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Members' Debrief

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By George Dallas

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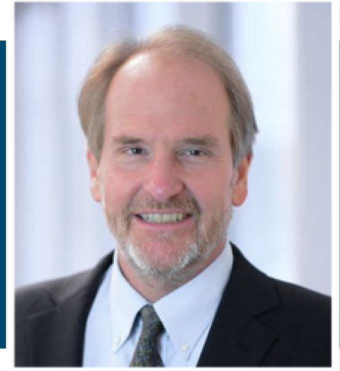
About the ECGI Members' Debrief



Greetings,

I'm George Dallas and I am a longstanding governance professional and one of the original practitioner members of ECGI since its launch in 2002. ECGI has been useful throughout my professional career in credit ratings at Standard & Poor's, asset management at F&C Investments and as a policy director of the global investor body, the International Corporate Governance Network. Though not an academic, I have authored dozens of professional publications, including two books, and have taught an MSc class in corporate governance at Bayes Business School.

I now divide my professional time between supporting ECGI with its content strategy and working in executive education in governance and stewardship at ICGN and the Cambridge Institute for Sustainable Leadership. ECGI is an important and cherished part of this mix. Throughout my professional journey, academic research in governance has always been an important resource and source of guidance for me— to keep track with current thinking, to support my conceptual understanding of governance issues and to have a better sense of what we do and do not know about governance empirically. As a practitioner I have found ECGI to serve as a high quality, convenient and efficient filter to focus on the leading governance research that is coming out.

The ECGI Members' Debrief

In February 2024, we introduced a resource exclusively for ECGI members called The ECGI Members' Debrief, this monthly newsletter was created to provide a timely, digestible overview of the latest developments in corporate governance and ECGI content. Each edition brings to your attention the past month's working papers from the ECGI Research Members, an update on key market and regulatory developments, along with a focus on three recent working papers that catch my eye— and which I approach critically as a practitioner discussant.

While the monthly newsletter is a benefit of ECGI membership, we now offer this bi-annual compilation to all of the members of our community. It includes a review of selected research papers that featured in the newsletters, leaving out the monthly round-up of news and events, which are more time-specific. For non-members who enjoy the content of this report, we encourage you to consider ECGI membership (very affordable, great value!) so that you can receive the full report every month, along with the update on key market and regulatory developments.

We hope you enjoy the discussions!

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Best wishes,
George Dallas
Head of Content
Editor of The ECGI Members' Debrief

Banking Regulation

Paper: **The Parade of the Bankers' New Clothes Continues: 44 Flawed Claims Debunked**
Authors: **Anat Admati and Martin Hellwig**
ECGI Working paper #951/2024

The sustainability debate has focused investors and companies in recent years on coming to grips with systemic risks relating to issues such as climate change, biodiversity and income inequality. In this context, the more arcane (and arguably less 'sexy') systemic threat of financial system stability runs the risk of being either ignored or simply taken for granted. In their paper 'The Parade of the Bankers' New Clothes Continues: 44 Flawed Claims Debunked', Anat Admati and Martin Hellwig challenge this complacency. Indeed, the 2023 failures of Credit Suisse and Silicon Valley Bank make it all too clear that the banking system remains full of risk, and Admati and Hellwig provide a list of 44 'flawed' claims about banking (up from 23 in their 2013 book) that they believe result in poor banking regulation and heightened risks to the financial system. This is a sober assessment of the global banking system, its social influence, the scope for 'wilful' blindness and the potential disconnect between private costs to bankers and social costs to society. It is important to keep these systemic concerns front of mind.

Read the paper: https://www.ecgi.global/publications/working-papers/the-parade-of-the-bankers-new-clothes-continues-44-flawed-claims

Comparative corporate governance

Paper: **The Global South in Comparative Corporate Governance**
Author: **Mariana Pargendler**
ECGI Working paper #751/2024

Geopolitics is another systemic issue that (at least in recent years) arguably has been upstaged by climate risks and the growing focus on sustainability in corporate governance. The Brazilian legal scholar Mariana Pargendler addresses this possible imbalance by bringing large emerging economies into focus in her working paper *'The Global South in Comparative Corporate Governance'*. Pargendler's attention is aimed at the 'BICS' — Brazil, India, China and South Africa. By ditching Russia, Pargendler has a somewhat less heterogeneous portmanteau (and less political baggage) to deal with than the clumsier 'BRICS' or 'BRICS+'. Pargendler argues that corporate governance systems in the Global South have often been misunderstood through crude or simplistic, if not pejorative, comparisons with the more developed Global North, and that the Global South needs to be interpreted in light of these countries' own distinct social and

development challenges. She observes that where there exist significant social inequalities or externalities, and a limited state capacity to address societal challenges, there is scope for corporations to help plug this regulatory gap. She provides practical examples of this in Brazil, India and South Africa as ‘heterodox’ forms of innovation and stakeholder protection, and suggests that the growing interest in sustainability and stakeholders in the Global North can be interpreted as a ‘reverse convergence’, reflecting social wisdoms from the Global South. Pargendler concludes by saying that the growing economic importance and unique dynamics of the Global South call for its ‘more forceful inclusion’ in the study of comparative corporate governance. Hear hear!

