

# Risks and the government of firms<sup>1</sup>

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## *Abstract :*

Due to risks of misconduct by company managers, corporate government should be reformed along the lines of a separation of powers and with the creation of a new position, namely that of risk and compliance officer reporting directly to the board of directors.

Increasingly, companies appear to be facing potential risks caused by their managers' behaviour. There have always been business leaders with questionable behaviour but it was less shocking and less widely reported. This was undoubtedly due to the fact that there was less free speech and fuller employment. Obviously, what we learn from ongoing legal proceedings or when managers step down is of great concern. Misappropriation of corporate philanthropy for personal use, real estate investments made by the company but for the benefit of managers, coverage by the company of personal losses on derivatives. These acts often lead to legal proceedings but it is interesting to note that companies usually only start in-house investigations once the court has brought an end to the manager's powers.

Over and beyond any criminal action, company managers have substantial authority over all the business's strategic decisions. Taking the example of France, everyone has an image of men and women rising to the summit of the business world but whose strategic decisions are suddenly found to be hugely misplaced investments. Although companies faced with losses and debts can ask their managers to leave, they only rarely challenge them prior to decisions being taken.

And, if firms are reluctant to contradict their managers, it is for a simple reason that unfortunately explains almost all instances of company managers being knocked off their pedestals in recent decades: if we attempt to tie corporate government in with political structures that have existed since the time of Montesquieu, the monarchy naturally comes out on top.

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<sup>1</sup> This paper draws significantly from Valérian F. (2011), *Crisis in Governance. Business Ethics and the Race for Profit*, Eska.

Government or governance? The two words are very similar. Corporate government is rarely referred to as the means in which authority is exercised within firms. Although sociologists have addressed the issue, this has often been within the established framework of power being wielded by a single person whose decisions are disseminated more or less effectively throughout the firm. This single person, the chief executive officer (CEO), is appointed under a defined procedure, is tasked with pursuing certain goals and is accountable to certain bodies for his/her actions. This type of authority, which is present in the majority of western firms, is a monarchy which, although elective and constitutional, remains a monarchy within the etymological meaning of authority exercised by a single person. Can the risks relating to the current monarchy be better controlled by reforming this authority?

Concerns regarding the excessive powers of business leaders are nothing new. They were raised by certain observers in the wake of the collapse of Enron and WorldCom, but did not spur a comprehensive overhaul of firms' in-house decision-making processes. American lawmakers focused on the boards of directors of listed US companies. The 2002 Sarbanes-Oxley Act placed several new responsibilities on boards mainly concerning auditing with the mandatory appointment of an audit committee which hires and oversees external auditors.

A few years later, these changes proved insufficient to prevent a global crisis which was partly attributable to the behaviour of financial companies and boards of directors that allowed themselves to be led by their managers along the glorious route towards high growth share prices to the detriment of all other considerations.

The CEO must be responsible for generating profits but should no longer be responsible for those who control how these profits are obtained. The true shakeup, which decades of recurrent crises have made necessary, should not take place on boards of directors but within firms. A single person cannot govern everything in the company from action to control. It might be said that such changes could make firms less efficient. It is true that the sole rationale for placing authority in the hands of a single person is the need to take rapid decisions but this would not be undermined by a separation of powers. On the contrary, the CEO would no longer be both an actor and controller and would be able to focus on profit growth.

To achieve this goal, the position of risk and compliance officer, reporting to the board and the board alone, should be created. This officer would be responsible for risk prevention and control, and would have duties that exceed those entrusted in many firms to a person with greying hair and very few or no associates. The teams overseen by this officer would come from two separate departments: the legal compliance team would come from the legal department and the internal audit team would come from the finance department. The risk and compliance officer would therefore verify that the company's actions comply with in-house rules and external regulations from both a legal and financial standpoint, and he/she would also be responsible for risk prevention, again from a legal and financial angle. Diagrams 1 and 2 provide a summarised organisation chart of a company before and after such a separation of powers.

