Response to the European Commission Study on Sustainable Corporate Governance

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Introduction

Thank you for considering this feedback. I am a Professor of Finance and Academic Director of the Centre for Corporate Governance at LBS, formerly a tenured professor at Wharton, who specialises in corporate governance and responsible business. I have published on these topics in all the top finance journals; written a book, "Grow the Pie: How Great Companies Deliver Both Purpose and Profit"; given a Gresham College public lecture series on "How Business Can Better Serve Society"; given a TEDx talk on "The Social Responsibility of Business"; testified orally in the UK government's inquiry into corporate governance; serve on the Steering Group of The Purposeful Company, a UK think tank that aims to embed purpose in business; and serve on Royal London Asset Management's Responsible Investment Advisory Committee. This broad mix of academic, practitioner and policy expertise forms the basis of this feedback.

Approach

I commend the European Commission for producing an extremely timely report and for being committed to ensuring that business works for wider society, not just short-term profit. However, given the substantial risk of unintended consequences, it is essential to base any reform on the highest-quality evidence. In places, the evidence presented in the report is very one-sided and low-quality. At times, it reads as if the authors have already decided that companies and markets are short-termist, and that short-termism is a cause of most of society's major problems, and then have searched for all evidence – regardless of quality – to support this contention, while ignoring even high-quality evidence that suggests the opposite.

This matters. While short-termism is indeed a problem, not every aspect of the economy is short-termist, and short-termism is not the cause of every problem in society. An accurate diagnosis of the problem is critical in order to guide the appropriate treatment, rather than labelling everything as short-termist and interfering with parts of the economy that are generally well-functioning.

Note that this concern is not due to any personal bias. My research and policymaker/practitioner engagement highlight the importance of long-term stakeholder value, so I personally benefit from evidence claiming that the current system is short-termist and needs to be radically reformed. However, I believe even more strongly in the importance of following the most rigorous evidence, regardless of what it finds. I serve as Managing Editor of the *Review of Finance*, the #1 finance journal in Europe, and gave the TED talk "What to Trust in a Post-Truth World" on the importance of evidence quality and the dangers of confirmation bias.

The following thoughts are grounded in rigorous academic research, which uses large scale datasets and, in many cases, demonstrates causation rather than correlation. Certainly, evidence should not be used dogmatically – we should be guided by evidence, not blindly follow it. Moreover, <u>it is important to be critical of the evidence. There is a huge range in quality of academic evidence, and most papers are wrong, or at best misleading</u>. At the *Review of Finance*, I reject 97% of papers; lower-ranked journals have substantially laxer standards. <u>It is almost always possible to find "evidence" that supports what one would like to show, often ignoring the quality of the journal in which it was published, or whether it has even been published</u>. The peer review process at the very top academic journals is critical to ensure the integrity of evidence. Many papers remain unpublished after several years because they have constantly failed peer review due to major mistakes. Almost all papers I cite here are either published in the very top journals, or "revise-and-resubmits"[1] in them.

It is surprising that such an influential document was produced by a consultancy with no academic coauthors. I recognise that academics were interviewed, but this is very different from an academic being a coauthor. I have very deep respect for practitioners and they have much greater knowledge of individual companies that any academic. But, for a study which aims to be grounded on evidence, academic oversight is necessary.

<u>Executive Summary</u>

1. <u>Shareholder value is an inherently long-term concept</u>. The study frequently uses the phrase "short-term shareholder value" and its variants. This makes no sense, because shareholder value is an inherently long-term concept – it includes all of the future cash flows of a company. A company that cuts value-creating investments in stakeholders is maximising short-term profit but harming shareholder value. Thus, the solution to short-termism is actually a greater focus on shareholder value, not less.

[1] In top academic journals, 90-95% of papers get rejected. Only 5-10% get a "revise-and-resubmit" decision, which means that the Editor is giving the authors a chance to address his and the peer reviewers' concerns. Upon a "revise-and-resubmit", the probability of acceptance rises from 5-10% to 65-70%.

2. Shareholder value and stakeholder value are aligned in the long-term. The study implicitly assumes a "fixed pie" mentality throughout, where the only way to increase stakeholder value is to reduce shareholder value; conversely, reducing shareholder value will automatically increase stakeholder value. However, the pie is not fixed. Evidence shows that a greater focus on shareholder value (not short-term profit) leads to an increase in stakeholder value. In contrast, reducing the CEO's accountability for shareholder value can lead to her pursuing her own interests, shrinking the pie for both shareholders and stakeholders.

