ECGI BLOG REVIEW

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The Board Foundation (BF) is a Swiss-based non-profit organization committed to the pursuit of excellence in corporate governance. It aims to create value for individuals, organizations, and society by providing a global platform for development, networking, and innovation to board directors, governance professionals, and academics in the field of corporate governance.

The BF has three operating units: the Swiss Board School (SBS), the Swiss Institute of Directors (SIoD), and the International Center for Corporate Governance (ICCG).

Founded in 2013, the BF is committed to promoting good governance practices. It provides guidance on corporate governance principles, promotes transparency and accountability, and advocates for maintaining high standards of board professionalism. It firmly believes that combining practical and academic, national, and international, and legal and economic perspectives leads to the best governance solutions.. Our approach is grounded in academic interest and enriched by the experience of a diverse team of people.

Over the past four decades, we've grown in size, expanded across Europe and delved into new sectors. We've followed our passion for working together with experts in government, regulation, courts and business to find answers to global challenges.

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About the Blog

Launched in February 2022, the ECGI Blog has become a key global platform for sharing insights and fostering dialogue on corporate governance, stewardship, and corporate responsibility. The blog showcases commentaries and analyses contributed by members of the ECGI network and experts from around the world, with the goal of broadening the understanding of research and igniting informed discussions that influence global perspectives.

Throughout the year, the ECGI Blog highlights emerging themes, current debates, and challenges in corporate governance, while also revisiting well-established topics of widespread 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 strives to inspire fresh ideas, prompt new research, and stimulate conversations that contribute to the advancement of corporate governance practices worldwide.

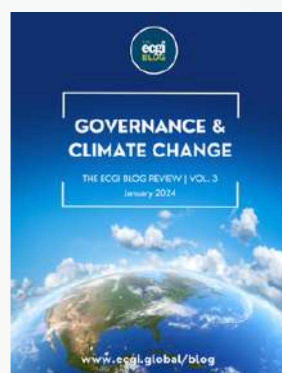
This series presents a collection of ECGI blog articles published between February 2024 and August 2024. It explores perspectives shared at leading corporate governance conferences worldwide, which shape key discussions and set the agenda in the field. The series also covers a range of essential topics in corporate governance, including BRICS+, climate finance, decarbonization, executive compensation, and more.

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

Past issues of the ECGI Blog Review

Available at: https://www.ecgi.global/publications/blog/ecgi-blog-review

'Special Editions'
August 2024



'Governance & Climate Change'
January 2024

'Technology & Governance'
January 2023

'Responsible Capitalism'
September 2022

ECGI Blog Review - Issue Nº 5

Welcome to the **ECGI Blog Review - Issue Nº 5**, a curated exploration of key topics and emerging trends in corporate governance, featuring perspectives from ECGI blog articles published between February 2024 and August 2024. This issue reflects the dynamic nature of corporate governance, capturing discussions from leading corporate governance conferences and drawing attention to themes shaping the field globally.

The compilation highlights a breadth of topics, ranging from **BRICS+ governance** and **climate finance** to the challenges of **executive compensation**, **decarbonization strategies**, and evolving board dynamics. Together, these articles paint a multifaceted picture of the opportunities and tensions in modern governance practices.

A recurring theme in this issue is the **integration of sustainability into corporate decision-making**. From critical analyses of carbon offsets to the challenges of financing a global transition to net-zero, these articles underscore the need for rigorous frameworks to ensure meaningful action. The discussions also reveal how regional approaches, such as Egypt's and Iran's entry into BRICS+, intersect with global sustainability goals.

Another prominent focus is on the **evolving role of shareholders and boards**. Articles delve into shareholder activism's ripple effects, the delicate balance of collaboration and control in boardrooms, and the pressures of meeting institutional investors' increasing expectations. This issue also brings forward thought-provoking analyses on governance challenges in family firms, the rise of private equity continuation funds, and the strategic implications of tenure-based voting rights.

As governance grows more complex, so does the **intersection of corporate actions and societal values**. Topics like corporate accountability, political entanglements, and perceptions of morality in business decisions reflect the broader implications of governance practices in a polarized world. **Geopolitical dynamics** are also leading to challenges to Western-focused governance models, particularly from the Global South and the BRICS+ markets.

We hope this compilation inspires meaningful conversations and innovative solutions. Thank you for exploring this issue of the ECGI Blog Review with us, and we look forward to bringing you future collections.

George Dallas
Head of Content, ECGI
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The views

Tim Bowley

The industry funds' distinctive origin story sets them apart from other major actors in the Australian capital markets and likely goes some way to explaining the industry funds' distinct style of stewardship.

Ruth Aguilera

The firms are incentivized by the issues presented in the proposals – the more intense the activism is, the more likely it is that firms will take measures to improve their non-financial performance.

Sarah Haan

The rising pitch of shareholder activism, particularly around ESG matters and the new universal proxy, challenges the passive shareholder paradigm.

Dionysia Katelouzou

A crucial question arises: should investor stewards serve "others" when these "others" are not financially material, or when their impact extends into the real world?

Steve Kourabas, Nick Sinanis & Timothy Peters

The function of 'corporate office' works both as a mode of accountability—imposing duties and obligations on the officeholder—at the same time as encouraging a sense of separation or irresponsibility for the actions performed.

Luca Enriques & Giovanni Strampelli

The different degree of political consensus over ESG investing on the two sides of the Atlantic, and the backlash ESG is facing in the U.S., help explain why European asset managers are keener to engage on ESG issues and to support ESG-related resolutions than are their U.S.-based competitors.

Susan Watson

The duty of good faith is owed to the corporation as an entity separate from its shareholders with the interests of shareholders, represented as the capital of the company, held in the entity.

Marco Becht & Jordi Canals

The boards of the future will reconsider their priorities to focus on developing long-term corporate development and value creation.

Amir Licht

Without denying possible effects of cognitive biases, it could be that directors respond to shareholder proposals also in light of their individual need for cognitive closure.

Bruno Cassiman

Boards are becoming more important in the value creation process as the interdependencies of a strategic decision become more relevant and important.

The views

Rodolphe Durand

Boards must actively engage with TMTs to ensure strategic decisions align with organizational values and societal expectations.

Anneloes Raes

The demonstrated benefits of Top Management Team behavioral integration may be a promising starting point for a behavioral approach to board decision-making.

Mireia Giné

When boards evaluate the most suitable CEO, they need to consider the match, not just the candidate on its own.

Herminia Ibarra, Claudius Hildebrand & Sabine Vinck

A leader's development journey towards a more enabling leadership style typically unfolds in three main stages: a departure, voyage and return.

Hagen Schweinitz & Sarah Mehrabani

Assessing how the BRICS+ agenda aligns or conflicts with the global net-zero objectives is pivotal for gauging potential contributions or hindrances to global progress.

Syrine Ismaili-Bastien

Egypt aims to develop alternative supply chains, promote economic growth, diversify the economy, minimize costs, develop e-commerce, and enhance market integration through cooperation with other BRICS countries.

Maximiliano Marzetti

It is difficult to find common political values between BRICS+ member countries, which comprise more or less democratic republics, monarchies, an autocratic federation, and a theocracy, other than diverging degrees of anti-West attitudes.

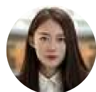
Mariana Pargendler

Heterodox stakeholderism in corporate law can be viewed as an institutional adaptation to environments of high inequality and insufficient state capacity to curb externalities and promote social welfare through other areas of law.

Aazam Virani, Tor-Erik Bakke, Mathias Kronlund & Hamed Mahmudi

Executives with GPBs -"growth-promoting bonuses" - leverage acquisitions to achieve bonus targets.

The views



Andrey Golubov & Yuanqing Zhong

The use of non-compete agreements and their enforceability appears to make managers more averse to takeovers.

Charles McClure, John Kepler & Christopher Stewart

Regulatory criteria for evaluating M&As based on asset-size thresholds overlook an increasingly substantial portion of firms' values, potentially allowing anticompetitive mergers to escape scrutiny.

Samuel Piotrowski, Jarrad Harford & Yiming Qian

Establishments benefiting from agglomeration externalities exhibit substantial increases in productivity, regardless of the type of firm being acquired.

René Stulz, Sinan Gokkaya & Xi Liu

Firms that learn from the market's reaction to their plans end up making better acquisitions.

Roy Shapira

The "shifts-in-disclosure" channel illustrates a broader problem with the quality of board expertise disclosure.

Mariassunta Giannetti, Martina Jasova, Maria Loumioti & Caterina Mendicino

Banks that overemphasize the environment in their reports do not lend more to green firms. On the contrary, these banks are more likely to lend to brown firms.

Jill Fisch

Political posturing increasingly portrays corporations as political actors, making it unappealing for those with different views to engage with them as shareholders, customers and employees, and leading to an increasingly polarized society.

Oliver Spalt & Elisabeth Kempf

Corporate decision-makers, who focus exclusively on maximizing shareholder financial value, may find their actions perceived as amoral by the broader public.

Woochan Kim

Don't fear the MBR. It doesn't hike acquisition costs or dampen the takeover market as much as critics claim.

The views

Alon Brav, Dorothy S. Lund & Lin Zhao

Institutions may exhibit differential growth in ownership due to the difference in return on the assets under management relative to the market return.

Mark Roe & Charles Wang

The legal explanation is unlikely to be the complete story for the package of changes over the past quarter-century of the American public firm sector and plausibly it's not even the most important one.

Kobi Kastiel & Yaron Nili

Supporters of continuation funds view them as a "win-win-win" for all parties involved.

Pranav Putcha

Exxon's actions (and the support it has garnered from business groups) could dramatically cool pro-sustainability proposals and mobilisation in the United States.

Jitendra Aswani & Shivaram Rajgopal

Financial firms, while not direct emitters, play a crucial role in channeling capital towards sustainable projects.

Paul Lee

It seems to me impossible to understand how any investor motivated by fiduciary duties can vote in favour of the pay scheme's proposed resurrection.

Claudia Imperatore & Peter Pope

TVR adoption can help resolve the control-growth dilemma in family-owned firms to the benefit of both insiders and outsiders.

Boris Vallée

Banks, through divestment policies, have a disproportionate influence on what gets financed and what doesn't.

Matthew Wansley & Mark Lemley

The tech giants built a powerful reconnaissance network covering emerging competitive threats by investing in startups as corporate VCs and by cultivating relationships with financial VCs.

Estelle Cantillon & Aurélie Slechten

Keeping emissions trading schemes and nature-based voluntary carbon markets separate ensures that we can simultaneously reduce emissions and increase nature-based carbon removals without compromising the integrity of either system.

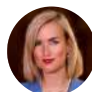
The views

Javier García de Enterría & Matteo Gargantini

While the concept of "acting in concert" was designed to prevent the circumvention of takeover rules, its expansion in many national legal systems now threatens to undermine ordinary shareholder cooperation.

Sehoon Kim, Tao Li & Yanbin Wu

Low-emission firms tap voluntary carbon offsets at a low cost while heavy emitters reduce their carbon footprints in-house.



Alissa M. Kleinnijenhuis, Patrick Bolton & Jeromin Zettlemeyer

The benefits from avoided emissions deliver large net economic benefits to advanced economies, even if these countries pay the lion share of the fossil fuel-to-renewable transition in EMDEs.

Viviane de Beaufort & Hichâm Ben Chaïb

The integration of ESG into executive pay remains uneven and often lacks the rigor needed to drive meaningful corporate change.

Event | 18 Jan 2024 | Organised by:

Monash Law's Centre for Commercial Law & Regulatory Studies (CLARS) - University of Auckland Waipapa Taumata Rau Business School - Queen's University - ECGI

The History of Business Law and Governance Workshop examined the trajectory of business law and governance and the various theoretical and doctrinal twists and turns it has taken along the way. The Workshop included papers by leading corporate law and governance scholars from around the world and the ECGI Blog highlighted four of those papers.

The first two articles provide historical accounts of company directors. Susan Watson (University of Auckland and ECGI) discusses 17th and 18th century oaths sworn by directors, which she argues were precursors to directors' duty of good faith. Steve Kourabas (Monash University), Nick Sinanis (Monash University) & Timothy Peters (University of the Sunshine Coast) provide an in depth discussion of The Charitable Corporation v Sutton (1742), the watershed on the role and responsibility of directors.

The focus of the next two articles is on legal history and shareholders. Sarah Haan (University of Virginia)'s article, challenges a central assumption of early 20th century corporate law – namely that shareholders are 'naturally or rationally passive', and Tim Bowley (Monash University) maps the trajectory of institutional investor engagement in corporate governance and considers the extent to which path dependence plays a role in this regard.

History and investor stewardship

Tim Bowley
Monash University

Much literature is devoted to exploring the factors that shape institutional investors' engagement in corporate governance. Agency theory, in particular, provides a key analytical framework, highlighting the constraints created by investors' business models and competitive pressures in the funds management sector. Legal requirements, political pressure, and transnational developments can also influence investors' approach to stewardship.

But what about history? To what extent do an institutional investor's origins influence their present-day behaviour?

This issue has intrigued me in relation to a significant Australian institutional investor: the industry superannuation fund. Industry funds are pension funds which manage contributions made on behalf of employees under Australia's compulsory retirement savings scheme.

Originally, the funds were established to manage retirement savings of employees within particular industries or sectors of the economy – hence their description as 'industry' funds. Although the funds are now open to employees from any industry or sector, the name 'industry fund' has stuck.

Industry funds adopt a distinctly activist stance in Australian corporate governance. This was highlighted on the international stage when, in 2020, a group of industry funds led a global investor revolt against the Australian/London listed resources company, Rio Tinto. The intervention, which prompted senior management and board changes, was in response to Rio's destruction of ancient indigenous rock art in Western Australia and serious corporate governance shortcomings revealed by the incident.

Industry funds' activism attracts considerable political scrutiny in Australia because of the funds' historical ties to the Australian trade union movement and the ongoing presence of union representatives on fund boards. Right-of-centre politicians and commentators regard the funds as financial Trojan horses for the unions and progressive politics. Industry funds and their supporters retort that the funds are apolitical investment vehicles focused on their members' best interests.

As a consequence of substantial in-flows into superannuation, industry funds are on track to become some of the most powerful investors in Australia. It is critical that policy makers and researchers understand the implications of this development for Australian corporate governance. This requires a nuanced assessment of the funds and their role in Australian corporate governance which moves beyond the one-dimensional political debate referred to above.

As part of a current research project into industry funds, I have applied a historical lens to investigate the factors that underpin the funds' prominent role in Australian corporate governance. This research has revealed an origin story that has several unique features.

First, the industry funds are not a capital markets innovation but a product of Australian industrial (labour) relations. They emerged in the 1980s as a part of a union campaign to compel employers to contribute to workers' retirement savings. For pragmatic reasons, unions involved employer groups in the management of the funds and, to this day, fund boards contain both union and employer representatives. This arrangement gives the funds a unique connection to Australia's labour markets and the business sector.

Second, the unions wanted to differentiate the industry funds from Australia's financial services sector and therefore minimised the involvement of commercial financial services organisations in the operation of the funds. Unions and employer groups typically own the fund trustees and operate them on a not-for-profit basis.

"The industry funds' distinctive origin story sets them apart from other major actors in the Australian capital markets and likely goes some way to explaining the industry funds' distinct style of stewardship."

This structure has in turn influenced the ethos of the industry funds. The funds perceive of themselves as a distinct and unique feature of Australia's finance sector — it is sometimes said that they consider themselves to be a social and capital markets 'movement'.

Third, the industry funds have faced sustained commercial and political scrutiny since their establishment. The funds have largely withstood this scrutiny. Their returns have regularly outperformed pension funds operated by banks and other financial services organisations and they have emerged largely unscathed from high-profile government and judicial inquiries.

Lastly, the industry funds embraced the strategic use of collective action from the early days of their existence. Among other things, this has involved the funds establishing a distinctive collective identity through joint marketing campaigns and founding an ecosystem of service providers and supporting organisations. The latter include the Australian Council of Superannuation Investors, a body which undertakes corporate governance advocacy and interventions on behalf of the funds.

As highlighted by the Rio intervention, this style is characterised by attentiveness to investee company performance, an emphasis on 'E' and 'S' issues as well as 'G' issues, a willingness to take the lead in forceful engagement activities, and the strategic use of collective action.

Applying a historical lens to the industry funds also raises an important question about the future. To a significant extent, the funds' unique institutional DNA is a product of historical circumstance and is not hard-wired into the funds' constituent documents or governing legislation. However, the funds are now evolving into major financial institutions with global operations. Will their institutional character change as they become globally significant investors and move further away in time from their origins? How will they change as senior leaders, who joined the funds in their formative years, retire in coming years? These questions merit careful consideration in light of forecasts which indicate that industry funds are on track to dominate the Australian capital markets.

By Tim Bowley, Centre for Commercial Law and Regulatory Studies, Monash University.

The pathology of passivity: Shareholder passivity as a false narrative in corporate law

Sarah Haan
University of Virginia

Are public company shareholders naturally or rationally passive? The idea of shareholder passivity gained wide traction after Adolf Berle Jr and Gardiner Means invoked it repeatedly in their 1932 book, The Modern Corporation and Private Property. Decades later, the law and economics movement refashioned shareholder passivity as 'rational apathy.' In Berle and Means's conception, shareholder passivity was irresponsible and blameworthy, but also inevitable in light of the separation of ownership and control. In the law-and-economics view, shareholder passivity evidenced the 'free rider problem' and was explained by incentives operating on homo economicus. It was rational decision-making by utility-maximizing investors and, therefore, a good (and efficient) thing. After shareholder passivity was reconceptualized by the law and economics movement, it ceased to be a governance problem in need of a legal solution.

In "The Pathology of Passivity," a chapter in the forthcoming book, Hidden Fallacies in Corporate Law and Financial Regulation (Saule Omarova, Alexandra Andhov & Claire Hill, eds.), I argue that the 'Passivity Thesis' was descriptively and normatively flawed. In both its New-Deal-era and law-and-economics versions, the Passivity Thesis located all of the responsibility for passivity in shareholders themselves, deflecting attention away from the role of corporate law in promoting or constraining shareholder participation. In fact, there are many reasons to believe that shareholder governance might have developed differently—that American shareholders might have taken a more active role in corporate organization—if corporate law had created mechanisms to make this possible.

Until Berle and Means popularized the idea of shareholder passivity, the absence of shareholders from corporate governance was commonly described as 'absentee ownership,' and it was presented as a system-wide problem, not an individual failing. Andrew Carnegie decried absent shareholders in the 1890s. Louis D. Brandeis wrote about absentee shareholding before and after joining the U.S. Supreme Court. In 1923, Thorstein Veblen published Absentee Ownership and Business Enterprise in Recent Times: The Case of America, which addressed the problem in detail. The shift from viewing 'absentee ownership' as a flaw of the emerging corporate law regime, to viewing 'shareholder passivity' as a personal quality of the small shareholder—one that manifested the small shareholder's lack of aptitude for governance—marked an important turning point in corporate theory.

The Passivity Thesis drew inspiration from emerging trends in the capital market, including the fact that women had become the fastest-growing segment of the shareholder class. During the Great Bull Market, the percentage of women shareholders rose steeply at public companies, and women were reported to outnumber men as shareholders at leading companies like General Electric (1921), the Southern Pacific Railway (1927), and the Pennsylvania Railroad (1927). At General Motors, women's percentage among shareholders increased from about 22% in 1921 to 40% in 1930. At U.S. Steel, between 1917 and 1927, the number of women stockholders increased by 25.4%—more than double the rate of increase of men. The flood of women into shareholding was widely covered by the popular and financial press, during a period when 'separate spheres' ideology presented women as naturally passive and docile, in contrast to men, who were seen as virtuously action-oriented.

At the same moment that Berle and Means were popularizing the trope of the passive shareholder, an emerging movement for 'corporate democracy' advocated an active, participatory role for shareholders in corporate governance. Shareholder activist Lewis D. Gilbert led the movement in the 1930s, 1940s, and 1950s, pressing for changes in corporate practice that would have made it easier for shareholders to obtain information, attend meetings, and vote effectively. He advocated for regional shareholder meetings and cumulative voting, and pressed the SEC to adopt the Shareholder Proposal Rule. Gilbert believed that shareholder participation was essential to self-government and to the American democratic project. 'Participation in the nation's business is the only real democracy,' he asserted, 'in a modern world where it is indisputable that industry and finance are primary even in the field of political decision.' Attendance at shareholder meetings shot up during this period, even while companies discouraged turnout. AT&T reportedly turned down an offer from CBS to televise the company's annual shareholders' meeting (at no charge) in the 1950s. Companies essentially turned away from opportunities to harness new technologies to inform and empower investors.

"The rising pitch of shareholder activism, particularly around environmental, social, and governance (ESG) matters and the new universal proxy, challenges the passive shareholder paradigm."

The validity of the ninety-year-old Passivity Thesis is called into serious question by twenty-first-century shareholders who demand an active role in the governance of public companies. This renewed activism is creating demand for innovation in corporate law and for new participatory mechanisms such as pass-through and client-directed voting, and advanced voting instructions.

Ultimately, the Passivity Thesis helped to solidify a particular set of power arrangements in corporate organization, which (at least in the United States) spilled into the political sphere once corporations began engaging in significant political activity in the 1970s. By habituating a large segment of Americans to passive corporate governance, the Passivity Thesis influenced the political economy of citizenship—that is, the economic arrangements that shape Americans' experiences and aspirations of self-government. The Passivity Thesis advances a normative theory about (corporate) democracy. It teaches shareholders to relinquish power in the organization, when doing so is efficient or individually wealth-maximizing. We must ask whether the influence of this passive conception of governance has extended beyond the economic sphere, and contributed to modern ideas about civic virtue, self-rule, and the role of the voting citizen in democratic governance.

By Sarah C. Haan, Class of 1958 Uncas and Anne McThenia Professor of Law, Washington and Lee University School of Law.

A historical perspective on corporate officer accountability

Steve Kourabas, Monash University
Nick Sinanis, Monash University
Timothy Peters, University of the Sunshine Coast

One of the main modern corporate accountability challenges relates to the representative nature of corporate power (what one of us refers to as its 'constitutive vicariousness'). Thinking of corporate power through the paradigm of 'office' recognises the representative nature of corporate power and the accountability challenge associated with the separation of official action from the individual occupying the 'office' at any particular time. This blog outlines the related projects of the authors regarding the historical origins of corporate officeholding and attempts to frame an accountability regime. The authors make two broad points. First, the duties of company directors were developed from a particular conception of the directorial office itself developed in 18th century cases in the UK courts of Chancery. Second, -

"The function of 'corporate office' works both as a mode of accountability—imposing duties and obligations on the officeholder—at the same time as encouraging a sense of separation or irresponsibility for the actions performed. "

The case of The Charitable Corporation v Sutton (1742) ('Sutton') provides an early example of an attempt by the courts to address both constitutive vicariousness and the challenges of accountability resulting from the diffusion of power through corporate office. The plaintiff-company was incorporated by royal charter in 1707 for the purpose of lending money to the poor. The company's management was vested in a committee (or board of directors) of seven, including prominent English parliamentarian and financier, Sir Robert Sutton. The dispute arose from a 'fraud' that five officers (though not directors) had perpetrated on the company. These officers loaned money upon old pledges without calling in prior loans and made loans to themselves upon fictitious pledges. In consequence, the Charitable Corporation suffered an enormous loss.

At the instigation of the Charitable Corporation's shareholders, the company brought a civil case, heard before Lord Hardwicke, seeking to hold to account fifty officers of varying ranks, including all seven directors. Lord Hardwicke conceived the directorial office as a 'mixed office' - comprising a public and a private aspect. Under Lord Hardwicke's conception, however, the office's public aspect was overshadowed by its essentially private aspect. For the Lord Chancellor, the closest and most compelling analogy between this private office was that of trustee of property held on trust for others because like trustees, directors were 'intrusted' with property that was to be held and managed for the benefit of others – the representative nature of corporate power.

This was despite the fact that, unlike trustees (who have legal title to the beneficiary's property), directors did not themselves have legal title to shareholder money. However, Lord Hardwicke nonetheless concluded that, in essence, the office of director is in the 'nature of a private trust for other persons' – meaning the company's shareholders.

The corollary of Lord Hardwicke's examination was that, whenever those who accepted the directorial office, breached their 'trust-like' duties, they too would be 'responsible to the corporation,' illustrating an attempt by Lord Hardwicke to address the diffusion of corporate power through the corporate office. Such 'breaches of trust' would broadly involve a director executing his office other than 'with fidelity and diligence' in which case Chancery would provide relief.

Interestingly, the authority cited in the judgment for the responsibility of directors was the English translation of the French jurist Domat's summary of Roman civil and public law. Whilst noting that the level of care and diligence of a director is the same as that of an agent, the obligations of directors are categorised not in relation to roles where there is an agreement governing the relationship (such as partnerships and agency relationships) but circumstances where obligations arise from a particular role (or 'office') —including that of tutor, guardian or curator. Such would ground the obligations of directors as arising from their particular office, rather than a voluntary agreement with shareholders, which has traditionally been considered the foundation for directorial accountability.

Lord Hardwicke also distinguished between actions that were a breach of trust and actions that constituted neglect. The former related to failures by directors to follow the requirements of the charter and by-laws.

The latter, however, were distinguished in that these were actions conducted within the powers of office—including repealing by-laws, appointing certain individuals and putting affairs in their management. These actions were held to be a breach of trust not because they had failed to exercise powers granted to them under their office, but rather because of the exercise of those powers or rather the character of their exercise. As such, a breach of office occurs not only in terms of a failure to perform one's obligations, but also in terms of the manner of their performance.

Lord Hardwicke's decision was as an attempt to balance the need to 'prevent the frauds of dishonest men' with the idea that corporate office should not be made 'unsafe or too perilous for honest men to accept offices of trust, by making them liable to losses in the execution of them.' The decision was of its time – with Lord Hardwicke characterising the corporate relationship through analogy with then available legal mechanisms in an effort to find a remedy for shareholders. This conception of the corporation has had significant ramifications for corporate accountability through to the twenty-first century. Through an exploration of Sutton, and similar cases, our related projects seek to shed light on the early framing of corporate accountability as an exercise of corporate power through office in a manner that questions the private and voluntarist nature of corporate accountability that has come to form the foundation of corporate governance regimes around the world.

By Steve Kourabas, Senior Lecturer and Deputy Director, Centre for Commercial Law and Regulatory Studies, Monash Law School, Nick Sinanis, Lecturer and Executive Group Member, Centre for Commercial Law and Regulatory Studies, Monash Law School, & Timothy Peters, Associate Professor of Law and Associate Dean (Research), School of Law and Society, University of the Sunshine Coast.

The duty of good faith: An origin story

Susan Watson
University of Auckland

A duty for board directors to act in good faith and in the best interests of the company is found in most jurisdictions. But fundamental questions around the duty remain unsettled in corporate law. One such question is to whom directors owe the duty; shareholders at any time, or the company as a separate entity. Those apparently mutually exclusive alternatives speak to underlying paradigm differences in our understanding of what exactly a modern company or corporation is.

Applying an historical lens provides a middle ground answer, revealing that -

"The duty of good faith is owed to the corporation as an entity separate from its shareholders with the interests of shareholders, represented as the capital of the company, held in the entity."

By 1657 the English East India Company (EEIC) could lay claim to being the world's first modern company. It had all the old incidences of a corporation including the ability to enter into transactions. It was an artificial legal person. The new charter granted by Oliver Cromwell turned the joint stock contributed by investing shareholders into permanent capital.

Unlike its Dutch equivalent, the VOC, or Vereenigde Oostindische Compagnie (Dutch East India Company), the capital in the EEIC was separated legally and but also for accounting purposes through double-entry book keeping from its shareholders.

Did the duty of good faith and to act in the best interests of the company exist in 1657? Members of governing bodies of all forms of corporation, including business corporations, swore oaths when taking up office. Committees (directors) were required to swear an oath on election 'that they and every of them shall well and faithfully perform their said office of Committees in all things concerning the same.' Oaths were not legally enforceable; they added moral obligations to pre-existing legal ones. The supporting nature of the oath did not mean that oaths were pointless, as people believed God would punish those who broke promises. Oaths were particularly useful where fear of men was not a great enough deterrent and where 'fear of men did not seem effective enough', and where there was a risk of lack of faithfulness.

John Evelyn, diarist and investor in the East India Company wrote in his diary in 1657 of new oaths, new orders, and a mixed committee in the EEIC. The November 17 meeting of the committees (directors) for the New Stock decided on the wording of the 'newe oath' for the EEIC. The new governing body included investing shareholders. As well as the requirement to faithfully perform their office, the members of the governing body swore to ensure "that an equall and indifferent hand [would] be carried in the government of this fellowship and in the affaires thereof to all the adventurers [shareholders] that shall adventure or putt in stocke".

