The European Commission's Sustainable Corporate Governance Report: A Critique

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Thanks go to Shuhao Fan, Jessica Ljustina, and Amelia Ricketts for outstanding research assistance.

Abstract

In July 2020, the European Commission published the "Study on directors' duties and sustainable corporate governance" by EY. The Report purports to find evidence of debilitating short-termism in EU corporate governance and recommends many changes to support sustainable corporate governance. In this paper, we point out deep flaws in the Report's evidence and analysis. We recently submitted the content of this paper in response to the European Commission's call for feedback.

First, the Report defines the corporate governance problem as one of pernicious short-termism that damages the environment, the climate, and stakeholders. But the Report mistakenly conflates time-horizon problems with externalities and distributional concerns. Cures for one are not cures for the others and a cure for one may well exacerbate the others. Second, the Report's main ostensible evidence for an increase in corporate short-termism is rising gross payouts to shareholders (dividends and stock repurchases). However, the more relevant payout measure to assess corporations' ability to fund long-term investment is net payouts (gross payouts minus equity issuances), which is much lower and has left plenty of funds available for long-term and short-term investment. Third, when the Report turns to other evidence for short-termism, it selectively picks academic studies that support its views on short-termism, while failing to engage substantial contrary literature. Significant studies fail to detect short-termism and some substantial studies show excessive long-termism. Conceptually, some short-termism is an unfortunate but an inevitable side effect of effective corporate governance and may not be a first-order problem warranting wholesale reform. Finally, the Report touts cures whose effectiveness has little evidentiary support and, for some, there is real evidence that the cures could be counterproductive and costly.

Keywords: corporate governance, short-termism, hedge funds, shareholder activism, European Union, securities regulation, agency costs, research and development, political economy, investment, payouts, repurchases

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The Sustainable Corporate Governance Initiative in Europe

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In July 2020, the European Commission published the "Study on directors' duties and sustainable corporate governance" by Ernst & Young (EY). The Report purports to find evidence of debilitating short-termism in EU corporate governance and recommends many changes to support sustainable corporate governance. In this paper, we point out deep flaws in the Report's evidence and analysis. We recently submitted the content of this paper in response to the European Commission's call for feedback. Parallel issues have arisen in American discourse, although none has reached the incipient lawmaking level that it has in Europe.

First, the Report defines the corporate governance problem as one of pernicious short-termism that damages the environment, the climate, and stakeholders. But the Report mistakenly conflates time-horizon problems with externalities and distributional concerns. Cures for one are not cures for the others and a cure for one may well exacerbate the others. Second, the Report's main evidence for an increase in corporate short-termism is rising gross payouts to shareholders (dividends and stock repurchases). However, the more relevant payout measure to assess corporations' ability to fund long-term investment is net payouts (gross payouts minus equity issuances), which is much lower and has left plenty of funds available for long-term and short-term investment. Third, when the Report turns to other evidence for short-termism, it selectively picks academic studies that support its views on short-termism, while failing to engage substantial contrary literature. Significant studies fail to detect short-termism and some substantial studies show excessive long-termism. Conceptually, some short-termism is an unfortunate but an inevitable side effect of effective corporate governance and may not be a first-order problem warranting wholesale reform. Finally, the Report touts cures whose effectiveness has little evidentiary support and, for some, there is real evidence that the cures could be counterproductive and costly.

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† Professors, Harvard Law School (Roe, Spamann, and Fried) and Harvard Business School (Wang). This paper is a slightly edited version of our submission to the European Union on their sustainable corporate governance initiative (*see* Holger Spamann, *Feedback F594640,* EUROPEAN COMMISSION INITIATIVES: SUSTAINABLE CORPORATE GOVERNANCE (Oct. 8, 2020) https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/F594640 [https://perma.cc/ML8A-NKVG]). Thanks go to Shuhao Fan, Jessica Ljustina, and Amelia Ricketts for outstanding research assistance.

Introduction

The European Commission commissioned and received a study from Ernst & Young (EY) on sustainable corporate governance[1]—an issue that has also engaged the attention of policymakers in the United States. The Report's main flaws are:

1. **Its definition of the problem**. The Report conflates time-horizon problems (short-termism)—which are the focus of its evidence collection—with externalities and distributional concerns. Cures for one are not cures for the others and a cure for one may well exacerbate the others. The difference is also critical for assessing the EU's ability to act under the principle of subsidiarity.
2. **Inapposite evidence**. The Report's ostensible evidence for an increase in short-termism, presented in its section 3.1, is primarily rising gross payout (dividends and repurchases) rates to shareholders coupled with declining investment intensity (the ratio of CAPEX and R&D to revenue) at certain large listed companies. However, the more relevant measure to assess corporations' ability to fund long-term investment is net

1. ERNST & YOUNG, STUDY ON DIRECTORS' DUTIES AND SUSTAINABLE CORPORATE GOVERNANCE: FINAL REPORT (2020), https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en?mc_cid=664fe83cf0&mc_eid=657d91711d [https://perma.cc/2PCL-5EXV] [hereinafter EY Report or Report].

payouts (i.e., gross payouts minus equity issuances), as EU firms frequently raise capital by issuing new shares; net payouts are substantially lower than gross payouts, leaving plenty of funds available for investment across the EU corporate sector. And the EY Report oddly fails to use a full sample of EU listed companies, an analysis of which shows that CAPEX and R&D intensity actually increased over the time period considered in the Report.

3. **Biased use of literature**. The Report selectively cites, and focuses only on the parts of, academic studies that support its views, while failing to engage substantial contrary literature. For example, the Report discusses studies detecting short-termism, but fails to mention major studies failing to detect short-termism or studies showing excessive long-termism. Nor does the Report acknowledge that empirical work in the academic literature is divided on whether short-termism—if present—is severe, and that conceptually, short-termism is quite plausibly an unfortunate but inevitable and modest side-effect of effective corporate governance, rather than a first-order problem warranting wholesale reform.
4. **Ill-considered reform proposals**. Having failed to analyze the problems properly—or, for short-termism, even to demonstrate that a substantial time-horizon problem exists—the Report touts multiple cures that can at best be described as hopeful: there is no strong evidence that any of them work as intended. For those cures that have been studied in the academic literature, the available evidence gives rise to considerable skepticism that they are effective, and some appear to be counterproductive. The Report does not examine any of this evidence.

For reasons of time and space, we only summarize the main arguments and data that are relevant to show the Report's main shortcomings, and we ignore many smaller shortcomings.[2] More complete analysis of the main substantive issues can be found in the academic articles we cite.

Many of the Report's flaws were repeated in the EU Commission's Inception Impact Assessment,[3] which relies on the Report. However, since the source of the flaws is the much more detailed Report, we do not separately comment on the Inception Impact Assessment except in relation to the principle of subsidiarity at the end of Part I below.

