Reforming Corporate Governance

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I. What is Good Corporate Governance?


MAVICA
SONY
SONY LENS 50mm
JAPAN

Kodak

- Clear market leader in film. Sales crossed $10 billion, nearly all from film
- Study by head of market intelligence, Vince Barabba, predicted digital would replace film, but in 10 years


RELEASE
digital
1.0 MIL CERTIFIED DIGITAL CASSETTE
digital equipment corporation · maynard, massachusetts
Memodyne CORPORATION

Kodak

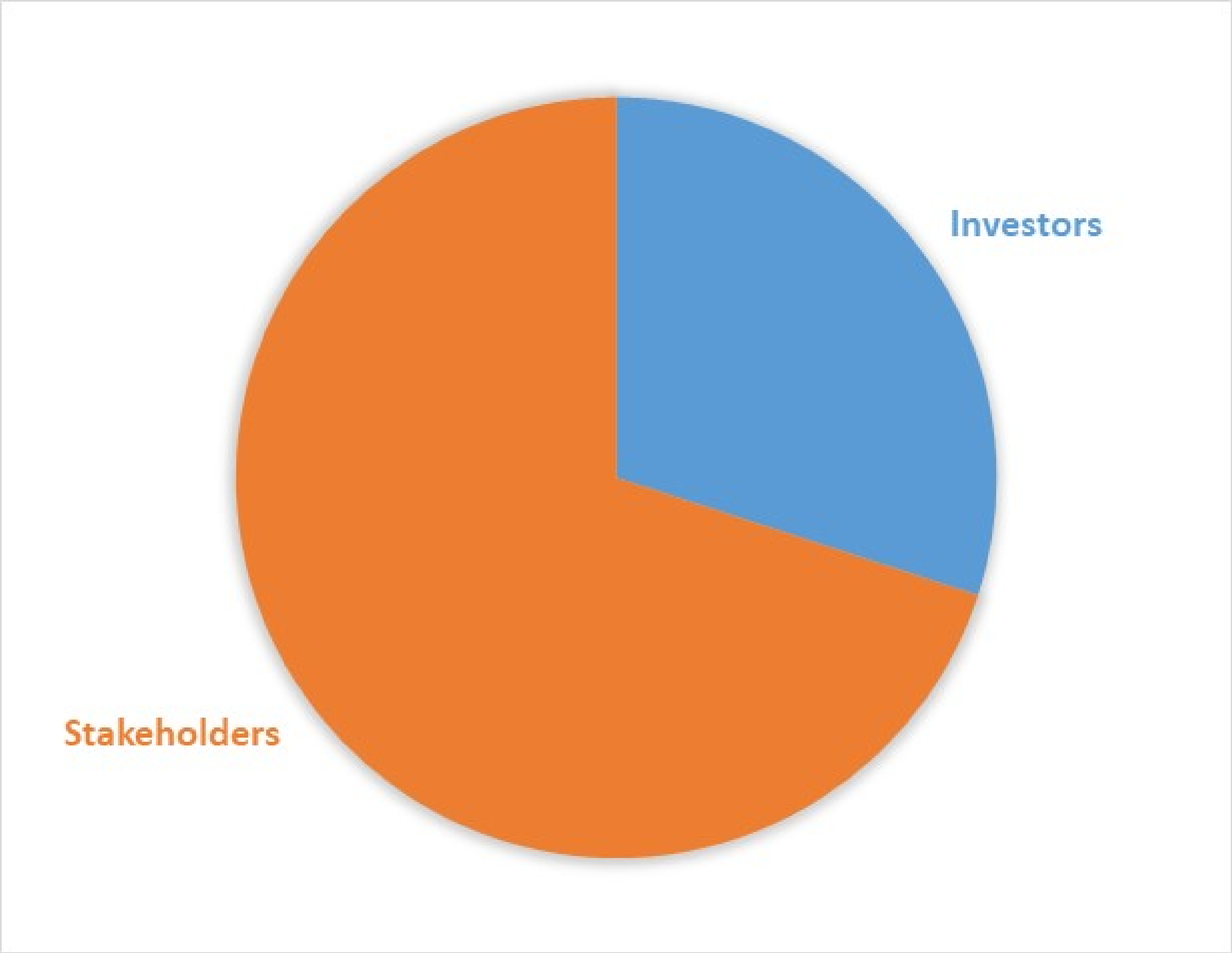
- Clear market leader in film. Sales crossed $10 billion, nearly all from film
- Study by head of market intelligence, Vince Barabba, predicted digital would replace film, but in 10 years
- "The company just never got around to developing the technology, because the money to be made from its traditional business of old-fashioned photographic film was so much bigger"[1]

