is also worth taking a step back and critically questioning whether the movement of corporate governance standardization in securities markets is optimal.

Standardization in corporate governance codes or rules tends towards inflexibility over the long term.[236] This may also apply to a regime of formalized exceptions to code standards. In the contests between flexibility and predictability, between business and investors, compromises made could result in the proliferation of formalized exceptions that become inflexible and quasi-mandatory.

The factors that stimulate innovation discussed above, i.e. access to a range of resources, designing incentives for innovation to occur at all levels in a firm, and having a range of structures that would support innovation, are open-ended in nature and would likely benefit from less straitjacketing standards. Yablon warns that the innovation mind-set and ethos seek to explore the 'weird and wonderful' rather than the conventional.[237] Hence, it could be optimal for companies to be subject only to minimal governance practices so that their resource-based opportunities are not constrained. Excessive standardization in corporate governance that is purported towards promoting innovation may ultimately achieve the antithesis of what is desired.

However, scaling back the development of corporate governance rules or codes is unlikely given the developments since the 1990s. Corporate scandals in the U.S. and U.K. have elicited market responses that demand better governed companies that issue publicly listed equity. The U.K. Corporate Governance Code was established in response to the failures of significant companies such as the Bank of Credit and Commerce International (BCCI), the Maxwell Group and Polly Peck Plc in the 1990s,[238] and the Code has grown in volume and detail over successive reviews, with some corporate governance practices hardened into binding obligations, such as shareholders' Say-on-Pay. Since the

---

236. Corporate governance codes tend to grow in volume and detail and ultimately minimize the original flexibility it was intended to provide. The U.K. Corporate Governance Code is an example in point.

237. Yablon, *supra* note 5.

238. CADBURY, *supra* note 147, provides the background for the genesis of the Code which incorporated the Committee's recommendations.

establishment of the Cadbury Code of Corporate Governance in 1992, the Code has incorporated concerns of executive remuneration in 1995,[239] consolidated requirements of directorial independence after the Higgs Review of 2003,[240] and strengthened the board's monitoring role of executives, as well as shareholders' monitoring of boards since the Walker Review after the global financial crisis.[241] Binding obligations include the shareholder's advisory vote for executive remuneration packages introduced in 2002,[242] now hardened into a three-year binding vote.[243] In the U.S., corporate governance issues have also become increasingly addressed in securities regulation, from the mandatory requirements of internal control and audit committees in the Sarbanes-Oxley Act of 2002,[244] which was passed in the wake of the Enron scandal in 2000, to the post-crisis Dodd-Frank Act 2010, which provides for a mandatory shareholder vote on executive remuneration.[245]

---

239. RICHARD GREENBURY, DIRECTORS' REMUNERATION (July 17, 1995), http://www.ecgi.org/codes/documents/greenbury.pdf [https://perma.cc/Y5HL-6WYB]. In 1995, the governance issue in the spotlight was executive remuneration, as public outcry mounted against excessive executive remuneration in privatized utilities companies, while staff reductions and pay restraint for staff took place in such companies. The Committee led by Sir Richard Greenbury to look into this issue produced a Report which recommended more robust guidelines for the structure and operation of independent remuneration committees on the board, and also advocated greater shareholder engagement with remuneration issues. The Code was modestly amended in that light. *See* Ian W. Jones & Michael G. Pollitt, *Who Influences Debates in Business Ethics? An Investigation into the Development of Corporate Governance in the UK Since 1990*, (Univ. of Cambridge, Econ. & Soc. Research Council, Ctr. for Bus. Research, Working Paper No. 221, 2001), https://www.researchgate.net/publication/4925039_Who_Influences_Debates_in_Business_Ethics_An_Investigation_into_the_Development_of_Corporate_Governance_in_the_UK_since_1990 [https://perma.cc/SMU9-5HSG].

240. HIGGS, *supra* note 208.

241. WALKER, *supra* note 170. The global financial crisis triggered important reviews such as the Walker Review of Corporate Governance in Banks and Financial Institutions which fed into Code amendments in relation to directorial time commitment, the importance of the Chairman and the monitoring role of independent directors, and the importance of risk management oversight at board level. *See* Moore, *supra* note 151.