The requirement that members of the governing body not favour their own interests above the interests of all of the stockholders (shareholders) by applying an equal and indifferent hand arose out of conflict in the EEIC in the early part of the 17th century. The controlling elite majority shareholders of the Company were wealthy merchants who made distributions in commodities or purchased commodities from the EEIC at rates favourable to themselves. The merchants had established retail networks where they were able to on sell those commodities. Investing shareholders, who comprised the generality and who had in personam voting rights, agitated through the new forum of the general meeting for distributions to be made to shareholders in cash, and for sales of commodities to be at market rates. The EEIC depended on investment by the generality to mount voyages so eventually gave into their demands.

The 'newe oath' also required that "an equall division from tyme to tyme be made to all the adventurers according to the proportion of their several stocke duly paid in." By 1657 the English East India Company was essentially a capitalist enterprise focused on a return on capital contributed by shareholders, rather than being focused on individual shareholders. The governing body was expected to consider 'the affaires' or interests of the shareholders, rather than the shareholders themselves. Thus whilst the fundamental obligation to faithfully perform their office that existed for all members of governing bodies of all form of corporation remained in place, "the newe oath" created obligations to the interests of all shareholders held as permanent capital in the EEIC.

In Charitable Corporation v Sutton in 1742 Lord Hardwicke recognised the duality in the role of directors. stating: "I take the employment of a director to be of a mixed nature. It partakes of the nature of a public office, as it arises from the charter of the crown. ut it cannot be said to be an employment affecting the public government; and for this reason none of the directors of the great companies, the Bank, South-sea &c., are required to qualify themselves by taking the sacrament. Therefore committee-men are most properly agents to those who employ them in this trust, and who empower them to direct and superintend the affairs of the corporation… By accepting of a trust of this sort a person is obliged to execute it with fidelity and reasonable diligence."

Lord Hardwicke recognises the long-existent obligation of office but distinguishes the oath that directors of business corporations are required to swear because they do not need to take the sacrament. Lord Hardwicke might appear to classify committee-men [directors] as agents of shareholders. It should be noted though that the concept of an 'agent' had a different meaning in 1742- it related to the agent being the doer of a thing with agency, as a significant and discrete subject did not emerge fully until the turn of the Nineteenth Century.

The significance of Sutton is that the mixed nature of role of director, the public aspect relating to office and the private aspect relating to shareholders was turned on its head so that the secondary obligation owed by directors of business corporations to the interests of shareholders – (those who 'employ them in this trust, and who empower them to direct and superintend the affairs of the corporation') (arguably) became paramount from that point on.

Although Charitable Corporation v Sutton is frequently credited as the origin case for directors' duties, the good faith obligation was not initiated in Sutton but rather in the earlier oaths sworn by all members of governing bodies of all forms of corporation. The obligation to the interests of shareholders of business corporations emerged in 1657 in the oath sworn by directors of the EEIC folllowing agitation by investor shareholders. Although clearly a watershed case, The Charitable Corporation v Sutton was a more incremental development than a leap.

By Susan Watson, Professor of Law at the University of Auckland Faculty of Law and the University of Auckland Business School and ECGI.

Towards a New Model of Boards of Directors

Event | 15 April 2024 | Organised by: IESE Business School, Barcelona

The 2024 IESE - ECGI Corporate Governance Conference reflected on major challenges that boards will face over the next years, including shareholders' engagement, corporate strategy in a disruptive world, CEO succession and development, the role of purpose in sustaining the firm's long-term development and how activists act upon it. Board design and board competencies are key for its effectiveness. And formal structures like board composition, roles, and committees alone do not guarantee effective governance. Rather, much depends on board dynamics and interpersonal relationships. The emphasis on the complementarity of board members' expertise and the need for diversity is particularly relevant in today's context with complex and multifaceted challenges. A board of directors is fundamentally a human group and even in highly structured environments, human behavior and group psychology play critical roles. This human-centric approach to governance adds a nuanced layer to understanding what makes boards effective and successful in navigating the complexities of the modern corporate environment. This collection of articles and presented research from the conference provides a wealth of insightful perspectives.

The ECGI Blog edition featured perspectives from Marco Becht (Université libre de Bruxelles) & Jordi Canals (IESE Business School), Luca Enriques (University of Oxford) & Giovanni Strampelli (Bocconi University), Dionysia Katelouzou (King's College London), Ruth V. Aguilera (Northeastern University),Amir N. Licht(Reichman University), Herminia Ibarra (London Business School), Claudius Hildebrand (Spencer Stuart) & Sabine Vinck (Spencer Stuart), Mireia Giné (IESE Business School), Anneloes Raes (IESE Business School), Rodolphe Durand (HEC Paris), and Bruno Cassiman (KU Leuven & IESE Business School).

Shareholder activism: Everything everywhere all at once

Amir Licht
Reichman University

In Unintended Consequences of Shareholder Activism: A Socio-Cognitive Stakeholder Theory, Ruth Aguilera and her co-authors, Maria Ruiz-Castillo, J. Alberto Aragón-Correa, and Nuria E. Hurtado-Torres, take a fresh look at a question that could not be more topical: does shareholder activism affect firm behavior on each of the sides of the ESG triangle? To address this empirical question, the authors advance a theoretical framework dubbed Socio-Cognitive Stakeholder Theory, which focuses on the board of directors and its decision-making process in strategy formation.

The central finding of this paper is rather striking, as captured by this article's eponymous motion picture.

In a longitudinal sample of just under 5000 shareholder proposals in general meetings of S&P 500 firms from 2006 to 2020, while distinguishing between governance-focused (G) and environmental and social-focused (E&S) proposals, the authors document positive associations between more shareholder proposals and higher scores in subsequent years both on the same and on the other dimension. That is, there are significantly higher E&S scores following years with more G-focused proposals, and higher though non-significant G scores following years with more E&S-focused proposals.

It thus appears that firms respond across the board to more intense shareholder activism through shareholder proposals, seemingly in disregard to the substantive subject matter of such proposals.

What could be the cause for that (especially when the vast majority of proposals are rejected or withdrawn)?

The authors propose that such responses could be explained in a socio-cognitive stakeholder theory framework that expands Freeman's (2010) seminal Stakeholder Theory. Drawing on the work of Rindova, Reger, and Dalpiaz (2012; see also Pfarrer et al. 2019), they argue that

executives react to activists' demands by considering stakeholders' umbrella evaluations that condition the firms' legitimacy, such that firms' responses to shareholder activism are not necessarily based on the issues shareholders demand the most; rather, they deploy their responses to cope with uncertainty and seek legitimacy. In short, they argue, executives' bounded rationality will lead them to prioritize issues that foster their firms' legitimacy in the eyes of multiple stakeholders.

The paper provides a crisp, clear, and compelling empirical analysis of a complex interaction. The findings are surprising yet plausible, which is key for a great paper. Its most important contribution lies in turning the limelight to decision-making processes at the board of directors. While the literature on boards, board members, and shareholder/stakeholder-related strategy is vast, relatively little has been done to uncover the psychological factors that could affect the thinking at the board (and by that I distinguish substantial work that has examined personal attributes such as narcissism among CEOs).

This "socio-cognitive" framework could be broken down into its two constitutive components – the "socio" element, which refers to the societal level of analysis; and the "cognitive" element, which refers to the individual level of analysis. The societal level analysis suggests that firms, through their boards, devise strategy inter alia with a view for it to be compatible with prevailing social norms and culture (Adams and Licht 2022; Gartenberg and Zenger 2023). As such, it is fully compatible with standard Stakeholder Theory.

The present paper's setting is less conducive to testing this "socio" hypothesis, however, as it deals with top-tier firms in a single country, such that it may be challenging to identify variation in social norms, to which firms might be responding. Further work could look into within-US regional differences – e.g., with regard to cultural individualism (Bazzi, Fiszbein, and Gebresilasse 2020).

The "cognitive" component of the framework appears to be more limited. According to Pfarrer et al. (2018), it "focuses on the roles of managers' and observers' attention; the bounded rationality of their cognitions, intuitions, and emotions; and the use of biases and heuristics…". These concepts connote several major research streams – e.g., by Daniel Kahneman and Gerd Gigerenzer on the use of heuristics in decision making, Herbert Simon's concept of satisficing (i.e., "good enough" thinking), and most notably, Keith Stanovich and his co-authors' groundbreaking work on System 1/System 2 thought processes. The latter in particular points to thinking that is quick, intuitive, effortless, and non-reasoned versus slower and deliberative thinking.

Boards' shareholder-vs.-stakeholder strategic decisions rarely are reflexive responses to an immediate stimulus, however. At least for S&P 500 firms it seems reasonable to assume that such decisions usually require and receive deliberation and careful consideration of relevant factors. Legal doctrine on the duty of care and the Business Judgment Rule further calls for well-informed decision making and careful weighing of alternatives. To the extent that the "socio-cognitive" framework indeed relies on System 1-like thinking at the board, it might need more development and substantiation.

A promising direction for research of board members' thinking about ESG factors would be to examine motivational factors - "what makes them tick?", so to speak.

Namely, a motivation to reach a definite answer, any answer as opposed to confusion and ambiguity (Kruglanski and Webster 1996).

An important and possibly more potent factor in shaping board members' thinking about stakeholders is their personal value preferences (e.g., Agle, Mitchell, and Sonnenfeld 1999; Adams, Licht, and Sagiv 2011). Board members around the world vary in their individual principled stances on shareholderism versus stakeholderism– stances that correlate with their personal values in strategic decision making, as documented in joint work with Renée Adams (Adams and Licht 2022). Moreover, we observe individual variation in terms of cultural background, in line with Aguilera et al.'s claim about boards' sensitivity to social norms.

Aguilera et al.'s thus provides a valuable contribution to an emerging literature that underscores heterogeneity among board members in individual psychological and cultural attributes that are closely linked to strategy formation regarding stakeholders.

By Amir N. Licht, Harry Radzyner Law School, Reichman University, ECGI.

"Without denying possible effects of cognitive biases, it could be that directors respond to shareholder proposals also in light of their individual need for cognitive closure."

The ripple effect of shareholder activism – the deceptive power of submitted proposals

Ruth Aguilera
Northeastern University

The exponential growth of shareholder activism is having a complex impact on the non-financial performance of firms that goes beyond traditional stakeholder theory.

The corporate board is the linchpin between purpose and strategy. It defines why the firm exists and the stakeholders it serves, and develops clear policies that align with the collective overall goals.

Within this fundamental relationship between board and stakeholders, the power and legitimacy of stakeholders influences the issues tackled by the board. According to traditional stakeholder theory, shareholders are primary drivers of a firms' financial stability: managing and responding to their proposals is an integral function of corporate governance.

Shareholders have multiple strategies at their disposal to influence firm's strategic direction. Money talks and walking away from shares in a firm that fails to deliver on its promises or drifts from its corporate purpose will hit where it hurts. Media campaigns, protests and boycotts are all tools also used frequently to influence and manipulate firm policy.

But formal proposals are the trump card of the shareholder. The non-binding requests submitted to annual shareholder meetings have significant consequences for firms' practices and give shareholders the power to hold boards and executives to account. Ignoring this very visible aspect of shareholder activism can breed uncertainty and distrust.

The impact of shareholder activism on financial performance has been studied extensively – but the landscape is changing. Interestingly, corporate governance proposals related to board practices are no longer the dominant force: in 2023, 56.7 percent of shareholder proposals in US publicly traded firms were related to social and environmental issues. This shift is more pronounced in relation to environmental proposals: climate change is the most common topic, with social aspects such as gender and racial pay gaps and civil rights all under the shareholders' spotlight.

In a working paper with colleagues from the University of Granada (Maria Ruiz-Castillo, Alberto Aragón-Correa, and Nuria Hurtado-Torres), we analyzed 8474 shareholder proposals received by S&P 500 firms between 2006 and 2020. Data and insights were gathered from Refinitiv Eikon, the Institutional Shareholder Services (ISS) database, Thomson Reuters Institutional (13F) Holdings and the RepRisk database. By dividing the proposals into governance and socio-environmental categories, we were able to uncover firm strategic responses that extended beyond governance concerns and addressed socio-environmental issues.

Of the total proposals submitted, 5133 proceeded to vote – with just 11 percent approved. Within S&P 1500 companies, the total approval rate of all proposals over the same period is just one per cent.

So where is the benefit? What effects do these shareholder proposals have on firms' non-financial performance, and what are the mechanisms driving this relationship?

To provide an answer, our research develops a novel theoretical perspective that integrates established stakeholder theory with a socio-cognitive perspective. And our analysis shows that while the majority of shareholder proposals may fail at the first hurdle, there is a much wider benefit: boards and executives are paying attention.

Shareholder activism – which traditionally represents minority groups - signals the issues at play to both fellow shareholders and other stakeholders. While firms may dismiss the specific issues brought up in most of the proposals they receive, they will engage indirectly with the concerns to seek to establish social approval and legitimacy. Our empirical study reveals the willingness of firms to engage with activists to bring about both governance as well as social and environmental change.

This social approval within a broader environment serves to reduce stakeholder uncertainty and can have wider implications for the interpretation of, and influence on, strategy.

"The firms are incentivized by the issues presented in the proposals – the more intense the activism is, the more likely it is that firms will take measures to improve their non-financial performance."

We observe clear association between governance proposals and firm governance improvements in succeeding years as well as between socio-environmental proposals and firm improvements in socio-environmental performance.

This impact can be clearly illustrated with high-profile examples identified within our analysis. For example, during the period we examined, Goldman Sachs received 13 governance proposals calling for greater independence. None of the proposals were approved in the annual shareholder meeting, but subsequent corporate governance performance was enhanced by 84 percent according to some governance KPIs, as defined by the firm.

Even more significantly, multinational consumer goods firm Colgate received 23 governance and six environmental and social shareholder proposals during the same period. And, while governance performance improved by 22 percent, their socio-environmental performance increased by a huge 227 percent according to some socio-environmental KPIs, as defined by the firm.

Our research advances traditional stakeholder theory to reveal a paradigm shift in awareness, transparency and accountability. We have refined the understanding of the indirect effects of shareholder activism and can draw clear conclusions regarding the intricate dynamics between activism and firms' non-financial performance.

Interestingly, we reveal that firms are open to progress on environmental and social performance as an indirect consequence of governance-based proposals, particularly when they are subject to environmental reputational risk.

Our study also has significant implications on policy. The sheer number of shareholder proposals and their ripple effects generates extra pressure on publicly listed firms and their need to provide globally appropriate responses. Understanding the impact of environmental and social activism is crucial for both the activists and the firms they target.

Our work provides novel insights into these challenges, and we welcome further research that considers the nuances of different institutional settings and the interactions between executives, boards and shareholders.

By Ruth V. Aguilera, the Distinguished Darla and Frederick Brodsky Trustee Professor in Global Business at the D'Amore-McKim School of Business at Northeastern University.

Bringing focus to the “others” in the stewardship picture

Dionysia Katelouzou
King's College London

In today’s fast-paced financial world, institutional investors play a pivotal role in shaping capital markets. Central to this influence is the concept of investor stewardship – a multifaceted term encompassing power, responsibility and commitment in managing assets on behalf of others. Despite ongoing debates about the roles and responsibilities of institutional investors and the increasing volume of literature on the topic, a critical gap persists: the lack of a comprehensive analytical framework for investor stewardship. This blogpost, drawing from ongoing research, aims to delve into the complexities of investor stewardship, unravelling a crucial, yet unexplored aspect – the concept of “others” for whom investor stewardship is exercised.

While the term investor stewardship may be relatively recent, its historical roots stretch back to the Middle Ages and the Anglo-Saxon words stig (house or some part of a house) and weard (keeper), etymologically meaning “housekeeper” or “house guardian”. In scholarly literature, the term stewardship has long been associated with managerial roles, emphasising the responsibilities of managers. Shareholders, on the other hand, have predominantly been discussed as principals within the agency framework. However, institutional investors in their role as shareholders act as intermediaries, blurring the lines between principals and agents. This duality raises fundamental questions about accountability, responsibility, and fiduciary duty.

As institutional investors navigate their roles as both asset-holders and intermediaries, investor stewardship embodies a complex interplay of power, responsibility and commitment.

While not universally understood or legally defined, the essence of investor stewardship comprises three key elements: (i) the exercise of power by a steward, (ii) acting on behalf of others and, (iii) for the benefit of others. Unlike self-interested agents, stewards act for others rather than self, aligning with the stewardship theory of management. However, it is worth noting that the others on whose behalf investor stewards act are not necessarily the same as the others they serve, or act for, marking a crucial yet underexplored observation.

In the context of investor stewardship in equity holdings, referred to as shareholder stewardship, shareholder engagement assumes a central role. Such engagement takes various forms, spanning from formal channels such as voting to more informal avenues such as private meetings. Asset managers prevalent in many markets, spearhead most contemporary shareholder engagement efforts, often collaborating with peers to advocate for changes in corporate policies or practices or address environmental or social concerns. Shareholder engagement by institutional investors carries significant weight and influence over the boards of the companies in which they invest, as boards must carefully consider and respond to the perspectives and demands of these influential investors. However, what is often disregarded is that this shareholder power is wielded on behalf of others, emphasising the importance of substitution and delegation in stewardship relationships.

Despite existing hard-law duties outlining institutional investors’ obligations to act on behalf of clients and beneficiaries, determining for whom shareholder power should be wielded remains elusive.

The UK Stewardship Code 2020 provides a foundational framework, aiming to align the end investors with the well-being of investable assets, emphasizing principles of accountability, transparency, and long-term value creation. However, challenges persist, particularly concerning the integration of ESG factors and determining which "others" should be prioritised in case of conflicted interests. The UK Stewardship Code 2020 envisions stewardship that serves "others". Yet challenges also remain in aligning stewardship parameters with the interests of ultimate beneficiaries in cases of delegated stewardship and third-party stakeholders, such as fellow shareholders, employees, customers or even broadly "the economy, the environment and society" (Principle 1 of the UK Stewardship Code 2020).

As the landscape of investor stewardship continues to evolve, embracing a holistic understanding of stewardship relationships, responsibilities and objectives is imperative.

"A crucial question arises: should investor stewards serve "others" when these "others" are not financially material, or when their impact extends into the real world?"

This debate is ongoing, with arguments on both sides.

Alignment with the currently defined hard-law duties for asset owners and asset managers would imply that the UK Stewardship Code 2020 solely endorses financially material ESG stewardship (alpha enhancement) and ESG stewardship leading to real impact which has some value in the long term (beta enhancement). However, the Code does not explicitly require or exclude stewardship addressing "intrinsic materiality", which refers to activities generating real-world impact outcomes of a non-financial nature.

A cautious reading of the UK Stewardship Code 2020 suggests that it does not unconditionally seek to internalise broader environmental and societal impacts of asset management in investment decisions. Instead, "the economy, the environment, and society" are warranted only if they meet certain criteria: (i) they are "material", meaning they affect profitability and valuation of a specific asset/investment portfolio or they impact long-term market returns, and (ii) they do not undermine the interests of the investors' clients and/or beneficiaries (Principles 4 and 7 of the UK Stewardship Code 2020).

Clarifying the concept of "others" on whose behalf and for whom stewardship is exercised are imperative steps towards fostering a more inclusive and responsible investment ecosystem. Soft law frameworks have a key role to play in achieving this clarification. The anatomy of investor stewardship underscores the need for next-generation stewardship codes to solidify the concept of "others" – especially those, such as end investors and third-party stakeholders, who are not protected by hard law. This is a crucial gap to fill, as uncertainty about who the others are can give the investor steward good reasons to choose on whose behalf and for whom they act.

By Dionysia Katelouzou, the Dickson Poon School of Law, King's College London.

Can boards live up to ever-increasing institutional investors' expectations?

Luca Enriques, University of Oxford
Giovanni Strampelli, Bocconi University

With (minority) shares now concentrated in the hands of a relatively small number of institutions, institutional investors are expected to play an ever-increasing role in the governance of listed companies worldwide. However, it is uncertain whether institutional investors can actually deliver on these expectations, as a number of economic and legal factors, as well as the methods of engagement and the issues covered, can influence their propensity to engage with portfolio companies.

In a forthcoming book titled "Board-Shareholder Dialogue", leading law, management, and finance scholars from around the world examine the theoretical underpinnings of the current governance framework as well as the relevant practices and the legal and policy issues relating to the dialogue between institutional shareholders and corporate boards.

In our introductory chapter, which was presented during the session on Boards and Shareholders at the IESE/ECGI Annual Corporate Governance Conference "Towards a New Model of Board of Directors", we take a broad perspective on the role of institutional investors in the governance of listed companies in the U.S. and Europe and focus on the factors that may influence investors' ability and willingness to engage.

First, we outline the phenomenon of reconcentration of share ownership in the hands of institutional investors across countries. We add to the existing literature by presenting newly collected data on the shareholdings of the 25 largest institutional investors in each of the Continental European companies included in the Euro Stoxx 50 and the 15 largest UK companies included in the FTSE 100. We find that leading institutional investors are among the largest shareholders in most of the companies in the sample and that an asset manager is the largest shareholder in most of them. As controlled companies have a lower weight in the index because the STOXX 50 index is weighted by the free float market capitalisation of companies, the size of the shareholdings of the Big Three – BlackRock, Vanguard, State Street – is smaller in companies with a controlling shareholder.

Second, we track asset managers' ownership and nationality as these may lead to a divergence in the incentive structure for shareholder engagement on both sides of the Atlantic and, in particular, may help explain potential conflicts of interest affecting asset managers' willingness to engage. To complement available anecdotal evidence showing that European asset managers controlled by banking or insurance companies do conduct a significant number of engagements covering a wide range of ESG issues, we present ownership data on the top 20 U.S. asset managers and the top 20 European (EU and UK) asset managers, tracking their weight in Stoxx 50 companies and the top fifteen FTSE 100 companies. We find that bank-owned asset managers are the largest category among the largest EU asset managers. In contrast, large institutions that are publicly traded or are not part of insurance or banking groups are much more common in the U.S.

American asset managers not belonging to insurance or banking groups, with the exception of Vanguard, all have other top asset managers among their largest shareholders. Whether such common ownership can influence asset managers' approach to engagement, particularly on social and environmental issues, is controverted. According to a first view, common ownership explains why major asset managers share common ESG preferences and regularly engage on these topics. An alternative point of view is that common ownership in the asset management industry is too low to influence the preferences and behaviour of leading investors.

To assess whether asset manager ownership affects engagement, we also look into the distribution of assets under management by asset manager ownership category. We find that publicly owned asset managers and those not belonging to insurance or banking groups hold, on average, significantly larger stakes in companies included in our sample than bank- and insurance-owned asset managers.

In terms of nationality, the blocks held by top U.S. investors are larger (in many cases, by far) than those held by top European investors in all the companies in our sample. On average, the U.S. asset managers included in our sample own 15.56 percent of the equity, while the European institutional shareholders in the sample own a mere 5.71 percent.

Finally, we consider factors other than ownership and nationality that may affect the actual ability and willingness of asset managers to engage with investee companies. In addition to cost issues and collective action problems, which have been widely explored in the literature, end-client preferences and potential regulatory backlash appear to be crucial.

“The different degree of political consensus over ESG investing on the two sides of the Atlantic, and the backlash ESG is facing in the U.S., help explain why European asset managers are keener to engage on ESG issues and to support ESG-related resolutions than are their U.S.-based competitors."

Indeed, the political risk arising from the ESG backlash may affect the stewardship strategies of U.S. asset managers by pushing them to adopt a less ESG-friendly approach.

By Luca Enriques, University of Oxford, Faculty of Law & Giovanni Strampelli, Bocconi University.

Human-centric boards: A new paradigm

Marco Becht, Solvay Brussels School for Economics and Management, Université libre de Bruxelles
Jordi Canals, IESE Business School, University of Navarra

The OECD Principles of Corporate Governance emphasize the board's critical responsibilities in guiding corporate strategy and overseeing management, ensuring the board's accountability to both the company and its shareholders. These guidelines advocate for a rigorous oversight mechanism, focusing on key areas such as risk management, ethical corporate behavior, and the strategic alignment of the company with long-term goals. The principles have evolved considerably since they were first adopted 25 years ago.

In their implementation, the distinction between the roles of the CEO and the board members is crucial to prevent conflicts of interest and promote transparency. This framework has been adopted globally and is reflected in the governance structures of companies across various jurisdictions. The OECD emphasizes the need for boards to possess a balanced mix of skills and experiences, enabling them to address complex business challenges effectively and enhance the company's long-term value creation.

Empirical evidence suggests that some of the recommended changes, including the growing number of independent board members, have been positive for corporate governance. Nevertheless, the overall impact of those changes on the quality of governance and corporate performance is not clear. Over the past 15 years, many companies with the right board structural attributes—including firms such as Boeing, Crédit Suisse, Deutsche Bank, Facebook, General Electric, Uber, Wells Fargo, WeWork, and Wirecard among many others—went through major corporate governance crises. Board structural conditions that those companies did have were not enough to guarantee the quality of their governance. In particular, those structural conditions did not prevent the board from bad resource allocation and business diversification, value-destroying acquisitions, negative board dynamics, or bad interaction between the chairperson and the CEO.

The complexity of boards' agendas has recently increased with major disruptions in the corporate world that include AI, sustainability and climate change, and geopolitical tensions. The European Corporate Governance Institute (ECGI) and the IESE Center for Corporate Governance organized the annual corporate governance conference on this theme: "Towards a New Model of Boards of Directors" in Madrid on April 15th, 2024.

The Conference was organized around five major themes for boards of directors: corporate purpose and sustainability; corporate strategy; CEO and leadership succession; board dynamics and board as a team; and boards and shareholders' engagement. We will summarize some key ideas around two major areas: "What should boards focus their attention on?" and "How should the board work?"

What should the board focus attention on?

The board mandate to monitor the CEO and financial performance remains important. Nevertheless, in this era of disruption and growing complexity, research and anecdotal experience suggest that an effective board should focus its attention on some critical areas.

The first is the firm's long-term strategy and its future growth and value creation. The board should leave the CEO and management team to prepare and work on the firm's strategy as R. Aguilera, B. Cassiman, and C. Torres highlighted. This work should include how the firm gets ready to improve its data management and adopt AI; how it defines a clear sustainability strategy; and how it takes into account and makes choices upon the firm's geopolitical challenges.

Strategy itself is not the goal; rather, it comprises the central decisions that the board and the management team should make to meet the goals that the board has set up for the next few years, tackle the challenges it faces, and contribute to achieving the firm's purpose. The board, after discussions with shareholders and other stakeholders, sets and approves the goals at which the firm aims. This involves a special collaborative work between the board and the management team to define ambitious and reasonable goals and set the best course of action for the firm for the next few years.

The second key area of attention for the board is leadership development and CEO and management transition plans, including succession plans as H. Ibarra and M. Giné highlighted. Many firms say that people are their first priority, but talk is cheap. According to data on CEO succession processes and CEO tenure, not many companies are really effective in leadership development. Only companies with competent managerial teams are able to tackle the complex challenges that firms face today. The way by which many boards monitor leadership development may not be up to this challenge.

How should the board work?

The board of directors is a human group. Group decision-making is subject to biases and dysfunctions that boards should be aware of. Moreover, boards should develop some group capabilities to perform as an effective team to fulfil its duties of care and loyalty.

Individual board member performance is not enough. A. Raes, A. Licht, and R. Durand stressed the importance of creating a positive board dynamic that facilitates deep discussions, manages conflicts, and eventually makes better decisions. The role of the chairperson in this respect is critical, the complementarity of board members' expertise and skills, and the adequate level of diversity of board members were considered critical factors. A well-defined and integrated corporate purpose would also serve as glue and reference for the board, management team, and employees. Without this set of factors, board dynamics would not work well, even if board structure matches some board structural requirements requiring board composition.

The board is appointed by shareholders in most jurisdictions. It has the duty to protect and promote the company and protect shareholders and other key stakeholders. Shareholders' engagement is a dual process: from shareholders engaging the board and the board reaching out to shareholders. An effective board should listen to shareholders and understand their concerns. It has the final responsibility for decision making but it would be unwise if it does not spend time understanding investors' views. L. Enriques and D. Katelouzou presented at the conference some interesting frameworks regarding investor engagement and stewardship.

Defining the right structure and composition is not enough. An effective board should work with the senior management team on strategy and leadership development. It needs to assess its capabilities and competence regarding the definition and advancement in central strategic priorities, purpose, board dynamics, 'teamness', and board culture.

> "The boards of the future will reconsider their priorities to focus on developing long-term corporate development and value creation. "

They will also assess how effective they are as a group of people understanding complex problems and making timely and effective decisions. The new paradigm of boards of directors is more complex than what is described in even the most recent corporate governance codes and principles, but it may help boards perform their functions more effectively.

By Marco Becht, Université libre de Bruxelles and ECGI & Jordi Canals, IESE Business School.