3. Quantitative ESG metrics are inherently incomplete. There is a significant role for quantitative ESG metrics, but they must be used with extreme caution as they omit many important qualitative dimensions. For example, quantitative measures of jobs created, wages, and working hours ignore many important qualitative dimensions such as meaningful work, skills development, and corporate culture. Thus, while companies should set targets and report on progress, they should beware of focusing excessively on meeting goals else they may "hit the target, miss the point". For the same reason, such targets should generally not be included in remuneration packages.

4. Shareholder payouts have a key role in creating value for wider society. Dividends and especially share buybacks are two of the most misunderstood corporate actions. Many of the accusations are based on no evidence, and in fact strongly contradicted by the evidence. For example, while both lead to a short-term stock price increase, the long-term stock price rises even more. Moreover, both forms of payout are critical to reallocate capital away from mature firms with poor investment opportunities to growing firms with good investment opportunities. While there are cases in which shareholder payouts are misused, they are often the symptom of underlying problems (e.g. short-term pay packages or a focus on quarterly earnings) rather than the problem itself. Solutions should tackle the root cause.

5. The focus on long-horizon investors, and encouraging them through loyalty schemes, is based on a fundamental misunderstanding. It mixes up the *horizon* of an investor (whether they hold for the long-term or short-term) with their orientation (whether they sell based on short-term or long-term information). An investor may sell a company, despite good short-term earnings, because it is insufficiently investing for the long term. Encouraging long-horizon investors may lead to investors remaining with the company regardless of its treatment of stakeholders, thus entrenching management.

6. Sustainability cannot be legislated; attempts to do so will lead to compliance rather than commitment. The study treats sustainability as a compliance exercise, suggesting that it is something that companies need to be forced to do because a focus on "short-term shareholder value" would lead to companies ignoring sustainability. A far more effective approach is to emphasise the business case for sustainability – that it is in a company's own interest to take sustainability seriously, as doing so improves long-term company performance and thus shareholder value. This will encourage companies to truly embed sustainability, rather than doing so to the minimum possible to comply with the law. The emphasis is "long-term", so any regulatory changes should be to encourage a long-term focus, rather to discourage a shareholder value focus. In contrast, regulatory changes to attempt to legislate sustainability may backfire – for example, companies may focus only on the quantitative sustainability measures included in executive pay contracts, rather than the very many qualitative dimensions of sustainability.

Detailed Comments

I will focus only on the issues in the study on which I have the greatest expertise, rather than covering all topics.

1. Problem Definition

1.1 Before proposing solutions, it is critical that we diagnose the problem accurately – just as in medicine, the appropriate treatment depends on the diagnosis. However, the first sentence of the abstract contains an important misunderstanding that pervades much of the study. It refers to "short-term shareholder value maximisation" (the first "key problem driver" makes a similar reference). This does not make sense, because shareholder value is an inherently long-term concept. Shareholder value is the present value of all future cash flows that a company generates. This is not just abstract theory; in practice, some of the world's most valuable companies are tech firms whose market valuations are orders of magnitude higher than implied by their short-term profits.

1.2 This is not just a semantic issue but one of fundamental importance. Many of the study's recommendations are to move towards a stakeholder model because it is assumed to be long-term, but shareholder value is an inherently long-term concept. Shareholder value takes long-term investment in stakeholders seriously – ethical treatment of workers, preservation of the environment, and building customer trust all increase a company's long-term cash flows and thus shareholder value. While there do exist "true" externalities, which are not internalised by shareholders even in the very long run, shareholder value and stakeholder value are much more aligned than the study implies. Advocates of stakeholder capitalism often promote "anti-shareholder capitalism", based on a fixed pie mentality that shareholder value is at the expense of stakeholder value, and the only way to increase the latter is to reduce the former. However, rigorous evidence supports the *pie-growing mentality*, that both are highly correlated.

1.3 Thus, while I fully agree with the advocacy of long-horizons, it is logically incorrect to equate "shareholder value" with "short horizons" or to argue that long horizons require a move away from a shareholder value model. For further details, see my article "What Stakeholder Capitalism Can Learn From Milton Friedman."

1.4 Certainly, it may be that executives are focusing excessively on "short-term profits" or the "short-term stock price" and the European Commission could play a major role in deterring such behaviour. However, the problem is "short-term stock price maximisation" or "short-term profit maximisation", not "short-term shareholder value maximisation". I fully recognise that markets are inefficient; the stock price might deviate from shareholder value if it myopically underweights future cash flows. Then, a executive could scrap investments in stakeholders, maximising the short-term stock price but harming shareholder value. But the solution is *more*, not less focus on shareholder value – for example, to pay executives with equity that they cannot sell for 5-10 years, rather than the current practice of bonuses based on short-term profit.

