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The "Ignored" Third Dimension of Corporate Governance

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Keywords: controlling ownership, corporate governance, innovation, investor relations, shareholder value, widely dispersed ownership

JEL Classifications: G01, G34, K20, K22, L22, L25, O16

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The problem of the separation of ownership and control has always been central in the corporate governance debate. It is hard to overestimate the resources and research that policymakers and academics have devoted to better understand and manage the performance and risk associated with different ownership and control structures. In the main, two categories of structures (each with its specific benefits and problems) have been identified: (1) widely dispersed ownership and (2) controlling ownership. This short essay analyzes the practical and policy challenges presented by the ownership structures in relation to three dimensions of corporate governance (shareholder value, long-termism and sustainable growth). It is apparent that investors and other stakeholders appreciate diversity in ownership structures when it helps accelerate sustainable growth and value creation.

The First Dimension: Shareholder Value

Widely dispersed ownership has attracted most attention in the corporate governance literature. This structure, which is characterized by small and numerous shareholdings, can be found in market systems, such as the United Kingdom and the United States. Much theoretical and empirical work stresses creating mechanisms that curtail managerial misbehavior and increase shareholder value. These mechanisms, most of which were introduced in the wake of the scandals of the beginning of the 21st century, include the certification of accounts, the regulation of audits and auditors, the imposition of independent audit committees, enhancing the role of non-executive directors, separation of the role of chairman and chief executive officer, and the implementation of risk-management systems and strict disclosure rules.

With controlling or concentrated ownership structures, the magnitude of managerial misbehavior is often mitigated because one or more insiders tend to have controlling stakes which give them an incentive to monitor and discipline management. Here, one should distinguish between two types of controlling ownership structures. The most straightforward structure is found in companies that have only one class of common stock (which carry a right to one vote per share) outstanding. However, controlling owners typically employ complex ownership arrangements to give them voting rights in excess of their cash-flow rights. These 'control-enhancing' arrangements are found in many variations in Europe and Asia. For instance, insiders often maintain control without having a majority stake in 'their' company by setting up pyramid or cross-shareholding structures, participating in shareholder coalitions or issuing multiple voting rights/dual-class shares. As a case in point, Facebook is a company with a dual-class share structure. Following the initial public offering (IPO) in May 2012, its founder Mark Zuckerberg held a 'minority' stake of approximately 28 percent of the outstanding shares, while the dual-class ownership structure (which gave him 10 votes per share) allowed him to exercise 56.9 percent of the voting power.

A large literature has sought to show that control-enhancing arrangements deter investors. Most of it has focused on three arguments. First, the immediate creation of shareholder value is usually not the main priority of the insiders. Second, restrictive control rights make these insiders often prone to tunnel vision. Third, dual-class share structures provide ample opportunity for insiders to act self-interestedly at the expense of other investors and stakeholders. Is there evidence in support of the investor deterrence view? To undergird their analyses, corporate governance experts use the disappointing IPO performances of Facebook and other recently listed companies with multi-class voting structures, such as Zynga and Groupon (see Table 1).

The theoretical argument proceeds as follows. In order to enhance shareholder value, it is important for listed companies to create a level playing field for investors by having only one class of common stock outstanding (according to the 'one-share-one-vote' principle). As a result, a level playing field increases insiders' accountability and adherence to generally accepted corporate governance mechanisms. Significantly, this is the case if the insiders do not have considerable voting blocks in the company, making them (similar to managers in widely dispersed companies) more susceptible to activist investors and hostile bids.

The Second Dimension: Long-termism

The short-term orientation of CEOs of banks and financial institutions to increase shareholder wealth played a significant role in the financial crisis of the late 2000s. In response, policymakers, academics and practitioners emphasize that corporate governance functions are best performed in companies that are characterized by a controlling ownership structure, such as founder-controlled or family-controlled companies. The basic argument is that investors in companies with a widely dispersed shareholder structure have a tendency to focus on liquidity and short-term results. The growing high frequency and algorithmic trading activity, short-term holding periods, stock market fragmentation and the emergence of dark pools are proof of this.

