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About the Blog

Launched in February 2022, the ECGI Blog serves as a prominent global voice on corporate governance, stewardship, and corporate responsibility. By featuring commentaries and analyses from the ECGI network and beyond, the blog aims to enhance the wider understanding of research, sparking and influencing global debate.

Throughout the year, the blog focuses on selected themes with global interest. The articles, written by experts in their field, showcase diverse global perspectives from academics, practitioners, and policymakers on the topics, aimed at general readership. The blog hopes to inspire new insights and provoke new research and debate in the field

In this series, we cover several key topics including Short-termism, ISSB Guidelines, Dual Class, Corporate Governance in Asia, Corporate Purpose, and Private Equity,

For further reading and to access all hyperlinks and article references, please visit the Blog section of the ECGI website: www.ecgi.global/blog

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Special Issues

Welcome to the ECGI Blog Review, Volume 4 - Special Editions, a comprehensive collection that captures the evolving landscape of corporate governance as explored in articles published on the ECGI Blog from August 2023 to February 2024. Many of these blogs were linked to ECGI's ongoing initiative relating to responsible capitalism, and three pillars of corporate purpose, family capitalism and responsible investment. We are delighted to present a series of thought-provoking articles that not only reflect on current practices but also challenge conventional wisdom in the realm of corporate governance.

As questions of responsible investment and good corporate governance, this volume stands out for its in-depth exploration of the **balance between short-term financial pressures and long-term value creation.** A recurring theme across the articles, this balance is central to modern governance challenges and opportunities. You will find compelling discussions on how short-termism, driven by market and investor pressures, can undermine long-term strategic goals and sustainable business practices. Our contributors delve into various perspectives on how regulatory frameworks and governance structures can be reformed to foster a more forward-looking approach.

One of the most exciting aspects of this compilation is its focus on the **integration of sustainability principles**, sometimes referred to as ESG (Environmental, Social, and Governance (ESG). Several articles underscore the growing importance of sustainability considerations in corporate decision-making to achieve sustainable growth and long-term success. The varied perspectives on regional approaches to sustainability, particularly the contrast between market-driven models in the West and policy-driven models in Asia, provide a rich context for understanding global trends.

Moreover, this volume features insightful analyses on the role of **controlling shareholders** and their impact on corporate governance. This is also related to ECGI's **family capitalism** initiative. Articles examine how these stakeholders can either support long-term stability or contribute to short-term pressures, depending on their alignment with broader corporate goals.

Finally, the evolving concept of **corporate purpose** is a key highlight, following our previous special issue on the topic. Our contributors explore how redefining corporate purpose to include broader stakeholder interests can lead to more inclusive and sustainable governance models.

We hope this collection not only informs but also inspires you to think critically about the future of corporate governance. Thank you for joining us on this intellectual journey with the ECGI Blog.

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The views

Tom Vos

Controlling shareholders have stronger incentives to think in the long term than other shareholders, due to the size and illiquidity of their participation, which exposes them to a larger extent to the long-term cash flows of the corporation.

Kim Willey

Optional longer reporting timeframes are not an effective counter to stock market short-termism, and the evidence of the harms of stock-market short-termism does not justify further regulatory intervention.

Jesse M. Fried

While EU policymakers have not yet followed their American counterparts in imposing a tax on buybacks, the persistent confusion about capital flows creates an ongoing risk.

Mark Roe

The system, the economy, and society are all short-term in putting too much carbon into the atmosphere, but individual companies and their stock market owners, for the most part, are not.

Umakanth Varottil

Given the dominance of the controlling shareholders, institutional shareholders lack the wherewithal to influence managements on ESG matters in the same way they might be capable of doing in dispersed shareholding settings.

Joon Hyug Chung

The existence of controlling shareholders in most listed companies hindered shareholder activism, and Korean asset managers who had existing business relationships with the chaebols, often supported the controlling parties.

Hao Liang & Jun Myung Song

As seen in the Singapore case, government support and commitment is crucial for developing an economy's green finance capability and landscape, as companies and investors may not be incentivized to internalize environmental externalities.

Yupana Wiwattanakantang, Vikas Mehrotra, Lukas Roth, & Yusuke Tsujimoto

Being included in the MSCI Empowering Women Index and investing in greater workforce gender diversity does not hurt shareholder value, an often-debated issue when it comes to greater investments in firms' social performance.

The views

Dan W. Puchniak

Any chance of succeeding in changing the behavior of companies to benefit the environment will need to focus on changing the behavior of controlling shareholders in almost every Asian economy.

Gen Goto

The traditional Japanese corporate governance system had been paying attention to the interests of stakeholders, in particular employees, much before the current wave of ESG woke up Anglo-American companies.

Dan Puchniak

Using an Anglo-American lens to understand jurisdictions in Asia misleads and autochthonous solutions should be the bedrock of corporate governance reforms for Asia in the future.

Sang Yop Kang

Without fundamental changes to the economic and legal infrastructure in China, at least from a short- to mid-term perspective, a more active takeover regime will likely lead to potentially counterproductive outcomes.

David Schoenherr

Does treating managers more harshly in bankruptcy improve firms' access to capital and boosts investment? Bankruptcy reform in South Korea sheds light on this question.

Lauren Yu-Hsin Lin

We hypothesize that the effect of party-building reform on a firm's valuation depends on the trade-off between the benefits from increased state capture and the costs of state influence in firm governance, and that the enhanced political control costs are mitigated for firms with stronger existing political ties.

Nathan de Arriba-Sellier

While the first international sustainability disclosure standards have been already hailed by many, it is doubtful that they will deliver on the promise to provide high-quality, globally comparable information meeting the needs of investors.

Stefanie Schacherer

Taxonomies are standardisation tools, and as any other kind of standard-setting, they are not exactly neutral but bear distributive consequences.

The views

Max Göttsche, Florian Habermann, Max Kolb, Frank Schiemann, Theresa Spandel, Max Tetteroo

Sustainability issues often have far-reaching consequences on the lives of individuals, communities, and the planet as a whole. Neglecting the impacts of financially-immaterial issues could lead to overlooking critical social and environmental concerns, undermining the very essence of sustainability reporting.

Paulo Câmara

It is very important that the areas of intersection are gradually extended so that companies applying IFRS Sustainability Disclosure Standards, GRI Standards or ESRSs are certain that by applying one they comply with all of them. This requires continuous and extensive dialogue between standard-setters.

Claudine Gartenberg

Does pursuing purpose actually boost profits or is there a trade-off between the two? These questions get to the heart of the vigorous and important debate about the role of business in society. New research sheds light on a potential answer.

Gaizka Ormazabal

Just as ESG criteria have been criticized for being overly broad and amorphous, a measure of purpose could be noisy and manipulable.

Judith Stroehle

Radical prioritization is not just a tool of complexity reduction. It fundamentally is meant to aid complexity appreciation.

Elizabeth Pollman

When corporations publicly commit to pursuing stakeholder interests, there may be a perception that government intervention is not needed. This perception, in turn, could chill or impede efforts to obtain regulatory reforms.

Rui Albuquerque & Luís Cabral

We propose that there are problems that firms in isolation cannot solve, but that the combined action of firms in an industry might.

Lucian Bebchuk

Our view is that embracing stakeholderism can indeed hurt and can be counterproductive from the perspective of society and the very stakeholders that many of the stakeholderists would like to protect.

The views

Douglas Cumming

Leveraging insights from a comprehensive dataset encompassing nearly 182,000 global VC deals spanning the period from 2005 to 2020, our research underscores the multifaceted impact of top-tier law firms on deal success and performance.

Brian Broughman & Matthew Wansley

After supplying capital, VCs need to motivate founders to implement the high-risk, high-reward strategies that can increase the company's potential for rapid, exponential growth.

Nadya Malenko

As startups progress through their life cycle, the roles of major shareholders evolve, leading to a transformation in board composition. Changes in board control have many potential consequences for startup growth and success.

Kobi Kastiel & Yaron Nili

In continuation funds, sponsors place themselves in a position where they are committed to two groups of investors whose interests are in direct conflict.

Paolo Giudici

Many concomitant factors are needed to foster the development of an environment conducive to the growth of start-ups. Not enough attention seems to have been paid to corporate law.

Luca Enriques & Casimiro Nigro

Bargaining in the shadow of the explicit and implicit mandatory provisions of Italian corporate law leads to the adoption of a contractual technology that is overall costlier and less effective than the US model.

Horst Eidenmüller & Javier Paz Valbuena

If Siemens Gamesa had a sound business model, its shareholder or other private parties could be expected to support its operations with the necessary capital and assurances, lending against its anticipated revenue stream. The fact that no one was willing to do so suggests that Siemens Gamesa should be liquidated rather than rescued.

Caroline Escott

The CP23/10 proposals would do nothing to tackle the actual barriers to a UK listing cited by companies, including the relative lack of tech expertise amongst the investor base.

The views

Tom Vos, Theo Monnens, Steven Declercq & Jeroen Delvoie

If legislators believe that loyalty voting rights play a useful role, they should also allow dual class share structures.

Ofer Eldar

By prompting startups to go public, VCs can reduce the risk of a major governance failure that they may be unable to prevent in an environment in which they compete for investments.

Dan Puchniak & Roza Nurgozhayeva

Does pursuing purpose actually boost profits or is there a trade-off between the two? These questions get to the heart of the vigorous and important debate about the role of business in society. New research sheds light on a potential answer.

Hiroyuki Watanabe

In the US since the 2000s, some companies that have adopted a dual class share structure appear to have introduced clauses that grant voting rights in proportion to the percentage of shares held during the takeover procedure.

Sang Yop Kang & Ling Tong

Considering the relative underdevelopment and inefficiency of the Chinese capital market, as well as the prevalence of tunneling, the Chinese authorities' approach to enhancing investor protection in the context of DCES appears appropriate, at least in the short term.

Alessio Pacces

To fulfil the mandate of climate-conscious beneficiaries, institutional investors should tie their hands to controlling shareholders with dual-class shares conditional on low-carbon innovation.

The missing role of controlling shareholders in the short-termism debate?

Tom Vos
University of Antwerp

Short-termist behavior by corporations is often seen as a large societal problem. For example, Joe Biden wrote in a 2016 op-ed for the Wall Street Journal: "Short-termism […] is one of the greatest threats to America's enduring prosperity".

However, the debate on short-termism has so far largely focused on the US and the UK, while short-termism in European corporate governance has received much less attention. On 30 May 2023, the University of Antwerp, Harvard Law School and the European Corporate Governance Institute (ECGI) organized a conference that tried to address this by focusing on short-termism in Europe. Focusing on European corporate governance is important, because it differs in important respects from corporate governance in the US and the UK, for example because much more listed corporations in Europe have a controlling shareholder.

At the conference, I argued that the presence of a controlling shareholder can have an important impact on corporate short-termism, regardless of what you believe is at the source of short-termism. First, short-termism could arise from short-termist institutional investors and asset managers, whose short-termism is transmitted to managers. For example, short-termist institutional investors and asset managers could vote in support of short-term based executive compensation or short-termist shareholder activists. I call this "investor short-termism".

Whether such investor short-termism actually exists is heavily disputed.

"Controlling shareholders can solve the investor short-termism and managerial short-termism – provided that they are actually not short-termist themselves. ."

However, what is clear is that such investor short-termism is unlikely to arise in the presence of a controlling shareholder, who can block the transmission of short-termism through their control over the corporation.

Second, short-termism could also arise if managers and directors are inherently short-termist. For example, managers may want to demonstrate good results during their tenure at the corporation, in order to have a higher chance of obtaining a better paid job at another corporation. Such "managerial short-termism" can only persist if the long-term shareholders do not have the ability or incentives to monitor the short-termist managers and directors. This type of short-termism is therefore just an example of the classic managerial agency problem, which arises due to a lack of accountability of the managers towards shareholders.

Again, controlling shareholders can solve this type of short-termism: their large ownership stake gives them the incentives and ability to monitor management. For example, controlling shareholders can use their voting rights to nominate directors who will stay with the corporation for the long term, and approve executive compensation that is long-term oriented.

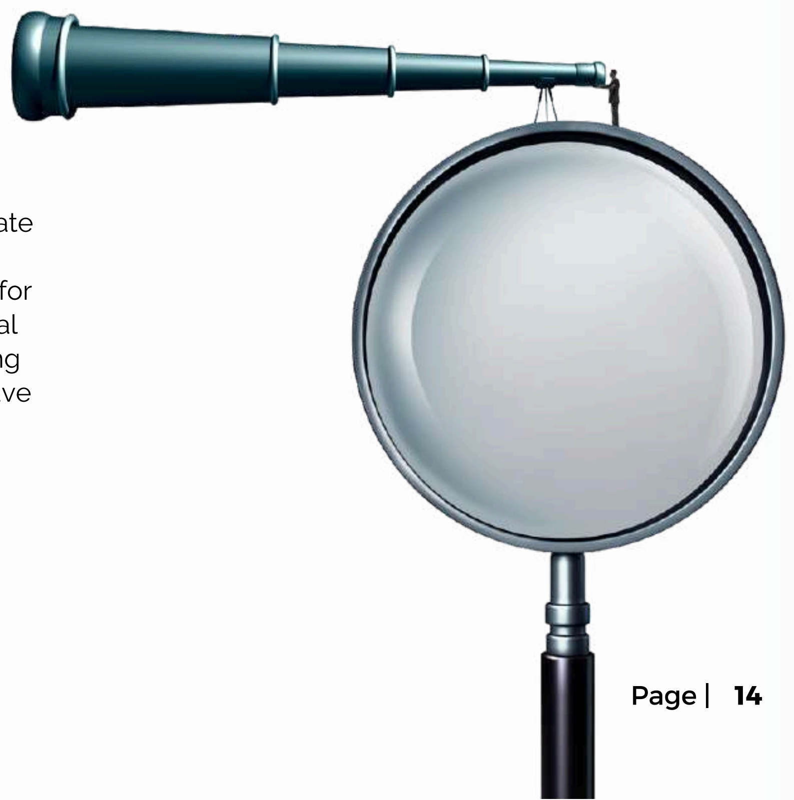
This analysis illustrates that controlling shareholders can solve the investor short-termism and managerial short-termism – provided that they are actually not short-termist themselves. Whether controlling shareholders are more long-term oriented will likely depend on the circumstances, and particularly on the type of controlling shareholders. On the one hand, controlling shareholders have stronger incentives to think in the long term than other shareholders, due to the size and illiquidity of their participation, which exposes them to a larger extent to the long-term cash flows of the corporation. On the other hand, controlling shareholders may also enjoy private benefits of control. Because some private benefits of control cannot be transferred easily, controlling shareholders may be "locked in" and forced to think of the long-term cash flows of the corporation. For example, a family shareholder may enjoy private benefits from keeping control over the corporation within the family. However, private benefits of control may also incentivize controlling shareholders to act in a short-termist manner. For example, a family controlling shareholder may prioritize the short-term liquidity needs of the family over the long-term investments needed by the corporation.

What can we conclude from this analysis of the role of controlling shareholders with regards to short-termism in corporate governance?
First, some of the solutions commonly offered for investor short-termism or managerial short-termism will likely be ineffective in corporations with a controlling shareholder. For example, discouraging short-termist activists or encouraging long-term shareholder stewardship is unlikely to make a difference, as controlling shareholders dominate the general meeting anyway.

Second, if we believe that controlling shareholders are generally more long-term oriented (which is debatable), we can facilitate the creation of control by allowing the separation of cash flow rights from control, for example through loyalty voting rights or dual class share structures. This allows controlling shareholder to diversify, even when they have limited liquidity.

The disadvantage of this is that the wedge between cash flow rights and control also increases the risk of the extraction of private benefits, which could be a source of short-termism. Ironically, it is precisely the tool that aims to encourage more long-term oriented controlling shareholders that can cause controlling shareholders to become more short-term oriented. Initiatives to facilitate controlling shareholders through multiple voting rights must therefore be accompanied by mechanisms that protect minority shareholders, such as approval by a majority of the minority shareholders. Only in this way can we arrive at a corporate governance system that truly facilitates long-term value creation.

Tom Vos is a full-time visiting professor and researcher at the Jean-Pierre Blumberg Chair at the University of Antwerp (Belgium), and a part-time attorney at Linklaters LLP (Belgium).



Why ending quarterly reporting will not solve the stock market short-termism problem…but may be justified for other reasons

Kim Willey
University of Victoria

Should further restrictions be placed on financial reporting timeframes in an effort to curb stock market short-termism? This question was on the agenda at the recent event hosted by the University of Antwerp Law Faculty, Harvard Law School and ECGI. At this event, I spoke on why such restrictions will not solve stock market short-termism concerns but may be justified on other grounds.

As background, both the EU and the UK have ended mandatory quarterly financial reporting and instead allow listed companies to provide half year reporting. These changes were made in large part due to concerns raised by policy makers that quarterly (i.e., three-month) reporting timeframes were contributing to the perceived problem of stock-market short-termism. In the UK, Sir John Kay, a leading economist, recommended in the Kay Review that mandatory quarterly reporting be removed in order to reduce perceived pressures for short-term decision-making arising from excessive – e.g., quarterly – reporting of financial performance. In the rationale for removing mandatory quarterly reporting in the EU, the EU Parliament/Council stated in Amendments to the Transparency Directive that, "[i]n order to encourage sustainable value creation and long-term oriented investment strategy, it is essential to reduce short-term pressure on issuers and give investors an incentive to adopt a longer-term vision".

The UK changes took effect in 2014 as a result of amendments to the FCA Handbook. The EU changes took effect the following year and provided that EU listed companies only require annual, and half year financial reports. Of note, although optional reporting is available in the EU, some EU member state exchanges continue to require quarterly reporting, so the effect may be limited in practice. There appears to be an increasing uptake on moving to semi-annual reporting by UK companies, but further research is required to verify this trend. See Owen Walker, The Long and Short of the Quarterly Reports Controversy, Financial Times (July 1, 2018), in which the author indicates that UK listed companies are moving from quarterly to semi-annual reporting. Similar research on the use of optional semi-annual reporting by EU listed companies would be useful to determine market interest in longer reporting periods.

The EU is currently discussing more draconian measures, including ways to discourage or ban listed companies from reporting on a quarterly basis (see the recommendations in the 2022 EU Commission Report). In contrast, the US continues to require quarterly reporting in the form of SEC 10-Qs. However, following broader discussion, including by former U.S. President Donald Trump, the US SEC released a Request for Comment on Quarterly Reporting in 2018. Comments received were mixed, with some stakeholders expressing concern about ending mandatory quarterly reporting, and others being supportive of optional longer reporting periods, including tri-annual reporting. Given this unsettled landscape, it is worth revising whether a move away from mandatory quarterly reporting is an effective remedy for stock market short-termism concerns.

In his recent book, "Missing the Target; Why Stock Market Short-Termism is not the Problem", Mark Roe boldly asserts that as an answer to short-termism, "ending quarterly reports will not have the desired impact: it is a small and bent arrow unworthy of its target". He goes on to argue that this approach "requires one to believe that if public firms reported results every six months instead of every three months, then they would make more five-year investments in plant and equipment and throttle up R&D…[S]ix months is not the long-term". Roe's book presents a case for why the evidence of actual harm from stock market short-termism is minimal at best. Although compelling, harms from short-termism are notoriously challenging to measure given the difficulty of isolating the impact of short-termism, and testing the hypothesis that harm is caused against a fictional market without short-termism.

Regardless, even if we assume there is problematic stock market short-termism, will removing mandatory quarterly reporting provide a solution? In my book, Stock Market Short-Termism: Law, Regulation and Reform, I present a dual pathway for effective reform. Specifically, in order to effectively combat stock market short-termism, the reform must either: (1) reduce actual or perceived discounting of future returns by 'enlightening' investors on the potential harms of a short-term bias; or (2) cut off the transmission of investor short-termism by: (a) insulating managers; AND (b) reducing their short-term compensation.

Following Pathway 1, the end of mandatory quarterly reporting may act to 'improve' or 'enlighten' investors (and asset managers) by forcing a longer-term approach. However, the impact may be minimal as reforms are voluntary, and not in place in the US and certain EU stock exchanges. Outright prohibitions on quarterly reporting could be more effective, but a ban is unlikely to be justified given the evidentiary issues on the harms of short-termism.

"Optional longer reporting timeframes are not an effective counter to stock market short-termism, and the evidence of the harms of stock-market short-termism does not justify further regulatory intervention."

Following Pathway 2, the end of mandatory quarterly reporting could assist with insulating company management from short-term pressures but would not be effective in the absence of restrictions on executive compensation based on quarterly or short-term metrics.

To conclude, optional longer reporting timeframes are not an effective counter to stock market short-termism, and the evidence of the harms of stock-market short-termism does not justify further regulatory intervention. Meanwhile, there may be strong policy reasons to further remove or restrict quarterly reporting, most significantly to reduce administration costs, but the short-termism rationale for doing so is largely rhetoric. Further, any change to reporting timeframes should be weighed against potential negative impacts to capital market transparency. Although not a small and bent arrow, the regulatory changes to quarterly reporting do certainly miss the mark as a remedy for short-termism.

By Kim Willey, Adjunct Professor at the University of Victoria Law Faculty and a partner with the corporate law firm ASW Law Limited.

Shareholder payouts and short-termism

Jesse Fried
Harvard Law School

From Washington, D.C. to Brussels, there is growing concern about corporate short-termism, with rising levels of shareholder payouts seen as both a symptom and a cause. But this concern is misplaced, as it is based on a misunderstanding of corporate finance and ignorance of the data.

In the United States, leading Democratic politicians have long argued that share repurchases are excessive, draining firms of funds that could otherwise be used for investment and paying higher wages. They point to data that dividends and repurchases by S&P 500 companies routinely exceed 90% of their net income. Between 2012 and 2021, for example, public companies distributed $11 trillion to shareholders, 99% of net income, mostly via repurchases. Last year, President Biden imposed a 1% tax on stock buybacks, and he recently proposed an increase to 4%.

But buyback critics like President Biden ignore equity issuances to shareholders, which move cash in the other direction. Across the market, firms recover from shareholders, directly or indirectly, most of the capital distributed by repurchases. Taking into account equity issuances, net shareholder payouts in public firms during 2012-21 were only about $4.4 trillion, far lower than the $11 trillion gross shareholder payout figure. Professor Charles Wang of Harvard Business School and I calculated that this left public companies with approximately $10 trillion for investment, not counting proceeds from debt financing.

Much of this money, our research shows, is in fact plowed into investment.

Overall investment levels, as measured by capital expenditures and R&D, reached historical record highs in six of the last 10 years, totaling $12 trillion during 2012-21. Investment intensity at these firms, measured by the ratio of investment to revenue, has also been rising over the past 10 years and is now near two-decade highs. These patterns are hard to square with corporate short-termism.

At the same time, firms are piling up cash. During 2012-21, cash balances rose by 78%, reaching around $8 trillion and thus leaving firms with ample resources for additional expenditure. There is no evidence that dividends and repurchases are starving firms of capital. If anything, public companies are sitting on too much cash.

Taxing buybacks to address the illusory problem of short-termism in large public companies will impose real harms on the economy. The cash from shareholder payouts by public companies often flows to private ones, such as those backed by venture capital or private equity. These private firms account for half of nonresidential fixed investment, employ almost 70% of U.S. workers, are responsible for nearly half of business profit, and have been important generators of innovation and job growth. Bottling up cash in public companies will reduce the capital flowing to private ventures—and thus their ability to invest, innovate and hire more workers.

Unfortunately, confusion over buybacks and their economic impact is not confined to the United States. In 2020, the European Commission released a sustainable corporate governance report claiming to find a problem of investor-driven short-termism.

As supposed proof of short-termism, the report points to rising levels of gross shareholder payouts — dividends and repurchases — and declining levels of investment. But like much of the policy literature in the United States, the Commission report misunderstands capital flows and ignores or misreports market data.

To begin, the Commission's report fails to account for equity issuances in measuring capital flows between firms and shareholders. But as Charles Wang and I have shown in a 2021 paper, stock issuances in the EU are substantial, far exceeding repurchases. During 2010-2019, for example, gross shareholder payouts represented 63% of net income. But equity issuances were almost half as large: 27% of net income. Thus, the ratio of net shareholder payouts to net income was 36%, a figure very similar to U.S. public firms.

We also show that both capital expenditures (CAPEX) and research and development (R&D) increased during the period covered by the report, both in absolute terms and relative to revenues (so-called "investment intensity"). Moreover, CAPEX and R&D both increased over the last decade, when shareholder activism has been most intense.

> "While EU policymakers have not yet followed their American counterparts in imposing a tax on buybacks, the persistent confusion about capital flows creates an ongoing risk."

The report implies that investment might be higher had shareholder payouts been lower. But cash balances grew by nearly 40% over the last decade, from €712 to €973 billion. This would suggest that investment by EU public firms is limited by the lack of additional opportunity, not by a lack of available cash. Moreover, even if a particular public firm lacked cash today, the firm could simply issue more equity. That, after all, is why firms go public in the first place. In fact, in each year during the last three decades, smaller EU public firms have absorbed more equity capital from investors than they have distributed: their equity issuances have exceeded dividends plus repurchases.

While EU policymakers have not yet followed their American counterparts in imposing a tax on buybacks, the persistent confusion about capital flows creates an ongoing risk - on both sides of the Atlantic - of more undesirable government intervention around share repurchases.

By Jesse M. Fried, Dane Professor of Law, Harvard Law School and ECGI Fellow.

Market short-termism: Its extent and its limits

Mark Roe
Harvard Law School

II began the conference on "Short-Termism in European Corporate Governance" in Antwerp with a keynote overview of four major questions about stock market short-termism. First, what is it? Second, what is the evidence of its extent and severity? Third, what are its cures and the cures' costs? And fourth, why has it been a vivid political issue, when so much else in corporate governance is for experts and specialists, not journalists and politicians?

The first question---what is it?---is a surprising question with which to lead off. With so much talk about stock market short-termism, we should know exactly what it is. But we do not. Problems attributed to stock market short-termism are indeed some of the most severe our planet faces. But many of the deepest of these problems do not arise from the stock market's time frame.

Consider a global warming, climate degradation theme from the World Economic Forum---the Davos operation where many of media, political, and business leaders meet. It's an instance of the wide attention the issue gets: "The finance world's short-termism will destroy our communities, economies, and the planet," the Forum was told. But the stock market's time horizon isn't the operative mechanism facilitating climate degradation. The problem is one of externalities, not time horizons (as I expanded on elsewhere on the ECGI blog). Firms can be quite long-term, but as long as the stock-market-listed firms earn big profits from burning hydrocarbons, then oil & gas firms will find, produce, and refine hydrocarbons in both the short- and the long-run, unless regulated, taxed, or otherwise discouraged from doing so. They have incentives to do so because they profit without absorbing the full costs of the damage from emitting too much carbon into the atmosphere. Indeed, many of the world's largest and strongest oil & gas companies are quite long-term operations, with planning departments considering the likely state of energy markets a decade or two or three down the road. Policy efforts to make these firms act longer-term will have limited, or maybe no, impact on our overly abundant carbon use. The system, the economy, and society are all short-term in putting too much carbon into the atmosphere, but individual companies and their stock market owners, for the most part, are not. It's the externalization of costs and internalization of profit that's the problem.

This conflation of externalities with time horizons can easily lead to misguided policy proposals. The EU's Sustainable Corporate Governance Project, for example, sought to make the stock market more sustainable by orienting it to the longer-term. But since sustainability and time horizons are largely separate issues, the proposals (even if valuable otherwise) would not produce the proponents' desired sustainability impact.

The second question: what's the evidence for the extent and severity of stock market short-termism? Are firms giving up longer-term value for immediate results? On a simple count of empirical inquiries, the results are divided, with about half finding short-termism and half not finding it as one would have expected.

The results have a tilt---quarterly reporting tends to be associated with more short-term focus and multiple studies debunk the idea that shareholder activism diminishes long-term value in the activists' target firms. And the results finding short-termism, when properly analyzed (which I seek to do elsewhere), tend to find it to be a small problem. A plausible conclusion for policymakers is that the data shows short-termism to be a small problem overall.

Much of the boost in policymakers' sense that stock market short-termism is a big problem comes from seeing climate degradation as a short-termism problem. But once that's properly seen as an externality problem, the perception of the severity of the stock market short-termism problem fades.

The third question I put forward was the following: if the best interpretation is that stock market short-termism is real but modest in scope, then what should policymakers do about it? Probably not much, particularly because most cures will have costs.[1] Yes, some firms are too short-term, but then other firms are too long-term; i.e., they persist with a losing investment well past its sell-by date. Policymakers must be careful that in aiming to reduce what short-termism we have, they could raise other costs---like exacerbating and worsening detrimental long-termism. Some firms—maybe many firms—stay too long in a business with no future.

Moreover, policymakers should distinguish local problems from economy-wide problems. That is, a firm is too short-term due to this or that characteristic (stockholders who trade too much, executives who pay too much attention to reported profits when their stock options are about to vest, etc.). Policymakers would like to cure the problem. But the problem is sometimes even less severe for the system than it is for the weakened company. I.e., if my company invests less, or does less R&D because of some short-termism, then that bolsters the profit incentive for another company, your company, without the targeted weakness to invest more and increase their R&D efforts.

"why does stock market short-termism have such a vivid profile in the media and among policymakers?"

Much of the empirical work in the area does not assess this potential for a systemic offset---is there one? what is its extent?---because measuring such offsets' extent is quite hard to do. But there are natural forces that would push for some offset that would reduce the system-wide costs of whatever real short-termism that we have.