Read the paper: https://www.ecgi.global/publications/working-papers/the-global-south-in-comparative-corporate-governance

Common ownership

Paper: **A Tale of Two Networks: Common Ownership and Product Market Rivalry**
Authors: **Florian Ederer and Bruno Pellegrino**
ECGI Working paper #953/2024

I’m not sure I’ve met an institutional investor who buys into the logic of how common ownership of companies, particularly by the large passive asset managers, reduces the incentives of investee firms to compete with one another. That is not how investors work or think (including the large passive funds), and it is a concern for investors if proposed public policy ‘solutions’ to the potential non-problem of common ownership result in marginalising basic shareholder rights and protections. Having said that, scholars continue to explore this issue and Florian Ederer and Bruno Pellegrino have added a substantial analysis to this mix in their working paper 'A Tale of Two Networks: Common Ownership and Product Market Rivalry'. Their headline conclusion is that the anticompetitive impact of common ownership can be a deadweight loss (inefficiency in resource allocation) that can range up to 21% in terms of social welfare, reflecting its anticompetitive impact on consumers. That does give pause for thought. Yet it should be noted that this paper ‘takes as a given that common ownership does affect competitive behaviour,’ and its main ambition is to measure its scale. The practitioner in me remains frustrated not to explore the ‘given’ of exactly how common ownership reduces competition in practice, whether explicitly or implicitly. Or is there something else going on? Without greater clarity on that point, many investors (and possibly companies too) may remain sceptical of the concerns related to common ownership. But it is important for practitioners to monitor the common ownership debate, and the Ederer/Pellegrino paper is a serious addition to this discussion.

Read the paper: https://www.ecgi.global/publications/working-papers/a-tale-of-two-networks-common-ownership-and-product-market-rivalry

Stewardship and shareholder voting

Paper: **Leading by Example: Can One Universal Shareholder’s Voting Pre-Disclosure Influence Voting Outcomes?**
Authors: **Ruediger Fahlenbrach, Nicolas Rudolph and Alexis Wegerich**
ECGI Working paper #758/2024

In relatively young areas of professional activity, such as investor stewardship, practitioners often lack an evidence trail to guide them in terms of applying principles in action most effectively. That is why it is great to get new nuggets of insight, such as the working paper 'Leading by Example: Can One Universal Shareholder’s Voting Pre-Disclosure Influence Voting Outcomes'— a welcome practitioner/academic collaboration between Lausanne academics and Norges Bank Investment Management (NBIM), the large sovereign wealth fund. Using NBIM 2021 data, the paper assesses the impact/influence of NBIM disclosing its voting decisions prior to company shareholder meetings. They conclude that ‘pre-disclosures’ of votes against company resolutions had an average increase of 2.7% against votes by other voting shareholders. That sort of impact will be noticed by companies and may contribute to an enhanced investor ‘signal’ and impetus for change. Not every shareholder may carry the clout and influence of NBIM, however the authors have identified a potentially promising stewardship tactic that other large shareholders may wish to consider enhancing the practical effectiveness and impact of their stewardship.

Read the paper: https://www.ecgi.global/publications/working-papers/leading-by-example-can-one-universal-shareholders-voting-pre-disclosure

Corporate governance and technology

Paper: **Corporate Governance Meets Data and Technology**
Authors: **Wei Jiang and Tao Li**
ECGI Working paper #970/2024

The potential for technology to disrupt—both positively and negatively—stretches across many fields of endeavour, including corporate governance. There is a lot going on in this space and, in part reflecting the complexity of technological change, it can be a challenge keeping track of what is going on. Wei Jiang and Tao Li help us out here in their interesting and timely paper 'Corporate Governance Meets Data and Technology'. The authors guide us through a wide range of technology influences on corporate governance, and help us organise our thinking by grouping this into the three main buckets of: 1) Big Data/Information Asymmetry; 2) Blockchain; and 3) Smart Contracts and DAOs (Decentralised Autonomous Organisations). In this comprehensive analysis the authors are careful to explore how technology presents positive and negative

potential, even if unwittingly. They observe, for example, that the SEC's innovative EDGAR system was meant to address the problem of information asymmetry by facilitating public access to data. Yet the huge volume of incremental data that EDGAR has produced is such that more sophisticated users of 'big data' will have a clear advantage over those without such capabilities: thus creating a new form of information asymmetry. It was also useful for the paper to identify the major sources of 'alternative data', including web data, satellite imagery, sensor data, credit card data, social media, and sentiment tracking.

