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IESE Business School University of Navarra Center for Corporate Governance

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CORPORATE GOVERNANCE AND OWNERSHIP WITH DIVERSE SHAREHOLDERS

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REPORT BY TOM VOS

Organising Committee

Prof. Jordi Canals
IESE Foundation Chair of
Corporate Governance, IESE Business School

Prof. Marco Becht
Goldschmidt Professor of Corporate Governance,
Université libre de Bruxelles, CEPR and ECGI

Prof. Gaizka Ormazabal
Grupo Santander Chair of Financial Institutions and
Corporate Governance, IESE Business School CEPR
and ECGI

Prof. Xavier Vives
Abertis Chair of Regulation, Competition and Public
Policy, IESE Business School, CEPR and ECGI

Introduction

Many policy recommendations that emerge from the flourishing literature on corporate governance do not take into account the diversity of company owners and the different goals of heterogeneous' shareholders in the 21st century. Many of them make the assumption that dispersed shareholders is the representative form of corporate ownership. This hypothesis is still dominant in most theoretical studies and in many empirical studies.

The fact is that ownership around the world in the twentieth century changed in many large countries, has become more heterogeneous and diverse than what is assumed in many studies, and its evolution is shaped by a diversity of factors, such as domestic taxation and regulation, capital markets and different management and business practices.

Understanding that ownership is heterogeneous and diverse has implications on how companies are governed. It is also critical for the improvement of corporate governance at the corporate level and the government's regulatory activity. In the end, it has an impact on companies' survival –many firms that didn't survive encountered problems with their own shareholders and their commitment- and their long-term development.

This Conference offered a context to reflect upon and better understand how the different nature of shareholders have an impacted on the way companies are governed and managed, and, eventually, on some key decisions – like board composition, board dynamics, CEO hiring and firing, strategy making and incentives design- that define corporate governance.

Jordi Canals (President of IESE Center for Corporate Governance (IESE CCG)) provided an introduction to the 2019 IESE CCG– ECGI Corporate Governance Conference highlighting that the focus of the conference was on shareholders because the nature, engagement and commitment of shareholders have a deep impact on corporate governance and the long-term survival of the firm.

Marco Becht (Université libre de Bruxelles and Executive Director of ECGI) briefly introduced ECGI and its mission, before **Andrew MacDougall** (Spencer Stuart and Social Trends Institute) introduced the Social Trends Institute which sponsored the event.

Finally, **Franz Heukamp** (Dean of IESE Business School) discussed how IESE Business School has focused since the beginning on decision-making at the highest level of the corporation, with programmes for board members and the new Center for Corporate Governance. Additional information about these institutes is contained at the end of this report.

Ownership, Agency and Trusteeship

In the first session, **Colin Mayer** (Saïd Business School, University of Oxford and ECGI) gave a presentation on "Ownership, Agency and Trusteeship". He began with the concept of "capitalism", which is conventionally viewed as an economic system of private ownership over the means of production and their operation for profit; as well as the concept of "ownership", which he defined as a bundle of rights over assets that confer strong forms of authority on its possessors. Firms are then typically viewed as a nexus of contracts, held together by the board, which maximizes value for the shareholders, the "owners" of the corporation. Mayer was critical of this analogy between shareholding and the ownership of physical property, such as a car, arguing instead that a corporation is a complex organization that coordinates a large number of stakeholders. Capitalism presumes the allocation of control rights to the providers of capital, the shareholders. Mayer, however, argues that if this was ever appropriate, it no longer is, due to the dependence on the success of the firm for many other stakeholders.

Mayer then discussed the idea of "enlightened shareholder value", which emanates from the idea that doing well for other stakeholders will also benefit the shareholders. The idea is that a corporation must act in the interests of shareholders and other stakeholders, similar to the formulation of directors' duties in the UK Companies Act. However, Mayer cautioned that this sweeps under the carpet the question of whose interests take precedence if the corporation has to choose between societal or shareholder interests. Enlightened shareholder capitalism supports avoiding paying taxes and polluting the environment to the extent that this is allowed by the law and does not impose reputational costs that outweigh the benefits to the shareholders. Some have argued that the dichotomy between shareholders and other stakeholders disappears as long as corporations are focused on creating long-term instead of short-term value, but Mayer argues that the problem is not just a problem of *which* horizon, but also of *whose* horizon.




Instead, Mayer argues that we should redefine the nature of ownership of the corporation: instead of viewing the directors as agents of the shareholders, the board should be viewed as a trustee that manages the corporation for the benefit of the parties in whose interests the company is established. Therefore, the key to defining this trustee relationship is to define the purpose of the corporation. Mayer argues that the purpose of the corporation is to produce profitable solutions to problems of people or planet. In this view, profit is not the fundamental purpose, but is derivative of the fundamental purpose. In other words, it is about delivering profits to shareholders by solving the problems of others. This also implies that corporations should not profit by creating problems for people, the purpose should be to create Pareto improvements. Mayer argued that the purpose should be a precise statement of whose and what problems the corporation is solving and how. For example, Novo Nordisk used to have a purpose to produce insulin, which is purely descriptive. Later, it realised that its purpose was actually to eradicate type two diabetes, through insulin or through other means (such as changes to people's lifestyles), which is the kind of purpose that Mayer advocates.

