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REFORMING CORPORATE GOVERNANCE

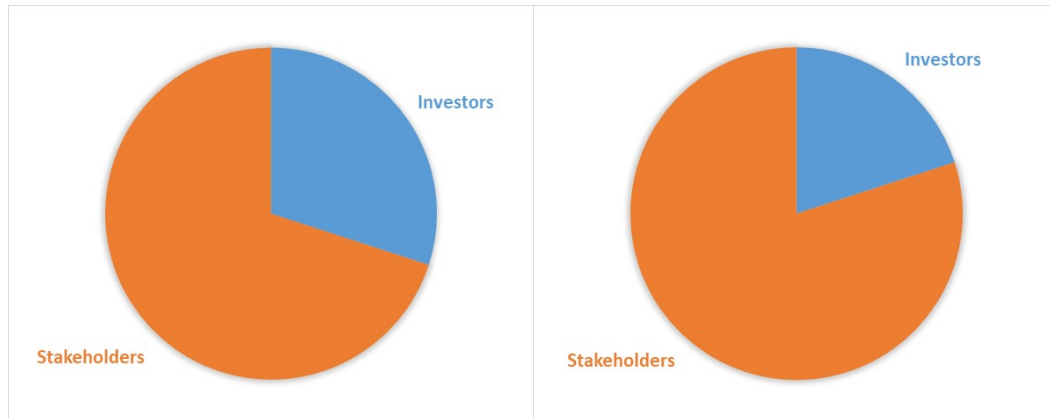
PROFESSOR ALEX EDMANS

What is Good Corporate Governance?

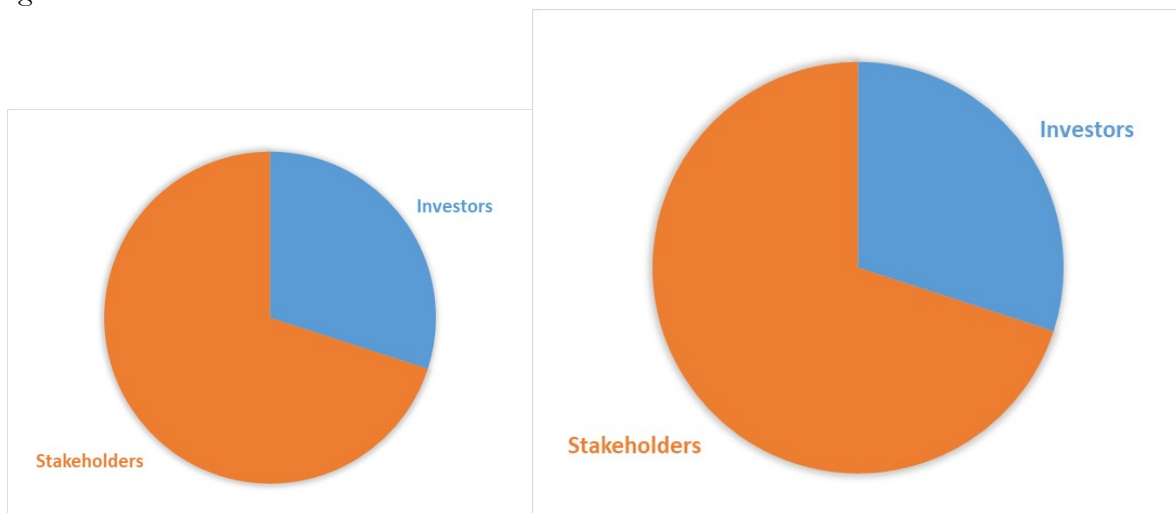
Corporate governance helps ensure that executives create great companies. Great companies deliver long-term value to both shareholders and stakeholders alike – rather than just focusing on short-term profit – and then ensure that this value is fairly distributed.

