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Members' Debrief

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By George Dallas

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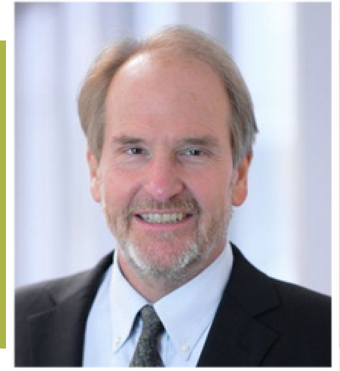
About the ECGI Members' Debrief



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

Director’s Duty and Corporate Purpose

Paper: **Directors’ Positive Duty to Act in the Interests of the Entity: Shareholders’ Interests Bounded by Corporate Purpose**
Authors: **Susan Watson** (University of Auckland and ECGI); **Lynn Buckley** (University of Auckland)
ECGI Working paper Law series #791/2024

Last month we looked at Gen Goto’s paper on how the business judgement rule might ‘collide’ with the Caremark standard vis-à-vis ESG related matters. In their paper, Directors’ Positive Duty to Act in the Interests of the Entity: Shareholders’ Interests Bounded by Corporate Purpose, the authors Susan Watson and Lynn Buckley take us on a not dissimilar journey in terms of a possible ‘collision’ between shareholder primacy and company purpose. And according to the authors, shareholders come out the worse for wear.

Watson and Buckley set the stage with a bit of legal history, beginning with the ‘Newe Oath’ in 1657, when the East India Company became the first corporation to have permanent capital that was legally separated from its investing shareholders in the form of a persona ficta, or artificial legal person. Maybe not a page turner like a John Grisham legal thriller, but it is an interesting historical analysis all the same, and it is useful for us non-lawyer practitioners to remind ourselves about this legal separation between shareholders and the capital they invest in the company (which is labelled the Corporate Fund).

Connecting this analysis to the current day, including Section 172 of the UK Companies Act, the authors then turn to the duties of company directors and conclude that the duty of good faith is owed by directors to the company as a separate legal entity than its shareholders. While this is pretty familiar ground for most of us, the authors then explore how fiduciary duty and good faith relate to corporate purpose and shareholder primacy, taking us on a spin through four differing categories of shareholder primacy, and using the 1742 case of the Charitable Corporation v Sutton to argue that the primary obligation of governing bodies is to comply with the terms of the corporate charter.

This brings corporate purpose into the discussion, as much as it is articulated in corporate by-laws or articles of incorporation. The authors argue that purpose is ‘more fundamental to business corporations than even the duty to act in the best interests of the shareholder.’ Reflecting on the renewal of interest in corporate purpose provisions in corporate constitutions, the authors further conclude that purpose outranks shareholder interests and could mark the end of shareholder primacy and a ‘myopic focus on wealth maximisation for current shareholders.’

It is both useful and interesting to explore the connection between corporate purpose, which includes broader societal interests, and the financial interests of a company’s shareholders.

Many of these same issues were addressed in ECGI's conference in Copenhagen last year focusing on corporate purpose. The authors make their case well, but I think may still find resistance among old school shareholder primacists. As a slightly critical note, the authors slip ESG factors into the paper in its last two sentences with no further elaboration. I felt a bit left hanging by this concluding point and if they wanted to leave us with this thought it would be useful if it could have been a more explicit part of the earlier discussion.

Read the paper: https://www.ecgi.global/publications/working-papers/directors-positive-duty-to-act-in-the-interests-of-the-entity

Differential ownership

Paper: **Multiple-voting shares in Europe -A comparative law and economic analysis -**
Authors: **Klaus J. Hopt** (Max Planck Institute for Comparative and International Private Law and ECGI); **Susanne Kalss** (Vienna University of Economics and Business)
ECGI Working paper Law series #786/2024

As a practitioner trying to get a solid grasp on comparative law and governance practices, particularly within Europe, I have long been a big Klaus Hopt fan. And his latest ECGI working paper about multiple voting shares in Europe, co-written with Susanne Kalss, continues the tradition with timely, authoritative and insightful analysis. The impressive structure and detail of the paper's outline alone show that the authors mean business, and they efficiently take us through comparative legal regimes, economic analysis and regulatory options relating to multiple class shares.

