european corporate governance institute

IESE Business School University of Navarra | Center for Corporate Governance

2019

ECGI ANNUAL MEMBERS' MEETING

BARCELONA | SPAIN

Conference Report

HOSTED BY
IESE BUSINESS SCHOOL | BARCELONA | SPAIN
24 OCTOBER 2019

REPORT BY TOM VOS

Introduction

The European Corporate Governance Institute (ECGI) held its Annual Members' Meeting in Barcelona on 24 October 2019, bringing together international academics and practitioners in the field of corporate governance for a programme that included a general assembly, a lecture, a panel discussion, presentation of the two best papers in 2018 and a dinner.

The event was hosted by IESE Business School, Barcelona. The annual lecture was delivered by Professor **Paola Sapienza** (Kellogg School of Management and ECGI). Professor Sapienza's lecture was entitled **"The Economics of Firm Culture"**. Following the lecture there was a panel discussion moderated by Prof. **Marco Becht** (ULB and ECGI) with Dr. **Beatrice Engström-Bondy** (Investor AB) and Professor Sapienza.

ECGI then awarded prizes for the best papers in the Finance and Law Working Paper Series' from the previous year. The Finance Series prize of EUR 5,000, which is sponsored by Aberdeen Standard Investments, the global fund manager, was awarded to Professors Patrick Bolton (Columbia University), Tao Li (University of Florida), Enrichetta Ravina (Northwestern University) and Howard Rosenthal (New York University), for their paper on "**Investor Ideology**" (ECGI Finance Working Paper 557/2018). The prize was collected by Prof. **Enrichetta Ravina** who presented the findings of their paper.

The Law Series prize of EUR 5,000, sponsored by Cleary Gottlieb Steen Hamilton, the international law firm, was awarded to Professors **Lucian Bebchuk** (Harvard Law School, NBER, CEPR and ECGI) and **Scott Hirst** (Boston University, Harvard Law School) for their paper on "**Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy**" (ECGI Law Working Paper 433/2018).

The ECGI Members' dinner took place that evening, with **Francisco Reynés Massanet** (Naturgy), providing the after-dinner speech to an audience of ECGI members and invited guests.

The Economics of Firm Culture

Following a warm welcome by **Jordi Canals** (IESE Business School), **Paola Sapienza** (Kellogg School of Management) delivered the ECGI Annual Lecture on "The Economics of Firm Culture", which proved to be a challenging topic to define.

Sapienza began by describing the rich literature that exists on culture in general, outside the firm, and how it affects economic outcomes. She then offered a definition of *corporate* culture, describing it as a "[s]tock of knowledge, norms, conventions shared by members of the firm" (Kreps, 1990; Cremer, 1993).

She also shared some examples on the significance of corporate culture, such as in the case of Siemens bribery scandal. Siemens had an elaborate and well-organized system of bribes in place, which included a large group of people (including people at the top), and therefore could be considered to be part of the corporate culture. She pointed out that in Germany, before the Siemens scandal, there was even an accounting line that could be used to account for bribes.

A second example of corporate culture is the collection of 14 leadership principles from Amazon, including the principle of having "the highest standards". These principles can be said to form part of Amazon's corporate culture, since Amazon uses these principles to *"hire around them, [...] promote around them, [...] think about them in how we plan the business."*

A third example is the case of the Barilla plant in Foggia, Italy, which suffered from unprecedent absenteeism, which in turn, severely affected production. Fixing the problem with economic incentives proved ineffective, after which, management cooperated with a psychologist on changing the corporate culture. This included a town hall meeting where it was made clear that the factory would be closed if the problem was not solved. This led to a large decline in absenteeism.

Sapienza then discussed how corporate culture is formed: some authors have suggested that managers select workers based on their own value and beliefs, while Cremer (1993) has argued that it emerges naturally from common experiences and a similar background. Gorton (2019), on the other hand has emphasized that corporate culture can also be shaped by training managers, for example. Sapienza notes that Jeff Bezos seems to hold a similar idea for Amazon, quoting him saying "high standards are teachable. In fact, people are pretty good at learning high standards simply through exposure." The Barilla case also illustrated that while corporate culture is shaped by local culture (absenteeism is a widespread phenomenon in the south of Italy), it can also be modified by managerial interventions.