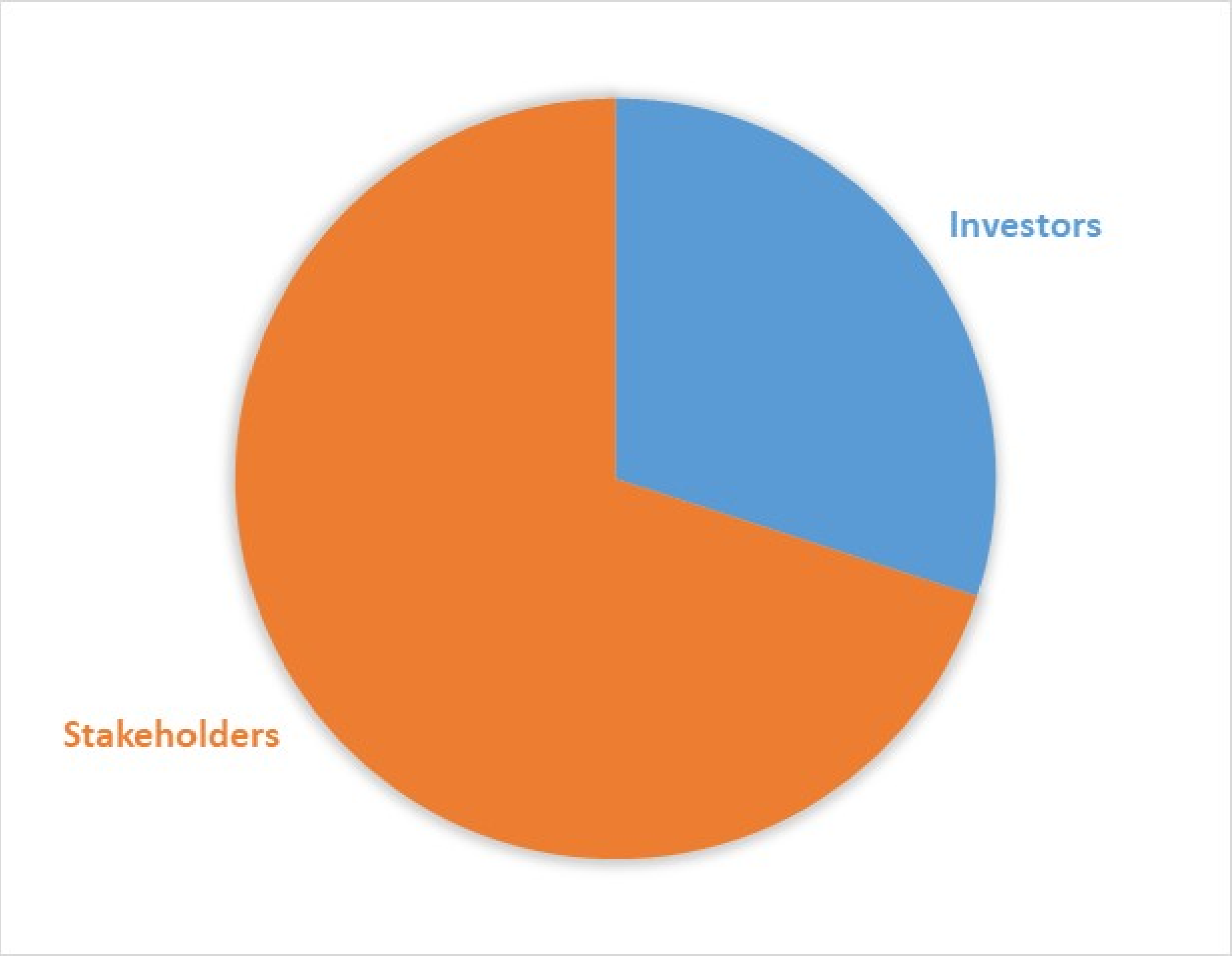
1. University of Pompeu Fabra case study

Kodak: The Aftermath

- Went bankrupt in 2012, a disaster for society
  - Worth $31 billion in 1997
  - Employed 145,300 in 1988
- Rarely thought of as a governance failure
  - No *errors of commission*
  - Investors, executives didn’t steal from other stakeholders


Stakeholders
Investors


Investors
Stakeholders


Investors
Stakeholders

What Is Good Corporate Governance?