The main motivator of the paper was the adoption of the European Directive in April 2024 relating to multiple share structures (to come into force in 2026). Hopt and Kalss are generally supportive of the Directive, though they also criticise it as offering only a minimum level of harmonisation, together with a narrow scope. Going back to the European Commission's 2003 Action Plan, the authors remind us that the principle of one-share/one vote was at one point the guiding ethos in the EU. But they also note that 'times have changed' and even Germany, which resisted multiple class shares for a long time, now provides for these in its Future Financing Act.

Hopt and Kalss then provide comparative analysis of multiple share structure regimes in a range of European jurisdictions, as well as the United States, illustrating the differing paths that have been taken regarding the use of these structures. Their economic assessment of multiple class shares is balanced in focusing on both potential strengths and weaknesses for investors, companies and the broader economies. With the investor perspective (and anti-multiple shares bias) I bring to the table I think the authors could have noted that the dilution of shareholder voting rights is anathema to the role that is expected of investors in terms of fulfilling their stewardship obligations.

And the argument commonly cited that multiple voting structures will promote international competitiveness and economic growth still strikes me as aspirational and potentially more hortatory than substantive.

In their review of the empirical studies, I found it interesting that the authors characterise the results as mixed, and to see their differentiation of 'conventional' (older) studies with negative conclusions about the economic impact of dual class shares, with more recent studies where the conclusions are mixed. But even in the more recent studies, the authors observe that the advantages of multiple class shares decline and agency costs increase after a period of seven to ten years. That is precisely what institutional investors and other minority shareholders are concerned about.

Hopt and Kalss conclude with seventeen sensible summary points to guide further thinking about how to make constructive use of multiple share structures— or at least avoid some of their potential downsides. Even though the multiple share structure 'horse' has bolted from the regulatory stable, the authors observe wisely that 'complete deference to private ordering... seems ill-advised from an economic point of view.' There must be appropriate limits and safeguards, and the paper includes more detailed discussion on sunset clauses, limits on the maximum voting rights ratio (they propose 10:1) and having some AGM votes subject to 1 share/1 votes (though not for board directors). I like in particular the idea to publish breakdowns of how the holders of different share classes vote on specific resolutions. That can allow minority shareholders to more clearly signal areas of support — and disagreement— with the holder of multiple voting shares.

In sum, greater use of multiple class shares in Europe will bring greater scrutiny of these instruments, and Hopt and Kalss have provided us with a balanced and authoritative assessment of the legal, economic and regulatory landscape to guide this ongoing scrutiny.

Read the paper: https://www.ecgi.global/publications/working-papers/multiple-voting-shares-in-europe-a-comparative-law-and-economic

Investor stewardship

Paper: **The Unseen 'Others': A Framework for Investor Stewardship**
Author: **Dionysia Katelouzou** (King's College London - The Dickson Poon School of Law, Transnational Law Institute, University of Cambridge and ECGI)
ECGI Working paper Law series #793/2024

In her paper The Unseen 'Others': A Framework for Investor Stewardship, Dionysia Katelouzou builds upon her growing list of stewardship scholarship by posing some big picture questions, such as who stewardship is supposed to serve and what is the role of institutional investment and stewardship vis-à-vis the broader economy and environment — which she labels the 'unseen' others.

With a focus on the UK and its Stewardship Code, Katelouzou's paper seeks to draw inspiration from section 172 of the UK Companies Act to build a more comprehensive theory of investor stewardship under the umbrella term 'enlightened' stewardship.

