EUROPEAN COMMISSION GREEN PAPERS ON CORPORATE GOVERNANCE AND THE ECGI RESEARCH AGENDA

Report of the discussion at a meeting held in Brussels on 8 September 2011 to identify the corporate governance research agenda of relevance to issues raised in the Green Papers.

Introduction

The financial crisis has raised fundamental questions about corporate governance. Much of the focus has been on the governance of financial institutions. But wider issues have also been raised. As a consequence, while the European Commission's first Green Paper in June 2010 was on the corporate governance of financial institutions, the European Commission subsequently produced in April 2011 a Green Paper on corporate governance of all European corporations. See Appendix 1 for references.

The purpose of the meeting was to identify what the research agenda on corporate governance going forward should be both from the point of view of what is of most relevance to policymakers, in particular the EU, and what is intellectually of particular significance to academics working in the field.

The meeting was structured in three sessions, each focusing on one of three of the main issues emanating from the April 2011 Green Paper:

- Shareholders and other Investors;
- Boards and Directors; and
- Gatekeepers.

This report recounts the thoughts and ideas expressed by the participants on each of these topics. Those attending the meeting were ECGI Research and Board Members, representatives of European Commission DG Internal Market and Services, the London Business School Centre for Corporate Governance, and CEPR-affiliated researchers. A detailed list of participants can be found in the Appendix 2. This report concludes with a summary of possible lines of research indicated by the participants during the day.

SHAREHOLDERS AND OTHER INVESTORS

Chaired by Professor Julian Franks, Professor of Finance, London Business School

Introduction

Professor Franks said he hoped that among the issues which would be discussed would be the question of why owners had not been more active; why were owners apparently so weak; the issues of ‘free riding’, conflicts of interest, agency problems and block holding versus dispersed ownership. He also felt that the topic of governance of debt holders should be considered. Should they be given the entitlement to be more active and prior to a default treated more as equity holders? Much time had been spent on boards but boards still appeared to have failed. Accordingly is the route forward less about improving boards but more about engagement with other market solutions, such as debt holders? In other words, when debt becomes ‘risky’, should the debt-holders be able to control the equity holders by means of voting rights? When the ‘risk premium’ reaches a certain level, debt holders might become enfranchised.

Discussion

The European Commission reported that it had received over 400 responses to the Green Papers and it was now starting to examine and discuss them with stakeholders. At this stage no timetable regarding future action has yet been agreed.

The view of the European Commission was that the governance of financial institutions is a more urgent issue than that of non-financial institutions. In respect of shareholders, the European Commission felt that the key principle is that shareholders should monitor closely management performance. The problem is that there is not sufficient engagement, and it is possible that institutions feel that engagement in some sense doesn't 'pay '.There is also the debate about 'short-termism' which came through strongly in the responses. Possibly the rules about acting in concert might be inhibiting engagement. In addition the difficulty in identifying shareholders might be a problem. Perhaps the increased use of proxy advisers is a factor in the international markets inhibiting dialogue between issuer and shareholder. At all events, the European Commission felt that more analysis was needed all along the investment chain.

In a *tour de table* of the researchers, the discussion ranged over many issues which can be summarised in a number of headings.

Short-termism

Views were expressed that there is a need for incentives for institutional investors to take the long-term view in the form of, for example, double votes; guaranteed dividends; payments for monitoring; and seats on the board. Both the industry and academics should be encouraged to devise new performance evaluation methods.

There are said to be 'good' shareholders (long-term) and 'bad' (short-term) shareholders but is this correct? Institutional shareholders may lack the expertise to do short-term trading, and short-term shareholders (in which institutional investors may well invest) are very good at signalling to management that things are not well and as a consequence pricing that lack of confidence. Empirical evidence (e.g. a recent Bank of England report) indicates that stock markets are short-term; but some participants expressed the view that there should be no regulation of short-termism. Solvency II, IFRS, but also insider trading rules, or acting-in-concert definitions might receive more close attention.

Shareholder engagement/activism/proxy advisers

Several researchers argued that there is no empirical basis for saying that shareholder engagement is effective in improving performance. Hedge funds pursue more 'abrasive' activism but their owners are in some cases long-term investors who delegate activism to hedge funds.

The question was also raised as to why institutional shareholders diversify beyond what financial theory tells us is sensible? Is it liquidity preference? Is it competitive pressures? Does such diversification make effective engagement impractical?

There was also discussion concerning the undue influence of proxy advisors: their lack of transparency and the conflict of interest in terms of consulting services. Institutional investors do not deviate from proxy advisers enough if at all. Why is this?