- Promotes great companies
  - Create long-term value for both investors and stakeholders
  - Ensure the gains are fairly distributed
- Importance of growing the pie through innovation and risk-taking
- Importance of errors of omission, not just commission
- (Some) failures are a statistical inevitability of innovation and risk-taking

What Good Corporate Governance Is Not

- Promoting the longevity of a company
  - A company only *creates value* for society if it delivers more value than the resources could deliver elsewhere
- "The ruthlessness of venture capitalists in killing bad ideas … is far more important to their success than the ability to identify diamonds in the rough. The arm's length system plants a thousand flowers, uproots hundreds when they do not thrive, and nurtures only a few to bloom. New opportunities abound, while old, tired ways of doing business are ruthlessly eliminated. The system's strength, then, is that it is not heavily biased towards preserving the privileges of incumbent firms and workers"
  - Raghu Rajan, *Fault Lines*

II. The Power of Shareholders

Common Wisdom

- Shareholders extract value at the expense of others
  - Reform should take power away from shareholders
- Claims are rarely based on evidence; often caricatured
  - "The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public"
  - "The Social Responsibility of Business Is To Increase Its Profits"
- Inconsistency with arguments on pay
- The UK is considered a leader in corporate governance; Code is exported overseas
  - BHS was private
  - Sports Direct had two NEDs, CEO was deputy executive chairman, owned 58%

Shareholder Rights

- Study of 24 governance provisions (e.g. staggered board, golden parachute)
  - Companies with few protections outperform those with many by 8.5%/year[1]
  - Particularly in non-competitive industries[2]
- Dual-class shares associated with lower firm-value[3]
  - Higher CEO pay, worse acquisitions, worse investments[4]

1. Gompers, Ishii, and Metrick (2003)
2. Giroud and Mueller (2011)
3. Gompers, Ishii, and Metrick (2009)
4. Masulis, Wang, and Xie (2009)

Shareholder Rights (cont’d)

- Study of 37 countries’ pro-investor laws:
  - Stronger laws positively associated with 11 out of 12 measures of stakeholder value (e.g. labour relations, community involvement, environmental orientation)[1]

1. Ferrell, Liang, and Renneboog (2016)

- "[Woo-Choong] Kim is used to making investment decisions on the spot, based on hunches" – *The Economist*
- Broken up in 1999

- Rejected a $47.5 billion takeover bid from Microsoft in February 2008; fell to 1/3 of bid by end of year
- Two Detroit public pension funds filed lawsuit

BHS
BRITISH HOME STORES

- “The three month inquiry … found a near-complete absence of the constructive challenge that is the hallmark of good corporate governance. Sir Philip, a dominant personality, ran his companies as a personal empire with boards taking decisions with reference to a shared understanding of his wishes rather than the interests of each individual company”

Evidence is Not Universal

- Contract manufacturer Pemstar went public in 2000; IBM was largest customer
  - Teamed up to open manufacturing operation in Brazil and share know-how
- Takeover defences increase going-public value if and only if large customer, dependent supplier, or strategic alliance[1]
- Optimal governance isn't one-size-fits all: comply-and-explain

1. Johnson, Karpoff, and Yi (2015)

Other Fallacies

- Workers are more interested in the long-term, since investors can sell at any time
  - Workers can leave at any time; if investors sell, the price they'll get reflects long-term profits

Other Fallacies (cont'd)

- "[T]here is virtually no evidence that shareholders ever prefer short-term gains that are smaller than larger (discounted) long-term gains. … Harvard Law School Professor Mark Roe put it this way recently, "[o]verall, the evidence that financial markets are excessively short-term is widely believed but not proven, and there is much evidence pointing in the other direction" (J.B. Heaton)
- "Far too often companies hide behind "long term" as a way to justify prolonged underperformance. There are good ideas that create sustained improvements and can be implemented quickly. Likewise, there are bad ideas that can take a long time to destroy value" (Paul Singer)

Other Fallacies (cont'd)

- Workers are more interested in the long-term, since investors can sell at any time
  - Workers can leave at any time; if investors sell, the price they'll get reflects long-term profits
  - Lumps all investors together in one basket. Large investors have particular governance power
  - Long-term-oriented investors care about upside, not just downside; all stakeholders
- "When Labor Has a Voice in Corporate Governance"[1]:
  - Firms "invest less in long-term assets, take fewer risks, grow more slowly, create fewer new jobs, and exhibit lower labour and total factor productivity"