The authors are possibly more positive about the potential for blockchain as a distributed digital ledger technology in addressing inefficiencies in the seemingly eternally leaky plumbing of the voting system, including the problem of overvoting. I am particularly tantalised by the suggestion that a blockchain technology could effectively implement a sunset of a dual class share structure based on an algorithm of firm age and performance. (Seeing is believing...). At the same time the authors observe that blockchain also has its dark side, and is subject to a 'governance void' as well as misuse, misreporting and misappropriation.

Smart contracts and DAOs which employ blockchain technologies are also explored in the paper, demonstrating their complexities as well as their potential merits and risks. The authors conclude that technologies have 'the potential to solve problems, enhance efficiency, and level the playing field in corporate governance; however, they also give rise to new inequalities and governance dilemmas.' This is a balanced assessment, but the warning flags are clear.

Read the paper: https://www.ecgi.global/publications/working-papers/corporate-governance-meets-data-and-technology

Artificial Intelligence

Paper: **Ownership and Trust A corporate law framework for board decision-making in the age of AI**
Author: **Katja Langenbucher**
ECGI Working paper #953/2024

Sticking to the theme of technology, and the potential abuse thereof, Katja Langenbucher focuses on Artificial Intelligence (AI) and its role in the board room in her paper 'Ownership and Trust - A corporate law framework for board decision-making in the age of AI'. She poses the interesting question as to whether AI augmented decision-making at the board level can constitute an 'abdication of authority' and provides a framework for a judicial review of board decisions that have been augmented by AI. From her point of departure Langenbucher posits that it is uncontested that machines can sometimes surpass human performance in some decision making, and labels AI as a powerful 'prediction machine' and an 'induction engine', driven by powerful probabilistic estimations inferred from existing data. But therein lies the rub. While powerful, there is no assurance that AI will always be accurate — whether it relates to the quality or timeliness of the data involved or biased inferences that prove to have no substance. So what

happens when AI goes wrong, and who is accountable for that?

In references both to German and Delaware law, Langenbucher argues that corporate law has a higher expectation for board directors to 'own', their decisions than it does for company executives and employees, and that board decisions are rarely exclusively driven by rules-based decision processes. An overlay of 'discretion, intuition and gut' — and ultimately trust—is required. Langenbucher makes it clear that it is legitimate for boards to make use of AI tools to aid their decision making, but then raises the question of how to use AI responsibly and where it effectively amounts to taking over decision making: how do you draw the line? To this end the main contribution of the paper is to provide a simple 2x2 framework, outlining board decisions along the dimensions of trust and ownership. This suggests a way to approach the nature of decisions taken by boards that may legitimately rely on AI and other technologies and those decisions that require high ownership and trust— and substantive board discretion.

At a tangent, and at a more prosaic level, this discussion reminds me a bit of the issue of investors using proxy voting agencies to support their voting processes— and the related furore as to whether investors themselves are guilty of abdicating authority in this process to the likes of ISS and Glass Lewis. There is certainly scope for some automation; indeed, it is hard to see how large institutional investors would be able to carry out their voting responsibilities without making some use of proxy agency services. Again, how to draw the line between legitimate use of technology and where abuse kicks in? In this context, Langenbucher's framework could loosely be applied here. Key voting decisions, particularly on qualitative issues such as board appointments, company actions and shareholder proposals require the same sort of 'ownership' by investors to ensure that complex decisions may be assisted with AI, but are ultimately guided by human 'discretion, intuition and gut'.

Read the paper: https://www.ecgi.global/publications/working-papers/a-tale-of-two-networks-common-ownership-and-product-market-rivalry

Political Economy

Paper: **How Did Corporations Get Stuck in Politics and Can They Escape?**
Authors: **Jill Fisch and Jeff Schwartz**
ECGI Working paper #757/2024

Going back to my investor days, I worked on the issue of corporate political donations, which is mainly, but not exclusively, a US phenomenon, particularly following the Supreme Court's Citizens United ruling of 2010. A short summary of a typical institutional investor view on this is that there can be legitimate merit in a company lobbying to inform the public policy debate, if related to the company's core business and expertise— as long as this process is properly disclosed and governed. But the issue of monetary donations is much murkier and should generally be avoided

— even if US companies freely do so anyway. In their paper 'How Did Corporations Get Stuck in Politics and Can They Escape?' Jill Fisch and Jeff Schwartz build on this issue, and take it in the new direction of political posturing. This bears no direct relation to regulation and policy making; the authors define posturing as taking public stands on controversial issues (be they 'woke' or 'anti-woke'), typically with a view to reinforce their visibility positively vis-à-vis their key stakeholders.

The paper is a compelling analysis of the potential merits — and pitfalls— that come with political posturing. Even if a company engages in posturing with noble ambitions and is seeking to generate competitive advantage, the authors effectively conclude that the downside is not worth the risk and could potentially, and unpredictably, trigger a 'backlash' that can be value destroying and have wider negative social impacts (e.g. polarisation). Several case examples were cited, including the 'Enron' of political posturing blowups: the ill-fated Bud Light campaign intended to express solidarity with the LGTBQ+ community, but ended up offending everybody.
I don't disagree with the authors' call for 'voluntary disarmament', just as I think that companies should also voluntarily disengage from political spending. But I do wonder how effective such a pledge might be in practice, especially as the authors expose the pernicious collective action/Prisoners' Dilemma pressures faced by companies — e.g., can I lose out if my competitors donate and I do not?