2. As an example of the Report's hasty and sometimes low quality thinking, consider its claim—authored by an accounting firm, no less—that "discounted cash flow analysis" is a "management practice[] that emphasise[s] short-term financial returns over climate change mitigation." *Id.* at 22-23.

3. Ares (2020)4034032 (July 30, 2020) [hereinafter "Inception Impact Assessment"].

I. Definition of the Problem: Short-Termism vs. Externalities and Distributional Concerns

The Report's starting point is the concern that companies "focus on short-term benefits of shareholders rather than on the long-term interests of the company," where the "interests of the company" encompass not just "the interest of shareholders [but also] . . . interests of employees; interest of customers; interest of local and global environment; interest of society at large."[4] This definition of the problem conflates two or even three separate issues: short-termism on the one side, and negative externalities and distributional concerns on the other.[5] Short-termism is the myopic, inefficient focus on short-term gains at the expense of larger losses in the longer term. Negative externalities are costs borne by people other than those who make the decision, which may create incentives to take actions that are harmful overall but that benefit the decision-maker. Distributional concerns arise even in the absence of externalities when some gain much more than others, or value is distributed from groups that should be favored to groups that should be disfavored.

The Report seems oblivious to these distinctions. For example, section 3 is framed as a discussion of "Short-termism in EU corporate governance" and "Factors contributing to corporate short-termism" despite the fact that many of the "Main consequences" the Report describes in section 3.1.2 are problems of *externalities*, not of a distorted time horizon.

The conflation is harmless for stating an ideal: in an ideal world, corporations would exhibit neither short-termism nor produce externalities, and the fruits of corporate activity would be equitably distributed. For policy analysis, however, the conflation is seriously debilitating. Real world companies will often fall short on all three dimensions, but cures for one of the three problems may exacerbate another one of the three.[6] In particular, long-termism per se is not necessarily desirable: the Mafia survived for a long time because it "shunned short-termism and took the long view," but we wish it had not.[7] More prosaically, companies that stick to a failed technology for the long-term are not to be praised.

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4. Report, *supra* note 1, at vi, viii.

5. The conflation is common, see Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 998 (2013); Mark J. Roe & Roy Shapira, *The Power of the Narrative in Corporate Lawmaking*, HARV. BUS. L. REV. (forthcoming 2021), and we would not fault the Report simply for following a common usage of the term if the Report differentiated the two concepts when necessary. As will be seen, however, the Report does not differentiate.

6. Labelling as short-term what are primarily externalities and distributional considerations makes short-termism seem more prevalent. For further discussion, see Roe & Shapira, *supra* note 5.

7. Jerold Zimmerman & Daniel P. Forrester, The Forensics of the American Mafia 1 (Jan. 2020) (unpublished manuscript), https://ssrn.com/abstract=3514247 [https://perma.cc/8ZYS-53CV].

The Report's confusion of time horizons with externalities is illustrated in the following examples. The Report's main indicator for nefarious corporate short-termism is a high payout rate. Yet the Report finds that the industry with the second-highest payout rate is *oil & gas*.[8] By the Report's *payout* logic, policymakers should push the oil & gas industry to pay out less and invest more in finding, refining, and burning hydrocarbons.[9] But do policymakers really want to induce the oil & gas industry to drill more, refine more, and burn more hydrocarbons? We don't think so.

As another example, the Report lists corporate tax avoidance among the consequences of short-termism.[10] We agree that tax avoidance is a serious problem, but it has little to do with stock market short-termism.[11] In fact, corporations incur significant up-front costs to reduce their tax bill in

8. Report, *supra* note 1, at 20. In reporting this example, we do not mean to imply that the oil & gas industry is actually "short-termist." As we show in Part II below, payout rates are *not* good indicators of short-termism, and in any event the Report calculates payout rates incorrectly. In fact, integrated companies in the oil & gas industry have historically been very long-term oriented, with long-term planning departments (as befits the nature of their long-term business) and they dedicate major resources and personnel to assessing and planning for the firm's and world's economy decades from now. Refineries are long-lived assets, as are pipelines and oil field development. (For example, Royal Dutch Shell has an "investment horizon of 10-20 years," ROYAL DUTCH SHELL PLC, ANNUAL REPORT 2019, 1, 2 (Dec. 31, 2019), while Total and BP both produce energy outlooks thirty years into the future, see Total SE, Total Energy Outlook 2020 (Sept. 29, 2020); BP P.L.C., BP Energy Outlook 2020 Edition (Sept. 14, 2020).) To us, it's quite plausible that high payouts in oil & gas are in part due to their long-term assessment of a potential decline in hydrocarbon use in the decades to come, inducing them to invest less in developing new sources of carbon-based fuels.

9. Some might argue that long-term investment in the oil & gas industry should be directed at renewable energies. But once the funds are retained, the firms may seek to develop oil & gas further. And we question why a policymaker should encourage oil & gas firms to develop renewables rather than reallocate resources to other companies less invested in and, one suspects, less habituated to the carbon economy.

10. Report, *supra* note 1, at 29. The Report's paragraph discussing tax avoidance does not mention "short-termism," but is itself part of section 3.1.2.3, which describes how "[s]hort-termism has serious adverse economic effects on companies, their shareholders and their stakeholders, and undermines the macroeconomy." *Id.* at 28.

11. This does not mean that one could not construct an example of a manager secretly directing the company to delay or even evade taxes to boost profits in the short-run, collecting immediate executive compensation bonuses based on these current profits, and then leaving the firm before the tax evasion is discovered, when the company pays a penalty (legal or reputational), resulting in a net loss to the company in the long-run. However, the short-termism in this example is incidental, is not the root cause of the problem, and is not the stock-market *preferring* short-term profits but the *manager* preferring them. To see this, consider a parallel example where the manager weighs the short-run costs of avoiding large long-run taxes and decides not to avoid those long-run taxes because the manager wants to boost short-run profits (by avoiding the short-run costs of avoiding the longer-run taxes) and that the manager thereby boosts his or her current bonus. The manager pockets the bonus and later leaves the firm before the market realizes that the company is paying more taxes over the long-run than is strictly legally necessary. Both examples arise not from stock market *preferring* short-run profits over long-run returns, but from the stock market's inability to fully understand the implications of the manager's actions for the firm. (That will often be implausible for major tax avoidance schemes because the largest can be discerned by knowledgeable analysts from public company filings.) On managerial short-termism induced by this kind of problem—i.e., when the manager has superior (short-run) information—see generally, Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 655-56 (1989).

the long term.[12] This is an area where it would be better for the world (or at least for public budgets) if corporations were more myopic.

