The missing role of controlling shareholders in the short-termism debate

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Short-termism in European corporate governance

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Available Data on Corporate Short-Termism in the EU

- Despite widespread media coverage about the negative consequences of corporate short-termism, there is little empirical evidence to demonstrate:
  - whether there is an effective problem of short-termism affecting listed companies
  - if this problem exists, to what extent it negatively effects the firms’ long-term investing and the economy

- The (few) empirical studies providing some evidence of corporate short-termism are almost all based on data collected in the US and the UK markets, where concentrated ownership is quite rare.

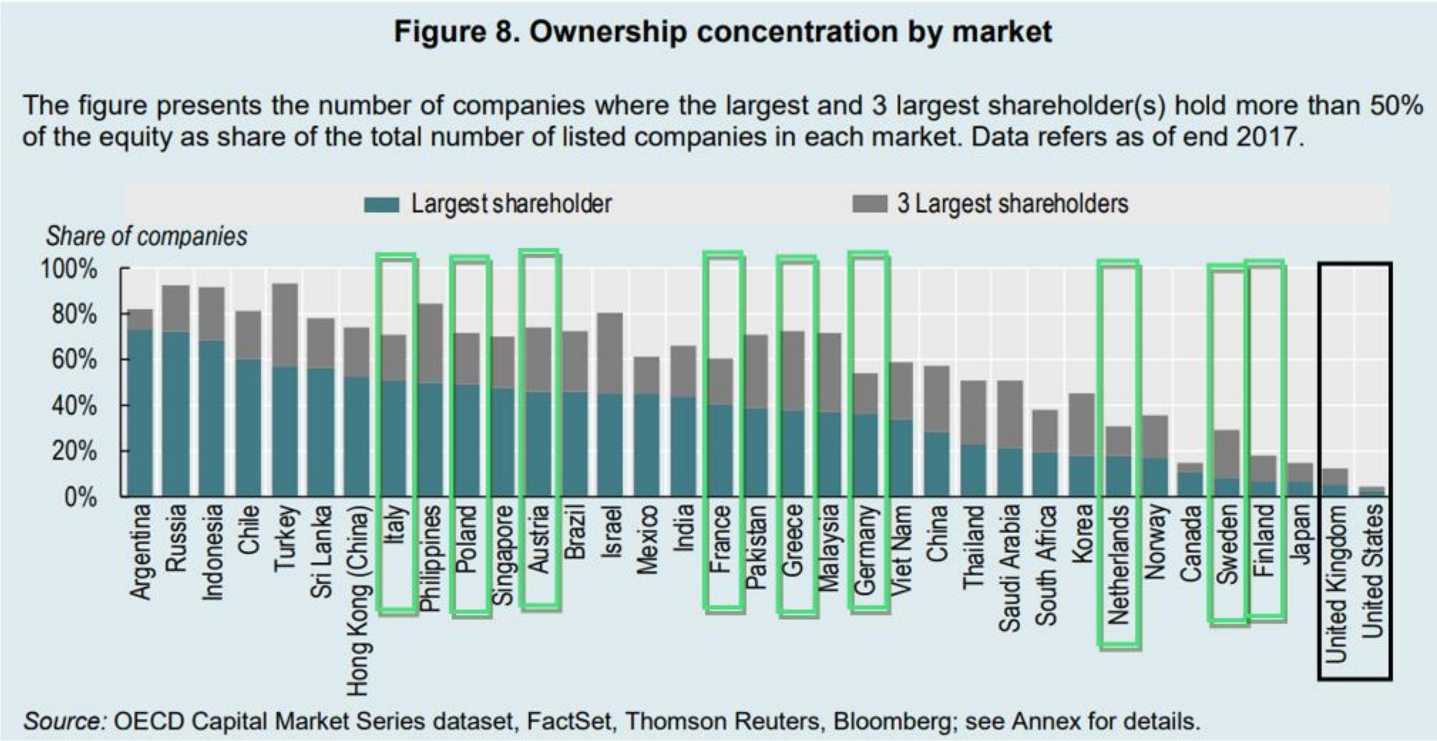
- A notable exception is the EY report (2020), which shows excessive payouts to shareholders. However:
  - it suffers from serious methodological flaws
  - Fried and Wang (2021) show that long-term investments have remained stable in the last 20 years and that corporations have more cash on their balance sheets than ever

- Short-term focused executives' compensation, one of the claimed transmission channel of investor short-termism, is much lower in the EU than in the US (Edmans, Gabaix & Jenter 2017).