Mayer then explored the implications for corporate ownership. If the sole purpose of the corporation would be to maximise shareholder value, we would expect a high degree of uniformity of ownership, with a dispersed shareholder base of mutual funds catering to the preferences and horizons of investors. Instead, we can observe a relatively high degree of concentrated ownership, especially outside the UK and the US. An important class of concentrated ownership is family ownership, which allows the family shareholder to continue to uphold its ethical principles. Empirical evidence finds that family ownership leads to more attention for the well-being of employees and local communities, although the research also finds that family-owned corporations perform worse on environmental and broader social measures.

Mayer also argued that a corporation with the trusteeship model may outperform a corporation with (enlightened) shareholder primacy. First, trust-based corporations may create more engaged employees and customers. Secondly, intrinsic trusteeship can be regarded as a substitute for extrinsic regulation, which is the traditional response to market failures. According to Mayer, trust-based corporations could potentially benefit from less intensive regulation, an important commercial benefit, by internalizing societal problems.

In conclusion, Mayer reiterated that capitalism should be redefined as a system where corporations produce profitable solutions to the problems of people and planet, and do not profit from producing those problems; where ownership is not only a bundle of rights but also of responsibilities towards the corporation's purpose; and where firms are not simply nexuses of contracts but nexuses of relations of trusts based on principles and values enshrined by the boards of directors. Mayer argued that it is the role of the law to provide corporations with a mechanism to credibly commit to this system.

Charlotte Ostergaard (BI Norwegian Business School and ECGI) acted as a discussant to Mayer's presentation. Ostergaard summarized the paper as arguing against a "property view" of the corporation and in favour of a "purposeful business view", where the board of directors is a trustee for all the beneficiaries of the business. She then offered a few questions for further reflection about Mayer's ideas.

Firstly, as the purpose of a corporation is probably dynamic and cannot be carved in stone by the founder, who should decide what the purpose is? Is this the owners or the board of directors? Mayer replied to this that it is initially the founders who would set the purpose of the corporation, and as long as the family is the primary owner, they can set the purpose and the professional management will have to execute it. Where ownership is highly dispersed, it is difficult for investors to set the purpose and then it is the role of the board of directors to set the purpose and execute it.

Secondly, Ostergaard raised the question of the accountability of the board of directors if they are the ones who set the purpose and they have many masters to serve. As the Council of Institutional Investors has pointed out, accountability to everybody means accountability to nobody. To this, Mayer replied that accountability to a single person, means that nobody else counts. He argued in favour of a board structure that facilitated taking into account multiple stakeholders. During the Q&A, one of the participants raised the idea of co-determination in this regard, but noted that accountability towards consumers is also required. Mayer replied that more important than accountability is the presence of a system of measurement and accounting which can ascertain whether corporations are delivering on their purpose.

Thirdly, Ostergaard noted that Mayer's claim that trust-based corporations outperform shareholder primacy corporations can be tested empirically. She pointed to evidence that corporations owned by industrial foundations, who are more likely to embrace a trusteeship model, were equally profitable, survive longer, but grow somewhat slower. However, this does not tell us anything about the mechanism of performance and could be subject to a self-selection problem. Ostergaard also pointed to her research which found that savings banks in Norway that faced competition from commercial banks had a higher survival rate if they had a high level of social capital, and that banks with high social capital distributed more surplus to the community. She noted that similar papers exist about US banks with high social capital.

Finally, Ostergaard questioned whether corporations are really the problem. Some divisive societal challenges, such as Donald Trump or Brexit, are not championed by corporations, but by regular voters. Perhaps the broader issue is a lack of civic engagement, although corporations can certainly be a vehicle of change. Mayer replied that it may not be a coincidence that it was the UK and the US who faced these challenges, given their governance model.

Responding to a question, Mayer also argued that the law should impose duties on shareholders. This idea is already present in the UK corporate governance and stewardship codes, but needs to be translated into the law, in his view. Another participant questioned whether a trusteeship model would lead to better results, referring to the Volkswagen scandal. Volkswagen was run by a strong family, provided strong rights to employees, had the state as an engaged board member and involved the local community, yet committed one of the most egregious corporate scandals. Mayer offered that this might be attributed to addressing the matter of ownership, but without having a legal duty for the corporation not to profit from creating problems more broadly. It is also consistent with the evidence that family firms may favour some stakeholders (employees and local communities) over other broader societal issues. Finally, in response to questions, Mayer noted that US and UK corporate law allows boards to take into account many stakeholders, but not at the moment of shareholder activism or hostile takeovers, where shareholders still decide. Instead, corporate law should facilitate corporations to pursue a plurality of corporate purposes, while the current system now constrains this potential.