A further problem with the conflation of short-termism and externalities is that it obscures who has an incentive to combat the two. The most likely players to combat the two differing problems are not the same. Externalities are, by definition, tempting for an industry producing them to neglect, because the industry does not pay the full costs of the externality. Furthermore, to the extent the externalities are borne by foreigners, they are also tempting for national governments and national regulators to neglect. Hence the case for regulation in general, and for EU regulation in particular, is strong for externalities. By contrast, short-termism per se (that is, in truncated investment horizons) primarily hurts those who succumb to it. Companies suffering from short-termism, or at least their national governments, are thus well incentivized to take corrective action locally, and EU action is not necessary.[13] (If indeed there is no national action against short-termism, the reason is perhaps that the premise—that there is debilitating short-termism—is inaccurate, as we discuss in Parts II and III.) The Report's failure to draw this important distinction is mirrored in the Inception Impact Assessment, which claims that "[n]ational action alone is unlikely to tackle corporate short-termism[,] which characterises EU capital markets across the board."[14]

Finally, chalking up all problems to short-termism sweeps under the rug thorny distributional questions. It is all fair and well to prioritize the "long-term interests of the company" over the interests of any individual group, as an abstract principle. But the mantra is of little help in deciding how to allocate costs and benefits between different groups, especially different groups that engage our sympathies, when they conflict, as they often will. We will highlight some such issues in the discussion of the Report's reform proposals.

In sum, the Report's analytical framework is wholly inadequate to shed light on the complex problems we are facing.

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12. A focus in the United States has been so-called inversions, in which corporations save taxes by engineering a major merger to move their headquarters for tax purposes out of the United States. At the same time, the EU has seen a variety of complex inter-Member transactions designed to limit the tax liabilities of companies doing business in Europe. Such transactions require extensive advanced planning. For instance, the EC recently prosecuted the Netherlands for illegal state aid to Ikea. *See* 2017 O.J. (C 121) 30. To arrange the first of the two tax-reducing transactions that were the subject-matter of the prosecution, Ikea signed an advanced pricing agreement with the Dutch tax authorities two years prior to the consummation of the relevant transaction, following five years of negotiations with the authorities (initiated seven years prior to the transaction). *Id.* at ¶¶ 28–29, 41–42. We are not defending these schemes, but stating that they are not due to truncated time horizons.

13. We use "companies suffering" and being "incentivized" as a shorthand for penalizing and incentivizing individuals who create and govern them and reap their profits.

14. Inception Impact Assessment, *supra* note 3, at 2.

II. Inapposite Evidence: The Report's Meaningless Gross Payout and Investment Measures

Section 3.1.1 of the EY Report presents its main "[e]conomic evidence of short-termism in EU listed companies" as an increase in the gross payout (dividends and share buybacks) rate and a decrease in investment (CAPEX and R&D) intensity at European listed companies over the years 1992–2018.

These are misleading measures for the narrow question of whether European listed companies have reduced their commitment to long-term projects. Lest we be misunderstood as accepting this narrow question as the relevant one, however, we preface our discussion by emphasizing that changes at large listed companies are the wrong evidence to look at. *Changes* are generally the wrong measure to assess whether levels are too low or too high. Changes are a valid criterion for levels *only* if there is strong reason to think that initial levels were optimal. Even the Report itself acknowledges skepticism over such an assumption.[15] Moreover, from a policy perspective, what happens at large listed companies is not the exclusive issue for the EU. What matters is what happens at all companies combined, including, in particular, at small and medium enterprises (SMEs). In the EU as a whole, the overall investment rate has remained flat and the R&D expenditure rate has increased over the time period considered in the Report.[16] There is no reason to fetishize listed companies: some long-term investment, and in particular some new forms of R&D, may be better placed outside of listed companies, and a decline in investment in large existing companies might just reflect a better allocation of

15. The Report formally acknowledges this point on page 11 ("there is not any defined threshold above which one can state that the focus on short term is excessive. Instead, the short-termism hypothesis is evaluated in relative terms") but then ignores this caveat in all of its subsequent discussion, which embraces absolute statements (see, e.g., Report, *supra* note 1, at 12: "The evolution of these indicators suggests the presence of short-termism behaviours in EU listed companies. . . [T]he indicators that proxy short-termism seems to have stabilised around high levels of payments to shareholders and low investment intensity."). Oddly, the passage just cited and others in the Report claim that European payouts are at "high levels" even though the Report itself acknowledges elsewhere (*Id.* at 16) that payouts in U.S. companies are much higher. In spite of the higher payout level, the U.S. economy is outpacing Europe in innovation. MCKINSEY GLOBAL INSTITUTE, INNOVATION IN EUROPE: CHANGING THE GAME TO REGAIN A COMPETITIVE EDGE (Oct. 2019), https://www.mckinsey.com/~/media/McKinsey/Featured%20Insights/Innovation/Reviving%20innovation%20in%20Europe/MGI-Innovation-in-Europe-Discussion-paper-Oct2019-vF.pdf [https://perma.cc/ENR5-XV9U].

For the avoidance of doubt, it is possible to invest too much, both at the firm level and at the country-level. At the firm level, managers can waste money on bad projects. *See, e.g.*, Michal Barzuza & Eric Talley, *Long-Term Bias*, COLUM. BUS. L. REV. (forthcoming 2020). At the country level, a country that invested 100% of its income would starve.

16. Gross capital formation in the EU-28 as a percentage of GDP was 21.8% in 1995 (the first year with data) and 21.7% in 2019 (calculations derived from https://ec.europa.eu/eurostat/data/database). Spending on R&D in the EU-28 as a percentage of GDP has increased from 1.6% in 1995 to 2.0% in 2018 according to the OECD (https://data.oecd.org/rd/gross-domestic-spending-on-r-d.htm) and from 1.8% in 2006 to 2.1% in 2017 according to Eurostat (https://ec.europa.eu/eurostat/statistics-explained/index.php?title=R_%26_D_expenditure).

capital and investment to smaller, younger, and more dynamic companies.[17]

With these important caveats in mind, we now turn to the Report's evidence on European listed companies, which have at least three glaring measurement and conceptual problems. First, the gross payout measure that the Report emphasizes is not the right measure for the question of whether companies are being deprived of the funds necessary for investment.[18] Gross shareholder payout fails to account for, and is offset by, equity issuances that move capital from shareholders to companies. *Net* shareholder payout is the more relevant measure. Companies are not being deprived to the extent pay-*outs* are offset by pay-*ins* from new financing, be it debt or equity. This is largely what has been going on: *net* shareholder payout rates are not particularly high. This is in part because EU listed companies issue much more equity than they repurchase.[19]

For example, during 1992–2019, EU companies distributed € 2.5 trillion in dividends and € 676 billion via stock buybacks (a total of about € 3.2 trillion in shareholder payouts), or 58% of these companies' total net income. But during the same period, EU listed companies issued € 2.5 trillion of new equity, moving cash from shareholders directly or indirectly back to these firms. *Net* shareholder payouts were only € 744 billion, or only 13% of these companies' total net income. This figure is exceedingly low because net shareholder payouts were negative (and often highly negative) during all but one year in the 1992–2001 period, as companies absorbed much more equity capital than they distributed. Negative net payouts were obviously an unsustainable investment equilibrium (why invest if over the long-term you get out less than you put in?). It is therefore not surprising that net payouts have risen since then. For the most recent decade (2010–2019), total shareholder payouts by EU companies were 63% of total net income and total net shareholder payouts were 36%, similar to the 41% for all U.S. listed companies during 2007–2016.[20]