Corporate culture can potentially fulfil many different functions, according to Sapienza: it can serve as a coordination device, affecting beliefs and actions but not preferences, for example by establishing conventions in a "repeated game" setting (Kreps, 1990); alternatively, corporate culture could actually change preferences and the identity of workers. It could provide intrinsic motivation to employees, which could reduce costs (as firms need to provide less extrinsic motivation to employees) and increase productivity (since employees put in more effort at work).

Sapienza then mapped the existing empirical literature on corporate culture, which she noted was quite thin. The first conclusion of the empirical literature that she drew was that local culture seems to matter, pointing to a study by Hofstede (2001) that discussed how the culture of the company IBM differed over countries. A second observation was that often, the stated values that firms profess have no resemblance to what employees believe and further, do not correlate with firm performance, making stated values inadequate to conduct empirical research on corporate culture. Finally, she argued that empirical studies that try to define positive or negative cultures and correlate this with outcomes suffer from an endogeneity problem. For example, it is possible that profitable firms have the luxury to put in place a good culture; but it is also possible that the good culture has caused the good performance.

The final part of the lecture outlined what separates corporate culture from the culture in other organizations. Sapienza argued this could be the presence of an entrepreneur or manager, the fact that workers bring with them their own social identity (although they suffer a cost if they deviate from the group norm), and the fact that the firm has a production function and a budget constraint. Sapienza then briefly used this model to illustrate how culture can affect the boundaries of the firm: even if activities have technological complementarities, a firm may want to separate them if they are not culturally complementary, for example because the tasks require different mindsets (creativity versus precision).

Sapienza then offered the following conclusions: Firstly, that corporate culture is important, and people in practice believe it is very important. Secondly, economists have tried to integrate corporate culture in their models, but these models fail to capture how firm culture can differ from culture in other organizations, which creates the need for a new paradigm.

Panel Discussion: Corporate Culture

After Sapienza's lecture, a panel discussion on firm culture followed, moderated by **Marco Becht** (Université libre de Bruxelles). **Beatrice Engström-Bondy** (Senior Advisor to the Chairman of Investor AB, a group owned by the Wallenberg Foundation) first responded to the lecture. She began by emphasizing the importance of corporate culture, given the large influence of corporations on society, from pharmaceutical companies on the opioid crisis to banks on the financial crisis. As Engström-Bondy works for the Wallenberg group, the largest group in the Nordic countries that owns stakes in many listed companies, a central question is how to foster a corporate culture that works well across all of the diverse companies within the group, across different sectors and geography. Engström-Bondy suggested that this can be accomplished by creating a dialogue and a network, along with a sense of pride and inclusivity across their portfolio companies, for example by organizing meetings between chairpersons, CFOs, heads of CSR, heads of HR etc. Secondly, she emphasized the importance of having an owner that employees can identify with. For example, the Wallenberg Foundations invests the profits it receives from its investments into Swedish research and education. They also hold their investments for the long-term and are willing to sacrifice short-term profitability in favour of long-term results, although the long term is never used as an excuse for weak short-term profitability. Finally, Engström-Bondy offered some thoughts on the difference in culture between listed and non-listed firms, concluding that this distinction may not matter that much and that the more important factor is who the shareholder is and whether they have a long-term view or not.

In response, Paola Sapienza noted how it could be more difficult for a CEO to ward off pressure in a listed company, for example in the case of Boeing, which faced pressure to rush the development of a new plane, which Sapienza argued may have compromised safety. Her point was not that the decision to compromise safety was a conscious one, but rather that the feasibility of developing the new plane in time was highly uncertain and that the corporate culture was such that nobody was able to step up in the face of the pressure to acknowledge the unrealistic expectations. She also noted that a private company can afford to give up profitability in the short term, while this is more difficult with an anonymous shareholder base. This conclusion was echoed by Engström-Bondy, who stated that Investor AB is able to have a bad quarter, knowing that next quarter will be better.