Passive Investors

In the second session, **Jill Fisch** (University of Pennsylvania Law School and ECGI) presented a paper on passive investors. She began by describing the growth in size and concentration of the passive fund industry (especially the so-called big three – BlackRock, Vanguard and State Street) and the controversy about their lack of engagement. She argued that this criticism is insensitive to the institutional context of the asset management industry.

More broadly, Fisch explained that passive investing is a strategy of investing on the basis of a company's inclusion in a pre-determined index rather than on the basis of firm-specific information. Engagement decisions are made at the level of the asset manager which typically manages both active and passive funds rather than at the level of the individual fund. As a result, institutional engagement must be understood at the level of the asset managers which do have incentives for engagement.

According to Fisch, the main criticisms of passive investors are that (1) they do not engage enough; (2) they do not challenge management enough (perhaps because of conflicts of interest); (3) they do not have the incentive or resources to engage intelligently (because they compete on costs); (4) they do not act in the interests of their beneficiaries; and (5) they do not act in the interests of society.

Fisch took issue with several of these criticisms. First she explained that, although index funds are locked into their investment in particular portfolio companies, investors are not locked into specific index funds. As a result, fund managers must compete for customers and that this competition is not based exclusively on cost. She noted that empirical studies demonstrate that investors choose funds on the basis of fee-adjusted performance, that the limited success of zero-fee funds suggests that fee-based competition has declined, and asset managers continue to innovate with products that enable them to charge higher fees including custom indexes, smart beta products and ESG funds.

Fisch further noted that passive investors' business model allows them to engage effectively. Large asset managers hold more assets, creating economies of scale with respect to engagement, and giving them greater leverage through their voting power. Although passive investors may lack the firm-specific knowledge to make operational interventions, their broad holdings increase the efficiency and value of market-wide initiatives. Finally, asset managers benefit from synergies between their active and passive funds.




Fisch explained that this theory of passive investor engagement is borne out by market developments. She highlighted the increasing resources being devoted to engagement, the involvement by the big three in private engagement and letter-writing, the participation in governance organizations, their growing political and regulatory influence, and their ability to mediate hedge fund activism. Fisch also invoked the Nirvana fallacy, arguing that it is inappropriate to compare passive investor engagement to the benchmark of the enlightened sole owner rather than evaluating their effect on corporate governance relative to the uninformed and unengaged retail investors who passive investors have largely displaced.

Fisch noted that the growth of passive investing raises several potential concerns. According to Fisch, the growth of passive investing at present is unlikely to undermine market efficiency, given that relatively little active investing is required for informational efficiency. She challenged concerns over increased ownership concentration, observing that empowered institutional investors do not all vote the same way and that they have significantly reduced the collective action problems associated with dispersed retail ownership.

Fisch acknowledged that passive investor engagement creates the potential for agency conflicts between fund managers and their beneficiaries and for fund level conflicts. She noted the complexity of the problem, given that beneficiaries may have very diverse interests may invest in multiple funds offered by a given asset manager. She noted that broadening the scope of engagement to include ESG increases the potential agency costs because of the difficulty of addressing issues such as the trade-off between economic and non-economic concerns as well as prioritizing among multiple societal interests. Although some commentators have identified pass-through voting by fund beneficiaries as a potential solution to the agency problem, Fisch noted that it suffers from some problems, including the lack of engagement and sophistication of fund investors.

Fisch concluded by observing that the market of passive investing is still evolving. New products and greater transparency may enable funds to distinguish themselves on the basis of their engagement, including ESG engagement, providing the opportunity for market forces to play a greater role. The effect of these developments will depend on the extent to which investors are willing to pay for greater engagement.

In his comments, **Rafael Repullo** ((Centre for Monetary and Financial Studies (CEMFI)), contrasted the paper by Fisch et al., which argues that the growth of passive funds makes increased engagement possible, with the paper by Bebchuk & Hirst (2019), which argues that index fund managers underinvest in stewardship. He developed a simple theoretical model that showed that the low management fees of passive funds implies lower monitoring by passive funds, higher monitoring by active funds, but lower overall levels of monitoring. In other words, the growth of the passive fund industry implies a lower overall level of monitoring. Repullo also questioned Fisch's argument that passive funds have large resources to devote to corporate governance, by arguing that they did not have the right incentives to do so, and that their staff devoted to engagement is still relatively small.

Repullo briefly discussed the implications for the common ownership debate. The impact of common ownership could be significant if Fisch et al. are right, or negligible if Bebchuk and Hirst are right. In the ensuing question session, it was argued that it was possible to have no engagement and still a lack of competition.

Repullo concluded that more empirical research is needed, given the competing theoretical models, and stated that this is an area where economists and lawyers can fruitfully collaborate.

During the Q&A, one of the participants asked whether there is tension between the two prize-winning ECGI working papers, by Bolton et al. (2019) on investor ideology and by Bebchuk & Hirst (2019) on index funds, since the presence of an investor ideology leads to consistent and deliberate voting. Fisch agreed with this, arguing that large mutual funds vote differently from proxy advisors because they focus on underperforming companies. Bebchuk disagreed, pointing to the evidence from Bolton et al. which shows that the big three are on the more management friendly side, as the Bebchuk & Hirst paper finds. The index funds can be deferential to management without spending much time on engagement by resorting to general governance principles instead of company-specific information.

