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

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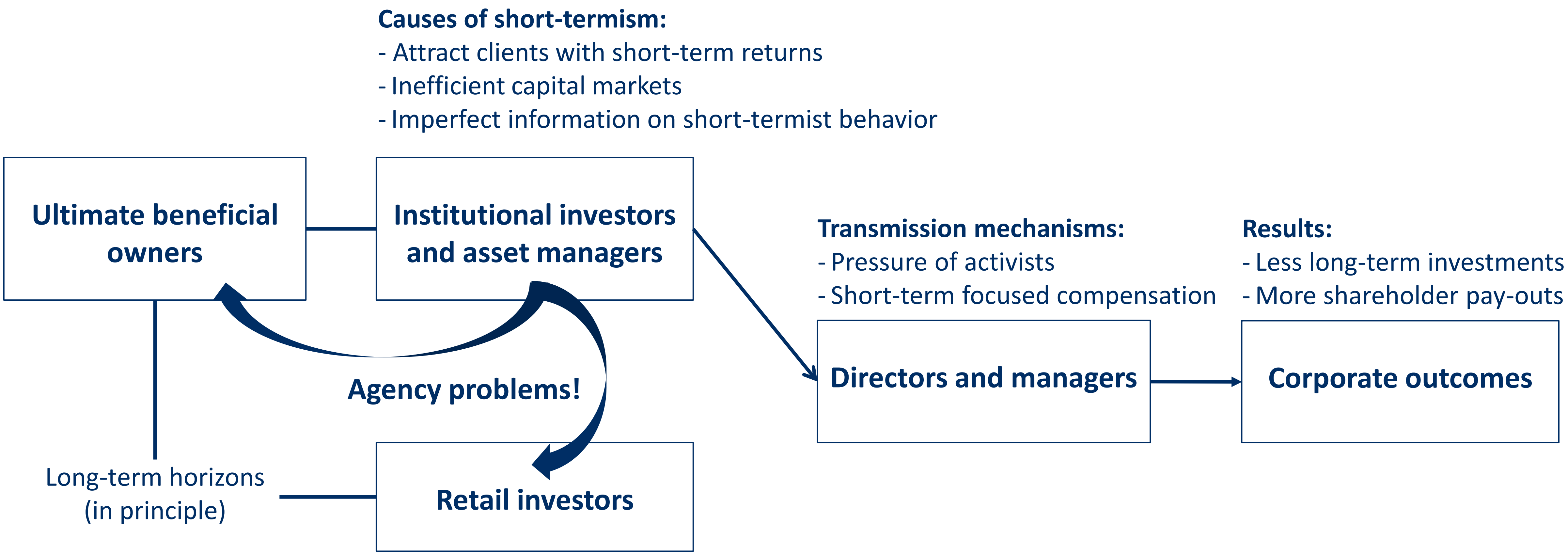
Conference “short-termism in European corporate governance” (30 May)