1.5 Critically, this solution remains within the shareholder value model and does not require an untried, untested approach of incorporating ESG metrics in CEO pay. Equally critically, this solution is buttressed by evidence. Flammer and Bansal (2017)[2] show that giving the CEO long-term incentives improves not only long-term profitability, but also various stakeholder outcomes such as innovation (the number and quality of patents produced) and ESG metrics pertaining to the environment, customers, society and, in particular, employees. They use a regression discontinuity approach to show that the effect is causation, not just correlation. Thus, long-term incentives induce the CEO to grow the pie for the benefit of both shareholders and stakeholders, rather than to split the pie in favour of shareholders and against stakeholders.

[2] Flammer, Caroline and Pratima Bansal (2017): "Does Long-term Orientation Create Value? Evidence From a Regression Discontinuity." *Strategic Management Journal* 38, 1827-1847.

1.6 Relatedly, "The Core Problem" on p.vi argues that the "upward trend in shareholder pay-outs" is evidence of a "focus on short-term benefits of shareholders rather than on the long-term interests of the company". This diagnosis is incorrect for several reasons (for more detail, see my *Harvard Business Review* article "The Case For Stock Buybacks"):

1.6.i While shareholder pay-outs indeed increase the short-term stock price, they increase the long-term stock price even more: see the seminal papers of Michaely, Thaler, and Womack (1995)[3] for dividends and Ikenberry, Lakonishok, and Vermaelen (1995)[4] for repurchases. While these papers were on older data (since they are seminal papers) and on the US, new research has found that the results continue to hold using more recent data from around the world, e.g. Manconi, Peyer, and Vermaelen (2019).[5]

1.6.ii It is not true that shareholder payouts are at the expense of society or stakeholders. One of the most wasteful actions that an executive can undertake is overinvestment, which uses both shareholders' and society's resources. There are countless examples of companies destroying substantial value through overexpansion, both through organic growth and M&A. Responsible companies know when to invest and when to show restraint. Once they have taken all profitable investments, and build up a buffer stock of cash, they should pay out surplus capital rather than wasting it.

1.6.iii Claiming that shareholder payouts stifle investment is "partial equilibrium thinking". It is true that, for the company in question, the cash paid out cannot be invested. But, shareholders will not sit idly on this cash (else they will not earn a return); they redeploy it to fast-growing companies that need the cash – this is "general equilibrium thinking". The reason that tech start-ups can attract substantial long-term funding – despite few short-term profits – is because investors have cash that has been paid out by mature businesses. It is well accepted that, in a conglomerate, the headquarters should reallocate cash from mature divisions to growing ones. Shareholder payouts allow this reallocation to happen between firms, not only between divisions of the same firm. Indeed, Chen

[3] Michaely, Roni, Richard H. Thaler and Kent L. Womack (1995): "Price Reactions to Dividend Initiations and Omissions: Overreaction or Drift?" *Journal of Finance* 50, 573-608.

[4] Ikenberry, David, Josef Lakonishok and Theo Vermaelen (1995): "Market Underreaction to Open Market Share Repurchases." *Journal of Financial Economics* 39, 181-208.

[5] Manconi, Alberto, Urs Peyer and Theo Vermaelen (2019): "Are Buybacks Good for Long-term Shareholder Value? Evidence from Buybacks Around the World" *Journal of Financial and Quantitative Analysis* 54, 1899-1935.

(2018)[6] follows the money and finds that the cash paid out by large firms is indeed reinvested in smaller firms.

1.6.iv The concern that CEOs use share buybacks to hit earnings per share (EPS) targets in bonus contracts is contradicted by the evidence. Bennett, Bettis, Gopalan, and Milbourn (2017)[7] find that CEOs undertake many actions to hit EPS targets, such as cutting R&D, but share buybacks are not one of them. The UK government jointly appointed PwC and me to conduct a study into the alleged misuse of share buybacks.[8] We found that not a single FTSE 350 firm used share buybacks to successfully hit a bonus target. Moreover, Brav, Graham, Harvey, and Michaely (2005)[9] find that executives first make investment decisions and, only once they have taken all profitable investments will they consider repurchasing stock – rather than buying back stock to hit targets and then making investment decisions out of the remaining cash.

