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MONEY IS NOT ENOUGH

Emerging Markets-Based Private and Sovereign Enterprises Need Entrepreneurial Governance to Advance Strategic Objectives in a Changing Environment

China's recent currency devaluation and handling of stock market losses led some investors and analysts to question its economic outlook and leaders' skillfulness. Given China's tremendous economic achievements in recent decades—punctuated last year by its ascent to the top spot in a ranking of economies by purchasing power parity—the deflated confidence in China may, at first blush, seem striking. But it is not.

"China's policymakers used to bask in a reputation for competence that put clay-footed Western bureaucrats to shame. This has suffered in the wake of their botched—and sporadic—efforts to stop shares from sagging."

-The Economist, The Great Fall of China, August 29, 2015

From Money to (Perceived) Quality: Governance is Key

Emerging economy countries (broadly categorized) that are financially strong and have global ambitions tend to encounter difficulties when transitioning to advanced phases of economic development that, while commensurate with their status, require that they adopt and project economic and general governance systems that are not only sound, but also reflect prevailing external norms. Even China is not, at present, immune from this phenomenon.[1]

China's internally controlled, export-fueled model no longer suits local or global conditions. Nor does it advance its aspirations, particularly those that are qualitative and require the buy-in of outsiders (and thus, the ceding of some internal control). To attain its strategic next level goals—*e.g.*, a market-based economy, the renminbi as a reserve currency, access to strategic overseas assets, and greater global prestige—China must sell a system, rather than goods, to diverse external constituencies: from investors, to central banks, to gatekeepers of foreign investment. For this, money is not enough. Sound governance systems are essential.

Emerging Markets Enterprises Need Entrepreneurial Governance to Advance Strategic Goals

As some transitioning emerging economy countries with qualitative goals need governance systems that (in part or largely) reflect external expectations, some EMEs that have had prior success and are financially strong need not just strong governance, but entrepreneurial governance to advance strategic objectives in today's interconnected environment in which business conduct standards are being set and enforced by diverse external constituencies and growing more material to the bottom line.

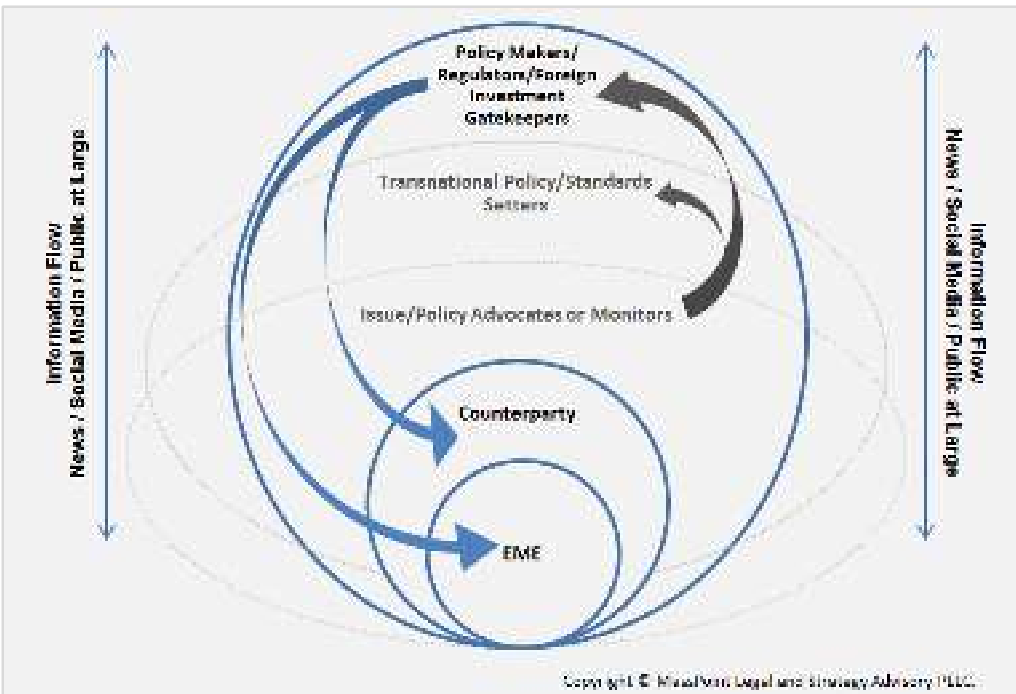
"In today's interconnected, rapid information flow environment, the terms and outcomes of business are not confined within the four corners of the contract or driven exclusively insider wishes."