If these first three inquiries are pointing in roughly the right direction, a fourth and last question follows immediately: why does stock market short-termism have such a vivid profile in the media and among policymakers? Some explanation comes directly from the first issue: we misattribute too much of our major externality problems (climate, environment, social degradation) to stock market short-termism. Hence, stock market short-termism seems to be bigger than it really is. And focusing on making stock trading longer-term lets us off the hook from taking tougher, politically more difficult actions. A carbon tax has been a nonstarter in American politics; people just do not want to pay a tax on gasoline to run their cars. But a carbon tax could do much more to lower carbon emissions than making the stock market more long-term. The latter goal, however, is politically easier to strive for.

Other major explanations for short-termism's vividness are important. There are interests that benefit from it being vivid. Executives and boards in the United States decry the stock market's short-termism and offer that debility as reason to lodge more legal and practical authority in the board and the executive suite and as reason to weaken the authority of stockholders.

Moreover, employees and social critics of the large corporation have reason to denigrate it for excessive short-termism. One reason to do so is to allow social critics to adopt a vocabulary more congenial to American political rhetoric. Criticizing social arrangements works better if it ties to financial market debilities---we're not criticizing capital movement and ownership, the critics can say. We're criticizing a degradation of the stock market, not the stock market itself.

This combination of interests can crowd out more worthy solutions to the social problems and to externalities. Hence, getting the rhetoric accurate can make a difference in policy thinking. Worse, sometimes interests can use the rhetoric of short-termism to push forward bad solutions.

Lastly, there's a psychological aspect to short-termism that deserves mention. Short-termism in ordinary discourse has negative connotations: a lack of reliability, fickleness, and so on. Long-termism has positive connotations: steadfastness and reliability. But for finance and business, the opposite is often true: Pigheadedness in the face of rapidly changing markets could look like long-termism, but it is a cost. A company should not stick to a money-losing strategy over the long-term. It's not good for stockholders and it is usually not good for society. And flexibility and adaptability in the short-run are advantages, even though they could be interpreted as short-term actions. Yet, "short-term" has become a pejorative in corporate governance circles, although flexibility and adaptability—closely linked to short-termism---are qualities that should be extolled not denigrated.

By Mark Roe, David Berg Professor of Law at Harvard Law School and ECGI Fellow.

The momentum for ESG in Asia: Less market, more government

Umakanth Varottil
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Environmental, social, and governance (ESG) factors have become a force to reckon with for corporations around the world. They constitute an integral part of investment decision-making, particularly for institutional investors. Such trends have been buoyed further by the emergence of concepts such as ESG stewardship and ESG activism, which have stirred investors to engage closely on environmental and social matters. Consumers too tend to pay considerable attention to the ESG attitudes of companies whose products or services they utilize. A market-oriented approach, which involves pressures imposed by corporate actors such as investors and consumers, has constituted the mainstay of the initial movement towards the recognition of ESG factors in corporate decision-making.

The evolution of ESG in the Asian context suggests an altogether different approach: governments constitute the primary motivator in spearheading the ESG movement. The focus of ESG has been via regulation rather than through the capital markets. This is altogether understandable.

At the outset, there are limitations on the extent to which institutional investors can influence corporate boards on matters of ESG. In most Asian jurisdictions, the corporate sector is populated either by family-owned companies or state-owned enterprises. Given the dominance of the controlling shareholders, institutional shareholders lack the wherewithal to influence managements on ESG matters in the same way they might be capable of doing in dispersed shareholding settings.

For instance, there is scant incidence of shareholder activism more generally in Asian markets, and much less success, and limited only recently to a few markets such as Japan and Korea.

Moreover, developments in governance of companies tend to be impelled in Asian jurisdictions through corporate regulation rather than by way of market impetus. Hence, considerable emphasis is placed on governments steering the course of corporate governance norms, with limited reliance on 'soft law' or forms of self-regulation. Developments in ESG in the Asian markets are consistent with these corporate regulatory trends.
To be sure, a regulatory-focused approach towards ESG is not restricted to Asia. The related developments in the European Union are suggestive of exhaustive regulatory oversight on aspects of ESG, leading scholars to term this phenomenon the 'hardening of ESG'. The difference in Asia, though, is the relative heterogeneity of approaches adopted by governments towards ESG. This is best demonstrated through the norms pertaining to disclosures on matters of ESG and, in particular, climate change. Through these, environmental and social risks are considered crucial to investors to the extent they bear a direct impact on the financial performance of a company.

While it would be a daunting task to analyse the developments in all Asian economies on this point, the examples of India, Singapore, and Hong Kong, whose legal systems are embedded in common law, might provide a flavour for the trends in the region.

The sample encompasses the fifth largest economy in the world in the form of India and the two key financial centes in Asia, being Singapore and Hong Kong.

India has been at the forefront among Asian economies to introduce sustainability reporting since more than a decade ago. In 2012, its securities markets regulator, the Securities and Exchange Board of India (SEBI) made it mandatory for the top 100 listed companies (based on market capitalization) to include a business responsibility report (BRR) as part of their annual report. Since then, not only has the universe of reporting companies expanded to the top 1,000 listed companies, but the scope of reporting obligations has been enhanced with effect from the financial year 2022-2023 in the form of the business responsibility and sustainability report (BRSR). More recently, in July 2023, certain core aspects of the BRSR have also been made applicable to value chains of a company (both upstream and downstream) with a need for limited assurance of such disclosures. By providing a uniform regime for dissemination of ESG data in an acceptable form, the BRSR has brought about an overall enhancement in the incidence and quality of reporting among Indian companies.

However, some challenges remain. The BRSR efforts do not, as yet, appear to benchmark against well-known global standards such as the recommendations of the Taskforce on Climate-Related Financial Disclosures (TCFD) on financial risk disclosure of climate-related aspects of a company's business. Moreover, commentators have argued that the BRSR still lacks comprehensiveness in comparison with international standards, which would enable companies to make do with boilerplate disclosures and also magnify the possibilities for 'green washing'. These factors make the comparability of disclosures of Indian companies across their global peers more daunting.

Unlike India, the two financial centres of Singapore and Hong Kong had followed a predominantly shareholder-oriented approach and undertook a specific focus on ESG only more recently

"At the outset, there are limitations on the extent to which institutional investors can influence corporate boards on matters of ESG"

.For example, the Singapore Exchange (SGX) introduced sustainability reporting requirements in 2016, requiring companies to disclose their practice on material ESG factors. The Hong Kong Exchange (HKEX) also requires companies to report on ESG matters at two levels, which involve certain mandatory disclosure requirements and other 'comply-or-explain' provisions. However, despite being late entrants to the ESG bandwagon, both Singapore and Hong Kong have strengthened their reporting obligations significantly within a short span of time. Pertinently, both jurisdictions require companies listed on their exchanges to progressively adhere to TCFD norms, which introduce a great deal of standardization with respect to climate reporting, and presumably help overcome some of the challenges faced in the Indian context.

In all, judging by the developments in the three sample Asian jurisdictions of India, Singapore, and Hong Kong, there is excessive reliance on governments rather than the markets to keep the momentum on ESG. While the markets (represented by actors such as investors and consumers) have some role to play, their influence is likely diminished in Asia compared to Anglo-American jurisdictions.

By Umakanth Varottil, Associate Professor of Law at the National University of Singapore and ECGI Research Member.

Korea's shareholder activism – A game-changing transformation since 2022

Joon Hyug Chung
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TThe year 2022 marked a significant turning point for shareholder activism in Korea. The engagement story of Align Partners, an activist fund, with SM Entertainment, a K-pop producing powerhouse and a listed company, has sparked great public interest. SM Entertainment, named after its founder Mr. Soo-Man Lee, recruited young talents and trained them to become K-pop superstars with the help of experienced producers, songwriters, and vocal and dance coaches. Mr. Lee was praised as a pioneer of the K-Pop business model and the Korean wave phenomenon (Hallyu), describing the recent growing popularity of Korean movies, TV series and pop music.

Beneath this success, SM Entertainment was marred by poor corporate governance. Despite holding only 18.5% of shares, Mr. Lee managed SM Entertainment to outsource production services to his wholly owned company, which received a significant portion of the company's annual profits, sometimes as much as 40%. This "tunneling" practice drew criticism from many shareholders, but the management, under Mr. Lee's influence, refused to terminate the contract, arguing that his consulting services were vital for the company's success.

n early 2022, a surprising development occurred. Align Partners, with a mere 1.1% stake in SM Entertainment, successfully appointed a statutory auditor at the annual general meeting of shareholders.

The statutory auditor, according to the Korean Commercial Code, holds the power to audit and review the activities of board members and inspect the company's operations. To ensure the auditor's independence and minimize the controlling shareholders' influence, voting rights of each shareholder are capped at 3% at its election under the Korean laws.

Align Partners' proposal received widespread support from other shareholders, including the National Pension Service (NPS) and Norges Bank Investment Management, both the world's largest pension funds. Proxy advisors such as ISS and the Korean Corporate Governance Institute also favored the proposal. Ultimately, more than 81% of voting rights supported Align Partners, which ultimately led to the termination of the tunneling contract between SM Entertainment and Mr. Lee's company. Subsequently, Mr. Lee sold his shares to Hive, the producer of the famous boy band BTS, and the company is now controlled by Kakao Group, a well-known IT giant.

Shareholder activism was once deemed irrelevant for Korean companies, with a few engagements initiated by US hedge funds against large conglomerates (chaebols) proving unsuccessful. The public sentiments against these funds were hostile, criticizing that they focus on short-term investment returns, without considering the long-term interests of the company and development of the Korean economy.

The existence of controlling shareholders in most listed companies hindered shareholder activism, and Korean asset managers who had existing business relationships with the chaebols, often supported the controlling parties.

However, the tide shifted with the introduction of the Korean Stewardship Code, making it difficult for asset managers to vote against proposals that clearly promote shareholder value, as their voting policies and results are disclosed. Since its adoption in 2016, more than 200 asset owners and managers, including the NPS, have adhered to the Code. The use of information technology also facilitated proxy voting, with Align Partners employing a fintech app that allowed shareholders to delegate voting rights online without the need of physical delivery of documents. This coincided with a significant increase in retail investors in Korea, from 6.14 million in 2019 to 13.74 million in 2021. The growing number of retail investors made it easier for activists to garner their support, especially for well-known companies like SM Entertainment, similar to the meme stock phenomenon in the US. The surge in retail investors and public interest in corporate governance issues also caught the attention of politicians and government officials, prompting them to address the undervaluation of the Korean stock market, known as the "Korea Discount Problem." As a result, the Financial Services Committee, the financial authority of the Korean government, announced a series of reforms, including the adoption of a mandatory takeover bid rule.

Align Partners' success has inspired other activists, with over ten public companies receiving shareholder proposals from various activist funds during the 2023 annual general meetings. lthough only a few of these proposals were accepted – due to the existence of a controlling shareholder in many companies – the trend is expected to continue in the coming years.

"Korean asset managers who had existing business relationships with the chaebols, often supported the controlling parties."

With the rise of independent hedge fund houses that do not have existing relationships with the chaebols, the challenge over their corporate governance issues is likely to increase. Controlling shareholders have become more open to addressing investors' concerns, exemplified by increased shareholder dividends and stock buybacks.

A more promising aspect is the increasing role of the market in Korean corporate governance. Contrary to LLSV's observations,[1] Korean corporate and capital market laws offer a comprehensive range of investor protection rights, from preemptive rights to derivative lawsuits against directors. Shareholding requirements for shareholder proposals have been relaxed, and the reappointment of outside directors for more than six years at a particular company has been prohibited to ensure their independence. Despite these efforts, investors have generally been passive in exercising their rights. The rise of shareholder activism is expected to act as a catalyst for investors to actively exercise their various rights stipulated under the laws.

By Joon Hyug Chung, Assistant Professor at Seoul National University School of Law.

Singapore's green finance efforts: Collective actions to drive sustainable growth and resilience

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BSingapore has emerged as a leader in promoting green finance in Asia by transiting towards a sustainable and low-carbon future. To foster green investments, Singapore has developed various initiatives and platforms such as Singapore Green Plan 2030 and Green Finance Action Plan, which provide frameworks to mobilise public and private sector efforts towards achieving a sustainable and climate-resilient Singapore.

Green finance and Environmental, Social, Governance (ESG) movements in the U.S. mostly follow a bottom-up approach, driven by corporations, institutional investors and activists. In Europe, in contrast, they largely follow a top-down approach, through government initiatives such as EU's Sustainable Finance Action Plan and various country-specific regulations.

Singapore applies both approaches. In its green finance efforts, one party that plays the most vital role is the Monetary Authority of Singapore (MAS), the city-state's central bank and financial regulatory authority. To encourage companies and financial institutions to raise funds for environmentally friendly projects, MAS has issued the Environmental Risk Management Guidelines across the banking, insurance, and asset management sectors. It has also launched various funding schemes to support green financing activities in the private sector.

For example, MAS set up a US $2 billion green investments programme to invest in public market investment strategies that have a strong green focus.

In addition, MAS launched the Green Bond Grant Scheme and the Green Bond Program which catalyze the green bond market in Singapore and encourage issuers to align their financing with sustainability objectives. Moreover, MAS launched the Green and Sustainability-Linked Loan Grant Scheme to encourage more issuers to obtain green loan certifications. Under this scheme, eligible borrowers can receive grants of up to SGD 100,000 to defray the costs of engaging independent sustainability consultants to validate their green loan frameworks and processes. More recently, MAS launched the Finance for Net Zero ("FiNZ") Action Plan in April 2023, where it built on the Green Finance Action Plan to include transition finance strategies.

Talent development is crucial in achieving Singapore's ambition to become a global green finance hub, which prompts MAS also to pay close attention to education, research and market regulations related to green finance. In October 2020, together with nine leading global financial institutions, MAS launched Singapore's first centre of excellence in this area, the Singapore Green Finance Centre (SGFC), co-managed by Imperial College Business School and Lee Kong Chian School of Business at Singapore Management University. A year later, MAS launched the Sustainable and Green Finance Institute (SGFIN) at the National University of Singapore. Meanwhile, the Singapore Exchange (SGX), supervised by MAS, organizes workshops, seminars, and educational programs to raise awareness and understanding of green finance among market participants.

SGX also requires listed companies to disclose their carbon footprints and board gender diversity, alongside other initiatives promoting sustainability reporting, such as the digital ESG disclosure platform ESGenome,[1] one of the four platforms of Project Greenprint by MAS.

The international financial hub is now aspiring to become a leading global green finance hub. Singapore's regulatory framework, infrastructure, and expertise in sustainable finance are expected to attract investors, companies, and professionals from around the world. According to the Sustainability Report 2021/2022 of MAS, Singapore is already "ASEAN's largest sustainable finance market, accounting for close to 50% of cumulative ASEAN green and sustainability-linked bond and loan issuances. From 2018 to 2021, over S$39.8 billion of green and sustainability-linked loans have been issued in Singapore."

As seen in the Singapore case, government support and commitment is crucial for developing an economy's green finance capability and landscape, as companies and investors may not be incentivized to internalize environmental externalities. Indeed, the academic literature offers mixed findings on the relationship between a firm's ESG performance and its financial performance. One SGFC working paper finds that a positive relationship exists between the two only when the government implements stringent environmental regulations. Another ECGI working paper by a SGFC author that was subsequently published at Management Science finds that government ownership is a strong predictor of a firm's environmental commitment.

Nevertheless, Singapore also recognizes the importance of harnessing the private sector's power through mobilizing capitals from investors, corporations and financial institutions to promote green finance. For example, MAS focuses on scaling the use of blended finance and voluntary carbon markets to support the region's transition.

"As seen in the Singapore case, government support and commitment is crucial for developing an economy's green finance capability and landscape, as companies and investors may not be incentivized to internalize environmental externalities."

Besides co-investing, MAS also works closely with industry partners on developing transparent and comparable frameworks for ESG and impact measurement and reporting that are consistent with global frameworks such as International Sustainability Standards Board (ISSB) and EU's CSRD.

In conclusion, Singapore's approach to driving the transition to a more sustainable and climate-resilient economy is a co-operative effort between the public and the private sectors. Clearly, regulators play a crucial role in creating an enabling environment for green finance through setting up taxonomies, rules and guidelines. Yet, it is equally important to mobilise the capital from the private sector and investors through innovative financial tools and appropriate incentives. We hope that Singapore sets a good example and a clear pathway for greener and sustainable finance in Asia and globally.

By LIANG Hao, Ho Bee Professorship in Sustainability Management & Associate Professor of Finance; Co-Director of Singapore Green Finance Centre and SONG Jun Myung, Research Fellow at Singapore Green Finance Centre and ECGI Research Member.

Can crafted equity indices bring about real changes in corporate social behaviour? Evidence from Japan's MSCI Empowering Women Index (WIN)

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In today's world, where sustainability and social responsibility are gaining increasing importance, the role of corporations in addressing societal issues has come under scrutiny. Our paper shows an innovative approach to encourage positive change—that is, can specially crafted equity indices bring about changes to corporate social behaviour? In 2017, the Government Pension Investment Fund of Japan, the world's largest pension fund, adopted the MSCI Empowering Women Index (WIN), aiming to address gender diversity in corporations.

The index features a quasi-tournament-like structure in that it is hived off the top half of the MSCI Japan IMI Top 500/700 Index. Each firm in the IMI 500/700 is ranked on its MSCI Gender Diversity Score relative to its industry, and the top 50% are included in the WIN. In other words, inclusion in the prestigious WIN is structured loosely as a 'tournament' in which companies compete with their peers based on certain criteria for the advancement of women in their workforce.

Why would belonging to the WIN lead to changes in firm behaviour and practices, or even be desirable? We posit two main channels through which this can happen.

First, the WIN is a prestigious index created by the GPIF, the world's largest pension fund, with ¥191 trillion (~$1.75 trillion) in assets under management in 2021. The index inclusion, therefore, provides positive recognition to qualifying companies. Second, the WIN is endorsed and invested by Japan's most influential financial institutions, the GPIF and the Bank of Japan, who share the goals of the index. Therefore, belonging to the WIN may increase the firm's visibility to investors, especially to the GPIF or other Japanese institutional investors and large foreign institutional investors pledging to consider a firm's sustainability performance in their investment decisions.

In our empirical tests we compared gender diversity performance for the marginal firm that either gains inclusion in the index or just misses it vis-à-vis firms that rank sufficiently low that exclusion from the index is a fait accompli. Thus, this difference-in-differences methodology affords us a plausible identification strategy in establishing causality. We identify treated firms as those that rank in the vicinity of the inclusion threshold (ranked between the 40th to 60th percentile; the threshold is the median), and control firms as those with a much lower probability of gaining inclusion (ranked between the 40th to 10th percentile).

IThe difference-in-differences analysis compares the differences of various workforce gender diversity measures in these two groups between the years before the WIN's inauguration in July 2017 and the years after 2017. The sample period is 2013 to 2020.

We measure workforce gender performance with data obtained from the Toyo Keizai CSR Workforce database. Toyo Keizai, founded in 1895, is among the top two prominent publishers in Japan along with Nikkei that has published economic and business news for more than a century. The Toyo Keizai database contains rich workforce survey data with more than 200 line items in aggregate and many line items broken down by gender—for example, the number of employees, turnover of employees, number of employees by position in the workforce, and maternity/paternity leaves, to name a few. These data allow us to construct various workforce gender diversity outcome measures.

The results, using our difference-in-differences design, controlling for firm characteristics and firm and time fixed effects, show that treated firms (compared to control firms) significantly improved the fraction of women in the workforce following the launch of the WIN. In terms of economic significance, treated firms improved their fraction of women in the workforce by about 5% per year compared to control firms. A visual parallel trends analysis and regressions in event time confirm that the change happened in the years after the WIN was created.

Our results show that the increase in women in the workforce is specifically concentrated at senior managerial levels, executives, and the board of directors. Thus, firms do not just hire more women at the lowest ranks, which is promising for firms' future improvements in the workforce through a 'trickle-down effect.' We also document positive social externalities and a possible shift in firms' workplace culture. For instance, we find that male employees in treated firms are more likely to take paternity leaves in the post period.

Treated firms also have shorter overtime working hours post WIN. These practices allow women to stay in the workforce. It is also a sign of a shift in culture in that male employees are not afraid of losing their jobs because they take parental leave (it is now more socially accepted) and they participate more equally in family responsibilities.

Finally, we document that institutional ownership growth is stronger for firms in the WIN vis-à-vis the excluded firms. WIN firms' institutional ownership increased by three percentage points compared to non-WIN firms. Our results also suggest that being included in the WIN and investing in greater workforce gender diversity does not hurt shareholder value, an often-debated issue when it comes to greater investments in firms' social performance.

In conclusion, the unique tournament-like structure of specially crafted equity indices such as the WIN, combined with its emphasis on gender diversity, has shown to be effective in promoting tangible improvements in a female friendly culture in corporate Japan. These findings pave the way for regulators, investors, and companies to explore the broader application of equity indices in advancing social responsibility. By leveraging the social power of index creation, asset owners can collectively foster a more inclusive and sustainable corporate landscape.

By Yupana Wiwattanakantang (National University of Singapore and ECGI), Vikas Mehrotra (University of Alberta), Lukas Roth (University of Alberta and ECGI) & Yusuke Tsujimoto (University of Alberta).

An Asian solution for the world's environment? Corporate governance in a non-anglo-american world

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Historically, when it comes to determining what counts as "good" corporate governance globally, the United Kingdom and United States have set the rules of the game. This has resulted in ill-fitting Anglo-American corporate governance solutions being transplanted to Asia with unforeseen consequences.[i] Will Asia repeat this history by adopting Anglo-American corporate governance solutions to solve its environmental problems?

Eight major Asian economies (India, Hong Kong, Japan, Malaysia, Taiwan, Thailand, Singapore, and South Korea) have adopted stewardship codes. All of Asia's inaugural stewardship codes were modelled on the UK's 2010 stewardship code (UK Code 2010) – the first of its kind in the world. The original goal of the UK Code 2010 was to solve the UK's systemic corporate governance problems by incentivizing passive institutional investors to become actively engaged shareholder stewards. In 2020, the UK issued a new stewardship code (UK Code 2020), which expanded the role for actively engaged shareholder stewards from solving the UK's systemic corporate governance problems to addressing its ESG problems, particularly climate change. Given this context, if the past is any predictor of the future, it seems likely that the eight Asian jurisdictions that modelled their original stewardship codes on the UK will follow in the UK's footsteps by reorienting their stewardship codes to focus on ESG.

The recently released updated version of institutional investor focused stewardship codes in Malaysia, Singapore, and Taiwan are evidence that this is already occurring. level.

In the UK, the focus on institutional investors as a solution for its systemic corporate governance and ESG problems makes sense. Institutional investors collectively own 68% of the shares of UK listed companies. Therefore, if a stewardship code can motivate institutional investors to be actively engaged promoters of ESG, it will result in significant changes in UK listed companies – as institutional investors collectively have the voting rights to legally control the companies. The rationale for viewing institutional investors as the key to getting companies to focus more on ESG is even stronger in the United States, where institutional investors collectively own 80% of the shares of listed companies.

However, in non-UK/US jurisdictions the situation is entirely different. Putting the UK/US aside, there is no other major economy in the world where institutional investors collectively own a majority of shares in listed companies. As I explain in detail elsewhere, the focus on institutional investors as a potential solution for environmental shortcomings (or any other corporate governance problem) is particularly misplaced in Asia, where on average institutional investors collectively own a paltry 11% of shares in listed companies. In some major Asian economies, their collective ownership stakes languish in the small single digits.

To be clear, this does not mean that institutional investors cannot have some impact on ESG in Asia by acting collectively as minority shareholders – especially in Japan where, as an outlier in Asia, institutional investors collectively own 36% of shares in listed companies. However, in almost every listed company in Asia, institutional investors – even if they act collectively – lack the voting rights to control the company. Moreover, in Asian jurisdictions like Singapore, where institutional investors collectively own 6% of the shares in listed companies, a focus on them as either the problem or solution for ESG (or any other corporate governance malady) is misplaced. In its 2020 Investment Stewardship Annual Report, BlackRock acknowledges this Asian reality. However, some of the most prominent UK/US research on institutional investors and stewardship overlooks this point.[ii] This fact also seems to have escaped the attention of regulators in the eight Asian jurisdictions that adopted UK-style stewardship codes, which are designed on the assumption that institutional investors have the voting rights to collectively control most listed companies.

The question then becomes: How can corporate governance strengthen ESG performance in Asia? Again, the answer to this question is entirely different in Asia than in the UK/US. As I explain in detail elsewhere, only 12% of listed companies in the UK and a mere 4% in the US have a dominant controlling shareholder – compared with, on average, 66% of listed companies in Asia.

"It appears that reforms to hard law will likely be necessary to effectively incentivize controlling shareholders to steward Asian companies towards ESG."

Therefore, any chance of succeeding in changing the behavior of companies to benefit the environment will need to focus on changing the behavior of controlling shareholders in almost every Asian economy. One notable exception is Japan, which (again) is an extreme outlier in Asia (and the world) due to the low level of controlling shareholders in its listed companies.

It is possible that reorienting stewardship codes in Asia to focus on controlling shareholders (as Singapore has already done) may provide a nudge towards ESG. However, it appears that reforms to hard law will likely be necessary to effectively incentivize controlling shareholders to steward Asian companies towards ESG. The entrenched interests of controlling shareholders will have to be challenged – something that powerful corporations, families, and governments, who themselves are the dominant controlling shareholders in Asia, seem well placed to thwart. However, if Asia can create corporate governance solutions to solve this problem, it will likely benefit the world – which has much more in common with Asia than Anglo-America. Perhaps then Asia will provide corporate governance solutions needed for global environmental problems – and, hopefully, ill-fitting Anglo-American corporate governance transplants will be a relic of the past.

By Dan W. Puchniak, Professor of Law at Singapore Management University, Editor-in-Chief of the ECGI Blog and ECGI Research Member.

Japanese corporate governance: Quo Vadis?

Gen Goto
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Corporate governance in Japan has gone through twists and turns over decades, just like in many other jurisdictions.The post-World War II corporate governance system in Japan, also known as the "company community", was characterized by features such as the so-called "lifetime employment" system, a board of directors consisting mostly of those promoted from employees of the company, a network of management-friendly "stable shareholders" who were often trade partners of the company, and the so-called "main bank" system, and focused on the interests of employees and other stakeholders. This traditional system seems to have worked quite well until the mid-1980s, supporting Japan's rapid economic recovery after World War II by enabling the management to focus on growth in the long term and incentivizing employees to make firm-specific human capital investments (see Shishido 2000).

With the bursting of the "Bubble Economy" in 1991, however, the Japanese economy entered a long period of low growth often dubbed as the "lost two decades", and a view that excessive risk-aversiveness due to the employee-oriented governance system had been one of the causes of Japan's structural stagnation gradually gained popularity among Japanese policymakers. In the meanwhile, the share-ownership structure of large listed corporations has changed dramatically, with less stable shareholders and more foreign institutional investors (see, Goto, 2014).

These developments resulted in a series of corporate governance reforms in the 2010s, which formed one of the main pillars of the so-called "Abenomics".

In particular, the Japanese Corporate Governance Code (adopted in 2015 and revised in 2018 and 2020) led to a significant increase in the appointment of outside/independent directors by Japanese listed companies (see Tokyo Stock Exchange, 2023), while the Japanese Stewardship Code (adopted in 2014 and revised in 2017 and 2020) sought to encourage domestic institutional investors to take a tough stance against the management of their investee companies when necessary (see Goto, 2022). These reforms may not have succeeded yet in changing the attitudes of Japanese managers toward risk and investment, but have sparked more shareholder-oriented viewpoints in Japanese listed companies, in particular in terms of profit distribution (see Miyajima and Saito, 2021).

When Prime Minister Fumio Kishida took office in October 2021, some might have feared (or hoped) that his focus on "New Capitalism" could change the course of corporate governance reform in Japan. As Professor Takeo Hoshi has pointed out earlier in this blog, however, Kishida's "New Capitalism" seems to be more rhetoric rather than an actual policy change. For example, while mandatory disclosure on matters relating to sustainability, in particular climate change and gender diversity in the workforce, was introduced in January 2023, it is based on the idea of single materiality, at least for now. Also, while statutory quarterly disclosure is expected to be abolished by a government-sponsored bill pending in the National Diet, quarterly earnings reports required by Tokyo Stock Exchange will be maintained.

Regulation of share buybacks, in which PM Kishida initially showed some interest, has never materialized. In contrast, the draft Guidelines for Corporate Takeovers now being considered by the Ministry of Trade, Economy and Industry emphasize that directors should prioritise shareholders' interests when receiving an unsolicited offer and that defensive measures should be implemented based on the will of shareholders. Also, Tokyo Stock Exchange, which often acts in cooperation with the Japanese government, requested its listed companies in March 2023 to pay more attention to the cost of capital and stock price, referring to the large number of companies with price-to-book ratio below 1.0. Overall, the pro-shareholder trend of corporate governance reforms in Japan is still in place.

One might question why Japan is still focusing on shareholders' interests in this era of ESG and sustainability. To answer this question, it would be appropriate to cite a recent work by Prof. Dan Puchniak that "context matters". As noted earlier, the traditional Japanese corporate governance system had been paying attention to the interests of stakeholders, in particular employees, much before the current wave of ESG woke up Anglo-American companies.

Ironically, this focus on employees' interests, which once contributed to Japan's economic growth, was seen as one of the causes of the "lost two decades" and led to a series of reforms championing shareholders' interests.