While I would share the authors' general scepticism of more prescriptive governance requirements of how boards should oversee this issue, I do think that board governance has an important role to play here, and there may be potential for companies to tighten corporate governance processes relating to board scrutiny and oversight on its political posturing. But is there a grey area, which might blur a company's illegitimate political posturing with its legitimate pursuit of a more sustainable corporate purpose? To this end, I would support the authors' proposal relating to transparency mechanisms to demonstrate how corporate actions link to stated political positions— particularly so if the SEC were to call for such disclosure. All in all, a very interesting read on an important issue, and while the issue of corporate political donations may be mainly a US concern, I would think that risks relating to political posturing may be more global in nature.

Read the paper: https://www.ecgi.global/publications/working-papers/how-did-corporations-get-stuck-in-politics-and-can-they-escape

Loyalty Shares

Paper: **Loyalty Voting Structures: A Better Dual Class?**
Authors: **Marco Becht**
ECGI Working paper #769/2024

When I first saw the title of this paper on loyalty voting shares by my friend, and ECGI Executive

Director, Marco Becht, I will confess that my heart sank a bit. Notwithstanding my differences with Marco in our approaches to dual class shares (mine from an institutional investor lens, his I daresay more contractarian), I have long had a separate issue, bordering on distaste, with loyalty shares — in that they look to be more equitable in theory than they are effective in practice. And therefore the 'danger' that they might come across as rhetorically more appealing, or more defensable, than dual class structures. So I was concerned that Marco might have been jumping on the loyalty shares bandwagon. But silly me. I should have paid more attention to the question mark in Marco's title and was very pleased that he used this working paper to challenge the nominal merits of loyalty shares as an 'attractive compromise' for a corporate control enhancing mechanism. He makes a strong case that loyalty shares, at least given current practice, are 'not a better but a different type of dual class.'

Becht sets out a concise summary of how these differential ownership structures work and what their differences are. While dual class structures typically have some form of A and B class shares with differing voting rights, in the case of loyalty shares (or tenure voting as it is often called in the US) a holder of shares can obtain multiple voting rights simply by holding onto the shares for a designated period, often two years, to provide an incentive reward for 'longer term' shareholders. So what's not to like about loyalty shares as 'an attractive compromise'? Well, maybe the fact that they really do not work in practice.

Becht develops this point through looking at several case studies in the US and Europe which show that institutional operational factors inhibit the ability of investors to take advantage of multiple voting rights— even if they have 'earned' them through their holding period. It is a journey through the arcane world of proxy voting, registered shares and bearer shares. Becht demonstrates that institutional investors are rarely in a position to fulfil registration requirements, given their operational need for holding fungible and liquid bearer shares as core to their investment strategies.

In what Becht labels the 'loyalty pretense', he is not attacking loyalty shares per se. It is in some ways more a labelling argument; he is challenging the way in which these share structures have been perceived or promoted by some as a 'better dual class.' It is appealing to few to identify technical institutional factors, such as registered shares or inadequate clearing or settlement systems, as obstacles to making a concept such as loyalty shares work in practice. But that is the inconvenient truth that Becht has rightly identified in this interesting and readable paper.

Read the paper: https://www.ecgi.global/publications/working-papers/how-did-corporations-get-stuck-in-politics-and-can-they-escape

Responsible Investment

Paper: **Blended Finance**
Authors: **Caroline Flammer, Thomas Giroux and Geoffrey M. Heal**
ECGI Working paper #973/2024

The term of art 'blended finance' is well-established in the world of sustainable investment, but is not an area that many institutional investors (at least in my past experience) were directly involved with, apart from the somewhat related field of impact investment. So I found the Working Paper 'Blended Finance' by Caroline Flammer, Thomas Giroux and Geoffrey M. Heal to provide a useful and insightful grounding in this area. They begin with a definition that blended finance involves the use of public and philanthropic funding to 'crowd in' private capital as a potential way to finance a more sustainable world. The paper then explores how blended finance has been — and can be— used to achieve raise capital for projects that seek to be both sustainable and profitable for investors. This is particularly relevant for emerging markets including the Global South.

The authors' focus on blended finance centres on Development Finance Institutions (DFIs), whose missions are focused on double bottom lines of social impact and investment returns. Most notably, the paper employs evidence provided by the International Finance Corporation (IFC) of the World Bank. They build a conceptual framework to demonstrate the tradeoffs faced by DFIs in balancing impact and risk, and use the term 'concessionality' to represent the level of concession a provider of blended finance would grant, as compared with free market terms. Not surprisingly, at least in the context of DFIs, the authors concluded that blended finance deals are more prevalent for projects that combine the greatest sustainability impact with the greatest level of political risks and information asymmetries. They note that blended financing can take the form of differing mechanisms, including concessional loans, junior equity tranches or risk management provisions.