Audience questions served to highlight some additional points, such as the complementarity of corporate culture to other (legal) institutions including the regulator, and to transparency and corporate governance. Also referenced was the concept in Australia of holding directors liable for poor corporate culture, although the panelists observed that this would be very hard for a court to decide on and could scare potential directors from accepting a board seat.

Aberdeen Standard Investments Finance Prize: Investor Ideology

Marco Becht introduced the Aberdeen Standard Investments Finance Prize for the best paper in the working paper finance series. He emphasized the innovative character of the paper, which brings a new method from political science to the corporate governance debate.

Mike Everett (Aberdeen Standard Investments) then awarded the prize on behalf of Aberdeen Standard Investments. He found it interesting that the research showed that companies such as Aberdeen Standard Investments voted in line with an apparent ideology, even though they may not set out to have a specific ideology, and that the apparent ideologies of investors fitted into definable groups.

Afterwards, **Enrichetta Ravina** (Kellogg School of Management) presented the prize-winning paper. The idea of the paper is to determine the ideology of institutional investors on the basis of how they cast their votes. Ideology should not necessarily be understood in a political sense in the paper, but rather as voting in a way that is internally consistent across issues. The authors focus on the ideology of institutional investors because they tend to cast the determining vote in most ballots, because they are repeat players, and because they influence a wide range of societal issues.

They use a spatial model of proxy voting, “W-NOMINATE”, based on a model from the political science literature that has been used to study Congress in the US. They mapped the results on several dimensions, in the end choosing to focus on two dimensions, since the additional dimensions did not add much in terms of explanatory power. They interpreted the first dimension as the socially versus profit-oriented dimension. The investors on the left support more socially and environmentally friendly proposals and tend to vote more often against say-on-pay proposals; while the investors on the right are more money conscious and vote against proposals that may cost shareholders money. Ravina noted that ISS is situated in the center of the first dimension, while most large mutual funds (like Blackrock, Vanguard and Fidelity) are more to the right and pension funds tend to be more to the left.

She also noted that it is currently still unclear whether this heterogeneity reflects different views on how to best accomplish the same objective of maximizing shareholder value, or whether the investors on the left also have a different objective than maximizing only shareholder value.

The paper interprets the second dimension as a more traditional governance dimension, of management disciplinarian investors versus more management friendly investors. The second dimension does not improve the fit much overall, but it does help to better explain the behaviour of a small subset of investors, including proxy advisor Glass Lewis. It should be noted that the statistical method is agnostic about the content of the shareholder proposals or the identity of the voters and merely returns patterns in the votes; it is up to the researcher to interpret the dimensions, and competing interpretations are possible.

Many studies in the literature model shareholders with unanimous preferences for shareholder value maximization. But the paper shows that preferences of shareholders are heterogenous and does not assume that investors vote to maximize shareholder value, which relates the paper to the debate on the purpose of the corporation. The paper is also related to the literature on corporate governance and proxy voting and the literature on the role of institutional investors in corporate governance (including Bebchuk & Hirst, 2018, which was awarded the Cleary Gottlieb Steen & Hamilton Law Prize). The paper is also close to a paper by Bubb & Catan (2018).

The W-NOMINATE method unites three tools: (1) random utility framework, which means that investors have heterogenous preferences; (2) spatial models of voting, which means that investors who vote similarly end up close to each other on a scale; and (3) alternating estimation methods developed in psychometrics. The method also assumes that investors vote sincerely for proposals that are closest to their ideal point, which the method estimates based on the votes. The method also allows to calculate the midpoint, which separates the investors who vote against a proposal from the investors who vote for it.

Ravina suggests that future research could investigate to what extent the investor ideology determined by the model lines up with the investment philosophy that is advertised by the funds on their website.

Responding to a question from the audience, Ravina also stated that funds from the same family almost always vote similarly; only 1% of the votes have two funds from the same family voting differently.

Cleary Gottlieb Steen & Hamilton Law Prize: Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy

Amir Licht (IDC Herzliya) introduced the Cleary Gottlieb Steen & Hamilton Law Prize for the best law paper in the working papers series. He praised the paper for being a prime example of what the ECGI working paper series is about: a paper about a complex issue, but with a simple but convincing and lucid analysis, which provides empirical evidence and policy recommendations.

