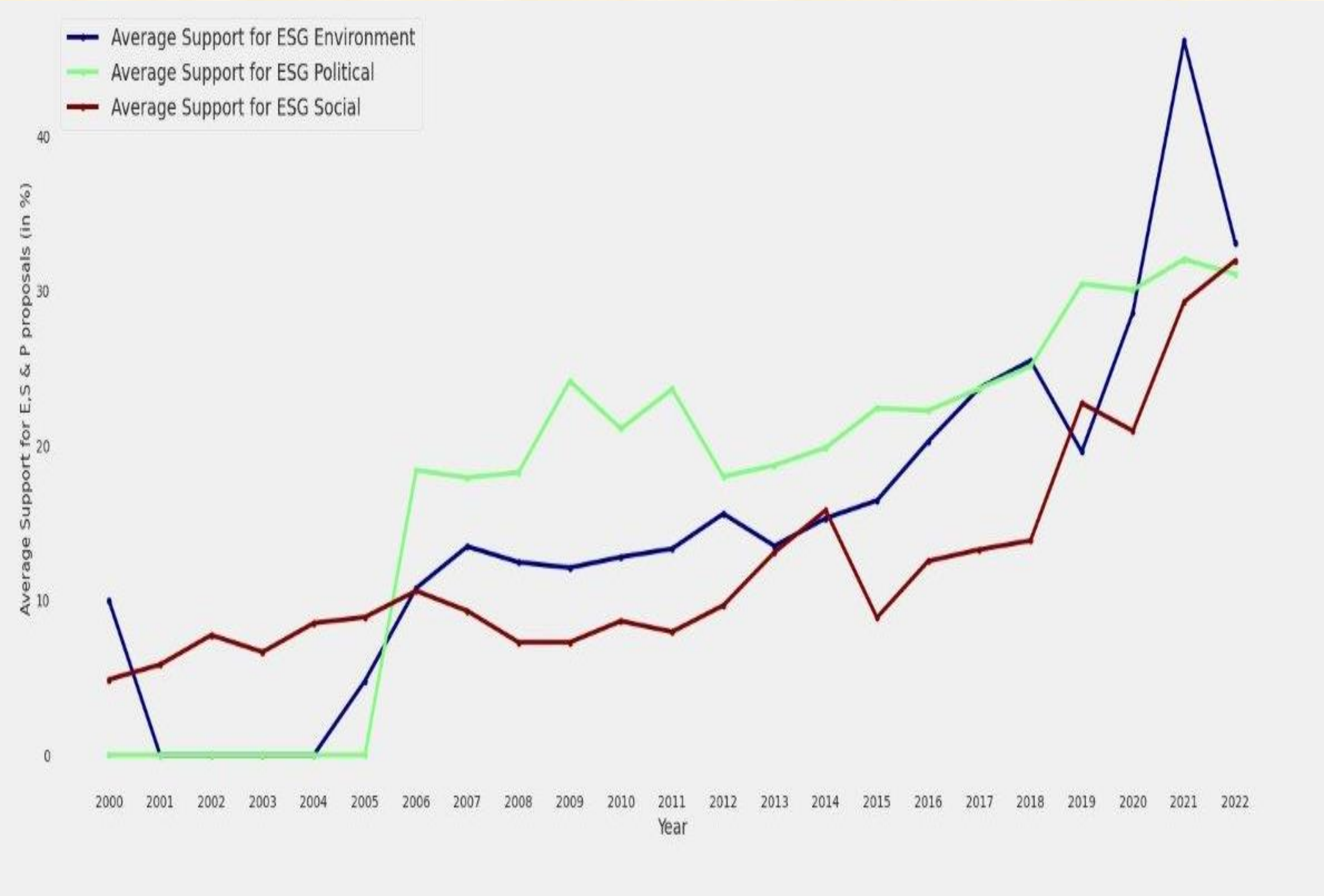
The New Corporate Governance

Oliver Hart and Luigi Zingales

ECGI Responsible Capitalism Summit

October 21, 2022

- In the last few years there has been a dramatic increase in shareholder engagement on environmental and social issues.


Average Support for ESG Environment
Average Support for ESG Political
Average Support for ESG Social
Average Support for E,S & P proposals (in %)
0
10
20
30
40
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
Year

- It is hard to explain this behavior using the dominant corporate governance paradigm in economics.
- According to the traditional view, shareholders have a single objective: shareholder value maximization (SVM).
- But many of the proposals illustrated on the previous slide are pushing companies to do things that might reduce value (most of which are opposed by management).

Why have things changed?

- Corporations are larger, more complex, and more powerful than they were in the 1970s and early 1980s when the traditional paradigm became established.
- In a more populous and interdependent world, the importance of externalities has also greatly increased, and many feel that governments are not dealing with them.
- The preferences of investors have also arguably changed: younger people are more sensitive to environmental and social issues.

- As a result we think that the paradigm needs to change.
- This is true even if one accepts, as we do, the idea of shareholder primacy.
- When externalities are important and some investors are prosocial, we argue that shareholders will want firms to pursue *shareholder welfare maximization* (SWM) not SVM.