Such a Japanese context, however, does not necessarily mean that consideration of ESG issues is not important for Japan today. While the "lifetime-employment" system has protected the interest of full-time employees of Japanese large companies by securing their jobs until their mandatory retirement age (traditionally 60 years old), it has also caused problems as well. To begin with, Japanese companies tend to limit new hiring in times of difficulty to avoid laying off current employees, making young people seeking their first jobs suffer. Also, employees enjoying "lifetime employment" are in return subject to a wide discretion of employers over the content and the location of their work, including transfers to subsidiaries in different regions or trade partners.

As mid-career job change is relatively uncommon under this system, the Japanese labor market has been illiquid, diminishing the bargaining power of employees against their employers. Harsh working environments that sometimes lead to death by overworking and average wages remaining flat for more than 30 years could be attributed to such an illiquid labor market. Also, long working hours and the possibility of sudden transfers have been unfriendly to the female workforce, particularly working mothers. With a declining population, promoting gender equality in the workplace is one of the top agenda items for Japan, not only for social justice but also as an economic policy

Facing these challenges, the Japanese government has also attempted to reform its labor market/system. Most recently, the Kishida administration has placed measures to increase labor market liquidity on top of its annual economic policy and announced its intention to set a non-binding goal for companies listed in the Prime Market of the Tokyo Stock Exchange to have 30% or more female executives/directors by 2030.

Turning to the "E" issues, in particular climate change, Japanese listed companies might be less "woke" compared to their European or American peers, but this might be because the Japanese society itself is arguably less "woke", even though Japan is also suffering from intense heat and increasing heavy rains and typhoons.

One recent survey has shown that the ratio of Generation Z feeling guilt or anger about climate change is lower in Japan than in other countries, and young Japanese tend not to speak about climate change with others.

This "unwokeness" among Japanese society might have multiple causes, but one possible factor might be Japan's stagnation over decades and a pessimistic view of the future, forcing people to prioritize their daily living. In other words, revitalizing the Japanese economy might be essential to gain public support for the fight against climate change.

Altogether, one thing seems to be quite certain. The case for reforming the traditional Japanese corporate governance system remains.

"The traditional Japanese corporate governance system had been paying attention to the interests of stakeholders, in particular employees, much before the current wave of ESG woke up Anglo-American companies."

By Gen Goto, Professor of Law at the Graduate Schools for Law and Politics, The University of Tokyo.

Asia's moment: Contextualizing the rules of the corporate governance game

Dan Puchniak
Singapore Management University

Whether this century is Asia's century is still open for debate. What is clear now, however, is that understanding corporate governance in Asia is a paramount issue of global importance. Asia is forecast to account for an astonishing 70% of global growth in 2023. India's stock market capitalization recently eclipsed that of the United Kingdom and France – something unthinkable at the dawn of the new millennium.Asia is now home to three of the top four largest stock markets by market capitalization in the world – with only the United States ranking ahead of China, Japan, and India. China alone now has more Fortune Global 500 Companies than the United States or all of Europe combined – with Asia now dominating every other region in this iconic American ranking of the world's most powerful corporations. Whether the purpose of companies is to maximize shareholder value or save the planet, success on a global scale is now, more than ever, unachievable without Asia.

Despite this, when it comes to determining what counts as "good" corporate governance globally, the United Kingdom and United States have set the rules of the game. Academia has reflected (or, perhaps, perpetuated) this trend as comparative corporate governance research has long been dominated by a propensity to use an Anglo-American lens to understand Asia. This has produced erroneous theories and sometimes ill-suited policy prescriptions about how corporate governance in the diverse and dynamic economies of Asia work – an issue that can no longer be ignored. The existential threat of climate change will become a reality if Asia's corporations are not part of the solution.

This is why the ECGI Blog decided to produce this Special Issue on corporate governance in Asia. Things are changing – fast. A decade ago, research comparing corporate law and governance within Asia was scarce. Intra-Asian research is now a burgeoning field of study. This is reflected in two posts in this Special Issue, one by Professor Umakanth Varottil (The momentum for ESG in Asia: Less market, more government) and one by me (An Asian solution for the world's environment? Corporate governance in a non-Anglo-American world). Both posts demonstrate that using an Anglo-American lens to understand jurisdictions in Asia misleads and that autochthonous solutions should be the bedrock of corporate governance reforms for Asia in the future.

The growing tensions between China and the United States have produced polarized positions that lack nuance. The two posts on China, one by Professor Lauren Yu-Hsin Lin (Behind the scenes: The Chinese government's influence on businesses and its impact on valuation) and one by Professor Sang Yop Kang (Deciphering China's hostile takeover terrain: The diminished role of corporate governance) illustrate that those who take unnuanced views of Chinese corporate governance do so at their peril. Professor Lin explains how a focus on the mere fact that a company has formally instituted a Chinese Communist Party committee into its corporate governance structure may tell us less about the level of political influence on the company than the detailed governance provisions in its corporate charter.

Professor Kang explains how the distinctive features of China's corporate governance context may result in the development of an active market for corporate control in China producing more problems than solutions – the opposite of what viewing these developments through an American lens would predict.

The past year has seen Japan's stock market boom and a renewed interest in Japanese corporate governance following decades of economic malaise. Like China, an accurate understanding of corporate governance in Japan requires a nuanced contextual approach. Its unique corporate governance system often behaves in ways contrary to Anglo-American-cum-global conventional corporate governance wisdom – which produces unique problems and unanticipated solutions. Professor Gen Goto's post (Japanese corporate governance: Quo Vadis?) explains why counterintuitively Japan is still focusing on reforms that advance shareholders' interests in a world where the Anglo-American inspired trend is towards stakeholderism. He also illuminates how the "unwokeness" of Japanese society may put sand in the gears of Japan Inc.'s will to address climate change.

Professor Yupana Wiwattanakantang and her coauthors' post (Can crafted equity indices bring about real changes in corporate social behaviour? Evidence from Japan's MSCI Empowering Women Index (WIN)) illuminates a fascinating strategy by the Government Pension Investment Fund of Japan, the world's largest pension fund, to adopt the MSCI Empowering Women Index (WIN) with the goal of advancing gender diversity in Japanese corporations. Based on their empirical research, it appears the strategy has been successful, suggesting that Japan – a country more often associated with gender inequality – may have uncovered a surprisingly effective way to use equity indices to advance gender equality in listed companies.

For all its success, Korean corporate governance is understudied. With a GDP per person that recently eclipsed Japan, the economic miracle of Korea is astounding

Whether the purpose of companies is to maximize shareholder value or save the planet, success on a global scale is now, more than ever, unachievable without Asia

It's global influence, whether through cutting-edge semiconductors or crowd-pleasing K-pop, make illuminating the governance behind its powerful corporations of global importance. Professor Joon Hyug Chung's post (Korea's shareholder activism – A game-changing transformation since 2022) details how an activist fund shook-up a Korean listed company, which was a K-pop producing powerhouse. This corporate governance episode gained a level of interest that is normally reserved for Korean blockbuster movies or TV dramas. According to Professor Chung, this episode illustrates how the tide in Korea "shifted with the introduction of the Korean Stewardship Code, making it difficult for asset managers to vote against proposals that clearly promote shareholder value, as their voting policies and results are disclosed". This portends a watershed rise in the power of shareholder activists in a country normally dominated by corporate groups (chaebols) and controlling minority shareholders – how this change plays out in the future, however, will be determined by Korea's unique corporate governance landscape.

Professor David Schoenherr's post (Can punishing managers in bankruptcy backfire?) explains how a legal reform in Korea, which allowed managers to stay in control during bankruptcy proceedings, increased credit usage and investment. But, again, context is key.

His empirical research suggests that this positive result only likely occurred due to Korea's corporate governance landscape being dominated by family-owned businesses with concentrated shareholding – and that the opposite result may have occurred in an economy, like the United Kingdom, which is dominated by dispersedly-held companies.

Last, but not least, Professor Hao Liang and Jun Myung Song's post (Singapore's green finance efforts: Collective actions to drive sustainable growth and resilience) explains how Singapore has emerged as a leader in promoting green finance in Asia by blending a United States-style bottom-up market-based approach with a European-style top-down government-based approach. Singapore's ability to position itself as a financial hub in Asia has resulted in it having one of the most dynamic economies in the world – with a GDP per person that is now higher than any G7 country. In today's world, where regionalization appears to be replacing globalization, could the Singapore model of green finance be the model for Asia? Only time will tell.

If this Special Issue on corporate governance in Asia has one message it is that context matters. Viewing Asia's dynamic and diverse engines of global economic growth through an Anglo-American lens never made sense to begin with – but now doing so is patently absurd. The shift in economic power towards Asia demands that its diverse and dynamic systems of corporate governance be understood on their own terms. Similarities that link many of Asia's diverse corporate governance contexts are evident: a pre-dominance of family-controlled and state-controlled companies, concentrated shareholding structures, government-based enforcement, shared corporate and legal cultures, growing economic interdependence and more. These commonalities suggest that it is long overdue for Asia to jettison Anglo-American based solutions. The time has come for Asia to set the rules for its corporate governance game.

By Dan W. Puchniak, Professor in the Yong Pung How School of Law (YPHSL) at Singapore Management University, Editor-in-Chief of the ECGI Blog and ECGI Research Member.

Deciphering China's hostile takeover terrain: The diminished role of corporate governance

Sang Yop Kang
Peking University

ISince 2011, when I began teaching at Peking University School of Transnational Law in China, I have consistently emphasized to my students that the distinctive socio-economic structure of China plays the key role in analyzing corporate governance in China. Due to these differences, the corporate governance mechanisms that are effective in the United States may not necessarily yield equivalent levels of success in China. As someone who appreciates Chinese history, I analyze the hostile takeover regime in Mainland China by employing a Chinese proverb, known as "橘化为枳 (南橘北枳)," which can be translated into English as "the shape of a fruit is determined by the different types of soil in which it is cultivated." Put differently, considering China's unique socio-economic landscape, the outcomes of establishing a viable hostile takeover system may diverge from conventional expectations.

China's economy currently holds the second position globally in terms of nominal GDP, trailing only the United States. When considering purchasing power parity (PPP), China has already surpassed the United States. However, severe market failures persist in China. For instance, compared to the United States, the Chinese product markets face issues with (quasi) monopolies that relate to China's indigenous industrial policies and market structures. Additionally, the Chinese capital markets experience more severe information asymmetry, primarily due to the underdeveloped disclosure system and less efficient enforcement mechanisms.

Another form of market failure in China is the inefficiency of capital markets, which arises from several challenges. These challenges include: (i) the aforementioned information asymmetry within the capital markets; (ii) various regulatory barriers that are not typically present in advanced economies, such as stringent IPO regulations and more restrictive short-selling rules; (iii) underdevelopment of related markets such as derivatives, bond, and foreign exchange markets, which can contribute to directly or indirectly "correcting" the abnormal pricing of the stock market; (iv) the significant role and substantial proportion of "mom and pop" retail investors, leading to noise trading and behavioral issues like herding; (v) the significant role of institutional investors controlled or influenced by the government that act as macroeconomic policy tools and can distort the price discovery function; (vi) direct government intervention through capital market policies; and (vii) limited access for foreign investors to Chinese capital markets due to incomplete openness to global capital markets (although this has been relaxed to some extent with initiatives like Shanghai-Hong Kong and Shenzhen-Hong Kong stock connects).

Against this backdrop, let's explore hostile takeovers in China. In 2015, Vanke, one of China's most prosperous real estate developers, found itself the target of a significant takeover attempt. The attempt was conducted by Baoneng, under the leadership of its controlling shareholder, Yao Zhenhua.

Although Wang Shi was the charismatic business leader of Vanke, unlike most Chinese companies, Vanke's ownership structure was notably dispersed and lacked a controlling shareholder. Despite Vanke's tenacious resistance, Baoneng became over time its largest shareholder. Ultimately, however, the control contest was quelled by government intervention, resulting in failure. When the dust settled in 2017, de facto control of Vanke had shifted to Shenzhen Metro, a local government SOE, marking the conclusion of the dramatic takeover saga.

While the Vanke-Baoneng case represents a full-fledged takeover attempt, the mechanism of hostile takeovers in China is still in its infancy, with such attempts being rather rare. However, in the fields of economics and corporate law, it is often argued that hostile takeovers—whether in China or other jurisdictions—have the potential to significantly enhance corporate governance. The conventional rationale can be encapsulated as follows.

Prior to hostile takeovers, potential target companies often encounter agency problems arising from inefficient management or tunneling. Consequently, the stock prices of these companies tend to be undervalued relative to their true worth. This phenomenon provides a financial incentive for potential bidders to pursue takeovers. After the takeover, as management afflicted by agency problems is replaced, the target company may undergo a transition to new management and improved corporate governance. Accordingly, the company is likely to experience an upswing in its stock price [1]Hence, hostile takeovers can serve a constructive role by acting as a mechanism to discipline management and enhance the quality of corporate governance throughout the economy.

However, while this perspective may have relevance in other economies, I do not agree with this viewpoint in the context of China. Instead, due to aforementioned 橘化为枳(南橘北枳), I predict that achieving an active takeover regime in China will likely take a long time and could be counterproductive in the short to medium term.

This prediction is based on the four issues that will be discussed below. Essentially, my argument centers on the idea that the influence of corporate governance is substantially limited within the context of China's hostile takeovers environment.

First, it is worth noting that a substantial portion of companies in China are state-owned enterprises (SOEs), which are also politically important in China. Given the near impossibility for an SOE to become entangled in a control contest, regardless of the level of agency problems they may have, SOEs are not vulnerable to being targeted in hostile takeovers.[3] In essence, factors of corporate governance bear limited significance in takeovers involving Chinese SOEs.

Second, unlike the United States, where dispersed shareholding is more common, China is dominated by controlling shareholders.

Chinese corporations typically employ a pyramidal ownership structure, which provides greater control stability compared to circular shareholding-based ownership structures. As a result, excluding SOEs, the pool of potential targets for hostile takeovers in China is further reduced significantly to a tiny number of privately-owned corporations with dispersed shareholding. Given this limited pool of available targets, the potential target companies in China are not necessarily those with inefficient management or tunneling. The case of Vanke, which had dispersed shareholding, serves as a prominent example highlighting the crucial role of a company's ownership structure in being a potential takeover target. While it is true that Vanke faced agency problems, I do not believe that Vanke's problems were considerably more severe than those of other corporations in China.

Third, regarding the role played by takeovers as a disciplinary mechanism in China, it is crucial to note that a target's low stock price is largely independent of its management efficiency or conflicts of interest. This is due to the inefficiency of Chinese capital markets, where stock prices do not accurately reflect the quality of a potential target's corporate governance. Accordingly, the premise of the takeover's disciplinary function, where potential bidders are attracted to the low stock price of a troubled company (i.e., target), does not hold true.

Fourth, corporate value in China is often influenced by the government's industrial policies (including subsidies), regulations, discretionary actions, and the prevalence of (quasi) monopolies in the product markets. In such circumstances, corporate earnings and stock prices might not accurately reflect the corporation's performance in product market competition or its agency problems. Considering this feature, it is also unlikely that the takeover system will effectively function as a disciplinary mechanism to punish management inefficiency or lack of management performance.

In addition, as indicated in the third point regarding capital market aspects, in China, a lower stock price does not necessarily imply inherent problems with a company's competitiveness, management, or governance in the product markets. For instance, a low stock price might simply result from a lack of the government's support or monopoly opportunities.

The overall economy of China operates under a unique model known as "socialism with Chinese characteristics (中国特色社会主义)," which combines aspects of a market economy with a socialist framework. The hostile takeover regime embodies the key characteristics of a market economy system. For such a market-oriented institution to function effectively in China, it is critical that the specific "soil"[4] of the "mixed economy" be suitably adapted. For instance, takeovers often lead to labor issues, including extensive layoffs, which will necessitate a comprehensive and lengthy policy deliberation process in China. Given that labor issues are core concerns that the Communist Party of China must address, large-scale layoffs may not be deemed an acceptable policy solution. In sum, without fundamental changes to the economic and legal infrastructure in China, at least from a short- to mid-term perspective, a more active takeover regime will likely lead to potentially counterproductive outcomes. For instance, in an active takeover system, when entities with a dispersed shareholder base are acquired, it is likely to reinforce the position of the controlling shareholders in the acquiring entities, who already hold a strong position. This could potentially aggravate existing issues related to controlling shareholders extracting private benefits, thereby further complicating China's corporate governance landscape.

By Sang Yop Kang, Professor of Law, Peking University, School of Transnational Law and ECGI Research Member.

Can punishing managers in bankruptcy backfire?

David Schoenherr
Princeton University

Conventional wisdom suggests that when companies go bust, the managers of the company should bear some of the consequences. It is also often argued that the threat of punishment prevents bad behaviors such as shirking or inefficient investments. A large academic literature apparently supports this view by showing that stronger creditor rights increase the supply of credit, allowing firms to access credit markets and finance a larger number of profitable investment projects.

One element that is missing from this argument is that companies may become insolvent for reasons other than managerial incompetence or misbehavior. For example, firms may be subject to industry shocks or ex ante good investment projects may fail for various reasons outside of the control of management. As a consequence, the prospect of harsh treatment in the case of bankruptcy may make even well-meaning and competent managers cautious about investing in profitable but risky projects.

Both views have merit. Ultimately, it is an empirical question which of the mechanisms are more relevant in practice. In 2015, Korea underwent a bankruptcy reform that sheds light on this question: Does treating managers more harshly in bankruptcy improve firms' access to capital and boosts investment? Or does treating managers more harshly in bankruptcy discourage risk-averse managers from seeking financing for investment?

Specifically, the reform, which went into effect in 2016, allowed incumbent management to stay in charge of the firm during bankruptcy proceedings in most cases, whereas before the reform management was routinely dismissed.

Does treating managers more harshly in bankruptcy improve firms' access to capital and boosts investment?

From the perspective of managers this was a major change, as under the old law filing for bankruptcy was equivalent with job loss, whereas under the new law they face realistic prospects to remain in control of the firm even after the firm went through the proceedings.

As it turns out, the data does not provide an unambiguous answer as to whether treating managers harshly in bankruptcy leads to better or worse outcomes in terms of borrowing and investment. As so often in economics, the answer is: it depends. But what does it depend on? There are firms in which managers enjoy what is called higher private benefits of control. This may include financial benefits, such as from higher ownership stakes in the firm, but also non-financial benefits, such as the pride of running a family firm through multiple generations. For these firms, the prospect of the manager being dismissed in bankruptcy has a strong negative effect on their willingness to finance investment with credit as this can increase the risk of ending up in bankruptcy.

On the other end of the spectrum, there are firms where private benefits of control are lower, for example widely held firms or firms with older managers who are close to retirement anyways.

For these firms, the discouraging effect of dismissing managers in bankruptcy is weaker and dominated by the disciplining effect that increases credit supply and allows the firm to realize more investment projects.

Given the structure of the Korean economy with many family-owned businesses with concentrated ownership, the risk-aversion channel dominates on average suggesting that allowing managers to stay in control during bankruptcy proceedings increases credit usage and investment. In a different economy with more widely held businesses, such as for example the UK, the tradeoff may turn out differently. As a result, the optimal policy needs to take into account the specific context of the economy and ownership and corporate governance structure in the economy.

By David Schoenherr, Assistant Professor of Economics at Princeton University, and ECGI Research Member.

Behind the scenes: The Chinese government's influence on businesses and its impact on valuation

Lauren Yu-Hsin Lin
City University of Hong Kong

IIn recent years, changes in government policy and public sentiment have led to global fragmentation and deglobalization. This trend has accelerated since the COVID-19 pandemic and has deepened the disagreements over ideology and values between China and the rest of the world. There is growing concern over the rise of Chinese power and its impact on Chinese businesses, particularly for private firms. In our research studies, my co-authors and I sought to answer two important questions: to what extent are Chinese firms influenced by the party-state, and what is the valuation effect of political influence on businesses?

To answer these questions, we examined the "party-building" reform initiated by the Chinese Communist Party ("CCP") in 2015. This reform aimed to strengthen the control of the CCP over businesses by requiring state-owned enterprises (SOEs) to amend their corporate charters and include party organizations in their governance system. Our analysis of hand-collected data from the first four years of the reform (2015-2018) revealed that not all SOEs (around 90%) mandated to amend their charters had done so, while some privately-owned enterprises (POEs) (around 6%), which were not targeted by the reform, voluntarily adopted relevant provisions. However, not all amendments were equal, and we found substantial variation in the provisions adopted by firms, both within and across ownership types.

POEs mostly adopted symbolic provisions and did not grant party committees substantive governance powers. While charter amendment was commonplace among SOEs, those with large non-state shareholders and those cross-listing their shares on non-mainland stock exchanges were less likely to adopt substantively intrusive charter amendments.

A more recent update on the adoption of party-building provisions, as of December 31, 2022, shows that nearly 37% of publicly listed Chinese POEs have responded to the CCP's call and amended their articles to establish internal party committees. However, less than 5% have adopted more intrusive governance provisions that grant the party committee real power in the firm (see Center for Strategic and International Studies webinar on "How Private Are Chinese Companies?"). This finding reveals the complexity of political conformity among Chinese companies and has significant policy implications. Another study has shown that party-building is a political renegotiation process, with the CCP regaining control over SOEs by institutionalizing party organizations in business. SOEs that have attempted to resist party orders are high-level, nationally important but less profitable and less internationally competitive SOEs, suggesting that they might suffer from insider-control problems. Even after multiple amendment requests from the party, resistant SOEs have adopted fewer party-building provisions than other adopting SOEs.

Therefore, when evaluating the level of political influence on Chinese companies, we should pay more attention to the detailed governance provisions adopted in each company's corporate charter, rather than focusing only on the general establishment of internal party committees or the inclusion of general wordings from the CCP charter.

The second question we explore is the valuation impact of such a reform. We hypothesize that the effect of party-building reform on a firm's valuation depends on the trade-off between the benefits from increased state capture and the costs of state influence in firm governance, and that the enhanced political control costs are mitigated for firms with stronger existing political ties. We use event studies to examine the market responses to the charter amendments and find that the market responded more positively to firms with a higher level of ex ante political influence. We also found that the market reacts negatively when firms elect to adopt charter provisions that allow the CCP to control their personnel decisions. In this study, we introduced a novel and integrated approach to measuring political influence that goes beyond traditional state ownership measurement and identified ex ante political influence as an important factor in corporate valuation.

> "When evaluating the level of political influence on Chinese companies, we should pay more attention to the detailed governance provisions adopted in each company's corporate charter, rather than focusing only on the general establishment of internal party committees.."

By Lauren Yu-Hsin Lin, Visiting Professor of Law at Washington University in St. Louis; Associate Professor of Law, City University of Hong Kong and ECGI Research Member.

The ISSB's new standards: breaking ground or low hanging fruits?

Nathan de Arriba-Sellier
Yale University

Long awaited, the International Sustainability Standards Board (ISSB) released the final version of its very first standards regarding sustainability disclosures and climate-related disclosures. These first standards, which are intended to set the global baseline for corporate sustainability disclosures, have been already hailed by many on the day of their release. Yet, it is doubtful that the new standards will deliver on the promise to provide high-quality, globally comparable information meeting the needs of investors.

The adoption of such standards responds to the rising global demand of investors and the public in reliable and comparable information on corporate sustainability performance. This demand has heightened with the rise of sustainability risks, and particularly environmental risks. But it is also the result of the market's failure to bring about some discipline in the quagmire that has become ESG disclosures. In this respect, the ISSB follows the global rise in regulatory scrutiny over sustainability disclosures, which prompted the SEC's climate disclosure rule proposal in the United States and the Corporate Sustainability Reporting Directive (CSRD) in the European Union. Thus, the creation of the ISSB was announced in 2021 during the COP26 climate conference in Glasgow. The ISSB is a body of the IFRS Foundation, which adopts the International Financial Reporting Statements, and it was endorsed by the Financial Stability Board and the G20.

In many respects, the ISSB's first two standards are a landmark. The voluntary soft law attempts to provide some regulatory harmonization at international level. Unlike the ISSB's precursor, the Taskforce for Climate-related Financial Disclosures (TCFD), the new standards cover a broader scope of disclosures than the sole climate-related ones, are worded in mandatory terms and aim at creating the global minimum standards for sustainability standards.

> "While the first international sustainability disclosure standards have been already hailed by many, it is doubtful that they will deliver on the promise to provide high-quality, globally comparable information meeting the needs of investors."

The ISSB is also in position to meet that objective, as the standards are expected to be endorsed by IOSCO, the international organization of securities regulators, and several jurisdictions – from the United Kingdom to Nigeria – have announced their intention to transpose them in national law. And the ISSB seeks to ensure emulation from other countries. It is further important to note that the ISSB's work has just begun. The first standard, IFRS S1, provides the general framework for sustainability-related disclosures, while the second, IFRS S2, focuses on climate-related disclosures, reflecting the ISSB's priorities. The ISSB will now turn to other important issues, such as biodiversity.

Both standards are built on the same model, which very much reflects the structure of the TCFD's recommendations following four categories: governance, strategy, risk management, data and metrics. They require fair presentation and set a number of safeguards to ensure clarity in disclosures.

iOf particular significance is the scope of the disclosure standards, which in both cases entails the consideration of the reporting entity's value chain. Moreover, the forward-looking nature of sustainability disclosures is reflected in the standards, which require to consider sustainability risks over the short, medium and long-term.

The ambition of the standards is further exemplified by the obligation in IFRS S2 for entities to disclose their scope 1, 2 and 3 greenhouse gas emissions. Initially, the ISSB had been more ambiguous on the need for companies to disclose scope 3 emissions (indirect emissions associated with a company's value chain not counted in Scope 1 or 2, which account for direct emissions and emissions from purchased energy respectively). The (unanimous) decision of the ISSB to include scope 3 emissions suggests a growing consensus that such a reporting, however difficult it may be, provides a more accurate description of the entities' exposure to climate-related risks. It will hopefully encourage the SEC to adopt a similar requirement in its final rule on climate-related disclosures, despite significant corporate and political pushback.

Nevertheless, the ISSB merely captures the low-hanging fruits of corporate sustainability disclosure and falls short of delivering on the promise to provide high-quality, globally comparable information meeting the needs of investors. Firstly, the ISSB is sticking to a single materiality approach limited to financial risks and opportunities, rather than the more ambitious double materiality approach that is embedded in the CSRD. Furthermore, the disclosure of material information is limited in several instances by the clause that businesses should use information that is available "without undue cost or effort".

Failing to disclose the impacts of a business's activity on climate and the environment is short-sighted given the unprecedented and alarmin extent of the environmental crisis, and could obfuscate some of the financial risks that companies are exposed to as a result of these impacts. While the ISSB will require information on climate-related targets (and sustainability targets in general), the obligations are rather general and will fall short on providing much clarity on the reporting entities' intentions to fulfill corporate net-zero commitments. Similarly, the ISSB added an unspecific obligation to publish climate transition plans that will only apply to those entities that already that such plans.

In general, the ISSB standards fall short of actually ensuring the standardization of corporate sustainability information. Reporting entities are sole judges of what information is "useful to primary users of general purpose financial reports" and of the ways to report that information. Thus, there is no minimum set of sustainability data and metrics that companies must report, beyond GHG emissions. And as a result, there will be no methodological uniformity in the reporting of corporate sustainability information. In addition, the ISSB remarkably does not require any verification of the required disclosures. This absence contrasts sharply with the assurance requirements introduced in the CSRD and the rule proposal of the SEC.

To conclude, the ISSB does not deliver on its core promise to provide high-quality, reliable and comparable sustainability information meeting the needs of investors and the public. It is also highly unlikely that it will create a global baseline for disclosure requirements, as both the SEC and CSRD have adopted vastly different orientations at odds in their own ways with the ISSB's.

By Nathan de Arriba-Sellier, Research Director of the Yale Initiative on Sustainable Finance.

Lost in transition: The regulatory challenge of sustainable finance taxonomies

Stefanie Schacherer
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When the European Union (EU) started to develop its taxonomy in 2018, the ambition was to create a common language for sustainable finance that investors can use to encourage investment in projects and economic activities that have a substantial positive impact on the climate and the environment. Five years later, over 20 states and various international organisations, including the Association of Southeast Asian Nations (ASEAN) have adopted or are in the process of adopting sustainable finance taxonomies.

In essence, these taxonomies seek to establish a framework for ESG measurement in sustainable finance. Their underlying rationale is to address the problems of greenwashing, investor uncertainty and lack of trust in ESG products. Yet taxonomies come with their own set of challenges. One of them is how to translate high level sustainability objectives into concrete criteria. For instance, how to capture transition activities with standards that are flexible enough and easy to adapt. As the adoption of the EU Taxonomy has shown, regulators can be lost in transition.

Regulatory Race

Regulators worldwide are responding to the growing demand from companies and investors for greater consistency in measuring ESG factors after years of proliferation of competing ESG measurement methods. One of the main criticisms often made against ESG investing stems from the lack of a generally accepted understanding of the individual attributes of 'environmental', 'social' and 'governance'. The absence of such an understanding has led to the formation of a subjective marketing-driven system, fraught with the risks of greenwashing, and ineffective allocation of resources. Sustainable finance taxonomies seek to address these shortcomings. They offer a classification system identifying activities or asset categories that deliver on key climate, green, social, or sustainable objectives with reference to clearly defined thresholds and targets. Taxonomies also distinguish between ESG as inputs into an investment process, and as outputs or goals to be maximized in the real economy. In general, taxonomies possess three fundamental elements. First, they define a set of objectives, such as climate change mitigation and adaption. Second, they provide a list of sector-specific economic activities with sustainability proprieties, and third, they set out detailed screening criteria in the form of performance indicators for each activity defining how an activity contributes to the pre-defined objectives.