Paolo Rainelli (Politecnic University of Turin and Cleary Gottlieb Steen Hamilton) then presented the prize on behalf of Cleary Gottlieb Steen Hamilton. He also praised the paper's combination of theory, evidence and policy recommendations, and emphasised the paper's importance for academics, practitioners and regulators, who all need to be aware of the important role that institutional investors should play in stewardship.

Scott Hirst (Boston University School of Law) and **Lucian Bebchuk** (Harvard Law School) presented their paper. The paper develops an agency cost theory of index fund stewardship decisions; provides empirical evidence on stewardship decisions by index funds that is consistent with this theory, using hand-collected and public data; and discusses policy implications from the theory and the evidence. The paper is part of a larger project, including a paper with an analytical framework for institutional investor agency problems (Bebchuk, Cohen & Hirst, 2017) and a paper providing empirical evidence on the growth of the three largest index fund managers (the "Big Three") (Bebchuk and Hirst, 2019).

Their theory starts from the observation that stewardship decisions are made by fund managers, rather than by the investors in the fund, which creates the possibility of agency problems. The benchmark that Bebchuk and Hirst use in their paper is stewardship decisions that would be optimal for the beneficial investors in a fund. The paper does not claim that stewardship decisions by index funds produce worse outcomes than those that would have occurred in a world with dispersed shareholders, but rather that the incentive problems of index fund managers mean that their stewardship falls short of the optimal level. The paper describes two incentive problems of index fund managers: (1) incentives to underinvest in stewardship; and (2) incentives to be excessively deferential to corporate managers.

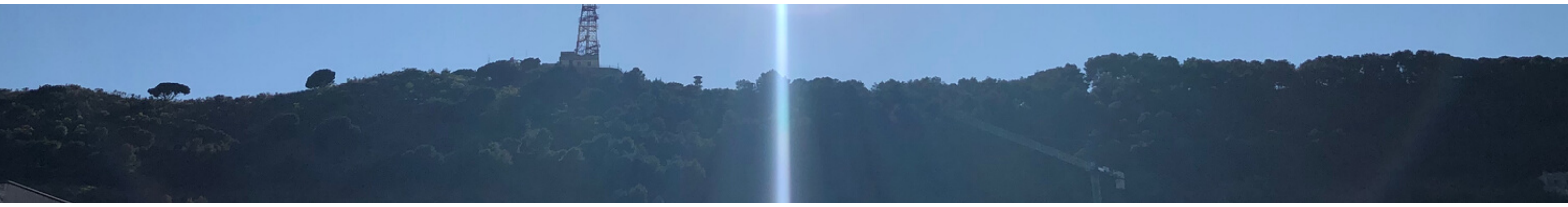
The paper puts forward evidence of what stewardship activities the Big Three do, and what they don't do, which is consistent with Bebchuk and Hirst's theory. For example, the expenditures of the Big Three on stewardship personnel are only a very small percentage of their fees and expenses of the big (0.14% – 0.18%). Even under the most generous assumptions, the Big Three index fund managers still devote less than four person-days per year for each $1 billion position they hold, but their staff must evaluate hundreds of pages of documents for each company. The paper also argues that the Big Three's private engagement cannot be a substitute for other stewardship tools, since for more than 90% of each index fund manager's portfolio companies, the fund manager had no private engagement with those companies.

The paper also documents that index funds focus on divergences from governance principles, rather than on business performance. Focusing on general principles enables economies of scale in stewardship and reduces the salience of the Big Three's influence, but does not take into account the financial performance of portfolio companies, and so fails to maximize value for beneficial investors. Additionally, the Big Three index fund managers

do not put forward shareholder proposals or director nominations, and have not taken an active role in corporate governance reforms, despite their substantial resources. Bebchuk and Hirst present evidence that the Big Three submit comments on less than 10% of the SEC proposed rule changes, much less than asset owners, such as CalPERS and CalSTRS, that have considerably smaller portfolios.