Overall, there was a strong sense that more analysis is needed of the nature and effects of engagement/activism.

Creditor governance

A discussion took place on ideas articulated by Professor Franks for 'creditor governance,' with some voices supportive of more work into this idea, others more sceptical.

Banks were felt to be different. It was observed that many of the banks with 'best' governance on paper had most losses. Some participants felt that the crisis was not a failure of governance but rather of regulation. Others felt that regulation in the field of engagement could be tricky. Instead, it was argued that the right answer is to capitalise the banks properly (the role of contingent convertible instruments –so called 'COCOS' was mentioned) rather than going for creditor governance.

Minorities

Several participants felt that minorities need 'special' protection. The example was given of the 'special enquiry' rights e.g. in the Netherlands Enterprise Chamber and in Germany where the court can step in and appoint an expert.

Unlisted companies

The view was expressed that the governance of unlisted companies is interesting and further research would be valuable. Consideration should be given to designing a body of principles or an 'aspirational' code. The European Commission should not be absent from any debate on this issue.

Hard law/soft law

It was recognised that the European Commission has a constitutional position in relation to regulation that originates from international bodies like the Basel Committee of IASB and also in relation to the debate as to whether regulation should be at EU level or at national level and whether soft law/hard law is appropriate. Views were expressed that_the crisis was one of regulation but limited to financial institutions and that the European Commission should not otherwise try to do too much by way of regulation.

Summing up

Systems of ownership - dispersed and block holder

Under these systems, agency costs had to be weighed against private benefits. The issue needs empirical evidence. Professor Franks observed that some private benefits are good – 'kinship is good.' However, he wondered why it seemed to be the case that widely dispersed ownership made monitoring so much more difficult.

Differential rights for shareholders - short-term and long-term

Should the monitors be rewarded in some way even though empirical work appears to show that the most effective monitors are hedge funds? Questions had been raised about whether hedge funds are profitable and how they get their profits: these matters would benefit from research together with the issue of whether long-term rewards (what should they be?) would encourage better monitoring.

Are banks different?

They are thought to be different, but is controlling them an issue of governance or regulation? It is probably both. The special position of banks means that the notion of creditor governance might be worth looking at further together with the question of why bank creditors do not demand more control already.

Liquidity of markets

This was thought to be very valuable but the actual meaning and implications of liquidity for shareholders and other investors (thus for corporate governance and its potential externalities) is a good question for future research.

BOARDS AND DIRECTORS

Chaired by Professor Colin Mayer, Peter Moores Professor of Management Studies, Said Business School, University of Oxford

Introduction

Professor Mayer identified three particular issues, about which there is not much, or certainly not much definitive, research. These are the nature of boards - appointments/composition/independence where he felt that the academic evidence is mixed particularly on the issue of boards containing members who represent classes of shareholders; controlling risks in organisations (the CRO/risk committees) where the question was should one look to classes of 'investors', for example, creditors, to ensure the monitoring of risk; and executive remuneration where there was mixed evidence as to the relationship of pay and performance.

Discussion

It was said that for the European Commission the current questions are about the justification for EU level intervention; how boards function; how much resource do they put into supervision; how effective are external evaluations; and how effective is the separation of functions.

In a *tour de table* of the researchers, the discussion ranged over many issues.

Appointments

It was felt that care was needed to ensure that appointees to the boards of firms were not mere 'delegates.' It was put as follows, that whilst such appointees may 'emanate' from a particular group, once on the board they are bound by company law to act in the best interests of the company. The 'List system' in Italy was commended by some participants as was the Swedish system of block-holder appointments through shareholder nominating committees.

Composition/diversity

Good boards are characterised by diversity, competence and board reviews. On the issue of gender quotas there were mixed feelings and a view that this was a good subject for research so as to study experience so far in those countries which had adopted regulation on board gender quotas.

External evaluation/induction/information

There was a general but not unqualified consensus that regular evaluation is good in that it often enables discussion of the 'undiscussable'. Research is needed however on what works and it might be good to standardise evaluation.

On the issues of induction and information, views were expressed that independent directors should have direct access to information and to auditors. Analysis was needed of the kinds of information given to boards. In too many cases, the quality of information provided is still too weak.

Quality of decision-making/ board behaviour

Board behaviour is key and the chairman's role is pivotal. A successful chairman will ensure substantive decision-making and ensure procedural effectiveness. The chairman can legitimise 'awkward' conversations. The 'polite' board needs a strong chairman to make it an effective board.

There was a plea for the need for research to observe boards in action to see whether 'rules' make any difference to the way boards behave.