Boards & Strategy: Discovering interdependencies

Bruno Cassiman
KU Leuven & IESE Business School

"If you ask a hundred or so directors whom I know well what they conceive their function to be, 99½ percent will say, 'To advise the management'…"

- Mace (1971, pp. 179) quoted in Coles et al. (2022)

The role of boards in companies is changing. Boards spend most of their time on strategy related issues. However, faster competitive shifts require much more and much better board engagement on strategy. As a result, boards are increasingly working to enact real change by asking probing questions and defining or refining the path forward. At the same time, boards are focusing the organization on the long-term perspective and protecting the commitment to long-term strategy and innovation, making sure that the course is clear and maintained, even in turbulent times. Nevertheless, board members often question whether they understand the industry's dynamics and the structure and the economics of the business well enough for this changing role.

Boards intervene in many decisions of the organization. However, not all of these decisions are strategic. To guide boards in their activities related to strategy, we should first define which decisions are "strategic decisions" and what the role of the board in strategy should be for the organization.

The defining characteristic of a strategic decision is the interdependencies that are created with other decisions. A decision that creates these interdependencies with other decisions has the potential to guide these other decisions, i.e. the choice of this decision becomes strategic. As a result of this choice, other decisions need to be aligned to realize the strategy (Van den Steen, 2017; Leiblein et al. 2018).

Unfortunately, the current state of the art of strategy discussion is not very well suited for guiding boards about understanding the critical interdependencies between actions. Therefore, an important task of the board related to the strategy of the organization is exactly understanding and clarifying the actual importance of these interdependencies in order to advise the top management team. As Rumelt (2011) mentions: "A great deal of strategy work is trying to figure out "what is going on". Not just deciding what to do, but the more fundamental problem of comprehending the situation."

Leiblein et al. (2018) characterize the interdependencies of a strategic decision along three dimensions:

1. interdependencies with other contemporaneous decisions faced by a focal economic actor;
2. interdependencies with other economic actors, possibly external to the firm, and,
3. intertemporal interdependencies indicating that the decision guides future choices.

These different dimensions of interdependencies relate to different types of strategic decisions.

First, interdependencies with other contemporaneous decisions faced by a focal economic actor are the decisions that Porter (1996) already considers when discussing the fit and trade-offs that Southwest Airlines or Ikea need to take into account when deciding on their activity set in order to minimize costs. These decisions are typically internal to the firm under the direct control of the top management team and require a fair amount of coordination.

Second, the interdependencies of decisions across different actors become critical in situations where actors from other organizations need to respond. These actors could be competitors that respond to a decision from the firm, but in today's interconnected economy, these actors are as likely to be suppliers, customers or complementors that need to respond to the focal firm and coordinate their decisions to jointly create value.

Finally, intertemporal interdependencies are critical in resource allocation decisions as earlier decisions affect the future flexibility of the organization in the decisions that can be made. Earlier decisions create irreversibilities and commitments that are difficult to undo at later moments in time (Ghemawat, 1991). Jeff Bezos from Amazon famously categorized decisions into one-way and two-way doors: You can only go through a one-way door in one direction, you cannot undo your decision and come back (Alberg, 2021). These are the decisions Jeff Bezos would urge his management team and board to focus on.

Understanding these interdependencies between different decisions is an important part of the strategic role of the board to advise the management team. These interdependencies between decisions make experimentation very difficult as the success of a strategic move depends on executing on all decisions simultaneously. The upside is that these interdependencies between different activities lead to more complex and harder-to-copy strategies and might be the source of a (more) sustainable competitive advantage (Rivkin, 2000, Porter and Siggelkow, 2000).

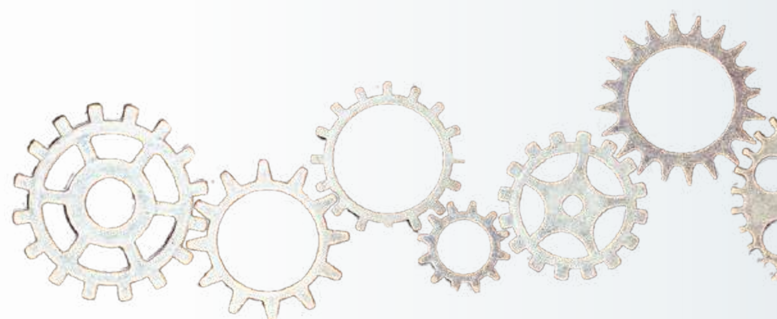
Unfortunately, these interdependencies are often implicit and poorly understood. Uncertainty and changes in the environment obscure their importance and the management team might consider different time horizons to complete the strategic decisions. Boards can help the management team clarify the critical interdependencies before strategic decisions are executed on.

As a result, interdependencies tend to provoke conflict within an organization. This is where boards often can weigh in with their advice. Resolving conflict requires debate and judgement (Eisenhardt et al. 1997). Boards can add different points of view and offer alternative solutions to these conflicts and uncertainties in understanding how to manage these interdependencies.

"Boards are becoming more important in the value creation process as these interdependencies become more relevant and important but are not very well understood."

In organizations where interdependencies are well understood, the role of the board limits itself to the selection of the top management team and monitoring the results over time. In environments where these interdependencies are not well understood or might shift, the board gets involved in the strategy process on a continuing basis. Therefore, it is not surprising that the role of boards is changing when geopolitical tensions rise and disrupt global value chains, generative AI is changing how we work in and across organizations, and climate change is affecting businesses all over the world.

By Bruno Cassiman, KU Leuven & IESE Business School.



Creating harmony between boards and management

Rodolphe Durand
HEC Paris

Today, dysfunctional relationships between boards of directors and top management teams (TMTs) hold greater potential for failure than in previous times. Firstly, dealing with geopolitical risks, sustainability imperatives, and social conditions of the firm's operations to name a few contemporary challenges raises the bar in terms of firm governance. Moreover, the challenges faced by firms are increasingly interconnected, exacerbating the consequences of discord between firm's board and TMTs. Secondly, stakeholders exhibit heightened expectations vis-à-vis firms, intensifying the repercussions of poorly managed relationships between the board and the top executives: stakeholders' reactions are more aggressive, sometimes violent, and in any case potentially detrimental for the firm if the board and the management are misaligned. Lastly, the presence of non-linear associations between firm actions (or reactions to certain issues) and effects renders issue resolution more arduous than before. Consequently, a lack of agreement and common view on expected effects of decisions amplifies the likelihood of organizational downfall when governance structures fail to foster effective collaboration.

Traditionally, TMTs have been tasked with setting strategic direction and overseeing the execution of organizational goals, while the Board of Directors acts as a fiduciary overseeing TMT actions and representing shareholder and other parties' interests. On its side, mid-management executes day-to-day operations and liaises between top-level strategy and frontline employees.

Due to the interdependencies across issues, stakeholders' demands, and nonlinearity of effects, the absence of common understandings and interests between Top Management Teams (TMTs) and both the Board of Directors and mid-management proves impractical and ineffective.

Firstly, a separation of interests between the TMT and the Board impedes effective communication and decision-making. While TMTs may prioritize short-term financial gains to appease shareholders, the Board should aim for the durable performance of the firm. Such misalignment can lead to conflicting strategies and a lack of coherence in organizational actions, ultimately undermining long-term sustainability and growth.

Second, the separation of interests exacerbates the agency problem, where TMTs may prioritize their own interests over those of shareholders and society at large. Without effective oversight from the Board of Directors and alignment with mid-management, TMTs may pursue strategies that maximize personal benefits, such as exorbitant compensation packages or risky business ventures, at the expense of long-term shareholder value and societal welfare.

To address these challenges, Board-TMT relationships require new attitudes, skills, and means to operate in the best interest of society and the organization. Firstly, fostering a culture of transparency and accountability is crucial.

“Boards must actively engage with TMTs to ensure strategic decisions align with organizational values and societal expectations."

Likewise, TMTs must involve mid-management in decision-making processes to leverage diverse perspectives and foster buy-in throughout the organization.

Secondly, developing empathetic leadership skills is today more essential than ever for effective collaboration across hierarchical levels. TMTs must demonstrate humility and empathy towards mid-management and promote their diversity, recognizing their integral role in executing organizational strategy. Similarly, Boards must cultivate a culture of trust and mutual respect with TMTs, encouraging open dialogue and constructive feedback.

Lastly, embracing innovative governance mechanisms, such as stakeholder engagement initiatives and diversity quotas, can enhance Board-TMT relationships and promote holistic decision-making. By incorporating diverse voices and perspectives, organizations can mitigate groupthink and make more informed choices that benefit both shareholders and society.

In a collective manifesto, alongside with practitioners and academics, I advocate for the following ideas:

- Individual board members should not satisfy themselves with limited information provided or ignoring so-called non-financial performance information, incorrectly perceiving their duty as primarily protecting shareholder interests by maximizing profitability. They should aim for more, actively seeking information, and embracing value creation for the sake of the firm itself, including other stakeholders beyond shareholders.
- It is the role of governance to position the firm relative to today’s daunting ecological and social challenges. In order to face these new realities, certification of board members on knowledge and skills related to climate or human rights, or designation of a board member responsible for ensuring stakeholders' interests should be considered. Other suitable approaches can be establishing an impact committee in charge of representing outside parties' interests with a board member's involvement and providing adequate financial resources for accessing expert advice on these vital challenges. Furthermore, regularly training and raising awareness among board members about sustainability and governance issues will enhance their effectiveness.
- In a board, independent and mature cooperative relationships are vital. This necessitates a board that has sufficient time and resources to form its own opinions and engage in open discussions with management, while maintaining critical scrutiny. Board members should have the ability and financial means to seek insights from external advisors, chosen experts, management, as well as lower levels of the organization when necessary. Such a Board budget shall be provided by the firm and independent from management’s purview.

As the challenges faced by firms increase in magnitude and complexity, it becomes crucial to keep adapting the nature and the means devoted to Board-TMT relationships to cultivate its quality and provide the firm with the best governing principles and decision processes possible.

By Rodolphe Durand, HEC Paris.

Board behavioral dynamics: Between collaboration and control

Anneloes Raes
IESE Business School

The Board of Directors and the Top Management Team (TMT) together steer organizations and their activities. Scholars have debated the specific role and functions of boards, the mechanisms by which board decisions shape the organization, as well as structural characteristics of boards, amongst others. Following and increased societal interest in enhancing board effectiveness, governance researchers have focused on the so-called ´internal operations´ of the board. Board internal operations capture the intragroup behavioral dynamics that characterize the board´s work processes and give insight into how boards come to decisions. Yet, because of the field´s traditional focus on archival methods and the difficulty of getting high-quality data on these types of processes, insight in this domain is still limited.

The adjacent field of research on TMTs has focused on the internal operations of TMTs, and has empirically demonstrated the relevance of TMT behavioral dynamics, including decision making, conflict, and behavioral integration, for organizational outcomes. TMT researchers have studied multiple aspects of the social and interpersonal processes of the TMT, and Organizational Behavior researchers studying non-managerial teams have developed even more detailed classifications. Less insight exists into the role of the board´s interpersonal processes. This is surprising, as board members - just as TMTs and other types of teams - need to find an optimal way to combine their members´ individual expertise and perspectives into outcomes and decisions for the collective.

Moreover, given the idiosyncratic nature of the work of a board of directors, we should not assume that existing knowledge on either TMTs or non-managerial teams directly transfers to boards of directors.

To study behavioral dynamics in decision-making groups, researchers generally point to task- and relationship focused aspects of people's interaction and collaboration. Task processes describe the cognitive, verbal, and behavioral acts that describe a group´s taskwork, including cognitive conflict, debate and dissent. In contrast, relationship processes describe the affective, verbal and behavioral acts that relate to group members relationships while working on their tasks. In general, it is widely accepted that communication contains both task and relational oriented aspects, and that both aspects of the process will need to be effectively managed to achieve optimal outcomes. Therefore, an assessment of board behavioral dynamics should contain both task and relational aspects of the group´s process.

A key task-related process was developed by Hambrick, who coined the construct of behavioral integration to provide an assessment of the extent to which TMTs are effective in capturing the value that comes from the different perspectives that people bring to a decision-making group. Specifically, TMT behavioral integration, or 'teamness', describes the extent to which TMT members make joint decisions, share information and opinions openly and work collaboratively. Research has shown that TMT behavioral integration is beneficial for numerous strategic- and performance-related outcomes, including strategic decision quality, economic performance and human resource performance.

TMTs with a higher level of teamness see the value of the complementarities and integration of each member's skills and knowledge, which makes them more effective in making and implementing strategic decisions as compared to TMTs with a lower degree of teamness. As such, it provides a comprehensive assessment of whether a group of executives resembles more a ´real team´ or rather a ´set of semi-autonomous barons´. While primarily documented for TMTs, a recent paper assessed the behavioral integration of boards in the context of high-tech start-ups. These authors used a 5-item board behavioral integration scale, and demonstrated the role of informal communication frequency, intra-board trust, and efficacious board chair leadership as factors that contribute to intra-board behavioral integration. While Bjornali and colleagues (2024) did not assess the impact of board behavioral integration on outcomes.

“The demonstrated benefits of TMT behavioral integration may be a promising starting point for a behavioral approach to board decision-making."

All in all, I argue for using the knowledge from TMT interpersonal dynamics, and particularly the concept of teamness to enhance understanding of board interpersonal dynamics, and the way in which those interpersonal dynamics relate to the outcomes of the board´s work, such as their decisions and organizational impact. This is ultimately of interest not only to researchers, but particularly also for board members who seek to enhance their value to their organizations.

By Anneloes Raes, IESE Business School.

The CEO hiring challenge

Mireia Giné
IESE Business School

What truly defines a "successful" CEO, and what attributes are essential for their effectiveness? In our session on Boards and CEOs Hiring, Development and Firing - at the ECGI / IESE conference "Towards a New model of Bords of Directors" held at IESE Business School, Prof. Herminia Ibarra focused her contribution on the leadership dimension of CEOs and the challenges some face to transform their management style to be more effective. Next, in my discussion, I provided a complementary view on hiring CEOs and their attribute profiles, from recent research in corporate finance.

The market for CEOs is not a classic competitive market since finding the right candidate involves a costly and elaborate search process. Yet, CEOs tend to come from a very small pool of candidates. Among the largest US corporations, an overwhelming 80% of new CEOs are promoted internally, a statistic that underscores the importance of company-specific knowledge and established networks (Cziraki and Jenter, 2022). However, this practice invites scrutiny over potential inefficiencies and the risk of insular thinking under disruptive or transformative phases. In contrast, private equity firms, often lauded for their ruthless efficiency, tend to look externally for 75% of their CEO hires.

The typical tenure for CEOs in the U.S. and Europe averages around five years, highlighting a dynamic turnover. CEO profiles have been shifting towards more general and transferable professional backgrounds, that is, having prior positions in different industries, experience in conglomerates, and increasing number of prior firms before reaching the CEO position.

Moreover, the compensation gap relative to other top executives continues to widen, with external CEO hires commanding salaries vastly superior to their internal counterparts.

This hints at the premium placed on candidates perceived to bring a fresh perspective from the outside. In fact, a generalist profile is associated with 20% premia relative to a more specialist one.

In this context, how crucial is the CEO's identity to a company's success? Traditional metrics of corporate performance often fail to isolate the impact of leadership from other variables such as benign market and macro conditions or a firm's organizational structure. Recent scholarly efforts aim to estimate this impact by employing advanced analytics and machine learning to parse out the effects of CEO behavior or "leadership styles".

What do CEOs Do?

Research spearheaded by Bandiera et al. (2020) has taken an innovative approach by collecting detailed activity logs from over 1,100 CEOs across six countries. This wealth of data reveals distinct "behavioral types" among CEOs that can be synthesized in two predominant styles of leadership: the "Manager" and the "Leader." We need to think of these styles as a continuum for each CEO.

Manager CEO's have a more hands-on operational focus and are experts in setting up systems, while Leaders focus on strategic vision and broad-based communication, and are experts in creating organizational alignment. The effectiveness of these two distinct styles depends on the specific needs of the company at the time of the CEO's tenure – and we need to wait at least 3 years to observe an impact on performance.

What emerges from this literature is that the match is key.

Some companies facing operational challenges might find greater value in a Manager's attention to detail and process optimization. In contrast, large firms undergoing radical transformations or pivoting in response to market changes may benefit more from a Leader's vision-setting capabilities.

And from this matching perspective, the research suggests that around 20% of firms could have CEO mismatch. This might be due to labor market frictions to find the right CEO in the specific geography, or to due to individual frictions of managers trying to evolve from managers to leaders – as Herminia noted in her presentation.

Are CEOs abilities different from other top executives such as COOs or CFOs?

Indeed, this seems to be the case when focusing on large scale assessment data (Kaplan and Sorensen 2021). In a comparative analysis, CEO are distinctly strong on 4 dimensions: General Ability (talent), Execution (to the expense of Agreeableness), Creative/Strategic and Charismatic (a combination of enthusiasm, persuasion, proactive). Interestingly, other executives such as CFOs or COOs look very different of these four dimensions. CFOs are, in fact, the most divergent relative to CEOs (CFOs are titled towards strong Analytical and Interpersonal/Agreeableness at the expense of the Strategic and Execution dimension).

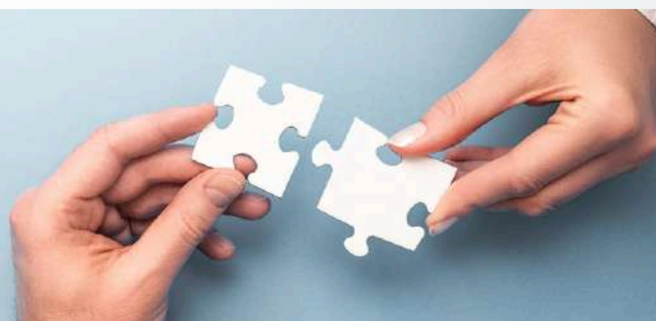
These four factors are as well predictive of who gets hired and, therefore, provide guidance for becoming a CEO. That is, you can modulate your abilities, very much in alignment to Herminia Ibarra's main idea. Still, boards tend to overweight interpersonal skills at the expense of execution.

Finally, setting the right pay is fundamental in the hiring and retention process. Periods of fast technological change, such as the one we currently live in, are associated with increases in pay differentials between CEOs and the rest of the top executive team. Firms are willing to pay for the ability to identify new growth projects and investments that will bring value. (Frydman and Papanikolaou, 2018). This skill is scarce and is exceptionally valuable for fast growing firms. Connecting this evidence to Kaplan and Sorensen's main point: CEOs that have both a strong creative and strategic ability, as well as the capacity for strong execution will be sought after in times of industry disruption.

> "When boards evaluate the most suitable CEO, they need to consider the match, not just the candidate on its own."

Also, they should be aware of certain biases: overweighting certain abilities, such as interpersonal capabilities at the potential expense of execution or underweighting the creative ability to discover growth projects under uncertainty.

By Mireia Giné, IESE Business School.



The leader's journey

Herminia Ibarra, London Business School
Claudius Hildebrand, Spencer Stuart
Sabine Vinck, Spencer Stuart

Leaders today are expected to empower and enable their people and teams. As Rafaella Sadun and her colleagues reported recently in this magazine (see "The C-Suite Skills That Matter Most", HBR July-August 2022) these so called "soft" or people skills matter increasingly for leadership succession.

We've observed this shift in our work as researchers, coaches, and leadership advisors. But we've also observed that leaders are having a hard time adapting to it. Moreover, few aspiring CEOs enter the succession process mastering the complete array of these skills, and few newly appointed CEOs have them fully ready to deploy.

Yet rigorous evidence about how executives acquire people skills is scant. To find out more—about what people skills executives struggle to learn, and what learning strategies pay off —we analyzed assessment, development, and interview data gathered during 75 CEO succession projects by Spencer Stuart, one of the world's premier leadership advisory firms.

We analyzed 75 CEO successions, involving 235 candidates, that took place at large-cap companies in the United States and Europe between 2009 to 2019. Forty-seven of these companies were public. We examined the correlation between CEO skills and firm performance, as measured by shareholder return, revenue growth, and operating margins. We also interviewed and examined the development journeys of a subset of leaders, to understand the variety of leadership styles they used to deliver results. In doing so, we looked for evidence of strengths and developmental opportunities along the spectrum between directive and empowering styles.

We also studied their ability to work through networks, and to enhance organizational performance by instilling and leveraging people skills.

> "A leader's development journey towards a more enabling leadership style typically unfolds in three main stages: a departure, voyage and return."

The departure is when a leader deliberately starts to leave behind familiar ways of working. Leaders only depart from their habitual—and successful—ways of doing things when they become aware of a gap between where they are and where they want to be. The catalyst might be a particular event or feedback from colleagues or coaches. But usually, they only embark on a concerted effort to change after multiple experiences and conversations that make them understand how their behavior is impeding outcomes they care about.

The voyage is a time of transition during which, having left those familiar shores behind, the leader encounters obstacles and trials that teach important lessons. We've found that a successful voyage involves creating a context for practice-based learning; enlisting helpers and actively seeking feedback; and persisting through setbacks, progressively gaining greater clarity about what one is trying to accomplish.

Creating a context for learning often entails putting oneself in situations – a task force, a board or support role – where one has to lead differently. This can be particularly helpful for CEO candidates whose leadership style is firmly rooted in holding people accountable, driving performance, and achieving results. Such leaders often have a hard time experimenting with a new style while they're working with teams familiar with their old style. By taking on roles or projects outside their own areas—roles in which they have no history or direct authority and have to adopt a collaborative manner of exercising influence—they develop additional people skills that they can later use with their own teams.

Leaders also need partners at every stage in the journey who can hold them accountable, provide honest feedback, help them connect the dots, and serve as mirrors of the new identity taking hold. Coaches and mentors outside a leader's normal reporting lines, can be very helpful, but they also need to rely on close colleagues and in some instances family or friends, who can hold them to account when they revert to their old habits (as all of us inevitably do) and offer in-the-moment feedback in ways that nobody else can.

The moment of "return" arrives when, after the trials and tribulations of the voyage, leaders at last internalize a more empowering leadership style, understand it as a genuine reflection of their new selves, and can employ it across the board in their professional lives. A second marker of having entered the "return" stage of the journey is a desire to transmit and amplify one's learning. This is critical, because by instilling people skills in others, leaders increase the organization's capacity to provide developmental experiences at scale.

More than ever, we need leaders who can harness people's ingenuity and engagement. Long-term success requires calling on a broad repertoire of people skills that make it possible to lead others indirectly and at scale. For many leaders, rising to this challenge requires an entire journey of transformation, one that's likely to be longer and more difficult than they'd imagined—but, ultimately, also more rewarding.

By Herminia Ibarra, London Business School, Claudius Hildebrand, Spencer Stuart, and Sabine Vinck, Spencer Stuart.

The market capitalisation of the global financial markets is dominated by North America, Europe, and developed Australasia, and these markets attract the most attention from global investors; this probably holds true in academia as well. Yet in terms of the sheer scale of the global population, GDP, and oil production, the recently expanded BRICS+ countries (Brazil, Russia, India, China South Africa, Egypt, Ethiopia, Iran, Ethiopia and the United Arab Emirates) have a substantive critical mass and represent a potential geopolitical counterbalance to the Western-dominated G7 countries. But, given this heterodox grouping, what is it that the BRICS+ countries seek to achieve in practical terms— and what are the implications for corporate governance?

Navigating corporate governance challenges in BRICS+ markets: A focus on Iran

Hagen Schweinitz, INSEAD International Directors Network
Sarah Mehrabani, Independent Advisory Services

Corporate governance stands as the linchpin of business success, especially in emerging economies like Iran. This blog post embarks on an exploration of the current state of corporate governance in Iran. By illuminating the challenges faced, we delve into the potential need for alternative governance models and underscore the imperative commitment to sustainability and stakeholder considerations.

Current Corporate Governance Landscape in Iran

Iran stands as an emerging economy, ranking as the second largest in the Middle East and North Africa (MENA) region. The publication of the Corporate Governance Code in 2018 by the Tehran Stock Exchange (TSE) has played a pivotal role in establishing a framework for accountability and transparency among Iranian companies.

Although the banking industry's Corporate Governance Code was published earlier in 2004, it did not have the same impact on the market as the TSE's code. This TSE code mandates a more independent board of directors, offering an opportunity for research to provide fresh insights into enhancing such policies in emerging economies like Iran. This, in turn, aids legislators and stakeholders in the stock market to formulate improved rules and regulations. Recently, the TSE code of conduct has been improved and the new version has been released in 2023 that has added some rules about reporting CSR and Sustainability initiatives for listed companies.

However, the landscape of corporate governance in Iran still has some challenges.

Transparency issues, limited shareholder rights, and the influence wielded by controlling and state shareholders collectively contribute to a complex governance environment. Recognizing and comprehending these challenges become fundamental steps toward formulating effective solutions and fostering improvements that align with global best practices. Despite being the second-largest economy in MENA, Iran faces a lack of comprehensive literature on the subject of voluntary sustainability reporting, highlighting a noteworthy gap in understanding and addressing sustainability practices within the Iranian business landscape.

Challenges in Iranian Corporate Sustainability

Iranian companies face challenges such as developing the internal auditing profession and improving communication with stakeholders through establishing suitable identifying and prioritizing models. These obstacles contribute to resistance against independent sustainability reporting alternatives, impeding the development of a robust sustainability culture within Iranian corporations. To overcome these barriers, proactive measures are essential, urging professional associations and standardizing bodies to establish comprehensive guidelines and standards for sustainability reporting auditing

In Iran, like many other countries, when delving into sustainability reporting, several challenges and risks emerge.

hese include the lack of necessary infrastructure in the company's information systems, the absence of accepted standards for sustainability reporting, the high costs associated with providing sustainability reports, uncertainty regarding the consequences of disclosing sustainability information, the need to strike a proper balance between quantitative and qualitative sustainability information, and the perspectives of suppliers of sustainability reports who may deem this information as not useful to stakeholders. These challenges collectively pose significant hurdles surrounding sustainability reporting.

T*Climate Change and the Net Zero Agenda*

The persistent threats of climate change present a unique challenge for nations with oil-based economies such as Iran. Striking a balance between short-term economic considerations and addressing climate change demands nuanced manoeuvring.

“Assessing how the BRICS+ agenda aligns or conflicts with the global net-zero objectives is pivotal for gauging potential contributions or hindrances to global progress."

Iran, situated in the Middle East and North Africa (MENA), emerges as one of the most vulnerable countries to climate change. Contributing approximately 1.8% of global greenhouse gas emissions (GHG), it ranks 8th worldwide and holds the lead in the MENA region due to its heavy reliance on oil and natural gas. The impacts of climate change manifest in reduced precipitation, escalating temperatures, and the unsettling distinction of recording Asia's highest temperature. Water scarcity affects around 35% of Iranians, exacerbated by rapid urbanization leading to compromised air quality and heat islands.

ince 2015, Iran has met its escalating power demand primarily through gas and oil generation, with fossil fuels constituting approximately 94% of its electricity production in 2022. This breakdown includes 79% from gas, 15% from other fossil fuels, and a marginal 0.2% from coal. Hydroelectric power contributes 4.5%, and nuclear power S accounts for 1%. Notably, Iran's transition to wind and solar energy lags significantly behind the global average. As of 2022, wind and solar collectively contribute only 0.5% to electricity

production, a slow increase from 0.05% in 2015. This figure falls well below Asia's average of 8% and even trails behind the MENA countries' average of 2%.

Crucially, Iran has yet to ratify the Paris Agreement as of May 2023. At COP26, the country announced its intention to ratify only after the lifting of sanctions. According to the IEA Net Zero Emissions scenario, achieving the goal of limiting global temperature rise to 1.5˚C necessitates Iran's complete decarbonization of its power sector by 2040 and achieving net-zero status across its economy by 2050. This ambitious trajectory underscores the critical importance of global cooperation and Iran's proactive measures to mitigate climate change impacts.

Opportunities for Iranian Companies

Climate diplomacy presents an untapped avenue for Iran to engage globally, offering a potential incentive by adopting the United Nations Sustainable Development Goals (SDGs) in exchange for sanctions or debt relief. This strategic move not only fosters regional trust but also propels the advancement of SDGs, enhancing shared climate resilience. As Iran intensifies its focus on South-South cooperation to cultivate alternative trade relationships and encourage greater economic multipolarity, seizing this opportunity becomes imperative.

Iran, grappling with the economic and climatic repercussions of global warming, has both the necessity and inclination to enhance its climate resilience. This urgency is further fueled by its history of resource extraction, necessitating proactive measures.

n response to international sanctions, Iran introduced the Resistance Economy concept in 2014. Emphasizing self-sufficiency, reduced reliance on oil revenues, and increased domestic production and innovation, this initiative aligns with Iran's 20-year vision. The primary objective is to diversify the economy, lessening dependence on oil exports and fostering sustainable economic growth and stability.