If Short-Termism Affects Controlled Companies Differently than Publicly Held Ones, Can We Rely on US Data in the EU as well?

— The paper shows that corporate short-termism affects controlled companies (which are common in the EU) differently and to a lesser extent than widely-held companies (which are typical in the US and UK)

➢ Is it therefore possible to rely on existing US and UK data on short-termism to claim the existence of the same issues in the EU?



(OECD 2019)

Possible Policy Implications Stemming from the Conclusion that Controlled Companies Reduce Corporate Short-termism

Possible policies:

Allow the adoption of loyalty shares or dual class shares

e.g. since 2015 Italian companies may issue multiple voting rights before the IPO granting up to 3 votes per share

Allow the adoption of loyalty shares or dual class shares after the IPO

e.g. introduction of loyalty shares in Italy (2014), Belgium (2018) and Spain (2021)

Actively pushing existing public companies to adopt loyalty shares

e.g. Florange Law in France in 2014, which automatically switched listed companies to loyalty shares, unless a resolution was passed with a 2/3 majority

Reducing minority shareholders' protections and insulating the board from activists

e.g. reducing supermajorities required to approve extraordinary transactions or using aggressive CEMs to overcome minority shareholdes' blocking rights

Would Loyalty Shares or Dual Class Shares Lead to the Creation of new Controlled Companies?

— Loyalty shares and dual class shares are very effective in helping existing controlling shareholders to keep their control in listed companies:

➢ if adopted before listing, they help to retain control after the IPO

➢ if adopted after the IPO, they allow the existing controller to either (i) raise more capital or (ii) reduce the investment in the firm, while keeping control

— However, they cannot be expected to lead to the creation of new controlled companies because:

➢ In order to be adopted, loyalty shares need to be approved by the shareholders' meeting (in some jurisdictions with a 2/3 supermajority) and institutional investors are strongly opposed to this kind of CEM. Hence, only existing controlling shareholders would have the votes to approve the introduction of loyalty shares.

➢ Even if loyalty shares are approved in non-controlled companies, in most countries (Belgium being the only exception) the crossing of the 30% voting threshold would trigger the duty on the new controlling shareholder to launch a mandatory tender offer on the entire share capital

Would Loyalty Shares Lead Financially Constrained Controlling Shareholders to Make More Long-Term Investments?

— In widely-held companies, mangers may forego new profitable long-term investments under the pressure of short-term investors, which are only focused on short-term profits.

— In controlled companies, the controlling shareholder may be expected to better understand the benefits stemming from long-term investments and support managers' long-term planning.
  - ➢ However, if raising new capital would cause insiders to lose control and the related private benefits, controlling shareholders may choose to pursue their own (long-term) interest in keeping the private benefits over the long-term interest of the company to raise new capital.

— Loyalty shares may solve this problem by allowing financially constrained controlling shareholders to raise new capital to fund long term investments while keeping control.
  - ➢ However, loyalty shares may also allow controlling shareholders to keep control while selling some shares. But if they plan to sell some shares in the short term they will be more focused on the short-term market value.