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17. The Report argues on page 10 that "there is no evidence that shareholder pay-outs are being reinvested into more productive sectors of the economy, and the measurement of long-term investments may differ from study to study." We urge the Commission not to accept this "burden shifting" argument. It is eminently plausible—indeed, a bedrock of modern economic thought—that money is flowing from less productive uses to more productive uses. The burden of proof should be on anyone arguing that this is not the case. Besides, there is good suggestive evidence that the plausible interpretation is correct, at least in the U.S. (Direct evidence of investors' use of returned cash is hard to impossible to come by, for obvious reasons.) The rise in U.S. buybacks over the last decade was characterized by a cash outflow from the S&P 500 and a cash *inflow* of approximately the same magnitude to the non-S&P 500. Mark J. Roe, *Stock Market Short-Termism's Impact*, 167 U. PA. L. REV. 71, 119 (2018).

18. *See* Jesse M. Fried & Charles C.Y. Wang, *Short-Termism and Capital Flows*, 8 REV. CORP. FIN. STUD. 207 (2019).

19. Jesse M. Fried & Charles C.Y. Wang, Short-Termism, Shareholder Payouts, and Investment in the EU (Jan. 2021) (unpublished manuscript), www.ssrn.com/abstract=3706499 [https://perma.cc/7K5F-JXQH].

20. *Id.* at 3.

Second, in its analysis of investment, the Report finds a decrease in CAPEX and R&D intensity in EU listed companies only because it examines incomplete, inconsistent, and skewed samples.[21] For example, the Report excludes from its examination of R&D intensity (the ratio of R&D to revenue) those companies with negative net income, even though R&D in such companies is the best sign of a well-functioning capital market and there is no reason to exclude these firms.[22] An examination of a complete and consistent sample reveals that both CAPEX and R&D actually increased at EU listed companies over the time period considered in the Report, both in absolute terms and as a share of revenue. CAPEX and R&D levels also increased over the most recent decade.[23] CAPEX intensity dipped during this period, but that decline has been more than offset by an increase in R&D intensity, which has risen to a historic high.[24] Thus, combined CAPEX and R&D intensity at EU listed companies has increased both over the period covered by the Report and over the last decade.[25]

Third, the Report's preferred statistic of (gross) payouts as a percentage of net income (figures 1–5) is doubly misleading as a measure of whether payouts to shareholders deprive a company of funds required for investment. It wrongly implies that "net income" reflects the totality of a company's resources that are generated from its business operations and are available for investment. In fact, net income is calculated by subtracting the many costs associated with future-oriented activities that can be expensed (such as research expenditures). That is, net income is what is left over *after* certain investments. Indeed, a company that spends more on research will, everything else being equal, have a lower net income and a higher shareholder-payout ratio. At most, net income indicates the additional resources generated by a company's business operations that are available for (a) investment activities whose cost must be capitalized rather than expensed and (b) additional R&D and other activities whose costs would be expensed in a later year. If we add R&D expense back to net income to get a better approximation of funds available for investment

21. *See* Fried & Wang, *supra* note 19, at 19–20.

22. *Cf.* Report, *supra* note 2, at 18 n.45 (stating the sample exclusion); Fried & Wang, *supra* note 19, at 20 n.14 (critiquing the exclusion).

23. Report, *supra* note 2, at 16–17. This and other figures of R&D we discuss are based on only the expensed portion of companies' R&D expenditure. Our measure thus ignores the capitalized portion of each period's R&D investments. The Report does not seem to discuss this complication. However, as discussed in Fried & Wang, *supra* note 19, at 18, the analyses of investment levels and trends are nearly identical when incorporating the capitalized portion EU companies' R&D investments.

24. Report, *supra* note 1, at 20.

25. Moreover, this increase in combined CAPEX and R&D intensity probably understates the growth in total real investment, as post-industrial economies increasingly invest in intangibles such as human resource developed that are poorly measured and generally undercounted. *See*, *e.g.*, David J. Denis, *Is Managerial Myopia a Persistent Governance Problem?*, 31 J. APP. CORP. FIN. 74, 78–79 (2019). For further discussion, see Roe, *supra* note 17, at 107–08.

("R&D-adjusted net income"), we see that net shareholder payouts as a percentage of investment-available income are even lower.[26]

Overall, the volume of shareholder payouts by EU listed companies does not strip them of the ability to invest or innovate. As we just showed, EU listed companies have been investing heavily and increasingly. Despite this, they have accumulated cash reserves that could be used for additional investments if they had attractive investment opportunities.[27] Additionally, a listed company with inadequate cash and attractive opportunities could raise new financing by issuing more stock, as EU listed companies have done extensively, or by selling new debt. In short, the Report's evidence of short-termism is a red herring. We are therefore not surprised that the Report found a "limited availability of empirical studies on the (long-term) effects of corporate short-termism."[28]

III. Biased Use of Literature

In the preceding Part, we pointed to literature that debunked the Report's major purported measure of corporate short-termism, gross payouts. Moreover, we added to that literature with an examination of the European data that, in our view, the authors of the Report should themselves have done. The debunking literature was published well before the Report, but it is not cited, discussed, or analyzed in the Report.

This is part of a larger problem of biased use of academic literature in the Report. This bias manifests on two levels.

First, articles—especially high-quality articles—whose results conflict with the Report's conclusion are simply not cited or discussed. The literature debunking the gross payout and accounting investment measures is just the tip of the iceberg. There are dozens of empirical studies on short-termism published in economics and finance journals—we count at least 75 in economics and finance journals since 2008, with about half not finding evidence of short-termism.[29] No doubt some of those studies are better than others, and some superficially conflicting findings might be explained by a difference in focus. The Report cites very few of these studies, and the few that it does cite all find short-termism to be a problem.[30] We think it

26. *See* Fried & Wang, *supra* note 19, at 14–16.

27. *See id.* at 20–21.

28. Report, *supra* note 1, at 5.

29. Compilation of Short-Termism Studies, 2008-2019 (on file with author).

30. *Cf.* the citations on pages 9–10 of the Report, particularly in footnote 16. Some examples of available work that the Report's authors ought to have consulted: Philippe Aghion, John Van Reenan & Luigi Zingales, *Innovations and Institution Ownership*, 103 AM. ECON. REV. 277 (2013) (companies with more institutional shareholders do more longer-term innovation than those with less); Alon Brav, Wei Jiang, Song Ma & Xuan Tian, *How Does Hedge Fund Activism Reshape Corporate Innovation?,* 130 J. FIN. ECON. 237 (2018) (finding that although R&D spending tightens with hedge fund activism, "target firms increase innovation output"); Naomi E. Feldman et al., Investment Differences Between Public and Private Firms: Evidence from U.S. Tax Returns (2020) (unpublished manuscript), www.ssrn.com/abstract=3674235

would have been incumbent on the Report to sift through the evidence, at least the evidence that conflicts with its conclusions, and more particularly the conflicting evidence published in top journals, which can be presumed to be high quality. For example, several studies in top finance journals find that shareholder activism—a key driver of short-termism according to the Report[31]— *increases* productivity, innovation, and key investment at targeted companies.[32] The reader—and EU policymakers—should be told about these studies, but the Report makes no mention of them. Moreover, not mentioning them, the Report per force does not assess their strength, and how they might temper the Report's conclusions.