Corporate Governance through Voice and Exit

Julian Franks (London Business School and ECGI) presented a joint paper with Marco Becht and Hannes Wagner. The paper seeks to answer the question of whether the fact that an active manager can exit its investment (in contrast with passive owners) affects its engagement. They use a proprietary data set with daily data over the course of nine years on the private engagements of a single asset manager, Aberdeen Standard Investments (previously Standard Life Investments), the largest active manager in the UK, in order to assess the importance of engagement and monitoring for trading decisions. The data also contains information on voting and daily holdings of the funds.

The paper describes the structure of the UK equities team of Aberdeen Standard Investments. It has a centralized Governance and Stewardship Group that manages all voting decisions and governance interactions for the funds. Voting decisions are executed by the voting manager, a member of the Governance and Stewardship Group. The votes of all of the funds of the asset manager are cast in the same way. The information gathered by the Governance and Stewardship Group is passed on to the internal analysts and the fund managers. The team can also flag corporations with a “governance health warning”. Internal analysts issue buy/sell recommendations to fund managers, who make the trading decisions. Analysts and fund managers also meet at least once a year with corporations in private engagements, often with the CEO and CFO, focusing on non-governance issues (such as raising capital, M&A, divestitures, under-performance and voluntary delisting). When the meetings involve governance, the Governance and Stewardship Group will join the meeting. The Governance and Stewardship Group also meets separately with a subset of the corporations, mainly those with a governance health warning or who received a negative vote, and most often with the lead independent director and/or the chairman.

Buy and sell signals are typically followed by significant trading, leading to increases of 13.5% and decreases of 22.1% on average of the participation. However, a majority of positions are unchanged in response to a change in recommendation by the analyst, and in a small number of cases fund managers actually trade contrary to the signals. This illustrates the decentralized trading decision-making and raises the question of why fund managers sometimes do not follow their own internal analysts. The paper also finds some abnormal returns after trades in the direction of internal analyst recommendations, suggesting that active trading around analyst recommendations contributes to alpha. These abnormal returns appear to be related to superior information.

The paper further finds significant trading around shareholder votes: funds tend to shift from buying to selling after negative votes, and especially so if this coincides with sell recommendations from internal analysts. There is also more intense engagement around negative votes. Finally, the paper finds abnormal trading activity in a stock after a governance health warning, with most fund managers selling the stock.

In conclusion, the paper finds evidence that engagement has a significant influence on trading decisions. Monitoring and engagement lead to the collection of valuable information, which feeds into analyst recommendations and contributes to alpha. In other words, voice influences exit, and active management seems to increase the incentives to engage.




In his comments, **Krishna Palepu** (Harvard Business School) first contextualized the paper, stating that there is significant competition between funds and that a significant number of actively managed mutual funds have underperformed their benchmarks. Investors are moving towards passive funds, and funds are cutting fees and investments in research, focusing on investments in marketing and distribution. Conflicts of interest could arise because fund managers often have incentives that are tied to fund size rather than fund performance, and because of the use of proxy advisors, who sometimes also provide governance consulting to corporations. Palepu notes that the paper is consistent with the literature that buy-side analysts outperform sell-side analysts. Palepu cautions, however, that Aberdeen Standard Investments can be considered one of the best, so it may provide an upper limit on the value of engagement.

The data suggests that engagement leads to superior returns, and Palepu asks how this squares with insider trading and disclosure laws. According to Franks, the information is not material under the mosaic rule and therefore escapes insider trading rules. It is mainly about the tone of the meeting and validating existing concerns.

Finally, Palepu raises the question of how much of the engagement is corporation-specific and how much is related to one-size-fits-all governance principles, to which Franks replies that this is not clear yet.

Activist Directors and Agency Costs: What Happens When an Activist Goes on the Board?

John Coffee (Columbia Law School and ECGI) presented a joint paper with Robert Jackson, Joshua Mitts and Robert Bishop on "Activist Directors and Agency Costs: What Happens When an Activist Goes on the Board?". The paper uses a data set of activist settlements to determine what happens after activists appoint directors to the board. The first main finding of the paper is that information leakage in firms in the treatment group increases by 25 to 27 percentage points above that of firms in the control group, as the market anticipates the impact of the filing of a form 8-K, an unscheduled filing. The paper also finds that this information leakage is associated with the appointment of directors who are an employee of the hedge fund that appointed them, and not with the appointment of outside directors. About two thirds of activist slates contain at least one nominee who is a hedge fund employee.

The second important finding of the paper is that this leakage is associated with a lack of confidentiality provisions. Coffee noted that Delaware seems to permit hedge fund nominees to talk to the hedge fund who appointed them, but not that this information is leaked to allies of the hedge fund (which is what seems to be going on).