242. The Directors' Remuneration Report Regulations 2002, SI 2002/1986 (UK).

243. Companies Act 2006, c. 46, § 439A (UK).

244. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 301, 302, 116 Stat. 745, 775–778 (2002) (codified at 18 U.S.C. § 1514A (2012)); *cf.* Romano, *supra* note 162 (critiquing the increase of corporate governance rules in securities regulation).

245. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 951, 124 Stat. 1376, 1899–1900 (2010) (codified at 15 U.S.C. § 78n-1 (2012)).

In this context, we see the moderation of the compliance environment for corporate governance, and not a major overhaul or abolition, as the only possible and incremental step that addresses companies' pro-innovation needs that require deviations from conventional corporate governance standards. The freedoms that companies need to exploit innovative potential in their resources ultimately have to be balanced against the need for investor protection and accountability. The development of exceptions-based regimes to prevailing standards allows the resource-based theory of corporate governance to be articulated and to provide balance against the agency-based perspective of corporate governance.

E. IMPLEMENTATION OF EXCEPTIONS-BASED REGIMES IN THE U.K. AND U.S.

There are likely to be interesting and pronounced differences in the implementation of an exceptions-based regime in the U.K. and U.S., as the principles-based approach in the U.K. would accommodate the exceptions in a different manner from the rules-based regime in U.S. securities regulation. These different frameworks present opportunities for certain achievements and drawbacks. In the U.K., we see the implementation of such an exceptions-based regime to face less *ex ante* challenges than in the U.S. However, the likely heavier lifting in the *ex ante* processes leading to rule adjustment in the U.S. may result in more balanced and credible content over the longer term.

In the U.K., we see the development of the exceptions-based regime by way of principles, consistent with the existing principles-based approach. Companies seeking exceptions will be *compelled* to articulate and explain how the exceptions allow them to leverage upon their resources and meet innovation needs. This regime would less likely undermine the established sense of trust that investors have in shareholder-centered agency-based corporate governance standards. As investors are required to scrutinize these exceptional situations, it is hoped that they will actively engage with corporate governance practices and *their connection* with corporate success. In other words, the principles-based approach relies heavily on the *ex post* scrutiny and feedback by investors to further refine and consolidate the exceptions-based regime. Investors should not just passively expect corporate compliance with prevailing standards. In this way, investors may develop more meaningful 'stewardship.'[246]

One can rightly query if it is inherently contradictory that we propose development of deviations from corporate governance standards and yet expect shareholders to provide scrutiny over the acceptability of those deviations. We acknowledge that this is a position that presents challenges given the U.K.'s subscription to shareholder primacy. Firms should not see the exceptions-based regime as giving them an opportunity to seek arbitrage from market demands, but investors should also moderate their agency-based demands and critically consider the firm's value-creation needs. In other words, we see that the exceptions-based regime presents opportunities for shareholder stewardship to be shaped more meaningfully. Such stewardship reflects two sides of the coin—as it continues to demand that companies are accountable to investors and securities markets, while investors should be prepared to engage with their investee companies in a more informed, considered, and holistic manner, taking into account the full range of corporate governance concerns from agency to resource-based perspectives, and seeing their corporate governance roles as unique to each company and not as a 'box-standard' slate of value protection demands. Whether such progress can be achieved in shareholder 'stewardship' remains to be seen, and the *ex post* risks in the U.K.'s '*laissez shareholders faire'* approach would lie in the sharpening of investor-firm conflict rather than the constructive seeking of balance and compromise.

In relation to rules-based regimes such as in the U.S., we previously suggested that the development of a formal exceptions-based regime requires explicit rule-making, corporate disclosure, and securities markets' involvement in considering and approving new exceptions. The development of such a regime would require more *ex ante* lifting than in the U.K., where the 'stewardship' expectations of shareholders provides the *ex post* scrutiny and feedback that further refines and shapes the regime.

It is argued that *ex ante* processes and dialectics prior to rule changes are not unfamiliar in the development of U.S. securities regulation.[247] The exceptions-based regime proposed here is ultimately a rule change that reflects a richer embrace of balanced ideology in corporate governance, and we must expect contests to take place in order to articulate the precise

246. *See supra* Part III.