Amidst these challenges, Iranian companies possess clear opportunities to elevate their sustainability endeavours. Strengthening the disclosure of voluntary sustainability information, adopting international standards, and reinforcing management commitment to sustainable performance unlock the full potential of sustainability reporting. These avenues pave the way for Iranian corporations to align themselves with global sustainability best practices. To enhance Non-Financial Sustainability Reporting it is recommended that professional institutions, the Tehran Stock Exchange, and the Securities Organization collaborate to define the legal requirements for disseminating this information.

Iran's current developments signal economic relief and geopolitical prominence. Amidst this, corporate governance emerges as a linchpin for sustainable business practices. Challenges persist in transparency and sustainability reporting, demanding continual refinement. Iran's vulnerability to climate change adds complexity, urging global cooperation and proactive measures. Opportunities lie in climate diplomacy, aligning with Sustainable Development Goals. Iranian companies can elevate sustainability by embracing international standards. Collaboration for Non-Financial Sustainability Reporting standards is pivotal. As Iran navigates its journey into economic inclusion, holistic governance, sustainability, and global cooperation will shape a resilient future in emerging markets.

By Hagen Graf von Schweinitz-Krain, Board Member, INSEAD Directors Network, and Sarah Mehrabani, Board Coach and Corporate Governance Advisor, Iran.

Egypt's entry into BRICS+: Implications for corporate governance in emerging markets

Syrine Ismaili-Bastien
IÉSEG School of Management

The recent expansion of BRICS to include Egypt marks a significant milestone, offering promising opportunities and challenges. As Egypt joins the ranks of Brazil, Russia, India, China, and South Africa, its integration into BRICS+ presents a unique chance to enhance its corporate governance practices, crucial for economic development and global integration.

The BRICS+ club is a very heterogeneous group. Economically, China far surpasses all others in scale, while other countries differ significantly in status. There are also important differences regarding diplomatic status and geopolitical presence. China and Russia are permanent members of the UN Security Council and possess nuclear weapons, while others do not. The expansion of BRICS suggests its attractiveness, allowing newcomers to advance their interests. The primary interest is to challenge the Western camp. BRICS+ countries weigh heavily demographically (over 40% of the world population), economically (25% of world GDP), and possess large gas and oil resources. Another key interest is to work on "de-dollarization" of the economy and find financing alternatives due to dissatisfaction with current development financing, primarily granted by the World Bank and IMF.

These interests seem to outweigh the group's internal divisions, such as political rivalries between Iran and Saudi Arabia or Egypt and Ethiopia. The differences are also reflected in approaches to corporate governance, which vary greatly among countries.

Why Egypt Joined BRICS+

Egypt's integration into BRICS+ creates various opportunities. The first is financial. The Central Bank of Egypt has limited foreign currency reserves (US dollars and Euros), and the country's foreign debt reached US$165 billion by Q1 2023. However, Cairo can diversify its portfolio by using BRICS currencies. BRICS efforts in forming alternative payment systems and non-dollar financial systems, along with the longer-term possibility of creating a common currency, can benefit Egypt.

Experts estimate this new currency will likely have a fixed exchange rate between BRICS monetary authorities. A more flexible system might define central parity and conversion rates for each country's currency in relation to the BRICS currency, allowing adjustments as needed. Some Egyptian analysts believe Egypt's presence in BRICS could save about US$25 billion due to a stronger Egyptian pound via increased usage of its currency when importing from BRICS countries. Using an alternative currency for trade initiatives with Russia, China, and India could reduce dependence on the dollar.

Egypt also hopes its integration into BRICS will help ease foreign currency shortages and attract new investment. The country's membership in the New Development Bank (NDB), created by BRICS members in 2015, will provide concessional financing for development.

As a BRICS member, Egypt has voting rights in the BRICS Development Bank, leading to financial aid, technical assistance, and soft loans to support sustainable development and investment.

Corporate Governance in Egypt

Egypt's economic benefits from BRICS+ are closely linked to improvements in corporate governance. Robust corporate governance is essential to attract and retain foreign investment, ensure transparency, and build investor confidence.

> "Egypt aims to develop alternative supply chains, promote economic growth, diversify the economy, minimize costs, develop e-commerce, and enhance market integration through cooperation with other BRICS countries."

The Egyptian legal system, a civil law system, is based on a well-established system of codified laws. Anglo-American common law concepts prevail in the Capital Market Law and the Central Depository Law. The Egyptian Civil Code of 1948 remains the main source of legal rules applicable to contracts. Much of the ECC is based on the French Civil Code and, to a lesser extent, on various other European codes and Islamic law, especially in personal status contexts.

Egyptian commercial law is based on the Commercial Code (Law No. 17 of 1999), which regulates various facets of commerce, including contracts, trade, and business establishment. The Companies Law (Law No. 159 of 1981) outlines processes and regulations for forming, operating, and liquidating corporate entities.

According to an African Development Bank Group study, the private sector accounts for around 60-65% of GDP and employs almost 70% of Egyptians. However, a significant part operates informally, with no registration in the commercial register and no insurance number. Entrepreneurs cite costs (registration fees, taxes) and perceived lack of benefits as reasons for remaining informal, complicating the study of corporate governance in Egypt.

Studies on corporate governance in Egypt identify challenges and assess progress. They find Egypt has started to appreciate the need for corporate governance in businesses but, like many other emerging markets faces several hindrances:

- Family-owned or closely held corporations dominate the private sector.
- State-owned companies still play a major role in the economy.
- The capital market is thin.
- There is a lack of awareness of corporate governance concepts and benefits, a lack of board independence, and weaknesses in the economic structure.

Over the past decade, significant efforts have been made to support private sector development. The business climate has improved, notably with the Investment Law approved on June 1, 2017 (Law No. 72 of 2017). The law aims to:

- Provide equal opportunities regardless of the size or location of the project.
- Support start-up entrepreneurs and micro, small, and medium companies.
- Consider the social dimension and protect the environment and public health.
- Guarantee competition, prevent monopolies, and protect consumer rights.
- Facilitate investment procedures and business operations.

The Egyptian government established the Egyptian Institute of Directors under the supervision of the Ministry of Foreign Trade.

The Institute works with international organizations to spread awareness and improve corporate governance practices through training and advocacy activities, providing information on corporate governance principles, codes, and best practices.

Several corporate governance rules have been adopted, such as the Egyptian Code of Corporate Governance (2005) for joint-stock companies listed on the stock exchange and those using the banking system as a major finance source, and the Code of Corporate Governance for State-Owned Companies (2006). These rules are not mandatory or legally binding but promote responsible and transparent management according to international best practices, balancing various parties' interests.

Corporate governance in Egypt, a term that started to appear in the late 1990s, requires structural and cultural changes to become firmly established. While progress is evident, more work remains. As Egypt steps into the BRICS+ framework, enhancing corporate governance will be pivotal for maximizing the benefits of this new economic alliance. By improving regulatory frameworks, promoting transparency, and ensuring accountability, Egypt can build a robust foundation for sustainable economic growth and greater global integration.

By Syrine Ismaili-Bastien, Professor of Law and Geopolitics, IÉSEG School of Management.

Why Argentina did not join BRICS+ and what does it mean to its Corporate Governance

Maximiliano Marzetti
IESEG School of Management

On August 24, 2023, Argentina's former President Alberto Fernández (Justicialist Party; center left) accepted the invitation to join an enlarged BRICS bloc (BRICS+) saying it opened up a new scenario for the future of the country. Argentina was supposed to become a full member of the BRICS+ on January 1, 2024. However, this new scenario never materialized. A new President, Javier Milei (Libertarian Party; center right), was elected in the interim and sworn in on 10 December 2023. In a letter sent to all BRICS members dated December 22, 2023, Mr. Milei rejected the invitation, stating at the time he did not consider it appropriate to join the bloc. What had happened in this brief period? Let us take it one step at a time and start from the beginning.

BRIC, BRICS and BRICS+

BRIC was an acronym coined in a 2001 Goldman Sachs report to allude to the biggest emerging markets, Brazil, Russia, India, and China. The name stuck as these countries started to meet informally. The first BRIC summit was held at Yekaterinburg in 2009, and the latest one (no. 15) was in Johannesburg in 2023. BRIC became BRICS after South Africa joined in 2011. As of 1st January 2024, the bloc was enlarged and renamed BRICS+, which now counts 10 members, the first five, plus Egypt, Ethiopia, Iran, Saudi Arabia, and the United Arab Emirates. BRICS+ represents half the world's population and a quarter of its wealth.

BRICS+ is not a proper multilateral organization, but an informal partnership between countries. Its goal is to give a single voice to the Global South and to propose an alternative model of global governance to that offered by the West (mainly represented by the G7).

> "It is difficult to find common political values between BRICS+ member countries, which comprise more or less democratic republics, monarchies, an autocratic federation, and a theocracy, other than diverging degrees of anti-West attitudes."

while Russia, India, and China are more open in their critique, South Africa and Brazil have adopted more moderate stances (Giaccaglia, 2022). There are also non-negligible intra-bloc economic differences between its members.

From economic, trade, and financial issues BRICS policies have expanded to health, agriculture, security, and climate change (Scaffardi, 2014). Currently, BRICS efforts focus on three pillars, Political and Security Cooperation; Financial and Economic Cooperation; and Cultural and People-to-People Cooperation.

Despite internal divergences and feeble institutionalization, intra-BRICS trade is growing steadily (Boston Consulting Group, 2024) and after the latest enlargement, the bloc concentrates a significant part of the world's energetic resources; more than half of the world's gas reserves and significant oil reserves (Devonshire-Ellis, 2022).

BRICS has not yet produced uniform corporate governance rules. During the last decades, BRICS members' corporate governance policies have been modernized on a voluntary basis, with varying degrees of success (Pargendler, 2015). Comparisons of corporate governance rules in the BRICS five founding members have shown some similarities but also significant differences (Majumder, Maiti & Banerjea, 2012), with Brazil, Russia, and South Africa more aligned to international (UN) standards than China (Oliveira et al., 2014). However, the potential of a larger BRICS+ to propose an alternative corporate governance model in the current state of world affairs should not be ruled out.

Argentina's original alignment with BRICS+

In recent decades China has become the main trading partner of many Latin American countries (Roy, 2023; Hurtado, 2022). Argentina has not been the exception. China has invested in key sectors of the Argentine economy, such as infrastructure, energy, and natural resources, in particular soybeans and lithium. Thus, Argentina's original decision to join BRICS+ can be considered a political gesture of alignment towards its main investor and trade partner. Argentina's former President's decision to join the Belt and Road Initiative, during his 2023 visit to Beijing, can be viewed in the same light. Argentina also gave positive signals to another founding member of BRICS. In February 2022, less than one month before the Ukraine invasion, Mr. Fernández visited the Russian Federation and announced in the presence of Mr. Putin that Argentina would become Russia's gateway to Latin America (Schmidt, 2022).

However, joining BRICS+ was probably more based on financial interest than political affinity. Argentina owes US$ 44 billion to the IMF and must still repay a big part of its renegotiated debt of US$ 65 billion to foreign creditors. Droughts negatively affected the soybean harvests in 2023, the country's main export and only source of hard currency. At the same time, expansive monetary policies and public spending led to a 211.4% annual inflation rate, the highest in 32 years (Rey, 2024). In 2014 BRICS member countries created a New Development Bank funded with more than US$ 100 billion. Barred from accessing global debt markets, the BRICS Bank became a coveted source of funding for a debt-strapped country.

The breakup

Mr. Milei's decision to reject the invitation to join BRICS+ was, to some extent, the fulfillment of an election promise. A self-declared anarcho-capitalist, Mr. Milei repeatedly stated his intention to re-align Argentina with the West. Moreover, he recurrently confronted China and said he would not deal with communist countries (a promise he did not keep). Evidence of his commitment to strengthening ties with the West, neglected by the previous administration, is his efforts to improve relations with the US and relaunch the MERCOSUR - EU Free Trade Agreement, which seems bogged down due to divergences within both the MERCOSUR (Brazil) and the EU (France).

However, despite his ideological stance, Mr. Milei has shown signs of pragmatism. After all, Argentina's huge debt has not disappeared, inflation is not decreasing fast enough, and China remains the country's main trading partner. That may explain why in his letter declining to join BRICS+ he left the door open to join the bloc in the future, if circumstances change, while stating he would like to intensify bilateral ties with its member countries, in particular, to increase trade and investment flows.

What does all this mean to Argentina's corporate governance policy?

Argentina's corporate governance policy has traditionally been influenced by continental European law, as reflected in its commercial laws and the General Companies Act (LGS). Public companies are governed by the Capital Markets Act, modified by the Productive Financing Act, which under the Kirchner administration, granted the CNV (local securities regulator) significant control. The Milei administration seeks market liberalization, opposing previous policies.

Anglo-American corporate governance concepts are increasingly integrated into Argentine law. For instance, listed companies must now include independent directors per an OECD requirement. While ESG reporting is not mandatory, it is common among multinationals, and a recent CNV resolution mandates ESG reporting for social, green, and sustainable bonds.

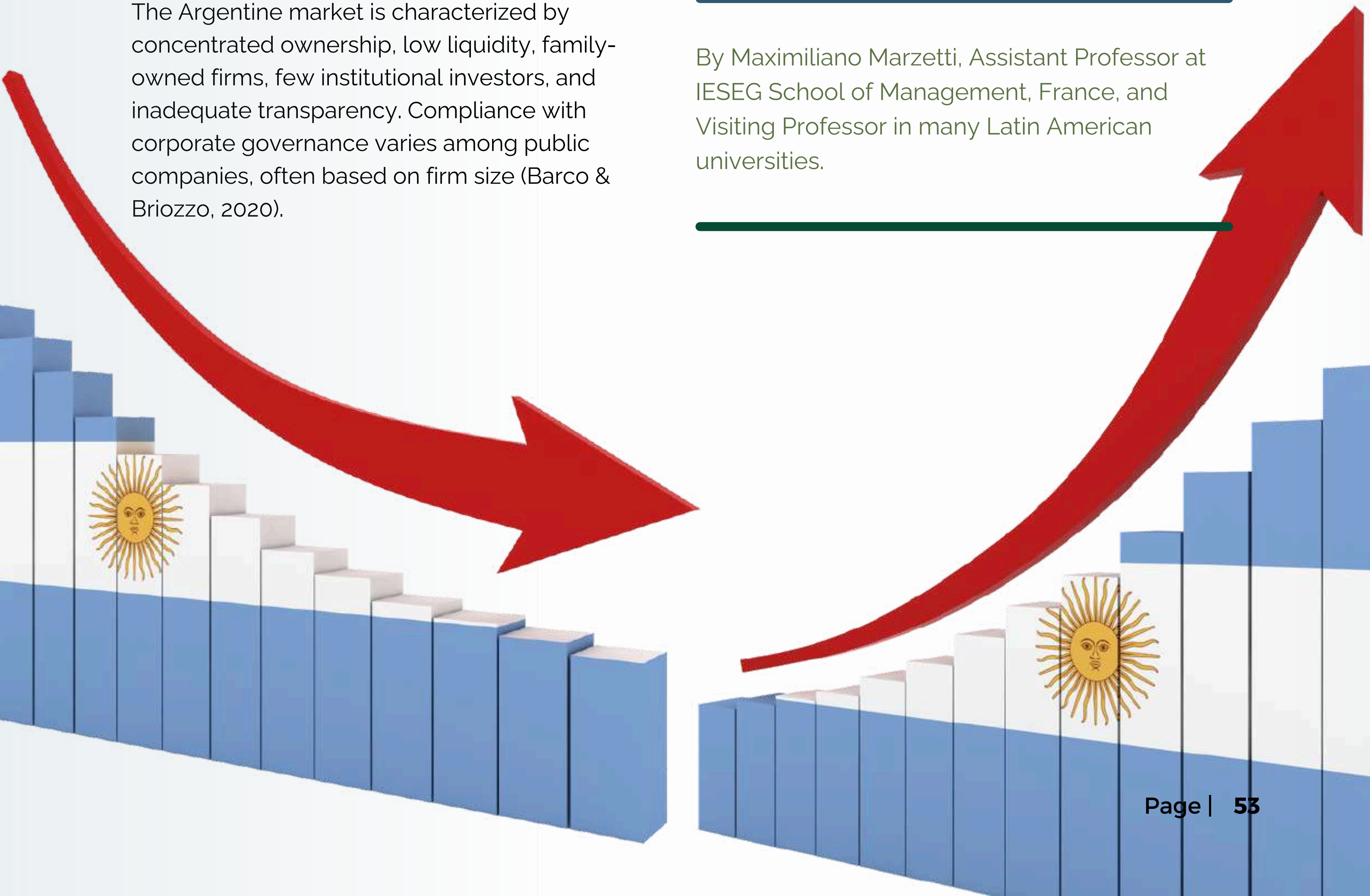
Despite global trends towards the Anglo-American model, structural issues in developing countries like Argentina can limit its effectiveness. The Argentine market is characterized by concentrated ownership, low liquidity, family-owned firms, few institutional investors, and inadequate transparency. Compliance with corporate governance varies among public companies, often based on firm size (Barco & Briozzo, 2020).

The Milei administration is pushing for major legal reforms. A decree issued on December 20, 2023, aims to deregulate the economy by allowing state-owned firms to convert to private entities and modifying the LGS to enable football clubs to become corporate entities. However, the Senate rejected this decree on March 14, 2024.

On December 27, 2023, Milei proposed an omnibus bill to Congress to enhance corporate flexibility, autonomy, and transparency, including making company records publicly accessible online. An amended version of the bill was approved by the Senate on June 13, 2024. Now it must be approved by the Chamber of Deputies to become law.

Milei's market liberalization stance contrasts with previous interventionist policies, potentially aligning more with the Anglo-American corporate governance model. However, this shift hinges on the administration's success, with Argentina's political volatility suggesting future policy reversals are possible, reflecting its broader instability.

By Maximiliano Marzetti, Assistant Professor at IESEG School of Management, France, and Visiting Professor in many Latin American universities.



Corporate law in the Global South through new lenses

Mariana Pargendler
Harvard Law School

How do the corporate laws of Global South jurisdictions differ from their Global North counterparts? Prevailing stereotypes depict the corporate laws of developing countries as either antiquated or plagued by problems of enforcement and misfit despite formal convergence. While these views contain elements of truth in numerous contexts, they offer an incomplete and impoverished perspective on corporate laws in the developing world.

The problem lies in that the corporate laws of Global South jurisdictions are typically studied through Global North lenses. Whether through case studies or through large cross-country comparisons, the legal systems of developing countries are typically analyzed based on the issues or benchmarks that are salient in the Global North. This approach has led commentators to downplay the degree of legal innovation in the Global South and the diversity of corporate governance arrangements worldwide.

Rather than being inevitably antiquated or mere copies of Global North models, Global South jurisdictions have pioneered distinct stakeholder approaches to corporate laws. I call these approaches 'heterodox stakeholderism' as they are different from and often bolder than the long-standing strategies of corporate law to protect non-shareholder constituencies in the Global North.

Preceding the 'rise of ESG' and the renaissance of a stakeholder focus in the Global North, core developing jurisdictions such as Brazil, India, and South Africa had embraced distinct, and ostensibly more aggressive, legal strategies to protect stakeholder interests through corporate law and governance.

Consider the following developments in the last few decades, which took place before interest in ESG exploded in the Global North:

- Brazil largely eliminated shareholders' limited liability for the benefit of stakeholders, such as workers, consumers, and victims of environmental harm;
- India mandated corporate social responsibility spending;
- India and South Africa required dedicated committees in charge of social responsibility;
- South Africa boldly pushed for Black ownership and board representation in corporate governance;
- South Africa allowed workers to enforce directors' duties under the Companies Act.

These findings illustrate the intellectual and policy payoffs of incorporating a broader view of Global South jurisdictions in studies of comparative corporate governance. First, this helps to overcome the 'World Series' syndrome in the comparative literature, understood as the pretense that insights from a select group of 'usual suspects' from the developed world are representative of global developments. Second, it helps overcome what I have called the 'odd duck' syndrome: because Global South jurisdictions are often examined in single-country studies, this can easily produce misleading diagnoses of exceptionalism.

For instance, commentators have described India's approach to parent company liability for environmental disasters as 'unique' and 'revolutionary' from a comparative perspective, without recognizing that Brazil and other emerging economies are part of a similar trend.

Appreciating the different manifestations of heterodox stakeholderism in the Global South not only expands our institutional imagination but also sheds light on the driving forces behind the evolution of corporate law.

"Heterodox stakeholderism in corporate law can be viewed as an institutional adaptation to environments of high inequality and insufficient state capacity to curb externalities and promote social welfare through other areas of law."

This is the flip side of the implicit 'modularity approach' that has traditionally dominated law-and-economics analysis. Under a modular approach premised on compartmentalization and functional specialization, each area of law should contribute to social welfare by focusing on one economic problem: for corporate law, the standard single objective is the reduction of agency costs associated with the corporate form. However, if other areas of law (such as tax, environmental, and antitrust laws) fail in accomplishing their objectives, the case for such a modular approach—whether or not it is optimal to begin with—falters accordingly.

Heterodox stakeholderism in the Global South also responds to the distributional consequences of corporate law rules across jurisdictional boundaries, which can be significant but have been thus far neglected.

Upholding the limited liability of parent companies for environmental harm caused in developing countries is not only questionable on efficiency grounds but also has perverse distributive implications in enriching wealthy Global North companies and their investors at the expense of poor Global South victims. The erosion of limited liability of parent companies in developing countries likely responds not only to failures of their regulatory state in preventing harm but also to the South-North distribution dynamics that limited liability entails.

Appreciating the different manifestations of heterodox stakeholderism in the Global South not only expands our institutional imagination but also suggests a different picture of the evolution of corporate law around the world. Scholars had long predicted that globalization would promote convergence to a shareholder-oriented model. However, in environments of rampant inequality, low competition and significant social and environmental degradation, the view that corporate law should focus exclusively on shareholder wealth maximization tends to lose legitimacy, if not economic justification. These pressures, which have long been felt in the Global South, are now reaching the Global North with greater force. This brings about the surprising prospect of 'reverse convergence' in comparative corporate governance—with corporate law institutions of the developed world coming to more closely resemble their developing country counterparts.

By Mariana Pargendler, Harvard Law School.

Event | 18 June 2024 | Organised by: Bayes Business School

This selection of articles begins begin with an exploration of how the announcement of acquisition plans influences firm strategies and market reactions, highlighting the strategic importance of such plans. Next, we examine the impact of geographic location and agglomeration externalities on post-acquisition decisions, emphasizing the benefits of retaining acquired establishments near existing operations. We then explore the shortcomings of current antitrust regulatory criteria that often overlook significant intangible assets, allowing potentially anticompetitive mergers to escape scrutiny. The fourth article discusses how non-compete agreements shape the takeover landscape, revealing that stricter enforceability of these agreements can lead to fewer and more hostile same-industry takeovers. Lastly, we investigate how growth-promoting bonuses drive executives to pursue M&A activities, often at the expense of shareholder value.

Each article offers insights into the various elements that impact the effectiveness and outcomes of M&A strategies, contributing to a comprehensive understanding of the corporate control environment. We hope you enjoy the collection.

Growth-promoting bonuses and Mergers and Acquisitions

Aazam Virani, University of Arizona
Tor-Erik Bakke, University of Illinois Chicago
Mathias Kronlund, Tulane University
Hamed Mahmudi, University of Delaware

Numerous studies have found that mergers and acquisitions (M&A) often destroy value for acquiring firms. This phenomenon is commonly attributed to executives' pursuit of personal gains through empire-building, whereby a growing their firms can increase executives' personal prestige, pay, or benefits, even if it does not benefit shareholders. These benefits from empire-building nevertheless tend to be indirect and are not explicitly outlined in advance. In our study, we take a different view and analyze the role of direct monetary incentives to grow a firm, which we term "growth-promoting bonuses" (GPBs).

GPBs are compensation contracts that directly tie managers' incentive payouts to measures of firm size, such as sales, production, and market share, thus explicitly encouraging executives to grow their firms.

Notably, most companies do not exclude "inorganic" growth through M&A when calculating whether an executive has met the growth-related bonus target. These incentives can thus drive executives to acquire other companies to achieve the target and receive the bonus even when a firm's own internal growth would have been insufficient. GPBs are prevalent, as more than one-third of U.S. firms provide these incentives at any given time. Despite their prevalence, the impact of these incentives on M&A activity has not been previously analyzed.

A case in point is AbbVie's acquisition of Pharmacyclics in 2015. AbbVie's CEO had a compensation package that included a $1.8 million bonus that was tied to meeting sales targets. AbbVie narrowly met its sales target that year, triggering the GPB payment to the CEO; however, the company would have missed this target without the sales contribution from the new acquisition. Notably, AbbVie's stock price plummeted upon the acquisition announcement.

Using a sample that covers 1,200 large U.S.-listed firms from 2007 to 2017 and 5,000 acquisitions, we establish two key findings regarding GPBs and M&A. First, firms are more likely to make acquisitions when executives have GPBs. Second, these acquisitions are more likely to destroy shareholder value, primarily due to the selection of targets with lower synergies.

We find that firms with executives who have GPBs are more likely to acquire other companies. This relationship holds whether GPB-related incentives are measured by the proportion of executives with GPBs or by the GPBs' dollar value. A one-standard-deviation increase in either metric is associated with a 25% increase in the likelihood of announcing an acquisition.

“Executives with GPBs leverage acquisitions to achieve bonus targets."

While one possible alternative explanation is that firms that offer GPBs are more likely to benefit from growth and that the boards of these firms therefore encourage such growth with explicit bonuses, our findings suggest otherwise. GPBs are primarily associated with acquisitions of smaller target firms, indicating a desire to narrowly meet size targets rather than a general pursuit of growth. Moreover, the relationship between GPBs and acquisitions is more pronounced in firms with weaker governance and larger cash holdings, pointing to the role of agency problems.

To better establish a causal relationship between GPBs and acquisitions, we examine shocks to firms' sales from large exchange rate movements. When the U.S. dollar weakens, exporting firms benefit from a windfall in dollar-denominated sales, making it easier for the subset of exporting firms that also have GPBs to meet their targets without resorting to acquisitions.

Using a triple-difference empirical strategy, we find that exporting firms with GPBs make relatively fewer acquisitions when the dollar weakens. These results provide additional evidence that GPBs drive acquisition behavior and reduce the likelihood that some omitted factor explains both the use of GPBs and the tendency to make acquisitions.

Our analysis further reveals that these acquisitions are crucial in meeting bonus targets. We find that around 30% of acquiring firms whose counterfactual sales (i.e., sales absent acquisitions) would have fallen short of the GPB threshold by 5% or less instead beat the threshold following an acquisition. In other words, these firms would have missed the target were it not for the acquisition.

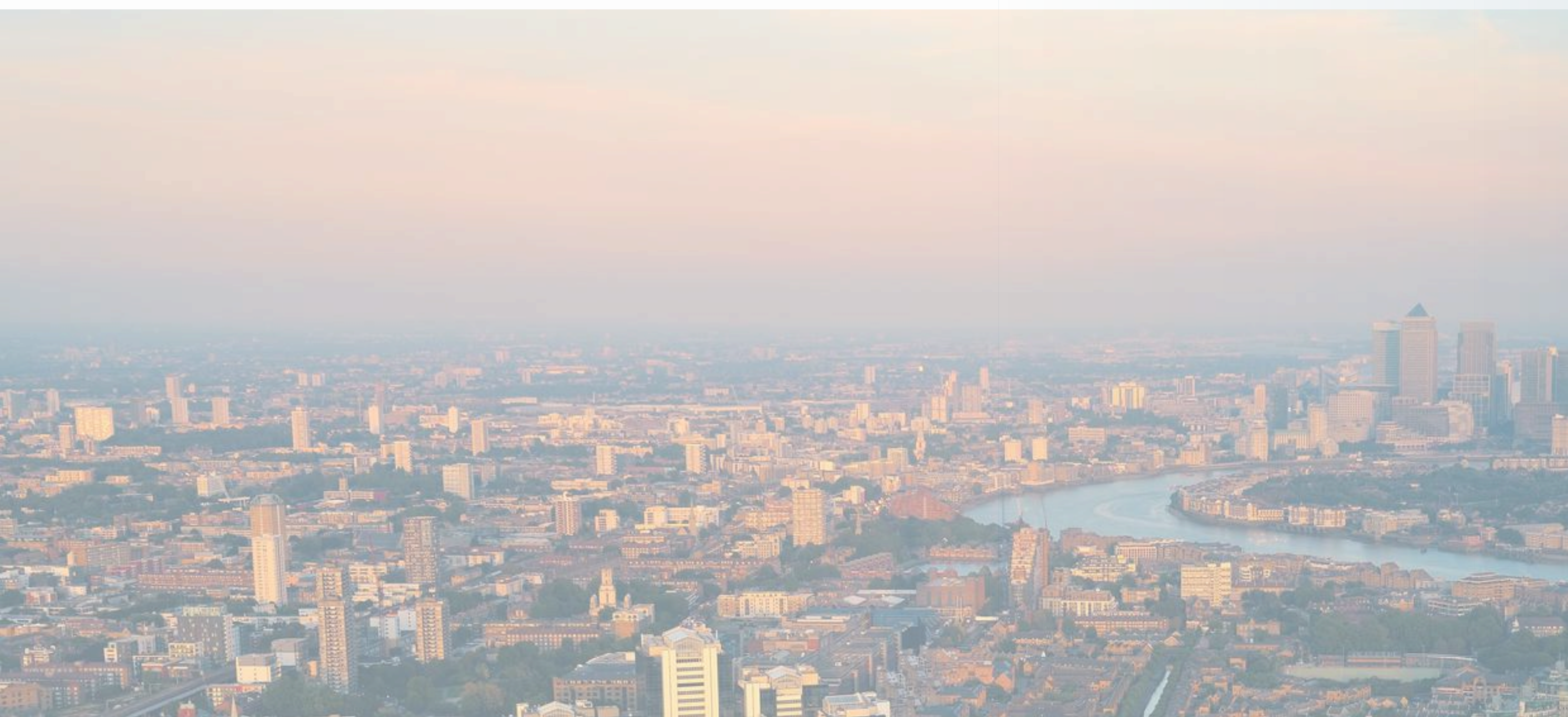
We next examine the impact of acquisitions by executives with GPBs on shareholder value. We find that GPBs are associated with lower acquirer returns around acquisition announcements. Acquisitions by firms with GPBs exhibit an average announcement return of -0.21%, compared to 0.64% for firms without GPBs. This indicates that acquisitions by firms with GPBs destroy shareholder value on average. We also observe lower combined acquirer-target announcement returns for these deals. This suggests that the reason for lower acquirer returns lies in the selection of lower-synergy acquisition targets and is less about over-payment for similar targets.