Examples illustrating the idea

- DuPont generates large quantities of plastic waste. Reducing the waste would improve the environment but reduce profit. Some shareholders may favor this, others not.
- Costco uses antibiotics in raising chickens. This is profit-maximizing but is a major cause of the development of antibiotic resistance, a problem that costs human live and billions of dollars in healthcare costs. Ditto.

- Danco is the US distributor of the abortifacient drug Mifiprex. Danco is a private company but one can imagine some shareholders wanting Danco to scale back its activities even though this would reduce profit. Other shareholders may want to expand the activities.
- Duke energy makes contributions to political candidates and parties. Disclosing /reducing these could be good for American democracy but might reduce shareholder value. Again shareholders may disagree.

- Friedman’s famous 1970 argument fails in these examples (separability does not hold; companies have a comparative advantage in reducing harm).
- No reason to think that SVM will be unanimously favored; or that it is socially efficient among the group of shareholders as a whole (or for society).
- Nothing “neutral” about SVM.
- Friedman suggested that deviations from SVM impose a tax on some shareholders. But it is equally true that SVM imposes a tax on other shareholders.

- How to replace SVM with SWM?
- Shareholder voting is one way…

But…

- Today most stocks in U.S.A are owned through mutual funds (e.g., Vanguard, Black Rock, State Street, TIAA).

- These institutions do the voting for their investors, that is, for us.
- Most institutions take the view that their fiduciary duty (duty of loyalty) to their investors requires them to consider only long-run financial return. (In some cases this is a legal requirement.)

A recent example

- Alstria, a German-listed REIT, proposed a so-called "green dividend" to shareholders at its May 2021 shareholder meeting. The proposal offered a €0.01 per share dividend and asked shareholders whether the dividend should be paid to shareholders or be invested into pre-identified climate-mitigation projects.
- The firm already pursues climate mitigation efforts as part of its normal business activities – such as purchasing 100% of its energy from renewable sources and undertaking an extensive carbon reduction plan.

- According to the company, what set these additional climate mitigation projects apart is that they would not have made compelling investments for the company to pursue from a purely financial perspective. The board said that if shareholders supported the project investments, they would treat this as “a clear mandate to invest outside the financial norms.”

- Dimensional Fund Advisors is a global asset manager that is a shareholder of Alstria.
- Dimensional engaged with Alstria’s CEO to discuss the green dividend proposed by the company.
- Dimensional emphasized their view that the duty of the board is to maximize shareholder value and that they appreciated that the company proposal was put in quantifiable, financial terms.

- Since Dimensional’s stewardship efforts are focused on protecting and enhancing shareholder value and given that the company’s own evaluation showed the “green” project investments were unlikely to enhance shareholder value, Dimensional voted against the proposal.
- In spite of this the proposal passed with 85% support.

- We think this kind of situation makes no sense. Fiduciary duty should surely mean acting on behalf of your investors (however it is currently defined in the law). That means finding out what shareholders want. And perhaps learning that they are willing to make trade-offs.

- At least three approaches are possible. The first one is to push down the voting decision to the level of individual investors. This is a strategy that BlackRock is trying to implement now with its major investors. Thus, if the New York State Common Retirement Fund invests in BlackRock S&P500 ETF, it will have the right to vote pro-rata the shares it indirectly owns in all the S&P500 companies.

- This strategy might work well for major pension funds and endowments, but it is unreasonable for individual shareholders. We cannot expect shareholders to express an opinion on all ballots of all the companies they own.

- Fortunately, there is a solution. Today many institutional investors buy proxy advising services customized to specific needs. For example, Institutional Shareholder Services (ISS) has six sets of “specialty” proxy voting guidelines – each geared toward a specific special interest group: Taft-Hartley Advisory Services, Public Fund, Socially Responsible Investment (SRI), Catholic Faith-Based, Sustainability, Climate. Each set of guidelines is like a detailed version of a party electoral platform.

- Thus, it would be relatively simple for each investor to choose one type of guideline and ask that her shares be voted accordingly.

- The second strategy would be for mutual funds to elicit investors’ preferences and then cast their votes based on an aggregation of these preferences. This may be challenging since shareholders may not report their preferences truthfully, but it may be possible to develop “incentive-compatible” mechanisms to deal with this.

- The third strategy is for mutual fund companies to offer investors funds with a very clear and predetermined voting strategy and let investors choose among them.
- This is actually happening. See Engine No. 1’s VOTE fund.

Summary and Conclusions

- SVM, although the established criterion, does not generally represent what shareholders want. It should be replaced by SWM.
- One way to do this is to make it easier for shareholders to express their preferences on environmental and social issues, e.g., by voting.

- The SEC could/should make it easier for shareholders to vote on proposals that pertain to a company’s comparative advantage (historically, the SEC has allowed management to block proposals that pertain to “ordinary business matters”).
- The meaning of fiduciary duty should be reconsidered. This may require changes in the law.
- Trade-offs should be acknowledged. It’s not all win-win!

Thank you!