A model of investor short-termism



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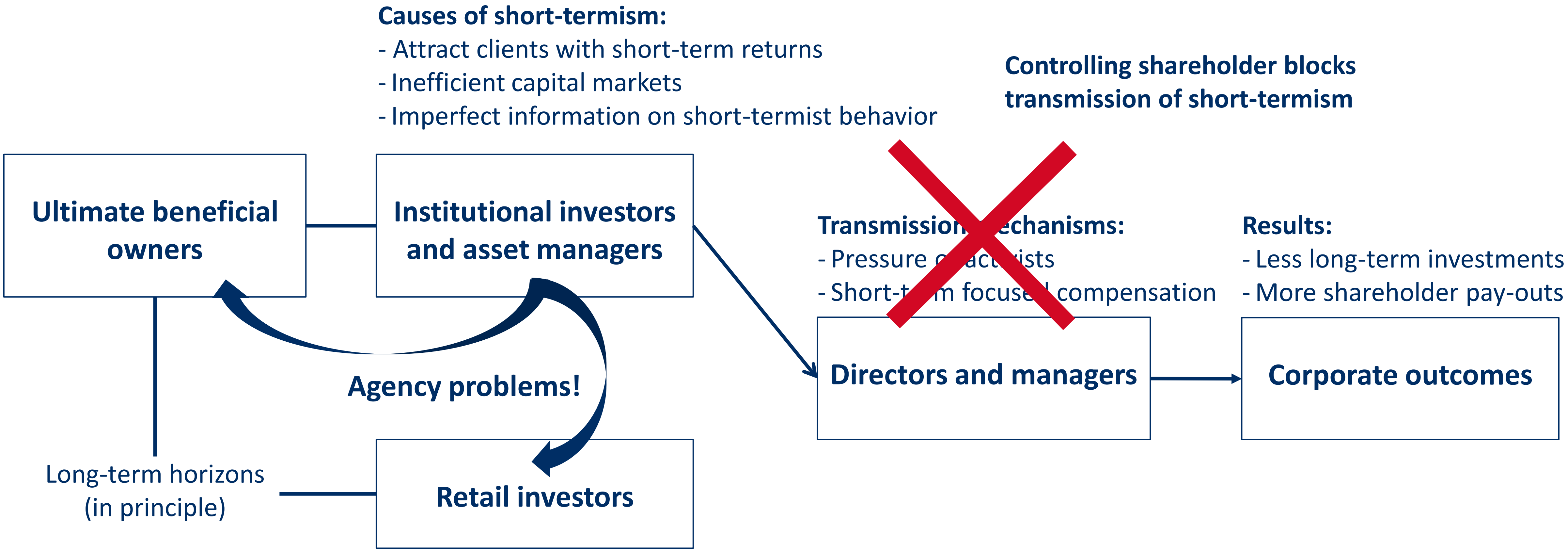
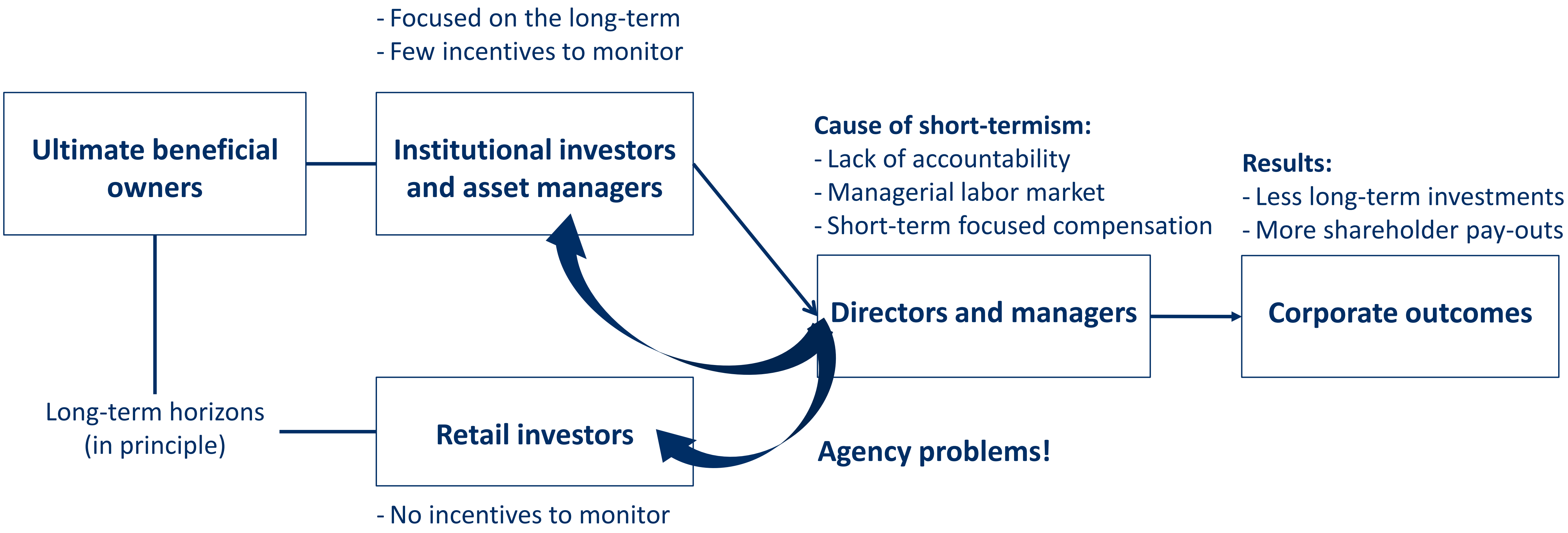