Since executives often own shares in their company, they are directly concerned about the share price. Given these mixed incentives, how do executives with GPBs fare overall? Despite the overall negative returns around these acquisitions, we find that the potential bonus payouts are large enough such that executives with GPBs on average retain significant financial incentives to meet bonus targets through acquisitions, even when those acquisitions destroy value. On average, executives gain about $200,000 in bonus compensation from acquisitions, a substantial increase in their total compensation.

This outweighs an average $18,000 loss in their equity portfolios from these deals being on average value-destroying.

Our study highlights how GPBs motivate executives to make acquisitions that benefit them personally but harm shareholders. It thus highlights the importance of ensuring thoughtful metrics in compensation plans that align executives' incentives with shareholder interests to prevent value-destroying investments.

By Aazam Virani, University of Arizona, Tor-Erik Bakke, University of Illinois Chicago, Mathias Kronlund, Tulane University, and Hamed Mahmudi, University of Delaware.



Do non-compete agreements shape the takeover market?

Andrey Golubov & Yuanqing Zhong
Rotman School of Management, University of Toronto

On April 23, 2024, the U.S. Federal Trade Commission (FTC) issued a ruling that bans U.S. employers from subjecting their employees to non-compete agreements (NCAs). A slight exception allows existing non-competes for executives (defined as those earning above $151,164 a year) to be grandfathered, but any new ones would be void. The FTC's ban on non-competes has received considerable media attention; legal challenge to the ruling is already underway. What exactly are non-compete agreements and what is the relevance of the FTC's regulatory move for the world of corporate governance?

NCAs are clauses in employment contracts that restrict a former employee's ability to work for a competitor or establish a competing business for a period of time upon leaving the employer. The primary purpose of such agreements is to protect employers' proprietary information, thereby encouraging employers to invest in human and intangible capital. Non-compete clauses are particularly common for corporate executives, with up to 80% of chief executive officers (CEOs) covered by NCAs.

Prior to the FTC's move, non-competes were governed at the state level: individual states' legislatures and judiciaries decided whether NCAs are allowed at all, how broad they can be, and how to enforce them in various situations. With just a few exceptions – most notably California – states generally allowed the use of NCAs. Therefore, the FTC's decision to ban NCAs nationwide is notable not only because it is the first time that the regulator attempts to govern them at the federal level, but also because it represents a major regime shift for NCAs: from valid to unenforceable.

The costs and merits of NCAs for the economy are multi-faceted. Generally, researchers have focused on their impacts on worker mobility and wages, as well as on firms' incentives to invest in intangible capital and to innovate. In our recent study "Non-Compete Agreements and the Market for Corporate Control", we examine a more indirect but nevertheless consequential way in which NCAs impact the real economy by altering the incentives of top executives. It turns out that non-competes have implications for the market for corporate control, or the takeover market.

The link between NCAs and the market for takeovers that we hypothesize rests on two basic premises. First, greater enforcement of non-competes means higher personal costs for executives, especially if they get dismissed. Second, dismissal is the typical outcome for a top executive whose firm is taken over. It is therefore natural to hypothesize that executives subject to more enforceable non-compete agreements would become more averse to being targeted for a takeover. We test this prediction using data on U.S. public firm takeovers over the period 1981-2013 and changes to NCA enforcement regimes in various states. Specifically, we compare changes in takeover-related outcomes for firms headquartered in states that reform their NCA enforcement regime vs. contemporaneous changes in the same outcomes for firms headquartered in non-reforming states (and controlling for other firm-level and state-level variables). We focus on same-industry takeovers – those where the bidder and the target come from the same or related industries; such deals entail a greater degree of operational overlap and a higher likelihood of executive dismissal.

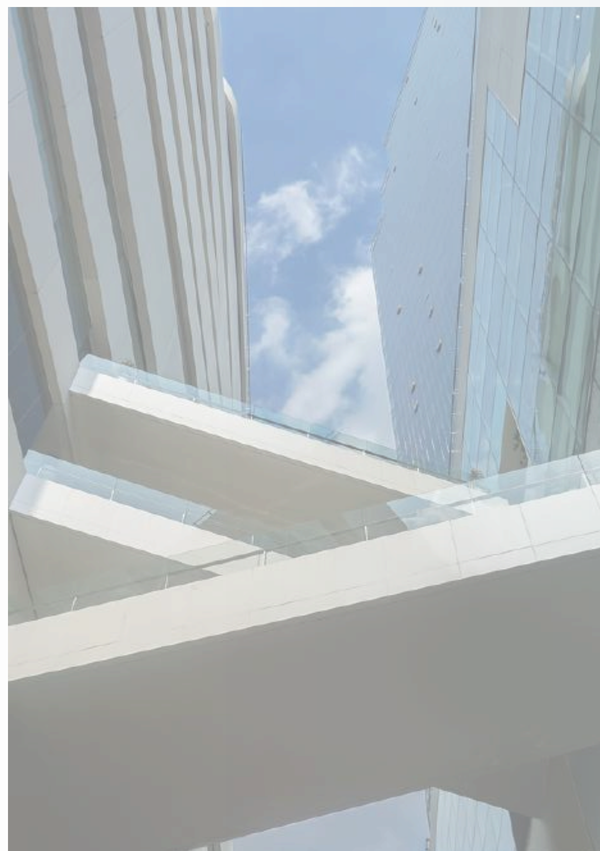
Our key findings are as follows. First, when NCA enforcement tightens, we see fewer takeover attempts. It appears that executives preclude takeover discussions in their infancy. Second, when bids are made, an increase in NCA enforcement is associated with a higher incidence of hostile bids, i.e. those that are met with resistance from target management. Third, tightening of NCA enforcement is associated with higher takeover premiums – as if the target management attempts to defeat the offer by asking high, or at least tries to offset personal costs of likely displacement by higher gains on any shareholdings. Fourth, tightening of the NCA enforcement regime is associated with a higher incidence of deal cancellations, whereby announced bids are later withdrawn.

“The use of NCAs and their enforceability appears to make managers more averse to takeovers."

The resistance we document takes different forms, some of which benefit target shareholders (higher premiums) and some of which preclude shareholder gains (bids that never see the light of day, cancelled attempts). Therefore, whether NCAs result in a sizeable agency cost for target shareholders is difficult to conclude. Moreover, NCAs can have more direct impacts on shareholder value through channels such as promoting investment in intangibles, etc. Nevertheless, our findings should raise boards' awareness of the potential incentive misalignment arising from the use of NCAs in executive contracts in the context of takeovers. Possible remedies could include carefully crafted golden parachutes or takeover-related compensation, as well as executive stock ownership – albeit these also come at a cost (e.g., golden parachutes raise the cost of acquisition for a potential bidder).

As noted above, NCAs can affect the real economy in multiple ways. We do not take a stance on the FTC's move to ban non-compete agreements – neither on its legal aspects nor on its potential effect on societal welfare. However, our analysis does offer a glimpse of what we might expect from the ban in terms of the takeover market: more M&A activity. Thus, taking our results at face value, our findings would suggest that banning non-compete agreements could actually promote consolidation in product and labor markets through more same-industry takeovers. This is a noteworthy unintended consequence, considering that the stated goal of the regulator was to increase competition for labor.

By Andrey Golubov and Yuanqing (Lorna) Zhong, Rotman School of Management, University of Toronto.



Assets beyond the balance sheet: Why antitrust regulators overlook the M&A they may care about most

Charles McClure, Booth School of Business, University of Chicago
John Kepler, Graduate School of Business, Stanford University
Christopher Stewart, Booth School of Business, University of Chicago

The US Federal Trade Commission (FTC) and the Department of Justice (DOJ) use several tools to determine whether corporate mergers and acquisitions (M&A) are potentially anticompetitive. One key screening criterion these regulators use to evaluate whether a deal is anticompetitive is the size of the target and acquirer's assets. However, firms' assets in the US are determined according to generally accepted accounting principles (US GAAP), which ignore nearly all internally generated intangible capital, such as technology, brands, and in-process R&D. This omission may be particularly problematic because a focus of the FTC and DOJ has been consolidation in the technology and pharmaceutical sectors, which rely heavily on intangible capital. In this paper, we explore the consequences of ignoring intangible capital in the antitrust scrutiny of M&As.

M&As have the potential to generate synergies and efficiencies, benefiting shareholders and consumers alike. But these deals can also be anticompetitive, resulting in higher prices and limited choices for consumers. The FTC and DOJ determine whether an M&A is potentially anticompetitive under the Hart-Scott-Rodino (HSR) Antitrust Improvements Act of 1976. HSR determines whether the FTC and DOJ review deals based on the transaction size and asset thresholds. In particular, for deals below a certain size threshold, the FTC and DOJ review deals if the targets and acquirers' assets exceed a certain threshold according to GAAP.

However, US GAAP ignores intangible capital because most costs associated with it are immediately expensed and, therefore, not treated as an asset.

Although US GAAP does not capitalize most intangible capital, it is becoming increasingly important in the US economy. This increase is evident in the values assigned to acquired company assets after the merger was completed: in 2001, the average value of intangible capital to tangible was four to one; by 2019, that ratio grew eight to one.

> “Regulatory criteria for evaluating M&As based on asset-size thresholds overlook an increasingly substantial portion of firms' values, potentially allowing anticompetitive mergers to escape scrutiny."

Our analysis reveals that many acquisitions bypass premerger scrutiny solely because intangible capital is not considered in the asset threshold.

These deals, which are not reported to antitrust regulators, represent a significant portion of M&A activity and are similar in size to those subject to the asset threshold. We estimate that if intangible capital were considered in the asset threshold, the FTC and DOJ would review an additional 90 horizontal deals, equating to approximately $32 billion of deal value per year.

We examine whether these unreported deals are potentially anticompetitive, as bypassing regulatory scrutiny may allow mergers to occur that would otherwise be blocked or require asset divestitures. Several findings suggest they may be. Even though acquirers pay more for these unreported deals, when unreported deals are announced, the acquiring firms have a 3 – 6% higher announcement return when there is a product-market overlap between the target and the acquirer. These returns are concentrated when the acquirer is purchasing a firm with intangibles. Rivals of the acquiring firms also benefit, as we observe they have an average return of 0.7% around the merger announcement. These announcement returns all suggest these unreported deals can be anticompetitive.

We also look at what happens after the deals close to see if unreported deals are more likely to appear anticompetitive. Antitrust regulators are particularly concerned about product-market consolidation because it can reduce customer choices and raise prices. Consistent with this concern, if an unreported deal consolidates a product market, the acquirer reports higher margins, suggesting these deals lead to higher prices.

Within the pharmaceutical industry—a focus of antitrust regulators—unreported deals tend to involve competitors engaged in similar research. We find that acquired projects are more likely to be discontinued, suggesting that firms may make these acquisitions to eliminate potential competition. Despite the greater likelihood of discontinuation, we observe other entrepreneurs engaging in "copycat" research as those acquired and discontinued, possibly in the hope of their research also being acquired. Assuming these entrepreneurs could have instead researched more novel therapies, our findings suggest a deadweight loss from these deals.

Our paper documents how omitting intangible capital from accounting assets can lead to anticompetitive deals avoiding antitrust review. It underscores the intricate relationship between accounting, regulation, and market dynamics. Although the FTC recognizes that firms acquiring smaller rivals in high-intangible industries can stifle future competition, if it does not review potentially harmful deals because they are below the asset threshold, there is little the FTC can do. Our study is especially timely as the FTC is considering modifying the HSR rules for the first since their inception. Under current HSR rules, our results suggest the growth of intangible assets may exacerbate market consolidation through unreported mergers in the sectors most concerning to consumers.

By Charles McClure, Booth School of Business, University of Chicago, John Kepler, Graduate School of Business, Stanford University, and Christopher Stewart, Booth School of Business, University of Chicago.

How geographic location and agglomeration externalities drive post-acquisition decisions

Samuel Piotrowski, NHH Norwegian School of Economics
Jarrad Harford, University of Washington
Yiming Qian, University of Connecticut

When a company acquires another, one of the critical challenges managers face is deciding how to integrate the new firm's assets with their existing ones. This decision to keep, sell, or close a newly acquired establishment is influenced by internal motivations, such as mitigating competition and reducing production redundancy, as well as external factors like economic agglomeration externalities. At the Eighth Annual Mergers and Acquisitions Research Conference held at Bayes Business School on June 18th, we presented our study highlighting the importance of geographic location and agglomeration externalities in shaping the boundaries of the newly combined firm.

Our research reveals that the role of geographic proximity in the decision-making process varies depending on the type of firm being acquired. For instance, when acquiring a competitor, establishments in the same city as one of the acquirer's existing establishments are more likely to be closed and less likely to be sold or kept. This trend is driven by the need to reduce production redundancies and maintain local competition.

In contrast, when the acquired firm is a customer or supplier, the newly acquired establishment is more likely to be kept if it's located in the same city as the acquirer's existing establishment. This highlights the strategic advantage of having geographically proximate inputs for production.

The Importance of Geography in Post-Merger Restructuring

Our findings underscore the significance of geography in the post-merger restructuring process, shedding light on how local agglomeration economies are established and reinforced. Economic agglomeration, which refers to the benefits of shared resources and knowledge spillovers, dates back to the early 20th century[1]. When firms can internalize these benefits post-acquisition, it makes sense to retain local establishments regardless of whether the acquired firm is a competitor, customer, or supplier.

Using proxies to capture three dimensions of agglomeration—input sharing, knowledge spillover, and labor pooling—we found consistent results supporting this notion.

Input Sharing

Input sharing refers to the benefits that arise from economies of scale in shipping, distribution, and localized production of inputs. When a firm acquires another company, the newly combined entity can achieve significant cost savings by consolidating and optimizing their supply chain and logistics operations. For example, if both firms use similar raw materials or components, centralizing their procurement and storage can reduce transportation.

When the benefits of input sharing are high, newly acquired establishments located in the same city as an existing establishment are more likely to be kept. This strategic retention maximizes the efficiency and cost-effectiveness of the firm's supply chain.

Knowledge Spillovers

Knowledge spillovers refer to the exchange and diffusion of ideas, technologies, and best practices between firms. When two companies that utilize similar technologies or operate in related industries merge, their geographic proximity can foster an environment of innovation and continuous improvement. Employees from both firms can collaborate more easily, share expertise, and develop new solutions to common challenges. When the benefits of knowledge spillovers are high, the newly acquired establishments located in the same city as an existing establishment are more likely to be kept. This strategic decision helps the firm capitalize on the synergies and collaborative opportunities that geographic proximity offers.

Labor Pooling

Labor pooling refers to the benefits of having access to a large, skilled labor force within a specific geographic area. When a firm acquires another company, having both establishments in the same city can create a robust labor market that attracts and retains talent. This is particularly advantageous in industries that require specialized skills and expertise. By maintaining a presence in a location with a rich labor pool, firms can benefit from a steady supply of qualified workers, reducing recruitment costs and minimizing the risk of skill shortages. When the benefits of labor pooling are high, newly acquired establishments located in the same city as an existing establishment are more likely to be kept. This strategic retention leverages the local talent pool to sustain and enhance the firm's operational capabilities.

Productivity Gains from Agglomeration Externalities

If agglomeration externalities are effectively internalized, the retained establishments should show significant productivity gains.

> “Establishments benefiting from agglomeration externalities exhibit substantial increases in productivity, regardless of the type of firm being acquired."

Our study provides valuable insights into how firms decide the fate of newly acquired establishments based on geographic proximity and potential agglomeration benefits. Managers are evidently aware of these benefits and actively seek to exploit them, reinforcing and expanding existing agglomeration economies. The decision-making process post-acquisition is highly sensitive to these potential benefits, ensuring that establishments that can leverage agglomeration externalities are retained, thereby strengthening local economies and enhancing firm productivity.

In conclusion, geography and agglomeration externalities play a crucial role in post-acquisition decisions. By understanding and leveraging these factors, firms can make strategic decisions that not only integrate the new assets effectively but also reinforce and expand the economic benefits of agglomeration, leading to stronger, more productive enterprises.

By Samuel Piotrowski, NHH Norwegian School of Economics, Jarrad Harford, University of Washington, and Yiming Qian, University of Connecticut.

Is there information in corporate acquisition plans?

René Stulz, The Ohio State University
Sinan Gokkaya, Ohio University
Xi Liu, Miami University

Mergers and acquisitions (acquisitions for simplicity) represent the largest corporate investments in the lifecycle of firms, shape corporate boundaries, and have significant implications for a wide range of stakeholders. The vast body of academic research on acquisitions typically focuses on the acquisition process starting with the public announcement of an agreement between an acquirer and a specific target firm. However, firms often develop and announce acquisition plans as a first step to execute a corporate strategy of growth through acquisitions before they initiate an acquisition process with a specific target firm. And yet, little attention has been paid to acquisition planning and to the communication of acquisition plans.

In our paper titled "Is there information in acquisition plans?" we construct a novel and comprehensive sample of 13,137 firm announcements of acquisition plans by 3,536 unique US firms from 2003 to 2015 from Mergermarket Ltd. We then examine the information content of acquisition plans for capital market participants, how acquisition plans potentially affect acquisition decisions, and the benefits to firms from announcing such plans.

We find that the number and percentage of acquisition-planning firms represents an economically important fraction of U.S. listed firms. For instance, acquisition-planning firms represent 32% of the total market capitalization U.S. listed firms. Perhaps more importantly, over 33% of acquisition transactions follow the announcement of an acquisition plan and 34% of unique acquirers communicate acquisition plans before executing a transaction.

This suggests that the announcement of acquisition plans is indeed an important component of the U.S. acquisition deal-making process.

We show that acquisition plans are generally non-numeric and contain soft information disseminated mostly in institutional conference settings and interactions with the financial press. Such plans vary greatly based on the strategic information furnished by management. For instance, firms communicate their target selection strategies as well as their level of commitment to acquisitions as a means of executing strategic corporate growth plans.

Our evidence strongly suggests that the stock market reacts to the announcement of acquisition plans, but the reaction can be positive or negative depending on the nature of the plan. Moreover, acquisition-planning firms are incrementally more likely to engage in subsequent acquisition transactions relative to other firms. In economic terms, acquisition-planning firms are associated with an incrementally 128% higher propensity of making subsequent acquisitions.

As a next step, we explore where the informativeness of acquisition plans comes from. Our evidence shows that acquisition plans are even more informative when acquisition-planning firms' target selection strategy involves an internal M&A pipeline and acquisition-planning firms explicitly communicate their commitment to future acquisitions.

These results are consistent with the view that such acquisition-planning firms have already expended resources to build an acquisition pipeline and are committed to future acquisitions to pursue their corporate growth strategy.

We investigate the potential benefits to firms from announcing acquisition plans. First, we expect and find that firms communicate acquisition plans to utilize information from market reaction to acquisition plan announcements, so that they can take the market's feedback into account when deciding whether to pursue acquisitions as well as about how to implement their acquisition plans. These results are most important for firms that have more flexible acquisition plans. More specifically, firms that are not committed to acquisitions to implement their corporate strategy and firms that do not maintain an internal M&A pipeline are more likely to adjust subsequent acquisition behavior based on market reaction to acquisition plan announcements. Specifically, if the market reacts negatively to the acquisition plan communicated by a firm, that firm is less likely to engage in subsequent acquisitions. Second, we find strong empirical evidence that the communication of acquisition plans lowers market uncertainty regarding subsequent acquisition activities.

Do firms that communicate acquisition plans create more value when they undertake acquisitions? The answer is yes. Acquisitions of planning firms, on average, generate significantly greater value for shareholders through acquisitions. However, these results are confined to acquisitions of firms that are most likely to learn from market feedback to their acquisition plan announcements.

"Firms that learn from the market's reaction to their plans end up making better acquisitions."

In sum, our research provides a novel and important perspective on the acquisition process by bringing light to the existence and importance of acquisition planning that evolves prior to the initiation of an acquisition process with a specific target firm. Our research is the first to demonstrate the information content and implications of acquisition planning for acquisition behavior and value created from acquisition transactions. Our paper shows that market feedback plays an important role for investment and resource allocation decisions of acquisition-planning firms, helping them to make better acquisitions and communication of acquisition plans reduce market uncertainty around subsequent acquisition announcements.

By René M. Stulz, The Ohio State University, NBER, and ECGI, Sinan Gokkaya, Ohio University, and Xi Liu, Miami University.

The first article in this collection explores continuation funds in private equity, showing that while they benefit sponsors, they often disadvantage legacy investors due to unresolved conflicts of interest and inadequate regulation. The second article questions the notion that fewer U.S. public firms are due to over-regulation. It finds that, despite the decline in numbers, profits and market value have risen, suggesting that industry concentration and firm size are significant factors. The third article reassesses the growth of major investment managers like Vanguard, BlackRock, and State Street. It argues that their market dominance is influenced by corporate actions and broader market trends, not just investor reallocations, challenging the idea of their overwhelming market share. The fourth article reviews the mandatory bid rule (MBR), finding it reduces control premiums and private benefits during takeovers without significantly increasing costs or reducing deal frequency, thus ensuring fairness with minimal financial impact.

The shifting tide of board expertise?

Roy Shapira
Reichman (IDC)

What types of skill sets do directors need for corporate boards to be effective? Over the past couple of years, this question has jumped onto the top of the list of important issues in corporate governance.

There has always been a consensus that corporate boards matter. But there has never been a consensus about what makes boards effective. Corporate legal scholars have traditionally approached the board effectiveness question by focusing mostly on directors' incentives. That is, we counted how many directors are independent, or in how many companies the roles of Chair and CEO are separated. By now, however, the board independence debate is largely over. Independence won.

In the S&P 500, for example, almost all companies have boards that consist mostly of people coming from outside the company. Further, even fully independent and motivated directors will need some experience and skills to ask the right questions, process the answers, and anticipate future developments. Unsurprisingly, then, investors, regulators and courts around the world are increasingly focusing on board expertise.

Once we turn our attention to board expertise, we notice indications of an important shift. Until recently, corporate boards consisted almost entirely of “generalists”: former CEOs in their 60s and 70s with general experience in running businesses on a large scale. Today, the emphasis is shifting to adding directors with specific expertise in environmental, social and governance (ESG) issues. More and more companies now feature a “cyber” director, a “diversity” director, a “climate” director, and so on.

In a new article, titled "Specialist Directors," Yaron Nili and I hand collected data from companies' disclosures on directors' skill sets over the past six years, and interviewed board nomination committee members and their search consultants, to try to gauge the magnitude of the shift in board expertise, and evaluate how it is likely to affect corporate behavior going forward.

The first finding to jump out of our dataset is that companies have started putting heavier emphasis on board expertise disclosure, as evident by the adoption of image-based "skills matrices." Skill matrices are basically a table where the rows are the types of expertise, and the columns are the individual directors. Back in 2016, only a small minority of companies adopted such image-based disclosure; nowadays, an overwhelming majority of them do. Companies have also started regularly tracking new types of expertise, as evident by the addition of new rows to skills matrices. To illustrate, over the 2016–2022 period, 215 of the S&P 500 companies started tracking "technology" expertise, and 143 started tracking more specifically "cybersecurity."

Aside from documenting a shift in how companies report board expertise, our dataset also reveals a shift in the types of expertise that companies have on their boards. For example, back in 2016 the number of directors designated as "cyber experts" increased from 25 in 2016 to 200 in 2019 to 723 in 2022.

But it was precisely the magnitude of the jump in the new types of board expertise that gave us pause. Knowing just how glacial board turnover can be, we wondered where all these specialist directors came from suddenly? To find out, we started examining director by director, and learned that there are at least three different factors contributing to the increase in domain-specific expertise. Some of the change is due to shifts in disclosure. The same director with the same expertise was not designated as a "cyber" or "ESG" expert back in 2016; but is now. Another part of the change is due to training existing directors.

Say that the company sent its directors to a cyber boot camp over one weekend in 2021, and now all of them check the "cyber" box in the skill matrix. Finally and most obviously, some of the jump is due to companies adding new directors with domain-specific expertise, including by reaching to different "pools" of candidates than they normally would.

Each one of these channels corresponds to different promises and perils.

> "The "shifts-in-disclosure" channel illustrates a broader problem with the quality of board expertise disclosure."

As things currently stand, there is no benchmark or definition of what counts as being a "cyber expert" or a "climate expert" or a "DEI expert." The lack of standardization too often turns expertise disclosure into "cheap talk." Indeed, we provide several examples of directors who serve on multiple boards and are listed as ESG experts in one company but not in another.

The "rookie-directors" (additions of new "specialist directors") channel raises questions about the desirability of targeting individuals for a specific, narrow skill set. When the demand for, say, "cyber directors" suddenly increases (perhaps because of regulatory disclosure requirements), the supply of quality candidates does not automatically rise to meet the demand. As a result, some companies are bound to compromise their director selection and onboarding processes. For example, companies may bring an individual with a particular skill set who lacks general understanding of the business or lacks the necessary bandwidth to be a good director.

To revisit our opening question, the point is that board expertise is highly company specific.

Changes to it should generally come in a firm-by-firm, organic manner. Cyber directors can add value to some companies but not to others. Climate directors can add value in some industries but not in others. Even within the same company, the issues that are on the board agenda may vary widely over time. Yet too often regulators and judges are treating board expertise as an unalloyed good ("what bad can come from adding more types of expertise?"). Our article ends with several concrete policy implications that recognize the problem with one-size-fits-all type legal interventions.

As the discussions in the recent GCGC (Columbia, June 2024) illustrated, the shift in board expertise is hardly a U.S.-only phenomenon, as markets in Europa and Asia grapple with the same trends (which are usually driven by larger trends like the rise in compliance and ESG pressures). Our article represents a first modest step toward injecting much-needed evidence and theory into this discussion.

By Roy Shapira, Reichman (IDC).

“Glossy Green” banks: The disconnect between environmental disclosures and lending activities

Mariassunta Giannetti, Stockholm School of Economics
Martina Jasova, Barnard College
Maria Loumioti, The University of Texas at Dallas
Caterina Mendicino, European Central Bank

In the wake of the Paris Climate Agreement, banks are under increasing pressure to demonstrate their commitment to environmentally responsible practices. In response, many financial institutions are increasingly emphasizing their environmental disclosures to showcase their commitment to sustainability. However, there is growing skepticism about whether banks are strategically disclosing information to burnish their sustainability image while masking their true sustainability impact. That is, their disclosures and claims may be nothing more than “cheap talk.”

Do banks walk the talk?

This blog addresses an important question: do banks that put more emphasis on the sustainability of their lending policies engage in greener lending? Not so much, our research suggests. If the emphasis on the sustainability of the lending policies reflected actual lending decisions, we would expect that banks issue less credit to brown borrowers. An insignificant relation between the sustainability of the banks’ lending policies and green lending would instead indicate greenwashing.