This is an ambitious topic that Katelouzou approaches by defining a three-dimensional framework: (1) a steward has power, which is exercised (2) on behalf of others and (3) for others. Reflecting the complexity of the asset chain, she then differentiates between four distinct stewardship relationships: (1) client stewardship, (2) end-investor stewardship, (3) asset stewardship, and (4) sustainability stewardship. With this multidimensional Rubik's cube of stewardship factors, the 'enlightened' part relates to stewardship relationships that extend beyond the traditional client/end beneficiary relationships to take consideration of wider social and environmental interests.

Reflecting a broad and holistic look at the complexities of the investment chain, Katelouzou takes us on an interesting journey through how stewardship is regarded in differing scholarly literature in accounting, management, ethics, leadership and ecology. Reflecting this complexity, she ultimately argues that the traditional agency theory view of looking at 'dyadic' (two party) relationships is inadequate for stewardship involving multiple principles — including the diverse array of 'unseen others'.

Ultimately Katelouzou seeks inspiration from the UK Company Act's Section 172, calling for investment stewards to show similar regard for sustainability factors (including stakeholders and the broader environment) while conducting their stewardship duties. She also observes that this social perspective may be broader for institutional investors than company directors, insofar as the company director is rightly focused on the success of the individual company itself, whereas institutional investors with large, diversified portfolios can rationally consider the health of the market and the economy as a whole, and this form of stewardship is not limited to the success of individual companies.

As Katalouzou notes, 'the extent to which enlightened stewardship can genuinely serve the public interest remains an empirical inquiry beyond the scope of this article.' Yet she is also encouraging the next version of the UK Stewardship Code to formalise an enlightened stewardship model. I would argue that many institutional investors in the UK are sympathetic with this notion of enlightened stewardship, particularly the larger 'universal owners' and other investors concerned with fundamental systemic risks. Having said that, we need to remember that the UK Company Act's Section 172 is focused, in the first instance, on the success of the individual company not broader society: there is self-interest involved, even if it is 'enlightened' self-interest. Its parallel application within stewardship is likely to have a similar immediate focus on the welfare of clients and beneficiaries of investment managers.

In this regard the paper could have possibly explored more the potential conflicts in this model. In other words, how should institutional investors deal with situations where there may be tradeoffs between value for their immediate client and broader social considerations. Trying to explain or justify these tradeoffs to a chief investment officer or a pension fund trustee can still prove a challenge regardless how stewardship is defined.

For this to have real traction we will need to identify who the unseen others are and how these relate to specific environmental and social impacts. Otherwise, there is the risk of abstraction.

Read the paper: https://www.ecgi.global/publications/working-papers/the-unseen-others-a-framework-for-investor-stewardship

Corporate purpose and ESG

Paper: **Success, Law and ESG**
Author: **Colin Mayer** (University of Oxford - Said Business School, CEPR, and ECGI)
ECGI Working paper Law series #795/2024

Those who follow the corporate purpose debate will know that Oxford's Colin Mayer is one of its leading advocates. Building from his academic leadership in the British Academy's Future of the Corporation project in 2019, Mayer has continued to develop his thinking about corporate purpose in his recent working paper Success, Law and ESG. Even though 'purpose' is not in the title of the paper, it is pulling the strings behind the scene.

The term 'success' receives considerable scrutiny by Mayer, in large part because it is often articulated as the objective of the company and its directors in corporate law, such as in Section 172 of the UK Companies Act of 2006. While success has traditionally been interpreted as financial success for shareholders, Mayer qualifies this through the British Academy's broader definition of corporate purpose to 'produce profitable solutions for the problems of people and planet, not profiting from producing problems for either' (my emphasis added). The last part of this phrase may be the most challenging and critical: focusing on the negative (even if legal) externalities and impacts that companies may create in their activities. In short companies should not profit from doing harm. With a bit of word play, Mayer suggests that 'success' will fail if it is too narrowly defined to exclude this consideration.