Pay

It was felt by some that pay is the one issue on which regulation could be effective, whilst others felt that the issue was more one of social policy. There was discussion as to whether transparency and information and whether 'say-on-pay' although on the face of it to be welcomed, had in fact worked in the UK. There is evidence to suggest that it has but it was thought that there may have been unintended consequences which had the effect of driving up pay: There was a case for more research on this.

Soft law/hard law for regulating boards

There was a strong feeling that the European Commission was mistaken in thinking that directors can be regulated to solve governance problems. "*We should not regulate on what we don't know*'' was the view expressed by many of the participants.

Summing up

It was agreed that this is not an area for prescriptive rules or harmonisation. Rather, it is a question of soft law or standards and practices.

At this point, the European Commission expressed the view that in reality, politicians *will* get involved in governance. There has been a loss of trust generally in the corporate sector which has rubbed off from the banking crisis, and there is a need to regain confidence as between politicians, civil society and industry. Better practice is now happening but the issue perhaps needs to be pinned down. There is a question however about the most appropriate kind of regulation. The comments during the session about appointments and getting the right people on board - were noted and the European Commission would take those thoughts away for further reflection.

Remuneration is about social policy of course, but 'governance' is understood much more broadly now. Suggestions about transparency (as in the UK) were probably 'pushing at an open door' and there is evidence that disclosure improves performance but there was a need to avoid unintended consequences of more transparency such as possibly pushing up pay.

GATEKEEPERS

Chaired by Professor Marco Becht, Professor of Finance and Economics, Université Libre de Bruxelles (ULB)

Introduction

Professor Becht began by defining what was meant by gatekeepers. In his view, they comprised, for example, banks and other financial institutions, auditors, analysts, proxy advisers, credit rating agencies and regulators.

The role of gatekeepers needs to be examined. The record of auditors, for example in the Enron case, analysts, proxy advisers, credit rating agencies and regulators (banking/deposit insurance) has in many cases been bad and needs examination. The vital question is of course who pays for the services of gatekeepers? If users pay, that doesn't work; if issuers pay there is a clear conflict of interest. The structure of the industry involving concentrations of auditors/credit rating agencies also needs examination.

Discussion

The European Commission indicated that the jury is still out on 'comply or explain' largely because of the diversity of standards of explanation. The issue of monitoring of explanations is still under consideration. 'Comply or explain' is not regulation. On the question of proxy advisers there were very different responses to the Green Papers but there is a case for some clear rules about transparency and conflicts of interest.

In a *tour de table* of the researchers, the discussion ranged over many issues.

Gatekeepers

Several participants felt that investors need advisers and that gatekeepers provide a real service to constituents, and therefore care was needed in generalising about all 'gatekeepers'. The view was expressed that gatekeepers are subsidised corporate or financial services providers. When there is a subsidy, there is usually a 'rent', and politicians will find ways to extract part of that rent through regulation. Accordingly, it is not surprising to talk about regulating gatekeepers. But is regulation the right answer? Gatekeepers have a fundamental problem, which is that the people they are supposed to provide the service for are not really willing to pay for the service, and so the corporation pays for the service, although it should not do so in principle.

Regulatory support of standard-setting by gatekeepers (particularly rating agencies, but a similar argument could be made for proxy advisers) may have unintended consequences on the incentives of gatekeepers who may care less for their market reputation, and on (rational) herding by investors. This creates micro-, and more importantly, macro-prudential problems.

Collusion

This can take different forms: collusion in gatekeeper-client relationships and collusion among competitors. There are various ways of testing for and breaking relationship collusion, such as rotation, random assignments and eliminating "multi-market" contact (e.g. banning dual capacity activities/conflict of interest). There is a need for more data, evidence and models on this. In terms of policy issues the scandals motivating political activism have strong elements of collusion. Prima facie, there seems to be much less evidence of collusion among competitors. Low-balling, i.e. aggressive pricing seems to be an element of the industry. However, is there enough switching? Is there collusion on quality (while maintaining competitive, or at least similar, price levels)? Surprisingly little research has been undertaken along these lines.

Information sharing

While there may be collusive aspects of 'secret information sharing' (i.e. information sharing among competitors), sharing information about company account information with regulators may be a reasonable thing to do. In a strongly concentrated auditing industry, each banking auditor, for example, will automatically get a pretty good picture of the aggregate risk positions of his clients. Sharing this means allowing regulators to get better estimates about exposures in opaque unregulated markets such as CDS and the market for "structured products". This information sharing provides for better assessments of systemic risks. Clearly, such regulation does affect the gatekeeper-client relationship as well.