Finally, Bebchuk and Hirst discussed the policy implications of the paper, focusing on implications for the debate on hedge fund activism and the debate on common ownership. First, they argue that stewardship by index funds cannot function as a substitute for hedge fund activist investors, and that such activists will continue to play a crucial role in corporate governance. Second, hedge fund activism cannot be a complete solution to overcome the incentive problems of index fund managers. Activist hedge funds will only engage if they expect relatively large and rapid returns, so they will not take advantage of some opportunities to increase value through stewardship. Activist hedge funds also require the support of index fund managers for their interventions to succeed, and this support is undermined by the incentives of index fund managers to be excessively deferential to managers of portfolio companies. The authors also argue that criticisms of common ownership are misplaced. The problem is not that index funds push corporations too much, as some critics of common ownership claim, but rather not enough. The paper concludes that the recognition of the agency problems of index funds could itself lead to an improvement in stewardship decisions, since index fund managers have an incentive to be perceived as responsible stewards.

In the question and answer session that followed a participant asked whether the recent letter from BlackRock Chairman and CEO Larry Fink can be seen as an example of stewardship. Bebchuk and Hirst replied that many portfolio companies that receive such letters from index fund managers do not make the requested changes, and index funds do not use the stronger tools at their disposal to encourage them to do so. A further question related to the paper's call for more transparency regarding private engagements. Another participant commented that index funds do not use shareholder proposals because their patient, long term perspective allows them to seek change through engagement rather than voting, but Bebchuk and Hirst pointed out that failing to use other tools at their disposal meant that changes happened more slowly that would be optimal for the beneficial investors in index funds.



Dinner Speech:Francisco Reynés Massanet (Chair and CEO, Naturgy)

Guy Jubb (ECGI Chair) introduced the dinner speech by **Francisco Reynés Massanet.** He emphasised that corporate governance does not have right and wrong answers, due to the diversity of investors and corporations, and that ECGI fulfils an important role in supporting that diversity with a corporate governance ecosystem.

Jordi Canals (IESE Foundation Chair of Corporate Governance, IESE Business School) further introduced the topic of the dinner speech: the diversity of shareholders of corporations and the impact on the board of directors and on corporate governance. Francisco Reynés Massanet, a graduate from IESE Business School, is the Chairman and CEO of Naturgy, a listed energy company.

Francisco Reynés Massanet noted that a lot had changed since he attended IESE Business School, since nobody talked about corporate governance then, while corporate governance now is here to stay. According to him, corporate governance is about helping companies to last forever. This means that profitability is necessary, but not enough. His own monthly management reports with the board do not only discuss the financials, but also the impact of the corporation on the people (such as safety and customer satisfaction) and on the broader society (including the environmental efforts and the work of the company's foundation).




A key actor that must support this long-term purpose is the board of directors. It is the place where the interests of the different shareholders (such as private equity funds, hedge funds, activists, foundations, retail investors, ...), who have different visions and different time horizons, are discussed and where a solution to these differences is negotiated. Reynés Massanet stressed that it is important that all of the directors have the same objective of taking the best decisions for the corporation, regardless of which shareholder they represent, as is also their legal duty.

Reynés Massanet also noted that the relationship between the board and the CEO is crucial, which involves both formal and informal communications. In this regard, it is important that the role of the board and the role of the management team and the CEO are clearly understood as separate roles, governing versus managing. Currently, Reynés Massanet combines the role of CEO and Chairman of the board, which he thinks works well. Nevertheless, he has to put on a different hat for each role: as a CEO, he is responsible for managing the day-to-day affairs and achieving the targets, while as Chairman, he has to facilitate the bigger discussions on vision and strategy. According to Reynés Massanet, a greater problem than combining the role of Chairman and CEO is when the non-executive Chairman of the board is the former CEO. In that case, the Chairman knows all the relevant executives and advisors, and it is too easy for that person to cross the line between governing and managing. The relationship between the board and the CEO can be a complex one, as it is about people and egos. However, what Reynés Massanet considers important in this regard is that the board does not contain any “prima donnas” and that the CEO views corporate governance as something that is there to help him or her, and not just as legal papers and bureaucratic hoops to jump through.

Reynés Massanet argues that boards today tend to be more powerful than in the past. This is because of legal rules that have empowered the board, but also because the board has become more professional. He illustrated the importance of corporate governance with his personal experience of taking an infrastructure company public. He tried to establish best in class corporate governance, an important aspect of which was to establish a top tier management team with international experience, which helped to ensure the success of the IPO. According to Reynés Massanet, this shows that the market also understands the importance of corporate governance.