Mayer's paper guides us through how corporate law and corporate governance codes can play a role in articulating that success of a corporation excludes profiting from doing harm— a governance cousin to medicine's Hippocratic Oath. He also invokes Adam Smith's notion of the 'impartial spectator' to call for board directors to ensure that companies avoid harming third parties in their pursuit of profit, a concept that also invites comparisons to John Rawls' 'Veil of Ignorance' in his theory of social justice.

The final leg of the paper relates to measurement and reporting and its implications for the ESG agenda. Mayer observes the limitations of the ISSB's focus on single materiality and asserts that a double materiality approach, as is currently being championed in EU regulation, is required to determine a company's true costs and profits. At the same time Mayer is aware of the practical challenges and complexities of sustainability reporting, given that there is no standardised 'one size fits all' approach to assessing a company's environmental and social impact.

He concludes that progress should require definitions of ESG factors not only to be harmonised globally for the purpose of sustainability reports, but also for incorporation in individual firm accounting, auditing and reporting requirements.

We are left with the tantalizing thought of more tightly linking sustainability issues with financial accounting standards, but this point was not developed in the paper. While this idea might cause the accounting profession to have kittens, it will have to wait for further elaboration. But I recommend this paper as a good read both for those who already know Mayer's work, and for those who may be new to it.

My only regret is that the paper really didn't need to conclude by focusing on the impact on 'ESG', as I increasingly believe that the term can be widely misunderstood or at least mean different things to different people. I suspect Mayer is trying to provide greater clarity on what ESG means in terms of corporate purpose (including that they are not one and the same thing). Still, the term 'ESG' may no longer be fit for purpose itself— and indeed may be the source of some current confusions about a company's purpose, impact, and sustainability. See the related reference to Bob Eccles' recent piece on ESG below.

Read the paper: https://www.ecgi.global/publications/working-papers/success-law-and-esg

Agency Theory

Paper: **Hidden Fallacies in the Agency Theory of the Corporation**
Author: **Jennifer G. Hill (**Monash University and ECGI)
ECGI Working paper Law series #799/2024

For most practitioners, the concept of agency theory tends not to crop up in day-to-day professional conversation. But it is a fundamental cornerstone of corporate governance theory dating back into the early 20th century. In her working paper Hidden Fallacies in the Agency Theory of the Corporation, Jennifer Hill provides a history and critical overview of agency theory, while also taking aim at what she sees at its deficiencies and logical fallacies.

Hill takes on a journey informed by the likes John Stuart Mill, Jeremy Bentham, Isaac Asimov, Molière, and Berle and Means. But her attention is focused on criticising the agency theory as articulated by the influential scholars Jensen and Meckling in 1976, which regarded corporations as 'legal fictions' and a nexus of contracts. She also traces how this contractarian perspective evolved from Milton Friedman's 'doctrine' of the firm's role as a value maximising institution.

The crux of Hill's criticism is that this formulation is myopic and unduly reductionist, and can lead to a narrow view of the corporation as purely an economic actor focused on shareholders without a wider connection to society. This leads to the potential tyranny of 'private ordering', e.g. a misguided reliance on market forces, and a disproportionate approach to shareholder primacy.

This criticism of agency theory and the contractarian conception of the company is that it effectively lacks a social feedback loop and has the potential to 'blind' us to the impact of corporate power on society, including the negative externalities that companies produce. Hill observes that an extreme interpretation of agency theory discounts the role of corporation regulation or public policy as an accountability mechanism.

Hill spends most of her time challenging the legitimacy of this form of agency theory and does not focus the paper on alternative models. Having said that, she does make reference to the British Academy's project on corporate purpose, which provides some connection of this paper to that of Colin Mayer, reviewed above, and she shares with Mayer the more 'pro-social' view of the firm, in particular with regard to her concern about corporate externalities.

This sort of discussion has the risk of coming across to practitioners as 'academic' and possibly arcane. Why should we care? How will it affect what we do tomorrow? Maybe not much. But for those of us with an interest in corporate governance, Hill's paper is a thoughtful challenge to traditional contractarian thinking and a useful prompt for us to re-evaluate the broader conception of public corporation. Maybe it will (or should) affect what you do tomorrow...