Comply or explain

'Comply or explain' is a very flexible tool of corporate governance but in the minds of some participants, the concept was felt to be *too* flexible. There was said to be some evidence that companies which do not comply but give good explanations outperform companies which comply. There are also significant problems of monitoring and enforcement.

Regulators/regulation

There was some scepticism about the effectiveness of gatekeeper regulation. The current focus of regulation is micro-prudential (but some thought it should be systemic, macro-regulation), resulting in a problem of creating unforeseen consequences. However, it was also thought by several participants that where regulators were given powers they should be more interventionist.

Auditors

There is a problem of concentration but a solution to this is not clear. Some felt that investors should have a say on choosing auditors but it was recognized that they do not want to do it, and are interested not so much in the quality of the audit, just the deepness of the pocket to sue!

The question was raised as to whether auditors would be appropriate judges of the quality of gatekeeper advice.

There was criticism of the role or lack of it played by auditors in the banking crisis. When giving a solvency statement for banks, did the auditors understand the real situation of the banks or did they think it was up to the regulators?

Proxy advisers

The European Commission felt that there was an argument for clearer rules on transparency and conflicts of interest. While proxy advisers play an important role in sharing the costs of information there was some concern about how they operate in practice.

Summing -up

Proxy advisers are perhaps the least worrying category of gatekeepers. Overall, if the issuer has to pay for certain of the gatekeepers then there may be ways (e.g. randomisation) of choosing them without creating a conflict of interest. It is still a problem however which needs further analysis.

The track records of gatekeepers are not well understood except in the case, possibly, of analysts. There have been substantial market failures, and regulation might help, but regulation will need to be very smart to be effective.

RESEARCH OPPORTUNITIES

In each of the three sessions, a number of pointers towards further research were identified.

Shareholders and Other Investors

1. From the European Commission's viewpoint, analysis is needed all along the investment chain on the following issues: engagement doesn't 'pay' for investors; the rules about acting in concert are inhibiting engagement; the difficulty in identifying shareholders for the purpose of engaging with them; the increased use of proxy advisers as a factor in the international markets inhibiting dialogue between issuer and shareholder ;
2. Short-termism: what does it mean? the empirical evidence of the reasons for and actual practice of short-term investment and its alleged adverse effects on issuers and their shareholders; the role of fund managers; over-diversification of portfolios; the need for liquidity; the negative/positive effects (if any) of short-termism on board behaviours and especially risk management;
3. Do hedge funds perform a useful role in pricing the company accurately? Is this 'abrasive' form of activism, in which institutional investors also take part as investors in the funds themselves, more effective than traditional ideas of engagement/activism? How are the earnings of hedge funds derived?
4. An empirical look at incentives for investors to take a more engaged and long-term view; the empirical evidence that long-term investment is beneficial for an issuer and its shareholders.
5. Minority protection rights: research into the different forms which it can take in different parts of the EU;

6. An examination of the rights of debt-holders to control management activity commonly found in modern debt instruments analysed as between bank and non-bank debt issuers ; how much information do debt holders currently get; what are the inhibitors in the minds of market participants (including debt holders themselves) against extending these rights to include elements of equity convertibility or further controls on management activity ; an examination as to whether creditor governance is more appropriate for banks.
7. The nature and effects of delegated activism (e.g. proxy holders).
8. Liquidity preference: the nature of liquidity preference and its effects on shareholder monitoring by fund managers. The provision of liquidity may be important in allowing some investors, including hedge funds and private equity investors, to take a longer view.

Boards and Directors

9. From the European Commission's viewpoint, how boards function and behave: do rules and regulations make any difference to the way boards behave; how much and what kind of resource do boards put into their own supervision; the types and frequency of external evaluation.
10. Rights of appointment to the board by minorities, evaluation of the Swedish appointment of block holders to the nomination committee, and the Italian 'List system'.
11. Empirical evaluation of the separation of powers between CEO and Chairman.
12. An analysis and evaluation of the information given to boards.
13. External evaluation: a survey of practices and results thought to have arisen from such evaluation; a standardised approach to evaluation, what form could it take.
14. An analysis of which banks use which consultants.
15. An evaluation of the use of quotas to ensure gender diversity.
16. An analysis of the number of mandates held by directors of European listed companies.
17. 'Say-on-pay'/transparency: had this worked or had there been unintended consequences?

Gatekeepers

18. A qualitative evaluation of 'comply or explain'.
19. An evaluation in the context of conflicts of interest of actual and possible methods of payment and appointment of gatekeepers.
20. Concentration competition among the gatekeepers.
21. Unintended consequences of standard setting by regulation.
22. Cross-border guidelines for ratings agencies.