Green by law

A business activity that fulfils the conditions of a taxonomy is considered as 'sustainable' or 'green'. Taxonomies are standardisation tools, and as any other kind of standard-setting, they are not exactly neutral but bear distributive consequences. n the case of sustainable finance, the question of whether an asset is classified as 'green' or not may have implications on the availability and cost of financing.

Therefore, the EU's announcement in July 2022 that certain uses of fossil gas and nuclear energy were deemed environmentally 'sustainable' under the EU Taxonomy elicited strong reactions. The EU justified the amendment of the Taxonomy by pointing out the important transitional characteristics of natural gas and nuclear energy, such as the lack of viable low-carbon alternatives, their relatively low emission levels, and the fact that using them for a certain period of time would not hinder the transition to a net-zero future.

However, by labelling natural gas and nuclear energy as green, the EU went against the experts of the Sustainable Finance Platform, a body that was established by the EU to help elaborate a science-based taxonomy. According to the experts, natural gas generates huge emissions, and nuclear energy creates highly radioactive waste, for which it is still unclear how it could be safely handled and disposed. As a consequence, a number of NGOs, have taken legal action by filing a case in the Court of Justice of the European Union. Finding that the EU's approach is inconsistent with the science-based approach, the principle of do no significant harm (DNSH), general EU Climate Law and the Paris Agreement. The case is currently pending.

For the claimants in this case, the EU is greenwashing. In light of energy security considerations in Europe, however, many (including green politicians) agree that these controversial energy sources will remain necessary in the next years. In my opinion, the case does not illustrate intentional greenwashing but rather that the regulatory approach taken by the EU is not nuanced enough to more adequately capture, albeit arguably necessary, transition activities.Hereto it is important to note that the EU Taxonomy employs a binary classification system where activities are categorized as either This binary outcome model runs the risk of not including gradations in financing conditions as the taxonomy itself does not allow for gradations in the degree of sustainability of economic activities. or not, i.e., as taxonomy-aligned or not.

The examples of natural gas and nuclear energy shows to what extent binary taxonomies are inflexible and easily susceptible to greenwashing. They place transition activities on the same level as uncontroversial sustainable economic activities, and might, in the opposite case, fall short in capturing relevant transition activities for the net zero pathway. A more nuanced approach favouring greater granularity has emerged in Asia. The taxonomies of ASEAN and Singapore, for instance, are designed with a 'multi-colour' screening system, which ranks an economic activity by assigning it a colour code: green (sustainable), amber (transition) or red (unsustainable). In other words, the traffic-light system allows a classification beyond mere identification of sustainable activities by also incorporating distinctions between transition activities and those that pose harm.

Way forward

Currently, there is a global regulatory race between different jurisdictions, and regulatory approaches differ. As I argue in a recent working paper, the efficiency of sustainable finance taxonomies hinges on international regulatory cooperation between states, government agencies and private experts. Non-concerted efforts would increasingly lead to a multiplication of different, and often divergent taxonomies and measurement approaches which would negate what taxonomies try to achieve, namely the establishment of consistency and clarity. The aim of regulatory cooperation initiatives is to achieve interoperability between different taxonomies. One design aspect for such interoperability is, for instance, the granularity of taxonomies, i.e., whether activities are subject to a binary or multi-colour classification. Regulatory cooperation can promote regulatory capacity and help establish best practices of ESG standardisation that is flexible enough to adapt to changing circumstances related to climate change and other sustainability challenges.

By Stefanie Schacherer, Assistant Professor of Law at Singapore Management University.

Striking a balance: The importance of double materiality in sustainability reporting

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The recent developments in standard-setting and policymaking hold profound implications for stakeholders worldwide. We agree with Dr. Nathan de Arriba-Sellier that the International Sustainability Standards Board (ISSB) "is sticking to a single materiality approach limited to financial risks and opportunities, rather than the more ambitious double materiality approach that is embedded in the EU's Corporate Sustainability Reporting Directive (CSRD)". Focusing on the underlying materiality definition – a crucial and heavily-debated cornerstone of sustainability disclosures and their standards – we aim to highlight some of the critical limitations associated with the narrower single materiality approach adopted by the ISSB. We base our arguments on scientific evidence – particularly, the findings of our current study.

Our findings highlight that a single materiality approach in sustainability reporting standards incentivises firms to focus on financially-material sustainability issues, while they neglect financially-immaterial ones. After the staggered releases of SASB's industry-specific materiality indications between 2013 and 2016, we find that US firms improve their financially-material sustainability performance. However, we also convey that financially-immaterial sustainability performance declines in the post-release period. Accordingly, we conclude that a single materiality approach may inadvertently disadvantage and impose costs on stakeholders affected by financially-immaterial issues.

Importantly, our study's insights are applicable to the context of the ISSB and its approach to materiality, as we investigate the effect of the SASB standards, whose materiality indications provide the basis of the ISSB's materiality indications. In the following, we highlight three key reasons why our study's findings should not be overlooked:

Single materiality is used as a synonym for financial materiality, which classifies sustainability issues as material only if they (potentially) influence a firm's financial performance. The ISSB's conception of single materiality is based on the SASB standards, which were developed predominantly for the use of investors and classify a set of sustainability issues as either financially material or financially immaterial based on firms' sector and industry affiliation.

First and foremost, our research points to the potential harm that a single materiality approach in sustainability reporting standards may impose on various stakeholder groups. Sustainability issues often have far-reaching consequences on the lives of individuals, communities, and the planet as a whole. Neglecting the impacts of financially-immaterial issues could lead to overlooking critical social and environmental concerns, undermining the very essence of sustainability reporting.

Secondly, investors increasingly have preferences that extend beyond just financial materiality. Nowadays, more investors are becoming attuned to firms' broader impact on society and the environment. They embrace a multifaceted approach that encompasses social and environmental considerations alongside financial performance. This growing cohort of impact and socially-responsible investors seeks to align their portfolios with firms that demonstrate a genuine commitment to sustainability, beyond a mere profit-orientation. By narrowing the focus on financial materiality, the ISSB risks alienating this essential group of investors who play a pivotal role in shaping a more sustainable global economy.

Thirdly, the World Economic Forum recently discussed the concept of dynamic materiality. The concept highlights that sustainability topics, which are only material from an impact perspective, will eventually become financially-material in the near or far future. For example, carbon emissions were considered financially-immaterial information before the adoption of the Kyoto Protocol, but now they are at the core of current sustainability disclosure regulation debates and developments – and are now financially- material. As a result, investors might not be sufficiently informed about potential financial risks if firms' sustainability disclosures are limited to what is currently perceived as financially-material information. Combined with the findings of our study, this becomes even more concerning. When firms tend to neglect impact-material sustainability topics under a single materiality approach, the potential risk of dynamic materiality is amplified and reinforced by pursuing it in policy decisions.

Consequently, if the ISSB standards remain restricted and focused on a single materiality definition they will reflect a materiality approach that differs substantially from that of the more comprehensive frameworks such as the CSRD. Thus, firms' sustainability disclosures will not be comparable internationally and create barriers to increased transparency.

Following the most recent and expected policy developments, the ISSB's approach to materiality will set the stage not only for climate, but also for non-climate sustainability reporting.

As the ISSB will take over the Task Force on Climate Related Financial Disclosures (TCFD) and is likely to pursue with biodiversity standards, we expect the same dynamic with the Taskforce on Nature-related Financial Disclosures (TNFD). The ISSB would have to expand their definition of materiality as the TNFD already stresses the "engagement with affected stakeholders" and "impact analysis". The ISSB should see this as an opportunity to integrate the TNFD's double materiality. By integrating double materiality considerations into the ISSB's sustainability standards, the ISSB would create a robust reporting regime that reflects the realities of our world today. It would decrease information asymmetries further and empower investors to make informed decisions aligned with their values and contribute to fostering a more equitable and sustainable future.

In conclusion, let us heed the call to action and prioritise the adoption of double materiality in sustainability reporting standards in general and within the ISSB standards in particular. This is because our findings demonstrate that single materiality fails to serve the interests of various stakeholders. We implore policymakers and standard-setters to take on the challenge with courage and conviction to pave the way for a sustainable and prosperous world that leaves no one behind.

By Max Göttsche, Florian Habermann (Catholic University Eichstätt-Ingolstadt), Max Kolb (Nature and Biodiversity Conservation Union (NABU)), Frank Schiemann (University of Bamberg),. Theresa Spandel, and Max Tetteroo (Climate & Company).

ESG disclosure rules: New developments as potential catalysts of the 'Cascade Effect'

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In 2023 we have entered a new cycle of sustainability reporting rules. European companies have started the adaptation process to comply with the Corporate Sustainability Reporting Directive (CSRD) while the European Commission has approved the first set of the level 2 measures that consist of the very important European Sustainability Reporting Standards (ESRS), following the proposal last year presented by EFRAG. In the meantime, the International Sustainability Standards Board (ISSB) issued its global IFRS S1 and IFRS S2 on sustainability disclosures. Finally, it is expected that the US Securities and Exchange Commission will adopt its final (and controversial) climate-related disclosure rule towards the year-end.

This new ESG (Environmental, Social, and Governance) reporting framework offers a unique opportunity for impact analysis. Progress in terms of ESG reporting rules will bring clear benefits to end-users of information (investors and stakeholders) in terms of transparency of non-financial performance by listed companies and other public interest entities. However, in respect to sustainability information, what mostly matters is the potential of transformation that these sustainability standards bring in terms of corporate sustainable business, aligned with the Sustainable Development Goals and the Paris Agreement.

In my recent article, I explore the concept of cascade effect as an assessment tool of the plethora of changes brought by ESG trends and by ESG regulation.

I define the 'cascade effect' as the potential aptitude for companies to engage in ESG-based decisions and to systemically influence others to do so, including investors, investee companies and their respective supply chain and community. ESG-driven decisions affect several types of entities and their systemic impact (namely reflected in changes to companies' policies, their board duties, their culture, and their actions) and it inspires other groups of entities in subsequent waves of influence. Institutional investors and consumers influence companies, the latter influence their supply chain, which in turn influences the community at large, namely investors and consumers. The concept of cascade effect therefore encapsules the potential and multifaceted systemic governance, operational, legal, and cultural changes derived from sustainable decisions.

At this juncture it is too early to assess the systemic impact of the new ESG reporting rules. In fact, they are not even yet into force. We will have to wait for another 2 to 4 years for a first assessment in terms of CSRD-induced systemic influences. However, looking specifically into the EU landscape there are three main factors that may negatively affect such cascade effect derived from ESG reporting rules.

On the one hand, some relevant differences persist in terms of the ESRS, Global Reporting Initiative (GRI) Standards, and IFRS S1 in relation to structure, concepts, and measurement bases of sustainability reporting.

The key objective is interoperability—a code name for convergence and mutual acceptance of sustainability reporting standards, both at its inception and in any subsequent adaptation that sustainability reporting rules may eventually suffer. It is very important that the areas of intersection are gradually extended so that companies applying IFRS Sustainability Disclosure Standards, GRI Standards or ESRSs are certain that by applying one they comply with all of them. This requires continuous and extensive dialogue between standard-setters (EFRAG/ISSB/GRI).

The second critical point is adaptation by SMEs. It is well-known that the CSRD only applies to small and medium listed companies, and with some adaptations. On the one hand, the SME sustainability report may be limited to key indicators. On the other hand, there will be special sustainability reporting standards for small and medium-sized undertakings and SME value chain companies. Finally, for listed SMEs the CSRD will apply from the financial year starting on or after 1 January 2026 but will still be optional for financial years starting before 1 January 2028. However, SMEs are clearly lagging behind in terms of preparation and internal capacity of adaptation for the ESG-related challenges. Recent EC Recommendations on facilitating finance for the transition to a sustainable economy provide tailored indications namely to SMEs. However, these recommendations failed to provide essential guidance in terms of adaptation of internal reporting processes, quality assessment of data and structural changes. To fill this gap, SME governance codes would certainly make a difference.

Finally, the CSRD deals with companies' disclosure duties and therefore solely applies to a small fraction of State-owned entities. However, as it has already been pointed out by several standard-setters, such as the International Public Sector Accounting Standards Board and the Chartered Institute of Public Finance and Accountancy (CIPFA), it would be also important to have disclosure of sustainability information imposed upon other public organisations. EU institutions, national central and local public entities should also follow the example of the private sector and start preparing reporting standards and data collection methods in respect to key sustainability indicators in the public sector. That approach would not only bring benefits in terms of operational and risk management, but it would also influence the ecosystem overall and therefore contribute to the ESG 'cascade effect'.

In sum, there are some uncertainties and incompletions on how the sustainability reporting regime will play out in the EU. The next few years will then be decisive to understand if the cascade effect derived from new EU rules will be displayed in full scale or not.

By Paulo Câmara, Professor of Law at Universidade Católica Portuguesa in Lisbon (Portugal) and Head of Governance Lab.

Understanding the relationship between corporate purpose and profits.

Claudine Gartenberg
Wharton, University of Pennsylvania

Nowadays, it seems every company claims to have some higher "purpose" beyond profits. Given that these companies are also for-profit entities, proponents claim that higher purposes invariably lead to higher profits. In the words of Blackrock CEO, Larry Fink, "Purpose is not the sole pursuit of profits, but the animating force for achieving them. Profits are in no way inconsistent with purpose--in fact, profits and purpose are inextricably linked."

Skeptics disagree. They dismiss purpose as empty sloganeering designed to confuse shareholders and shield poor performance. Pursuing purpose may be admirable but ultimately distracts from the business of running a business.

Which view is correct? Does pursuing purpose actually boost profits or is there a trade-off between the two? These questions get to the heart of the vigorous and important debate about the role of business in society. New research sheds light on a potential answer.

The biggest challenge in empirical research on corporate purpose is how to measure it. Purpose is, by nature, intangible. This intangibility means that it is impossible to observe directly and instead can only be measured by proxy. So what proxy to use? Rather than relying on CEO statements and corporate filings that have been critiqued as cheap talk, we have developed a measure based on the aggregated beliefs of employees themselves.

Purpose and profits do appear to coexist and reinforce each other, but only under certain conditions - when innovation and intangibles drive value creation and owners take a long-view

We consider these beliefs as a credible signal of purpose: if employees believe that their work has meaning, then there is something the organization is doing to instill that sense of purpose, even when we cannot observe it. Importantly, our survey data also allows us to measure this sense of purpose independently from other sentiments, including overall job satisfaction and trust in management.

Using this measure, we find the purpose-profit connection varies dramatically by company and sector. In some industries like healthcare, purpose and profits are mutually reinforcing – stronger purpose corresponds to stronger financial performance. But in others like financial services, we see a trade-off - more purpose translates to less profit.

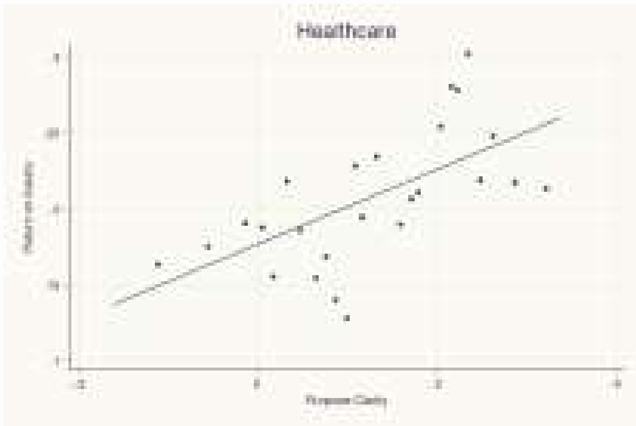

Figure 1

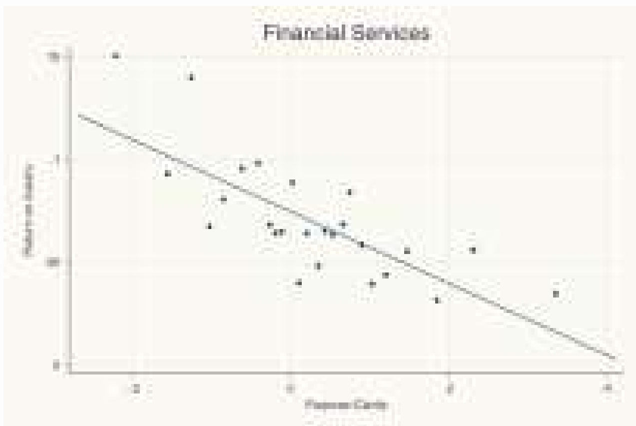

Figure 2

What explains this pattern? The research points to two key factors.

The first is how much a company relies on innovation and intangible assets like intellectual property, brands, and capabilities. In high intangibles settings, purpose may be vital for motivating creativity and teamwork that formal incentives do not elicit. Purpose provides inspiration and direction that enable companies to outperform. In low intangibles settings – for example, those companies reporting zero R&D expenses – we find the opposite pattern. Stronger purpose corresponds to lower profits. Those settings may be relatively more focused on cost-savings and efficiency as the basis of profitability, and a strong purpose may indeed be challenging to pursue alongside those goals.

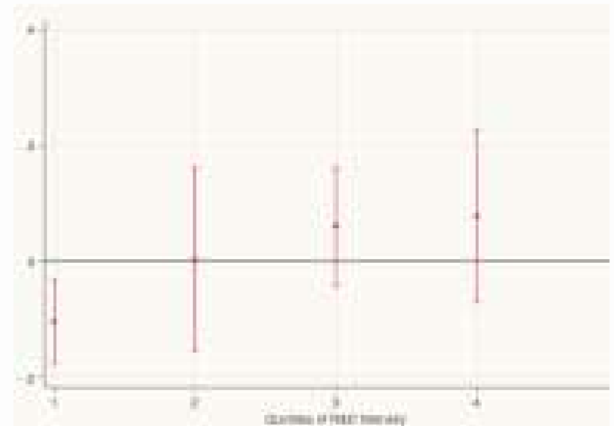

Figure 3

The second is the temporal horizon of the company's owners. Companies owned by patient investors exhibit a positive link between purpose and long-run profits. Those owned by short-term investors show the opposite pattern - purpose detracts from near-term earnings. This divergence suggests that patient owners may be better positioned to realize the long-term value that can arise from purpose, whereas short-term owners prioritize immediate results which purpose may hamper. Short-term owners may also apply greater pressure on executives to deliver immediate returns, which could come at the expense of purpose-driven decisions that pay off over longer periods.

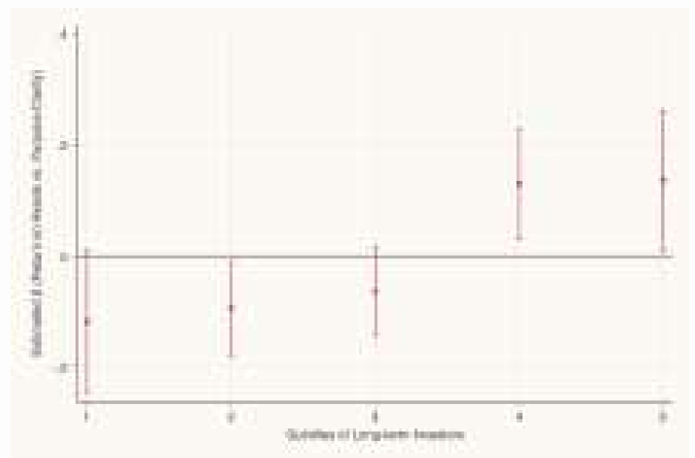

Figure 4

So what does this teach us? Several insights emerge:
First, purpose and profits do appear to coexist and reinforce each other, but only under certain conditions - when innovation and intangibles drive value creation and owners take a long-view. Second, we cannot assume this positive purpose-profit relationship holds everywhere. Trade-offs exist. In settings with inherent trade-offs, mandating purpose may prove an ineffective tool for achieving social objectives via for-profit entities. Different approaches are likely needed.

Lastly, two sweeping trends appear to be colliding with unpredictable consequences. First, the economy is shifting more toward innovation and intangible assets as the basis of production, conditions that are consistent with purposeful companies flourishing financially. Second, the nature of capital markets is shifting, with many signs pointing toward shorter-horizoned and more engaged owners. How these two shifts combine to support or detract from purpose-aligned strategies remain unclear.

In the end, this study counters the sweeping generalizations of the current debate. The findings reveal that purpose can lead to stronger financial performance given the right conditions - when innovation and intangibles form the basis of value creation and owners take a long-term view. The implications are clear: we should be realistic about where tradeoffs exist, while also encouraging settings in which purposeful, profitable businesses can flourish.

By Claudine Gartenburg, Assistant Professor of Management at the Wharton School of the University of Pennsylvania.

Should companies link Executive Pay to Corporate Purpose?

Gaizka Ormazabal
IESE Business School

Amid the movement to value companies beyond profit and share price, there is a debate on whether to do the same with the pay packages of top executives, incorporating non-financial performance criteria into incentive plans. Should "purpose" be one of them?
We recently conducted a global survey of boards of directors to gauge views on issues related to purpose, culture and strategy. A remarkably high number of board directors -- 89% -- reported that their company had an explicit statement of purpose. They also said they believed the CEO was the chief figure in shaping purpose, more than the board itself or than other employees.
However, the need to link executive pay to corporate purpose (henceforth "purpose pay") is not immediately obvious. To begin, one could argue that caring about people and the planet is a "must", and thus should not be subject to variable remuneration. A related argument is that executives already have powerful non-monetary incentives to fulfill their firms' purpose in the form of social pressure, reputation, and the like. Others might argue that purpose statements can tend toward the vague and aspirational whereas pay packages are overwhelmingly concrete, requiring reliable metrics. Finally, if purpose is about "finding profitable solutions for the problems of people and the planet", one could argue that the fulfilment of corporate purpose will eventually show up in the financial metrics currently used in compensation contracts..

The discussion around incorporating environmental, social and governance (ESG) criteria in executive compensation can provide useful insights into the possibility of "Purpose Pay".

In a recent study on ESG pay, we looked at nearly 4,400 publicly traded firms in 21 countries. We found that the practice of linking compensation to ESG goals had jumped to 38% of firms in 2021 from just 1% a decade earlier – a sign that incorporating novel metrics is possible. We examined three potential reasons for companies to base executive compensation arrangements on ESG metrics. These rationales are interrelated and not mutually exclusive.

The first reason relates to incentive contracting. To the extent that ESG metrics are viewed as leading indicators of future financial performance and potential risks, existing agency models provide an efficient contracting rationale for ESG-linked pay (ESG Pay), even if the firm's shareholders preferences are purely pecuniary.

A second potential reason to adopt ESG Pay is aligning managerial objectives with the interests of select stakeholder groups, including the firm's shareholders. If the firm's current or prospective shareholders have an intrinsic (i.e., non-pecuniary) preference for improvements in ESG related outcomes, the adoption of ESG Pay may serve as a mechanism for aligning the objectives of management with owners' preferences. Note that this rationale does not necessarily imply that higher ESG performance leads to higher financial performance.

A third potential rationale for ESG Pay is that the decision to tie managerial compensation to ESG outcomes may strengthen the credibility of a company's existing disclosures and pledges to improve its ESG outcomes.

The results of our tests suggest that each of the three rationales can explain part of the variation in ESG Pay adoption. In exploring two additional factors which may affect the adoption of ESG Pay, we find support in the data that the decision to adopt this practice is affected by individual perceptions, specifically personal opinions and expectations about ESG outcomes and/or ESG Pay, as well as peer effects. We do not find that ESG Pay is related to abnormal CEO compensation, but this does not necessarily mean that this compensation practice is on average optimal for shareholders.

We also explored the potential consequences of the implementation of ESG Pay. While our tests are descriptive (establishing causality is not possible given the limitations of our data), we found evidence consistent with the notion that ESG pay can be instrumental in improving sustainability performance. For example, our results suggest that, when companies include emission-specific metrics in their pay packages, they exhibit a subsequent decrease in their CO_2 emissions.

In contrast, we did not find that the introduction of ESG Pay was followed by stronger financial performance. If, anything, the results pointed in the opposite direction. One explanation is that improving ESG performance is costly from a financial perspective. An alternative explanation is that improved ESG performance will yield long-term financial benefits, not yet captured in earnings and/or stock prices.

It is not difficult to see the likely connections between ESG pay and "Purpose Pay". Similar to ESG metrics, a measure of purpose could be a leading indicator of future financial performance. Of course, this assumes that purpose really means "producing profitable solutions to the problems of people and planet, not profiting from producing problems".

Just as ESG criteria have been criticized for being overly broad and amorphous, a measure of purpose could be noisy and manipulable. Like ESG Pay, "Purpose Pay" would require a clear definition of the underlying concept of purpose, along with well thought-out and transparent metrics and targets. Otherwise we run the risk of "purpose-washing".

If purpose is about "finding profitable solutions for the problems of people and the planet", one could argue that the fulfilment of corporate purpose will eventually show up in the financial metrics currently used in compensation contracts.

By Gaizka Ormazabal, Professor of Accounting and Control at IESE Business School, and ECGI.

Purposeful measurement requires radical prioritization

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IBusiness leaders today are faced with an increasingly complex and fast-changing environment through which to steer their organizations. Systemic climate and biodiversity crises, resource scarcities, growing social inequalities, pandemics, political polarization and geopolitical conflicts, technological disruption, and the changing nature of work – to just name the most obvious – all require meaningful responses from businesses if they are to continue operating successfully into the second half of the 21st century. In other words, long-term sustainable business performance depends on a fundamental understanding of both social and environmental dependencies and impacts of a business venture.

In this context, and to develop this understanding, the importance of new measurement systems that go beyond traditional financial performance has been elevated. Yet, neither offers from for-profit ESG data-providers nor frameworks from non-governmental and international organizations have been able to deliver on a practical system that business leaders could use to steer meaningful change within their organizations. If anything, the plethora of measurements and methodologies created has added to the complexity that managers are facing in this space. And while the last years have seen promising advances in standardization and regulation of sustainability-related measurement that will increase clarity and comparability of corporate disclosures, we are still left wondering whether and how these measures will help companies manage – that is steer towards meaningful increases or decreases of – their dependencies and impacts in a sustainable way.

What we want to avoid is that measurement of sustainability becomes a mere compliance task. This would move insights from data collection directly into boilerplate reports without receiving proper consideration from managements and boards. Such measurement for the sake of measurement would not only be a waste of resources but, above all, would mean a missed opportunity for businesses to future-fit their organization.

So how can we ensure the meaningfulness of measurement? In my ongoing research, using both conceptual and empirical approaches, I explore various business and investor settings to understand when and why sustainability information seems to enable business leaders most to make impactful decisions. By impactful decisions I mean those decisions that really move the needle. The non-incremental. The transformational. The starting point here is usually the recognition that numbers are not an end in themselves, but that they are a tool with a function. Conceptually, this means tying measurement to specific pre-existing or novel logics of action. Empirically, this means assessing how businesses link sustainability measurement to their own conceptualization of corporate performance. Based on this work, two interdependent logics have emerged as being particularly powerful in enhancing the use and usefulness of sustainability-related measurement: 1. Tying measurement to purpose, and 2. “Radical prioritization”.

In a first instance – and at the risk of sounding tautologist – tying measurement to corporate purpose can help making measurement purposeful again.

Or, to make it sound less redundant, for sustainability-related measurement to be meaningful to management, it needs to be closely linked to the core value proposition (economic, social, and environmental) that a company pursues with its business model. For this to work, of course, businesses need to first know what their corporate purpose is and what value they want to create through it. Colin Mayer's definition of finding "profitable solutions to the problems of people and planet, without producing harm" describes a tangible way of how companies can think about this. Tying a business model to such a meaningful challenge, and measuring its achievement as a strategic goal, can be extremely beneficial for the strategic market development of companies, as evidenced by examples such as Novo Nordisk ("Defeating Diabetes and other Diseases") or Mars Petcare ("Bettering the Health of every Cat and Dog"). It can also be powerful in shifting the logic of performance within a business altogether.

Measuring the social and environmental dependencies and impacts of a business model, of course, remains to be a complex task. This is exactly why the focus on core value propositions and purpose is so important: It enables what I call "radical prioritization", meaning that the core of sustainable performance measurement and management should focus on a few, select issues which are the most central to the social, environmental, and economic value that the business seeks to create. It is radical, as it goes beyond the mere concept of single and double materiality, asserting a strategic lens of value creation in selecting only the most important topics and, thus, also making conscious choices about which are considered less important. It is about prioritization, as it requires a company to then manage these topics actively and with the same commitment and attention as it manages, for example, earnings and margins.

Yet, radical prioritization is not just a tool of complexity reduction. It fundamentally is meant to aid complexity appreciation. By concentrating on a select range of topics, the trap of superficial analysis can be avoided.

The core of sustainable performance measurement and management should focus on a few, select issues which are the most central to the social, environmental, and economic value that the business seeks to create

Within the selected areas, assessments should thus focus on the entire impact chain (capturing inputs, outputs, outcomes, and impacts), include key stakeholder perspectives, and rely not on one, but various methodologies. Core KPIs should relate to short-, medium- and long-term targets, capital allocation should be aligned to the achievement of these targets, and measures and methods that provide evidence on progress should be externally audited wherever possible. In other words, within the few select issues which enjoy radical prioritization, specificity, credibility, and legitimacy must be managed to the maximum.

Finally, it is important to highlight that the concept of radical prioritization, perhaps against expectation, does not advocate for a disregard of the advances made in standardization and regulation – particularly where these focus on negative firm impacts. Indeed, it needs to be complemented by comparable measures in relation to negative externalities to allow for external accountability in their regard. In other words, radical prioritization must be based on a "do-no-harm" principle of value creation, which avoids its misuse for fig-leafing disregards of fundamental rights, such as human rights or grave environmental pollution.

By Prof. Judith C. Stroehle, Assistant Professor of Sustainability Governance, University of St. Gallen.