Read the paper: https://www.ecgi.global/publications/working-papers/hidden-fallacies-in-the-agency-theory-of-the-corporation

Common Ownership and Proxy Advisors

Paper: **Common Ownership and Proxy Advisors**
Author: **Tove Forsbacka** (Stockholm School of Economics)
ECGI Working paper Finance series #1006/2024

The question of common ownership and the influence of large institutional investors continues to attract attention from scholars, as well as some degree of controversy with institutional investors themselves. Adding to this debate— and controversy— is a new paper by Tove Forsbacka, The Proxy Advice Industry and Common Owners' Coordination. The main contribution of this paper is that it brings the proxy advisor industry (manifested by industry giant ISS) into the discussion, leading to the suggestion that ISS promotes common ownership in its proxy voting recommendations in the interests of investment clients, which in turn leads to lower levels of competition amongst portfolio companies.

Forsbacka develops a theoretical framework, based on the premise that the fiduciary obligation of a proxy advisor is to give proxy advice that maximises client (e.g. investor) value— importantly shifting from an individual firm focus to considering the portfolio effects for investors that have holdings in the same sector. This is a critical, but I think flawed, starting point that I will address below.

Forsbacka then makes use of the idea of profit weights to measure the extent of common ownership in individual companies. With a data set on US companies, ownership and shareholder meetings from 2003-2017, Forsbacka finds empirical support for her framework that ISS voting recommendations on three types of voting resolutions that she argues will result in promoting lower competition: director interlocks, merger activity and performance based executive remuneration (stock option incentive grants). From this the paper concludes that the empirical results confirm the prediction of the theoretical framework that proxy advisors 'coordinate' common owners' interests.

This paper is somewhat technical (for non-economists), but it is an intriguing and impressively detailed modelling exercise and economic analysis. Forsbacka digs deeply into proxy advisory data and illustrates how influential proxy advisors can be, particularly the industry giant ISS. This is true not only for the many institutional investors that simply default to ISS for their proxy votes, but also for those investors with their own nominal voting policies whose votes nonetheless track very closely with ISS recommendations.

At the same time, I have some reservations from my own professional experience as an institutional investor (and former ISS client) that keep me from fully accepting the paper's core assumptions and conclusions. Perhaps the main one is the suggestion that ISS' recommendations focus on maximizing the portfolio impact for diversified investors, rather than on the governance of an individual company. That is not what ISS does; or if it is, it is not articulated in its public voting policy. Nor is it what investors are looking for in a proxy advisor. But Forsbacka is suggesting an implicit (if not potentially criminal) conspiracy that ISS and its clients buy into, in which investors use ISS as a mechanism to reduce competition amongst companies— such that investors and companies win, consumers lose, and ISS profits by serving as an accomplice.

That is a very ambitious premise, one that belies my own asset manager experience and one I believe that both ISS and institutional investors would challenge. It brings to mind Coase's argument that economic assumptions should 'correspond with the real world.' While the paper's impressive data analysis is supported by statistically significant results, I was the least satisfied about the inferences drawn from how board interlock, merger and executive remuneration AGM resolutions promote less competition in practice. I suspect this paper is not the last word on this topic, but it is a creative and provocative analysis that I enjoyed and very much recommend.

Read the paper: https://www.ecgi.global/publications/working-papers/the-proxy-advice-industry-and-common-owners-coordination

Sustainability Assessments

Paper: **Green Gatekeepers**
Authors: **Luca Enriques** (Bocconi University, University of Oxford, and ECGI); **Alessandro Romano** (Bocconi University); **Andrew F. Tuch** (Washington University in St Louis and ECGI)
ECGI Working paper Law series #800/2024

As awareness of social and environmental impacts of business continues to build, it is normal that consumers of products linked to sustainability impacts will benefit from third party guidance as to how a specific company or product measures up in terms of 'green' or socially impactful issues. This helps consumers to mitigate potential informational asymmetries and explains the growing cottage industry of what is labelled Green Gatekeepers in a new working paper by Luca Enriques, Alessandro Romano and Andrew F. Tuch.

