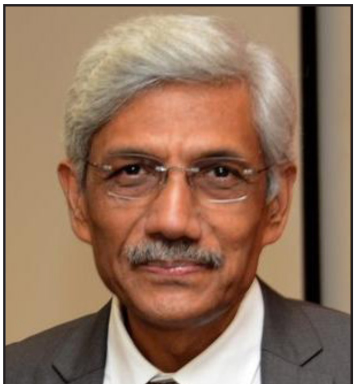
Adaptation of AI - Possibilities for Corporate Governance



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Much of the discussion about AI has centred on the possibility of rogue AI programmes going out of control, new use-cases for businesses, data privacy, and job losses. In this article we shall explore the possibilities in the practice of corporate governance that might emerge from large scale adaptation of AI tools. Before delving further into the topic, it would be necessary to understand the scope of the words 'corporate governance' lest it should cause any confusion.

Most of the literature about AI in corporate governance takes considers how the management could function more efficiently. For example, a research paper asserts:

"The broad application of AI in corporate governance highlights how technology can alter how businesses function and make decisions. It promises greater strategic insights, cost savings, and increased efficiency.[1]"

Some other papers blur the difference between AI Governance and Corporate Governance.

Regulators across various jurisdictions are embarking on a pioneering endeavour, exploring the development of AI governance frameworks to address the intricate legal, ethical, and regulatory challenges that arise from the adoption of AI in corporate governance practices[2].

The traditionally accepted scope of Corporate Governance is more specific. Indian Institute of Corporate Affairs (IICA) defines

Corporate governance essentially involves balancing the interest of the many stakeholders in a company. These include its shareholders, management, employees, customers, suppliers, bondholders, financiers, government and the community.

Corporate Governance has been understood more in the sense of resolution of agency problem between the management of a company and an inexperienced and diverse set of shareholders. Milton Friedman said,

"Corporate governance is to conduct business in accordance with the owner's or shareholders' desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs."

Even Cadbury Committee while defining corporate governance mentions *" fulfilling long terms strategic goals of the owners"* before mentioning employees, environment and local community.

The problem of Entrenched Management

In India where the companies have been traditionally family run, the focus of regulators has been to limit the powers of the controlling shareholders by insisting that the companies in India should be board driven. If the controlling shareholders want to do something in the company, they have to act through the Board of Directors. The situation has changed substantially over the last two decades. With the spread of equity holding in public either directly or through Mutual Funds, the controlling shareholders are actually holding less stock in companies while their hold on the management and the Board has not reduced. The issue has been aggravated with increasing investments by Private Equity Funds who invest substantially but lacking local experience and expertise in particular fields of business leave the management in the hands of the former controlling shareholders. This often gives rise to a situation where the Board is totally controlled by former controlling shareholders, holding sometimes as little as four percent of a company. The institution of Independent Directors should theoretically act up and stand for the vast majority of shareholders. However, even the Independent Directors are independent only in the technical sense that they didn't have any pecuniary relationship with the promoters in the past three years. The Management is instrumental in identifying Independent Directors and appointing them. Even where there is no formal alliance with the Management, the appointees feel a natural obligation towards the Management which spotted them in the first place. Unless there is an imminent existential threat to the company, the Independent Directors go along with the Management. The vast majority of shareholders remain a silent spectator in the entire act.

There were many historical reasons why the Board became the execution arm of the shareholders. During the sixteenth and seventeenth centuries, the chartered companies who were the precursors of the Joint Stock Companies were run by a Court of Directors that consisted of the original set of merchants who had petitioned for the royal charter. It would be obvious that they ran the company. Later, in the Joint Stock companies too, the Board of Directors remained the execution arm of the shareholders for two reasons. One, the large body of shareholders could not be expected to gather at a short notice to take a decisions about business. Secondly, the vast majority of shareholders couldn't have been expected to understand and vote sensibly on technical business matters. Finally, as investments in the Joint Stock Companies became more popular and shareholders got spread over the whole country, there was a physical limitation in holding frequent shareholder meetings. Over the next century, the hold of shareholders on the affairs of the company considerably weakened and the Board of Directors became progressively more powerful. Shareholders' role became limited to gathering once in a year for accepting the statement of accounts and confirming the Board's choices for further appointments on the Board. This imbalance of power is amply illustrated by the AT&T saga.