Corporate acceptance of stakeholderism: Will it hinder or boost government regulation of corporate externalities?

Elizabeth Pollman
University of Pennsylvania Law School

he 2023 ECGI Annual Meeting brought together academic scholars and business leaders to address central questions relating to modern capitalism and corporate purpose. The three-day event at the Copenhagen Business School concluded with the Wallenberg Lecture by Professor Lucian Bebchuk on "Three Conceptions of Capitalism." The distinguished lecture was an excellent culmination of his recent works and raised a number of interesting issues.

One of the critical points he emphasized was the potential impact of stakeholderism on government regulation. As Professor Bebchuk noted, "Acceptance of stakeholderism raises illusory hopes that corporate leaders would protect stakeholders on their own. This could substantially chill or impede efforts to obtain regulatory reforms that could produce real benefits for stakeholders." This statement encapsulates a pivotal debate: does corporate acceptance of stakeholder interests impede or encourage government regulation of corporate externalities? The answer is likely more complex than it might seem, and richly deserving of further inquiry.

Understanding Stakeholderism and Regulatory Efforts

In recent years, there has been a notable shift in investor and corporate thinking towards at least some measure of stakeholderism. This view posits that businesses should not solely prioritize shareholder interests but should also consider the well-being of a broader range of stakeholders, including employees, customers, communities, and the environment. Different proponents of stakeholderism have asserted this view with varying strength as to whether, and the extent to which, corporations should give stakeholder interests independent weight and be willing to make tradeoffs at the expense of shareholder interests.

The Potential Chill Factor

Professor Bebchuk's point regarding the illusory hopes raised by stakeholderism raises a critical concern. When corporations publicly commit to pursuing stakeholder interests, there may be a perception that government intervention is not needed. This perception, in turn, could chill or impede efforts to obtain regulatory reforms. This concern might worry observers from different viewpoints who share in common a belief that government regulation of externalities is necessary and important for promoting societal interests.

In this scenario, corporate leaders may believe or at least give the appearance that their voluntary efforts to address stakeholder concerns are sufficient, thus creating a disincentive for governments to step in with more comprehensive and enforceable regulations.

For instance, if a corporation widely publicizes its commitment to environmental sustainability, it might be less inclined to support stricter environmental regulations. Policymakers might see investor and corporate statements concerning a wide range of issues, from carbon emissions to worker wages, and conclude that private action is responsive.

In addition, corporate lobbying and political influence play a significant role in shaping government regulations. Companies with substantial resources often engage in lobbying efforts to sway regulatory decisions in their favor. In such a context, it's plausible that corporations advocating for stakeholder interests could simultaneously work against stringent regulation of externalities. A corporation might, for example, publicly support environmental sustainability while using its lobbying power to resist regulations that impose costly environmental compliance measures. This dual approach can create a contradictory situation, in which corporations are ultimately working against regulatory actions that would address their externalities.

A Catalyst for Regulatory Action?

On the other hand, corporate acceptance of at least a measure of stakeholderism might create an environment in which government regulation of corporate externalities is more likely. Stakeholderism can spotlight areas where current regulations may be lacking or ineffective. When corporations actively engage with stakeholders, valuable insights into the shortcomings of existing regulatory frameworks might come to light.

Investors, consumers, and employees, when informed and engaged, can exert pressure on corporations and governments. They can demand that companies live up to their stakeholder commitments while advocating for government regulations to help ensure consistency and accountability.

When corporations publicly commit to pursuing stakeholder interests, there may be a perception that government intervention is not needed. This perception, in turn, could chill or impede efforts to obtain regulatory reforms.

Corporations that embrace the pursuit of stakeholder interests may be more willing to collaborate with government bodies, civil society organizations, and other stakeholders to address complex issues.

A shift in corporate culture and support may prompt governments to follow suit, recognizing the need to codify and enforce these principles through regulation that serves broader societal needs. While chilling corporate externality regulation is a serious concern, the type and direction of outcomes that follow from corporations embracing stakeholder interests is not clear.

Conclusion

In sum, the relationship between corporate acceptance of stakeholderism and government regulation of corporate externalities is complex and multifaceted. There is a risk of stakeholderism being exploited for public relations purposes without substantive action. Corporations might engage in performative gestures that give the appearance of prioritizing stakeholder interests, while sidestepping meaningful systemic change. This could, indeed, chill the drive for robust government regulation, as it may seem that corporations are already taking adequate steps to protect stakeholders.

There is so much, however, that is not understood about the relationship between private ordering efforts and government regulation. While it is conceivable that stakeholderism could chill regulatory efforts by creating a perception that voluntary measures suffice, it is equally possible that it could drive an environment where regulation becomes more likely.

In practice, whether corporate acceptance of stakeholderism chills or fosters government regulation of corporate externalities likely depends on various factors, including the sincerity and transparency of corporate commitments, the level of public awareness and engagement, the political landscape, and the responsiveness of government bodies. Among many important issues highlighted by this year's superb Wallenberg Lecture was the value of further studying this dynamic.

By Elizabeth Pollman, Professor of Law at the University of Pennsylvania Law School and ECGI.

Strategic Corporate Purpose

Rui Albuquerque, Boston College
Luis Cabral, New York University, Stern School of Business

The purpose of a corporation is to advance solutions to problems and to create wealth along the way. As Colin Mayer puts it: "corporate purpose [...] recognizes profit as being derivative of solving, not producing problems, and measurement that needs to account for the costs of rectifying and avoiding producing problems."

In recent research, we propose that there are problems that firms in isolation cannot solve, but that the combined action of firms in an industry might. To put it in a game-theory context, the nature of these problems involves a prisoners' dilemma. We view a solution to these problems as the manifestation of strategic corporate purpose.

Consider the problem of green-technology adoption. In many instances, adoption is ruled out because the financial gains are not there when a firm is the sole adopter. The outcome results in the preservation of the status quo. But suppose there is an externality associated with non-excludable learning by doing where production costs decrease with production volume and the knowledge acquired is available to all. Then, the production cost of an adopter is lower the greater the number of other firms that make the same choice. As an example, consider the move to electric vehicle production, and the associated investment in complementary assets such as charging stations or batteries. In this context, it makes a big difference whether only one firm moves to producing electric vehicles as opposed multiple firms in tandem.

In our research, we discuss the implications of adding an initial game stage, a mission-statement stage.

Corporate purpose takes a strategic dimension: it advances the wellbeing of the firm by advancing the wellbeing of the whole industry.

To continue with the previous example, firms would have the chance to commit to a green-friendly mission statement. Such mission statement commits the firm to pursue an objective function that, in addition to profitability, includes other goals such as adoption of environmentally-friendly technologies. We provide conditions such that, in the equilibrium of the two-stage game, all firms adopt a green mission statement, which in turn leads them to optimally adopt a green technology.

This result is significant because green mission statements may be adopted by profit-maximizing shareholders whose utility is not affected by the move to green technology. Basically, the mission statement stage effectively turns a prisoner's dilemma into a coordination game. Firms are better off by adopting a green statement; sticking to the legacy technology is no longer a dominant strategy. In this way, firms coordinate in adopting a green technology, which in turn makes them better off — even from a purely financial point of view. In this sense, our two-stage framework provides a natural interpretation of the oft-repeated mantra "doing well by doing good."

Our model suggests an additional perspective on corporate responsibility (CSR), namely that of strategic leadership. We provide conditions such that the mission statement 'game' is a pure coordination game: firms are better off by committing to CSR, but no firm has the incentive to unilaterally do so. By committing to CSR, a firm effectively pulls other industry participants along, thus achieving a more efficient equilibrium. In this sense, corporate purpose takes a strategic dimension: it advances the wellbeing of the firm by advancing the wellbeing of the whole industry.

There is ample and increasing evidence of firms departing from straight value maximization. There is also evidence of within-industry interdependence in such moves. For example, research shows that product-market peer firms appear to adopt CSR policies after a close-call vote approving a CSR proposal on a shareholder meeting by another firm in the industry. Similar patterns are discussed in other research. Our theory of Strategic Corporate Purpose provides an explanation for these patterns, one that goes beyond the traditional, partial equilibrium view of CSR.

By Rui Albuquerque, Professor of Finance, Carroll School of Management, Boston College; Research Associate, ECGI Research Member; and Research Fellow, CEPR and Luís Cabral, Paganelli-Bull Professor of Economics, Stern School of Business New York University; and Research Fellow, CEPR.

Three Conceptions of Capitalism

Lucian Bebchuk
Harvard Law School

I thought it would be fitting, since the lecture is named after the Wallenberg family, to start by relating what I'm going to talk about to the Wallenberg family example. It's an inspiring example. I've read much about it before coming to deliver this Wallenberg lecture. You've heard a lot about it already from Peter Wallenberg, who heads the Foundation. It's an inspiring example of a family that, over a long time, has been committed to using its wealth for the betterment of society and with a clear impact. The question is, what should we learn from the Wallenberg family example? One possible inference is that maybe we should advocate and hope that business leaders, in general, follow the Wallenberg example and run businesses much more to the benefit of stakeholders and society than what we have seen in the business world thus far.

And when you look at this question, people here can have two different views. One view, one answer, would be, to quote a well-known presidential candidate in the US, "Yes, we can". We should just urge corporate leaders until they see the light. The answer that I will put on the table for you today is no. We cannot. No matter how inspiring this example is, we cannot expect that, by and large, corporate leaders are going to follow this example and use their discretion in the way that the Wallenberg have done.
But we should use this inspiring example to think about how to fashion the rules of the game of capitalism so that we do advance this commitment to the benefit of society, even when business leaders themselves cannot be assumed to be driven by the moral and societal commitments that the Wallenbergs have displayed.

So, my general question, and I know that many of you have been thinking about this, is, there is an ongoing and heated debate about how to make capitalism work better for society, for employees, for other stakeholders, for protecting the planet, which is a pressing issue nowadays.

In this connection, one question that has been debated is, what guidance should we give to corporate leaders when they run their businesses?
I'll talk today about three kinds of traditional alternative conceptions about this question, and I'll suggest to you a number of questions that each of us should ask in choosing among those conceptions, which conception to follow. I'll use this language to explain why I support one of the conceptions and reject others.
So, there are three rival conceptions that have different variations, but those are conceptions that have had a lot of traction in public discourse, in politics, and in scholarship over the last half-century: Friedmanesque capitalism, managerial stakeholderism, and democratic capitalism.

Friedmanesque capitalism, named after Milton Friedman, supports a vision of the world in which we have profit-maximizing firms operating alongside limited government. An alternative view that has become increasingly influential over the last decade expresses dissatisfaction with the Friedmanite paradigm and suggests addressing the problems of society and stakeholders by encouraging and relying on corporate leaders to use their discretion to serve not only shareholders but also stakeholders. This view has been increasingly endorsed by many corporate leaders.

There are two versions of managerial stakeholderism that we try to distinguish. One is stakeholderism as a mere instrument for improving long-term shareholder wealth, and a pluralistic version in which all stakeholders are an independent end. One version is often referred to as enlightened shareholder value. It reflects an enlightened recognition of the fact that if you don't look after the stakeholders, this will hurt the company's profits in the long term. Therefore, corporations should protect stakeholders if, when, and only to the extent that doing this would serve long-term value. Our argument has been that, if you assume corporate leaders seek to maximize long-term shareholder value, then this enlightened shareholder value is not operationally different than simply long-term shareholder value.

There's another version that some people have advanced, saying that we need this enlightened shareholder value because we're concerned that corporate managers are sometimes myopic. They don't give enough weight to long-term consequences, and any stakeholder-oriented actions have long-term effects. For example, treating your employees well will have long-term benefits. To the extent that corporate leaders are myopic, urging them to look at the long term is not going to make a difference. And secondly, if you understand that the main problem is short-term incentives, then the way to address them is not to urge corporate leaders to pay attention to the long term. The best way to address this problem is to give corporate leaders incentives to focus on the long term, such as using incentive pay which is tied to long-term shareholder value.

An alternative version was incorporated in some constituency statutes that were adopted by some US states, giving an independent weight to the interests of different stakeholder groups and urging corporate leaders to look at the aggregate of interests.. That could lead to operationally different instructions than a Friedmanesque guideline. That's not the version most used by proponents of stakeholderism. .

> It's skeptical that corporate leaders should be expected to serve stakeholders beyond what would serve shareholder value.

But whichever version is used, sometimes it's for political convenience. As long as you're relying on is the discretion of corporate leaders and not having their choices second-guessed by courts, then in the end you're relying on their discretion. The key question is how they are going to use their discretion.

A third conception, which is my own view, is different from Friedmanesque capitalism because it's deeply concerned about the externalities that companies impose on the world, the array of effects companies have on their environment. It's skeptical that corporate leaders should be expected to serve stakeholders beyond what would serve shareholder value. Instead, it combines the traditional focus of corporations on shareholder value with strong governmental regulations and policies that would constrain and incentivize companies. These incentives would work together with the traditional way that corporations operate, leading to good outcomes. For example, if you care about climate change, use carbon taxes and subsidies or have labor-protecting laws to protect the interests of employees.

How should anyone make a choice between these different conceptions or variants thereof, or decide to which conception they are closest? I suggest to you that there are four questions that you should ask yourself. One question is how well capitalism, and by this, capitalism in the Milton Friedman sense of profit-maximizing firms alongside limited government. How well this is working for stakeholders? Milton Friedman saw that this is going to work well for everyone or at least as well as is possible in this world. An alternative view is that it's not working well. That's what has driven the stakeholderism movement. Rebecca Henderson, in a nice articulation, said, "The world is on fire."

So when you answer this question, obviously there is a continuum of answers. The more you think that this capitalism works well and we can leave it to operate as is, that drives you toward Friedmanesques capitalism. The less well you think it works, it moves you either towards managerial stakeholderism or towards Democratic capitalism.

The second question is whether corporate leaders can exercise discretion. One view is that corporate leaders can be expected to be guided by the stipulated corporate purpose that society will communicate to them. The managerial stakeholderists strongly hold this view. Milton Friedman, he didn't like the implications of this view, but if you read his famous essay, you see that he saw that if we tell corporate leaders to look after the stakeholders, if we say that that's acceptable corporate social responsibility, which he was very much rejecting, he saw that they will indeed go and do it, so they would go out and serve stakeholders big time. An alternative view that the Democratic capitalists subscribe to is that it's not going to happen because of the incentives of corporate leaders.

A third question is whether government interventions are beneficial when they happen. Are they at all feasible given political gridlock, lobbying by interest groups, and so forth? Friedmanesque's capitalists answer this question by a resounding no. Milton Friedman believed that government interventions are the problem, not the solution to any societal ill's. The managerial stakeholders don't take a strong view on this, but if you read the writings, the main motivation they have is they don't really hope that governmental interventions are going to do the job, and therefore, they are putting their chips, so to speak, on the discretion of corporate leaders.

Democratic capitalists, on the other hand, they think that because they don't really... They're not very hopeful that the discretion of corporate leaders is going to be effective. They think that governmental interventions are indispensable.

The fourth key question you might want to ask yourselves is to what extent is corporate political spending and lobbying detrimental or perhaps on the other side, beneficial, or at least acceptable. On the view of Milton Friedman, corporate politicking is beneficial. It's actually a necessary counterweight to the desire of bureaucrats to expand their tariff and intervene wherever possible. Therefore, we need the corporate countervailing force. Managerial stakeholders don't have a strong view about this. They don't focus on this issue, but they take corporate politicking as given, and this premise that it's given also is part of the motivation why they want corporate leaders to step in and help. On the other hand, Democratic capitalists think that what we need is for the democratic process to provide adequate constraints on the operations of companies. Therefore, it's very important to limit the ability of corporations to impede governmental interventions. Again, where you stand on this would lead you in one direction or another.

Some implications: there is now a lot of debate on the Business Round Table statement on corporate purpose, about the Davos Manifesto, and so forth. Usually, when you read the literature or you read the media coverage of this, it often seems to conflate all the critics, all those who do not accept managerial stakeholderism in one group. They think about all of them as people who are committed to shareholder primacy because they are not stakeholders. But I think that's a big mistake because those two positions, even though they are similar in that they don't want to urge corporate leaders and to rely on them to serve stakeholders, they are fundamentally different, as I just described. To put it together, they have at least four drastic differences. Friedmanesque's capitalists and Democratic capitalists start from very different premises as to the outcomes of capitalism.

On a conceptual level, the key problem that we see is an incentive problem. If you go over the incentives that corporate leaders have and they have an array of factors that provide them incentives, they have compensation schemes, they have market for corporate control constraints, labor market constraints, product markets, and so forth. If you go systematically through this array of incentives, you have to conclude that corporate leaders have some substantial alignment with shareholders, not as much as some people would like. That's the well-known agency problem. But corporate leaders have very little alignment of interest with stakeholders, and therefore you have to conclude that corporate leaders have incentives, not only they don't have incentives to serve stakeholders but they actually have incentives not to serve stakeholder interest beyond what would serve shareholder value.

Now, there is, as anyone who looks at corporate documents or read the newspapers have noticed, there is a lot of stakeholder talk by business leaders and by corporations. There is definitely a great deal of stakeholder rhetoric, and the question is what one makes of it. We have done a significant number of empirical studies trying to look at corporate action and how it compares with corporate rhetoric. And all those papers are available on my homepage if anyone is interested. What we have found in one study after another is that the current stakeholder talk is mostly for show. It's not matched by corporate action. So starting with the first paper, we surveyed a large number of corporations that signed the Business Round Table statement. We found out that almost all of them did not have the decision by the CEO to endorse, to sign the Business Round Table statement, it wasn't ratified by the board, either before or after.

The clear interpretation to us was not that this was a governance failure but rather that this was a reflection of the fact that the CEOs did not see that this was a meaningful commitment. They viewed it more as a public relations move.

What we have found in one study after another is that the current stakeholder talk is mostly for show. It's not matched by corporate action

Indeed, when we then went on to look at what happened in the signatory Business Round Table companies and we looked at over 140 such companies and we tracked all the communications over the next several years. We saw that almost all of them retained to this date corporate governance guidelines that expressed a commitment to shareholder primacy. They all left director compensation, again, to this date, and director compensation is perhaps the clearest signal that the company sends to the board as to what the company wants the board to pay most attention to. So director compensation is linked substantially to stock price, and it has no connection in any of those companies to stakeholder metrics.

Lastly, a large number of companies are responding to shareholder proposals to get a report about what were the consequences of their endorsing the Business Round Table statement. They took the view that they don't need to file such reports because the Business Round Table statement didn't require them to make any changes beyond what they have been doing in the past. We then also looked at a large number of acquisitions that took place over the last two decades, in states in the United States that have constituency statutes. Those constituency statutes are kind of the best where the word stakeholder is envisioned. Those are statutes that call on corporate leaders, especially in the context of an acquisition, to look after the interests of employees, communities, and so forth and so on. voluntary form of taxation to promote the public good.

Our view is that embracing stakeholderism can indeed hurt and can be counterproductive from the perspective of society and the very stakeholders that many of the stakeholderists would like to protect.

They were passed with the support of unions at the time. Then we found when we went into the documents that reflected what happened in those transactions, we saw that corporate leaders generally used their bargaining power only to obtain benefits for their shareholders and often also to themselves through secure jobs or through substantial monetary payoffs. But you can't find, even though again we were able to document this, even though there were substantial risks to stakeholders as a result of the transaction, reduced labor force, and so forth, there were no deal protections for the interests of employees or other stakeholders.

We did the same thing for all the transactions that took place during the pandemic period. The pandemic period was bad in almost all respects except it was a very good period for those who practice corporate law for M&A transactions. So there was a massive number of transactions, and we saw that this was a good setting to study this issue because this was a period right after the Business Round Table statement, right after the Davos Manifesto. It was also a period in which stakeholders were viewed as especially vulnerable. Employees, communities, and the like. So again, we went into the documents and we found that in this very large number of transactions, with an aggregate value close to a trillion dollars, corporate leaders generally did not negotiate for any material protections for any group of stakeholders but rather focused on shareholder interests and the interests of private managers.

Actually, the Twitter acquisition by Musk is a good example.

We did a case study about this particular acquisition because we saw that this provides a vivid example of this point that we are trying to press because Twitter was a company that, for many years, has engaged with a great deal of stakeholder rhetoric. It had this fond label for its employees, they were called the tweeps, and the company has expressed, again and again, its commitment to look after the interests of the tweeps. It had strong commitments to other values, to the type of discourse they are trying to advance and so forth. However, when negotiating the deal with Musk, in order to get the massive premium to the shareholders and some significant private benefits to the corporate leaders themselves, we argue that the corporate leaders, and here we are not blaming Musk, Musk was maximizing his own interests. We are blaming the corporate leaders for acting in a way that was so starkly different from their own rhetoric over so many years from the commitments they have themselves expressed. We claim that they, as it were, pushed the stakeholders under the bus.

Within several months, 75% of the tweeps were out of a job, and many of them even mistreated in ways that were unnecessary. All of this is something that we explained could have been dealt with when negotiating the deal but was not.

Some of you might say that maybe the positive effects are not that large, maybe it's just the beginning and it will get better. But certainly, stakeholderism cannot hurt. Our view is that embracing stakeholderism can indeed hurt and can be counterproductive from the perspective of society and the very stakeholders that many of the stakeholderists would like to protect. There are two main ways in which embracing stakeholderism can hurt. One is by making corporate leaders less accountable to shareholders or to anyone else because stakeholderists push for giving and relying on expanded discretion of corporate leaders and, managements all over the world have been using the stakeholderist argument, to try to get more defference from institutional investors, less support from institutional investors, to hedge funds, activists, and so forth.

Their argument is we need to have some space, we need to get some defference so you can let us operate without intervention for the long term to the benefit of society. And indeed, there is some evidence that some of the business leaders who have been pushing for stakeholders and endorsing it have been partly motivated by the hope of getting this substantial defference from institutional investors. In our view, embracing stakeholderism, which means making corporate leaders less accountable to shareholders, but really not accountable to anyone else, is not going to benefit stakeholders and is not going to benefit shareholders. It's only beneficial for the private interests of managers, but not for others.

The other adverse effect is that of the spreading belief that we can count on corporate leaders to look after the interests of stakeholders, which is shifting energy from the real action, from trying to press governments to take action to protect stakeholders and trying to press companies to stop intervening in politics and channeling this energy to a lot of activism that is trying to go after companies and try to nudge them in one way or another to make commitments that, according to our studies, do not turn out to be meaningful.

If you take the example of climate change, which I know is probably in the minds of many of you. All the effort that we have to get companies to express commitments to a reduction of carbon emissions by 2050, which would be decades after the CEOs who express those commitments would be out of office, channeling all this energy in that direction is not going to move the needle. It can just have two adverse effects. One effect that people might feel, on the margin, less urgency about the situation, they might think private ordering is coming to the rescue, and we can count on it, or at least let's wait a decade and see how well it worked, and it gives some argument for the private sector towards regulators that they don't need to intervene because private ordering will take care of things.

There are now also around some versions of stakeholderism that are not managerial. I call them not managerial because they try not to rely as much on the discretion of corporate leaders. But still, what they share with stakeholderism is to try to work with the corporate governance instruments to try to rewire, so to speak, the internal corporate governance processes. For reasons that the paper will explain, none of them can really make significant difference in the effects of stakeholderism, and in the end, society would be best, and stakeholders would be best, if we leave the internal governance processes, as they have worked well, as the economic engine of our world for a long time, but just face companies through governmental reforms with the cost of the externalities they impose. And this way, make capitalism work best for society.

By Lucian Bebchuk, the James Barr Ames Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School and ECGI Fellow.

Top-tier law firms: Do they create additional value to venture capital deals?

Douglas Cumming
Florida Atlantic University

Top-tier law firms frequently assert their ability to create additional value for their venture capital (VC) clients. Information asymmetry stands as a significant hurdle to the success of VC deals, potentially hindering capital provision transactions and leading to less-than-ideal results. Law firms play a key role in offering legal counsel and contract design for VC deal agreements, influencing communication and coordination between VC investors and their portfolio companies. Thus, it is expected that the expertise of the law firms should facilitate information flows among the parties, addressing the information asymmetry inherent in VC deals. Yet, the effect of top-tier law firm involvement on VC deal outcomes remains unexplored.

There are two main arguments, which yield conflicting predictions with respect to the economic value of aligning VC deals with high-quality legal services. On one hand, if top-tier law firms engage in VC deals primarily to safeguard their interests and prevent opportunistic behaviours by the counterparty, this could lead to excessive formality and tension. This atmosphere could potentially undermine the overall success of VC deals. Conversely, if top-tier law firms mitigate information asymmetry in VC investments – for instance, by providing robust legal advice on fiduciary responsibilities, lowering communication expenses, building greater trust through thorough due diligence, formulating efficient contract terms, and acting as essential negotiators between VCs and portfolio companies – the involvement of legal services could indeed augment investment success.

Leveraging insights from a comprehensive dataset encompassing nearly 182,000 global VC deals spanning the period from 2005 to 2020, our research underscores the multifaceted impact of top-tier law firms on deal success and performance.

Therefore, whether the participation of top-tier law firms leads to better deal outcomes is the central empirical question in our recent research paper titled "Top-tier law firm expertise and VC investments: Global evidence".

Leveraging insights from a comprehensive dataset encompassing nearly 182,000 global VC deals spanning the period from 2005 to 2020, our research underscores the multifaceted impact of top-tier law firms on deal success and performance. While diverse in their roles, top-tier law firms exert significant influence within the VC legal advisory market. The study documents the increasing prevalence of top-tier law firms' participation in VC deals over time.

"We document that top-tier law firms' participation is associated with a reduction in the likelihood of deal failure."

Second, VC deals involving top-tier law firms attract larger investments, resulting in a larger ownership stake in portfolio companies. Cross-sectional analysis reveals that the influence of top-tier law firms varies across different attributes of the legal system.

“Countries with more robust civil justice systems, well-structured courts, and strong property rights experience a less pronounced impact.”

Our study also investigates the relationship between the participation of top-tier law firms and subsequent VC deal performance. We identify a positive connection between the participation of top-tier law firms and subsequent financing rounds or successful exits.

Deals involving top-tier law firms yield higher returns from one financing round to the next, substantiating their positive influence on post-deal financial performance.”

This study paves the way for a deeper understanding of the role of top legal advisory services in the unique market of private equity investments. Specifically, by demonstrating that the involvement of top law firms is associated with increased investment amount, a reduced likelihood of failure, higher deal valuations, and superior returns in subsequent financing rounds, we highlight the pivotal role that legal expertise plays in shaping the financial structure and success of private equity investments.

Furthermore, we illustrate that the effect of institutional legal framework substitutes that of top law firms. This offers a fresh perspective on the broader institutional context and the specific legal advisory services involved in VC investment process.

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To summarise, this study advances our comprehension of the role of legal advisors in VC investments. It demonstrates a positive impact of top law firms' involvement on deal outcomes, including deal completion, investment returns, and successful exits, regardless of the party they represent. Our research also emphasizes the significance of legal institutions, with the impact of top-tier law firms being more pronounced in countries with less developed legal systems. This research enriches our insights into the intricate dynamics of VC deals and the valuable contribution of top-tier law firms to their success.

By Douglas Cumming, the DeSantis Distinguished Professor of Finance and Entrepreneurship at the College of Business, Florida Atlantic University and ECGI.

Risk-Seeking Governance

Brian Broughman, Vanderbilt Law School
Matthew Wansley, Cardozo School of Law

Venture capitalists ('VCs') are retreating from their traditional role as monitors of their portfolio companies. Startup founders are retaining more equity and control over their companies, and VCs are promising not to replace founders with outside executives. At the same time, startups are taking unprecedented risks—defying regulators, scaling in unsustainable ways, and racking up billion-dollar losses. And there have been a series of high-profile scandals—Uber, WeWork, FTX—in which VCs proved unable or unwilling to prevent founder misbehavior. These trends raise doubts about the standard account, which claims that VCs actively monitor startups to reduce the risk of moral hazard and adverse selection.

In our article 'Risk-Seeking Governance', we propose a new theory—VCs use their role in corporate governance to persuade risk-averse founders to pursue high-risk strategies. We are motivated by the fact that returns to venture investing are driven by outliers. The success of a venture fund depends on finding one or two 'home runs'—portfolio companies that grow 10x or more, and the most successful funds generate even more skewed returns. The importance of outlier companies to venture returns is universally acknowledged, but its implications for corporate governance have not been fully appreciated.

After supplying capital, VCs need to motivate founders to implement the high-risk, high-reward strategies that can increase the company's potential for rapid, exponential growth. Founders may be reluctant to take on so much risk.

After supplying capital, VCs need to motivate founders to implement the high-risk, high-reward strategies that can increase the company's potential for rapid, exponential growth.

Founders typically invest a large percentage of their human and financial capital into their startups and consequently are unable to diversify firm-specific risk. By contrast, VCs and the large institutions that invest in venture funds can diversify idiosyncratic risk associated with any specific portfolio company.

In our model, VCs address the divergence in risk preference by striking an implicit bargain with founders. The founders agree to pursue the high-risk strategies that the VCs think will increase the chance of a home run. In exchange, the VCs agree to let the founders extract private benefits from the business. To develop this intuition, we model a hypothetical financing contract between a founder and a VC staged over two rounds of investment.

Similar to the standard account, we predict that VCs will purchase preferred stock, but our explanation is different. Under the conventional view, preferred stock reduces adverse selection at the time of investment.

Our analysis suggests it also encourages founders to take risks.

The liquidation preference associated with the VC's preferred stock reduces the founders' payout in an underwhelming exit and increases their percentage of the returns in a home run. It effectively turns the founder's common stock into a non-linear financial claim, akin to a stock option, that rewards founders who pursue high-risk strategies.