These green gatekeepers are specialist information services that both set standards for assessment and conduct third-party assessments for companies relating to sustainability performance. They help to bridge a knowledge gap between producers and consumers, particularly in complex topics such as environmental impact. But how good are these gatekeepers in practice? Are they worth relying on? How do we know if they are providing quality conclusions? Enriques, Romano and Tuch explore this topic in depth and conclude that so-called green gatekeepers face weaker reputational constraints than the more traditional financial gatekeepers (auditor, credit rating agencies, etc). In so doing, the authors throw a bit of cold water on the 'warm glow' that comes with the blind usage of green gatekeepers.

The authors' framework is supported by an assessment of 456 green gatekeepers operating in 25 sectors, and a deeper dive is taken in the cases of a voluntary carbon market, responsibly sourced gas, certifying net-zero targets through SBTi, energy efficiency and animal welfare. The authors speak to the 'warm glow' that consumers get through using certified green products, whether or not the certification itself has substance. Digging into psychology and human nature, they describe the notion of how 'motivated reasoning' leads users of green gatekeepers' services to seek positive confirmation for their product choices, allowing them to feel upright, even if acting selfishly.

Compared with more traditional financial gatekeepers, the authors assert that green gatekeepers are more likely to issue inaccurate certifications. The reasons for this in part may lie with the scientific or technical complexity of what is being certified, particularly in cases of what the authors call a 'credence attribute' — a characteristic of a product that cannot easily be assessed or verified by its consumers, even ex post.

Before addressing whether there is a market failure here that calls for regulation, the authors briefly visit organisational choices of green gatekeepers, and suggest that not-for-profit business models are more transparent and less subject to commercial pressures to apply lax standards.

As for regulation, the authors note that consumer protection laws and securities laws already exist to protect consumers and investors. Nevertheless, they conclude that greenwashing appears inadequately deterred. But they also argue that direct regulation would seem ineffective here, and they specifically advise against regulatory certifications, as this can replace potentially more powerful reputational mechanisms. To the extent that further regulation is required, the authors present a policy mix framework in a two-by-two matrix, based on the parameters of high and low verifiability and the significance of private costs for users relying on inaccurate certifications.

It is very good to appreciate the complexities— and limitations— affecting gatekeepers of any sort, but especially green gatekeepers. But given the diverse range of sustainability impacts and indicators that companies face, the authors rightly avoid a simplistic regulatory solution to improving the quality and verifiability of green gatekeepers. Having spent 25 years at a financial gatekeeper (S&P) I would agree that reputation is — and should be—the critical factor driving the license to operate, and this is only earned by providing a transparent high-quality service, not through regulatory fiat.

Read the paper: https://www.ecgi.global/publications/working-papers/green-gatekeepers

Family Business

Paper: **Placeholder CEOs**
Authors: **Mario Daniele Amore** (Bocconi University, CEPR, ICGS and ECGI); **Morten Bennedsen** (INSEAD, University of Copenhagen and ECGI); **Vikas Mehrotra** (University of Alberta); **Jungwook Shim** (Kansai University); **Yupana Wiwattanakantang** (National University of Singapore and ECGI)
ECGI Working paper Finance series #1012/2024

Family business is the dominant business model in most of the world and succession planning is typically one of the thorniest challenges affecting family companies. The transition from family management to professional management is a key step in the evolution of a company. But what if this is just for a limited period of time before reverting back into family management? This is the topic addressed in the working paper Placeholder CEOs, by Mario Daniele Amore, Morten Bennedsen, Vikas Mehrotra, Jungwook Shim and Yupana Wiwattanakantang.

One of the main benefits of the paper is the distinction drawn between what the authors call ‘professional’ CEOs versus ‘placeholder’ CEOs. Placeholder CEOs are defined as professional, non-family members whose role it is to manage the company to plug gaps between a retiring family CEO and the ability of a (presumably younger) heir to assume power. In so doing the placeholder CEO supports what the authors call a family firm’s ‘dynastic control motives’.