Technology entrepreneurs in this new environment, particularly if there has been a lot of hype surrounding a possible listing (which has been the case for most social media companies), often implement multi-class structures not only to maintain a tight post-IPO grip on control, but mainly for strategic purposes, such as resisting the short-term attitude of the stock market. Remarkably, controversial venture capital firms, such as Andreessen Horowitz, have openly heralded the move towards these structures. In their view, successful entrepreneurs should protect themselves against indifferent boards and investors that have no real interest in the company, do not care about the sector it operates in nor understand its technical and long-term prospects. In the case of Facebook and the other social media companies, this means that investors should surrender themselves to the long-term commitment and focus of Facebook's founder. For these reasons, the 2013 rebound of the stock prices of multi-class companies that completed their IPOs in 2011 and the first half of 2012 is evidence in favor of controlling ownership structures (see Table 1 Here).

Table 1: Multi-Class Companies that completed their IPO in 2011-2012 (1H)

Company	IPO Performance					**Stock Price Performance 2013 (31 July 2013)**
	1-day	30-day	60-day	6 months	31 December 2012	
Facebook	0.6	-21	-26	-38	-30	**31**
Groupon	31	-5	-4	-50	-76	**79**
KiOR	0	1	-33	-30	-57	**-28**
Yelp	-4	20	50	47	26	**112**
Zillow	79	20	46	39	39	**161**
Zynga	-5	-11	44	-44	-76	**25**

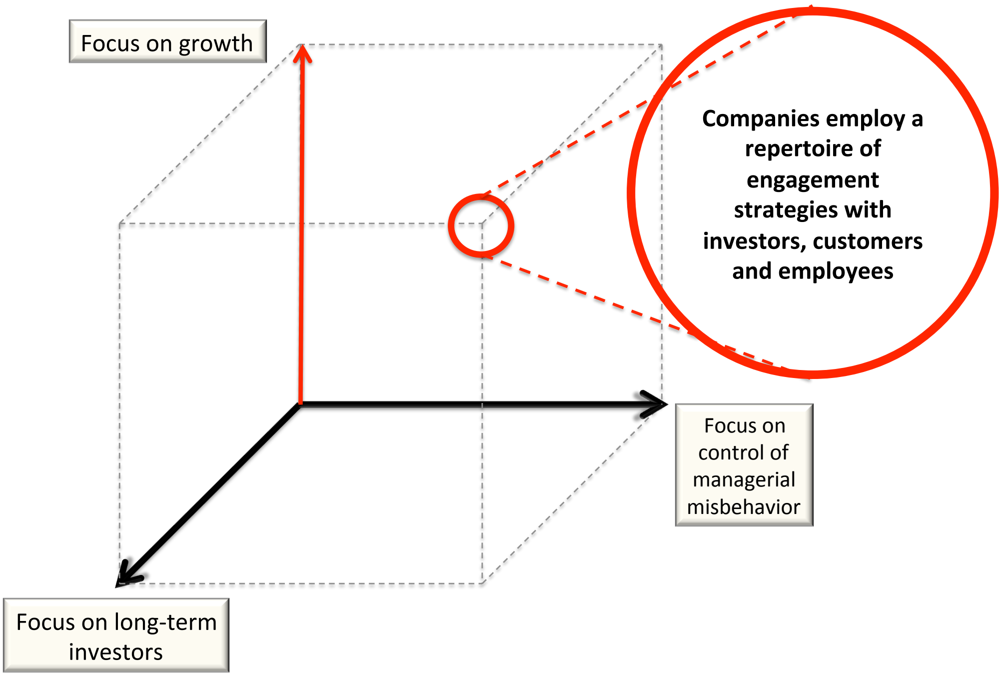
Again, the short-term orientation of stock markets is viewed as one of the key challenges for policymakers and regulators. They endeavor to build trust and long-termism into companies and stock markets by introducing rules and principles that either support shareholder engagement or discourage short-termism. The advisory 'say-on-pay' rules introduced by the Dodd-Frank Act in the United States, the Stewardship Code in the United Kingdom and the proposals to make the disclosure rules in the 1934 Securities and Exchange Act more stringent offer good examples of recent reforms.