1.6.v Even though buybacks are not driven by EPS targets, they may be driven by other myopic factors, such as quarterly earnings forecasts (Almeida, Fos, and Kronlund (2016))[10] or imminent vesting of equity (Edmans, Fang, and Haung (2020))[11], as correctly pointed out in the study. However, such buybacks are the symptoms of underlying problems (e.g. quarterly reporting or short-term equity pay) rather than the problem themselves. Solutions should be targeted at the underlying problems, not the symptoms. A crackdown on buybacks could have severe unintended consequences by deterring efficient payouts that prevent overinvestment in the paying company and allow the capital to be reallocated in other companies. Moreover, if buybacks were restricted, companies would still cut investment to meet quarterly earnings targets or boost the short-term stock price, and simply hold onto the cash.

1.7 It is disappointing that the evidence cited in Section 3.1.1 in particular is both one-sided and low-quality. For example, the footnotes on p9 contain 12 articles arguing that stock buybacks are short-termist, but only one of them has been published in a top journal. That paper, by

[6] Chen, Huaizhi (2018): “Capital Redeployment in the Equity Market.”
[7] Bennett, Benjamin, J. Carr Bettis, Radhakrishnan Gopalan, and Todd T. Milbourn (2017): “Compensation Goals and Firm Performance.” *Journal of Financial Economics* 124, 307-330.
[8] “Share Repurchases, Executive Pay and Investment.” BEIS Research Paper Number 2019/011.
[9] Brav, Alon, John R. Graham, Campbell R. Harvey, and Roni Michaely (2005): “Payout Policy in the 21st Century.” *Journal of Financial Economics* 77, 483-527.
[10] Almeida, Heitor, Vyacheslav Fos and Mathias Kronlund (2016): “The Real Effects of Share Repurchases” *Journal of Financial Economics* 119, 168-185.
[11] Edmans, Alex, Vivian W. Fang and Allen Huang (2020): “The Long-Term Consequences of Short-Term Incentives.”

Almeida, Fos, and Kronlund (2016)[12], does not argue that stock buybacks in general are bad, but that stock buybacks induced by the desire to meet quarterly earnings forecasts may be bad – the underlying problem is quarterly reporting.

1.8 In particular, the research by William Lazonick is copiously cited even though none of it has been published in even a second-tier academic journal. The papers make very basic mistakes which would not even pass an Accounting 101 class, let alone peer review. For example, his 2014 article laments that 91% of net income went to investors, which "left very little for investments in productive capabilities or higher incomes for employees". But this statistic makes a very basic mistake. Net income is already after deducting wages, other expenditures on colleagues such as training or wellness programmes, and intangible investments such as R&D and advertising.

1.9 The bespoke analysis in Section 3.1.1 is also of very poor quality and would not pass the requirement for even a first year PhD student paper. It contains charts showing the evolution of total payout vs. net income, without any control variables whatsoever. There are very many factors that determine a company's optimal payout ratio, but these are ignored in the quest to claim "short-termism".

1.10 The evidence in Section 3.1.2 on the consequences of short-termism cites many papers published in lower-level journals which document correlations but not causation. Again, the presentation of the evidence is very one-sided, as if the authors had already decided that short-termism is a problem and then searched for evidence to support this contention. It is not difficult to find evidence suggesting the opposite. For example, Kaplan (2018) "Are US Companies Too Short-Term Oriented"[13] and Roe (2020): "Stock Market Short Termism's Impact"[14] argue that companies and markets are far less short-termist than people believe.

1.11 Again, I believe that short-termism is a major problem and that quarterly earnings is a cause, so I would personally like these papers not to exist. However, it is critical to have a balanced portrayal of the evidence. For example, I cover the Kaplan paper on my blog.

[12] Almeida, Heitor, Vyacheslav Fos and Mathias Kronlund (2016): "The Real Effects of Share Repurchases" *Journal of Financial Economics* 119, 168-185.

[13] Kaplan, Steven N. (2018): "Are US Companies Too Short-Term Orientated? Some Thoughts." *Journal of Applied Corporate Finance* 30, 8-18.

[14] Roe, Mark J. (2020): "Stock Market Short Termism's Impact."

2. Problem Driver 1: Directors' duties and company's interest are interpreted narrowly and tend to favour the short-term maximisation of shareholder value

2.1 As mentioned in points 1.1-1.4 above, "short-term maximisation of shareholder value" does not make sense since shareholder value is an inherently long-term concept. However, I do agree that some directors and executives may be maximising the short-term stock price. For example:

2.1.i Edmans, Fang, and Lewellen (2017)[15] find that, when CEOs' equity is about to vest, they cut R&D and capital expenditure, and are more likely to just meet analyst earnings forecasts.