Risk-bearing also has implications for ex ante pricing. When VCs pay more for a startup's equity, they increase the founder's share of residual returns, but also amplify inefficient risk sharing. A price increase transfers uncertain pay-outs away from the most efficient risk bearer (the VC) to an undiversified founder. To address this problem, our model predicts that VCs will compete on non-price dimensions. In particular, a VC can promise to protect the founder's private benefits. This protection could be formal. For example, the VC might not bargain for board seats or other control rights. Or it could be informal. VCs can promise to give founders early liquidity when their startup grows, job security when it struggles, and a soft landing if it fails. VCs who develop a founder-friendly reputation have a competitive advantage in ex ante pricing but are more exposed to poor performance ex post due to suboptimal monitoring.

Critically, our model does not require irrational behaviour or underappreciation of the potential benefits of monitoring. Even when the potential benefit of VC monitoring is large, a founder may prefer to raise capital from a founder-friendly VC to lower their risk exposure. Our analysis can help explain founder-friendly VC behaviour. VCs facilitate the sale of founder equity—providing liquidity—in follow-on financing. When startups fail, VCs seek to arrange a face-saving acqui-hire or a new job for the founders. More generally, VCs are increasingly promoting themselves as founder-friendly, which is hard to reconcile with their role as monitors.

What does all this mean for corporate law?

We think the rise of risk-seeking governance shows that Delaware courts have little power to shape behaviour in Silicon Valley. The monitor model suggests that VCs behave roughly as corporate law envisions that directors should behave—they monitor managers, police self-dealing, and create incentives for performance. By contrast, the risk-seeking model explains that VCs behave more subversively—they skip monitoring, indulge self-dealing, and push managers to take risks. VCs and founders both get what they want out of the implicit bargain. But other corporate stakeholders, and society more generally, may be stuck bearing un-bargained for risks.

By Brian Broughman, Professor of Law at Vanderbilt University Law School and Matt Wansley, Associate Professor of Law at Benjamin N. Cardozo School of Law.

Board dynamics over the startup life cycle

Nadya Malenko
Boston College, Carroll School of Management

Startups are often hailed for their contribution to innovation and creative destruction. One potential explanation for their contributions is their unique, dynamic governance structure. In our study, we provide a comprehensive analysis of startup board composition and dynamics.

The ownership structure of startups sets them apart from established public firms. Major shareholders in startups are typically a mix of entrepreneurs and venture capitalists (VCs), each with their own set of goals and both playing an active role in the management and operations of the business. Unlike publicly traded companies governed by many regulations, private firm boards operate in a somewhat uncharted territory. At one extreme, firms like FTX raised billions of external financing with a single board member, the founder-CEO. FTX's board highlights the extreme flexibility of private board structures and shows we can learn much about startups from their board composition choices.

Typically, the composition of these boards and who holds control results from intense negotiations between VCs and entrepreneurs, with relative bargaining power being a critical factor. In scenarios where capital is abundant and thus entrepreneurs have strong bargaining power, boards tend to be under their control, with founders and executives of the startup occupying the majority of board seats.

However, board composition and who has control is far from static. As startups progress through their life cycle, the roles of major shareholders evolve, leading to a transformation in board composition. Changes in board control have many potential consequences for startup growth and success.

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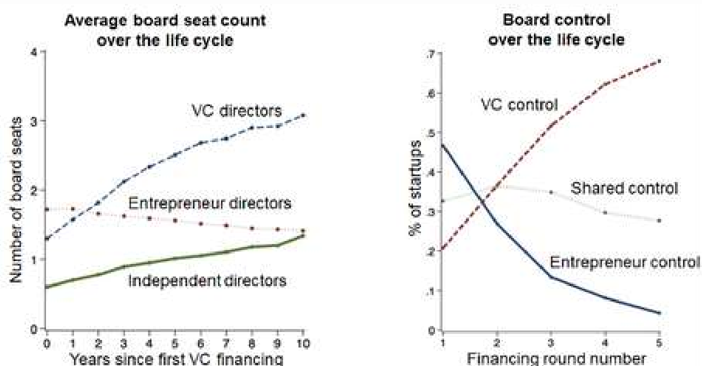
Shifting Control and the Role of Independent Directors

During the early stages, before the second VC financing round, entrepreneurs typically control startup boards, but over the life cycle, control shifts to VCs, with most board seats held by investors by the fourth round of financing. This transition isn't solely driven by ownership percentages; it also reflects the declining significance of the entrepreneur's ideas and role as the startup matures and enters the product development phase.

Interestingly, independent directors – directors who are not affiliated with either entrepreneurs or investors and are mutually elected by the two parties – play an important role in this shift of control. Between entrepreneur control early on and investor control later, a typical board goes through the stage of shared control.

This is when neither investors nor entrepreneurs control the majority of the seats, and independent directors effectively have a tie-breaking vote when the two parties disagree. The typical board structure in the second and third financing rounds is two investors, two entrepreneurs, and one independent director in a tie-breaking role.



The Unique Role of Independent Directors

The prevalence and voting power given to independent directors on startup boards is at first look quite puzzling. Their presence on the board is not mandated by law, and their traditional monitoring role, as seen in public firms, is not as critical. Instead of dispersed public shareholders, the shareholders of startups are large, sophisticated investors who play an active role in the firm's operations and management and have ample ability and incentives to monitor the executives. So, why do we see so many independent directors having a tie-breaking vote?

Our analysis suggests that these directors act as mediators, resolving potential conflicts between VCs and entrepreneurs. Assigning a tie-breaking vote to independent directors serves as a commitment by both parties to maintain a fair playing field, even when disagreements arise. This commitment safeguards the interests of both parties and nurtures a mutually beneficial relationship.

We find that independent directors are less likely to have a tie-breaking vote when VCs and entrepreneurs have worked together in the past. Here, a repeated investment relationship is more likely when the VC and executives have shared views and trust each other, reducing the need for mediation. On the other hand, when VCs have a reputation for being heavy-handed in replacing startup executives, independent directors become a valuable resource for settling disputes over the company's strategy and are more likely to join the board with a tie-breaking vote.

Evolution of Independent Directors' Roles

But mediation isn't the only role of independent directors. As startups mature and control leans more towards VCs, these directors often morph into advisors, aiding in the professionalization of the startup, particularly as investors prepare for an eventual exit. This changing role is reflected in the characteristics of independent directors over the startup's life cycle.
Independent directors joining in the early stages are less likely to have interacted with either VCs or entrepreneurs in the past, consistent with the mediation role requiring them to be independent and impartial. Conversely, in later stages, independent directors tend to have stronger connections with VCs, more executive-level experience, and previous service on public boards

In Conclusion

Overall, our results highlight unique features of startup governance. Independent directors' roles as mediators and advisors are likely a critical component of how VC-backed startups navigate the complexity of risky, high-growth investments. The mediation role is likely to be especially important in the current environment, where capital is scarcer and VCs have more bargaining power. While in boom times, disagreements between investors and entrepreneurs are not very pronounced, such disagreements become especially relevant at times when valuations are low and VCs struggle to exit their investments to generate returns.

By Nadya Malenko, Professor of Finance at Boston College and ECGI Research Member.

The rise of continuation funds

Kobi Kastiel, Tel Aviv University
Yaron Nili, University of Wisconsin Law School

The private equity business model has reinvented itself over the years, with continuation funds now its latest development. These funds offer a creative solution to circumvent the constraints of the traditional private equity model by enabling fund sponsors to retain assets beyond the customary 10-year fund term. In the past, funds' investments were expected to be liquidated once the fund term lapsed. With a continuation fund, instead of liquidating an asset that has not yet realized its full potential and selling it to third parties, the same fund sponsor sells this asset to the newly established fund. Limited partners (LPs) that invested in the legacy fund can either roll their interests into the continuation fund or exit. For new investors, continuation funds offer the opportunity to invest in more "mature" and visible assets and to reinforce their relationship with the sponsor. For these reasons, supporters of continuation funds view them as a "win-win-win" for all parties involved.

Continuation funds are not an esoteric phenomenon. In the past few years, they have grown increasingly popular within the private equity space, and are now the most common type of secondary transactions led by private equity sponsors. In 2021, these transactions reached their highest volume in history, estimated at around $68 billion in deal value, representing a 750% (!) increase over five years. According to market experts, these funds are here to stay and to grow.

Despite their surging popularity among private equity sponsors, continuation funds face unusual investor resistance. The Chief Information Officer of Europe's largest asset manager went so far as to claim that certain parts of the private equity industry look like "Ponzi schemes" because of their "circular" structure, tossing assets back and forth.

With a continuation fund, instead of liquidating an asset that has not yet realized its full potential and selling it to third parties, the same fund sponsor sells this asset to the newly established fund

Another leading pension fund executive warned that private equity groups are increasingly selling their companies to "themselves" on a scale that is not "good business for their business" see here and here). The Securities and Exchange Commission (SEC) has not remained indifferent to this important market development. In August 2023, it approved new rules that, among other changes, aim to provide a check against a sponsor's conflicts of interest in structuring continuation funds.

These general concerns, however, leave some crucial questions open:

- What types of misalignments of interests might continuation funds cause?
- What are the economic interests of the sponsors?
- Why do most investors decline the option to roll over their stakes into the continuation fund, even though it is run by the same sponsor in which they have trusted their investments up to that point?
- Do these investors have the power to fend for themselves or is a regulatory intervention required?
- How effective are the existing regulatory and market mechanisms in addressing continuation fund conflicts?

Despite the growing impact of continuation funds on the U.S. and European capital markets, no academic study has closely examined these questions. Our recent Article, forthcoming in University of Pennsylvania Law Review (2024), fills that gap.

We make three key contributions to the existing literature.

First, we provide a systematic analysis of the web of conflicts continuation funds generate. We show that continuation funds guarantee substantial benefits for sponsors, including additional management fees, an option to receive an additional carry in the future, and an opportunity to control the fund's assets for a longer period. Further, in continuation funds, sponsors place themselves in a position where they are committed to two groups of investors whose interests are in direct conflict—the exiting investors interested in selling the fund's assets at the highest possible price and the incoming investors in the continuation fund interested in paying the lowest possible price for the assets. The tendency of most existing investors (80–90%) to cash out instead of rolling over their investments intensifies the severity of this conflict.

Assessing how this conflict unfolds in practice is challenging due to data limitations. While in theory one group of investors (sellers or buyers) could sometimes have the upper hand—and sometimes the lower hand—our analysis suggests that the sponsor always wins. We also show that sponsors' incentives to establish the continuation fund and the close relationships between the sponsors and the new investors in continuation funds, often sophisticated and repeat players specializing in secondary transactions, might lead sponsors to favor new investors' interests over those of the legacy fund investors electing to cash out. Recent empirical evidence supports this view. We further explain how investors in the legacy fund may face losses on two fronts: they can no longer rely on the sponsor as their faithful agent in the transaction's negotiation, and they lose exposure to the assets if the continuation fund proves to be a successful investment.

In continuation funds, sponsors place themselves in a position where they are committed to two groups of investors whose interests are in direct conflict.

This web of conflicts not only results in distributional effects but also imposes efficiency costs. Sponsors' strong financial interest in establishing continuation funds could lead them to forgo better exit options, resulting in suboptimal utilization of investors' capital. Continuation funds also exacerbate the information asymmetry problem in the private equity industry.

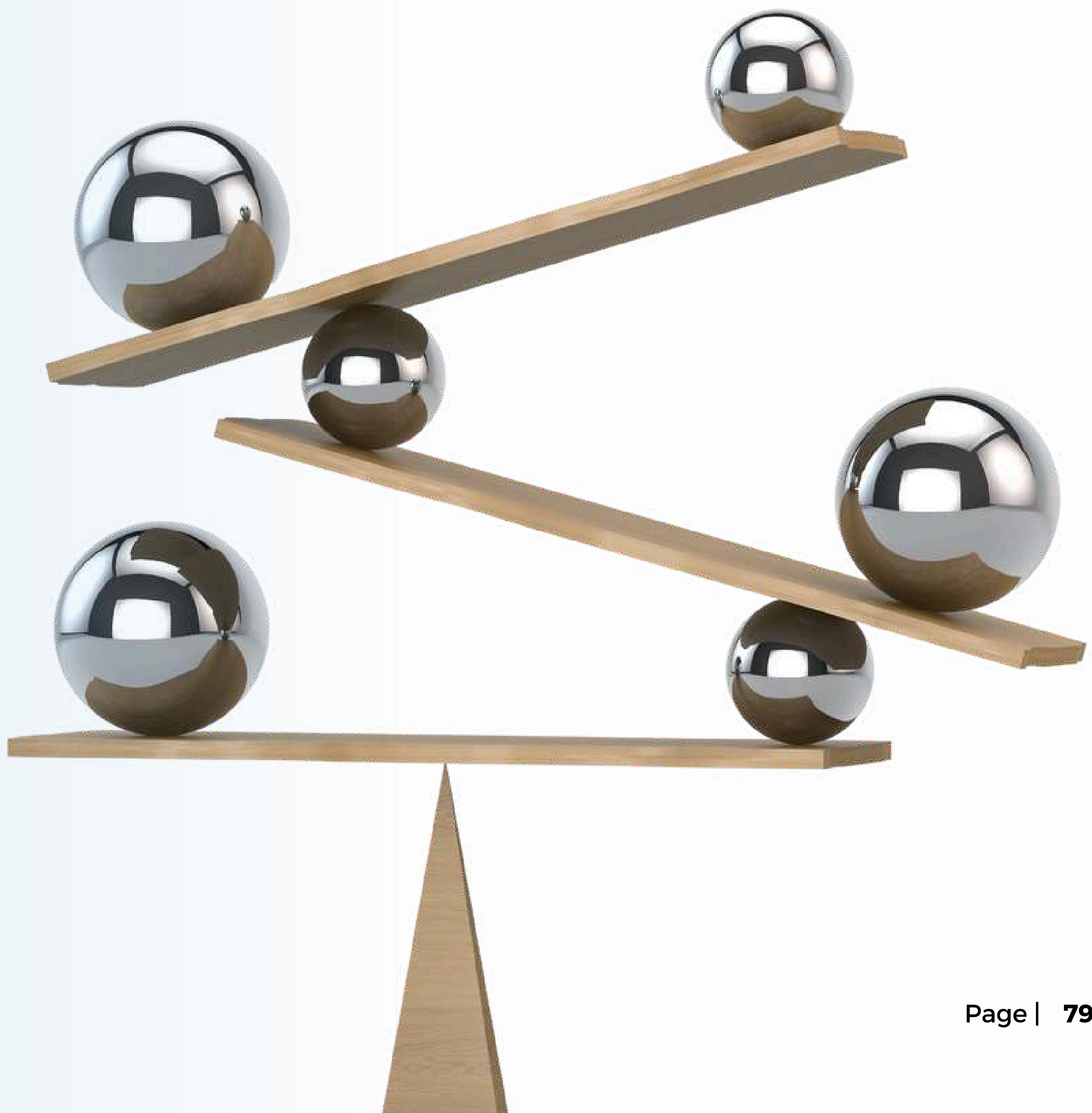
Second, we utilize qualitative data from interviews with market participants from both sides of the transaction––investors and sponsors––to provide a more comprehensive analysis of continuation funds' dynamics. We discuss the shortcomings of the SEC's regulatory approach, which has focused on the mandatory use of fairness opinions, as well as other mechanisms used by market players to solve continuation fund conflicts (such as subjecting the initiation of these funds to the approval of a limited partnership advisory committee, requiring the sponsor to reinvest its profits into the continuation vehicle, and using a competitive bid). Based on insights from our interviews, we explain why these mechanisms are unlikely to cure the structural biases generated by continuation fund transactions.

Finally, we explore two alternative viewpoints regarding continuation funds: the market outcome view and the market failure view. The market outcome view holds that continuation funds are effective price discrimination mechanisms, reflecting a trade-off between price and contractual protections, and that reputational forces can be relied upon to mitigate any opportunistic use of them.

In contrast, the market failure view suggests that continuation funds impose significant efficiency costs, which reputational forces are unlikely to mitigate fully. Against this backdrop, we offer a set of policy recommendations directly addressing the misalignment of incentives between sponsors and investors. These proposals are particularly important in light of the recent SEC reform.

The study of continuation funds is an important setting for examining power dynamics in the private equity industry, particularly the differences in sophistication and bargaining power between various players. This setting also sheds light on the institutional and agency problems many investors face, their limited power to mitigate sponsors' conflicts, and the limits of reputational markets in an industry lacking extensive disclosure and regulation, or any effective underlying threat of litigation.

By Kobi Kastiel, Professor of Law at Tel Aviv University and ECGI Research MEMBER, and Yaron Nili, Professor of Law and Smith-Rowe Faculty Fellow in Business Law at the University of Wisconsin Law School and ECGI Research Member.



Startups, European Company Law, and the Colosseum

Paolo Giudici
Free University of Bozen-Bolzano

The European Union hopes to increase the number of startups that scale up to large innovative corporations and contribute to the EU's technological sovereignty, accelerating the green and digital transformation. Many concomitant factors are needed to foster the development of an environment conducive to the growth of startups. Not enough attention seems to have been paid to corporate law to address this issue. The need for fast and cheap procedures to establish a company are usually mentioned, as well as the possibility to issue stock options that are not subject to capital gain tax before their sale and that entitle the holder to acquire non-voting shares. Not much else is usually referred to with regard to corporate law. Is this reasonable?

Before answering this question, let us look at the United States for a moment. US corporate law and, in particular, Delaware law, which leaves ample room to freedom of contract, created no obstacles to the development and optimization of startup financing in Silicon Valley. Today there seems to be almost no significant mandatory law feature standing in the way of negotiations between founders and investors under Delaware law. Moreover, if founders and investors think that the very few mandatory rules of the Delaware corporation are an impediment to their negotiations, they can opt for the full freedom of contract offered by the Limited Liability Company (LLC).

What happened instead in many European legal systems? Founders discovered that their national legal systems did not offer similar flexibility. Italy was a case in point.

If founders and investors think that the very few mandatory rules of the Delaware corporation are an impediment to their negotiations, they can opt for the full freedom of contract offered by the LLC

The Italian public company ('società per azioni', S.p.A.) had some traits that could cope well with some startup features, in particular in terms of financial flexibility. But it also required a mandatory minimum capital of Euro 50,000 and a compulsory board of three statutory auditors ('collegio sindacale'). The new social class of 'startuppers' could not turn back to the 'società a responsabilità limitata' (the Italian LLC) either, which could not issue classes of stock or convertible notes and was thus financially 'lame'.

Many Italian startuppers created Delaware corporations. However, in 2012, in the wake of the Greek government-debt crisis, pressed by European institutions which were seeking to reignite economic growth, Italy changed its own LLC law, which could now issue classes of shares and financial hybrids, and could even (this was absolutely revolutionary) offer shares to the public. The continental tradition of the GmbH-type (Gesellschaft mit beschränkter Haftung, a German term meaning company with limited liability) was turned on its head, together with the distinction between the private and the public company.

The revolution was not complete, and some significant uncertainties persist in the new law of the LLC. It is worth noting that there were no signs of any European regulatory competition in this reshaping of Italian law – there were no anecdotes of Italian startups established in France, in the Netherlands or the UK, at the time. The reshaping was entirely influenced by US corporate law.

In an empirical paper published last year, Peter Agstner, Antonio Capizzi and I report that almost all Italian startups now adopt the new LLC form, and we identify some Italian law idiosyncrasies in the drafting of charters that are mainly the product of old doctrinal constructions. But we also observe that Italian corporate practice is pushing the envelope in its efforts to adapt Italian charters to startuppers' and investors' needs. Accordingly, we conclude that the Italian reforms look more successful than we expected.

What happened in the rest of Europe? We do not know precisely. If one searches the European law journals of the last ten years, one finds very little on the subject. Crowdfunding has been widely commented upon by legal scholars both at a national and European level, whereas startup financing and the related clauses in startup charters (concerning preferred convertible stock, antidilution, co-sales, etc.) are covered by a very few articles. An alien landing on earth would think, while reading the European legal literature, that the crowdfunding discipline is a central issue in making Europe a land of startups, while venture capital financing is almost irrelevant.

Yet, we do know something. For instance, we know that the UK law of the private company is very flexible and UK startups have not had not many problems in adapting their charters to the needs of venture capital financing. We know that Professor Thilo Kuntz, the scholar who has most studied the topic in Germany, concludes that German corporate law allows the adoption of most US-like arrangements, particularly in the GmbH.

Many concomitant factors are needed to foster the development of an environment conducive to the growth of start-ups. Not enough attention seems to have been paid to corporate law.

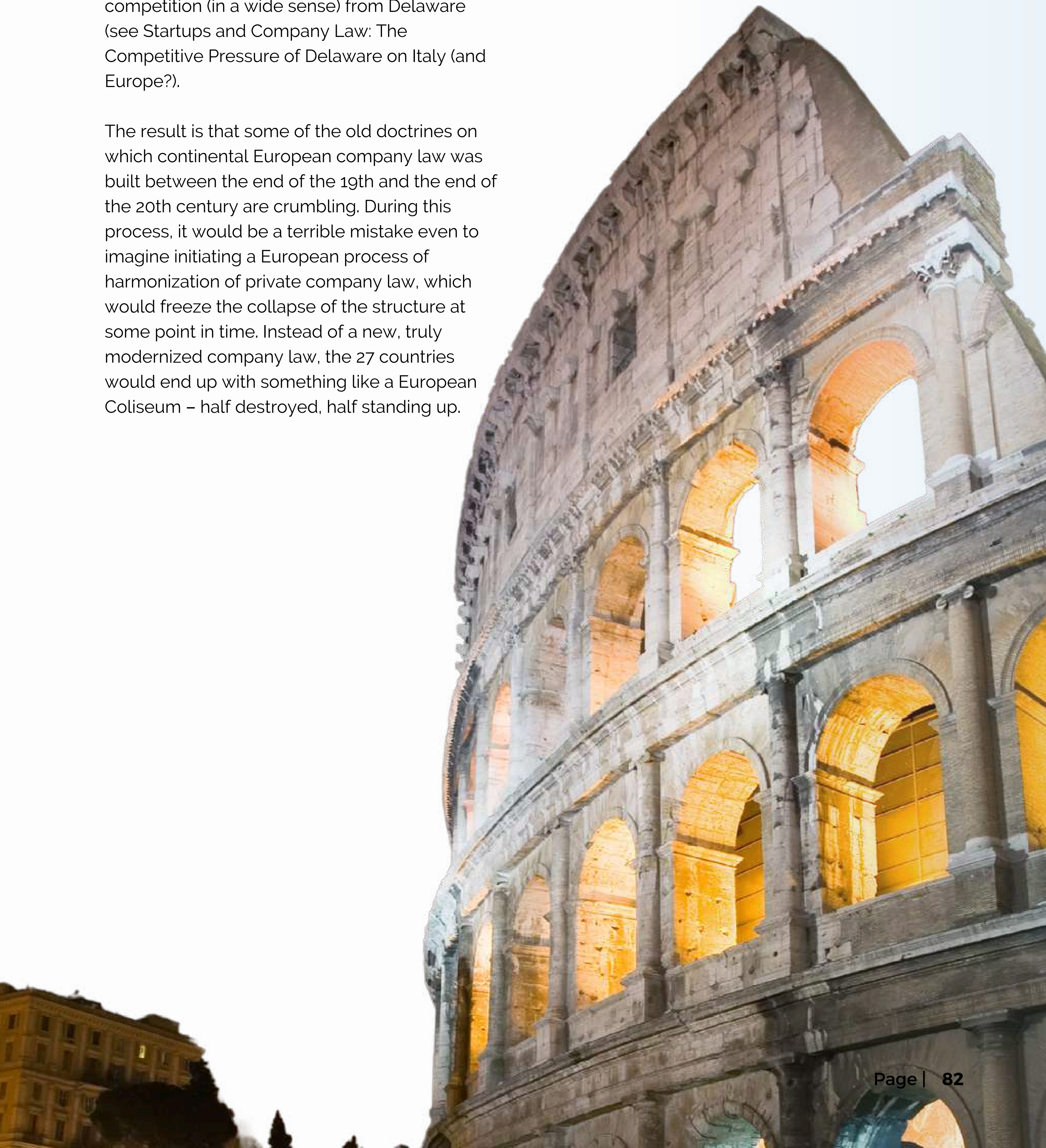
In the AG (Aktiengesellschaft or joint stock company), many provisions cannot be inserted in the charters due to the principle of Satzungsstrenge (statutory rigidity/rigor) and should instead be included in shareholder agreements.We know that in France startups generally enjoy the special and very liberal regime of the société par actions simplifiée (SAS). We know that in 2023 in Spain a new law on startups entered into force, very much influenced by the Italian one. But we also know, for instance, that the recent 2019 Belgian Companies Act has not taken into consideration the needs of venture capital and private equity investors – as Professor Hans De Wulf noted in a recent article, it was looking backwards (legal issues of the past) and not forwards (legal issues of the future).

So, Europe offers a very varied landscape and cannot be treated as a whole. However, we can see some trends. Startups tend not use the corporation form that is partly harmonized around Europe (AG-like form), therefore the European harmonization process has no relevance here. In many countries startups use the GmbH-form, which was created as a form of partnership-like corporation for family business and has proven to be more flexible and less expensive than the corporation form that should be the typical vehicle for startups which want to become unicorns. The UK had no problems with its private company law, whereas France, with its own SAS structure, seems to have found a very good way out from the paternalistic approach of Continental Europe law.

Italy is apparently doing well too with its overturning of the GmbH-form, even though contractual innovation processes are still hampered by old doctrines that are no longer in tune with the needs of modern society.[2] Wherever flexibility wins, rigidity succumbs. The reason probably is that there is no inter-European regulatory competition in action here – pressure comes from economic forces and competition (in a wide sense) from Delaware (see Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?).

The result is that some of the old doctrines on which continental European company law was built between the end of the 19th and the end of the 20th century are crumbling. During this process, it would be a terrible mistake even to imagine initiating a European process of harmonization of private company law, which would freeze the collapse of the structure at some point in time. Instead of a new, truly modernized company law, the 27 countries would end up with something like a European Coliseum – half destroyed, half standing up.

By Paolo Giudici, Professor of Business Law at the Free University of Bolzano and ECGI Research Member.



Corporate Law and Venture Capital in Italy: What Does the Empirical Evidence (Really) Tell Us?

Luca Enriques, University of Oxford
Casimiro Nigro, Goethe-Universitaet Frankfurt

Is Italian corporate law flexible enough to accommodate venture capital contracting? Initially, Italian scholars who addressed this question, including the two of us, converged on the view that it is not. However, some of them have now gathered empirical evidence that, they claim, supports the conclusion that Italian corporate law is more adequate than previously thought. This post pushes back against this conclusion.

Corporate Law and Venture Capital ('VC')
A vibrant VC market relies on the adoption of complex private ordering solutions at the portfolio company level (Gilson, 2003), which, in turn, requires a flexible corporate law (Nigro & Enriques, 2021). In the United States, venture capitalists and entrepreneurs have capitalized on Delaware's highly malleable corporate law (Brougmann, Fried, & Ibrahim, 2014) to develop a contractual framework that, while not necessarily socially optimal, is presumed to be efficient and thus bound to be exported globally (Kaplan, Stromberg, & Martel, 2007).

Elsewhere, however, rigid corporate laws can hinder the use of this contractual framework and, unless they allow functionally equivalent alternative arrangements, impede, at the margin, contract formation and VC investments, with negative consequences for social welfare (Nigro, 2019; Nigro & Enriques, 2021).

> Bargaining in the shadow of the explicit and implicit mandatory provisions of Italian corporate law leads to the adoption of a contractual technology that is overall costlier and less effective than the US model.

How Does Italian Corporate Law Fare?
In parallel with similar initiatives in other jurisdictions (Neville & Sorensen, 2014), between 2012 and 2017 Italian lawmakers have modernized various aspects of the corporate law regime for private companies, inter alia, to make it more respondent to the needs of VC market players (Giudici & Agstner, 2019). These interventions addressed a few key areas but left unchanged both corporate law provisions with a broader scope and, more importantly, the 'metarules' that scholars and courts apply to interpret existing legal texts, as we elaborate in companion work with Tobias Tröger (currently in preparation).

Following those corporate law reforms, scholars have examined whether Italian corporate law displays the flexibility required to accommodate the VC contracting techniques developed in the U.S. Initially, there was agreement on the view that Italian corporate law imposed various regulatory constraints that hindered the adoption of the contractual solutions commonly found in US VC deals (Nigro, 2019; Giudici & Agstner, 2019; Nigro & Enriques, 2021; Nigro & Maltese, 2022).

Based on a map of the regulatory constraints stemming from both explicit and implicit mandatory corporate law, one of these studies (Nigro & Enriques, 2021) concluded that, under Italian corporate law: (1) conversion rights are unavailable; (2) as a consequence, anti-dilution provisions do not adjust the conversion price but require the issuance of additional shares and are at risk of being declared void even in this peculiar design; (3) liquidation preferences, which must be participating due to the unavailability of conversion rights, are also at risk of being declared void; (4) the legality of drag-along provisions depends on providing a minimum price based on the legally determined fair value of the shares in the event of a shareholder divestment (a 'floor,' in the local legal jargon).