The analysis of the authors included the extent to which the Sustainable Development Goals were featured in the IFC's blended financings, noting that the more 'economics-related SDGs (e.g. SDG's #8 and #9) were the most prevalent factors, as compared with social and environmental issues — where gender equality and climate action were the most prevalent sustainability-related factors.

The IFC data on blended finance is at once a strength and weakness of the paper. It provided the data to test the author's conceptual framework for blended finance solutions with 'live ammunition'. But as the authors acknowledge the IFC is only a relatively small data set and that IFC may not be representative with other DFIs. Moreover, the DFI focus skews the analysis to more developing economies and not to developed markets. The authors conclude by noting the need to understand practical challenges and bottlenecks that might inhibit greater institutional use of blended finance mechanisms. Here is where I believe the scope of enquiry ultimately could

and should go further beyond the DFI world to connect blended finance with other pools of capital, including philanthropic foundations, charities— and even impact investment more broadly.

Read the paper: https://www.ecgi.global/publications/working-papers/blended-finance

Executive Remuneration

Paper: **ESG & Executive Remuneration in Europe**
Authors: **Marco Dell'Erba and Guido Ferrarini**
ECGI Working paper #767/2024

Executive remuneration has always been an evergreen topic in corporate governance, and probably always will be. Using executive pay to channel the interests and alignment of company managers with shareholders remains an art and a journey, particularly with regard to what factors to include as incentives (or disincentives) in an executive remuneration package. As authors Marco Dell'Erba and Guido Ferrarini argue in their paper 'ESG & Executive Remuneration in Europe', this journey gains further complexity with regard to greater interest in stakeholder capitalism and corporate sustainability practices, often expressed in the shorthand of 'ESG': environmental, social and governance factors.

Through a carefully compiled analysis of the 300 largest companies in the FTSE EuroFirst300 (including the UK) the authors make it clear that ESG indicators in pay packages are indeed alive and kicking in Europe, with a headline outcome that 183 of the 300 companies in the index (61.6%) take ESG into account for purposes of defining executive compensation. If nothing else it is very interesting to see how the authors have broken down elements of incentive packages along the lines of stakeholder welfare, including employee diversity and treatment, customers, communities, suppliers and the environment. They identify a wide range of sustainability-related indicators that feature in European remuneration packages.

At the same time Dell'Erba and Ferrarini identify less encouraging factors, including reviewability and measurability, concluding, for example that only 32% of European companies provided reviewable targets and metrics in their incentive plans. The general theme is that ESG considerations in executive pay remain problematic, and possibly adrift, with a lack of clear patterns emerging from corporate practice.

From the lens of an investor practitioner, I am sympathetic with the authors' critique. It is a natural impulse for those wishing to promote sustainability in business practices to bake sustainability metrics into executive pay. But it is hard to do well. But I would go further. In addition to the issues of reviewability and measurability raised by the authors I would add the issue of materiality, which I think is just as critical (both single and double materiality). But here is where the complexity sets in, given how sectoral issues often drive the most material sustainability risks. And I am hoping for the day when what we now call material 'ESG risks' can be stripped of the oft confusing and

a lienating ESG label and simply be regarded amongst other financial, operational and reputational risks in management tools such as balanced scorecards and executive remuneration plans that encourage responsible and long-term performance.

Read the paper: https://www.ecgi.global/publications/working-papers/esg-executive-remuneration-in-europe

Governance of Sustainability

Paper: **Corporate Social Responsibility Committee: International Evidence**
Authors: **Jenny Chu, Xi Li, Yuxia (Sarine) Zou**
ECGI Working paper #984/2024

The governance of sustainability is a topic that continues to build in focus by companies, regulators, and investors - particularly with regard to how boards of directors most effectively provide oversight over a company's material sustainability risks. Certainly, within the institutional investment community, there is the investor expectation that the board is accountable for both the understanding and ownership of the company's social impact. But investors, and for the most part regulators, tend not to be prescriptive about how a board should go about this in practice. A dedicated sustainability or CSR (Corporate Social Responsibility) committee is a seemingly obvious way for companies to go about this. But is this the best way to achieve appropriate governance of CSR issues? In their paper Corporate Social Responsibility Committee: International Evidence, authors Jenny Chu, Xi Li, Yuxia (Sarine) Zou explore this topic, specifically regarding companies that voluntarily establish CSR committees at the board level: what types of companies choose to do this and how does this relate to CSR outcomes?

Using an international data set of over 18,000 publicly listed firms between 2002 and 2018, the authors set the scene with the descriptive statistic that voluntarily established CSR committees grew from 8.54% to 10.58% over this period. They develop hypotheses drawing from resource dependence, legitimacy, institutional, and agency theories in existing academic literature to explain the growing prevalence of these committees. They build a model of determinants reflecting regulatory disclosure requirements, as well as pressures from investors, stakeholders, and other sectoral factors. For the most part, this seems logical, though I question the authors' use of the variable 'socially conscious' investors as defined by the investor's country jurisdiction. I suspect that may be a misleading label, and is possibly more a proxy for the rule of law than for investor preferences.