This note discusses the role of external constituencies in today's interconnected environment and the business value of entrepreneurial governance, particularly for EMEs that: (1) have interests in assets that are strategic (*e.g.*, technology; food, agriculture, water), invite wide scrutiny, and/or are subject to foreign government approval; (2) have goals that require strong governance (*e.g.*, Middle East family owned companies considering IPOs or other expansions of investor bases); or (3) are seeking partnerships with risk-averse, reputation-conscious entities (*e.g.*, sovereign wealth funds, other asset owners seeking joint investments with pension funds).

Beyond the Four Corners of the Contract: Diverse External Constituencies Are Setting and Enforcing Business Terms

In today's interconnected, rapid information flow environment, the terms and outcomes of business are not confined within the four corners of the contract or driven exclusively by contractual terms or insider wishes. Today's global business environment is participatory to the extent that diverse external constituencies—*e.g.*, non-governmental issue or policy advocacy/monitor groups, transnational policy setters (*e.g.*, the OECD), and the public at large—are part of a feedback loop through and from which business conduct standards are being developed, reinforced, and materializing in the form of laws,[2] influential standards or benchmarks,[3] enterprise codes of conduct, and public campaigns (*e.g.*, through social or other media) (**Figure 1**).

Figure 1



At the business-to-business level, these standards are being enforced by reputation-conscious enterprises that are increasingly requiring partners, counterparties, suppliers, and others in their business orbits to adhere to standards that—while variously purposed and styled—require or are the byproducts of strong internal and market-facing governance —*e.g.*, transparency and disclosure, responsible investment, ESG (environmental, social, governance), SCI supply chain integrity.

The upshot for EMEs (and others) is that, to succeed in today's environment, they must not only be good principals, but also good partners or counterparties. With entrepreneurial governance, EMEs can both: (1) avoid reputational and related risks that flow from unyielding or passive approaches to today's participatory environment and (2) capitalize on opportunities that increasingly favor well-governed enterprises.

Entrepreneurial Governance: Necessity, Value, Representative Elements

As illustrated above, today's circle of business influence is global, multi-layered, and distended—non-traditional constituencies are shaping public expectations, transnational policies, national laws, and business-to-business practices. This interconnected, participatory, and conduct-conscious business environment favors well-governed enterprises (wherever located). It offers material and intangible benefits to enterprises that understand and adapt to its dynamics. And it can be costly for enterprises that continue to operate as if real influence emanates *only* from traditional sources, such as C-Suites, financial centers, and governmental authorities.

EMEs—particularly those that have strategic, qualitative objectives that invite wide scrutiny and/or require the buy-in of outsiders—have an interest in practicing entrepreneurial governance. This means that they put into place practices and systems that allow them to, among other things:

- understand whether and how external constituencies are influencing their business environment (lawmakers, foreign investment gatekeepers, business partners) or their business directly;
- identify whether evolving or established business conduct standards will become binding (as a matter of law); confer tangible business value of adopted; or present risks if ignored;
- assess their market positioning from the perspective of relevant outsiders (including by seeing their own risk reflection) and make appropriate adjustments to ensure that they are not excluded from opportunities or made to pay, in deal settings, a premium to compensate for real or perceived shortcomings in enterprise quality;
- ensure that, internally, their entire business objectives (financial, legal, reputational) are clearly identified and communicated and that internal resources are deployed toward those objectives, including by:
  - facilitating information flow between key internal functions—management, business, legal, public relations, CSR (corporate social responsibility) or their equivalents—such as by distributing to relevant functions market, legal, or other information that, when shared, can be better contextualized and leveraged. This includes sharing, as appropriate, information generated internally or procured from external parties (such as strategy advisors, legal counsel, investment advisors, etc.). Enterprises that permit such information flow will have to do so in ways that are workable, as determined by enterprise size, organizational dynamics, and other factors.[4]
  - Expanding the scope of what is regarded as "legal" or "compliance" information to make it more likely that internal or external legal, compliance, or risk advisors consider non-traditional sources of potentially binding or influential rules (such as established and evolving OECD or other standards).
- As noted, the above elements of entrepreneurial governance are representative. These or others should be adopted to suit specific enterprises. Related to this, an entrepreneurial approach to governance may be preferable to standard corporate governance, particularly where the latter is implemented in piecemeal fashion, largely or wholly in response to externally imposed codes of enterprise management and conduct that are insufficiently customized to operational dynamics or whole enterprise objectives. In contrast, entrepreneurial governance may better position entities to anticipate and address risks and opportunities because it: (1) emanates from within; (2) is customized to an enterprise's operations, goals, and risk profile (including risks the enterprise itself is perceived by the market to pose); and, (3) promotes the strategic and efficient use of internal and procured resources, thereby maximizing their value (measured both by gains and cost savings).