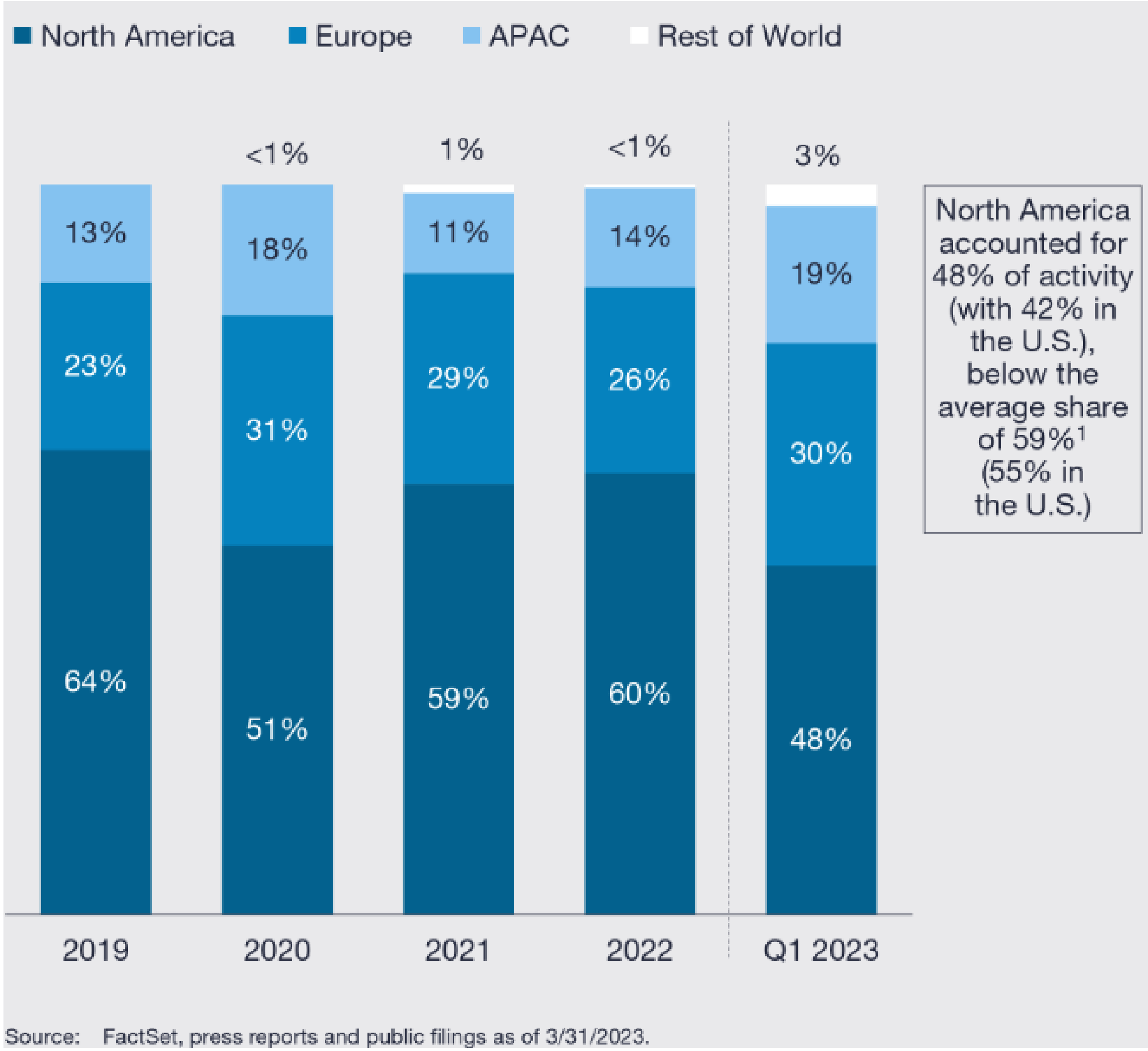
— Empirical data on loyalty shares in the Italian market shows that "*Loyalty shares neither anticipate acquisitions, nor equity issues by the adopting firm. Instead, they allow controlling shareholders to reduce their equity stake without losing control*." (Bajo, Barbi, Bigelli & Croci 2020).

Activist Investors in the EU

- There are less activist investors in the EU than in the US, but they are on the rise

- Sometimes they also target controlled companies (Kastiel 2016)

- There is widespread concern that activist investors may increase short-termism in the EU and certain member states have considered reforms to address the problem (e.g. Woerth & Dirx 2019)



(Lazard 2023)

Would Insulating the Board from Minority Shareholders and Activists Foster Long-Term Strategy?

— Policy solutions should be aimed at keeping the benefits of the long-term view of controlling shareholders, without reducing the power of minority shareholders and activist to intervene when the controlling shareholder is pursuing his/her own benefit rather than the interest of the firm.

— Example: 2/3 majorities required to approve share capital increases and/or key transactions may in certain scenarios:

- ➢ give a veto power to short-term minority shareholders or activists on key transactions, such as capital increases aimed at funding long-term investments, if the long-term controlling shareholder does not have 2/3 of the votes

- ➢ not be effective in blocking transactions in the sole interest of the controlling shareholder, such as self-serving by-laws amendments, if he/she holds 2/3 of the votes

<u>Possible solution</u>: 2/3 majorities to approve key shareholders' resolutions may be replaced by simple majorities requiring also the approval by the majority of minority investors if the relevant resolution disproportionally benefit the controlling shareholder

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