Between 1905 and 1907, financier Clarence Mackay purchased some five percent of AT&T's outstanding shares, giving him four times as much stock as the next largest owner. Such a large stake, Mackay argued, entitled him to representation on the company's board of directors. Mackay wrote to AT&T's President Frederick P. Fish, "Not one of your eighteen Directors . . . owns over 2,000 shares of your stock in his own right . . . .". Control rested in the hands of AT&T managers. Thirty-six percent of the stock was in the company treasury, voted by the AT&T directors through a trust agreement. Directors voted an even higher percentage when proxies were added in. Mackay had pointedly raised the issue of control in a corporation composed of numerous stockholders. It was an issue that would grow enormously important in the coming decades with AT&T as one of the central firms in the debate over who had the right to control and manage big firms. After consulting with other AT&T directors, Fish penned a lengthy reply. Each director, he wrote, had an obligation to serve "each and all of the stockholders," and it was "unwise to have any stock interest specifically represented on the Board." This was somewhat disingenuous because AT&T had several constituencies on its Board. Mackay noted, for example, that the telegraph giant Western Union owned just 20% of the stock of New York Telephone (a large AT&T subsidiary), yet held five of thirteen directorships. But most outrageous, in Mackay's opinion, was what he termed Fish's "new theory" that a large owner was somehow disqualified from management. By that logic, Mackay scoffed, "it would be better if the directors own no stock whatsoever, which, of course, is contrary to the theory on which corporations are organised." AT&T episode led to many changes in the corporate governance theory and practice. Now after more than a century, a need has arisen to have a relook at how companies are being run.

Independent Directors are not truly Independent

The discourse on corporate governance has so far centred on how to strengthen the position Independent Directors in a Board. How do we find directors who are independent? The job of finding and inducting Independent Directors is left to the Boards and their Nomination Committees. Whosoever holds sway over the Board, whether it is the professional management or the promoters or even a group of Independent Directors , will willy-nilly appoint persons with whom they are comfortable. They are more likely to add old friends and colleagues. There is little chance that a person so inducted will go publicly against the person who gave him the position and in case of severe misconduct by the management; an Independent Director is more likely to tender resignation on personal grounds rather than confronting. SEBI's expectations that IDs will put their real discomfort in their resignation letter at the pain of denying them further positions appear to be more of wishful thinking. Larger corporations might induct retired bureaucrats or other persons of eminence to the Boards. While doing so, they will take care not to recruit any person who is known to be prickly or thought to be a stickler. With the recent upward trend in the remuneration of Independent Directors and unprecedented increase in longevity, the Independent Director position has become a prized position, especially in large companies.

Regulators have an unwavering faith in Independent Directors and so do most of the academicians. Towards this end, most of the suggested use cases of AI in corporate governance revolve around helping the Independent Directors summarise the voluminous materials in a simple to understand formats. This use can be of great help as AI may summarise and as well translate technical jargon often used in Board presentations. AI tools can be developed that can interpret financial statements in easy to understand terms. While all this will be a positive step, it is difficult to believe that it would alter the situation drastically.

Experience over a last few decades has amply shown that the institution of Independent Directors and the Committee Structure has not been particularly effective in curbing major corporate wrongdoings. Most of the busted companies had stellar boards. We need to go back to drawing board to implement the basic aim of corporate governance, i.e. fulfilling long term strategic goals of the owners.