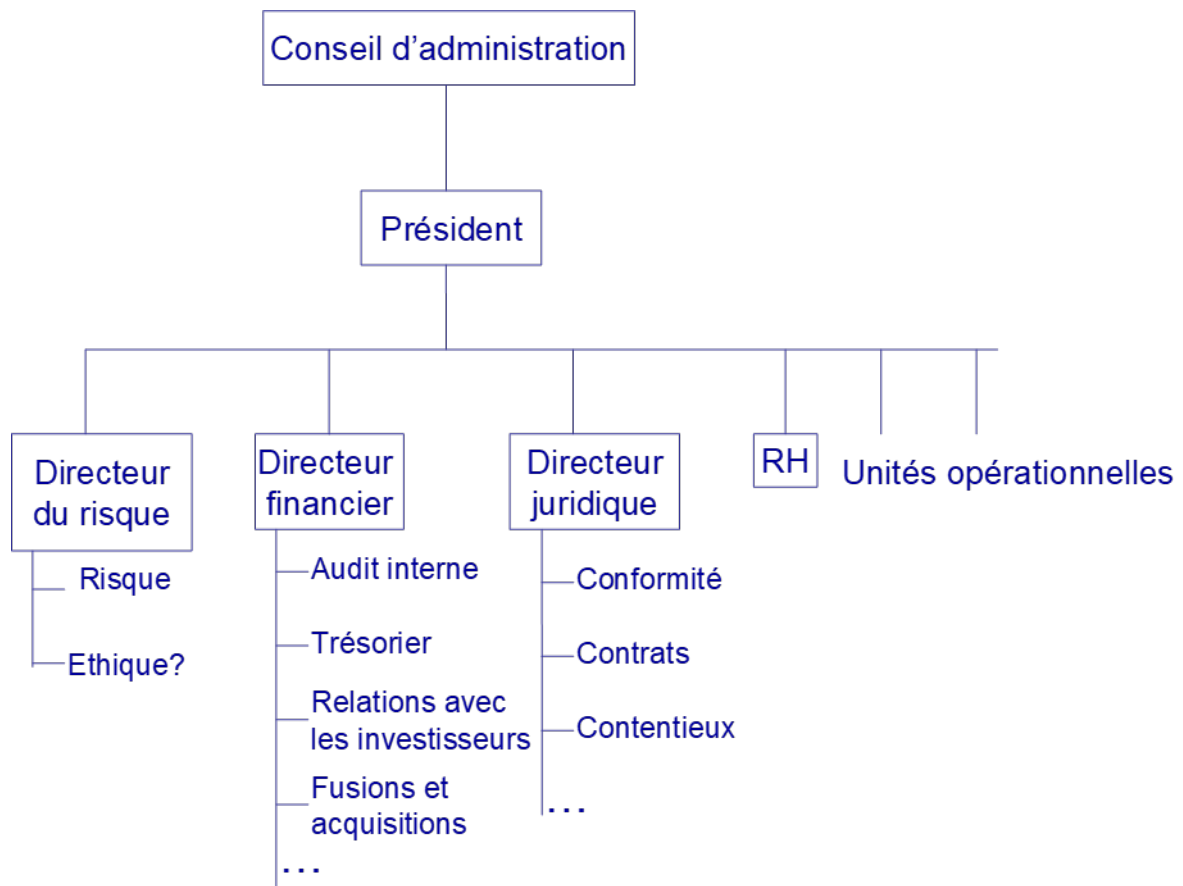


Diagram 1: The firm prior to the separation of powers.

Conseil d'administration	Board of Directors
Président	CEO
Directeur de risque	Risk officer
Directeur financier	Chief financial officer
Directeur juridique	General counsel
RH	HR
Unités opérationnelles	Operational units
Risque	Risks
Ethique	Ethics
Audit interne	Internal audit
Trésorier	Treasurer
Relations avec les investisseurs	Investor relations
Fusions et acquisitions	Mergers and acquisitions
Conformité	Compliance
Contrats	Contracts/agreements
Contentieux	Litigation