2.1.ii Graham, Harvey, and Rajgopal (2005)[16] find that 80% of CFOs would scrap value-creating long-term projects to meet an earnings benchmark.

2.1.iii Bhojraj, Hribar, Picconi, and McInnis (2009)[17] compared firms that just beat analyst forecasts due to low R&D, low advertising or high accruals, with those who just missed due to high R&D, high advertising or low accruals. Beaters outperformed missers by 2% to 4% in the short-term, suggesting that the market took the earnings increase at face value. However, over the next three years, they underperformed by 15% to 41%, suggesting that these actions harm long-run value.

2.2 Even though there is indeed evidence of short-term behaviour by CEOs, it is important to be precise about the cause of the problem – short-term stock price or profit maximisation, not short-term shareholder value maximisation. As mentioned earlier, this is not just a semantic distinction but a fundamental one. It means that the solution is to make directors truly accountable for (long-term) shareholder value – being incentivised with shares that they cannot hold for 5-10 years, rather than asking them to "properly balance the … interests" of both stakeholders and shareholders.

2.3 There are several problems with redefining directors' duties to balance stakeholder and shareholder interest.

15 Edmans, Alex, Vivian W. Fang and Katharina A. Lewellen (2017): "Equity Vesting and Investment" *Review of Financial Studies* 30, 2229-2271.

16 Graham, John R., Campbell R. Harvey and Shivaram Rajgopal (2005): "The Economic Implications of Corporate Financial Reporting" *Journal of Accounting and Economics* 40, 3-73.

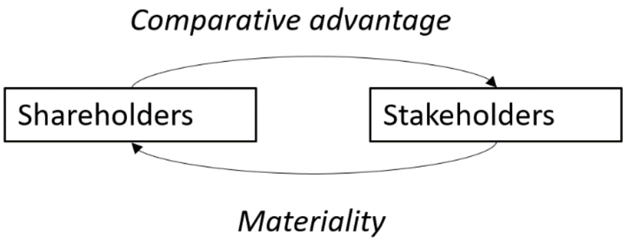
17 Bhojraj, Sanjeev, Paul Hribar, Marc Picconi, and John McInnis (2009): "Making Sense of Cents: An Examination of Firms that Marginally Miss or Beat Analyst Forecasts" *Journal of Finance* 64, 2361-2388.

2.3.i Directors may become unaccountable, because “balance” is hard to define. Many decisions benefit some stakeholders but harm others. If an energy company closes a polluting plant, this helps the environment but hurts employees. Which decision – closure or non-closure – best represents “balancing” these interests? It is far from clear. What weights should the CEO apply to the environment versus employees when making her decision? This is also far from clear.

2.3.ii In real life, citizens make many decisions balancing multiple interests – for example, they will balance salary and working conditions when choosing a job. But, it is the citizen who bears the consequences of his actions, so it does not matter that he applies his own weights. However, the CEO is an agent of shareholders (or, some argue, society at large) so it is dangerous if she applies her own weights. She may overweight stakeholders that she personally happens to favour, or be susceptible to lobby groups. Both closure and non-closure could be said to “balance” interests (if the CEO chooses closure, she can say that the environment is more important; if she chooses non-closure, she can say that employees are more important). Thus, the CEO can make whatever decision she likes, and thus be unaccountable.

2.3.iii Arguments for redefining directors’ duties away from shareholders and towards stakeholders are based on a fixed-pie mentality that directors who focus on shareholders will pay insufficient attention to stakeholders; conversely, reducing the focus on shareholders will automatically increase the attention to stakeholders. However, the pie is not fixed. Reducing accountability to shareholders could shrink the pie, *harming both shareholders and stakeholders*. It could lead to accountability to no-one and the CEO pursuing her personal interests.

2.3.iv When directors are accountable to shareholder value, there is a clearer way to resolving these trade-offs. Companies will place greater weight on stakeholders they have a *comparative advantage* in serving, as then a given investment by shareholders generates the greatest value to stakeholders. They will also place greater weight on stakeholders that are *material* to the business as then a given amount of value created for stakeholders generates the greatest value to shareholders.