While establishing a CSR committee may have good PR value, does this do any good in terms of outcomes? Here the authors present positive evidence that based on metrics related to carbon emissions and employee injuries companies with CSR committees had improved social impacts. While this is encouraging, one must also realise that these two specific metrics, while important, are not necessarily a proxy for the company's sustainability performance along a wider range of

factors. The authors also raise the issue of whether the presence of a CSR committee might tilt a company's focus away from shareholders and more toward stakeholders. In this context, it would have been very interesting to see how companies with CSR committees performed in terms of financial metrics as well. The link to risk oversight and profitability was not really explored.

Possibly the most interesting thing to me is the issue of how companies with voluntary CSR committees compare to companies in jurisdictions (India and South Africa) where a CSR committee is mandatory. Here the authors observe no superior CSR performance in these two jurisdictions. The message for regulators: prescribing board practices may tick more boxes, but will not necessarily lead to desired outcomes.

Read the paper: https://www.ecgi.global/publications/working-papers/corporate-social-responsibility-committee-international-evidence

Family-controlled firms

Paper: **Family-Controlled Firms and Environmental Sustainability: All Bite and No Bark**
Authors: **I. J. Alexander Dyck, Karl V. Lins, Lukas Roth, Mitch Towner, and Hannes F. Wagner**
ECGI Working paper #983/2024

One of the pillars of ECGI's Responsible Capitalism initiative is its focus on family capitalism. In this context, the received wisdom from academic research and ESG indices is that family-controlled firms perform less well on sustainability matters as compared with widely held public companies. The potential good news is that 'truism' is challenged in a recent paper by I. J. Alexander Dyck, Karl V. Lins, Lukas Roth, Mitch Towner and Hannes F. Wagner: Family-Controlled Firms and Environmental Sustainability: All Bite and No Bark.

Using a sample of 3832 companies in 35 countries (excluding the US, China, and Russia for differing reasons) the authors draw the conclusion that using the specific (and real) indicator of carbon emissions, family-controlled firms do not perform worse—and in some situations perform better— than widely held firms. The authors suggest that family companies may experience fewer environmental disclosure pressures than public companies, with the result that they compare less favorably against the panoply of what they label 'qualitative metrics', relating to disclosures of environmental policies, procedures, and targets.

The authors conclude that family companies are more focused on substance than form and that the hard 'bite' of emissions outcomes may be a more meaningful 'summary statistic' than the panoply of what the authors label the 'bark' of qualitative metrics. This is an encouraging conclusion, and it will be interesting to see if further research strengthens the argument that family companies deserve more credit for their sustainability performance. A potentially important detail here is that the data analysis of the study was limited to Scope 1 and Scope 2 emissions.

It would be interesting to explore the extent to which their narrative might change if the study was able to capture Scope 3 emissions as well.

The nature of this paper also highlights the challenge that ESG raters and index providers have in working with —and making sense of— sustainability-related disclosures. At least for family companies, the authors suggest that rating or scoring systems based on an ‘alphabet soup’ of qualitative ESG metrics (which have been tagged as ‘empty promises’ in other academic studies) are less substantive than emissions outcomes and put family companies at a perceived unfair disadvantage. This challenges the value of ESG rating systems, or at least underscores the importance of how to balance and weigh differing ESG disclosures.

Read the paper: https://www.ecgi.global/publications/working-papers/family-controlled-firms-and-environmental-sustainability-all-bite-and

Public Capital Markets

Paper: **Half the Firms, Double the Profits: Public Firms' Transformation, 1996-2022**
Authors: **Mark J. Roe and Charles C.Y. Wang**
ECGI Working paper #771/2024

Should we be concerned about the dropping numbers of publicly listed companies? Most likely we should, but possibly not as much as we may currently fear. And for different reasons than what conventional wisdom would have us believe. So suggest Mark J. Roe and Charles C.Y. Wang in their working paper Half the Firms, Double the Profits: Public Firms' Transformation, 1996-2022.

Their basic argument is straightforward and implied in the paper’s title. Focusing on the US market the authors acknowledge the significant drop of listed firms in the US market over the recent period from 1996 to 2022 (from over 7000 to fewer than 4000). But they also observe that by other financial and economic metrics (profits, sales, investment, employment) the public markets are not shrinking: they are alive and kicking— albeit more concentrated than before.

While Roe and Wang position this ‘real economy’ argument as the center of the paper, I found their analysis most interesting concerning how they categorize and interpret the causal factors that have driven the sharp drop off of listed public companies in the US. Specifically, they challenge the received wisdom that what they call Legal Explanations (regulatory overkill in particular) are the main explanatory drivers behind this change, and instead, the authors present a more microeconomic argument — which they call the Industrial Organization Hypothesis. They argue that the structure of the US industrial economy has shifted over the past 30 years; their hypothesis takes into consideration industrial and competitive dynamics— including economies of scale and benefits of extended networks— as well as the influence of somewhat looser antitrust policies allowing for more firm consolidation through acquisitions. In their words, ‘the I.O.