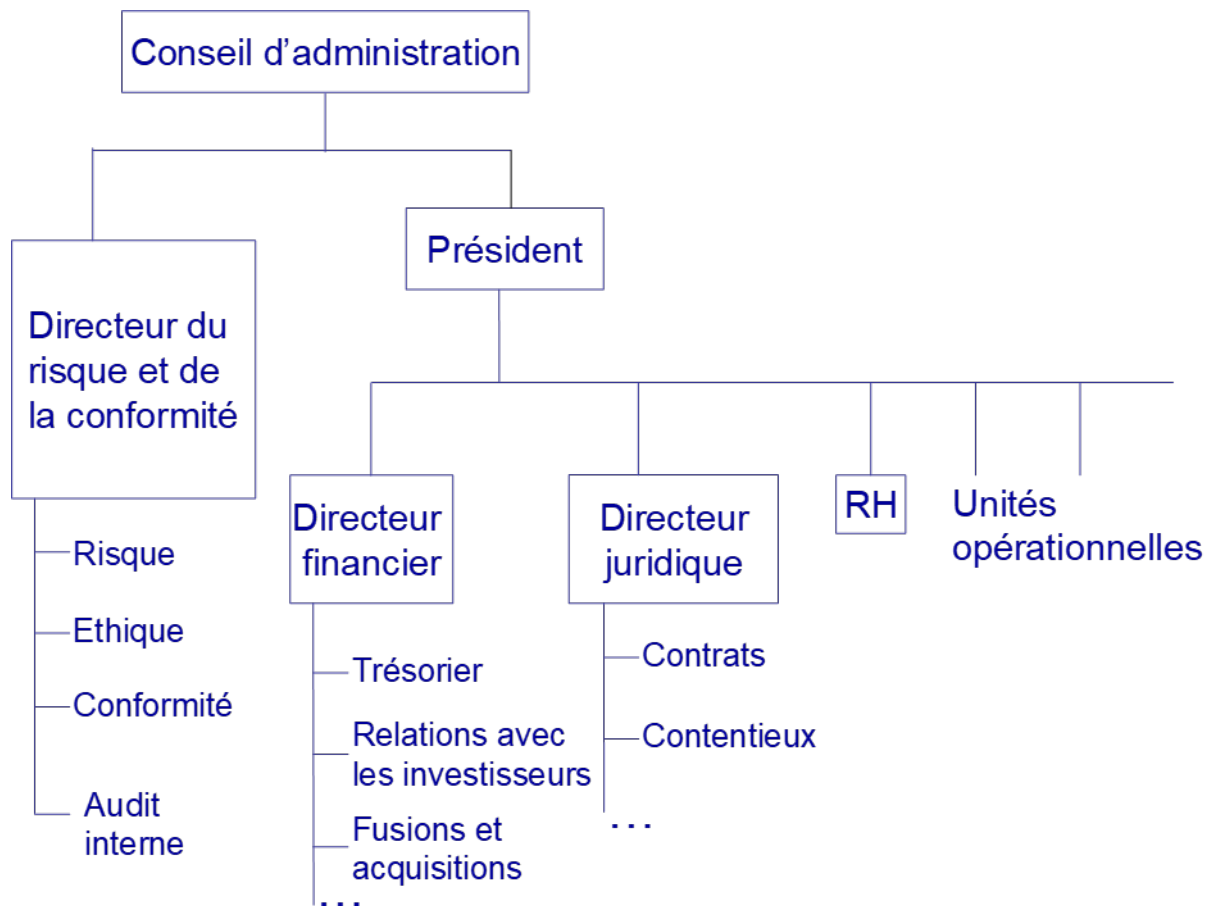


Diagram 2: The firm after the separation of powers.

Conseil d'administration	Board of Directors
Président	CEO
Directeur de risqué et de la conformité	Risk and compliance officer
Directeur financier	Chief financial officer
Directeur juridique	General counsel
RH	HR
Unités opérationnelles	Operational units
Risque	Risks
Ethique	Ethics
Conformité	Compliance
Audit interne	Internal audit
Trésorier	Treasurer
Relations avec les investisseurs	Investor relations
Fusions et acquisitions	Mergers and acquisitions
Contrats	Contracts/agreements
Contentieux	Litigation

Often, as matters stand, risk officers are not responsible for compliance and internal audit. Their risk management duties simply involve issuing wise judgments concerning the main decisions taken by the firm. Sometimes risk officers also have authority over ethical issues, listen to employees' concerns in this respect and coordinate the drafting or updating of the code of ethics. In the best case scenarios, there is a direct reporting line between the risk officer and the CEO. In many companies, the risk officer reports to the chief financial officer (CFO).

Following the separation of powers, the risk and compliance officer would report directly to the board and would be assisted by strong teams able to prevent risks. The extent to which compliance and internal audit teams are transferred would certainly depend on each company and there are a number of ways in which the new position could be bolstered. Nevertheless, it would be highly logical for risk prevention and legal or financial control to be combined within the same department. Feedback on control of bad transactions in the past is crucial for tabling opinions on future transactions. It is also essential that the position should be independent. Projects for new products or acquisitions often generate such collective enthusiasm within the company that nobody objects to the hierarchy being entirely controlled by the CEO.

As he/she would have control responsibilities, the risk and compliance officer should also have access to broader information sources which would be available precisely because he/she is independent of the CEO. This means that he/she should have authority over so-called whistleblowing systems. Many companies have now introduced such systems which enable employees to confidentially report ethical concerns about issues such as conflicts of interest, fraud or corruption. Whistleblowing could be extended to cover excessive risk-taking so as to facilitate the risk and compliance officer's control work. This would not mean that the officer would become an ombudsman, namely an independent person who hears complaints and endeavours to settle disputes. Ombudsmen often make telling contributions to resolving or preventing disputes between employees, or between employees and management. The risk and compliance officer would have a different role focusing more on the company's activity and on one specific aspect of this activity, risk prevention and control, which has been systematically ignored by many firms, as successive crises have highlighted.