2.4 In sum, I strongly support emphasising that directors take the long-term interests of shareholders and the company into account, and that identifying and mitigating sustainability impacts is part of directors' duty of care. I support emphasising that directors take into account "long-term interests of the company; interest of employees; interest of customers; interest of local and global environment; interest of society at large" but not that they be "balanced … alongside the interest of shareholders" as this will reduce accountability.

3. Problem Driver 2: Growing pressures from investors with a short-term horizon contribute to increasing the boards' focus on short-term financial returns to shareholders at the expense of long-term value creation

3.1 This problem driver confuses two issues. It refers to "investors with a short-term horizon", but the *horizon* of an investor is fundamentally different from its *orientation*. The former is how long an investor holds shares before it sells. The latter is the basis – long-term value or short-term profits – that triggers an investor to sell. Critically, having a long-term orientation may not entail holding for the long-term. (For further detail, see my *Harvard Business Review* article "The Answer to Short-Termism Isn't Asking Investors To Be Patient.")

3.2 The common argument against short-horizon investors is the following. They sell shares in a firm that has delivered poor short-term earnings. This pressures managers to increase short-term earnings (to avoid their shares being sold), by cutting investment. However, selling could instead be motivated an analysis of long-term value. It could be that an investor sells, despite short-term earnings being high, because it recognises that the company has not invested enough for the long-term. For example, Ford hit record profits in 2015 and 2016, but many investors sold because they were concerned that Ford was not investing enough in electric and self-driving cars. This drove the stock price down and contributed to CEO Mark Fields being fired.

3.3 Thus, what matters is whether shareholders *trade on short-term or long-term information* – which is what I mean by an investor's *orientation* – not whether shareholders *hold for the short-term or long-term*. In particular, short-term trading can based on long-term information; selling in the short-term does not mean taking a short-term perspective (Edmans (2009)).[18]

3.4 In contrast, patient investors, who retain their stake regardless of performance, are widely lauded. However, *unconditional* loyalty is undesirable, as it means that investors remain with the firm even if it is exploiting its stakeholders and failing to invest for the future. Such patience merely entrenches management. What we want is *conditional* loyalty – a shareholder who stays with a firm, even if short-term earnings are low, as long as the firm is pursuing long-run value – but will exit if the company is prioritising the short term. Shareholders who sell their shares in a non-purposeful company are exerting discipline rather than being short-termist.

3.5 The criticism of selling is surprising because it is generally accepted that divestment is a legitimate governance mechanism. Investors sometimes have *generalised divestment* policies, which will involve selling a company (or not investing in it) due to the industry or country it is in, or another criterion that can be applied across all companies such as insufficient board diversity. However, there may be even greater need for investors to engage in *specialised divestment*, based on firm-specific factors such as a company's contribution to society, intangible assets, and strategic direction. Customers can easily assess a firm's industry or country and organise boycotts, but are less likely to be able to evaluate these deeper issues. So large investors have a particular role in such evaluations, given their access to management and financial incentives to monitor.

3.6 How can we ensure shareholders trade on long-term information? By encouraging them to take large stakes. Gathering information on a firm's long-run investment and treatment of workers, suppliers, customers, and the environment is costly. Small shareholders have little "skin in the game" and so will not bother to bear this cost; instead, they will base their trading decisions on short-term earnings, as this information is freely available – "the market sells first and asks questions later." In contrast, blockholders' large stakes give them the incentives to ask questions first and analyse long-term value (Edmans (2009)). If a firm has delivered low earnings due to investment, blockholders will not sell (and may buy more). Informed

[18] Edmans, Alex (2009): "Blockholder Trading, Market Efficiency, and Managerial Myopia." *Journal of Finance* 64, 2481-2513.

blockholders insulate managers from the need to cater to short-term pressures, and free them to focus on long-term purpose.

3.6.i Warren Buffett's strategy is to take large stakes in companies and allow them to build their brand for the long-term. Since management knows that Buffett will be basing his evaluations on long-term information, due to his large stake, they are free to build their brand rather than focusing on short-term profit. But, Buffett is conditionally, not unconditionally, loyal. If the firm has not built its brand after several years, he sells his stock. In sum, stake size, not holding period, is key.