Entrepreneurial Governance For EMEs with Strategic Objectives: Examples

SEE YOUR RISK REFLECTION

Example: State-Owned Enterprises Carry a Presumption of Risk

SOEs, for a number of reasons, have a compelling interest in enhancing their governance (internal and business conduct (external)). By their nature, SOEs radiate risks associated with their home jurisdictions; are subject to higher scrutiny because they act in furtherance of home government objectives (or are perceived to even when they hold themselves out as commercial actors that happen to be government-owned); and through their business conduct, reflect on their home governments. Thus, when SOEs enter foreign markets or transactions with foreign counterparties, they enter—fairly or unfairly—with the baggage of SOE status. They need strong governance to overcome negative presumptions, achieve their business goals, and avoid conduct that jeopardizes the reputations of their government owners. (This is particularly true in situations where, for example, the quality of an enterprise's governance is a factor that is explicitly considered in determining a transaction's success or failure, as is the case under Australia's Foreign Investment Policy (discussed below)).

UNDERSTAND CONSTITUENCIES AND INTERESTS IMPLICATED BY SPECIFIC ASSET OR RESOURCE TYPES

Example: EMEs with Interests in Strategic or Sensitive Assets: Technology; Food, Agriculture, Water

EMEs have recently become active in acquiring or procuring strategic assets and resources that, by their nature, invite heightened public and governmental scrutiny. Of recent and growing interest to EMEs are technology assets (as in the cases, particularly, of private and state-owned Asian firms) that often invite public and media interest and may require government review and approval, including for national security purposes (such as by CFIUS (The Committee on Foreign Investment in the United States)).

EMEs (private and state-owned) have also been actively acquiring or pursuing food, agriculture, and (indirectly) water assets such as farmland and food producing assets on several continents. These movements have drawn the attention (and suspicion) of governments, non-governmental policy/issue monitors and advocates, and the news media. In notable cases, the scrutiny has had significant consequences, including, for example:

- political turmoil, reputational damage for investors, and the cancellation of deals;[5]
- the implementation or consideration of more stringent or exclusionary regulations for foreign and corporate investors in farmland and agricultural assets (*e.g.*, in Saskatchewan, Canada and Australia);[6]
- calls from within the U.S. Congress for changes to the U.S. investment review process for foreign acquisitions of U.S. agricultural assets (in response to the acquisition by Shuanghui Intl. (China) of U.S.-based Smithfield Foods);[7] and,
- the adoption of transnational, non-binding (for now) standards on responsible investment in agriculture.[8]

Given global concern about food, resource scarcity, and the environmental, social, and governance dimensions of food, agriculture, and water, EMEs with interests (direct and indirect) in such assets and resources need to calibrate their practices (*e.g.*, transaction analysis, transparency, contractual terms, asset management) to reflect outsiders' concerns; anticipate events that might adversely impact their interests at the deal and portfolio levels, and minimize reputational, commercial, and legal risks. This includes by means of context-appropriate contractual terms or other approaches that disincentivize or address non-performance by counterparties (*e.g.,* governments) that may, because of (usually predictable) public pressure, disavow commitments and leave investors with little to no meaningful recourse.[9]

UNDERSTAND HOW GOVERNANCE QUALITY DIRECTLY INFLUENCES TRANSACTIONAL OUTCOMES

Example: EMEs in Foreign Investments Subject to Government Review

As noted above, investments in strategic or sensitive assets are sometimes subject to review and approval by government authorities, as a matter standard procedure or in specific cases, such as where national security is implicated. The quality of an investing enterprise's governance and business conduct can favorably or adversely affect such investment reviews and outcomes. For example, in Australia—an important investment destination for EMEs, particularly Asia-based—governance is explicitly considered in the investment review process. As stated in Australia's Foreign Investment Policy: "The Government also considers the corporate governance practices of foreign investors . . . Proposals by foreign owned or controlled firms that operate on a transparent and commercial basis are less likely to raise national interest concerns than proposals from those that do not." [10]

> *"'The [Australian] Government . . . considers the corporate governance practices of foreign investors . . . Proposals by foreign owned or controlled firms that operate on a transparent and commercial basis are less likely to raise national interest concerns than proposals from those that do not.'"*

EMEs that are planning investments subject to foreign government review would be well served by understanding the relevance of their governance and business conduct to such investments and adjusting their practices accordingly. Such adjustments should be programmatic and made well in advance of investment bids, rather than shortly before for the specific purpose of persuading foreign investment gatekeepers.

IDENTIFY HOW STRONG GOVERNANCE CAN ADVANCE OR THWART STRATEGIC, NEXT LEVEL GOALS

Example: EMEs Such as Family Owned Firms, With Next Level Goals That Require Strong Governance

Particularly in the Middle East, family owned (and other closely held firms) tend to be strong brands with stellar market positioning. These firms, owing to their diligence and, in some cases, legacy benefits of advantageous arrangements (*e.g.* exclusive commercial arrangements), have had the financial and reputational resources to expand within and across business lines, often as early movers. Today, as these EMEs pursue next level goals—particularly IPOs or other expansions of investor bases—the quality of their governance and business conduct (as determined largely by outsiders) will become more material to their success. Clearly, strengthening governance and conduct quality with future goals in mind will position these EMEs more favorably.