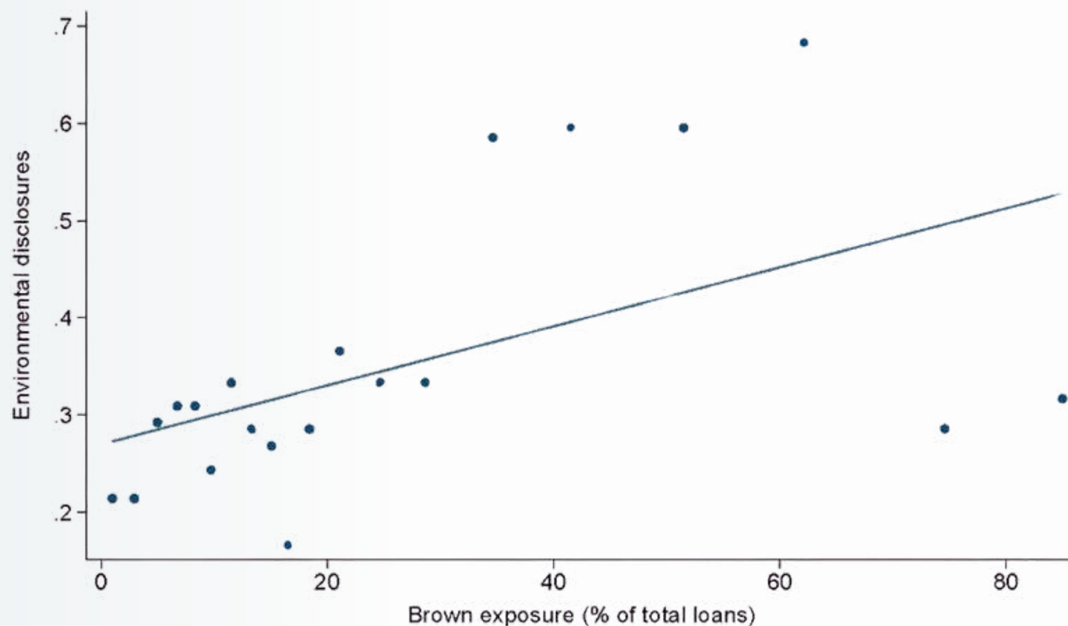
However, our findings highlight a serious disconnect between what banks claim in their disclosures and the environmental impact of their lending decisions.

Not only banks that portray themselves as more environmentally conscious do not have greener portfolios, but they make more brown loans. Banks thus appear to be strategically disclosing positive sustainability actions and withholding information about negative ones, casting doubt on the extent to which they can be active players in the green transition.

To reach this conclusion, we turn to the rapidly developing field of large language models (LLMs) for analyzing financial texts. Using ChatGPT, we examine annual and sustainability reports to see how banks discuss the sustainability of their lending policies. We combine textual analysis of these reports with granular data on banks’ lending from AnaCredit, the credit registry of the entire Euro area.

Our findings reveal a striking trend: banks with more extensive environmental disclosures tend to have better environmental ratings provided by external agencies but also a history of significant exposure to brown industries. As shown in Figure 1, the banks with more extensive environmental disclosures have large exposures to brown industries, which may indicate that banks have incentives to communicate about how their lending model is changing towards more green policies. But going forward do they actually engage in greener lending?

Figure 1. Banks' Emphasis on the Sustainability of Lending Policies and Exposure to Brown Industries



Notes: The figure shows the bin scatter plot depicting the relationship between banks' Environmental Disclosures and their ex-ante exposure to brown borrowers. It displays a bin scatter plot for the lagged share of the bank's lending to brown borrowers as a proportion of total credit outstanding (Brown exposure) and the continuous variable bank's Environmental Disclosures. Both scatter plots present averages for the data sorted into 20 bins based the exposure to brown firms.

"Banks that overemphasize the environment in their reports do not lend more to green firms. On the contrary, these banks are more likely to lend to brown firms."

Green talk and brown loans

Banks that emphasize the sustainability of their lending policies in their disclosures end up increasing the share of loans they give to brown industries, while reducing that to green industries. Furthermore, these banks do not appear to use stricter terms or higher interest rates to discipline their brown borrowers.

These patterns are more pronounced for loans to small brown borrowers, which are hardly verifiable by market participants.

Our results thus suggest that focusing on banks' entire loan portfolios, i.e. going beyond the largest borrowers, such as those in the syndicated loan market or those with available carbon emission data, is crucial for assessing the environmental impact of banks' lending decisions.

Are banks helping brown industries get greener?

We examine whether banks that portray themselves as environmentally conscious are more likely to support brown borrowers in their efforts to transition towards greener business models. We use several proxies to capture whether a firm is in its green transition phase, including borrowers' age, capital expenditures or investments in R&D, or whether the borrower is signatory of the Science Based Target initiative. We find no evidence consistent with this argument.

Instead, we document that banks with high environmental reporting are particularly inclined to continue lending to brown zombie borrowers, i.e., financially underperforming firms with a negative carbon footprint. Banks seem to have incentives to hide their exposure to brown industries by keeping zombie polluters alive. Thus, banks' strategic disclosures appear to be accentuated by their incentives to continue lending to financially unhealthy brown borrowers that are likely to have fewer financing alternatives. These are the borrowers that would experience distress if their bank relationships were severed, with potentially adverse effects on banks' balance sheet.

Policymakers are increasingly recognizing that climate change poses a major and urgent threat to our economies. The green transition is essential, and banks could play a critical role in this transition. However, our findings show that banks currently lack incentives to report on their environmental policies in a way that truly reflects their lending practices. Greater transparency and standardization of sustainability disclosures would help bridge the gap we have highlighted.

Our results also have important policy implications, as we provide empirical evidence that banks offer inadequate and potentially misleading environmental disclosures. The recent adoption of the EU Sustainable Finance Disclosure Regulation (SFDR) has already enhanced transparency among asset managers. Introducing similar regulations in the banking sector could limit greenwashing and possibly drive a more genuine green transition.

By Mariassunta Giannetti, Stockholm School of Economics, Martina Jasova, Barnard College, Maria Loumioti, University of Texas at Dallas, and Caterina Mendicino, European Central Bank.

How did corporations get stuck in politics and can they escape?

Jill Fisch
University of Pennsylvania Law School

Corporations have long sought to promote their business interests through political engagement. Today, however, corporations are increasingly taking high-profile positions – through advertisements and public statements – that are unrelated to their business operations. In our article, How Did Corporations Get Stuck in Politics and Can They Escape? (forthcoming University of Chicago Business Law Review), co-authored with Jeff Schwartz, the Hugh B. Brown Presidential Professor of Law at the University of Utah S.J. Quinney College of Law, we challenge this practice. We argue that what we term "corporate political posturing" is bad for both corporations and society. We then offer suggestions for how corporations can get "unstuck" from this new form of political engagement.

Examples of corporations taking a stand on politically contentious issues abound. They include Coca-Cola's "crystal clear" opposition to Georgia's 2021 legislation to restrict voting access, Gillette's campaign against "toxic masculinity," and Disney's statement opposing Florida's "Don't Say Gay" law. Corporations take political positions for a variety of reasons – to market their products, to appease stakeholder groups including customers and employees, and to respond to the demands of activists. Social media heightens the pressure on corporations to conform by empowering critics to denounce any failure to speak as complicity.

Many welcome greater corporate engagement in controversial political and social issues. They argue that corporations are powerful and wealthy, that they can bring increased attention to important issues, and that they can amplify the voices of corporate stakeholders. Public statements also enable stakeholders to identify and support those corporations that share their political views.

We argue, however, that corporate political posturing creates significant business risks. Political engagement is fraught, and many corporations lack a formal process to oversee the decision to engage in politics. As a result, a corporation's speech may not reflect the multiple and often conflicting political viewpoints of its shareholders and other stakeholders. Corporate decisionmakers may also misperceive the potential consequences of political posturing, which can generate backlash from shareholders, customers, and politicians. We see examples of such backlash in the consumer boycott of Bud Light following the company's advertising campaign featuring transgender influencer Dylan Mulvaney from which the company's stock price has yet to recover. Disney faced similar backlash from Florida Governor Ron DeSantis, who implemented adverse legal changes following the company's opposition to the state's new education statute.

More problematic are the risks that corporate political posturing poses to society. Corporations are designed to pursue the objectives of their shareholders and other stakeholders, not to serve as moral stewards, and corporate leaders lack the training and tools necessary to determine how best to pursue difficult societal and political objectives. In addition, because political posturing can threaten profits, corporations are often hypocritical – they may openly advocate one position while providing financial support to political campaigns that take the opposite side.

Their political statements may be empty virtue-washing, unsupported by their actions. And they may flip flop, shifting their positions based on the public's response.

"Political posturing increasingly portrays corporations as political actors, making it unappealing for those with different views to engage with them as shareholders, customers and employees, and leading to an increasingly polarized society."

Given these concerns, we advocate that corporations stop their political posturing. Although some commentators have sought to use traditional governance tools, such as heightened fiduciary duties, to hold corporations more accountable for their political engagement, we question the efficacy of such an approach. Instead, we advocate a combination of voluntary disarmament and transparency. We recognize that peer pressure, political activists and other collective action problems, make it difficult for corporations to resist the temptation to speak out on political issues. In response, we suggest that corporations publicly and collectively pledge to refrain from engaging in political posturing. We advocate an "Anti-Political Posturing Pledge" akin to the Business Roundtable Statement on Corporate Purpose, saying something like:

'*We believe that our role as leaders of Corporate America is to serve our stakeholders by providing quality goods and services in an ethical and sustainable manner. Because we do not believe that taking stands on political issues furthers these goals, neither the corporation nor its executives will do so, nor will we engage in politically explicit marketing and promotional activities.*'

Our proposal would offer accountability and assist corporations in resisting the political arms race. Shareholders could use the shareholder proposal process to urge corporations to adopt the pledge.

To further enhance corporate accountability for their political statements, we argue that corporations should disclose the extent to which their actions match their posturing. If a corporation publicly endorses the BlackLivesMatter movement, for instance, it should disclose its diversity practices. If a corporation takes a public stand on a political issue, it should disclose any lobbying or political expenditures that are in opposition to that issue. Corporations should also disclose the process by which they decide to take political positions, providing shareholders with information about the extent to which the corporation is properly managing political risk.

As with our proposed pledge, we would prefer that corporations make these disclosures voluntarily. Indeed, a number of recent shareholder proposals ask corporations to disclose their political engagement or the extent to which their political contributions are aligned with their public statements. Alternatively, the Securities & Exchange Commission could adopt rules or informal guidance requiring such transparency. The SEC could also take the position that a material misalignment between a corporation's political posturing and its actions could potentially subject it to liability for securities fraud. Greater transparency and the threat of litigation would incentivize companies to align their words with their actions or reduce their political posturing. We believe that shareholders, stakeholders, and society would be better off as a result.

By Jill E. Fisch, University of Pennsylvania Carey Law School.

Corporate actions as moral issues: Unpacking the public's perception

Oliver Spalt, University of Mannheim
Elisabeth Kempf, Harvard Business School

In the realm of corporate finance, we often hear about maximizing shareholder value, optimizing financial performance, and achieving market dominance. But there is an undercurrent that is becoming impossible to ignore: the morality of corporate actions. Our latest research, "Corporate Actions as Moral Issues," sheds light on how Americans perceive the morality of various corporate decisions, revealing some important implications for both academics and practitioners.

The growing emphasis on ESG issues is reshaping corporate landscapes, yet the discussion either often stops at the financial impacts of these issues, or lacks empirical evidence on how important these issues are to the firm's stakeholders from a moral perspective.

In our study, we surveyed 3,000 Americans to evaluate the morality of 11 different corporate actions, ranging from CEO pay and layoffs to renewable energy usage and workforce diversity.

The findings were surprising: classic finance decisions, such as CEO pay and layoffs, are perceived as significantly more moral issues than many ESG concerns currently emphasized in executive pay contracts, such as renewable energy usage and workforce diversity. This challenges the traditional notion that these decisions are purely value-driven without moral implications.

One important aspect of our study is the willingness of shareholders to pay for morally desirable corporate actions. We randomly assigned survey participants into three stakeholder groups: they were asked to put themselves in the shoes of a customer, an employee, or a shareholder of the firm.

Shareholders, often depicted as solely profit-driven, showed a greater willingness to bear monetary costs for the sake of moral actions compared to customers or employees. Importantly, the same was true for participants who reported to invest in the stock market in real life. This revelation flips the script on the stereotype of the profit-maximizing shareholder and suggests a deeper, moral motivation may also be at play.

Our data reveal significant demographic differences in how corporate actions are perceived. Older, white, Democrat, and female participants are more likely to view corporate actions as moral issues and to see them as morally wrong. However, despite observing sizable variation across participants in the absolute importance given to moral considerations, the relative ranking of the moral importance of different corporate actions is surprisingly stable across participants. For example, all subgroups (including both Democrats and Republicans) agree that CEO pay ranks among the two most important moral issues. Partisan differences are largest for renewable energy usage and workforce diversity. These insights are crucial for understanding the broader societal expectations placed on corporate behavior.

Our findings also inform finance education. Leading textbooks and curricula emphasize financial metrics while largely ignoring the moral dimensions of corporate decisions. This oversight risks leaving future managers ill-equipped to navigate the complex trade-offs between financial performance and moral responsibility.

Our survey shows that stakeholders view many classic corporate finance decisions as moral issues and are willing to forego financial returns for the sake of ethical behavior.

"Corporate decision-makers, who focus exclusively on maximizing shareholder financial value, may find their actions perceived as amoral by the broader public."

This disconnect could contribute to the distrust in corporate elites and underscores the need for a better understanding of how legal financial decisions can influence trust in the business environment.

In sum, our research underscores the importance of understanding moral dimensions in corporate decision-making. By addressing stakeholders' moral concerns, corporations can serve their stakeholders better and foster trust in the business environment.

By Oliver Spalt, University of Mannheim and Elisabeth Kempf, Harvard Business School.

Does mandatory bid rule discourage acquisitions above the threshold?

Woochan Kim
Korea University Business School

The mandatory bid rule (MBR) requires anyone who buys a significant portion of a company to make a fair offer to the remaining shareholders. Introduced in the UK in 1972, this rule ensures fairness by guaranteeing that everyone holding the same class of securities is treated equally. Essentially, if someone gains control of a company, minority shareholders have the right to cash out at the same price, giving them an exit if they disagree with the new leadership.

The MBR has become the global standard, embraced by 29 out of 38 OECD countries and many non-OECD nations. While Europe is its main hub, countries in Asia, Latin America, and Africa have also adopted it. Yet, South Korea and the U.S. remain notable exceptions.

Critics argue that the rule is a financial burden, making takeovers too costly and potentially stifling efficient control transfers. They believe that under the mandatory bid rule, acquisition costs may escalate for two reasons: first, acquirers must offer minority shareholders the same control premium as that given to the controlling shareholder; second, this offer must be extended to all minority shareholders.

However, these two critical features of the mandatory bid rule may not necessarily lead to higher acquisition costs. First, acquirers may not continue to offer the same level of control premium as they did before the implementation of the MBR. Acquirers will negotiate harder to lower the offering price, knowing they have to extend the offer to all shareholders.

Second, a lower offering price may make the bid less attractive to minority shareholders, making many choose not to tender their shares. As a result, the overall acquisition costs may not necessarily increase; in fact, they could potentially decrease.

Our study investigates these possibilities by examining the MBR's real impact across 41 countries. The findings suggest that the MBR reduces the control premium—the key factor in determining overall acquisition cost and the extent of private benefits an acquirer can gain post-acquisition. Specifically, our analyses show that the MBR leads to a 45-percentage point reduction in the control premium and a 10-percentage point reduction in private benefits of control in deals above the rule-triggering thresholds.

Some might argue that the reduction in premium is due to acquirers gaming the system by buying just below the threshold to avoid the MBR when premiums are high. However, our data doesn't fully support this. While there is some strategic clustering below the threshold, this pattern does not extend to ownership levels distant from the threshold.

Our findings show that the mandatory bid rule reduces post-acquisition ownership size (toehold plus newly acquired shares from the block seller) by only 3.3 percentage points. Additionally, our results do not support the claim that the likelihood of post-acquisition ownership exceeding the threshold decreases.

Moreover, our analyses demonstrate that the MBR does not necessarily result in fewer deals occurring above the rule-triggering threshold. In one analysis, comparing the UK (an MBR adopter) and the US (an MBR non-adopter), we found that the gap in deal frequency between transactions below and above the threshold is less pronounced in the UK, where the deal frequency for transactions above the threshold is 46.2 percent less than for transactions below the threshold. In contrast, in the US, the deal frequency for transactions above the threshold is 57.6 percent less than for transactions below the threshold.

In conclusion, the mandatory bid rule is a crucial regulation that ensures fairness in corporate takeovers. Despite criticisms about its potential to raise acquisition costs, our study shows that the MBR can lead to a reduction in control premiums without significantly affecting the overall number of transactions. This rule strikes a balance between protecting minority shareholders and maintaining an efficient and dynamic corporate control market.

Instead, it promotes fairness without significant financial drawbacks. The MBR is a smart policy choice for countries looking to regulate corporate takeovers effectively.

Our study contributes significantly to the literature on corporate takeovers by providing the first empirical examination of the MBR's impact on post-acquisition ownership levels. Previous research has been largely theoretical or has focused on different aspects, such as control premiums for block sellers and acquirers, shareholder returns around the time of rule adoption, and the extraction of private benefits of control.

> "Don't fear the MBR. It doesn't hike acquisition costs or dampen the takeover market as much as critics claim."

An obvious extension of this study would be to investigate the impact of the mandatory bid rule on the overall costs of acquisitions, including the expenses incurred from making tender offers to remaining minority shareholders, as this is another factor that determines the overall acquisition costs, along with the control premium paid by the acquirer. It would also be interesting to examine how frequently mandatory bids are triggered and whether voluntary full-takeover bids have increased following the adoption of the mandatory bid rule to avoid mandatory bid triggers.

By Woochan Kim, Korea University Business School.

The factors that matter for growth in institutional ownership

Alon Brav, Fuqua School of Business
Dorothy S. Lund, Columbia Law School
Lin Zhao, Duke University's Fuqua School of Business

The growth and concentration of the investment management industry has captivated the scholarly community. Recent scholarship has focused on the "Big Three" investment managers -- Vanguard, BlackRock, and State Street Global Advisors -- and charted their rapid accumulation of assets with alarm, predicting that these institutions will soon control the U.S. equity market. And yet, few scholars have examined how exactly the Big Three, and institutional investment managers more broadly, exhibit growth in equity ownership. The conventional narrative is that institutional ownership increases when investors move dollars from one investment fund to another. We show that these "reallocational flows" are only part of the story. Indeed, decisions made by investors, institutions, and the corporations that they invest in can accelerate the growth of certain institutions relative to others.

"Institutions may exhibit differential growth in ownership due to the difference in return on the assets under management relative to the market return."

Less obviously, corporate decisions to either distribute or raise equity capital, which we term "balance sheet effects," provide another mechanism that drives differential growth in institutional ownership.

Consider, for example, corporate repurchases. When a firm repurchases its own shares via a stock buyback, only some investors sell their shares. The investors that do not are left holding a larger portion of the firm, whose market value has declined due to the buyback. It follows that institutional investment managers that tend not to sell during buybacks (such as those that specialize in passive funds) and do not experience contemporaneous outflows will see their ownership stake increase when there are aggregate net buybacks in the market. Other corporate distributions that have a similar effect on ownership are cash financed acquisitions and going private transactions. Likewise, aggregate equity issuances via initial and seasoned equity offerings can affect ownership, depending on the degree to which institutions participate in such offerings and the magnitude of contemporaneous inflows they receive. The overall impact of corporate aggregate distributions depends on the magnitude of such distributions and their covariation with institutional-level flows.

This last point reveals an important insight -- when evaluating the growth of an investment manager's ownership of the market, one cannot consider its inflows in isolation, i.e., without accounting for aggregate market flows. For example, an institution with zero dollars of inflows in a certain year may still feature growing ownership of the market if the market has shrunk due to net corporate distributions. Indeed, in years where the aggregate market flows were negative due to net stock buybacks, zero or slightly positive inflows can lead to an increase in investment manager ownership.

Our article formalizes these insights, showing how fund fees, capital gains returns, dividend and capital gains distributions, and balance sheet effects shape institutional growth. Our framework generates novel insights about institutional growth, and why certain institutions (and those that specialize in passively managed mutual funds in particular) might have grown faster than others.

We also use our framework to establish the most complete picture of institutional and market flows since 2000, combining data from several sources. We hand collect data on institutional ownership, distributions, fees, and reinvestment of dividends and capital gains directly from SEC filings. The picture that emerges is likewise counter to conventional wisdom. Specifically, we reveal slower growth of the Big Three's ownership of the market than the conventional narrative suggests, with substantial differences between each institution. In particular, BlackRock's scaled flows are only slightly positive on average following its acquisition of BGI in 2009, while State Street exhibits scaled flows that are slightly negative over the past decade. Vanguard's scaled flows remain positive, although we find a steady decline approaching zero in recent years. Fidelity -- which is excluded from the Big Three, despite its large size and share of inflows into passive funds -- likewise exhibits more outflows than inflows. By contrast, smaller asset managers like Geode, JP Morgan, and T. Rowe have exhibited increasing ownership over the past few years. These results suggest that the market is more robust than the conventional narrative would suggest, and that the Big Three are not quite "eating the world."

More important, our analysis points to multiple factors - the size of fees, corporate payout policy, dividend reinvestment, corporate financing decisions, and asset manager M&A -- that will shape the future growth of the Big Three and other large investment managers.

For example, in order for the Big Three to achieve the alarming ownership levels that some scholars have predicted, their flows will need to be consistently higher than market flows - a feat that becomes exceedingly more difficult as an institution grows to encompass a larger share of the market. More broadly, as this discussion reveals, debates about the Big Three interact with many other policy conversations, and those who are concerned about the rise of giant investment managers should be aware of the myriad factors that contribute to their growth.

By Alon Brav, Duke University's Fuqua School of Business, Dorothy S. Lund, Columbia Law School, and Lin Zhao, Duke University's Fuqua School of Business.

Half the firms, twice the profits: American public firms' transformation, 1996-2022

Mark Roe, Harvard Law School
Charles Wang, Harvard Business School

The number of public firms in the United States has nearly halved since 1996, causing consternation among some corporate leaders and securities law regulators.

Representative analyses plead for a "wake-up call for America" because of a "decimation of the U.S. capital markets structure [and a] demise of the IPO market," that led to "the systemic decline in the number of publicly listed companies." Jamie Dimon, JP Morgan Chase's CEO, lamented in his 2023 JPMorgan Chase letter to shareholders the "shrinking public markets" and the "diminishing role of public companies. . . . From their peak in 1996 at 7,300, U.S. public companies now total 4,300. . . . The trend is serious. . . . Is this the outcome we want?" Those who lament the decline in number since 1996 often bring forward over-regulation as a central cause, as did Mr. Dimon. This perspective of decline, with regulation a primary cause, has become a standard narrative in important circles. But a look at the overall changes in the American public firm sector should make us hesitant of accepting that narrative.

The basic fact that corporate leaders, such as Jamie Dimon, and many regulators worry about—a sharply declining number of public firms—is accurately reported. The figure below shows the decline in number from more than 7,000 in 1996 to fewer than 4,000 in 2022.

Declining number of public firms, 1990-2022

The dominant explanations, often advanced by Securities and Exchange commissioners when considering policy initiatives, come from over- or under-regulation of the stock market. The central legal explanation is that the heavy burden of corporate and securities law has made the cost of being public too high. Conversely, goes the second legal explanation, capital-raising rules for private firms were once very strict but have loosened up. Private firms can now raise capital nearly as well as small- and medium-sized public firms. Private firms are displacing public ones. Either way, these views see legal imperatives as explaining the sharp decline in the public firm.

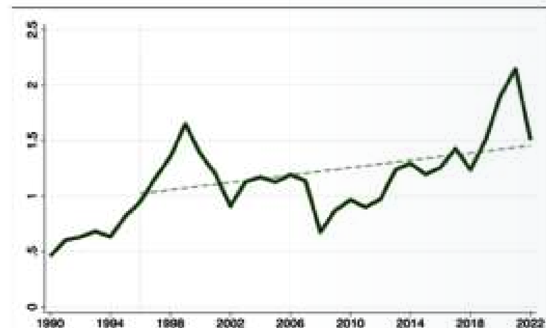
We challenge the implications of this thinking. While the number of firms nearly halved, public firms' economic weight has not halved. To the contrary, the public firm sector has held steady by every other measure for the past quarter-century that we examine. For several central qualities, the American public firm sector has become much bigger: profits are up greatly over the past three decades, the market value of the public sector is also up greatly, and revenue, investment, and employment have all kept up with the economy's growth. In fact, net income and stock market capitalization have grown much faster than the economy, with revenues and investment keeping up with its economy's growth. The next two figures show the rise in net income and the rise in stock market capitalization of the public firm sector, scaled to GDP. Compare their rising trendlines to the declining number of firms in the first figure above.

The public firm sector outside of the FAANG companies, and indeed outside of the S&P 500, have grossly diminished in the number of public firms, but not in profit or stock market capitalization.

These results are not artifacts of particular profit conceptualizations. The major conceptualizations of profit show results rising or steady: profit before extraordinary items, pre-tax profit, and economic profit.

This rise in net income as a proportion of American GDP has implications about what really is happening in the public firm sector, which is the second challenge we raise: does the explanation for the changing configuration of the public firm sector lie primarily in corporate and securities law's burdens?

Rising profitability of the American public firm sector, scaled to GDP, 1990–2022



Rising total stock capitalization, scaled to GDP, 1990-2022

We emphasize that the far fewer firms are producing more net income not less. At the profit rise's peak in 2021 public firm income was double that of 1996 profits, amounting to 6% of the country's GDP. This rise in income has not been stressed in prior work looking at the declining number of public firms.

The rise in net income amounts to $1 trillion in current value—a very big number, equal to several percent of GDP. Moreover, it would be a mistake to dismiss this profit and stock market capitalization trend as due to the enormous success of the FAANG companies (Facebook, Amazon, Apple, Netflix, and Google) and others.

The rise in net income cannot be readily explained by changes in securities regulation and corporate law. And in other policy circles—at the Federal Trade Commission or the Justice Department's Antitrust Division, for example—policymakers ask why American industry is so much more concentrated now, with fewer firms in most industries today than there were at the end of the twentieth century. Yet these policymakers —and their academic correlates—bring forward efficiency, industrial organization, and sometimes antitrust explanations, not corporate or securities regulation.

Little crossover exists between these two policymaking circles, one focusing on corporate and securities regulation (the SEC) and the other on competition (the FTC). We explore real economy changes that could readily explain the reconfiguration of the American public firm sector to one that is more profitable, more valuable, and with bigger but fewer firms.

These real economy developments largely tie to industrial organization via changes in the efficient scope and size of the firm (according to much academic analysis) or perhaps to changes in antitrust enforcement (according to common progressive political views). In a single article, this explanatory effort can only be exploratory. We build a baseline: There are fewer firms, but the firms are much more profitable, bigger, and often in more concentrated industries. It's plausible that these two trends are connected—part of the same transformative phenomenon. Our purpose is not to reject the general relevance of the regulatory thesis, but to show its limits.

"The legal explanation is unlikely to be the complete story for the package of changes over the past quarter-century of the American public firm sector and plausibly it's not even the most important one."

Corporate policymakers should adjust appropriately.

By Mark J. Roe, Harvard Law School, and Charles C.Y. Wang, Harvard Business School.

The rise of private equity continuation funds

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

The private equity business model has reinvented itself over the years, with continuation funds now serving as 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.

"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 $65 billion in deal value, representing a 750% increase since 2016. 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. 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". 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, were aimed to provide a check against a sponsor's conflicts of interest in structuring continuation funds. Just recently, the Fifth Circuit vacated the SEC rule, leaving the private equity regulatory landscape murkier than ever.

These general concerns, however, leave some crucial questions open: What types of misalignments of interests might continuation funds cause? How severe are these conflicts? 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 they have trusted with their investments up to that point? Do these investors have the power to fend for themselves or is regulatory intervention required and 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 (or to earn carry on previously non-qualifying investments), an opportunity to control the fund's assets for a longer period, and in the case of early-stage continuation funds, the benefit of a fast crystallization of carried interest.

However, 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 almost 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.

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 to suboptimal utilization of investors' capital. Continuation funds also enable fund sponsors to retain assets beyond the customary ten-year fund term and 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 show how informational disadvantages, lack of expertise, lack of time, diversification and liquidity considerations, and internal agency problems of institutional investors often force the legacy fund investors to sell their stakes under unfavorable conditions. A recent survey supports this analysis, showing that a small minority of all investors express significant interest in continuation funds. We also examine the convention that, in an industry in which investors rarely use litigation to enforce their rights, non-legal incentives are sufficient to maximize value for all parties involved. We highlight the limitations of this theory, particularly regarding less sophisticated LPs with limited bargaining power.

Third, 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 fully cure the structural biases generated by continuation fund transactions. Against this backdrop, we also offer a set of policy recommendations directly addressing the misalignment of incentives between sponsors and investors.