The need of a new paradigm of corporate governance

As of now Board of Directors is the almost only means by which the shareholders can achieve their long term goals. With the advent of large diversified shareholding of public, their dependence on the Board of Directors is total. There are cases where the management is so entrenched that even the majority shareholder is left with no choice but to toe along on the lines of the Board and the management as they do not want to risk a public showdown. We have discussed above how the golden bullet of Independent Director has been ineffective. What can be done?

Technological progress has often redistributed power in favour of the weak. Thanks to technology, the masses are no longer forced to trudge long distances on foot, are spared much of back breaking labour in the field, factories and mines, can listen to high quality music and see movies at near zero cost, and have access to information and education. Nearer to our subject matter, small shareholders can trade in stocks nearly independent of their broker at a minimal cost. Why can't we use technology to give control over corporations back to the vast multitude of the owners?

We have discussed above why almost all the decisions regarding business are taken in the Board of Directors and the shareholders meet once a year to pass routine resolutions. This factual position is reflected in the law and regulation too. The responsibilities of the Board of Directors are vast and all pervasive while the shareholders are left with routine acceptance of statement of accounts, voting for appointment of directors among the names suggested by the Board, and voting on some special matters like preferential allotment of shares and amendment to the Articles of Association.

The ostensible reason for such state of affairs can be several,

a. It is a costly affair to hold a shareholder meeting and is a logistic nightmare;
b. a meeting of the shareholders takes considerable amount of time to convene;
c. small shareholder do not have time to go through the voluminous agenda papers and is not able to understand the complex issues; and
d. the meetings are held in working hours when most of the shareholders are busy in their day jobs.

While the first and the last problems have already been solved by virtual meetings, AI tools are in a position to not only distil the long Explanatory Statements into understandable summary, but also to help them assess the implications in the light of domain knowledge of the business and technical knowledge that have not been captured in the Explanatory Statement to the agenda. For example, if an agenda is in respect of adoption of a particular technology, it is possible for a user to tell the AI agent about the problem at hand and the kind of company in question and ask it what all rival technologies are available and to recommend the best one based on various factors, including cost.

SEBI has been collapsing the time lines drastically in almost every securities market action. After closure of the IPO, it used to take sometimes months to list a company leading to many undesirable practices.. Now it takes three days as SEBI has leveraged technology to the fullest. A trade in shares could take weeks to settle, now it is settled the next day and technologically instant settlement is possible. In the same way it is not difficult to collapse the time lines of a shareholder meeting gradually to three days. If these meetings are held at regular intervals, it can be possible to examine whether many powers of the Board can be exercised by the shareholders themselves. This may solve the problem of managements and boards usurping the powers of the shareholder to an extent that even the majority shareholders are at their mercy.

One can still argue that the small shareholder will not have either time or inclination to vote even if she has all the technology at her command. To solve this problem, the role of Proxy Advisors can be expanded and instead of only advising as to how to vote, they can be authorised to actually vote on behalf of the small shareholders. A shareholder can authorise one of the Proxy Advisors to vote on her behalf for a small, rather minuscule fee. If the shareholder is not ready to even spend even that minuscule amount then she has voluntarily surrendered her 'democratic right' to govern the company and the society may not lament about her powerlessness before big shareholders and management. Of course, it will be necessary to drastically increase the number of Proxy firms and to regulate them strictly and closely.

All the above suggestions or possibilities might be totally fantastic and impractical. The thrust of the article is not on actually implementing any of the suggestions. Rather it is to recognise that widespread adoption of AI can result in unlimited possibilities. While debating about uses of AI, we should not be limited to its applications to existing processes. A debate should be initiated in the true brain storming mode where no suggestion is too foolish to be examined.

[1] ARTIFICIAL INTELLIGENCE IN CORPORATE GOVERNANCE Mustafa Kenan Ustahaliloglu; https://virtusinterpress.org/IMG/pdf/clgrv7i1p11.pdf

[2] AI's Influence on Corporate Governance; https://hscollp.in/ais-influence-on-corporate-governance/