UNDERSTAND AND ADAPT TO GOVERNANCE AND BUSINESS CONDUCT EXPECTATIONS OF KEY BUSINESS PARTNERS AND COUNTERPARTIES

Example: EMEs Seeking Alliances with Reputation- Conscious Enterprises

Sovereign wealth funds and other emerging markets-based asset owners have recently become more proactive, taking direct roles in the sourcing and management of deals and assets. As they seek to directly manage their assets (to cut out intermediary fees and costs) and jointly invest with other asset owners (*e.g.*, pension funds), enterprise integrity will become more important. For example, established asset owners that are fiduciaries, are reputation conscious, are subject to stringent regulations, and/or adhere to non-binding investment standards (such as the Principals for Responsible Investment) are unlikely to partner with entities that are perceived to have inadequate governance or reputations where risks of association potentially outweigh financial benefits. EMEs seeking alliances with reputation- and governance-conscious investors should take steps to ensure that they do not, because of inadequate governance or poor business conduct, miss opportunities to associate with parties whose market standing and experience offers substantial tangible and intangible benefits.

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NOTES

[1] Whether the status quo is fair or sustainable is the subject of much discussion, but is beyond the scope of this Note. For a related discussion of efforts by China and other non-Western states to build alternative economic, trade, and finance frameworks, see MassPoint PLLC, A Great BRIC Wall? Emerging Trade and Finance Channels Led by Non-Western States Could Curtail the Global Reach of U.S. Law.

[2] For an example of how different constituencies can influence business conduct norms (and laws in some cases), see MassPoint's February 2015 Business Update discussing, *inter alia*, that the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas—a non-binding document produced by a transnational body informed by input from policy advocates/monitors and others—came to be incorporated in the U.S. Securities and Exchange Commission's final rule implementing Section 1502 (conflict minerals) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[3] *E.g.*, the OECD Guidelines for Multinational Enterprises that, to date, 44 governments have agreed to promote; the United Nations-backed Principles for Responsible Investment (PRI), part of an initiative that as of the date of this note, self-reports 1380 signatories that are asset owners, investment managers, and services providers with combined AUM (assets under management) of $59 trillion.

[4] For example, in an extended MassPoint Note on Globalized Anti-Corruption Enforcement, the option of appointing compliance liaisons to connect dots between information and internal functions was discussed in the context of anti-corruption compliance. Internal liaisons can further other objectives, such as entrepreneurial governance.

[5] *See, e.g.,* Hdeel Abdelhady, Islamic Finance as a Mechanism for Bolstering Food Security in the Middle East: Food Security Waqf at 30 and n. 25, stating, *inter alia*, that: "Acquisitions of overseas land and land use rights by Arab countries and other parties have not been without controversy. These transactions are very likely to pose significant legal and political risks, an expectation that is borne out by the inhospitable reception they have received both inside and outside their host countries. They have been characterized as "land grabs"—modern scrambles for resources reminiscent of nineteenth-century colonization. The terms of these land acquisitions and their details are often, if not always, undisclosed. This opacity has fueled suspicion that the deals are opportunistic usurpations of scarce resources by relatively wealthy countries at the expense of relatively poor countries and their small farmers. The lack of transparency and controversy surrounding agricultural land acquisitions raises questions not only about their nature, but about their long-term viability as a means of securing food supplies."

[6] *See, e.g.*, Bruce Johnstone, Agriculture minister launches consultation process for Farm Security Act, Leader-Post, May 21, 2015; The Guardian, Foreigners buying Australian real estate to face tougher rules and fees, February 24, 2015.

[7] *See, e.g.*, Doug Palmer, Senators urge inclusion of food safety in Smithfield review, Reuters, June 20, 2013; U.S. Senate Agriculture, Nutrition, and Forestry Committee, Chairwoman Stabenow Calls for Legislation to Protect American Interests in Foreign Acquisitions, September 14, 2014.

[8] The Principles for Responsible Investment in Agriculture ("The Principles represent the first global consensus on defining how investment in agriculture and food systems can benefit those who need it most." "They are voluntary and non-binding, but represent the first time that governments, the private sector, civil society organizations, UN agencies, development banks, foundations, research institutions and academia have agreed on what constitutes responsible investment in agriculture and food systems that contribute to food security and nutrition.").

[9] For a related discussion of some of the risks and other aspects of agricultural investment, see MassPoint's February 2014 Note, Food Security, and Agricultural Investment Require Multidimensional Strategies.

[10] Australia's Foreign Investment Review Policy, 8 (English version 2015).