Finally, Reynés Massanet talked about shareholder activism. He sees a simple explanation for why activists exist: they see value that the management team has not yet unlocked, potentially because it is too difficult or because the management team is too lazy, conservative or afraid of change. He argues that activists often find obvious ways to improve a corporation’s value, and that it is the board’s responsibility to identify and disclose these opportunities.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About the European Corporate Governance Institute (ECGI)

www.ecgi.global

The ECGI is an international scientific non-profit association which provides a forum for debate and dialogue focusing on major corporate governance issues and thereby promoting best practice. It is the home for all those with an interest in corporate governance offering membership categories for academics, practitioners, patrons and institutions.

Its primary role is to undertake, commission and disseminate research on corporate governance. Based upon impartial and objective research and the collective knowledge and wisdom of its members, it can advise on the formulation of corporate governance policy and development of best practice. In seeking to achieve the aim of improving corporate governance, ECGI acts as a focal point for academics working on corporate governance in Europe and elsewhere, encouraging the interaction between the different disciplines, such as economics, law, finance and management.

About the IESE Center for Corporate Governance (IESE CCG)

https://www.iese.edu/faculty-research/research-centers/iese-ccg-center-corporate-governance/

The IESE Center for Corporate Governance aims to advance the theory and practice of corporate governance by promoting evidence based research, fostering an inter-disciplinary discussion among scholars and experts and helping to create a learning context in which chairs of boards, CEOs, board members, investors and senior executives can reflect on and acquire new frameworks and ideas to improve their firms' governance.

About Aberdeen Standard Investments

www.aberdeenstandard.com

Aberdeen Standard Investments (ASI) is a leading global asset manager dedicated to creating long-term value for clients, and is a brand of the investment businesses of Aberdeen Asset Management and Standard Life Investments. With over 1,000 investment professionals, ASI manages £505.1 billion* of assets worldwide and has clients in 80 countries supported by 50 relationship offices. This ensures ASI is close to its clients and the markets in which it invests. As high-conviction, long-term investors ASI believe teamwork and collaboration are the key to delivering repeatable, superior investment performance.

(*as at 31 December 2018)

About Cleary Gottlieb Steen & Hamilton LLP

www.clearygottlieb.com

Founded in 1946, Cleary Gottlieb has grown to over 1,200 lawyers from more than 50 countries, working across practices, industries, jurisdictions, and continents to provide clients with simple, actionable approaches to their most complex legal and business challenges.

We support every client relationship with intellectual agility, commercial acumen, and a human touch. We have a proven track record for serving with innovation. We are fluent in the many languages of local and global business. And we have achieved consistent success in multiple jurisdictions.

Global corporations, financial institutions, sovereign governments, local businesses, and individuals come to us for consistently practical and forward-looking advice.

Videos of all of the presentations are available on the ECGI website

About the ECGI Working Paper Series

The primary purpose of the two series (Law and Finance) is to publish research papers on corporate governance related topics that are authored or co-authored by ECGI Research Members i.e. those who have been elected as ECGI Fellows or appointed as ECGI Research Members.

The series editors generally apply a broad definition of corporate governance and also include papers on the interface between corporate governance and other areas, or papers of which only a part touches on corporate governance. However, papers in other areas whose relevance for corporate governance is only indirect or methodological are not included.

About the European Corporate Governance Research Foundation

www.ecgrf.org

Through an initiative of the ECGI, The European Corporate Governance Research Foundation was established in 2013 to support the continuing flow of academic research on corporate governance and stewardship for the public good. The Foundation does this by providing financial support to the European Corporate Governance Institute (ECGI) which in turn provides a forum for debate and dialogue focusing on major corporate governance and stewardship issues and thereby promoting best practice. The mission of ECGI is to improve corporate governance and stewardship through independent scientific research and related activities. It is to assist the top academics in the field of corporate governance in bringing their research to the attention of leading practitioners, policymakers and thought leaders by making state of the art knowledge accessible and relevant to them. It is to make high quality research accessible for the public good.

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