Third, Coffee discussed the fact that 95% of the seats on the board won by activists are a result of a settlement and not a proxy fight, arguing that the target management seems to be risk averse and choose to settle in order not to be ousted. The paper finds that the market reaction to these settlements is more positive if the activist director is not an employee of the hedge fund and if the settlement contains a confidentiality agreement, which indicates that the market recognizes the agency cost of informed trading by activist directors. In addition, if the director is an employee of the hedge fund or the settlement does not contain a confidentiality agreement, bid-ask spreads seem to widen, indicating that the market expects that there will be insider trading. Option trading, a classic avenue for informed trading, also increases after the appointment of activist nominees. Finally, Coffee supported the conclusion that activist directors engage in informed trading and that the market already anticipates this.



Coffee then discussed why we should care about these findings. Some may argue that informed trading will always occur and actually rewards activists who are doing useful work. Coffee suggested, however, that the current state of the debate on the long-term effects of shareholder activism is inconclusive. More importantly, informed trading is a subsidy to hedge fund activism, which could make even inefficient engagements profitable. In addition, these settlements are privately negotiated and not approved by other shareholders, which is why index funds, for example, often protest against them.

Coffee also responded to criticism that was voiced against earlier versions of this paper, especially the argument that the firms subject to an activist engagement are very different from the firms in their control group. In response, they added another control group, of firms also subject to activist engagement but without a settlement agreement. The results with the alternative control group are consistent with the earlier results. In addition, they also compared the information leakage within the same corporation after the settlement agreement with the information leakage that occurred before the settlement agreement but after the start of the activist engagement. The results stay the same, indicating that the information leakage is really driven by the appointment of the activist directors and not by the activist intervention *per se*.

Coffee concluded that the evidence suggests the presence of informed trading by activist directors. It is unclear who the beneficiaries are of this informed trading, so it may or may not be unlawful, but it is most likely harmful to shareholders. One theory is that the activist directors tip information to their allies to assemble a “wolf pack”, to be able to put more pressure on management. In more recent research with a later data set, Coffee also found that information leakage is larger in smaller and younger hedge funds, which could be explained by the fact that they need a bigger wolf pack to succeed.

Marco Becht (Université libre de Bruxelles, Executive Director ECGI) commented on Coffee’s presentation. Becht first noted that the data on what happens in activist settlements is consistent with earlier research, such as Bebchuk et al., “Dancing with Activists” (2019). Becht also stated a possible alternative explanation for the increase in informed trading. It could be that the presence of activist directors leads to a different type of news announcement, for example more M&A, which we know from previous research is more prone to information leakage. To exclude this explanation, the authors would need to conduct a more detailed review of the 8-K filings, classifying the news into different topics. Previous research has used text algorithms to determine tone and topic of news announcements. Lucian Bebchuk (Harvard Law School) also echoed this part of Becht’s comment, stating that his paper found that more and more profound changes occur when activist directors enter the board, much more than when there is an outside director or only the pressure of an activist engagement, so the control groups

still suffer from a deficiency. Coffee replied that they found that the number of 8-K filings did not change after an activist intervention and that it may be too difficult to check whether their topic also did not change. Furthermore, Becht pointed out that there is no direct evidence of who leaked. It is plausible that the activist leaked to other activists, who could support them. But it could also be possible that management itself leaked information to active funds in return for support against the activist, although one could wonder why they did not use this strategy before the settlement with the activist. Coffee replied that he suspected the activist director to be the cause, because almost all of the gain from shareholder activism is contained in the initial jump at the moment of the announcement of the activist intervention. One reason why activist hedge funds could nevertheless hold on to the stock is to acquire information that can be gifted to their allies.

Despite the lack of direct evidence, Becht also raised the question of why securities regulators are not looking into this more systematically. Similarly, one of the participants in the Q&A asked why nobody is suing against this leakage. Coffee replied that tipping the information may simply be based on a general norm of reciprocity between fund managers, which would not satisfy the personal benefit test under US insider trading law. Informed trading may not necessarily be illegal insider trading.

CEOs Roundtable

In the next session, **Jordi Canals** (IESE Business School) moderated a panel of executives, with Amra Balic (Managing Director, BlackRock EMEA), Jordi Gual (Chairman, CaixaBank) and Juvencio Maeztu (CFO and Deputy CEO, Ingka Holding BV). **Juvencio Maeztu** kicked off the discussion. He described the purpose of IKEA as creating a better life for many people by providing products under the democratic design concept: affordable, well-designed, quality, functional and sustainable products. He also stressed the importance of the IKEA culture and values.

He stressed the importance of the long term approach of the company and how this is also reflected in the governance. Ingka Group (Ingka Holding B.V. and its controlled entities) is owned by Stichting Ingka Foundation which ensures independence and a long-term approach along with making the company financially independent. The financial direction of the company is focused on creating low prices for customers while investing to transform. The holding company is organised under three businesses: IKEA Retail, Ingka Center and Ingka Investment. The Investment business focuses on securing the longevity of the company by investing in financial assets, business transformation, business acquisitions and investments in renewables and forestry to help achieve the major sustainability agenda of the company. The sustainability agenda, called People & Planet Positive, is making it possible not to only have a purpose but to be a purpose-led company.