What would happen in the event of disagreement between the CEO and the risk and compliance officer concerning an acquisition or business partnership in an emerging country? The company may decide that the CEO's opinion will always take precedence but that all disagreements and both sides' arguments will be reported to the board. The board would therefore finally be aware of conflicting views, scenarios that do not follow the official line and would no longer only work on reports by the CEO and his/her associates.

A direct reporting line with the board would not in itself ensure full independence in relation to profit maximisation goals. The risk and compliance officer's compensation, determined by the board, should be unrelated to the firm's financial performance. It has been suggested that risk officers should be paid on the basis of risk assessment, which could be envisaged for financial companies,<sup>2</sup> but the most preferable approach is doubtlessly to negotiate a fixed

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<sup>2</sup> Lo A. W. (2009), "Regulatory reform in the wake of the financial crisis of 2007-2008", *Journal of Financial Economic Policy*, vol. 1, no.1, pp. 4-43.

salary with the risk and compliance officer, who would therefore be removed from profit making considerations. Were enough firms to apply this separation of powers, a new profession could be created, with professional officers moving from company to company, unlike current risk or compliance officers who often come from operational units and hope to return to them, and overly communicate on all issues with their former and future colleagues. When a person is looking for a higher bonus or a promotion, he/she does not have the same outlook as he/she would have if he/she was fully independent vis-à-vis the company's hierarchy. The appointment of a risk and compliance officer for a fixed term of three to five years could also bolster his/her independence vis-à-vis the board itself, and the latter would undertake to only dismiss the officer on the grounds of serious misconduct.

The separation of powers in firms has similarities with the separation of powers set out in a country's constitution. Political science researchers have noted that a firm's in-house control responsibilities can be likened to judicial power with the CEO exercising executive power and the board representing the elected legislative body.<sup>3</sup> On the basis of this distinction, the judicial function – held by the risk and compliance officer – would control the CEO's executive authority.

The corporate world is just waking up to the concept of the independence of risk management, without mentioning that of compliance or internal audit. The subject has been raised in a rather restrictive form by a number of academics.<sup>4</sup> A survey published in 2010 by Ernst & Young, in the wake of a report from the Institute of International Finance (IIF) on the 2008 crisis,<sup>5</sup> found that only 9% of the sixty-two financial firms that participated in the study had a chief risk officer (CRO) who reported directly to the board of directors or the board risk committee. 22% of them had a CRO with a dual reporting line to both the CEO and the board. These officers' responsibilities were often restricted and did not include compliance or internal audit.<sup>6</sup>

However, the concept is not as novel as it may appear and has already been rolled out by many firms that are never affected by surveys into corporate governance. These are the subsidiaries of major groups which often have CEOs who have no authority over compliance or internal control responsibilities. These departments report directly to the parent company which allows for better risk prevention. It could even be said that many parent companies are less effective at risk prevention than their subsidiaries.

A separation of powers would facilitate the work of CEOs who would no longer have to split their time between ensuring higher profits and controlling the way in which these profits are made to grow. Business ethics would be upheld much more in this manner than in the best-worded codes of conduct. Employees would realise that profit is not the only gauge of their work and that there are people within the organisation whose sole mandate is to ensure that risks are mitigated for both the business and the community. Corruption prevention and

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<sup>3</sup> Lurie Y. & Frenkel D. A. (2003), "Corporate governance: separation of powers and checks and balances in Israeli corporate law", *Business Ethics: A European Review*, vol. 12, no. 3, July, pp. 275-283.

<sup>4</sup> Lo A. W., *op. cit.*

<sup>5</sup> Institute of International Finance (IIF) (2008), Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, Financial Services Industry Response to the Market Turmoil of 2007-2008, July.

<sup>6</sup> Ernst & Young (2011), "Making strides in financial services risk management", p. 14.

control would also be greatly enhanced by full independence in relation to the CEO and his/her associates.

Authority which is not contradicted cannot be said to be ethical. If the powers of corporate CEOs are truly subject to potential contradiction by the board of directors and a risk and compliance officer, the confidence of investors and the general public will be boosted. A firm in which powers are effectively separated can move towards the ideal of a “company of citizens”, a concept that has often been mentioned but which has not met with great success up to now.<sup>7</sup>

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<sup>7</sup> Manville B. & Ober J. (2003), “Beyond Empowerment: Building a Company of Citizens”, *Harvard Business Review*, January, pp. 48-53.