The study of continuation funds is an important setting for examining the power dynamics in the private equity industry, particularly the differences in sophistication and bargaining power between various players. It 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, Tel Aviv University, and Yaron Nili, Duke University School of Law.

A rip current in climate litigation? Exxon Mobil sues shareholders

Pranav Putcha
European University Institute

Litigation has become a firmly entrenched avenue for pursuing climate-related goals. Much academic and journalistic coverage focuses on claims against national governments in domestic courts. Successes like Urgenda v Netherlands and Leghari v Pakistan underline the potential of such litigation to compel states to act against climate change. Actions against private companies have also proliferated in recent years; however, fewer successes have been forthcoming. The Milieudefensie case is one of few successful actions against a private company: a Dutch court ordered Royal Dutch Shell to reduce its group-wide emissions, pursuant to civil rules on negligence. Many other claims against private companies have failed, whether under doctrines of negligence or otherwise. A prominent recent example is the UK case of ClientEarth v Shell in which the environmental NGO ClientEarth, as the owner of 27 shares in Shell, unsuccessfully brought a claim under UK company law against the directors of Shell (now no longer "Royal" or "Dutch").

A recent case in the United States puts the proverbial shoe on the other foot, with ExxonMobil apparently noticing an opportunity concealed within the threat of climate-related litigation. On January 21st, Exxon filed a claim against two investors, Arjuna Capital and Follow This, seeking relief from a shareholder proposal which would require Exxon to set targets relating to Scope 3 emissions (i.e. emissions in Exxon's broader value chain, mainly from the consumption of its petroleum products). Exxon suggests that the defendants are benefitting from a system that enables "abuse by activists with minimal shares and no interest in growing long-term shareholder value".

Despite the offending proposal having been withdrawn, Exxon remains unsatisfied. The claim currently continues before a court in Texas, the most prolific petroleum-producing state in the US and location of Exxon's corporate headquarters. In a recent development, Exxon's claim has been endorsed by the US Chamber of Commerce and the Business Roundtable, who made a joint amicus curiae submission to the court.

The defendants, Arjuna Capital and Follow This, represent two very different species of "activism". Arjuna is a registered investment adviser in the US, in the tightly-regulated business of investing on behalf of clients (albeit "while promoting a more vibrant economy, a healthier environment, and a more just society"). Exxon's complaint suggests that Arjuna does not itself hold any stock in ExxonMobil; rather, Arjuna is said to have received an authorisation to submit the relevant proposal from two of its clients. Follow This is instead a Dutch non-profit organisation which "organise[s] shareholder support for climate resolutions". Anybody can combine the purchase of a single share in an oil major with a one-time donation of €5 to Follow This, in return for which it acts on the shareholder's behalf at general meetings of the company in question. While exact data is difficult to come by, one would assume that Follow This owns a fairly small portion of the $426bn of listed Exxon shares.

Nevertheless, Exxon pulls no punches. In its complaint, Exxon asks the court to exclude the relevant proposal under SEC Rule 14a-8(i)(7) and (i)(12). These relate, respectively, to the exclusion of shareholder proposals that concern a company's ordinary business operations, and to resubmitted proposals that address "substantially the same subject matter" as previous proposals.

Indeed, making the SEC adopt a more restrictive approach towards shareholder proposals is a major factor motivating this claim. The complaint further describes the defendants as "driven by an extreme agenda" and "[misusing] the shareholder proposal rules". While some of this language could be ascribed to the unyielding zeal of Exxon's lawyers, the claims themselves seem unconvincing. If (per Reuters, as linked above) "Exxon is the only of the five Western oil majors which does not have [Scope 3] targets", it seems reasonable to demand such targets be set. I wouldn't dare comment on the legal merits of Exxon's claim under the rules mentioned above; interestingly, though, the Chief Governance and Compliance Officer of Norway's $1.5tn sovereign wealth fund has suggested that the offending proposal "is quite similar to shareholder proposals we have supported earlier".

Even though this matter was described by the Norwegian fund's CEO as "worrisome" and "very aggressive".

"Exxon's actions (and the support it has garnered from business groups) could dramatically cool pro-sustainability proposals and mobilisation in the United States."

Especially if the SEC changes its approach as a result of this claim. Will similar effects be felt further afield? Exxon's claim could be ascribed to the peculiarly intense and heavily-politicised debate about "ESG" in the United States. This could also feed into the broader debate about corporate purpose and the role of companies – is "growing long-term shareholder value" Exxon's only purpose? Ultimately, though, neither the outcome nor a withdrawal of this specific claim might matter. Instead, there is now a clear example of the judicial sword being wielded by the big corporation.

Clearly, even in our multipolar zeitgeist, litigation remains a powerful weapon and deterrent. In suing Arjuna Capital and Follow This, ExxonMobil has fired a warning shot at all shades of climate "activist". At a time when nearly three out of four businesses identify "ESG disputes" as a major risk to their activities, Exxon is using litigation to fight its way out of a corner. This threat – of being sued by the big corporation – would be ominous in any political or social setting.

By Pranav Putcha, PhD Researcher (Law) in EU Sustainable Finance Regulation at EUI.

Where to search for Greenium?

Jitendra Aswani, MIT Sloan
Shivaram Rajgopal, Columbia Business School

Achieving global climate objectives necessitates substantial financial commitments, with estimates suggesting a monumental investment exceeding $270 trillion is required for decarbonization efforts to realize net-zero ambitions by 2050. This translates to an annual investment of around $9.4 trillion. Within this context, sustainable debt, including green bonds, has experienced significant growth, reaching $3.7 trillion USD. Corporate sustainable debt notably constitutes approximately half of this amount, around $1.7 trillion USD. In this paper, we revisit prior predictions regarding the pricing of green securities and their environmental implications using green bond data. We propose a relatively novel hypothesis termed the 'sustainability gatekeeper.'

The 'sustainability gatekeeper' hypothesis suggests that the bond market trusts the financial sector to screen out "brown" issuers while deploying funds raised via green bonds as green loans.

> “Financial firms, while not direct emitters, play a crucial role in channeling capital towards sustainable projects."

They are responsible for about 50% of green bond issuance. In contrast, industries known for their pollution, such as the industrial, material, utility, and energy sectors, account for around 40% of the green bond market. However, their immediate environmental impact may not be evident, as they require substantial time and investment in long-term projects to significantly reduce their negative environmental footprint.

Analyzing the market reaction to green bond announcements reveals intriguing trends. We found that the market reaction (measured as cumulative abnormal returns (CARs)) for the announcement of green bond issues from 2013-2022 is 0.274%. However, this result is primarily attributable to financial sector firms. The 16-day market reaction for financial sector green bonds is 0.330%. Surprisingly, the analogous stock price reaction for green bonds issued by sectors known to pollute the environment is statistically insignificant. These findings are consistent with the role of financial firms as 'sustainability gatekeepers' channeling capital to sustainable projects.

Previous research has focused on the primary market of green bond issuance and found no apparent premium when compared with conventional bonds. However, analyzing the secondary debt market is critical. Post-issuance reports, such as impact reports, second opinion reports, capital allocation reports, and use of proceeds reports, influence pricing dynamics over time. Comparing conventional bonds, we find a 'greenium' of 5.7 basis points accumulated over one month. The average greenium is mostly explained by the 8.2 bps greenium for green bonds issued by the financial sector. This pattern aligns with the sustainability gatekeeper hypothesis. We also find higher yields for green bonds issued by polluting sectors of the economy, suggesting perceived higher risk by investors.

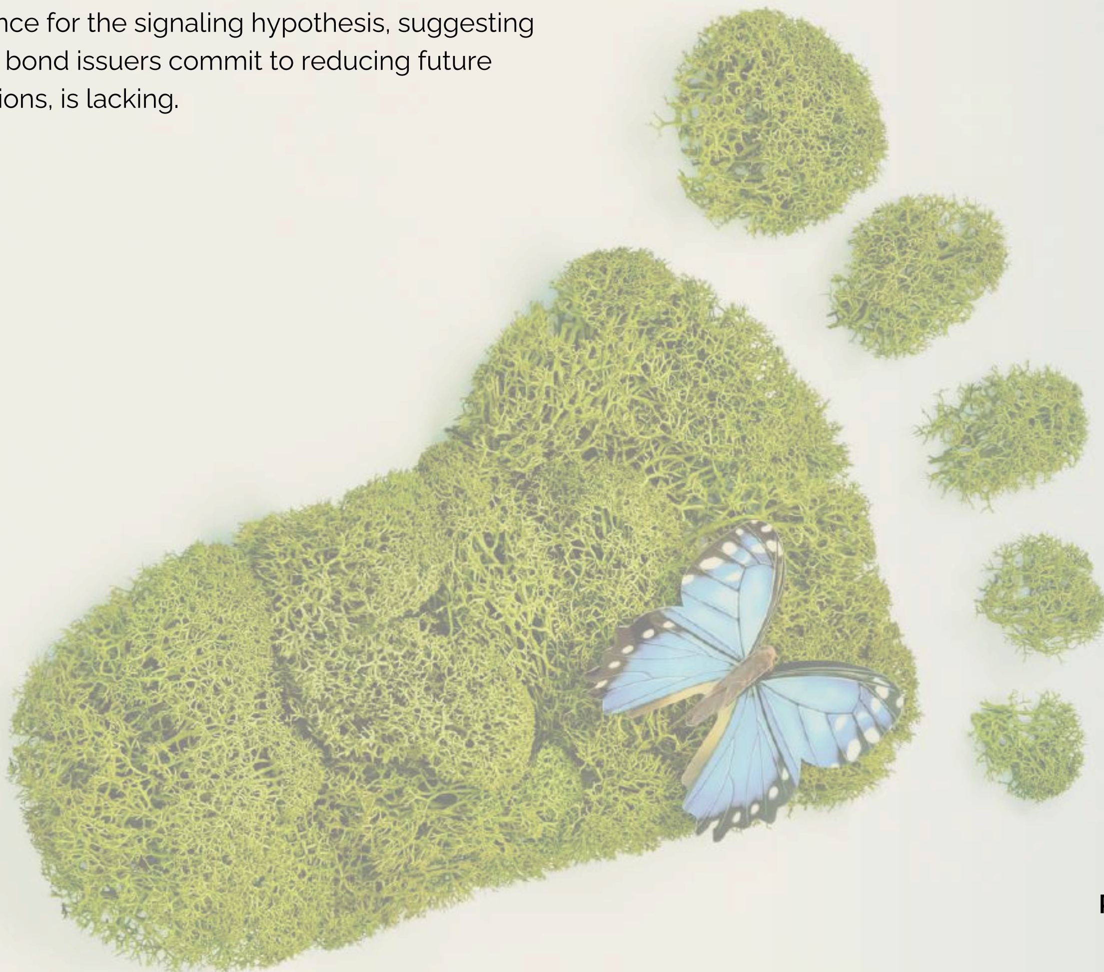
Moreover, the difference in illiquidity between green bonds and conventional bonds explains the differences in greenium across these two sets of bonds. The greenium has reduced with time in both stock market as well as in debt market.

In our additional analysis, we investigate the effect of issuer-level concentration in the green bonds market on cumulative abnormal stock returns (CARs). This concentration emerges because only certain firms that can restrict their use of proceeds are active in the market, leading to issuer-level concentration and frequent issuances by these firms. This trend of issuer-level clustering is seen worldwide, with companies such as Solar City (Tesla), Vasakronan AB, Credit Agricole Corporate & Investment, and Deutsche Bank AG leading green bond issuances in their respective countries. Our findings indicate higher CARs for these issuers, particularly among financial firms.

Next, we evaluate who issues green bonds and whether such bonds are associated with intended positive social and environmental outcomes. Firms with higher environmental risks, as indicated by various metrics, are more inclined to issue green bonds, potentially signaling intentions to mitigate their environmental impact. However, despite this initial intent, these environmental risks do not decrease even after three years, a trend observed even when analyzing voluntarily disclosed emissions data. Consequently, robust evidence for the signaling hypothesis, suggesting green bond issuers commit to reducing future emissions, is lacking.

In conclusion, our work adds to extant knowledge on the pricing of sustainable debt and the environmental implications of this asset class. We find support for the socially conscious investor hypothesis in that the greenium for the average sample is 5.7 basis points. However, consistent with the sustainability gatekeeper hypothesis, this lower yield is concentrated in green bonds issued by financial firms. Finally, the signaling hypothesis, related to firms issuing green bonds to indicate their commitment to cutting environmental exposure, is not borne out by our data.

By Jitendra Aswani, Post-Doctoral Associate, MIT Sloan, and Shiva Rajgopal, Columbia Business School.



Tesla voting challenges

Paul Lee
Redington

Investors at Tesla are faced with a series of challenging voting decisions at its June 13 AGM. That's not least because of what they have learned about the board and its relationship with founder and CEO Elon Musk through the January Delaware court decision that set aside Musk's multi-billion dollar pay scheme. While the board says it disagrees with that decision, it doesn't respond to the court's findings – which are damning about board independence and processes.

Some voting matters are literally a consequence of the court decision. The board proposes to reinstate the pay scheme. And while the board spends 40 pages of the Proxy Statement (published at the end of April) explaining why the proposed shift of corporate domicile from Delaware to Texas is not on the basis of a fit of pique over the Delaware decision, not all investors will be convinced – not least given Musk's polling of his X (ex-Twitter) followers on the domicile question almost immediately after the court decision and announcement that it would be taken forward following the 87% support shown in this poll.

The first resolutions on the AGM ballot are re-elections to the board. Because Tesla has a so-called classified board, not all directors are put up for election each year. The two candidates in 2024 are James Murdoch and Kimbal Musk (Elon's brother), neither of whom was directly involved in the discussions on the pay scheme. Nonetheless, the Delaware court specifically found that Murdoch was "beholden" to Musk given their close personal relationship – indeed, the court found that either the members of the board were "beholden" to Musk or "acted beholden" to him over the pay scheme. Kimbal is acknowledged not to be independent given his family relationship.

In this context, will shareholders vote in favour of these non-independent board members?

AGM resolution 3 is proposed redomicile from Delaware to Texas. Given how effective the Delaware court has just proven to be in protecting shareholder interests, it would be surprising if institutional investors welcomed a move to the unproven corporate law jurisdiction in Texas (as the Proxy states, "Texas's business courts were just created and will not start hearing cases until September 2024"). There is a further and crucial aspect of the Texas redomicile proposal, which may matter particularly to those shareholders who care about the existence of multiple share classes and the differential voting rights often associated with them. The intended Certificate of Formation of the new Texas Tesla includes powers for the board to issue new preferred shares (Article 4.1) and to give those preferred shares differential voting rights (Article 4.4(a)). This means that if the Texas redomicile goes ahead, this may be the last Tesla AGM where the success of the proposed resolutions is in any doubt.

Resolution 4 is the proposed reinstatement of the pay scheme. This was set aside by the court because the process for approving it was not fair, the outcome – essentially the quantum of the award – wasn't fair, and shareholders were misled about it in the company's communications. This meant that the 2018 endorsement of the scheme by independent shareholders could be set aside. The court was particularly damning about the process: "Put simply, neither the Compensation Committee nor the Board acted in the best interests of the Company when negotiating Musk's compensation plan. In fact, there is barely any evidence of negotiations at all."

The board never appears to have considered whether any additional pay for Musk was needed at all, given the incentive he already had as a 20% shareholder – notably Musk had said that he would stay at Tesla whether the pay scheme was approved or not. So the scheme – let alone a pay scheme 250 times larger than the average – simply wasn't necessary.

It seems even harder to think it is necessary now.

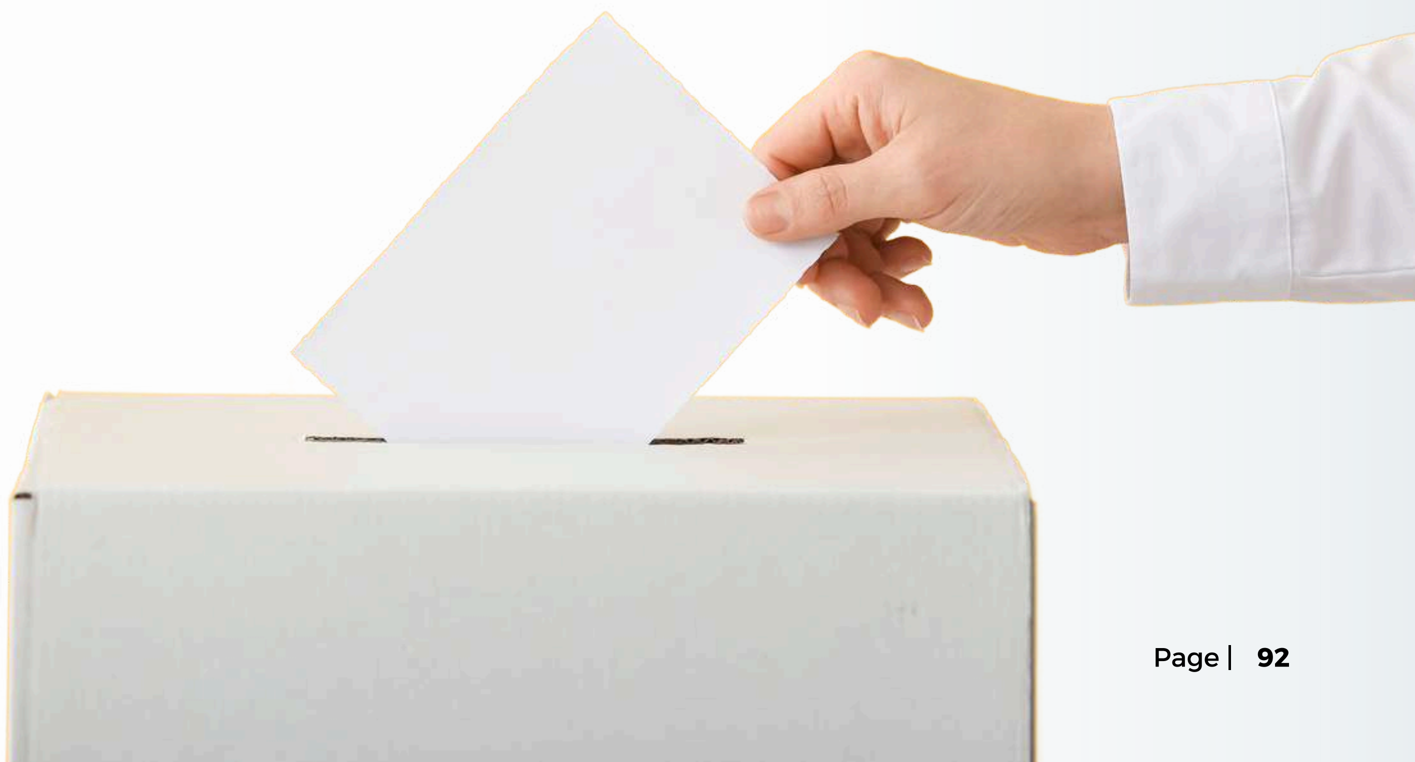
> "It seems to me impossible to understand how any investor motivated by fiduciary duties can vote in favour of the pay scheme's proposed resurrection."

The proposal now is to make an award to an individual for value that has already been created (in fact, some of that value has since dissipated given more recent share price falls). The proposal will create no new value for shareholders, rather it is simply to give money away for no benefit. That is not a fiduciary-led decision. While it is still called a 100%-performance linked award, there is no performance still to be delivered.

The clients to whom those fiduciary duties are owed may well seek particularly robust justifications from any fund manager that decides to vote in favour of making a gift –especially such a sizeable gift.

There are a number of shareholder resolutions, perhaps most notably one considering the Tesla policy on freedom of association and collective bargaining, and one regarding anti-harassment and discrimination efforts. The results on these will be interesting, but inevitably the greatest attention will be on the decisions regarding the Texas redomicile and the pay scheme. We'll see what investors choose.

By Paul Lee, Head of Stewardship & Sustainable Investment Strategy at Redington.



Tenure-based voting rights and the control-growth dilemma in family firms

Claudia Imperatore & Peter Pope
Bocconi University

Family-controlled firms are numerous and economically important in most economies. But, do they leave valuable investment opportunities on the table because of the so-called "control-growth" dilemma family owners face? If they do, economy-wide economic growth will be impaired. Do notions of good corporate governance contribute to this potential problem?

The control-growth dilemma arises because family owners might prefer to forego profitable investments if the alternative is losing family control when investment requires new external equity capital to be issued. This problem may prevent a family-controlled firm from going public. But if it is already publicly listed, a family-controlled firm may underinvest as a consequence. There is much accumulated evidence that this is the case.

A potential solution to the control-growth dilemma is the adoption of control-enhancing mechanisms (CEMs). Examples include multiple voting rights and tenure-based voting rights. CEMs can enable family owners and founders to raise external equity without relinquishing control. Yet, CEMs are controversial because they can enable insiders to impose their idiosyncratic vision without reference to outside shareholders' interests. They can also be used to expropriate outsiders since they weaken the connection between voting rights and cash flow rights thus deviating from the one share–one vote principle.

In a recent paper published in the Strategic Management Journal we take a forensic look at the potential role of a relatively new form of CEM– tenure voting rights (TVRs) – a mechanism that grants additional voting rights to longer-term shareholders. Several countries have introduced TVRs, or are considering their introduction, to attract IPOs of promising firms or to retain valuable firms that are controlled by families or founders.

The Italian government introduced a provision allowing the voluntary use of TVRs by Italian companies in 2014, justifying the decision with claims that TVRs will facilitate the sale of equity stakes in state-owned companies, discourage short-termism, reduce the risk of hostile takeovers, and, above all, incentivize family-controlled public companies to raise external capital for investment. Italian TVRs grant double voting rights to shareholders who have held the shares for at least two years. The adoption of tenure-based voting rights is not mandatory (as it is in France)—firms choose to adopt TVRs through a modification of corporate charter that must be approved by the AGM with a qualified majority (i.e. two thirds). Tenure-based voting rights are not a distinct class of shares. They are rights that any shareholder can obtain if they hold the shares for at least two years and they are lost if the underlying shares are sold or transferred.

The number of companies adopting TVRs in Italy increased from 8% in 2015 to over 23% in 2019.

Smaller, financially constrained companies with greater investment opportunities are more likely to adopt TVRs. Family firms are more likely to introduce TVRs when family control is fragile and new equity issuance is likely to lead to loss of control. We find:

1. Family-controlled firms maintain an above-average investment trajectory after TVR adoption.
2. Family firms with fragile control actually increase investment after TVR adoption.
3. Family firms issue more equity after they adopt TVRs, with an average increase equal to 3.7%
4. After they adopt TVRs, family firms subsequently increase dividend payout and have a three-fold increase in minority shareholder representation on the board of directors.

We interpret the last set of findings as evidence of commitment by family owners to outside shareholders that TVRs will used in their interests, and not for expropriation purposes. This increases the attractiveness of the firm to outside investors and enhances new equity issuance.

We also find that performance is higher after family firms adopt TVRs, consistent with family owners using TVRs to pursue investment opportunities that increase firm value, not to extract private control benefits.

> “TVR adoption can help resolve the control-growth dilemma in family-owned firms to the benefit of both insiders and outsiders."

Our results should be interesting for capital markets regulators. TVRs do not necessarily undermine good corporate governance or corporate performance.

By Paul Lee, Head of Stewardship & Sustainable Investment Strategy at Redington.

Banking's role in climate action: The case for exit policies

Boris Vallée
Harvard Business School

The battle against climate change is intensifying, and while individual actions like reducing flights and installing solar panels are commendable, they are not enough. We are in a race against time, and it's clear that large-scale institutional actions are needed to steer the world towards a sustainable future. Enter the banking sector, wielding a surprisingly powerful weapon against climate change: divestment policies.

In collaboration with my colleague Daniel Green, we have unearthed compelling evidence that these policies, enacted by major banking institutions, are not just symbolic gestures—they have a tangible impact on reducing carbon emissions. Coal firms subjected to strict divestment policies slash their borrowing by 25% compared to their peers. This financial squeeze forces these firms to shutter some of their operations, directly cutting CO_2 emissions. Until now, the fossil fuel divestment movement, which began in 2006, lacked concrete evidence of its efficacy. Our work demonstrates that when banks pull their funds from coal, the ripples are felt far and wide. The coal industry, heavily reliant on capital from a small set of banks, finds itself cornered with few alternative financing options. This financial stranglehold accelerates the decommissioning of coal-fired power plants, a crucial step towards lowering global emissions.

The implications are profound. If banks apply similar divestment pressures to other high-polluting industries like oil and gas, we could see a significant shift towards a low-carbon economy.

"Banks, through divestment policies, have a disproportionate influence on what gets financed and what doesn't."

By choosing to divest from fossil fuel, they directly contribute to the retirement of dirty energy sources, making way for cleaner alternatives.

The financial sector has a responsibility—and now, thanks to this research, we know it also has the power—to drive systemic change.

In conclusion, the evidence is solid: targeted divestment by banks works. It reduces carbon emissions and can play a significant role in the fight against climate change. Financial institutions must step up and embrace their role as agents of change. A growing share of investors are explicitly asking their portfolio companies, including banks, to tackle climate change. We need more banks to adopt strong divestment policies and expand them to other fossil fuel industries. The clock is ticking, and the planet cannot wait. It's time for the banking sector to leverage its immense power and help steer us towards a sustainable, net-zero future. However, it is also crucial to recognize that the magnitudes of the effects we find, while significant, are not large enough for private sector interventions alone to tackle climate change comprehensively.

Systemic changes driven by government policies, international agreements, and coordinated global efforts are indispensable. Banks and other financial institutions can indeed be powerful allies, but their actions must be part of a broader, concerted strategy to mitigate climate change effectively.

By Boris Vallée, Harvard Business School.

Pollution versus provision markets for the environment, and why it matters

Estelle Cantillon, Université libre de Bruxelles and CEPR
Aurélie Slechten, Lancaster University Management School

Carbon markets are playing an increasingly important role in climate action. They can take the form of "pollution markets," where a set of emitting activities in a given jurisdiction must cover their emissions by allowances, which they can buy in a market. The supply of allowances is restricted to meet the climate goals of the jurisdiction. Such emissions trading schemes cover around 18% of global greenhouse emissions today. One example is the EU emissions trading scheme (EU ETS), which is still the largest carbon emissions trading scheme by value.

Alternatively, carbon markets can take the form of voluntary "contribution markets," where credits from certified projects that reduce emissions or remove carbon are sold to companies or individuals who want to offset their emissions. Many such projects are nature-based, including planting trees and land restoration. Despite the numerous scandals, falling prices and thin liquidity that have plagued the voluntary carbon market, many observers and stakeholders are still bullish about its outlook.

One reason for this optimism is the recent policy developments in the UK and EU, where credits from the voluntary carbon market are being considered for compliance in regulated emissions trading schemes. The UK has indicated its intention to include carbon removals, both nature-based and technology-based, into its emissions trading scheme, the UK ETS.

And the EU has recently taken steps to create a new standard for certified carbon dioxide removals from eco-farming practices and industrial processes, with a view to potentially integrating industrial carbon removals in the EU ETS in the future. Integration is likely to boost demand for carbon credits and increase investment in these projects. By pooling more sources of emissions and carbon removals, it will likely also contribute to greater cost-effectiveness of climate action.

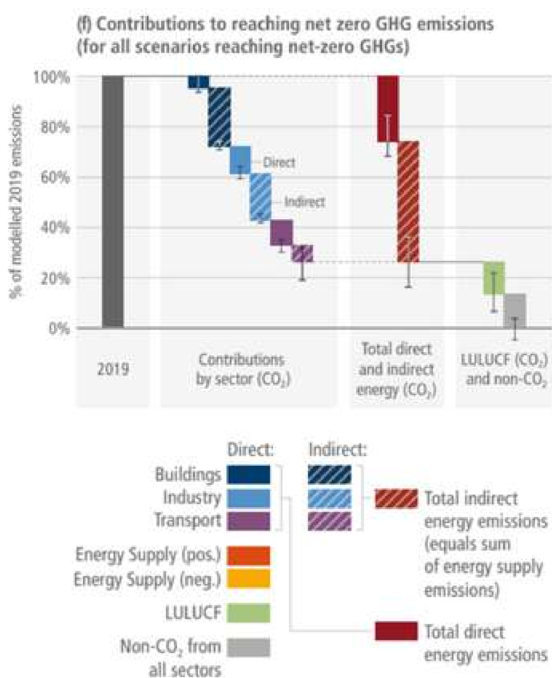
There are concerns, however. Opponents to integration point to the mounting evidence documenting that carbon emissions avoided or carbon removals by projects in the voluntary carbon markets are often over-estimated and impermanent. Moreover, many projects would have taken place even without funding, suggesting a lack of additionality. Integrating voluntary credits into regular emissions trading schemes, they argue, would threaten the integrity of emissions trading scheme and encourage greenwashing.