Next, **Amra Balic** spoke about BlackRock, the largest asset manager in the world, and its role in stewardship. Amra noted that most studies on stewardship by index funds are based exclusively on the data from the US market, which should not be used as the proxy for the rest of the world. BlackRock is a global investor with stewardship activities in countries all over the world. Amra gave an example of developing/emerging markets, where BlackRock typically holds very small percentage in companies across the market, and how in those cases they work with policy makers to address corporate governance issues at the market level focusing on driving change for the market as a whole. In their stewardship meetings, they center on the five priorities: (i) corporate governance, (ii) executive pay, (iii) long term strategy and capital allocation, (iv) environmental risks and opportunities and (v) human capital management. If they identify issues with executive pay, they expect companies to address those




by the next shareholder meeting. However environmental issues are long term by nature hence the emphasis of their engagements is on ensuring that companies have a clear long-term strategy for dealing with the environmental risks in their business and disclose material information year on year, helping investors form their investment decisions. Quality and content of engagement between companies and investors have evolved notably over the last decade. Today, board directors understand that a part of their job is to talk to investors. BlackRock typically speaks with the CEO, the chairman and/or an independent director, or for example, with the remuneration committee chairman if the issue is compensation or with the nomination committee chairman if the issue is succession planning.

Finally, **Jordi Gual** discussed the structure and governance of the group La Caixa, which he described as being a hybrid between a public and a private corporation. The group consists of three levels: La Caixa Foundation, which holds a variety of assets and is committed to the promotion of social welfare; the CriteriaCaixa holding company, which is fully owned by La Caixa Foundation and whose dividends are the foundation's main source of financing; and CaixaBank, a listed commercial retail bank which is the most important asset held by the holding company (it has a 40% stake). Gual observed that having a reference shareholder provides purpose, culture and a long-term focus, all of which are particularly relevant to the banking business. At the same time, this ownership structure also allows the bank to take a stakeholder-oriented approach while ensuring market and financial discipline. Although, in the short-term, there might be a trade-off between a shareholder and a stakeholder approach, such contradiction does not prevail in the long-term, according to Gual. For instance, the bank recently went through a voluntary process of reduction of the workforce, which concluded satisfactorily for all parties. While this hurt profitability in the short term, it sent an important message to the remaining workforce. It showed them that in the long run the bank is committed to their employees since they are the most important asset of the bank.

During the Q&A, one of the participants remarked that the three corporations discussed during the roundtable had different ownership structures. BlackRock is entirely public owned, Ikea is owned by a foundation, and La Caixa is a hybrid of public and private ownership. In response, some of the relative merits were cited: access to capital markets provides the possibility for growth and financial discipline, while reference shareholders provide stability and a long-term orientation.

Mutual Funds as Venture Capitalists? Evidence from Unicorns

In the sixth session, **Josh Lerner** (Harvard Business School and ECGI) presented a paper on "Mutual Funds as Venture Capitalists? Evidence from Unicorns", joint work with Sergey Chernenko and Yao Zeng. Previous research found that start-ups (especially more mature start-ups) have been raising more capital from non-VC investors, such as mutual funds, who traditionally focused more on listed corporations. This influx of money has also been associated with more founder-friendly terms. Previous research showed how VCs are uniquely positioned to monitor start-ups, but mutual funds are unlikely to have similar incentives and resources. Their open-ended structure and the daily marking-to-market are also hard to reconcile with illiquid investments in start-ups, which raises questions about how mutual funds provide governance to start-ups.

The paper uses a unique data set, since they look at certificates of incorporation and their amendments of a sample of unicorns in Delaware and manually code the contractual terms. This leads to a couple of interesting findings. Firstly, the paper finds that mutual funds are increasingly likely to invest in unicorns, and mainly in later financing rounds and in start-ups with more employees. Secondly, larger mutual funds from large fund families and funds with less volatile flows are more likely to invest in unicorns. Thirdly, mutual fund participation in financing rounds is positively associated with redemption rights and IPO-related rights (the right to veto down IPOs and ratchets to acquire more shares if the IPO price is low); but it is negatively associated with standard control rights and cash flow rights. Redemption rights allow the investor to have their initial investment paid back (sometimes with additional considerations). They are mainly used as a threat during bargaining, since the start-up is likely to have already spent the funds. Unfortunately, there are no data on the actual use of the redemption rights. One potential explanation offered by Lerner is that redemption rights may allow mutual funds to better meet mutual funds' liquidity needs and the SEC regulatory requirements, and that the IPO-related rights reflect mutual funds' vulnerability to down valuation IPOs. In exchange, mutual funds have to give up on some of the traditional cash flow and control rights.