Policies to Increase Shareholding Periods

3.7 I am deeply concerned with the study's intention to promote policies to lengthen shareholding periods, which are based on no evidence that they are beneficial. Such policies may involve a higher capital gains tax on short-term holdings or "loyalty shares", which give shareholders additional dividends or voting rights if they hold their shares for a minimum period. Over and above the arguments earlier in this section, there are numerous problems with such proposals:

3.7.i It deters new shareholders forming a large stake. Shareholders can only buy if other shareholders sell. While an obvious point, this seems to be virtually ignored in the criticism of selling. Indeed, Holderness and Sheehan (1988)[19] and Barclay and Holderness (1991)[20] find that trades of large blocks between investors lead to a significant increase in firm value, consistent with the block being reallocated to a more effective monitor. To encourage block formation, we need to facilitate selling for two reasons. First, if existing investors face disincentives to sell, there are fewer shares for new blockholders to buy. Second, if potential new investors know that they will be locked up for several years, they will be less willing to buy a large block in the first place.

3.7.ii Once the investor has formed its block, it is less willing to bear the costs of gathering long-term information if it knows that it will be unlikely to sell due to trading

[19] Holderness, Clifford G. and Dennis Sheehan (1988): "The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis." *Journal of Financial Economics* 20, 317–346.
[20] Barclay, Michael J. and Clifford G. Holderness (1991): "Negotiated Block Trades and Corporate Control." *Journal of Finance* 46, 861–878.

restrictions (Edmans (2009)). Instead, investors will simply accept a firm's high earnings and not bother to find out if they are instead driven by short-term manipulation.

3.7.iii It encourages only *holding* for the long-term, rather than *engagement* or *monitoring*. Investors can now outperform the benchmark by simply holding their stake to collect the loyalty dividend.

3.7.iv Once an investor has reformed a company, you would like it to take its capital and reform another company. Lock-ups would deter this.

3.7.v If an investor has to wait several years before receiving full voting rights, it will be unable to engage. Thus, such proposals may entrench management, and stifle good ideas. It would similarly be undesirable to force new employees to wait a few years before they can participate in employee town halls, or vote for employee representatives.

3.7.vi What matters is an investor's (conditional) <u>holding period going forwards rather than in the past</u>. That an investor has held shares for many years in the past does not imply that it will continue to do so in the future. Indeed, with a higher capital gains tax for short holding periods, an investor who has held shares for many years will be more likely to sell.

<u>The Evidence for the Benefits of Trading</u>

3.8 The criticism of liquidity first appeared in the early 1990s when commentators advocated the Japanese model of long-term illiquid stakes. The underperformance of Japan over the intervening 25 years suggests that this model is not the panacea previously thought. While this underperformance may be for many reasons other than liquidity, there is evidence on the direct effect of liquidity on firm value. This evidence is causal. Simply correlating liquidity with firm value is not proof that liquidity improves firm value, as it may be that higher firm value increases liquidity or a third variable causes both. These studies use the decimalization of the major U.S. stock exchanges in 2002 as an exogenous shock to liquidity. Before, prices were quoted in 1/16ths of a dollar; after, they were quoted in 1/100ths of a dollar. For example, if a stock used to cost \$8 1/16 (= \$8.0625) to buy and \$8 to sell, post-decimalization it might cost \$8.01 to buy and \$8 to sell, significantly reducing the cost of trading.

3.8.i Fang, Noe, and Tice (2009) found that decimalization had a positive causal effect on firm value.[21]

3.8.ii Bharath, Jayaraman, and Nagar (2013) [22] found that this positive effect was particularly strong in firms with large blockholders and in firms where the manager's wealth was particularly sensitive to the stock price (i.e. the manager was particularly sensitive to governance through exit).

3.8.iii Edmans, Fang, and Zur (2013) found that decimalization had a positive causal effect on block formation, and that governance through exit improves firm value. [23]

3.9 However, I agree with the recommendation to move away from quarterly earnings guidance and quarterly reporting.

4. Problem Driver 3: Companies lack a strategic perspective over sustainability and current practices fail to correctly identify and manage relevant sustainability risks and impacts

4.1 I agree with the value of measurable sustainability targets but would emphasise caution. Many of the most important dimensions of sustainability cannot be measured. You can measure the number of jobs created and the wages paid to employees, but not meaningful work, skills development, or corporate culture. You can measure demographic diversity but not diversity of thinking or whether the company actively seeks dissenting viewpoints.

4.2 It is well-known that focusing on measurable financial objectives causes perverse behaviour (e.g. a focus on quarterly earnings). It is also well-known that focusing on measurable non-financial objectives causes perverse behaviour (e.g. focusing on students' test scores when evaluating teachers encourages "teaching to the test"). Thus, measurable sustainability targets should not be put on a pedestal.