Paolo Giudici and Peter Agstner, together with Antonio Capizzi, have now radically re-evaluated their initial conclusions in a new empirical study – summarized here. Their study analyses the charters of 183 firms incorporated between 2015 and 2021 and having an outsider financier, chiefly a VC. It aims to identify the presence of contractual solutions commonly found in US VC deals, such as convertible preferred shares, anti-dilution provisions, liquidation preferences, and drag-along provisions.

t reveals that: (1) conversion rights are close to non-existent; (2) anti-dilution provisions are frequent, but mandatory corporate law may undermine their effectiveness or even lead to their invalidation; (3) liquidation preferences are mostly participating; some charters contain provisions resembling non-participating liquidation preferences but these are of dubious validity because courts may consider them as attempts to circumvent mandatory corporate law provisions and thus declare them void, as the study acknowledges; and (4) drag-along provisions consistently include a floor, which contracting parties seek to bypass through arrangements whose validity, again as acknowledged by the study, is highly doubtful.

Based on this evidence, the study concludes that local transactional practice appears to be more advanced than initially believed, inferring that Italian corporate law is more accommodating to US-style VC contracting than previously thought. The study's bottom line is that there is thus no justification for 'the grim view expressed by some scholars.'

Do Empirics Really Support This Conclusion?
Giudici, Agstner and Capizzi interpret their evidence as follows: the US contractual framework is key to fostering VC investments; contracting parties in Italy attempt to emulate it but encounter corporate law constraints in doing so; they thus experiment with alternative arrangements, which, however, admittedly prove less effective or possibly even unenforceable; nonetheless, all in all, corporate law works.

This conclusion appears to be logically inconsistent with its premises and is likely the result of loose usage of the idea of functional equivalence: implicit in the authors' reasoning is that two alternative contractual arrangements are functionally equivalent so long as they aim for the same objective. Yet, functional equivalence requires more than that.

Two technologies are functionally equivalent if they deliver the same productive outcome, which is not the case if the production costs associated with them differ.

Similarly, two alternative contractual arrangements are functionally equivalent if and only if they deliver the same response to a given governance challenge.

This is not the case, however, if two alternative contractual arrangements entail different costs, including, for instance, when (a) one is self-enforcing and the other requires a number of procedural steps if not a court's decision; (b) one coordinates smoothly with other components of the relevant contractual and legal framework while the other is inconsistent with other elements thereof; and (3) one is plainly in line with corporate law's mandatory rules while the other is at risk of being declared null and void (cf. Davis, 2013). Variations in the costs associated with two alternative contractual arrangements imply divergence in their outcomes, ruling out the claim that they are functionally equivalent.

Now, let us build on these concepts to consider whether, for example, the anti-dilution provisions employed in Italian VC deals are genuinely functionally equivalent to those in the US. In Italy, the most frequently used anti-dilution clause stipulates that, following a down round (that is, a new issue of shares at a price lower than their valuation in the preceding round), all shareholders must unanimously approve an additional capital increase, allowing the venture capitalist to purchase additional shares at a minimal price to offset any dilution they may have incurred. These arrangements undeniably entail greater costs than the corresponding terms in the US. Firstly, they require VCs to follow a more cumbersome process. Secondly, they introduce the risk that the additional share issuance never materializes or is delayed, because these arrangements lack the essential feature of self-enforceability. Thirdly, their validity is uncertain. Claiming that these contractual provisions are functionally equivalent to those found in US VC deals is therefore simply wrong.

A similar analysis could extend to the alternative arrangements that aim to replicate US-style convertible preferred shares and drag-along rights as well as to nearly all the other private ordering solution included in US VC deals, as we document in companion work with Tobias Tröger.

In light of these qualifications, what do the empirical findings of Giudici, Agstner, and Capizzi really tell us? First, they corroborate our (and their prior) finding that bargaining in the shadow of the explicit and implicit mandatory provisions of Italian corporate law leads to the adoption of a contractual technology that is overall costlier and less effective than the US model; in other words, that Italian corporate law is unable to accommodate (US-style) VC contracting. Second, they indicate that, very much like in other jurisdictions (Lin, 2021; Pereira, 2023), highly specialized lawyers are responding to local corporate law's rigidity by engaging in contractual experimentation and devising alternative arrangements whose legality, however, is highly uncertain.

Conclusion

We have argued that the reality of Italian VC arrangements and the legal obstacles to their transplant from US contractual practice do not really support the conclusion advanced by Giudici, Agstner, and Capizzi.

In fact, with their contribution, Giudici, Capizzi and Agstner now provide empirical evidence that Italian corporate law constraints do significantly impact local transactional practice, which in turn is consistent with 'the grim view expressed by some scholars' regarding the detrimental influence of Italian corporate law on VC contracting, if not on VC investments. What is undeniably true is that smart lawyers are engaging in contractual experimentation to (attempt to) circumvent the constraints imposed by Italian corporate law.

By Luca Enriques, Professor of Corporate Law at the University of Oxford and ECGI Fellow and Casimiro A Nigro, Assistant Professor at the Foundations of Law and Finance Research Center, Goethe Universität, Frankfurt.

Taxes blown in the wind? The Siemens Gamesa bailout

Horst Eidenmüller, University of Oxford
Javier Paz Valbuena, University of Oxford

In this post, we discuss the recent €7.5 billion bailout of the wind energy firm Siemens Gamesa by the German government. We argue that Siemens Gamesa should not have been bailed out, and certainly not on the specific terms of this rescue.

Transition to a Net-Zero Economy and Siemens Gamesa

Governments worldwide are encouraging investment in the transition to a net-zero global economy. Onshore and offshore wind energy is a key part of this policy agenda. An important player in the industry is the Spanish firm Siemens Gamesa Renewable Energy, S.A.U. ("Siemens Gamesa"). Siemens Gamesa is a global provider of wind power products and service solutions. It is a wholly-owned subsidiary of the German firm Siemens Energy AG ("Siemens Energy"). Siemens Energy's main shareholder (25.1%) is Siemens AG ("Siemens"), a highly profitable German industrial giant.

But Siemens Gamesa is in trouble—and so is Siemens Energy. The market for wind turbines is competitive. Manufacturers must guarantee performance for decades, and Siemens Gamesa has struggled with severe quality problems, particularly with its onshore wind turbines. The CEO of Siemens Gamesa, Mr Jochen Eickholt, was quoted in the press as saying that "[w]e sold turbines too quickly [that] had not been sufficiently tested". The situation escalated with the release of Siemens Energy's Q3 results for the 2023 fiscal year in August 2023. Siemens Energy warned of a loss for the fiscal year of €4.6 billion—of which €4.4 billion were attributed to Siemens Gamesa. Then the company ran into difficulties obtaining the financial guarantees it needed to offer its wind turbine customers. Banks hesitated, signalling that without state support they might not be willing to extend such guarantees in the future.

The Siemens Gamesa Bailout

After protracted negotiations, the German government agreed to rescue Siemens Gamesa in November 2023. The core element of the German bailout is a guarantee from the Federal Republic of Germany ("FRG") worth €7.5 billion, backstopping an €11 billion line of performance guarantees from a banking consortium. Siemens Gamesa is currently in similar discussions with the Spanish central government about backstopping performance guarantees from private lenders worth €3 billion.

The FRG conditioned its bailout on the support by other stakeholders. But Siemens contributes little (if at all) to the bailout. Siemens Energy's shareholders (including Siemens) do not provide Siemens Gamesa with additional capital. They are also not looking for M&A alternatives or the sale of some parts of the business. No director or senior manager appears to have been dismissed or suffered any other negative consequences, apart from restrictions on the payment of bonuses while state guarantees are outstanding.

Siemens is injecting 2.1 billion euros in cash into Siemens Energy by agreeing to acquire an 18% stake in Siemens Ltd ("SL") from Siemens Energy.

SL is an Indian joint venture between Siemens and Siemens Energy, listed on the National Stock Exchange of India ("NSE"). The purchase price paid by Siemens (€2.1 billion) reflects a non-trivial discount of 15% on the NSE share price. It is therefore unclear whether this transaction makes a meaningful contribution to improving Siemens Energy's financial position. It could actually do the exact opposite.

Siemens is also supporting Siemens Energy by reportedly agreeing to a reduction in the fees it receives from Siemens Energy for using the Siemens brand, and it secures the position of banks providing another €1 billion guarantee line with a first loss tranche. Siemens Energy commits to a cost-cutting/restructuring plan to return the company to profitability within the next 3 years. The plan is intended to reduce costs by €400 million. However, there is no clear schedule for how this could be achieved.

In addition to these "contributions", the government guarantees appear to stipulate that Siemens Energy may not pay dividends to its shareholders during the term of these guarantees.

The Limits of Bankruptcy

The assessment of the Siemens Gamesa bailout requires an assessment of the limits of bankruptcy restructuring. Bankruptcy is not always the best response to financial distress. Sometimes this is due to the structural limitations of a bankruptcy restructuring. It rearranges the financial claims against a distressed firm. This is appropriate if the firm has an unsustainable financial structure. But consider the millions of firms worldwide affected by pandemic lockdowns or the energy crisis following the war in Ukraine. These firms suffer(ed) temporary revenue losses (pandemic lockdowns) or cost increases (energy crisis). Recapitalization is not necessary. What is needed is a limited cash injection.

Another reason why bankruptcy restructuring is not always the best response to financial distress relates to the type of firm that is in difficulty.

> If Siemens Gamesa had a sound business model, its shareholder or other private parties could be expected to support its operations with the necessary capital and assurances, lending against its anticipated revenue stream. The fact that no one was willing to do so suggests that Siemens Gamesa should be liquidated rather than rescued.

Bankruptcy proceedings concern the interests of a limited group of parties, namely those who have a financial claim on the firm's assets. Decisions about the future of the company are made with the aim of maximizing the pie available for distribution to these claimants ("microeconomic efficiency").

But sometimes the closure or restructuring of a company has a significant negative or positive effect on third parties or even on the entire economy ("macroeconomic efficiency"). These effects are external to the bankruptcy process in the sense that they are not decisive for the restructuring/liquidation decision in the proceedings. One can speak of bankruptcy-externalities. Examples would be regional or even national employment effects, geostrategic effects and implications or environmental effects.

If a firm's liquidation or restructuring is likely to result in significant bankruptcy-externalities, the firm may be designated as "critical" to a particular nation state. Non-bankruptcy proceedings may be justified to resolve the financial distress of a critical firm.

An ad hoc bailout of the firm by the state is one such process. Current examples include the bailout of Lufthansa in the context of the pandemic or the bailout of Uniper following the energy crisis.

The Economic Viability of Siemens Gamesa

Against this background, can the Siemens Gamesa bailout be justified in principle? We do not think so. First, Siemens Gamesa likely is not an economically viable company, even if one accepts that the relevant baseline is that of a heavily-subsidised industry. The quality issues with their flagship X.5 and X.4 turbines are the company's responsibility. They are said to affect at least 2,900 of the approximately 65,000 models. These figures suggest that there are systemic/critical problems with the products, operations and potentially even business model of Siemens Gamesa, raising serious doubts about the (economic) viability of the company.

After all, once Siemens Gamesa's problems became public, the company could not obtain the guarantees that its business required, even though it appeared to have an adequate financial position. Government intervention seemed to be the only "solution" to the problem. At the same time, the (financial) markets in which the company operates are functioning properly in the sense that they are not currently experiencing exceptional turbulence. If Siemens Gamesa had a sound business model, its shareholder or other private parties could be expected to support its operations with the necessary capital and assurances, lending against its anticipated revenue stream. The fact that no one was willing to do so suggests that Siemens Gamesa should be liquidated rather than rescued.

Bankruptcy-Externalities and Siemens Gamesa

But let's assume that Siemens Gamesa was an economically viable firm. This would not suffice to justify a government bailout. As discussed, financially distressed firms can also be restructured in a bankruptcy proceeding.

For a bailout to be justified, the state must be able to capture significant bankruptcy-externalities as a "return" on the investment it makes with the bailout.

In the present case, we must consider two potential bankruptcy-externalities. The first is the number of jobs that would potentially be lost if Siemens Gamesa were put into a bankruptcy proceeding. Siemens Gamesa employs approximately 25,000 workers, 5,000 of which are based in Spain, mainly in the northern regions of Navarre and the Basque Country.

Unnecessary layoffs should be avoided, particularly on a scale that could create additional problems by straining a dysfunctional labour market or an underfunded social security system that must provide unemployment benefits and continue operating with reduced tax revenues.

However, we do not believe that this is a likely scenario in the case of Siemens Gamesa, even if the company were to be liquidated. Even in this worst-case scenario, it seems plausible that the labour market could redistribute at least many of its employees: they work in an emerging industry. A more likely scenario is that competitors of Siemens Gamesa take over some of the facilities and associated employees. The opportunity to increase production capacity at a bargain price and with skilled employees should prove interesting enough for at least one of these competitors. The wind turbine manufacturing sector is suffering from a shortage of skilled workers in Europe, and the sector is expected to continue to grow rapidly.

The second potential bankruptcy-externality worth considering are strategic policy considerations. The German government has emphasized that it sees Siemens Energy as a crucial part of its plans for a green energy transition. Bailing out Siemens Gamesa could also be helpful in achieving the energy sovereignty goals set after the start of the war in Ukraine.

However, there is nothing critical about Siemens Gamesa's technology or manufacturing processes. Many other companies make wind turbines used by the same customers. Quite a few of them do so at lower cost and with better quality. If Siemens Gamesa were liquidated, we would expect that some of its competitors would take the opportunity to acquire some or all of Siemens Gamesa's factories (and skilled workers) at a discounted price.

Is there a geostrategic advantage in keeping Siemens Gamesa running as a national champion? The benefits for the German economy and security are unclear. In contrast, the negative efficiency effects are significant: a company that is probably not viable continues to operate with government support and distorts market processes and competition. Add to this assessment the increased risk of moral hazard that results from bailing out companies without compelling arguments, and the answer to the question is clearly "no".

The Terms of the Bailout

However, let us assume, arguendo, that Siemens Gamesa is economically viable and that there are significant "macroeconomic externalities" that would make the firm a candidate for a bailout. In this scenario, too, the question remains as to how the bailout should be structured so that such an intervention in the economy with taxpayers' money is appropriate.

Bankruptcy is a highly regulated process. Ad hoc bailouts are much less regulated. Some hard constraints are in place, reflected, for example, in applicable state aid and antitrust laws. But the accountability for bailouts is currently primarily political, not legal. This stark discrepancy in regulatory density should be reduced. In prior work, we have developed a set of principles that should govern ad hoc bailouts of critical firms: efficiency, proportionality, equity and transparency. Adherence to these principles is critical to ensuring that a bailout represents a legitimate use of taxpayer money.

The Siemens Gamesa bailout is inadequate on all four points. As discussed, Siemens Gamesa likely is not an economically viable firm. Even if it were, it is not a critical firm in the sense that there were significant bankruptcy-externalities that would justify the use of public money for a bailout.

Proportionality was maintained—but only to a very limited extent. Since the bailout is designed as a backstop guarantee, the funds may never be needed. However, these are real commitments for which public resources must be allocated and earmarked over a very long period of time. The terms of the guarantees, in particular their remuneration, enforcement and security, will be crucial to understand whether the bailout is proportionate. It appears that the state does not share in the (potential) future profits of a company that could not continue to operate without its support—but it should.

The bailout is neither fair nor equitable. It is worrying that Siemens Energy's shareholders have little involvement in the rescue operation, but benefit significantly from the use of government resources to protect their company. It is also worrying that a lack of responsibility has been shown by the managers and directors whose decisions and (lack of) oversight led to the material manufacturing and quality problems that have brought Siemens Gamesa to its current predicament.

It is even more concerning that Siemens Energy shareholders may view government support as a "cheap" resource that can be used instead of their own funds—at no significant cost to them. This potentially creates problematic incentives for investors, directors and managers in other companies and industries. Moral hazard, after all, is one of the main complications of any form of government intervention, including bailouts.

Equity also requires that other parties be not unduly disadvantaged unless this is necessary and they can be adequately compensated. Compared to its other EU competitors, there is nothing unique about Siemens Gamesa that would justify a special treatment.

If its competitors complain that they have been prejudiced because they compete in the same market, under the same pressures, but without the support of their governments, the solution cannot simply be to write additional checks until we run out of resources.

Finally, as regards transparency, it is well known in the market that Siemens Energy is benefiting from the rescue and is not providing fresh money. It is also well known that the bailout is carried out through guarantees that do not involve any immediate costs. But what are the terms of these guarantees, how will the government benefit from them, and how exactly has it protected its position? These are key elements about which very little is known. The bailout would not be legitimate if the implementation of the package and its subsequent political and/or judicial control was not easily understandable to the general public.

Conclusion and Implications

Overall, we come to a sobering conclusion: Siemens Gamesa should not have been bailed out, and certainly not on the specific terms of this rescue. Siemens Gamesa likely is not an economically viable firm. Even if it were, it is not a critical firm in the sense that a bankruptcy process would trigger significant negative macroeconomic or geostrategic externalities. And even if a bailout were justified (which it is not), it should not occur without a major contribution from Siemens and the other shareholders of Siemens Energy.

The bailout would not be legitimate if the implementation of the package and its subsequent political and/or judicial control was not easily understandable to the general public.

The readiness with which the German government was willing to bail out Siemens Gamesa does not bode well for a possible future scenario in which one of Germany's leading automobile manufacturers experiences a significant downturn or even financial difficulties because its electric vehicles are of lower quality or more expensive than those of its American or Chinese competitors. The subsidies in the Siemens Gamesa case are small change compared to what might be necessary to save the German automotive industry.

By Horst Eidenmüller, Statutory Professor for Commercial Law at the University of Oxford and ECGI Research Member and Javier Paz Valbuena is DPhil in Law candidate at the University of Oxford.

Dual-class share structures are the wrong answer to the UK listings problem

Caroline Escott
Railpen

There has been extensive discussion amongst UK policymakers about how to fix the recent decline in IPOs as the current government looks for ways to boost economic growth in the wake of the pandemic.

These include the May 2023 FCA proposals in CP23/10: Feedback to DP22/2 and proposed equity listing rule reforms. Proposed changes include taking "a more permissive approach to dual-class share structures" (DCSS) as well as relaxing rules around shareholder votes on related party and significant transactions. The stated rationale for DCSS specifically is that it would allow "a full range of company models to list in the UK" and appeal to tech firms in particular, with the FCA paper noting a "higher prevalence of DCSS particularly among companies in the technology sector."

This proposal was unexpected, given that previous relaxation of the rules around dual-class share structures had only come into force 18 months previously. Also unexpected was the lack of evidence demonstrating that a key reason high-growth companies list elsewhere is the UK's shareholder rights regime.

In our response to the FCA, and in light of the issue's complexity, Railpen – which is overweight UK listed equities (versus the major global indices) and has an extensive history as an early-stage, pre-IPO investor in UK companies – opted for a "first principles" approach.

This required us to examine the assumptions inherent in the current policy debate and review the evidence regarding; i) what creates healthy capital markets, ii) what attracts companies to list in a given jurisdiction and iii) why investors choose to invest in a specific company. Our research suggested the proposals would not support the thriving capital markets we all want to see but would instead exacerbate the problem, damaging the UK's longstanding USP as the world's "quality" market.

Healthy capital markets

A 2023 UK Finance/EY report argues that capital markets operate in a circular fashion: companies want to access a large and liquid pool of high-quality investor capital, while investors seek access to dynamic companies that can generate long-term sustainable financial returns. It is therefore clear that any reforms proposed need to make UK capital markets attractive to both companies and investors.

How companies choose where to list

Lord Hill, in the 2021 UK Listings Review that preceded the FCA's current proposals, noted that factors considered by pre-IPO companies in choosing where to list include "…the wider business ecosystem; the visibility of companies and IPOs; the presence of a pro-investment culture; and the prestige [of a] market."

UK Finance/EY also found that the top five factors considered by companies were (in order): access to a strong investor base; valuation and research coverage (of technology companies); liquidity; comparable companies and the "ease and cost of being publicly traded".

This echoes Railpen's own conversations, with one IPO adviser noting that governance practices (including DCSS specifically) were "a marginal consideration, if at all" for their clients. It also aligns with our own analysis of the UK-based companies that have chosen to list in the US since 2017: of the 12 companies that gave reasons for doing so, only one (Endava) cited governance rules. The others mentioned liquidity, access to capital and the quality and nature of the investor base.
We can therefore infer that reducing corporate governance safeguards and shareholder rights would have minimal impact on companies' decisions regarding listing jurisdiction.

The importance of shareholder rights to investment decisions

Robust shareholder rights (including the right to exercise a meaningful voice through the vote) are vital if a company's shareholders are to be able to effectively (and appropriately) influence corporate behaviour on material issues and in support of long-term performance; the FCA itself noted in its 2019 paper the clear link between meaningful, well-targeted stewardship and financial performance.
Railpen votes with its feet on companies where there are insufficient shareholder rights, including dual-class share structures, through our governance-focused exclusions process and bottom-up active investment decisions. We are not the only investors to do so, with recent examples of companies that listed with dual-class share structures at IPO and traded at a discount including Deliveroo and The Hut Group. This micro-level evidence aligns with macro-level academic research showing that strong shareholder protections mean "suppliers of capital are more willing to…provide investment", leading to "more dynamism[4]" in capital markets.

It can therefore be inferred that reducing shareholder protections makes investors more reluctant to allocate capital to companies in a given jurisdiction, unless it is in return for a higher risk premium (leading to a greater cost of capital for the company).

The CP23/10 proposals would do nothing to tackle the actual barriers to a UK listing cited by companies, including the relative lack of tech expertise amongst the investor base.

Conclusions – a vicious UK capital markets cycle?

We think UK policymakers currently underestimate the extent to which robust investor protections helped make the UK the global financial powerhouse it is today and have not fully explored the problem through both a company and an investor lens.

The CP23/10 proposals would do nothing to tackle the actual barriers to a UK listing cited by companies, including the relative lack of tech expertise amongst the investor base. In fact, we think they could exacerbate the situation: investors could become more reluctant to invest in UK-listed firms because our reputation for strong investor protections has been damaged, meaning companies would look elsewhere for their liquid, high-quality pool of capital. This in turn risks creating a vicious UK capital markets cycle that will leave investors, companies and beneficiaries worse off.

By Caroline Escott, Senior Investment Manager, at Railpen and Chair of the Investor Coalition for Equal Votes (ICEV).

Why loyalty voting rights and dual class shares should coexist

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In the last decade, several European countries have relaxed the principle of one-share-one-vote for listed companies and have allowed companies to introduce classes of shares with multiple voting rights ("dual class share structures"). In France and Belgium, the only type of multiple voting rights that is allowed in listed companies is loyalty voting rights, i.e. multiple voting rights for shareholders who have held their shares for a certain period (in Italy and the Netherlands, both loyalty voting rights and dual class shares are allowed). In this blog post, we argue that loyalty voting rights are nothing more than a control-enhancing mechanism. Therefore, there is no reason for France and Belgium to allow loyalty voting rights, but not dual-class shares.

In general, two main justifications for loyalty voting rights are given by European legislators: first, loyalty voting rights are thought to combat "corporate short-termism", i.e. the sacrifice of long-term value for short-term profits, by encouraging shareholders to hold their shares for a longer period and redistributing power to these shareholders. Second, loyalty voting rights could encourage IPOs by allowing the founders to retain control with a smaller participation.

Although these considerations appear to be intuitive, our recent empirical study in Belgium nuances this story. First, in Belgium, similar to France and Italy, loyalty voting rights are almost exclusively used by controlling shareholders (or at least by large insiders). Minority shareholders and institutional investors are not interested, due to the restrictive and liquidity-reducing registration requirement.

This, however, is not fatal from the perspective of combatting short-termism: there are some arguments why controlling shareholders could be more long term orientated and why loyalty voting rights can help to promote the long-term strategy of a company. For instance, cash-restrained controlling shareholders can use the additional voting rights to reduce their equity stake and raise new capital to finance (long-term) investments, without losing control over the company. However, that same goal can be accomplished by dual class share structures. In addition, while that loyalty voting rights could be preferred to dual class shares, since they are open for all (loyal) shareholders, in practice, loyalty voting rights are only open to controlling shareholders. Hence, there is no reason to treat loyalty voting rights more leniently than dual class shares. Making loyalty voting rights the default rule (as the Loi Florange has done in France) or lowering the threshold for introducing loyalty voting rights (as Belgium and Italy have done), while being stricter or even banning dual class share structures, therefore makes no sense to us. If legislators believe that loyalty voting rights play a useful role, they should also allow dual class share structures.

This is important, because the second objective of loyalty voting rights, encouraging IPOs, can be achieved in a much more effective manner by allowing dual class shares. The mere possibility, however remote, that another shareholder would obtain double voting rights and challenge the control of the founders, makes it difficult to convince founders to go public with only loyalty voting rights.

In Belgium, for example, none of the IPOs since 2019 (when loyalty voting rights were introduced) have made use of loyalty voting rights. In addition, dual class shares are more transparent to the market, given that it is ab initio clear that they are used to strengthen the position of the controlling shareholder. This would avoid the misleading narrative that all loyal shareholders can benefit equally from the additional voting rights. Finally, dual class share structures can be easier to administer for companies, as the fluctuating number of voting rights can give rise to problems when voting and ownership thresholds need to be calculated.

In any case, both dual class shares and loyalty voting rights should require some form of minority shareholder protection when they are introduced, especially in the midstream phase, for example by banning the beneficiary of the multiple voting rights (the controlling shareholder) from voting on the introduction of dual class shares and loyalty voting rights (basically "majority of the minority" approval). Another possibility to protect minority shareholders would be to link multiple voting rights to a mandatory transfer- or time-based sunset clause, which avoids a perpetual entrenchment by the controlling shareholders and allows dual class share structures to be abolished when they are no longer efficient, considering the company's lifecycle.

Some have also argued that the multiplicator of voting rights should be limited, to limit the wedge between cash flow and voting rights. This argument has also been used to defend loyalty voting rights, on the basis that the multiplicator for loyalty voting rights is limited to two (at least in Belgium and France). This argument is unconvincing, as it is perfectly possible to also limit the multiplicator in dual class share structures. In addition, we believe that such a limit to the multiplicator is an arbitrary and unnecessary limit on multiple voting rights, as long as minority shareholders are adequately protected when the multiple voting rights are introduced.

If legislators believe that loyalty voting rights play a useful role, they should also allow dual class share structures

These arguments illustrate that dual class shares can be a useful alternative to loyalty voting rights. Hence, legislators that allow loyalty voting rights (such as France and Belgium), should also give companies the option to choose for dual class shares, as long as minority shareholders are sufficiently protected.

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Dual-Class IPO's: A solution to unicorn governance failure

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Dual-class stock structures have proliferated in recent years. In 2017-2019, almost 30 percent of IPOs in the US had a dual-class structure, and most of them were founder-controlled technology firms (Aggarwal, Eldar, Hochberg and Litov, 2020). Their increasing popularity has drawn the ire of many institutional investors, proxy advisory firms and academic scholars who view dual-class structures as detrimental to shareholder value. Founders with superior voting rights may have strong incentives to extract private benefits or pursue fanciful projects at the expense of shareholder value.

The standard accounts of dual-class structures ignore the full menu of organizational choices that are available to entrepreneurial firms. The critique of dual-class structures rests on the assumption that the alternative to a dual-class IPO is a single-class IPO in which shareholders' voting power is identical to their economic interests. However, if dual-class structures were not legally permissible, the firms that opt for dual-class structures could opt to remain private indefinitely or, at the very least, postpone the IPO.

The underlying motivation for adopting dual-class structures is that founders place very high value on maintaining control. If they cannot maintain control after the firm becomes public, they may choose not to become public at all. Indeed, during the same period that dual-class firms have proliferated, there has also been a dramatic increase in the number of startups with over $1 billion valuations, commonly known as unicorns. The proliferation of unicorns underscores that remaining private is a viable and attractive option for sizable startups.

If dual-class structures were not legally permissible, the firms that opt for dual-class structures could opt to remain private indefinitely

From a governance perspective, the private option may be particularly concerning. Unicorns with dominant founders have experienced a multitude of scandals in recent years, some of which ended with major losses for investors. Well-known examples include the collapses of WeWork, Theranos and FTX. These companies not only had a toxic work culture or failed to comply with laws and regulations, but more importantly, their whole business model was either fraudulent or could not realistically support the firm valuation. Most of these failures resulted directly from the irresponsible behavior of a dominant founder, and the inability of investors, including reputable VC (venture capital) firms, to monitor their actions in a material way.

In comparison to the dramatic governance failures in large unicorns, dual-class corporations have arguably fared reasonably well. While there is an ongoing debate about the performance of dual-class firms, overall performance appears to have been reasonably strong, at least when considering the founder-controlled firms that became public in the 2010s (see Ahn, Fisch, Patatoukas & Solomon, 2021). Moreover, none of them experienced a failure that amounted to a complete collapse of the business model.

The explanation I offer in this article is that the IPO process is effective in distinguishing founder-controlled firms that have viable business models and valuations from those that do not. Perhaps the largest agency cost associated with founder control is that the founder may exaggerate the growth potential of the firm in order to raise capital at higher valuations. Investors can suffer extreme losses when they discover that the valuation is grossly inflated, or worse, that the business model is fraudulent, and the firm generates no value. By ensuring that the firm has a viable business model and a reasonable valuation, the IPO process mitigates the tail risk of the agency problem in founder-controlled firms that could result in dramatic losses for investors.

To the extent that they facilitate the IPO decision, dual-class structures effectively mitigate the agency costs of founder control. Without the option to create dual-class structures at the IPO, these founder-controlled firms may stay private, and if they do, they will escape the scrutiny of the IPO process. As the recent failures of large unicorns suggest, even reputable VC firms may fail to monitor startups effectively. The IPO process, which includes detailed disclosure and financial analysis, can elicit new information on these private firms that may end in the delay of the IPO, adjustments to the valuation, or even the withdrawal of the IPO.