The Third Dimension: Sustainable Growth and Value Creation

Ironically, the recent financial crisis has also led to a deregulatory movement. The research underlying this approach is that the focus on more stringent and detailed rules that dictate how companies should be organized and managed is destructive to business growth. Overregulation makes companies bureaucratic and short-term oriented. Strict adherence to the corporate governance framework would then lead to companies not being able to reach their growth potential. This would in turn lead to increased competition, insiders selling shares, and negative analysts sentiment. Clearly, a negative stock price performance increases the cost of capital and makes it more difficult to acquire and retain talented employees. For firms, the success formula is the acquisition and retention of these employees needed to ensure future growth and value creation.

Mindful of this, investors and high performance companies appear to have added an 'ignored' third dimension to the corporate governance debate: the prospect of sustainable business growth and value creation. But does a three-dimensional approach provide a better understanding of the dynamics of the corporate governance practices that we currently observe in listed corporations? To support this position investors and analysts do not seem to care too much about ownership structures that offer controlling insiders total protection from investor pressures as long as it incentivizes the insiders to continue grow the businesses or (as written in Google's 2012 Founders' letter) create 'technology products that enrich millions of people's lives in deep and meaningful ways'. What is interesting in this respect is that a growth-oriented ownership structure not only reduces investors' demand for managerial control mechanisms, but also tends to build long-termism into the organization (See Figure 1).

Figure 1: The Three Dimensional Model of Corporate Governance



Still, in most companies, corporate ownership and control discussions are segregated from the sustainable growth and innovation process and relegated to the role of managerial control and accountability. Sustaining growth is, at the best of times, often a challenge for most firms. What kind of measures could or should be implemented? Here there is much to learn from high performance companies. It appears that it is vital for companies (irrespective of their ownership and control structure) to embrace transparency and information sharing with respect to their growth expectations. In practice, we observe different repertoires of engagement with investors. There are examples of innovative investor relations' strategies that companies have established, such as more frequent and timely interactions with investors that make it easier for firms to disclose vital information. The effects of attending investor conferences organized by investment banks are likely to stimulate more widespread interest in a firm. For successful companies, implementing a well-functioning engagement strategy is not only key in building strong relationships with investors, but is also a tool to connect with employees and customers.

Ultimately, a failure to focus on sustainable growth and engagement with investors could trigger, particularly after lackluster profits, the attention of 'activist' investors, such as hedge funds and private equity funds. There is cross-country evidence that activist investors can play an important role in the process of recapturing sustainable growth and value creation in listed companies. Yahoo! is a recent example of this. If a company looses its focus on growth and value creation, activists can employ a variety of mechanisms, such as negative media attention and short selling activities, to introduce stricter control mechanisms on corporate executives, corporate reorganizations, and increased dividends and stock buybacks. Clearly, once investors are committed to such a strategy, the company needs to halt the slide and avoid ending up in a vicious circle of corporate governance discussions, making it extremely difficult to recapture the focus on sustainable growth, innovation and value creation.

Conclusion

To make further progress in this area, policymakers, academics and practitioners should be careful in deriving conclusions about the most effective ownership and control structures. Ownership is firm specific and varies across life cycle stages, sectors, regions, countries and cultures. Ownership structures are also dynamic in that they (should) change over time according to evolving markets and shifting business strategies and practices. In the aftermath of the financial crisis we have the chance to avoid – or at least minimize – the regulatory debate regarding the challenges posed by corporate ownership structures. Indeed, the focus on sustainable growth and value creation has led to new insights that may prove hard to ignore in future corporate governance discussions and reforms.

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