247. Suggested in the 'collaborative' model espoused in Thompson, *supra* note 156.

balance between issuers' and investors' interests in the adoption of the resource-based and agency-based perspectives of corporate governance. The arena for rule-change is more complex in the U.S., and there is a possibility that shareholders may not dominate the processes for rule adjustment in the diverse landscape of interests in U.S. corporate governance. In particular, we encourage strong representation from experts in resource-based perspectives of the firm to be involved in shaping the exceptions-based regime so that the exceptions reflect empirically well-accepted positions. We also encourage securities markets to engage with ongoing research in this area for future developments for rule changes. This allows the arena for rule change not only to be shaped by the interests of key players, but also by substantive dialectics in ideology and conceptualization, which form the fundamental premises for securities regulation. These dialectics and processes are likely to be more challenging *ex ante* and the key risk is that the proposed rule adjustments may become jettisoned if compromises are not secured. However, such ideologically enriching dialectics, if successfully culminating in rule adjustment, would allow U.S. securities markets the opportunity to provide conceptual leadership that would be of global interest. One particular issue we see in rules-based regimes is that there may be a preference for exceptions to be crafted with precision and clarity as specific compromises are made. This may present some challenges as the needs for promoting innovation may be more optimally met by open-ended and flexible frameworks that allow 'weird and wonderful' resource-based opportunities to be taken hold of. Further, we see the need for securities markets to become more active in administering a more complex rules-based regime with the exceptions added to it, and to establish more robust and credible vetting procedures for determining eligibility to apply exceptions. Securities markets have the expertise to offer insights into the optimal balance between firm and investor interests and should not merely be led or incentivized by their own business case.

CONCLUSION

A company's pro-innovation needs are often met by the exploitation of its resources, widely defined. The resource-based theory of the firm provides immense empirical insights into how a firm's corporate governance factors can contribute to promoting innovation. These implications may however conflict with the prevailing standards of corporate governance imposed on many securities markets for listed companies, which have developed based on theoretical models supporting a shareholder-centered and agency-based theory of the firm. Although prevailing corporate governance standards can to an extent support firm innovation, tensions are created in some circumstances where companies pit their corporate governance compliance against resource-based needs that promote innovation. Such tensions have arisen in controversies surrounding listed companies that issue dual class stock that protect founder-members' innovative visions for the company, in companies with influential controlling shareholders, or where stakeholders may be important for corporate success. We argue that what is at the heart of many of these controversies is a contest between a resource-based perspective of the firm that seeks to maximize innovation and enterprise opportunities as a *collective* endeavor, and the agency-based perspective of the firm that seeks to mitigate the power of influential constituents such as directors or controlling shareholders in order to protect minority investors.

In the present context of steady internationalization and convergence in corporate governance standards in global securities markets towards a shareholder-centered agency-based model, we argue that there is a need to provide some room for accommodating the resource-based needs for companies in relation to promoting innovation. We explore a number of options and suggest that the most practicable option would be the development of recognized exceptions that deviate from prevailing corporate governance standards. We believe this approach is likely to be more acceptable and constructive in today's securities markets and is able to advance the importance of the resource-based theory of the firm that promotes long-term success of the corporate sector. We propose a structured, coherent, and formalized regime for such exceptions to occur in a way that would be subject to adequate investor scrutiny and market governance. This is because the exceptions-based regime must still continue to strike a balance between the 'value-protection' needs championed by investors anxious about the agency problem, and the 'value-creation' needs for firms that wish to exploit 'weird and wonderful' opportunities in innovation. This Article offers some suggestions for the exceptions-based regime drawing from wisdom in the resource-based perspective of corporate governance. These form a starting point and we acknowledge that the details of the balance struck would ultimately be dependent on the contest of interests and ideology in each jurisdiction's markets.

We further explore how an exceptions-based regime can be implemented in the U.K. and U.S., comparing the rules-based regime in the U.S. with the principles-based regime in the U.K. for corporate governance standards. We highlight implementation challenges and fully acknowledge the limitations that may continue to subsist in either jurisdiction. The importance of taking steps to introduce a countervailing balance to the shareholder-centered agency-based model of corporate governance cannot be overstated, and we argue that it is timely to give recognition to the wider and more holistic view of the corporation as a collective endeavor, with needs to continually create value for sustained success.