Second, a narrow focus on the literature examining the existence, or not, of short-termism does not resolve the policy question of what to do about it. In the economic and finance literature, short-termism is often seen as but one problem among many that governance needs to address.[33] A perfect governance system without frictions and costs does not and cannot exist.[34] Trade-offs are inevitable. Any system to monitor the behavior of corporate managers will incentivize managers to engage in occasional short-termist behavior to fend off an intervention from the monitor,

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[https://perma.cc/EJ8N-M8DC] (matched sample of public and private companies shows public companies invest more than the matched private firms). *Cf.* Tingfeng Tang, *Hedge Fund Activism and Corporate Innovation*, 85 ECON. MODELLING (forthcoming 2021) (activism leads to improved innovation). While our principal criticism is that the Report concludes that short-termism is severe without analyzing the studies failing to find it to be a deep problem, the Report also does not analyze some of the most important studies finding evidence for short-termism. *See, e.g.*, John Asker, Joan Farre-Mensa & Alexander Ljungqvist, *Corporate Investment and Stock Market Listing: A Puzzle?*, 8 REV. FIN. STUD. 342 (2015).

31. Report, *supra* note 1, at 33.

32. *E.g.*, Alon Brav, Wei Jiang & Hyunseob Kim, *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 REV. FIN. STUD. 2723, 2753–54 (2015) (finding increases in productivity and IT investment but also stagnating wages at the plant level at hedge fund target firms). *See also* Hadiye Aslan & Praveen Kumar, *The Product Market Effects of Hedge Fund Activism*, 119 J. FIN. ECON. 226 (2016) (competitors of activist-targeted firms react to heightened post-engagement competition from the activist's target); Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015) (reporting evidence that initial stock-price increases upon the announcement of an activist campaign are still present five years later); Lucian A. Bebchuk, Alon P. Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1 (2020) (finding that settlement agreements that companies reach with activists are followed by improvements along several dimensions in the subsequent years); Mariassunta Giannetti & Xiaoyun Yu, *Adapting to Radical Change: The Benefits of Short-Horizon Investors*, MGMT. SCI. (forthcoming 2021) (finding higher levels of investment following shocks among firms with more short-term investors).

33. *See generally* Marco Becht, Patrick Bolton & Ailsa Röell, *Corporate Governance and Control*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 1, 42–47 (George Constantinides, Milt Harris & Rene Stulz eds., 2003); Jeremy C. Stein, *Agency, Information and Corporate Investment*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 111, 122–23 (George Constantinides, Milt Harris & Rene Stulz eds., 2003); Alex Edmans, Xavier Gabaix & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence*, *in* THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 383, 460–61, 486–87 (Benjamin E. Hermalin & Michael S. Weisbach, eds., 2017).

34. *See* Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324 (1982). *Cf.* Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1678–81 (2013) (discussing the tradeoffs of insulating boards of directors); Alex Edmans & Xavier Gabaix, *Executive Compensation: A Modern Primer*, 54 J. ECON. LITERATURE 1232, 1260–71 (2016) (discussing dynamic incentives in CEO compensation schemes).

particularly around any preset reporting dates. The only way to avoid this is to forego monitoring altogether, an option few would even consider. A moderate degree of short-termism is therefore widely seen as an inevitable part of the best possible governance design.[35] Similarly, a modest amount of pernicious long-termism—executives sticking to a poor strategy for a little longer than is ideal—is an inevitable result even in a strong corporate governance system that must accord much discretion to the board and senior management.[36] Judging governance arrangements solely by the existence of short-termism is like negatively judging a pharmaceutical that cures a deadly cancer solely by the existence of an uncomfortable side effect.

The existence of extensive contrary studies and of important trade-offs does not mean that the Report's policy conclusions are necessarily wrong. However, we think that the main purpose of a report like this one is to sift through the evidence to determine which is convincing, which is not, and what overall picture emerges from the totality of the best evidence. The Report does none of that and hence fails to provide even a basis for discussion.

IV. Ill-Considered Reform Proposals

In this final Part, we point out additional, specific problems with the Report's proposals for EU policy measures. Obviously, the Report's proposals stand on shaky foundations because their ostensible target—short-termism as inducing declining investment—may be modest or even a mirage,[37] whereas the real problems—externalities and distribution—are not clearly articulated in the Report.[38] We will not repeat those general concerns for individual proposals. Rather, we want to draw attention here to specific concerns with individual proposals. For each one of the seven proposals, there are reasons to doubt that the proposal will be effective, and sometimes even reasons to think the proposal will be harmful. The Report fails to see these concerns because it again fails to examine and weigh the relevant literature and because it generally does not contemplate how its proposals would work in practice.

Time and space do not permit us to analyze these proposals in detail, but even a cursory review will show that they are more problematic than the Report lets on. We focus primarily on the measures in the "Legislative/Hard" Option C. The Report also considered an "Option A (non-legislative/soft) — [s]pread[ing] sustainable corporate governance practices through awareness raising activities, communications and green papers;" and an "Option B (non-legislative/soft) — [f]oster[ing] national regulatory initiatives aimed at orienting corporate governance approaches towards

35. *See* references *supra* note 33.
36. *See* Barzuza & Talley, *supra* note 15.
37. *Supra* Parts II and III.
38. *Supra* Part I.

sustainability through recommendations."[39] However, with one exception, the Report ultimately favored "Option C (legislative/hard) – [s]et[ting] minimum common rules to enhance the creation of long-term value while ensuring a level playing field through EU legislative interventions."[40] Option C measures also have the greatest potential to do harm. Hence, these are the Report's policy options on which we focus.

We address the seven proposals in the order and with the numbering of the Report. Like the Report, we will often cite to studies using U.S. data owing to the greater number of such studies; we have no reason to believe that studies of the parallel phenomena in Europe would reach different results and, in any case, the Report does not cite such studies.