In this sense, dual-class structures provide a solution to the unicorn governance problem. When there is great availability of private capital, founders can delay the IPO or keep their startups private. There is indeed evidence that tech unicorns that invest in intangible assets tend to go public later than other startups of similar age (Davydova, Fahlenbrach, Sanz & Stulz, 2022). The VCs who are scrambling to get a piece of a startup with substantial growth potential have little leverage in negotiating for control rights, and often have very few tools to monitor the operation and even the strategy of the firm.

By acquiescing to the dual-class structure at the IPO, the VCs can get the startup founder to go public at a relatively early stage of the startup life cycle..

By prompting startups to go public, VCs can reduce the risk of a major governance failure that they may be unable to prevent in an environment in which they compete for investments.

Indeed, the average age of dual-class firms at the IPO is substantially lower than that of other IPO firms. By prompting startups to go public, VCs can reduce the risk of a major governance failure that they may be unable to prevent in an environment in which they compete for investments. Within this broader perspective that accounts for private markets, the dual-class structure is paradoxically a solution to the relative laxity in the governance of entrepreneurial startups

This account provides an overlooked explanation for why VCs have warmed up to dual-class structures, and some have even lauded them as an ideal structure for founder-controlled technology startups seeking to go public.[1] The reason is that under economic conditions in which founders have the upper hand, VCs are likely to be less concerned about founders' control after the IPO. Instead, their primary concern is that the firm may remain private without any meaningful scrutiny, thereby exacerbating the risk of a major failure.

This analysis underscores the role of the IPO process in instilling discipline within founder-controlled firms. The scrutiny of capital markets, combined with mandatory disclosure during the IPO stage, effectively filters out founder-controlled startups lacking viable business models. In equilibrium, startups lacking plausible models would opt not to pursue a public offering. The WeWork case may be perceived as an off-equilibrium event wherein the founder, Adam Neumann, chose to go public with Softbank's support, seemingly expecting that public investors would overlook the facts disclosed in the company's registration statement.

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The subsequent withdrawal of the IPO and the founder's removal, prompted by weak demand from public investors, further emphasizes the disciplining impact of the IPO process.

It is important to emphasize that the accountability and transparency requirements that are imposed on public firms do not cure all governance problems, such as compliance failures or a toxic work environment (Platt, 2023). Many public firms, whether they are founder-controlled or not, have experienced such failures. While it is possible that publicness reduces the risk of compliance failures and scandals, this appears to be largely a marginal impact of going public. Rather, it is the IPO process with its requirements for detailed disclosures about the firm's business model and financial accounts followed by market scrutiny that is effective in screening the entrepreneurial startups that have good (or at least plausible) ideas from those that don't. In this sense, my account of dual-class IPOs reveals the true role that publicness serves in disciplining founder-controlled entrepreneurial firms.

My analysis of the role of dual-class IPOs might also have normative implications. In the absence of a dual-class structure, it's conceivable that fewer unicorns would have opted for the IPO route. Consequently, without the prospect of an IPO, many unicorn founders might have experienced less oversight, attracting more private investment for potentially implausible or even fraudulent projects. The availability of the IPO option creates incentives for founders to avoid inflating startup valuations by making unrealistic promises. Paradoxically, the absence of dual-class structures could potentially lead to more pronounced and extreme startup failures.

Accordingly, in the enduring debate surrounding the advantages and drawbacks of dual-class structures, it is crucial to recognize their role in streamlining the IPO process for startup unicorns. When evaluating policies that seek to limit firms' adoption of dual-class structures, the assessment should extend beyond their potential performance as single-class entities. Equally significant is an examination of their performance as private firms, taking into account the elevated risk of an extreme governance failure.

By Ofer Eldar, Professor at UC Berkeley School of Law and ECGI.

Corporate purpose beyond borders: A key to saving our planet or colonialism repackaged?

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The "corporate purpose" debate has captured the attention of academics, lawyers, policymakers, and entrepreneurs around the world. Leading corporate governance scholars see it as one of the "hottest public policy issues" of our time. Governments have embraced legislation to make corporations more purposeful and financial titans have pledged over 100 trillion dollars under their management to foster a broader conception of corporate purpose globally. The realization that climate change is likely the issue of the century and that any chance of successfully addressing it will require a change in the way corporations are governed, seems to justify the attention that the corporate purpose debate is receiving. And yet, the corporate purpose debate, while extremely important, has largely been built on an understanding of corporate law and governance that is local – jurisdiction bound – while the issue of climate change is global; pollution does not respect jurisdictional borders.

This myopic, jurisdictionally bound, conception of corporate purpose forms the logical foundation for Milton Friedman's (in)famous 1970s New York Times article "The Social Responsibility of Business Is to Increase Its Profits". In Friedman's jurisdictionally bound world, local elections and each country's democratic process are the linchpins holding together his theory that policy decisions related to social responsibility should be left to governments – not the management of companies – justifying his core argument that the focus of companies should be maximizing shareholder value.

Friedman's world, in which corporate purpose was assumed to solely be determined within jurisdictional borders, if it ever existed at all, is now dead.

The idea that externalities, such as pollution, may cross jurisdictional borders and that, in turn, those impacted by extraterritorial externalities would not be part of the democratic process, was not contemplated in Friedman's seminal article – a fact that those who both love and loath Friedman's article have almost entirely overlooked.

Friedman's domestic, jurisdictionally bound, understanding of corporate purpose is not an aberration in the leading academic discourse on corporate purpose – it is the norm. The Anatomy of Corporate Law, which is widely considered to be the world's leading comparative corporate law treatise, frames its discussion of corporate purpose around "local communities" and the interests of "society". The primary tension in the corporate purpose debate among legal academics – whether to protect non-shareholder stakeholders inside or outside the corporate law – presupposes that the company in question is within the jurisdiction of the government making this policy decision.

This illustrates how the extraterritorial effects of companies, and the formal and informal legal mechanisms used to manage those effects extraterritorially, have almost entirely escaped the current academic understanding of corporate purpose.

However, many of today's pressing environmental and societal issues, including climate change, are clearly global. As a result, a panoply of informal and formal legal mechanisms has been produced by states, multinational firms, and transnational organizations that aim to shape corporate purpose beyond jurisdictional borders. Collectively, these mechanisms have created the "globalization of corporate purpose", raising myriad possibilities for effectively addressing global issues, the most prominent of which is climate change. However, the globalization of corporate purpose is not unambiguously a force for good. When powerful-states, powerful-firms, and powerful-organizations define corporate purpose beyond borders it risks corporate purpose being defined in the interest of these powerbrokers, to the detriment of less powerful communities around the world.

Our recent ECGI Working Paper – Corporate Purpose Beyond Borders: A Key to Saving Our Planet or Colonialism Repackaged? – creates a taxonomy to understand and analyze the forces driving corporate purpose beyond borders. Our taxonomy identifies the three major drivers of the globalization of corporate purpose – states, multinational firms, and transnational organizations. We demonstrate how these three actors use formal and informal, corporate and non-corporate legal mechanisms to shape corporate purpose beyond borders and how the future of corporate purpose will be significantly influenced by powerful-states, powerful-firms, and powerful-organizations beyond jurisdictional borders.

The realization that corporate purpose is increasingly determined beyond borders raises a myriad of important issues that escape the classic corporate purpose debate.

In such a complex and rapidly changing environment, it would be unwise to predict whether the colossal implications of the rise of corporate purpose beyond borders will provide a path to sustainable development for all or colonialism repackaged.

Is the EU's aggressive use of its sizable market and regulatory power (state-based) to force companies to focus on environmental and social issues unrelated to corporate value going to help save our planet or is it colonialism repackaged? Is the enormous economic power and geographical presence wielded by multinational firms (firm-based), such as IKEA/BlackRock, to promote sustainability globally through their supply-chains/investments a key to addressing climate change or a recipe for greenwashing on a global scale? Are initiatives to promote sustainable corporate governance globally by transnational organizations (organization-based), such as the UN, IMF, OECD and World Bank, a geopolitical remedy to mitigate climate change or an example of geopolitical capture to promote the interests of the Global North at the expense of the Global South?

As we illustrate in our article, there are no easy answers to these questions. However, what is clear is that the world has changed. The EU's recent sustainability initiatives (i.e., the EU Corporate Sustainability Reporting Directive, the Corporate Sustainability Due Diligence Directive, and the EU Carbon Border Adjustment Mechanism) are an unprecedented attempt to create a regulatory architecture designed to shift the purpose of companies around the world to promote the EU's conception of sustainable corporate governance globally.

iIn today's world, Western dominated multinational firms wield enormous economic power and increasingly claim to use that power to promote sustainable corporate governance around the world.

International organizations, which have defined the post-World War II era, have come to see the promotion of ostensibly global corporate governance standards as a significant part of their mission – with sustainability, arguably as defined by the Global North, as their new aim.

Friedman's world, in which corporate purpose was assumed to solely be determined within jurisdictional borders, if it ever existed at all, is now dead.
This new world in which states, firms, and transnational organizations drive the evolution of corporate purpose beyond borders is rapidly changing and replete with complexity. California's democratic governor recently signed three pieces of legislation (The Climate Corporate Data Accountability Act (SB253), The Climate-Related Financial Risk Act (SB261), and the Voluntary Carbon Market Disclosures Act (AB-1305)), to address climate change – and which aim to change director's considerations and the behavior of corporations prompting a shift in corporate purpose beyond California's borders.

However, as we explain in our article, distinct from the EU's globally focused sustainability initiatives, California's legislation is designed primarily with a focus on US companies and is far less ambitious than the EU's initiatives in pushing companies to shift their purpose towards stakeholderism on the shareholderism-stakeholderism continuum. The meteoric rise of China's economic power and of its state-controlled firms, provides China with the ability to promote sustainable corporate governance beyond its borders. However, as we explain in our article, China has chosen not to use this power – which may be seen by its supporters as exemplative of its respect for state sovereignty or by its detractors as facilitating a global race to the bottom for corporate governance sustainability standards for its own gain.

To add to the complexity, a loss of confidence in the international organizations that have dominated the post-World War II era (the UN, World Bank, OECD, and IMF) and the rise of new organizations like BRICS+, suggest that the ability of international organizations to drive corporate purpose beyond borders to promote sustainability will be less uniform and more regional than in the past.

Finally, multinational companies and multijurisdictional investors possess enormous resources and capacity to drive sustainable corporate purpose globally. However, they also may contribute to greenwashing on a global scale and might be influenced by their home states' political and economic agendas.

In such a complex and rapidly changing environment, it would be unwise to predict whether the colossal implications of the rise of corporate purpose beyond borders will provide a path to sustainable development for all or colonialism repackaged. However, what is clear is that the classic corporate purpose debate is fatally myopic as Friedman's jurisdictionally bound world no longer exists. Thus, to understand the future of corporate purpose, corporate governance, and sustainability, we must now understand corporate purpose beyond borders.

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Equal and unequal treatment clauses in takeovers of companies with dual class share structures

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It is often argued that takeovers are difficult in companies with a dual class share structure because the founders and others hold a large number of voting shares and therefore control the company. However, from the point of view of good corporate governance, it is very important that the possibility of a takeover of the company, i.e. a change of control, is open. This article examines the arrangements that can be used to facilitate a takeover, assuming the introduction of a dual class share structure. 〔For the argument that the issue of introducing a dual class share structure should be dealt with primarily by including the clause in the charter or articles of incorporation (hereinafter referred to as "articles of incorporation") at the time of the IPO, See, Berger & Fisch & Solomon (2023)〕.

In this regard, it has been suggested that companies adopting a dual class share structure should include in their articles of incorporation the granting of a control premium in the event of a takeover, so that shareholders with a high proportion of voting rights have an incentive to tender their shares in a takeover bid, thereby increasing the likelihood of a successful takeover (Position A, a type of 'unequal treatment clause', See, Smith(2017)). For example, a specific clause might read: 'In the event of a takeover procedure (e.g., takeover bid), high vote shares may receive an X% higher consideration than low vote shares'. Such an arrangement is a noteworthy approach that focuses on the incentives of shareholders holding high vote shares.

In the US since the 2000s, some companies that have adopted a dual class share structure appear to have introduced clauses that grant voting rights in proportion to the percentage of shares held during the takeover procedure.

However, if a company with a dual class share structure has a clause such as (A) in its articles of incorporation, the payment of a control premium for high vote shares will require more acquisition funds than in the case of a normal takeover. This could act as a disincentive to complete a takeover. It should be noted that, in many jurisdictions, takeover bids in relation to companies issuing class shares are made on a class-by-class basis, which means that an acquirer may make a takeover bid on different terms for each class of shares, even if the target company does not provide for an arrangement as described in (A). However, even in this case, the payment of a control premium for high vote shares is effectively required, and the total amount of acquisition financing is likely to be higher when acquiring a company that has adopted a dual class share structure.

On the other hand, in the US since the 2000s, some companies that have adopted a dual class share structure appear to have introduced clauses that grant voting rights in proportion to the percentage of shares held during the takeover procedure (See, Smith(2017); Petrucci (2023)) (Position B, a kind of "equal treatment clause"). Such clauses are problematic because they cause shareholders with high vote shares to lose control and the associated control premium, thereby reducing the incentive for shareholders with high vote shares to tender their shares to the bid. To overcome the problems associated with the equal treatment clause in (B), the use of a type of 'unequal treatment clause' as in (A) has been advocated.

Under clause (B), however, the high vote shareholder is no longer the controlling shareholder under the clause at the time of the takeover procedure, and if many of the other shareholders who were low vote shareholders accept the takeover bid, there is a good chance that the takeover will be completed. In light of the above considerations, in order to facilitate takeovers in companies with a dual class share structure, it would be more desirable to introduce a clause in the articles of incorporation that "allows high vote shareholders to lose control (and premium)" (position B) than a clause that "takes into account the control premium of high vote shareholders" (position A). In other words, an "equal treatment clause" (position (B)) would be preferable to an "unequal treatment clause" (position (A)) in the phase of corporate takeovers.

There may be some criticism that clause (B), which allows shareholders with high vote rights to lose control during the takeover procedure, would undermine the importance of introducing a dual class share structure in the first place. However, the introduction of a dual class share structure is not only important as a takeover defence. The fact that founders and others hold a high proportion of voting rights, and above a certain level of voting rights, enables them to do various things as majority shareholders under company law.

It may be a reasonable option to introduce a clause in the articles of incorporation that facilitates a takeover of the company in exchange for such advantages for the founder shareholders and others under a dual class share structure.

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China's Experiment: Dual-Class Equity Structure

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The adoption of the "dual-class equity structure" (DCES) has been expanding across Asia. Japan has implemented a system functionally akin to DCES. Singapore and Hong Kong have embraced it. Notably, in April 2023, Korea also adopted the DCES. However, the DCES continues to be a subject of debate. Advocates of the DCES underscore its benefits in maintaining control by founders endowed with significant "human capital"—skills such as technology expertise and visionary leadership—which could ultimately be advantageous for all shareholders and society. In contrast, opponents raise concerns about investor protection, pointing to potential risks such as founders' lack of accountability, entrenchment, suppression of legitimate shareholder activism, and increased risks of tunneling. These advantages and disadvantages are also relevant to Mainland China. In our paper, Exploring China's Dual-Class Equity Structure: Investor Protection Measures and Policy Implications, we delve into the recent developments of the DCES in China.

Traditionally, China has strictly adhered to the one-share-one-vote (OSOV) principle as a core aspect of its corporate law.[1] However, in 2019, the China Securities Regulatory Commission (CSRC) introduced rules to facilitate the DCES (in Chinese, 特别表决权, meaning "special-voting rights"), allowing "innovative enterprises" to issue shares with multiple voting rights to their founders. Yet, in China, the DCES system is governed by a de facto "stringent permit system." The Chinese authorities have exercised caution regarding the system's potential misuse and negative impacts on investors. Consequently, as of November 2023, only eight companies have received the "green light (绿灯)" from the Chinese authorities to adopt DCES in their IPOs, as detailed in Table 1 below. Notably, the most recent case dates back to July 2022. Since then, the DCES-IPO process has been dormant in China.

Table 1: Companies Listing in Mainland China with the DCES

Company	Listing date	Percentage of issued share capital controlled by founder(s)	Percentage of founder(s)' voting rights	Votes per Special Share
UClould	20/1/2020	23.12%	60.06%	5
Ninebot	29/10/2020	25.79%	63.47%	5
Huiyu Phar.	26/10/2021	31.27%	60.95%	5
Jing-Jin Electric	27/10/2021	16.04%	59.29%	10
Jingwei Hirain	19/4/2021	33.27%	50.76%	6
SmartSens	20/5/2022	13.71%	44.26%	5
Cloudwalk	27/5/2022	19.78%	59.67%	6
Orbbec	7/7/2022	35.73%	64.84%	5

The Chinese system of the DCES emphasizes stringent investor-protection measures, including: (1) "three numerically specified rules" (which we refer to in our paper), (2) sunset provision rules, and (3) rules converting special-voting shares (i.e., shares with higher-voting rights) into shares with one vote. For a comprehensive overview, refer to Table 2 below.

Table 2:
Investor Safeguard Rules in the Chinese DCES[2]

(1) Three numerically specified rules	**(i) 10% equity rule (ii) 10-time voting-right rule (iii) 2/3 voting-right rule**
(2) Sunset provision rules	**(i) Event-driven sunset (ii) Time-based sunset**
(3) Rules on converting special-voting shares into shares with one vote	**(i) Conversion in a hostile takeover (ii) Conversion in an amendment of the charter**

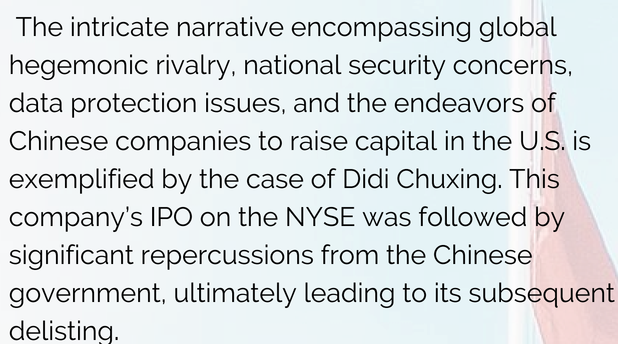
For example, the "three numerically specified rules" comprise: (i) the 10% equity rule, stipulating that founders' equity contributions must be no less than 10% of the total; (ii) the 10-time voting-right rule, ensuring that founders' special-voting shares do not possess more than ten times the voting rights of ordinary shares; and (iii) the 2/3 voting right rule, which limits founders' total voting rights, including those from special-voting shares, to no more than two-thirds of the total voting rights. These rules collectively aim to balance the interests of founders with those of other shareholders, ensuring a fair and equitable governance structure within the framework of the DCES in China. n the legal framework of the Chinese DCES, there are rules regarding event-driven sunset provisions; however, rules pertaining to time-based sunset provisions are absent.

Nonetheless, theoretically, time-based sunset provisions, although not favored by founders in practice, can be incorporated through negotiation. Additionally, the rules concerning the conversion of special-voting shares into shares with one vote are particularly relevant in scenarios like mergers or when amending a company's charter.

Given that there are approximately 5,000 listed companies in Mainland China's capital market, the mere eight listed companies adopting the DCES suggest its limited use. Indeed, the permit system enforced by Chinese authorities is stringent: even if a corporation meets the statutory requirements of DCES on paper, this does not ensure its adoption in practice since the government authorities' permission is needed. For instance, in the UCloud case presented in Table 1, the founders' equity contribution was 23.12%, significantly higher than the required 10%. While votes for special shares could legally be up to 10 times that of ordinary shares, UCloud opted for a more conservative ratio of 5. This approach brought the percentage of founders' voting rights to below 2/3 (66.6%) of the total votes of the company, a "soft-law" threshold closely monitored by the Chinese authorities.[3]

Considering the relative underdevelopment and inefficiency of the Chinese capital market, as well as the prevalence of tunneling, the Chinese authorities' approach to enhancing investor protection in the context of DCES appears appropriate, at least in the short term. However, the Chinese government's stringent permit system may inadvertently stifle entrepreneurship, which is crucial for China's economic development. It is also important to note that regulations such as the 10% equity rule and the 10-time voting-right rule seem to be more heuristic than scientifically substantiated.

Additionally, as of January 2023, about 250 Chinese corporations were listed on the U.S. capital market, and many of them embraced DCES. Yet, with growing tensions between China and the U.S., China faces challenges in utilizing the U.S. market and is strategically reducing reliance on it.



The intricate narrative encompassing global hegemonic rivalry, national security concerns, data protection issues, and the endeavors of Chinese companies to raise capital in the U.S. is exemplified by the case of Didi Chuxing. This company's IPO on the NYSE was followed by significant repercussions from the Chinese government, ultimately leading to its subsequent delisting.

From this perspective, China's DCES should be crafted to not only promote entrepreneurship but also to serve as a response to Chinese companies' loss of DCES opportunities in U.S. capital market. However, if China maintains its strict stance on DCES, as evidenced by the stringent permit system and the very limited number of DCES-listed companies, it implies that Chinese companies' loss of DCES-IPO opportunities in U.S. capital market might not be recaptured in China. Furthermore, the DCES-IPO market in Hong Kong is also not very active, offering limited opportunities for innovative Chinese companies. Consequently, establishing a viable DCES-IPO market in Mainland China is becoming increasingly important.

Given this situation, Chinese authorities should consider gradually easing the current strict DCES regime. While relaxing investor protection measures may increase the disparity between cash-flow rights and voting rights and elevate the risk of tunneling, this can be mitigated by enforcing legal systems that adequately penalize such misconduct through civil, administrative, and criminal penalties. Therefore, a dual approach—easing DCES regulations and strengthening enforcement against tunneling—is advisable in China. In this regard, discussions surrounding the DCES should also incorporate considerations for reforming the derivative suit system, which is a principal mechanism for civil remedies against tunneling and remains largely dormant and ineffective in China. Additionally, there should be a focus on developing the newly introduced investor-protection mechanisms in the China Securities Investor Service Center (ISC), a government-affiliated body.

In sum, China's DCES system represents a multifaceted function interwoven with a range of issues. These include fostering entrepreneurship, ensuring investor protection, addressing sluggish economic growth in China, navigating the ongoing tensions between China and the U.S., and considering the Hong Kong capital market as an alternative to Mainland China's capital market. For example, should the China-U.S. tensions ease following the meeting of their top leaders in November 2023, it could also have implications for the future direction of China's DCES system.

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Dual-class shares for low-carbon innovation

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One way to look at the climate change problem is through the lenses of low-carbon innovation: to reduce CO_2 emissions, the world needs alternatives to fossil fuels. According to the latest estimates by the International Energy Agency, 35% of the green energy required to reach Net Zero by 2050 depends on technologies not yet on the market. Slow technology undermines governments' ability to reduce CO_2 externalities through traditional instruments, such as taxes and regulation, because starving people of energy is politically difficult and hard to coordinate internationally. A related problem affects sustainable finance: so long as burning fossil fuels is profitable, the impact of sustainable finance on global CO_2 is limited. However, sustainable finance can incentivize controlling shareholders to pursue low-carbon breakthroughs and step up the transition. Controlling shareholders are best positioned to pursue radical low-carbon innovation because, as opposed to managers of dispersed-ownership companies, they have vision, tolerance for failure, and indefinite time horizons.

In a recent paper, I have argued that dual-class shares, which enable control with less than half of the equity, allow institutional investors to finance low-carbon innovation solving a double commitment problem. On the one hand, controlling shareholders that commit to pursuing low-carbon innovation without increasing agency costs can tap the funds of climate-conscious investors to scale their vision. On the other hand, climate-conscious institutional investors can commit to supporting the controlling shareholder's vision by relinquishing control rights conditional on the achievement of an ambitious CO_2 target.

Controlling shareholders are best positioned to pursue radical low-carbon innovation because, as opposed to managers of dispersed-ownership companies, they have vision, tolerance for failure, and indefinite time horizons.

A target-contingent sunset and a divestment sunset support this double commitment.

While dual-class shares allow controlling shareholders to scale their vision, potentially they also increase agency cost. This concern is often exaggerated. Although controlling shareholders have more incentive to 'steal' from minority shareholders the lower their equity, this problem is less severe in good corporate law jurisdictions where effective procedural constraints on self-dealing are or can be implemented. Still, the wedge between voting rights and the controller's equity created by dual-class shares could undermine the incentive to acknowledge the vision's failure as the controller's stake becomes too small (for example, a 10:1 wedge enables control with 9.1% of the equity; 20:1 requires only 4.8%). However, the presence of idiosyncratic

Private Benefits of Control (PBC) rules out excessive wedges. Idiosyncratic PBC represent the vision's subjective value – for instance, the pride of making a negative-emissions vehicle – and motivate controlling shareholders to invest all or most of their wealth in a company to implement their vision.

To protect the value of their undiversified investment, controllers stop selling noncontrolling stock when investors require a discount as high as idiosyncratic PBC: selling stock for less would reduce the value of the controller's equity. As investors anticipating agency cost require a higher discount the higher the wedge, finite idiosyncratic PBC limit this wedge setting a lower bound on the controller's stake. Because controlling shareholders value their vision and may lose everything from failing to acknowledge its failure, the agency cost of dual-class shares is limited.

A target-contingent sunset commits controlling shareholders to pursuing low-carbon innovation to monetize idiosyncratic PBC. Such a sunset would collapse the dual-class structure into one-share-one-vote if the control block is sold before achieving the decarbonization target. Conversely, the dual-class structure would become permanent when the target is achieved. Although controlling shareholders face no time pressure to deliver innovation, they must wait until they hit the target before they can cash in idiosyncratic PBC as control premium. With a target-contingent sunset, climate-conscious investors may incentivize controlling shareholders to pursue low-carbon innovation, as opposed to any other innovation. Importantly, the target must be technologically out of reach in the particular industry. Think, for instance, of a net-zero vehicle (meaning negative CO_2 emissions) or low-carbon aviation. Moreover, CO_2 targets should be fool-proof and include measurable upstream and downstream (so-called Scope 3) emissions. In my paper, I show with a numerical example that controlling shareholders prefer to commit to low-carbon innovation if climate-conscious investors buy noncontrolling stock at a lower discount than financial investors who only care about risk-adjusted returns.

> To fulfil the mandate of climate-conscious beneficiaries, institutional investors should tie their hands to controlling shareholders with dual-class shares conditional on low-carbon innovation.

But why should investors offer such a good deal to controlling shareholders? Institutional investors, particularly mutual fund managers, cater also to the preferences of climate-conscious beneficiaries who are willing to forgo short-term return, however little, to improve climate change.

This is not just theory; there is evidence that this mechanism affects mutual fund flows, including of large, mainly index-tracking investors such as the "Big Three" (Blackrock, Vanguard, and State Street). In turn, ownership by the Big Three and comparable asset managers is negatively correlated with CO_2 emissions. However, the size of CO_2 abatement that can be attributed to institutional investor engagement is much too small compared to the Paris agreement goals. More disturbingly, a recent study reveals that CO_2 emissions are positively correlated with low-carbon innovation, suggesting a Jevons paradox: when burning fossil fuels become more efficient, companies – and their institutional owners – prefer cashing in the value of innovation to pursuing further decarbonization. This frustrates the purpose of climate-conscious investors.

To fulfil the mandate of their climate-conscious beneficiaries, institutional investors should tie their hands to controlling shareholders with dual-class shares conditional on low-carbon innovation. This is necessary because, so long as climate risk is mispriced – and it will remain such until catastrophes or new technologies become easier to value – even "universal" institutional owners cannot simultaneously provide competitive returns and have more impact than foreseeable government policies.

This clashes with a mandate from climate-conscious beneficiaries to forgo short-term returns for long-term impact. Short of greenwashing, which arguably the EU Taxonomy will curb, such a mandate implies subsidizing low-carbon innovation until it will become profitable in a futuristic decarbonized world, in the spirit of the delegated philanthropy theory of Bénabou & Tirole.

Large, institutional owners cannot support delegated philanthropy for three reasons: a) they are time-inconsistent as they cannot commit to forgoing short-term returns; b) they are incompetent to judge firm-specific innovation, exposing managers to hedge fund activism; c) they have a conflict of interest with low-carbon breakthroughs because, as horizontal, or common owners, some scholars would argue they prefer less competition. Controlling shareholders are a good commitment device for institutional investors because they face none of these limitations: as large, undiversified shareholders, they are committed to the long term; as controllers, they cannot be ousted unless they underperform severely; as visionaries, they compete aggressively.

While a target-contingent sunset supports climate-conscious investors' subsidy to low-carbon innovation (in the form of a lower discount/higher wedge of dual-class shares), institutional investors could still worry that controlling shareholders increase agency cost after getting undisputed control. To facilitate contracting and overcome this concern, corporate law should feature a divestment sunset as a default rule. A divestment sunset stipulates that a dual-class structure revert to one-share-one-vote if the controller's equity falls below a certain proportion as of the IPO (or the subsequent establishment of dual-class shares). Complementing corporate law restrictions on self-dealing and other safeguards, a divestment sunset prevents controlling shareholders from increasing agency cost with time by legitimately taking cash out of the company while retaining control.

There are recent examples of controlling shareholders using dual-class shares to support low-carbon innovation rather than to extract cash from the company. Porsche raised €9.4 billion selling non-voting shares, allegedly to foster Volkswagen Group's global leadership in Electric Vehicles, whereas leveraging on Berkshire Hathaway's dual-class structure, Warren Buffett has become the largest shareholder of Occidental Petroleum, market leader in Carbon Capture and Sequestration technology. In both cases, institutional investors have played along. Combining a target-contingent sunset with a divestment sunset aims to mainstream dual-class shares for low-carbon innovation.

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