While this definition might seem intuitive, it's far less obvious than it sounds for three reasons. First, it highlights that the main role of corporate governance is to grow the pie both shareholders and stakeholders, rather than splitting the pie differently – redistributing value away from shareholders towards stakeholders. Shareholders and stakeholders are much more aligned than commonly believed: both benefit from growing the pie. Thus, shareholders have a critical role in ensuring good corporate governance, rather than being the enemy.

Pie-Splitting



Pie-Growing





Second, *errors of commission* are viewed as major corporate governance failures. These are actions that are perceived to be pie-splitting, such as overpaying a CEO or underpaying workers. These are certainly important issues that should not be ignored. However, even more serious for society are *errors of omission* – failing to innovate and take risks. These may lead to opportunities to grow the pie being lost. Had Merck not developed ivermectin for human use, as I explored in Lecture 1 (Purposeful Business: The Evidence and the Implementation), then millions more citizens may have gone blind, but Merck would have never received the media criticism currently given to executives for errors of commission. Errors of omission may also lead to a company failing to take action to prevent the pie shrinking. Kodak failed to invest in digital cameras, leading to a once-great company going bankrupt. Kodak is not seen as a governance failure because it was an error of omission, but its collapse was disastrous for both workers and investors - Kodak employed 145,300 in 1988, and was worth \$31 billion in 1997.

This observation means that good corporate governance is not only about avoiding corporate failures. It is equally important to promote success – a failure to take an opportunity is a failure. We should also recognise that some failures are almost a statistical inevitability given the large number of companies, and that a governance regime that promotes risk-taking and innovation will lead to more failures. Even though each failure is serious and should not be taken lightly, the cost of not innovating is also serious. As an analogy, halving all speed limits would likely reduce the number of road accidents, but come at a cost of significantly increasing commuting time, which is why such calls would likely be resisted despite the accident reduction.

The third reason for why the definition is non-obvious is that it does not argue that good corporate governance involves growing the company or even preserving the longevity of a company. A company uses scarce human, physical, and financial resources. It only grows the pie if it creates more value with these resources than the value they would create if used elsewhere. As Raghuraj Rajan, the former Governor of the Central Bank of India, noted (in a book that criticised many elements of the economic system rather than seeking to defend it): “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.”¹ Note that executives may have personal interests to preserve the longevity of a company (to preserve their jobs) even if this is not in society’s interests.

The Value of Shareholder Rights

There is a common view that shareholders extract value from stakeholders in their pursuit of short-term profit. Thus, some companies put devices in place to insulate themselves from accountability to shareholders. For example, a “staggered board” involves spreading out the elections of a board across three years, so that only one-third comes up for election each year. “Dual-class shares” are where the shares sold to outside investors confer only a tenth of the voting rights of those held by executives (in the case of Facebook and Google), or no votes at all (in the case of Snap). The rationale is that insulating executives will allow them to focus on creating long-term value for society, rather than meeting short-term profit targets. However, these insulation mechanisms may actually entrench bad managers and allow them to destroy value for both shareholders and stakeholders alike.

So which is it? Let’s look at the evidence. A seminal study gathered data on staggered boards plus 23 other insulation mechanisms. Companies with the fewest insulation mechanisms and thus the strongest investor rights beat those with the opposite by 8.5% per year.² A concern might be that the use of protection mechanisms is correlated with other factors, and those factors are responsible for the poor performance. However, a follow-up study found that the link between insulation mechanisms and stock returns was particularly strong in non-

¹ Rajan, Raghuram G. (2011): “Fault Lines: How Hidden Fractures Still Threaten the World Economy.” Princeton University Press.

² Gompers, Paul, Joy Ishii, and Andrew Metrick (2003): “Corporate Governance and Equity Prices.” *Quarterly Journal of Economics* 118, 107-156.



competitive industries.³ This makes it more likely that it's governance that's driving the results – governance is likely to be more important in non-competitive industries, where executives have greater latitude to destroy value. Other research found that dual-class shares are associated with significantly lower value.⁴ The sources of this decline include higher CEO pay, worse acquisitions, and worse investment decisions.⁵

While most of the above outcomes are primarily relevant to shareholders, a study of 37 countries found that the ones with stronger pro-investor laws performed better on 11 out of 12 measures of stakeholder value, such as labour relations, community involvement, and environmental orientation.⁶ Thus, it appears that investors generally grow the pie for all, rather than splitting the pie to benefit only themselves.