A model of managerial short-termism



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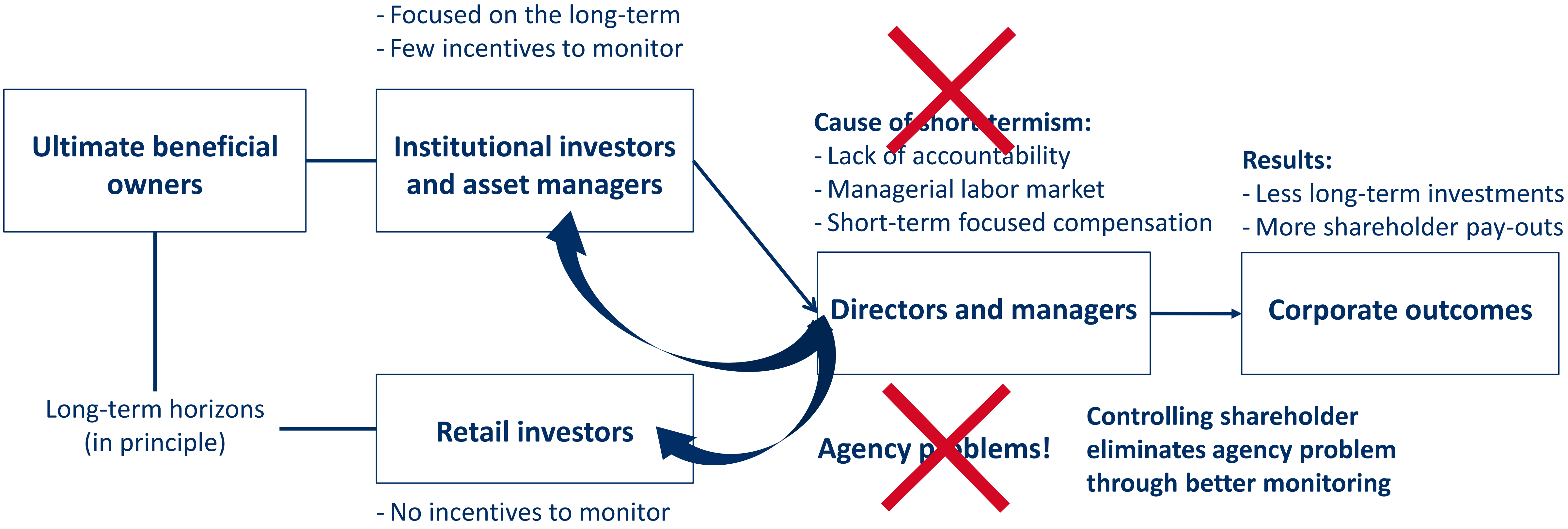

Are controlling shareholders more long-term oriented?

- **Long-term incentives (controlling shareholder lock-in):**
  - Size and illiquidity of ownership stake locks in controlling shareholder
  - Non-transferable private benefits of control lock in controlling shareholder (Choi, 2018)
    - E.g. retaining control over corporation within family ("family name") or state ("national champion")

Are controlling shareholders more long-term oriented?

- **Short-term incentives (private benefits of control):**
  - Controlling shareholder-CEO could tie their compensation to short-term results, which are easier to manipulate
  - Corporation may pay out excessive dividends to fund controlling shareholder's liquidity needs (e.g. family lifestyle, state budget, …)
  - Controlling shareholders may block share issuances necessary to finance long-term investments if they lack financial means and want to retain control
  - Controlling shareholder may be more reluctant to support (risky) long-term investments due to lack of diversification

Evidence on controlling shareholders & short-termism

- **Ownership concentration in general:**
  - Positively associated with innovation in Switzerland (Puca & Vatiero, 2017)
  - Non-linear effect on firm value in the US (Morck et al., 1988)
  - No effect on firm value once endogeneity is taken into account (Demsetz & Villalonga, 2001)
- **Family ownership:**
  - Positively associated with firm value, but only if founder is CEO or chairman (Villalonga et al., 2015)
  - Negatively associated with R&D investment, except if later generations remain involved in management (Chrisman & Patel, 2012) or if family owns more than 30% (Block, 2009)
- **Industrial foundation ownership** (Thomsen et al., 2018)
  - Negatively associated with manager replacement
  - Positively associated with firm survival
  - Positive/neutral effect on financial performance
- **State ownership:**
  - Negatively associated with financial performance (Thomsen & Pedersen, 2000)
    - Could also be caused by non-financial goals and inefficiency
- ➢ **Conclusion:** Long-term incentives of controlling shareholder depend on the circumstances and the type of controlling shareholder