A. Directors' Duties

The Report alleges that "[d]irectors' duties and company's interest are interpreted narrowly and tend to favour the short-term maximisation of shareholders' value."[41] As a solution, the Report proposes "an EU-wide formulation of directors' duties and company's interest, requiring directors to: 1. Properly balance …, alongside the interest of shareholders, …: long-term interests of the company (beyond 5-10 years); interests of employees; interest of customers; interest of local and global environment; interest of society at large. 2. Identify and mitigate sustainability risks and impacts . . . ."[42]

As the Report recognizes, many European jurisdictions already define directors' duties to go beyond shareholder primacy,[43] but clearly the Report itself does not think that this has solved the problem. The Report's way to deal with this recognition is to double-down and hope that the formulations will become more effective if enshrined at the level of the EU. In our view, changing the jurisdictional status here is unlikely to have a discernible impact. The better way to deal with this recognition is to accept this and other evidence—not cited in the Report—that such formulations are unlikely to make a meaningful difference. In the United States, the effect of so-called constituency statutes has been extensively studied by comparing companies in states that did or did not adopt such a statute. The best evidence is that they had no effect, at least none large enough to be measurable in the data.[44]

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39. Report, *supra* note 1, at vii.

40. The Report's "Assessment by criteria" at xi-xii consistently gives Option C the highest scores among A, B, and C on the numeric criteria ("Effectiveness" and "Efficiency") and, among the seven C measures, gives all but C2 a "yes" for "Coherence" and "Proportionality." We reference these scores merely to support our statement that the Report favors option C, not to endorse any of these scores. In fact, we believe the numeric scores are essentially arbitrary.

41. Report, *supra* note 1, at 51, section 4.4.1; 61, section 5.1.

42. *Id.* at 51.

43. *Id.* at 23-33.

44. Jonathan M. Karpoff & Michael D. Wittry, *Institutional and Legal Context in Natural Experiments: The Case of State Antitakeover Laws*, 73 J. FIN. 657, 683 (2018) (Table IV, in

To us, the lack of effect is not surprising. For reasons explained *infra* Section IV.G, it is not possible to enforce the fine details of directors' duties and simple exhortations will have only a modest impact. That is why even moving from the much-maligned "shareholder primacy" norm for fiduciary duties to a broader formulation, such as that favored by the Report, is unlikely to have much bite in altering behavior.[45]

Besides, the Report's suggested formulation leads to—or perhaps better: reveals—serious tensions. Under the Report's proposal, directors are to "balance … interests of employees; [and the] interest of customers" against, inter alia, the "interest of … [the] global environment." These often conflict. Take car manufacturers and oil companies: Their employees' interest in stable employment and their customers' interest in reliable and inexpensive individual transportation are at least in tension with the interests of the environment. As everyone is aware, balancing these interests has been a decades-long struggle in the EU and elsewhere. For example, European countries are still divided on the merits of a carbon tax, and conventional cars continue to be widely used in spite of their obvious negative consequences for carbon emissions. We are skeptical that deputizing corporate boards—mostly elected by shareholders who are highly unrepresentative of the citizenry—to tackle these problems and make these complicated trade-offs is a good idea. The better way is for EU and national policymakers to decide these issues directly, such as by incentivizing carbon-avoidance via rules and/or a carbon tax or by promoting carbon capture via rules and rewards for burying environmental carbon—and then to expect EU corporations to faithfully implement any new rules and to respond to any anti-climate change incentives.

B. Investor Pressure

The Report alleges that "[g]rowing pressures from investors with a short-term horizon contribute to increasing boards' focus on short-term financial returns to shareholders at the expense of long-term value creation."[46] Specifically, the Report blames "shorter tenu[r]e of shares and increased frequency of portfolio turnovers . . . combined with the increased role played by activist investors – like activist hedge funds"[47] as well as "disclosure of quarterly returns and earnings guidance."[48] As a solution, the Report considers, but ultimately rejects as disproportional, "binding

particular, shows that directors' duties laws, such as constituency statutes, have no statistically significant effects on firms' operating performance); *see also,* Lucian Bebchuk, Kobi Kastiel & Roberto Tallarita, *For Whom Corporate Leaders Bargain*, S. CAL. L. REV. (forthcoming 2021) (showing that corporate leaders used the leeway afforded by constituency statutes to bargain for shareholders, executives, and directors, but not for other stakeholders).

45. *See generally* HOLGER SPAMANN, SCOTT HIRST & GABRIEL RAUTERBERG, CORPORATIONS IN 100 PAGES, ch. 10.B.2 (2020).

46. Report, *supra* note 1, at 52, section 4.4.2, 79, section 5.2.

47. *Id.* at 33.

48. *Id.* at 34.

rules requiring Member States to introduce mechanisms to incentivise longer shareholding periods"[49] and "to prohibit both earning guidance and quarterly reporting for listed companies."[50]

1. Faulty Premises: Is There Really a Problem?

One problem with this proposal is that it partly rests on faulty premises. First, the concern with "shorter tenu[r]e of shares and increased frequency of portfolio turnovers" betrays a fallacy of averages. The average turnover rate of stocks has indeed increased dramatically in recent decades, i.e., the average holding period has decreased.[51] However, as the Report itself acknowledges,[52] the increase in *average* turnover is driven by a subset of investors that trade extremely and increasingly frequently, with little direct impact on corporate governance. (It does not matter for corporate governance if an investor owns a share for a day or for a nano-second, as either way such a shareholder will not be directly involved in corporate governance and its impact will be only from its trading. But many "nano-second" traders will affect the average holding period.) These high-frequency investors' presence in the average masks the fact that the holdings of long-term investors (such as the growing index funds) have actually *increased* over the last couple of decades. In other words, shares are increasingly owned by longer-term investors, even while the remaining short-term investors trade increasingly frequently and thus drive up the average turnover rate.[53]

Second, we already mentioned above that several studies in top journals show hedge fund activism as *increasing* productivity, innovation, and key investment at targeted companies, without any sign of long-run reversals.[54] For this and good theoretical reasons, many consider activists to be important helpful ingredients of contemporary corporate governance.[55] We do not seek to resolve that issue here but, once again, the Report fails to examine these studies. In fact, the Report does not cite any empirical

49. *Id.* at 52.

50. *Id.* at 53.

51. *Id.* at Annex I, 105.

52. *Id.* at Annex I, 105 n. 218.

53. Wei Jiang, *Who are the Short-Termists?* 30 J. APPLIED CORP. FIN. 19, 20–21 (2018); Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 998–1001 (2013).

54. *See* articles cited *supra* note 32.

55. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 896–902 (2013); Holger Spamann, Indirect Investor Protection: *The Investment Ecosystem and Its Legal Underpinnings* (Harvard Olin Faculty Discussion Paper No. 1046, 2020), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Spamann_1046.pdf [https://perma.cc/JUK9-24Z3].

studies on the effects of hedge fund activism.[56] A sound report for the EU would need to engage with the substantial empirical literature investigating the effects of hedge fund activism before making proposals to curb it.

2. Failure to Consider the Proposal's Likely Effects

The other problem with the Proposal to "incentivise longer shareholding periods" and "to prohibit both earning guidance and quarterly reporting" is that even while they may have unintended side effects, their effectiveness is highly doubtful.