These findings go against current thinking. There are many calls to restrict investor rights, believing that they extract value from stakeholders or interfere with the CEO's vision. Entrepreneurs certainly have substantial value for society. However, the pie-growing mentality stresses the importance of balance – between an entrepreneur's vision and investors' oversight, just as cars have both accelerator and brake pedals. There are several cautionary tales of once-promising businesses declining due to an untouchable founder, such as Woo-Choong Kim of Daewoo, Jerry Yang of Yahoo, and Andrew Mason of Groupon.

Some authors or influencers caricature current governance models as catering exclusively to investors, whom they in turn caricature as being focused only on the short-term. They then propose their own model of corporate governance, and it's easy to argue that theirs is better when the current system is presented as a caricature. It's also easy for them to argue that their calls for reform are radical, and thus their ideas to gain influence, when the current system is portrayed as being very backward. However, a careful consideration of the evidence suggests that investor rights are much more beneficial for long-term value than often believed.

Indeed, the current criticism of UK corporate governance is somewhat surprising, since the UK is seen by many other countries as a leader in corporate governance, and its Corporate Governance Code has been very influential in other codes worldwide. It's also inconsistent with the calls to tighten shareholder oversight of pay – for example, by giving shareholders binding say-on-pay votes. Some critics argue that, when it comes to pay, CEOs are crooks who will enrich themselves in the absence of shareholder scrutiny – yet the same critics argue that, when it comes to long-term strategy, if protected from the interference of pesky shareholders, they will suddenly behave in a socially optimal manner.

The findings also contradict arguments that workers should be put on boards, because they are more interested in the long-term, unlike investors who can sell at any time. It is critical for companies to take worker welfare very seriously – in Lecture 1 I presented evidence that employee satisfaction is correlated with long-term shareholder value, and I will shortly discuss reforms to ensure companies invest in their workforce. However, this is very different from putting workers on boards:

- Workers can leave at any time, whereas large shareholders cannot do so without lowering the stock price. They may have tens of millions invested in a company.
- Shareholders receive what's left after all other stakeholders have been paid, i.e. they are affected by how a company treats not only workers but all stakeholders. Poor treatment of workers, suppliers, customers, or the environment all harm the long-run stock price. Workers are not the “bottom-line” claimants and

³ Giroud, Xavier and Holger M. Mueller (2011): “Corporate Governance, Product Market Competition, and Equity Prices.” *Journal of Finance* 62, 563-600.

⁴ Gompers, Paul A., Joy Ishii, and Andrew Metrick (2009): “Extreme Governance: An Analysis of Dual-Class Firms in the United States.” *Review of Financial Studies* 23, 1051-1088.

⁵ Masulis, Ronald W., Cong Wang, and Fei Xie (2009): “Agency Problems at Dual-Class Companies.” *Journal of Finance* 64, 1697-1727.

⁶ Ferrell, Allen, Hao Liang and Luc Renneboog (2016): “Socially Responsible Firms.” *Journal of Financial Economics* 122, 585-606.



are not always affected by the stewardship of other stakeholders. For example, workers may oppose the closure of a polluting factory, or oppose the Night Tube even if customers support it.

- Workers may be more concerned with downside protection – preserving existing jobs rather than creating new ones, and with ensuring the longevity of a company even if it no longer creates value for society. Shareholders care about both downside protection and upside potential, and so will take risky investments with the potential to create new jobs. Indeed, a study found that “when labour has a voice in corporate governance”, 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.”⁷

Note that – like any evidence – these results are not universal and don’t apply in every setting. For example, there is evidence that insulation mechanisms may be beneficial when companies have long-term stakeholder relationships they wish to cement.⁸ However, it does mean that shareholders and stakeholders are more aligned than commonly thought. Moreover, it highlights the danger in one-size-fits-all approaches to governance – what’s optimal will vary across firms. This suggests that “comply-or-explain” guidelines – where a company either follows a guideline or explains why it has chosen not to – are preferable to hard-and-fast rules.