1. Faleye, Mehrotra, and Morck (2006)

Summing Up

- Reforms should hold companies accountable to grow the pie for both investors and stakeholders, rather than pitting one against the other

III. What Should Be Reformed?

Say-On-Purpose

- Purpose: *who* a company exists for and *why* it exists
- UK currently has say-on-pay; EU SRD is mandating it
  - Forward-looking vote on pay policy; backward-looking vote on pay implementation
  - Easy to box-tick
  - Often focuses on pie-splitting not pie-growing
- Say-on-purpose
  - Forward-looking vote on purpose; backward-looking vote on delivery of purpose
  - Ensures investor buy-in; that purpose isn't just a way for companies to be unaccountable
  - Ensures investors understand the metrics that matter
  - Hold companies accountable to report on purpose

Long-Term Incentives

- Long-term shares for
  - Executives (perhaps make the default)
  - Directors
  - Employees

Board Committees

- Currently: remuneration, nominations, risk, audit
- Human Capital Committee
  - All aspects of workers: pay, training, engagement, discrimination, mental and physical wellness etc.
- Innovation Committee, Environment Committee (or fold within Strategic Assets Committee)

Board Diversity

- Boards with more outside directors perform better[1]
  - Not if R&D-intensive firm[2]
- UK Corporate Governance Code consultation:
  - "There is clear evidence that greater female representation in the boardroom and senior management has a positive impact on performance. More recently, research has found a statistically significant relationship between ethnically and gender diverse leadership teams and better financial performance. Companies that focus on increasing diversity in the boardroom, in their executive teams and across their workforces as a whole can expect a positive impact on their performance"

1. Weisbach (1988)
2. Coles, Daniel, and Naveen (2008)

Board Diversity: The Evidence

- A single McKinsey study
  - Ignores controls (firm size, age, recent performance)
  - 2-year performance
  - No tests for significance
  - Stock price growth measure ignores dividends
  - 2003-5 for profitability, 2005-7 for stock returns
  - No causality
- Meta-analyses
  - 140 studies of > 90,000 firms in > 30 countries[1]
  - 20 studies in peer-reviewed journals[2]

1. Post and Byron (2015)
2. Pletzer, Nikolova, Kedzior, and Voelpel (2015)

Board Diversity: The Evidence

- "Research conducted by consulting firms and financial institutions is not as rigorous as peer-reviewed academic research … Rigorous, peer-reviewed studies suggest that companies do not perform better when they have women on the board. Nor do they perform worse. Depending on which meta-analysis you read, board gender diversity either has a very weak relationship with board performance or no relationship at all" – Katherine Klein

Board Diversity: The Evidence

- “From advocacy and policy perspectives, there is an obvious appeal in simple, straightforward claims that diversity in groups and organizations produces performance gains. Given this appeal, simplistic renditions of scientific findings on diversity continue to find favor among diversity’s advocates and the legions of practitioners and consultants engaged in helping organizations meet their diversity goals. Presented as if they were evidence-based findings, broad claims about the advantages of diversity for group and organizational performance appear regularly in promotional materials of consultants and advocates” – Alice Eagly[1]

1. “When Passionate Advocates Meet Research on Diversity, Does the Honest Broker Stand a Chance?” (2012)

Board Diversity: The Assessment

- "In sum, the research results suggest that there is no business case for - or against - appointing women to corporate boards. Women should be appointed to boards for reasons of gender equality, but not because gender diversity on boards leads to improvements in company performance" – Katherine Klein

- "Diversity is highly desirable in its own right, and firms should pursue it even in the absence of a target and evidence showing that it instrumentally improves performance. It would be a sad world if the only reason firms increased diversity was to obtain higher performance or meet a regulatory target. Companies must give all of their workers equal opportunities, pay, and promotion prospects regardless of their gender, ethnicity, sexual orientation or other characteristics. This is simply the right thing to do"
    - My response to the Corporate Governance Code consultation

Mandated Diversity: The Evidence

- Norway's law requiring 40% of directors to be women reduced firm value for firms that were not previously complying[1]

1. Ahern and Dittmar (2012)

IV. Conclusion

Conclusion

- Good corporate governance is about growing the pie for both investors and stakeholders, rather than restraining the former to benefit the latter
  - Say-on-purpose
  - Long-term incentives
  - Board committees
- Investors are key to enforcing – see next lecture on The Stewardship Role of Investors