CONCLUSION

Summing up the meeting, Professor Mayer felt that in session 1, the questions which had emerged were about the different systems, the benefits and costs of those systems and the different types of shareholders, long-term and short-term, and the relevant fund managers/activists etc. If banks are different, do they need different governance structures? These are all good research topics.
In session 2, clear ideas had been expressed about the risks of regulation in the field of boards and directors. A 'soft touch' seems appropriate whether or not we know or don't know enough.
In session 3, there was a similar view expressed of the danger in being over-prescriptive. There had been an emphasis on making 'comply or explain' better. In cases where serious market failures have happened, there may be a case for regulation.
There was an important common thread to the day that heterogeneity is an important characteristic of corporate governance. Banks may require different corporate governance from non-banks, and small companies with concentrated ownership may need different boards from large companies. There is a need for research that establishes the governance arrangements that are required in different circumstances.

Appendix 1: References

Corporate governance in financial institutions and remuneration policies
Green paper published by the EU Commission on 2 June 2010
http://www.ecgi.org/commission/documents/green_paper_com2010_284_en.pdf

The EU corporate governance framework
Green Paper published by the EU Commission on 5 April 2011
http://www.ecgi.org/commission/documents/eu_corporate_governance_framework_5apr2011_en.pdf

Appendix 2: List of participants

ECGI Research Members

Professor Marco Becht	Professor of Finance and Economics, Université Libre de Bruxelles
Ms Magda Bianco	Ufficio Diritto dell'economia, Banca d'Italia
Professor Arturo Bris	Professor of Finance, IMD
Professor Mike Burkart	Gösta Olson Professor of Finance, Stockholm School of Economics
Professor Pierre-Henri Conac	Professor of Commercial and Company Law, Faculty of Law, Economics and Finance, University of Luxembourg
Professor Paul Davies	Allen & Overy Professor of Corporate Law, Faculty of Law, University of Oxford
Professor Luca Enriques	Commissioner, Commissione Nazionale per le Societa e la Borsa (CONSOB)
Professor Julian Franks	Professor of Finance, London Business School
Professor Marc Goergen	Professor of Finance, Cardiff Business School
Professor María Gutiérrez Urtiaga	Associate Professor, Department of Business and Finance, Universidad Carlos III de Madrid
Professor (em.) Klaus Hopt	Emeritus Professor, Max-Planck Institut für Ausländisches und Internationales Privatrecht
Dr Stefano Lombardo	Assistant Professor of Economic Law, Free University of Bolzano
Professor Ernst Maug	Professor for Corporate Finance, Mannheim Business School, University of Mannheim
Professor Colin Mayer	Peter Moores Professor of Management Studies, Said Business School, University of Oxford
Professor Joseph McCahery	Professor of International Economic Law and Professor of Financial Market Regulation, Tilburg University Faculty of Law and Tilburg Law and Economics Center
Professor Peter Muelbert	Professor of Law, and Director of the Center for German and International Law of Financial Services, Johannes Gutenberg-Universität Mainz
Professor Giovanna Nicodano	Professor of Financial Economics, Università di Torino
Dr Alessio Pacces	Associate Professor of Law and Economics, Rotterdam Institute of Law and Economics, Erasmus Universiteit Rotterdam
Professor Fausto Panunzi	Professor of Economics, Istituto di Economia Politica & IGIER, Università Bocconi
Professor Christoph Van Der Elst	Professor of Business Law, Tilburg University

ECGI Board Members

Mr Leo Goldschmidt	Director, European Corporate Governance Institute
Professor Jaap Winter	Partner, De Brauw Blackstone Westbroek
Mr Eddy Wymeersch	Chairman, European Corporate Governance Institute

DG Internal Market and Services, European Commission

Ms Claire Bury	Acting Director, Capital and Companies Directorate

Mr Eric Ducoulombier	Deputy Head, Corporate governance, social responsibility unit
Mr Marc Hertgen	Policy Officer, Capital and Companies Directorate
Mr Matthias Schmidt-Gerdts	Policy Officer, Capital and Companies Directorate
Mr Tim Wittenberg	Trainee

London Business School Centre for Corporate Governance

Mr Paul Coombes	Chairman, Centre for Corporate Governance, London Business School

CEPR-affiliated researchers

Professor Xavier Freixas	Professor, Universitat Pompeu Fabra, Barcelona
Professor Thomas Gehrig	Professor, Faculty of Business, Economics, and Statistics, University of Vienna
Dr Kostas Zachariadis	Lecturer in Finance, London School of Economics