Overall, the evidence suggests that corporate governance reforms should ensure that companies grow the pie for both investors and stakeholders, rather than trying to help the latter by shackling the former.

What Should Be Reformed

With that in mind, I focus on three potential reforms. Each reform is substantive, so I do not believe that current governance is perfect and should be left unchanged. But equally I do not have a long list of potential reforms (even though doing so would make this lecture more radical), because a careful consideration of the evidence suggests that current corporate governance is far better than widely believed.

The first is to give investors a “say-on-purpose” vote. Currently, UK investors have a “say-on-pay” vote, and the EU Shareholder Rights Directive will give such a vote to investors in other EU countries. There are two elements to this vote – a forward-looking “policy vote” on a company’s pay policy, and a backward-looking “implementation vote” on the actual amounts that a company proposes to pay executives. While pay is an important company decision, purpose is even more important. As discussed in Lecture 1, purpose is how a company aims to grow the pie – its reason for existing and the role it plays in the world. An effective purpose statement acknowledges trade-offs between different stakeholders and (in some cases) between stakeholders and investors.

As with “say-on-pay”, a “say-on-purpose” vote can be split into two. The “policy vote” would ensure that investors have bought into company’s purpose including how it will manage any trade-offs, and that purpose is not an excuse to cheerfully ignore profits and be unaccountable for profits. It should also spur investors to understand the company’s purpose, and which metrics (beyond profits) that the company views as important given its purpose. The “implementation vote” would encourage investors to track the relevant metrics and hold the company accountable for delivering on its stated purpose.

The second is to reform executive pay away from complex, formula-driven bonuses to long-term shares. Long-term shares should also be given to both directors and employees. Giving shares to employees is important to ensure that they also benefit from the company’s success, and address concerns of fairness. It also ensures that employees and executives are rewarded more symmetrically. These reforms were fully described in Lecture 2,

⁷ Faleye, Olubunmi, Vikas Mehrotra, and Randall Morck (2006): “When Labor Has a Voice in Corporate Governance.” *Journal of Financial and Quantitative Analysis* 41, 489-510.

⁸ Johnson, William C., Jonathan M. Karpoff and Sangho Yi (2015): “The Bonding Hypothesis of Takeover Defenses: Evidence from IPO firms.” *Journal of Financial Economics* 117, 307-332.



“Executive Pay: What’s Right, What’s Wrong, and What’s Fixable” so I refer the reader to the transcript of that lecture.

The third is to make stakeholders a board-level issue. This can be done by creating board committees dedicated to particular stakeholders. For example, a Human Capital Committee would be responsible for all aspects of worker welfare – not only their pay, but also their training, engagement, discrimination issues, mental and physical wellness, etc. Depending on the company, an Innovation Committee or an Environment Committee may be relevant, or these could be folded into a Strategic Assets Committee which considers all stakeholders other than workers (who are sufficiently important to have a dedicated committee.) This approach is superior to putting stakeholder representatives on the board because, as discussed, they may only be concerned with the particular stakeholder they are representing (some decisions may pit the Worker Representative against the Environmental Representative). By law, UK directors currently all have the same responsibility – to investors with due regard to stakeholders. Teams work best when all members have the same goal – but just as each team member can have different roles, board members can sit on different committees.

Diversity

I finally tackle a thorny issue that is also the subject of many governance reform proposals, which is board diversity. Some countries have diversity quotas; some investors have a policy to vote against director nominations that fail to bring diversity up to a certain level. There are many very good reasons for such a policy – in particular, the view that diversity is desirable for intrinsic reasons, in the absence of any instrumental benefits. However, there are some arguments for such a policy based on the belief that it will improve firm performance. For example, the UK Corporate Governance Code consultation stated that:

“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.”