[21] Fang, Vivian W., Thomas H. Noe, and Sheri Tice (2009): "Stock Market Liquidity and Firm Value." *Journal of Financial Economics* 94, 150-169.
[22] Bharath, Sreedhar T., Sudarshan Jayaraman, and Venky Nagar (2013): "Exit as Governance: An Empirical Analysis." Journal of Finance 68, 2515-2547.
[23] Edmans, Alex, Vivian W. Fang, and Emanuel Zur (2013): "The Effect of Liquidity on Governance." *Review of Financial Studies* 26, 1443-1482

4.3 While companies should indeed set measurable sustainability targets, they should be aware that such targets are necessarily incomplete and ignore important qualitative dimensions. They should not be so focused on meeting these targets that they “hit the target, miss the point”.

4.4 In addition to being incomplete, over-provision of measurable sustainability targets will encourage investors to evaluate companies superficially, using these targets to tick boxes, rather than deeply getting into the weeds of a company, meeting management, and visiting its stores or factories. It is similar to an over-reliance on using big data and psychometric tests to assess potential new hires for a company rather than interviewing them.

5. Problem Driver 4: Board remuneration structures incentivise the focus on short-term shareholder value rather than long-term value creation for the company

5.1 I strongly agree with paying directors and executives according to the long-term stock price. See http://alexedmans.com/simplicity and Chapter 5 of “Grow the Pie”.

5.2 However, I have serious concerns about tying pay to ESG metrics. This can lead to the problem of “hit the target, miss the point”, where CEOs focus on meeting the ESG dimension captured in the target at the expense of non-measured ESG dimensions – for example, demographic diversity rather than diversity of thinking, or employee wages rather than working conditions and meaningful work. The problems with tying pay to specific targets have been documented extensively for decades, most notably in Steven Kerr’s classic article “On the folly of rewarding A, while hoping for B”.

5.3 I agree with setting measurable ESG targets (see part 4), since it is important for managers internally to be able to track progress, and for investors and stakeholders externally to hold the company to account. However, there is a big leap between tracking a measure and incorporating it into a pay contract – teachers track student test scores, but linking pay to them would create perverse incentives. Goodhart’s Law states “when a measure becomes a target, it ceases to be a good measure.”

5.4 The long-term stock price is a comprehensive measure, as it takes into account not only shareholder value, but also very many measures of stakeholder value. See Edmans (2011, 2012) for employee satisfaction,[24] Fornell et al. (2006)[25] for customer satisfaction, Derwall et al. (2005)[26] for environmental efficiency, Eccles, Ioannou, and Serafeim (2014)[27] for sustainability policies, and Khan, Serafeim, and Yoon (2016)[28] for material stakeholder issues.

5.5 Indeed, as explained earlier, Flammer and Bansal (2017) show that long-term equity incentives cause the CEO to increase innovation and various measures of stakeholder value. The best way to improve stakeholder performance is to incentivise the CEO to grow the pie for both stakeholders and shareholders, rather than to split the pie differently. This requires giving her a slice of the pie, i.e. long-term equity. When the CEO knows she is paid according to long-term value, she will invest for the long term.

6. Problem Driver 5: The current board composition does not fully support a shift towards sustainability

6.1 I strongly disagree with creating a new board role of the Chief Value Officer. Sustainability should be the responsibility of the full board, rather than a niche issue to be delegated to a particular board member. Every director should be concerned with value; every director should be a Chief Value Officer.

6.2 Indeed, by presenting the business case for sustainability, rather than treating sustainability as a compliance exercise, the full board will voluntarily wish to take sustainability seriously as they will recognise that it improves long-term value.

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[24] Edmans Alex (2011): "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices" *Journal of Financial Economics* 101, 621-640. Edmans, Alex (2012): The Link Between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility" *Academy of Management Perspectives* 26, 1-19.

[25] Fornell, Claes, Sunil Mithas, Forrest V. Morgeson III and M.S. Krishnan (2006): "Customer Satisfaction and Stock Prices: High Returns, Low Risk" *Journal of Marketing* 70, 3-14.

[26] Derwall, Jeroen, Nadja Guenster, Rob Bauer and Kees Koedijk (2005): "The Eco-Efficiency Premium Puzzle" *Financial Analysts Journal* 61, 51-63.

[27] Eccles, Robert, Ioannis Ioannou and George Serafeim (2014): "The Impact of Corporate Sustainability on Organizational Processes and Performance" *Management Science* 60, 2835-2857.

[28] Khan, Mozaffar, George Serafeim and Aaron Yoon (2016): "Corporate Sustainability: First Evidence on Materiality" *The Accounting Review* 91, 1697-1724.