After Lerner's presentation, **Antonio Davila** (IESE Business School) raised some follow-up questions, for example why mutual funds are doing this. Lerner answered that it is about shared capabilities and he gave the example of Fidelity, which has a small family office within its structure that has a lot of experience in doing this. Fund managers tend to have varying levels of skills regarding this kind of investment. Davila also asked why unicorns were interested in doing this. Lerner replied that during the 1990s VCs were rushing start-ups to IPO after two or three years, because they were unable to keep funding the firms' expansion. Access to capital from the mutual fund industry (and other investors) allows start-ups to go public much later, often after 10-12 years. During the Q&A, one of the participants noted that adding mutual funds to a corporation's investor base before its IPO also adds credibility to the IPO, since mutual funds are also typically going to be investors in the IPO.

Responding to a question about the dilution of IPO investors due to IPO ratchet rights, Lerner gave the example of the failed WeWork IPO, where SoftBank had IPO ratchets that would have kicked in the months after the IPO. This was disclosed in the S-1 prospectus, but only in one sentence, which was probably not enough to inform investors. There was a substantial risk that IPO investors would be significantly diluted by the ratchet.

The Long-term Consequences of Short-term Incentives

Alex Edmans (London Business School and ECGI) presented three papers related to the short-term incentives of CEOs and their long-term consequences. Currently, there is a huge debate about short-termism, both in and outside academia. What is missing from the debate, however, is empirical evidence on the short-term incentives of CEOs. Because actual equity sales of CEOs are endogenous and potentially unpredictable, the paper uses scheduled vesting of equity as an instrument. This measure is highly correlated with CEO equity sales, but is arguably not endogenous because it is driven by equity grants made years earlier. A first paper by Edmans, Fang & Lewellen (2017) finds that a scheduled vesting of equity is associated with a decrease in long-term investment, measured in different ways. The paper controls for several variables, including the presence of already vested and unvested equity, which could deter CEOs from engaging in short-termism, because they remain exposed to the long-term performance of the corporation.

Edmans discussed several potential explanations for this finding. First, the vesting equity could cause CEOs to *inefficiently* reduce long-term investment (myopia hypothesis), which hypothesis the authors consider most likely. Secondly, the vesting equity could cause CEOs to *efficiently* reduce investment growth, the vesting being necessary for the CEO to take tough decisions (efficiency hypothesis). There is less support for this hypothesis, since the operating performance of the corporation is not increasing at the same time. Finally, it is possible that the correlation is simply explained by omitted variables (timing hypothesis), but this would require that the board predicts many years in advance when a decline in investment would occur and adjusts the vesting schedule accordingly. The authors also find no support for this hypothesis.

A second paper in this series (Edmans, Goncalves-Pinto, Groen-Xu & Wang, 2017) looks at news releases and equity vesting, since investments are costly and take time, but timing news releases is easier. The paper finds that when equity vests, corporations are more likely to release positive and discretionary news. This leads to a short-term spike in in stock price and trading volume, which CEOs use to cash out their equity, which again confirms the myopia hypothesis.

Edmans also discussed a third paper (Edmans, Fang & Huang, 2019). In the previous papers, it was difficult to identify whether the actions taken were good or bad, which is why in this paper, the authors used two types of transactions, share buybacks and M&A transactions, where they could measure the impact on shareholders. Consistent with the myopia hypothesis, this paper also finds that equity vesting is associated with corporations engaging in buybacks that destroy shareholder value in the long-term; and with M&A transactions that do well in the short-term but not in the long-term. The paper also finds that CEOs are cashing out their equity shortly after the transaction, which is inconsistent with the corporation buying shares or engaging in value-creating transactions.

In conclusion, short-term incentives caused by equity vesting seem to cause short-termism with CEOs. However, longer vesting periods are not necessarily better, since they subject the CEO to more risk.

Mireia Giné (IESE Business School and ECGI) commented on the paper. She first contextualized the paper in the broader debate, referring to the finding that capital formation is declining and to papers that discuss the short-term incentives and horizons of investors. She also praised the paper for solving two problems, the endogeneity problem and the lack of research on the long-term effects. Giné raised many additional questions, one of which was how the board of directors could miss this problem. Edmans replied that they did control for governance quality, but found no effect, potentially because governance quality is endogenous. Giné also asked whether the recent increase in performance-based vesting instead of time-based vesting is going to solve the problem. Edmans responded that these performance thresholds can also be gamed by CEOs taking short-term actions. He concluded that thresholds are bad and that contracts should not contain "kinks", although this recommendation does not seem to be followed in practice.

Prompted by audience questions, Edmans also discussed how stock ownership guidelines, which require executives to hold a minimum percentage of vested equity, are the direction in which pay should be going. Similarly, Edmans discussed how having a formal policy for post-employment shareholding (as required under the UK corporate governance code) could deter short-termism. He also argued in favour of black-out periods after important events, where executives are restricted from selling. Comments from the public also asked about the economic significance of the phenomenon. Edmans replied that a "back of the envelope" calculation of the benefit to the CEO amounted to about $30,000, which is similar to the gains from insider trading. One participant remarked that this is quite small and that focusing on the level of pay is perhaps more important. However, Edmans replied that the level of pay is often only a small part of a corporation's value, while the horizon of the pay can actually distort important decisions.