We hold no brief for earnings guidance and do not consider quarterly reporting a *sine qua non* for the sound financial management of listed companies. But as a matter of judgment, it hardly seems to us that moving earnings reporting from every three months to every six months—the common response to the view that quarterly earnings management is pernicious—will foster the greater than 5- or 10-year planning that the authors of the Report seek. Yet, changing reporting frequency will have costs: public information will drift further from inside knowledge if earnings reports come out every six months. The extra three months of "going dark" will give opportunities for insider trading and other misdeeds.[57] We do not know what the extent of these malfunctions would be, and we support the Report's acknowledging them.[58] Frequent reporting may be necessary to effectively govern firms having outside ownership and a stock market listing.

To "incentivise longer shareholding periods," the Report touts wider use of loyalty shares in Europe.[59] They are in use now and the evidence thus far is that they are often and perhaps primarily used to protect insiders, rather than in widely-held companies where loyalty shares can best mitigate any short-termism.[60] We wish that the Report's authors would

56. Their only engagement with this empirical literature is an entry in Annex I's list of "Scientific Literature" (Report, *supra* note 2, at 174–183) of a paper critiquing some of the empirical studies: John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016). This list also contains a blog post on activism by a lawyer, Martin Lipton (Martin Lipton, *Current Thoughts About Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (2013), https://corpgov.law.harvard.edu/2013/08/09/current-thoughts-about-activism/ [https://perma.cc/PWL8-C6CM]).

57. *See* Robert C. Pozen & Mark J. Roe, *Six Months Isn't 'Long-Term,'* WALL ST. J., Aug. 20, 2018.

58. Report, *supra* note 1, at 89, 92.

59. *Id.* at 91.

60. *See* Chiara Mosca, *Should Shareholders Be Rewarded for Loyalty? European Experiments on the Wedge Between Tenured Voting and Takeover Law*, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 245 (2019); Emanuele Bajo, Massimiliano Barbi, Marco Bigelli & Ettore Croci, *Bolstering Family Control: Evidence from Loyalty Shares* (Eur. Corp. Governance Inst. – Fin. Working Paper No. 619/2019, 2019), www.ssrn.com/abstract=3428887 [https://perma.cc/S9EQ-L6LP]; Thomas Bourveau, Francois Brochet & Alexandre Garel, *The Effect of Tenure-Based Voting Rights on Stock Market Attractiveness: Evidence from the Florange Act* (Nov. 5, 2019) (unpublished manuscript), www.ssrn.com/abstract=3324237 [https://perma.cc/4JY3-YLS3]; Mark J. Roe & Federico Cenzi Venezze, *Can Loyalty Shares Cure Corporate Short-Termism?* BUS. LAW. (forthcoming 2021). *But see* Chiara Mio, Elise Soerger Zaro & Marco Fasan, *Are Loyalty Shares an Effective Antidote Against Short-termism?*

have shown why this evidence is incorrect before asserting that wider use of loyalty shares would combat short-termism, or why the tax incentives that they mention as an alternative would avoid these consequences.[61]

C. Lack of Strategic Perspective

The Report alleges that "[c]ompanies lack a strategic perspective over sustainability and current practices fail to effectively identify and manage relevant sustainability risks and impacts."[62] As a solution, the Report proposes "requiring corporate boards to integrate sustainability aspects (risks, opportunities, impacts) into the business strategy, . . . and to disclose appropriate information."[63]

There is an odd mismatch here between the Report's diagnosis and proposed cure on the one side, and its own findings on the other side, which it relegates to a footnote: according to the Report's own "survey answers, 85.7% of companies declared to have a sustainability strategy" already.[64]

In any event, we see no major downside in asking or requiring boards to consider sustainability as part of their business strategy, but we question whether doing so will have more than a minor impact on global warming unless corporate incentives are better aligned with climate sustainability (such as, for example, via a carbon tax). But the tool of mandated board reflection is weak relative to the climate change goal sought. We would not want the EU, if it required boards to consider sustainability, to be able to walk away contented, with a sense that their mission had been accomplished or even anything more than slightly helped.

D. Board Remuneration

The Report alleges that "[b]oard remuneration structures incentivise the focus on short-term shareholder value rather than long-term value creation for the company."[65] As a solution, the Report proposes "to align executive remuneration policy with the long-term and sustainability goals, in particular by: 1. Regulating executives' ability to sell the shares they receive as pay; 2. Making compulsory the inclusion of non-financial, ESG

Empirical Evidence from Italy, 29 BUS. STRATEGY & ENV'T 1785, 1785 (2020) (finding evidence that Italian companies with loyalty shares structures reduce earnings management, which the authors see as a proxy for corporate short-termism).

61. Report, *supra* note 1, at 87, 91.

62. *Id.* at 54, section 4.4.3, 93, section 5.3.

63. *Id. at 54.*

64. *Id.* at 35, n.125. The main variance between this state of corporate affairs and the Report's suggested mandate seems to be that the Report's proposal would require the use of "measurable, specific, time-bound, and science-based sustainability targets." *Id.* at 54. Even the Report, however, seems to struggle to give an example of a "science-based" target (n. 126 mentions one but caveats that "this initiative only focuses on GHG emissions").

65. *Id.* at 55, section 4.4.4, 109, section 5.4.

metrics, linked to a company's sustainability targets, in executive pay scheme."[66]

The first point—restricting executives' sales of their stock—is already firmly established in the corporate governance codes and national legislation of many Member States and standard practice in EU listed companies, with minimum holding periods of 3-5 years. Some may consider this time period too short for certain long-term consequences to manifest at the company level. But extending holding periods further runs up against the problem that they become increasingly onerous for the equity's recipient and more and more subject to subsequent events outside their influence, thus diluting their incentives.[67]

As to the second point—including non-financial ESG metrics in the pay scheme—we wholeheartedly agree that this can be a powerful means to align directors' private incentives with social goals when companies create externalities that are not addressed through other regulation.[68] At the same time, we also caution that the devil is in the details. To make this workable, there need to be relevant outcomes that are both measurable and meaningful. To be meaningful, a metric must be one that directors can directly influence and that is not already captured by other regulation (assuming directors keep getting paid mostly in stock-linked compensation). For example, linking directors' pay to the world's attainment of sustainable development goals is not meaningful because each individual director has only a negligible influence on those goals. Conversely, linking directors' pay to measures of their companies' environmental fines is partly redundant because they already have that link through their stock ownership. (If the fines and resulting stock price impact were deemed insufficient, the fine could be raised.)

If the outcome can be clearly described, then the question is why society should rely on companies' executive compensation packages rather than regulate the issue directly. That is, if there is a public benefit on fining the errant directors and executives, then there is reason for the authorities to consider fines that are levied directly on the errant corporate players (with means to stymie the corporation from reimbursing these fines), rather than relying on the corporation to, in effect, fine executives and directors who diminish the public good.

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66. *Id.* at 55-56. Although we share concerns about the excessive short-term focus of compensation arrangements, we note that the use of such structures seems to be driven not by pressures from short-term investors but by the private interests of corporate leaders. For an analysis of how such structures benefit those private interests, see LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE, THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

67. *See generally* Edmans, Gabaix & Jenter, *supra* note 33; Edmans & Gabaix, *supra* note 34.