Hypothesis predicts that larger, typically public companies have been better able to capture extra profit over time due to their ability to reap the benefits from efficient economies of scale (or to overcome competition).'

Roe and Chang present this paper as a jumping-off point to a new research agenda to further explore these dynamics. There are inevitable policy implications, starting with the specific takeaway that the number of listed companies cannot be taken in isolation when assessing the health of a public securities market. Institutional investors, whose rights and protections have been watered down in many markets out of fears of 'overregulation', should welcome this dialogue — which challenges the conflation of a regulatory burden and the corresponding reduction of issuers in current capital markets.

But are we happy with what the authors call 'larger, more profitable but fewer firms'? As the authors note this issue is of relevance to the US SEC, the Federal Trade Commission, and the Antitrust Division whose agendas are not necessarily competing with one another. But they are also not the same. Even though the Roe and Chang paper is US-focused, the research agenda that I hope they catalyze should also bring under review these important questions in other global capital markets.

Read the paper: https://www.ecgi.global/publications/working-papers/half-the-firms-double-the-profits-public-firms-transformation-1996-2022

Corporate Governance and Culture

Paper: **Culture and Law in Corporate Governance**
Authors: **Amir N. Licht**
ECGI Working paper #777/2024

As Amir Licht observes, in his paper Culture and Law in Corporate Governance, culture has not traditionally been a popular theme for governance scholars, at least within the realm of law and finance. Too gooey to define, and too difficult to observe or measure.

But culture, while a 'soft' topic, is nonetheless very real. In fact, Licht argues that it is 'the mother of all path dependencies'. In his paper he draws on the field of social psychology for guidance, including the pioneering work of Geert Hofstede, who framed culture as 'collective mental programming' and as the 'software of the mind.' And he also makes reference to other social psychologists, including Shalom Schwartz, who defines culture as 'the latent, normative value system, external to the individual, which underlies and justifies the functioning of societal institutions.' Both Hofstede and Schwartz present similar, but different drivers of culture. Licht ultimately favours the more theory-based Schwartz formulation of three bipolar cultural dimensions that confront all societies: embeddedness/autonomy, hierarchy/egalitarianism, and mastery/harmony. These dimensions help to frame differing cultures and how they may affect

corporate management and governance. This includes Confucianism, which pervades East Asia, with its emphasis on guanxi (relationships); the US 'rugged individualism' and libertarianism, as reflected in the settlement of the American West; and the greater emphasis on egalitarianism, sustainability and social harmony in the tightly packed countries of Western Europe.

>From this base Licht then focuses on how these cultural dimensions help to explain differing objectives of the company in these jurisdictions and how these relate to governance matters such as earnings management, dividend policy, executive compensation, the board of directors, CEO relations, board diversity and investor networks. Going back to my days at S&P in the 1980s when I was a young twenty-something traveling all over the world to conduct corporate credit ratings, I developed a longstanding interest in comparative management systems and cultures. While 'purpose' was not the same term of art then as it is now, it was clear to me that the purpose or broad objectives of companies differed from country to country. So I found this to be an interesting, even enjoyable, read. There is certainly more going on than homo economicus when we think about models of governance. Social values and preferences and basic cultural anthropology all have a critical role to play, and it is important to build awareness of these forces.

Read the paper: https://www.ecgi.global/publications/working-papers/culture-and-law-in-corporate-governance-0

ESG and the Business Judgement Rule

Paper: **ESG, Externalities, and the Limits of the Business Judgment Rule: TEPCO Derivative Suit on Fukushima Nuclear Accident and the Expansion of Caremark**
Authors: **Gen Goto**
ECGI Working paper #780/2024

Where does the business judgment rule end and the Caremark standard begin? Are they at odds with one another and how might this affect boards, directors and corporate governance? In his paper ESG, Externalities, and the Limits of the Business Judgment Rule: TEPCO Derivative Suit on Fukushima Nuclear Accident and the Expansion of Caremark, Gen Goto takes this topic on through the lens of both Japanese and US law. He focuses on the Japanese electric utility TEPCO and the derivative lawsuit following the Fukushima nuclear accident of 2011. Specifically, in 2022 the Tokyo District Court found five TEPCO directors to be in breach their duty of care and ordered them to jointly pay a whopping fee of 13.2 trillion Japanese Yen (roughly US$ 85 billion). The basis for this ruling was the disregard by the directors of a Japanese scientific study that identified safety concerns relating to the possible effects of a tsunami.