Pollution markets are not the same thing as provision markets

In a recent working paper, we contribute to this debate by arguing that emissions trading schemes and voluntary nature-based carbon markets should remain separate because they pursue different goals: emissions trading schemes aim to reduce emissions from human activities, while nature-based voluntary markets aim to encourage the provision of nature-based emissions carbon removal.

Existing Paris-aligned emissions trajectories treat these two goals separately and require both to be met simultaneously.

This point is best exemplified in the figure below, which comes from the latest report from the IPCC. The figure shows the contribution of different sectors and sources to reaching net-zero greenhouse gas emissions by 2050. The bulk of the effort will need to come from emissions reduction in the buildings, industry and transport sector (the black, blue and yellow bars in the second panel, and the red bars in the third panel). About 15% of the effort will additionally come from nature-based carbon removal solutions (the green bar). Voluntary carbon markets are designed to encourage contributions to this green bar. Making such contributions also count towards emissions reduction in the other sectors, as implied by market integration, would amount to double-counting. We need to reduce emissions and increase nature-based carbon removals.



Source: IPCC (2022), AR6, WGIII, Figure T.S. 10.

The figure shows shows the contribution of different sectors and sources to the emissions reductions from a 2019 baseline for reaching net zero GHG emissions. Bars denote the median emissions reductions for all pathways that reach net zero GHG emissions. The whiskers indicate the p5–p95 range. The contributions of the service sectors (transport, buildings, industry) are split into direct (demand-side) as well as indirect (supply-side) CO2 emissions reductions. (Direct emissions represent demand-side emissions due to the fuel use in the respective demand sector. Indirect emissions represent upstream emissions due to industrial processes and energy conversion, transmission and distribution.

Interestingly, the discussion at the EU level about market integration only concerns industrial carbon removals at this stage and thus avoids this double-counting trap. The UK proposal does not.

Should SBTi allow companies to use carbon credits to meet their decarbonization goals ?

These debates are not limited to emissions trading schemes. On April 9, 2024, the Board of Trustees of the Science-based Target Initiative (SBTi), the leading organization supporting companies in their definition of science-aligned decarbonization, created a furore when it opened the door for the use of carbon credits from the voluntary carbon market to meet scope 3 emissions reduction targets (scope 3 emissions are indirect emissions taking place in a company's value chain). Until then, the organization had staunchly refused to consider carbon credits, despite intense economic and diplomatic pressures. The SBTi is expected to release a draft for its revised Corporate Net-Zero Standard in the Fall.

Critics of the announcement referred to the extensive scientific evidence that most existing carbon credits are unreliable and that allowing for them would ruin SBTi's reputation as a serious actor of corporate decarbonization. These are of course valid concerns. Our point is that, additionally, nature-based carbon removals are not a substitute to emissions reduction.

A balanced approach is needed

In conclusion, while carbon markets, both pollution and voluntary, are essential tools in the fight against climate change, their integration must be handled with caution.

“Keeping emissions trading schemes and nature-based voluntary carbon markets separate ensures that we can simultaneously reduce emissions and increase nature-based carbon removals without compromising the integrity of either system."

The future of our climate depends on a balanced approach that recognizes and leverages the strengths of both market types.

By Estelle Cantillon, Université libre de Bruxelles and CEPR, and Aurélie Slechten, Lancaster University Management School.

How Big Tech coopts disruption–and what to do about it

Matthew Wansley, Cardozo School of Law
Mark Lemley, Stanford Law School

Our economy is dominated by five aging tech giants—Alphabet, Amazon, Apple, Meta, and Microsoft. Each of these firms was founded more than 20 years ago: Apple and Microsoft in the 1970s, Google and Amazon in the 1990s, and Facebook in 2004. Each of them grew by successfully commercializing a disruptive technology—personal computers (Apple), operating systems (Microsoft), online shopping (Amazon), search engines (Google), and social networks (Facebook). Each of them displaced the incumbents that came before them. But in the last 20 years, no company has commercialized a new technology in a way that threatens the tech giants. Why?

We start with the premise that the tech giants are smart. Their executive suites are filled with MBAs and engineers who realize the power of disruptive innovation, and they don't want to become the next IBM. And though they would not say so publicly, they realize that as a large incumbent, they will struggle to overcome the diseconomies of scale and develop disruptive innovations in-house. Imagine yourself as an executive at one of the tech giants tasked with preventing the company from being leapfrogged by disruptive competition. Despite the advantages of network effects created by your platform and the possibility of cloning startups' products, past experience has shown that your current monopoly status is no guarantee against future disruption. What would you do?

We think you would take four steps. First, you would learn as much as you can about which companies had the capability to develop disruptive innovations and try to steer them away from competing with you—perhaps by partnering with them, or perhaps by investing in them. Second, you would make sure that those companies could not access the critical resources they would need to transform their innovation into a disruptive product. Third, you would tell your government relations team to seek regulation that would build a competitive moat around your position and keep disruption out. Fourth, if one of the companies you were tracking nevertheless did start to develop a disruptive product, you would want to extract that innovation—and choke off the potential competition—in an acquisition.

That is precisely what the tech giants are doing.

> "They have built a powerful reconnaissance network covering emerging competitive threats by investing in startups as corporate VCs and by cultivating relationships with financial VCs."

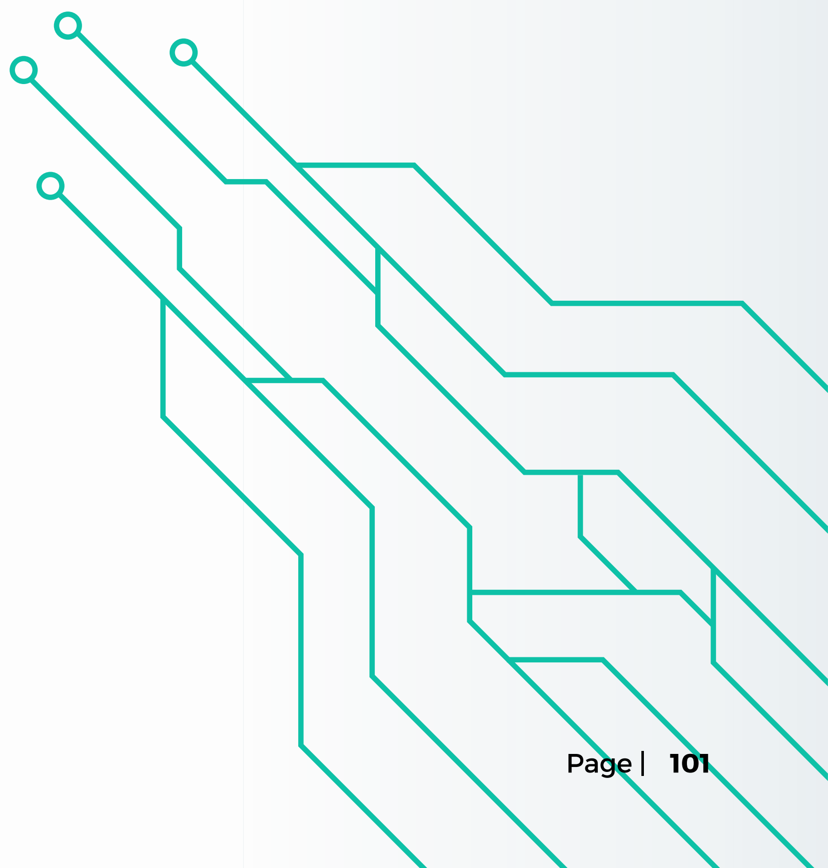
They have accumulated massive quantities of data that are essential for many software and AI innovations, and they dole out access to this data and to their networks selectively. They have asked legislators to regulate the tech industry—in a way that will buttress incumbents. And they have repeatedly bought potentially competitive startups in a way that has flown—until a few years ago—below the antitrust radar.

In our new paper, Coopting Disruption, we show how these seemingly different acts are part of a pattern tech companies and other incumbents use to maintain their dominance in the face of disruptive new innovations. And we document how three important new technologies—artificial intelligence (AI), virtual reality (VR), and automated driving—are being coopted. This is a critical legal issue right now. Indeed, after we wrote this paper, the Federal Trade Commission (FTC) announced that it would review incumbent investments into startups in one of the areas we identified—AI.

Coopting disruption is a challenging problem for the law. Cooption can look a great deal like competition and innovation. And partnering with an incumbent can sometimes offer real benefits to both startups and their customers. Nonetheless, we think incumbents coopting disruption is bad for both competition and innovation in the long run. At best, consumers receive incremental improvements to the tech giants' existing products. They miss out on the more fundamental innovations that an independent company would have developed—both innovations that threaten an incumbent's core business and those that a company locked into an existing mindset (and revenue stream) might simply not appreciate. And cooption cements incumbency, undermining the Schumpeterian competition—competition to become the next dominant firm—that drove innovation in the tech industry throughout the 20th century.

We suggest several ways the law can reduce the harm from coopting disruption. We can revitalize a century-old law that prevents people from serving as officers or directors of their competitors, extending it to prevent incumbents from controlling the direction of startups. We can make it illegal for incumbent monopolies to discriminate in the access they provide to their data or programs based on whether the company is a competitive threat. We can ensure incumbents cannot use regulation as a mechanism to undercut competition from startups. And we should make it presumptively illegal for incumbent monopolies to acquire startups developing innovations that might prove disruptive.

By Mark A. Lemley, Stanford Law School, and Matthew Wansley, Cardozo School of Law.



Acting in concert: An observational tale

Javier García de Enterría, Centro Universitario de Estudios Financieros
Matteo Gargantini, University of Genoa

Imagine a grand European orchestra, each musician a different country, each instrument a distinct legal system. The conductor, tasked with harmonizing these disparate elements, is the Takeover Bids Directive. Our story unfolds over two decades of this symphony, revealing how the concept of "acting in concert" has evolved and impacted the mandatory bid regime in the European Union.

Long ago, in the realm of corporate takeovers, the concept of "acting in concert" was born from a simple yet profound principle: to prevent the circumvention of mandatory bid rules. The image one would think of is one where a group of savvy investors, sneaking their way through a series of clandestine meetings, acquiring shares piecemeal to avoid triggering a mandatory takeover bid. The Takeover Bids Directive, with its broad definition, aimed to catch these crafty manoeuvres by treating concerted actions as equivalent to individual share purchases. The UK Takeover Panel, where this system originated, famously quipped that concerted action could be as subtle as "a nod or a wink."

But as the directive attempted to conduct its symphony, each member state interpreted the score differently. Some countries, let's call them the purists, stuck closely to the directive's original script. For them, the mandatory bid rule only applied when shares were acquired, not just when shareholders decided to join forces and coordinate their votes. No acquisition, no mandatory bid – simple and straightforward.

Then there were the innovators. These countries expanded the role of concerted action beyond mere share acquisitions.

In their interpretation, if a group of shareholders came together to pursue a common, lasting policy towards the company's management, a mandatory bid was triggered, acquisition or not. This approach aimed to reinforce the anti-elusive function of concerted action by pre-emptively addressing potential circumventions.

You might be wondering, what's the harm in this expanded view? Well, here's where the tale takes a turn into the murky waters of legal uncertainty. Linking the mandatory bid rule to concerted action alone, without any share acquisition, casts a wide net. It risks ensnaring ordinary forms of shareholder cooperation, particularly those involving the board of directors, under the umbrella of concerted action. The result? Shareholders might find themselves unwittingly triggering a mandatory bid simply by coordinating their votes on governance matters, even when they do not buy a share altogether.

Enter ESMA, the European Securities and Markets Authority, attempting to calm the stormy seas. At the behest of the European Commission, ESMA drafted a "white list" of shareholder cooperation forms that should not count as concerted action. Think of it as a guidebook for musicians to avoid hitting the wrong notes. But, as with any guidebook, its impact is limited. It clarifies some uncontroversial scenarios but leaves out thornier issues, like the joint filing of board candidate slates.

Where does this leave us? In a paradoxical situation where the very rules meant to protect investors and foster market integration end up creating confusion and discouraging cross-border investments. It's a classic case of the road to hell being paved with good intentions.

In conclusion, our tale of "acting in concert" is a cautionary one.

“While the concept was designed to prevent the circumvention of takeover rules, its expansion in many national legal systems now threatens to undermine ordinary shareholder cooperation."

Without the possibility of European harmonization on the horizon, we must rely on the restraint and reasonableness of national legislators and supervisory authorities to apply this concept judiciously.

The concept of acting in concert is one of the building blocks of the European approach towards takeover bids and plays a crucial role in the mandatory bid regime. In our paper, we reassess the functions of concerted action in the EU legal framework and in its national implementations twenty years after the Takeover Bid Directive. What emerges confirms that the low intensity of harmonisation in EU takeover law paves the way to diverse legal treatments of similar situations, to the detriment of cross-border investments and market integration.

By Javier García de Enterría, Centro Universitario de Estudios Financieros (CUNEF), and Matteo Gargantini, University of Genoa.

Unlocking trillions of climate finance at COP29

Alissa Kleinnijenhuis, Cornell SC Johnson College of Business
Patrick Bolton, Imperial College London
Jeromin Zettlemeyer, Bruegel

Despite the urgency in reducing greenhouse gas emissions, the global transition to net-zero has barely begun in economically advanced countries. Moreover, emissions in emerging and developing market economies (EMDEs) are growing rapidly. So that global annual emissions are at an all-time high. The remaining carbon budget, if we are to keep the increase in temperatures below 1.5-degrees above pre-industrial levels, will be exhausted within five years at the current rate of annual emissions.

Why do we care about the 1.5 degrees limit? Because any 0.1 degree increase above 1.5 degrees significantly increases the risk of crossing irreversible tipping points, plunging the planet into a hothouse climate.

Any timely transition to net zero must include "climate finance at scale" to support a green development path of emerging and developing economies. While domestic climate packages, such as the EU's Green Deal and the US Inflation Reduction Act have incentivized renewable investments in advanced economies, capital flows into renewables in emerging and developing economies have been close to non-existent (IEA-IFC 2023). This is despite the exponential decline of investment costs in renewable technologies. As many analysts have highlighted, a critical hurdle is the prohibitively high cost of capital in EMDEs. Another hurdle is the fierce lobbying by owners of fossil fuels and communities dependent upon them against early retirement of fossil fuels.

A 2024 paper, "The economic case for climate finance at scale," proposes one way forward: supporting climate finance at scale to EMDEs by tying renewable investments to the phase out of coal.

> "The benefits from avoided emissions deliver large net economic benefits to advanced economies, even if these countries pay the lion share of the fossil fuel-to-renewable transition in EMDEs."

With a share of one quarter of public funds and three quarters of private funds, the total fiscal cost of paying for all of the coal-to-renewable transition in EMDEs (excl. China) for advanced economies would be around $1.3tn from 2024 to 2030. This would be less than 0.3% of the annual GDP of a coalition including the US, EU, Canada, the UK, and Japan. It would deliver a net economic return exceeding 150%, even on the conservative assumption that the global social cost of carbon is $80 per ton of carbon dioxide.

It is not sufficient for advanced countries to reach net zero in time. The planet would still be headed for climate disaster if EMDEs are not on board.

We all know that climate finance is far from having reached the necessary scale. There has been too much foot dragging for far too long. An important reason is that the case for climate finance at scale has been wrongly argued. It has been exclusively framed in terms of fairness (a just energy transition), overlooking the immense economic benefits to the world, and therefore also to advanced economies, from replacing fossil fuels with renewable energy (obtained by tying renewable energy development to the phasing out of fossil fuels). Paying a polluter, EMDEs, to stop polluting is not only just, but, as we show, also in the economic interest of the West.

With less than five months to go before the COP29 Climate Summit in November, there is still no agreement in sight on how to bridge the near-one trillion-dollar gap between what EMDEs say is needed and the roughly $100bn annual climate finance currently offered by advanced countries. The Azerbaijan Presidency of the COP29 confirmed that brokering a global agreement on a new annual international climate finance goal is its "top negotiating priority" for the COP29 climate summit.

Moral obligations are not a strong enough impetus for action. As William Nordhaus notes, "Global warming is a trillion-dollar problem requiring a trillion-dollar solution, and that demands a (far more) robust incentive structure". Climate finance at scale can provide such a structure, benefiting key stakeholders: (1) countries, (2) fossil fuel communities, and (3) investors.

Countries

Climate finance at scale for EMDEs is not charity, but hard-nosed economic self-interest. Paying the polluter to stop polluting, by offering climate finance that covers both (i) compensation for the stranded asset value of fossil fuels and their communities and (ii) finance the catalytic part of the investment costs in replacement renewables is sound economic logic, as it makes Western countries (1), as well as recipient countries, economically better off.

Fossil fuel communities

Compensating for early fossil fuel closure (which can, for instance, be operationalized via auctions) provides financial incentives for the fossil fuel industry to support the green transition, ensuring that fossil fuel owners and workers are at least as well off as they would be under business as usual. It is also an economic bargain, as economic benefits exceed the compensation cost by several magnitudes. Compensation is preferable over carbon credits to close fossil fuels early, as the latter will at best be additional (offsetting a positive emission), whereas rapid absolute emission reductions are needed to stay within the carbon budget.

Investors

Deploying government climate finance funds to attract private capital through a blended finance approach minimizes the burden on public coffers. This strategy means that investors do not need to be impact or ESG investors to finance the EMDE transition. By de-risking investments against, among others, political, foreign exchange, and return risks, public climate finance raises private risk-adjusted returns above the hurdle rate, making renewable investments in EMDEs by investors simply good business.

In today's climate of ESG backlash, where ESG investors face scrutiny over their fiduciary duty to maximize shareholder returns, this approach is crucial. Multilateral development banks (MDBs) would collaborate with EMDE countries to prepare both the fossil fuel phase-out and renewable phase-in pipelines. This preparation would involve compensating for phase-out and de-risking phase-in investments, allowing capital market investors to invest in large-ticket size, bankable renewable projects. This collaboration is crucial to ensure that the transition to a green economy is both feasible and economically beneficial for all parties involved. As part of this collaboration, MDBs must evolve from a project-based finance model to facilitating a system-wide transition in these countries.

For company directors, this means integrating climate financing and risks into their overall risk management frameworks and strategic planning. Boards should ensure that their investments and corporate goals are aligned with sustainability objectives. Enhanced transparency and disclosure of climate-related risks and opportunities are crucial, with companies expected to report comprehensively on their climate impact and mitigation strategies. Active engagement with stakeholders, including investors, regulators, and the community, is vital to build trust and accountability on climate issues

Investors, on the other hand, play a pivotal role in driving the transition to a green economy. They should demand public-private partnerships for influencing (or setting) the cost of capital for renewable investments in EDMEs, where costs of capital are punitive, and call on advanced countries to scale public climate finance for EMDEs (via MBDs) to make this possible via system-wide blended finance. They should also demand climate accountability, support sustainable investments, and advocate for policy changes that foster a robust framework for large-scale climate finance. By prioritizing investments in renewable energy and supporting policy advocacy, investors can help create a more sustainable and stable global economy.

"The economic case for climate finance at scale" maps a way forward grounded in basic economic logic. Tying the benefits from avoided emissions to the development costs of renewables is key. Equally important is compensating affected owners and workers for the early termination of fossil-fuel production (by compensating for the stranded asset value and temporary loss of wages and retraining cost), which should motivate them to accept the green transition. Public finance must also crowd in private capital via system-wide blended finance, which would reduce the burden on taxpayers.

As the world approaches the critical juncture of COP29, the imperative for climate finance at scale has never been clearer.

It is a matter of strategic economic necessity that promises substantial returns for advanced economies while averting global climate catastrophe. Unlocking trillions in climate finance is achievable through a multi-faceted approach. Blended finance models can reduce the overall fiscal burden on taxpayers. Tying renewable investments to the phase-out of fossil fuels ensures that the transition to a green economy is economically viable. Compensation mechanisms for affected owners and workers can facilitate the acceptance of this transition. Additionally, multilateral collaboration involving development banks, capital markets, and renewable energy developers is essential to create large pools of bankable projects. By embracing this path, we can unlock trillions in climate finance, foster global stability, and secure a sustainable future for generations to come.

By Alissa M. Kleinnijenhuis, Cornell University and Imperial College London, Patrick Bolton, Imperial College London, and Jeromin Zettlemeyer, Bruegel.

Carbon offsets: Decarbonization or transition-washing?

Sehoon Kim, Tao Li, and Yanbin Wu
University of Florida

As the world is racing to transition to carbon neutrality, voluntary carbon markets (VCMs) have emerged as a potential tool to support decarbonization efforts. By tapping VCMs, corporations can offset their emissions by purchasing and retiring carbon offset credits issued by third-party project developers.

However, there is widespread skepticism regarding the authenticity of climate claims made by some offset projects and their end users. On May 28, 2024, the U.S. Treasury, Energy, and Agriculture Departments jointly announced a policy statement featuring a template of rules to govern VCMs, underscoring the importance of understanding the implications of the lack of transparency and authenticity in VCMs for the incentives of corporations that participate in these markets. There is a big gap in our understanding of these issues.

Our paper, Carbon Offsets: Decarbonization or Transition-Washing?, aims to fill this gap by providing the first systematic evidence on the landscape of carbon offset projects and the determinants of offset usage by publicly listed firms around the world. We use a rich hand-collected dataset that includes information about which entities retire how many carbon credits to offset their greenhouse gas emissions in a given year, and which offset projects those credits originate from.

Our analysis covers a variety of offset projects, such as those developing renewable energy, installing energy-efficient housing and appliances, and preserving forests and grassland. These projects are geographically dispersed, with the majority of them based in Asia, Africa, and the Americas. About half of all projects issue carbon credits that are purchased and retired by listed firms around the world. Consistent with offsets being a transition tool, larger firms with higher institutional ownership and net-zero commitments are more likely to use offsets to reduce their carbon footprints.

We formulate the incentives of firms to use carbon offsets with two non-mutually exclusive economic hypotheses. The first is an "outsourcing hypothesis:"

> "Firms with smaller carbon footprints use offsets more intensively to reduce their carbon emissions indirectly due to lower marginal costs associated with offsetting compared to reducing emissions directly through abatement investments and innovations, while heavy-emission firms are more likely to reduce their emissions in-house."

The second is a "certification hypothesis," where firms care about their credentials with outside stakeholders and use offsets strategically to signal their commitment to reducing their carbon footprints.

Supporting the outsourcing hypothesis, we find that low-emission industries, such as services and financials, are highly intensive in their use of offsets relative to their modest emissions, almost offsetting their direct emissions one-for-one. In contrast, the aggregate share of direct emissions that are offset using carbon credits is close to zero in high-emission industries such as oil and gas, utilities, or transportation. Also consistent with the certification hypothesis, we find that relatively few offset projects are externally verified as having high quality and that most offset credits used by firms are quite cheap (more than 70% of retired offsets are priced below $4 per tonne).

To make causal inferences, we exploit an exogenous change in companies' ESG ratings – and their incentives to boost these ratings – triggered by a major rating methodology change at a leading ESG rating agency, Sustainalytics. At the end of 2018, Sustainalytics implemented a new methodology for their ESG scores that created an average within-industry ESG rank reshuffle of 20 percentiles. Consistent with the strategic role of carbon offsets, firms offset more of their emissions using carbon credits after experiencing an exogenous ESG rating downgrade. In particular, light emitters in industries with narrow cross-peer emission gaps become more likely to behave this way, whereas heavy-emission firms in large-gap industries do not. Moreover, firms that strategically increase the use of offsets do so by retiring credits from low-quality offset projects, which command lower prices and therefore provide a cost-effective way of "transition-washing."

These findings do not support proponents who argue that carbon offsets can be effective at facilitating net-zero transitions by heavy-emission firms.

Although we find some evidence that heavy-emission firms can be incentivized to choose high-quality offsets over low-quality ones, we find no evidence that these firms would use such "good" offsets in large enough quantities to meaningfully reduce their net emissions.

Our study has important implications for understanding the current state of VCMs and designing future policies and regulations. Our findings suggest that VCMs are currently flooded with cheap, low-quality offsets due to the lack of integrity guidelines and regulations, which likely discourages the use of high-quality offsets by firms motivated to take serious steps to reduce their emissions. This highlights the importance of commonly adoptable rules and regulations to ensure the transparency and authenticity of offset projects. Much future research is needed to help design and regulate the carbon offset market so that it facilitates a healthy transition to a carbon-neutral economy.

By Sehoon Kim, Tao Li, and Yanbin Wu, University of Florida.

In search of a philosophy on executive compensation and ESG

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As researchers at ESSEC Business School's European Centre for Law and Economics (CEDE), we have been closely studying the evolving landscape of executive compensation. What we observe is a fascinating intersection between corporate strategy, shareholder interests, and the broader societal demands encapsulated by the growing emphasis on environmental, social, and governance (ESG) factors. Our recent studies "ESG Criteria & Executive Directors' compensation" and "Some Recommendations on ESG Criteria to Prioritize in the Executive Directors' Compensation Policy" of the CAC 40, France's leading public companies, sheds light on how these dynamics are playing out in the realm of executive pay. The results are both encouraging and sobering.

The design of executive compensation has long been a balancing act—a high-stakes puzzle where companies seek to align the incentives of their leaders with the interests of shareholders, employees, and now, the public at large. Over the years, this puzzle has grown increasingly complex. Stock options, performance shares, and now ESG criteria are all pieces that must fit together to drive both financial and non-financial performance.

> "The integration of ESG into executive pay remains uneven and often lacks the rigor needed to drive meaningful corporate change."

To appreciate the significance of current trends, it is useful to take a step back and consider how executive pay has evolved. In the past, CEOs were typically compensated with straightforward salaries and bonuses, based primarily on the financial success of the company. However, as corporations grew in size and influence, and as shareholders demanded greater accountability, the design of executive compensation began to change. Performance-based pay became the norm, with stock options emerging as a key tool to align executives' interests with shareholder value.

The logic was simple: if the stock price rises, everyone benefits. But this approach had unintended consequences, leading some executives to focus on short-term stock performance at the expense of long-term strategy. This realization prompted the introduction of long-term incentives such as restricted stock and performance shares, aimed at encouraging a more sustainable focus.

In recent years, ESG criteria have been added to the mix, reflecting the growing awareness that companies must consider their impact on the environment and, society, as well as their governance structures. The European Corporate Sustainability Reporting Directive (CSRD) has aimed to increase transparency and accountability by requiring companies to disclose their ESG impacts.In theory, linking executive pay to ESG performance should motivate leaders to take these issues seriously. But as our study shows, the reality is more complex.

Our analysis of the CAC 40 reveals that, as of 2022, all companies in this index have incorporated ESG criteria into their short-term variable compensation plans. This is a significant milestone, reflecting a widespread recognition of the importance of ESG factors. However, the actual influence of these criteria remains limited. On average, ESG components account for just 19.6% of short-term variable compensation and 19.8% of long-term incentives. In other words, while ESG is part of the conversation, it is not the dominant factor in executive pay in France - but not a trivial portion either. Often, ESG targets are included to embellish compensation packages rather than to drive substantial non-financial performance. This approach risks reducing the credibility of ESG initiatives, as executives might meet only the minimum requirements to secure bonuses rather than strive for genuine sustainable improvements. One way to make ESG factors more credible is as a negative incentive in the form of a malus clause— which could use salient ESG shortcomings to withhold incentive awards to company managers.

Moreover, there is a clear imbalance in the types of ESG criteria that companies prioritize. Environmental factors, particularly those related to carbon emissions, receive the most attention, while social and governance criteria are often secondary. This trend is consistent with what we have observed in other studies and markets: companies are more comfortable measuring and managing environmental performance, where the metrics are clearer and the regulatory pressures stronger. Social and governance factors, which are harder to quantify and sometimes seen as less urgent, receive less emphasis.

Even more telling is the lack of transparency and consistency in how these ESG criteria are applied. Only 23 of the 40 companies in the CAC 40 provide a detailed breakdown of ESG criteria in their short-term compensation plans, and just 16 do so for long-term incentives. This lack of clarity raises questions about the true impact of ESG-linked pay on corporate behaviour.

Where does this leave us? The future of executive pay will likely involve continued experimentation with compensation structures that seek to balance financial and non-financial goals. As ESG metrics become more standardized and reliable, we may see these criteria play a larger role in determining executive rewards. However, for now, financial performance remains the primary driver of executive pay.

For ESG-linked compensation to have a transformative impact, it must be given greater weight and treated with the same rigor as traditional financial metrics. This requires not only clearer and more consistent application of ESG criteria but also a cultural shift within companies to prioritize long-term sustainability over short-term gains.

We advocate for a set of principles to guide remuneration committees in selecting, assessing, and measuring bespoke ESG criteria. In French fashion, we propose moving beyond compliance to a philosophy where ESG performance is seen as integral to overall business success. The integration of ESG criteria into executive pay is a positive step, but much work remains to be done to ensure that these metrics drive meaningful change in corporate behaviour.

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