The short-termism policy matrix

	Managers short-termist	Managers not short-termist
Institutional investors short-termist	1) **Lengthen horizons of institutional investors** (allow loyalty shares, eliminate quarterly reporting, require sustainability reporting, encourage stewardship …) 2) **Make managers accountable to shareholders** (if (1) is succesful, otherwise despair)	1) **Lengthen horizons of institutional investors** (allow loyalty shares, eliminate quarterly reporting, require sustainability reporting, encourage stewardship …) 2) **Insulate managers from shareholders** (discourage shareholder activism, allow dual class share structures, reduce short-term compensation, reformulate directors’ duties away from shareholders …)
Institutional investors not short-termist	**Make managers accountable to shareholders** (require quarterly reporting, encourage shareholder activism, require say on pay, …)	**No problem, no policy implications**

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What doesn’t work in case of controlling shareholders

- **Reformulating directors’ duties to long-term interests of shareholders and stakeholders**
  - Not very effective due to business judgment rule and barriers to shareholder litigation
  - Even less effective with controlling shareholders, because of high-powered incentives to serve controlling shareholder
- **Discouraging or encouraging shareholder activism**
  - Irrelevant because shareholder activism is unlikely to be effective in case of controlling shareholder
- **Encourage long-term stewardship of institutional investors and asset managers**
  - Shareholder stewardship is unlikely to have impact in case of controlling shareholder (Puchniak, 2021)
- **Banning quarterly reporting and introducing sustainability reporting**
  - Won’t impact long-term orientation of managers, because of high-powered incentives to serve controlling shareholder
- **Nuance: stewardship, activism and disclosures may have some “soft” impact by influencing the reputation of controlling shareholders**

What could work in case of controlling shareholders

- **If controlling shareholders are generally more long-term oriented, we can facilitate control by allowing separation of cash flow rights from control**
  - E.g. through loyalty voting rights, dual class share structures or pyramid structures
  - Allows controlling shareholder to diversify and/or retain control when share issuance are needed and controlling shareholders have limited liquidity
- **However, the wedge between cash flow rights and control also increases the risk of private benefit extraction (a source of short-termism)**
  - ➢ Majority of minority approval or appraisal rights when introduced
  - ➢ Strategies to reduce private benefits (if minority shareholders are not short-termist):
    - Regulation of RPTs (disclosure, voting prohibition for conflicted persons, fairness opinion, …)
    - Minority shareholder vote on controlling shareholder executive compensation
    - Minority-appointed independent directors

The short-termism policy matrix (with controlling SH)

	Controlling shareholder short-termist	Controlling shareholder not short-termist
Institutional investors and asset managers short-termist	**(1) Lengthen horizon of controlling shareholders** (2) **empower** minority shareholders if minority shareholders are less short-termist than controlling shareholders, **insulate** controlling shareholder otherwise	**(1) Encourage the creation of control** (for example through dual class share structures and loyalty voting rights) (2) **insulate controlling shareholder** (even more) from minority shareholders
Institutional investors and asset managers not short-termist	**(1) Lengthen horizon of controlling shareholders** (2) reduce extraction of private benefits of control by **empowering minority shareholders**	**No problem, no policy implications**

Conclusions

- **Controlling shareholders should have a more important role in the short-termism debate, especially in continental Europe**
- **If controlling shareholders are generally more long-term oriented, we can facilitate control by allowing separation of cash flow rights from control**
  - But this also encourages extraction of private benefits of control, which exacerbates short-termism
- **If controlling shareholders are the cause of short-termism, many policy proposals are unlikely to be very effective in combatting short-termism**
  - Reformulating directors' duties, discouraging or encouraging shareholder engagement, banning quarterly reporting, regulating executive compensation, …
- **Empirical studies on corporate short-termism should control for insider ownership**
  - Many empirical studies don't do this (Graham et al., 2005; Asker et al., 2015; Ladika & Sautner, 2020; Edmans et al., 2021; Cremers et al., 2022; …)
  - Empirical studies that do study the impact of controlling shareholders often do not use an external shock to study impact of ownership changes