While Goto never tells us how these five individuals are to be expected to cough up that kind of loot, he does present this as a widening standard of directors' duty and oversight in Japan, consistent with what he interprets as an expansion of the scope of Caremark standard vis-à-vis

ESG related issues in the US. Goto identifies the potential for the expanded duty of ESG oversight to 'collide' with the business judgment rule, not only in the US, but globally (equivalent concepts exist in other jurisdictions). In turn, he notes that this could have a 'chilling' effect on directors that could discourage them from serving on boards or result in them being unduly risk averse.

Goto observes that following a seminal decision in 2019 by the Delaware Supreme Court in Marchand v. Barnhill, the idea to expand the Caremark duty of oversight beyond legal risks to ESG risks is gradually getting traction. In the case of TEPCO, the systemic threats of a nuclear meltdown were and are huge; the gravity of this externality no doubt contributed to the Tokyo court's ruling.

But there seems to be less clarity in where and how to draw the line. Goto presents differing schools of thought on this, linked to shareholder and broader stakeholder/social perspectives. He identifies the need for more discussion and debate on this point. Goto makes the important observation that 'ESG' is a very broad concept, and as an acronym has limited intrinsic meaning (and much potential to be misunderstood). To be meaningful, the components of ESG need to be unpacked for individual firms to identify the material company/sector risks and externalities.

Read the paper: https://www.ecgi.global/publications/working-papers/esg-externalities-and-the-limits-of-the-business-judgment-rule-tepco

Shareholder Activism in China

Paper: **The Overlooked Reality of Shareholder Activism in China: Defying Western Expectations**
Authors: **Chun Zhou, Wei Zhang, and Dan W. Puchniak**
ECGI Working paper #776/2024

For many Western observers, the notion of shareholder activism in China may be something of an oxymoron: too much state control and too many controlled companies for minority shareholders to wield any clout. However, in their paper The Overlooked Reality of Shareholder Activism in China: Defying Western Expectations, Zhou Chun, Zhang Wei, and Dan Puchniak challenge this conventional wisdom. They argue that activism in China is thriving and that the state is supportive of activism as a rules-based system to improve corporate governance and shareholder protections - and to support the financial markets more broadly.

These conclusions build from a hand-collected data set of Chinese companies from 2007-2023. The descriptive statistics show the steady growth of shareholder activism in China over this period and that minority shareholder activism can be successful, against State Owned Enterprises (labelled as 'National Champions'). Using regression analysis, the authors further conclude that there is no statistically significant difference between activism outcomes for SOEs vis-à-vis privately owned firms. They also provide case studies, including a successful retail shareholder campaign against the state-owned shipping firm COSCO; but this is balanced with another case

(First Automobile Works) in which a 97% minority shareholder vote was disregarded with no consequences. In the end, the authors suggest that shareholder activism and rules-based market system is encouraged by the Chinese government and is driven more by economics than politics and as a complement to the regulatory regime. With a wide raft of legal shareholder protections in China— including a 3% shareholder proposal right, cumulative voting, derivative lawsuits and majority of the minority provisions— the authors cite references that China has 'one of the most robust shareholder-empowering corporate statutes in the world'.

These are interesting and counterintuitive insights about a huge financial market and economy that Western academics and practitioners probably know way too little about. And it challenges the received wisdom that the Chinese state is pulling all the strings for its own political agenda. We sometimes forget how large and heterogeneous the Chinese equity market is (second largest in the world, with over 2200 issuers) and the great challenge that the government and its securities regulator, the CSRC, must have in monitoring this market.

As a practitioner with some (but not extensive) experience in China, I wonder if this picture might be a bit rosy. I say this because I have a hard time reconciling the rules-based market system described by the authors with other widely recognised country indicators of legal protections. Here I'm thinking specifically of the World Bank Rule of Law indicator and similar comparative metrics, where China comes out well below the major G7 countries, but also below all the BRICS countries apart from Russia.

Specifically, I wonder what the authors' conclusions suggest about minority protections of overseas shareholders, given that the activism studied in the paper appears to all come from domestic Chinese investors. I know from my asset management experience that Chinese companies can be difficult for overseas investors to engage with, even with native Mandarin speakers on the team. While the paper suggests that the state is encouraging investor activism by minority shareholders, this encouragement may be for the specific types of domestic activism the state would like to see. I would strongly suspect a less laissez-faire response in the event that overseas shareholders were to press for significant managerial or structural changes in the governance of a 'National Champion' Chinese SOE. The overseas investor angle could be an interesting follow up to this thoughtful and well-researched paper.

Read the paper: https://www.ecgi.global/publications/working-papers/the-overlooked-reality-of-shareholder-activism-in-china-defying-western

CONTACT

George Dallas
Head of Content
European Corporate Governance Institute (ECGI)
george.dallas@ecgi.org

Kateryna Varava
Project Manager
European Corporate Governance Institute (ECGI)
blog@ecgi.org
www.ecgi.global

European Corporate Governance Institute (ECGI)
c/o Royal Academies of Belgium
Palace of the Academies
Rue Ducale 1 Hertogsstraat
1000 Brussels
Belgium

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