68. For an example where one of us has argued that executive compensation can be used in this way, see Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010).

E. Board Composition

The Report alleges that "[t]he current board composition does not fully support a shift towards sustainability."[69] As a solution, the Report proposes "rules on board composition of listed companies, including a requirement for companies to consider sustainability criteria in the board nomination process."[70]

We see no major downside in this relatively mild proposal ("requirement . . . to consider"). However, we would caution against expectations that this proposal will have much or any impact.

F. Stakeholder Involvement

The Report alleges that "[c]urrent corporate governance frameworks and practices do not sufficiently voice the long-term interests of stakeholders."[71] As a solution, the Report proposes "requiring corporate boards to establish mechanisms for engaging with and involving internal and external stakeholders in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy."[72]

Once again, there is an odd mismatch between the Report's proposal and its own findings, in this case its own experience in "engaging with … stakeholders" as it conducted this study. The Report itself confesses that it had difficulty (a) delineating the relevant stakeholders and (b) getting feedback from the stakeholders that it did consider relevant.[73] The Report does not explain why it thinks this would be easier for companies.

The issue of stakeholder delineation is a thorny one. Different stakeholders will have different, often conflicting interests, so whom to consult and how much weight to give their input is of primary importance. For example, if a European company sources most of its products from outside the EU, should it be mostly governed for the benefit of the foreign producers? As another example, should an integrated oil company prioritize the input of its workers, who may defend their jobs (and, hence, continued investment in hydrocarbons), or the input of communities threatened by climate change? We take no position on this question but caution against the adoption of principles without thinking through their implications.

69. Report, *supra* note 1, at 55, section 4.4.5, 122, section 5.5.
70. *Id.* at 56–57.
71. *Id.* at 57, section 4.4.6, 136, section 5.6.
72. *Id.* at 57–58.
73. *Id* at 5.

G. Enforcement of Directors' Duties

The Report alleges that "[e]nforcement of directors' duty to act in the long-term interest of company is limited."[74] As a solution, the Report proposes "to strengthen the enforcement of the directors' duty to act in the interest of the company."[75] Specifically, the Report proposes to "[a]llow stakeholders (other than shareholders) to bring suits in courts for alleged violations by directors of the duty of care and loyalty."[76]

This proposal completely ignores a central tenet of corporate law policy, which is that judicial enforcement of the business content of fiduciary duties—absent fraud or similar intentional harm—is generally not desirable because judges could not possibly acquire the information to perform this function well.[77] This tenet is often explicitly enshrined in national corporate laws under a label like "business judgment rule" or, if not, is implicitly recognized through various procedural hurdles to claims against directors.[78] As the leading comparative corporate law textbook explains, "judges are poorly equipped to evaluate highly contextual business decisions … given hazy standards and hindsight bias, the risk of legal error associated with aggressively enforcing the duty of care might lead corporate decision-makers to prefer safe projects with lower returns over risky projects with higher expected returns."[79] The ostensible beneficiaries of liability, shareholders, agree. When a 1985 decision of the Delaware Supreme Court briefly raised the specter of a greater liability threat for corporate decision-makers, shareholders of Delaware corporations—by far the leading jurisdiction for incorporations in the United States—quickly voted to adopt amendments to corporate charters that waived directors' monetary liability for breaches of the duty of care.[80] Through different doctrinal

74. *Id.* at 59, section 4.4.7, 147, section 5.7.

75. *Id.* at 59.

76. *Id.*

77. REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, 70–71 (3d ed. 2017); Holger Spamann, *Monetary Liability for Breach of the Duty of Care?* 8 J. LEGAL ANALYSIS 337, 338-40 (2016); *see also* Andreas Engert & Susanne Goldlücke, *Why Agents Need Discretion: The Business Judgment Rule as Optimal Standard of Care*, 13 REV. L. & ECON. 1, 2 (2016).

78. KRAAKMAN ET AL, *supra* note 77; *see also* Martin Gelter, *Why Do Shareholder Derivative Suits Remain Rare in Continental Europe*, 37 BROOK. J. INT'L L. 843, 856 (2012) (indicating that "[p]ercentage limits can be rationalized as a screening mechanism against abusive lawsuits").

79. KRAAKMAN ET AL, *supra* note 77. This explanation is incomplete in that it assumes that liability has to be complete (put the victim in exactly the position as if the injurer's behavior had been perfect) and that courts will only err on the side of penalizing risk-taking rather than inactivity and conservatism. For present purposes, however, those assumptions seem plausible. In any event, the ultimate conclusion is the same under a simple cost-benefit argument: courts are not a cost-efficient way of guiding corporate decision-makers' behavior given the availability of governance mechanisms such as shareholder voting and incentive compensation. *See generally* Spamann, *supra* note 77.

80. *See* Lawrence A. Hamermesh, *Why I Don't Teach Van Gorkom*, 34 GA. L. REV. 477, 490 (2000). The shareholder votes were in turn enabled by a quick reaction of the Delaware legislature, which enacted section 102(b)(7) of the Delaware General Corporation Law, that the

constructions, different jurisdictions reach the same result. In 2006, two major studies showed the risk of out-of-pocket liability for outside directors in seven major jurisdictions, including France and Germany, to be close to zero.[81]

It is possible that combatting externalities requires a different approach.[82] But the Report's glaring omission is not even to confront the question. The answer is by no means obvious: after all, we also do not judicially enforce the public welfare mandate of governments and civil servants (except to punish self-interested behavior—corruption—that would trigger litigation in corporate law as well). The comparison to governments would be quite apt if the Report's proposal regarding the scope of directors' duties were implemented (cf. *supra* IV.A).

Conclusion

The Report fails on every important dimension. A properly done Report for the EU would define the problem accurately, better conceptualize its main evidence, assess the full range of available evidence, and assess the costs and likely success of ameliorative policy proposals. But this Report does not define the problem properly because it conflates externalities and respect for stakeholders with distorted time horizons. These are different problems with different solutions. It presents inapposite evidence, by presenting increased gross shareholder payout rates as a strong indicator of short-termism. But gross payouts are substantially offset by the simultaneous issuances of new equity that move capital from shareholders to companies, leaving plenty of funds available for investment. It fails to address, or even cite the considerable relevant academic research, much of which is inconsistent with the Report's perspective. Lastly, the Report neglects elementary problems with its policy proposals, many of which will have considerable collateral costs and some of which should not be expected to have much effect. No EU policymaker should rely on this Report and American policymakers should begin anew before considering its substance.

Delaware legislature quickly adopted after the Delaware Supreme Court's decision. The Delaware Supreme Court decision is *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

81. Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059 (2006) (analyzing outside director liability in the United States); Brian Cheffins & Bernard Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1388 (2006) (extending the study to six other countries).

82. *See* Spamann, *supra* note 77, at 358–59.

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