Common Ownership

Xavier Vives (IESE Business School and ECGI) presented the final session on the topic of common ownership. He stated that the oligopoly problem, of increasing market concentration, is on the rise. There is also a trend of increasing and more consolidated institutional ownership, with the rise of passive investing and the big three index funds. These trends raise the question of whether common ownership aggravates the oligopoly problem. The underlying idea is that in case of overlapping ownership, management may have incentives to maximize the value for other firms as well. Although this is an under-researched area, some papers have argued that common owners may have incentives to influence management and especially to try to relax competition. One paper has even argued that not pushing for aggressiveness in management contracts is a way for common owners to relax competition. On the other hand, other papers claim that index fund managers may not have incentives to maximize the wealth of their beneficiaries, which could alleviate the common ownership problem.

Vives then discussed a common way of formalizing this theory, with a model where a manager maximizes a weighted average of its shareholders' portfolio profits. Theoretical work has also extended this model, modelling how managers' sensitivity to other firms' profits increases as ownership by passive investors increases, assuming that passive investors are more diversified than active investors. Empirical evidence on the effects of the increase of passive ownership seems to confirm this theoretical prediction.

Next, Vives analysed the impact on welfare. Under the market power hypothesis derived from the structure-conduct-performance paradigm, firms in markets with a high level of common ownership earn higher margins and profits, because of reduced competitive pressure. Some papers have found empirical evidence supporting this conclusion, but there is a big debate on the validity of these results. An alternative hypothesis, the efficiency hypothesis, states that high levels of common ownership are associated with efficiency, as common ownership improves information sharing, internalization of external effects, and corporate governance; and because large firms have more common ownership and are more efficient ("superstar firms"). Therefore, common ownership and industry profitability should go together, which also finds some empirical support.

Some authors have shown tentatively that common ownership has led to a decrease in product market competition. On the other hand, an innovation defence is possible: it could also be that common ownership allows firms to internalize technological spillovers where R&D investments are complementary, a theory that also generates testable predictions. If this theory is true, a regulator may wish to allow some level of common ownership.

Vives also discussed the macroeconomic effects of common ownership. In a multi-sector economy, the previous results have to be qualified: intra-industry common ownership could have an anti-competitive effect, but inter-industry effects could be pro-competitive.

Vives concluded that patterns of ownership have changed, which necessitates a revision of the standard profit maximization hypothesis. The theoretical models and the empirical evidence suggest market power concerns, but also points to possible efficiency gains due to the internalization of externalities. There are many policy discussions about the antitrust concerns of common ownership, but according to Vives the debate is still inconclusive and it is too early for major changes in antitrust policy. According to Vives, there is a need for a better understanding of the channels of transmission of ownership patterns into competitive outcomes via corporate governance, as well as a need for more empirical evidence on the impact on consumers, innovation, and general equilibrium effects.

In his commentary of the paper, **Ernst-Ludwig von Thadden** (University of Mannheim and ECGI) described how the common ownership literature departs in two ways from the first fundamental theorem in welfare economics, which states that if preferences are rational and locally non-satiated and firms maximize profits, any competitive equilibrium allocation is Pareto efficient. Firstly, common ownership shows why firms are perhaps not competitive. Secondly, common ownership shows why firms could maximize another objective than their own profit. Von Thadden framed the main policy question as whether one achieves competition with coordination on fixed costs (the best of both worlds), or central planning without accountability (the worst of both worlds). He then raised some topics for discussion. For example, how do common owners communicate with corporate managers? Is there any evidence of explicit communication, is this via letters like the one from Larry Fink, or is this an example of anticipatory obedience? Could the mechanism also be that CEO pay is less performance-sensitive in industries with large common ownership (see Anton, Generer, Giné et al., 2018)?

One of the participants remarked that this last mechanism is exactly the topic of ongoing research, where the model shows that common ownership can affect behaviour, even without engagement. CEO compensation does seem to be flatter in industries with common ownership. Another participant also remarked that one needs to consider both active and passive funds, and that hedge funds often take concentrated positions, and have no incentive to reduce competition. Vives replied that ongoing work is trying to incorporate this in the models.

After the discussion, Jordi Canals concluded the conference, thanking the presenters, the discussants, the attendees, the sponsors and the coordinating staff.

The papers and discussions presented are available on the ECGI website and also at www.iese.edu/IESECCG-ECGIconference.

Contact

membership@ecgi.org

Prof. Marco Becht
Executive Director and Fellow
European Corporate Governance Institute
Tel: +32 2 550 2340
marco.becht@ecgi.org
www.ecgi.global

Prof. Jordi Canals
President
IESE Corporate Governance Center
jcanals@iese.edu
www.iese.edu

c/o The Royal Academies of Belgium
Palace of the Academies
Rue Ducale 1 Hertogsstraat
1000 Brussels
Belgium


Speakers

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.

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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.

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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.