I am a very strong supporter of gender diversity, ethnic diversity, and more broadly diversity in all forms (in particular, diversity of thinking in addition to diversity on observable dimensions). I would benefit from diversity initiatives myself. However, despite my own views, I have to acknowledge that the evidence base for diversity improving performance is much weaker than commonly stated. For example, the “clear evidence” that the consultation referred to quotes only one study by a consulting firm, not published in any academic journal. As Professor Alice Gast, a leading social scientist at Kellogg, wrote about this and other studies of diversity, “These studies would certainly not be publishable in academic journals because of the elementary form of their data presentations. Such group comparisons do not reveal the strength of the relation between the participation of women and financial success. The analyses lacked even correlations relating the percentages of women on corporate boards to corporate outcomes or simple scatter plots of these relationships. Such studies do not meet the standards of the relevant academic disciplines, which are economics and management. Does it matter that the studies are academically substandard? The answer to this question is an emphatic yes.”⁹

The study quoted in the consultation claims to find that diversity is positively linked to both profitability and stock price growth. Unfortunately, it has very basic flaws:

- It ignores very basic control variables, such as firm size, age, growth opportunities, recent performance etc. Small firms and young firms typically have lower profitability.

⁹ Eagly, Alice H. (2016): “When Passionate Advocates Meet Research on Diversity, Does the Honest Broker Stand a Chance?” *Journal of Social Issues* 72, 199-222.



- Performance is measured over only a two-year horizon – a particular issue for a governance reform since corporate governance is about creating long-term value for society.
- The study does not check for statistical significance. Given the very short time periods, the results could be driven by luck or outliers.
- The stock price growth measure ignores dividends, which is a very basic omission.
- The study uses inconsistent time periods. It uses 2003-5 for profitability, and 2005-7 for stock price growth, making one wonder whether it selected the time periods that led to the most favourable results.
- It fails to distinguish correlation from causation. It may be that a high-quality board understands the intrinsic value of diversity, and appoints women executives; in addition, a high-quality board improves firm performance anyway. Thus, there is a positive correlation between diversity and firm performance without causation. Or, causation could run the other way. Perhaps only once a company starts to perform well can it be forward-thinking about diversity and appoint women to senior roles (regrettably, given prior biases, the “default” or “safe” option might have been to appoint men).

The reason for covering these issues in the lecture is *absolutely not* to embarrass the authors of this particular study, nor the Consultation. Very many studies of diversity have made similar errors, and very many other bodies have believed there is “clear evidence” for the benefits of diversity. It is instead to highlight how critical we must be with evidence – a major theme throughout my lectures. We must be especially discerning on evidence about issues that we personally feel strongly about – being a big supporter of diversity, I would be tempted to take at face value any evidence suggesting that diversity is beneficial. This study has been influential despite such basic errors, highlighting the severity of “confirmation bias” in issues that people feel passionately about. As Professor Eagly writes:

“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”

What does the rigorous evidence show? Professor Katherine Klein, a leading management scholar at Wharton, summarises the evidence as follows¹⁰:

“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.”

What does the evidence mean for diversity initiatives? It *does not at all* mean that such initiatives are misguided. As emphasised above, diversity is beneficial for intrinsic reasons even in the absence of any instrumental effect on performance. Instead, the role of evidence is to make the effects and trade-offs clear, so that investors and policymakers can make informed decisions. Investors and policymakers can certainly push for diversity in its own right, but should not do so expecting any significant effect on performance. Thus, those concerned with performance should not implement it in a “box-ticking” manner that ignores other aspects of board composition that may affect performance. As Professor Klein concluded: “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.”

¹⁰ Klein, Katherine (2017): “Does Gender Diversity on Boards Really Boost Company Performance?” *Knowledge@Wharton*



As I concluded in my submission to the Corporate Governance code consultation: “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.”

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