Identifying placeholder CEOs may be difficult to do ex ante, and companies are unlikely classify their CEOs publicly according to a placeholder designation. As such, they can only be identified ex post in cases where a placeholder CEO is succeeded by a family member. This is exactly what the authors did, looking both at six individual cases of placeholder CEOs (Zara, Hermes, H&M, Bering Bank, Toyota and Ford). This is complemented with an empirical study of placeholder CEOs in Japanese family firms from 1949-2015, and the authors conclude that 7% of Japanese family companies have placeholder CEOs.

What is interesting about this paper are the different attributes associated with placeholder CEOs versus more traditional professional CEOs. Placeholder CEOs are older, well-educated and typically more experienced than family managers, and the authors suggest that placeholder CEOs can add value and stability to longer term family succession. Professional CEOs on the other hand are typically brought in to address problems facing the business without the expectation that the leadership would revert back into family management. Their job is to bring change and introduce greater professional competence, often in difficult situations. The authors assert that professional CEOs tend to improve firm performance while the placeholder CEO's role is more to maintain the family legacy without changing the trajectory of the business. A possibly unapt sporting analogy is that a professional CEO may be playing to win, but a placeholder CEO may be playing not to lose.

All in, the authors make an important distinction of the role of the placeholder CEO as a tactic in supporting a family's dynastic control motives over time. Indeed, the introduction to the paper is: 「血は水よりも濃い」–Blood is thicker than water.

But is dynastic control the right endgame here? While placeholder CEOs might be regarded as regents preserving the monarchy, what about the antiroyalists out there? As an investor I was struck by the authors' assertion that professional CEOs generally improve firm performance, while placeholder CEOs' role is to maintain performance. For minority investors who do not enjoy the private benefits of control it is not clear if the placeholder CEO mechanism is the best way to preserve and create sustainable value.

Read the paper: https://www.ecgi.global/publications/working-papers/placeholder-ceos

Emerging Markets/Board Effectiveness

Paper: **The Abolition of Independent Directors in Indonesia: Rationally Autochthonous or Foolishly Idiosyncratic?**
Authors: **Royhan Akbar** (Universitas Gadjah Mada); **Nathaniel Mangunsong** (Universitas Indonesia); **Dan W. Puchniak** (Singapore Management University and ECGI)
ECGI Working paper Law series #802/2024

This paper has a lot of intriguing features. In writing The Abolition of Independent Directors in Indonesia: Rationally Autochthonous or Foolishly Idiosyncratic?, the authors Royhan Akbar, Nathaniel Mangunsong, and Dan Puchniak showcase Indonesia's corporate governance system, particularly following the 2018 decision to abolish a requirement for independent directors on the boards of listed companies, something that is quasi-heretical through the lens of Western corporate governance. The paper presents Indonesia's 'autochtonous' (e.g., indigenous) approach to independent oversight through the role of independent commissioners as a substitute for board independence. But they also indicate that this is only a partial substitute, and identify key limitations of independent commissioners vis-à-vis powerful controlling shareholders that are prevalent in Indonesia.

The Indonesian corporate governance context has been shaped both by the Dutch roots of its company law, including a two-tier board structure, and also by the 'forced transplant' of American style independent directors in the wake of the 1990s Asian financial crisis, following pressure by global bodies such as the IMF, World Bank and the OECD corporate governance principles. Yet the authors note that the primary corporate governance problem in Indonesia is not the need for independent directors to oversee managers with widely dispersed ownership. Rather, in the Indonesian context the main governance challenge is the extraction of private benefits by controlling shareholders at the expense of minority shareholders.

As a consequence, in the Indonesian Company Law review in 2007, the authors report that the Anglo-American concept of the independent director was seen as 'an ill-suited imposition on Indonesia's path dependent, civil-law based two tier board system', which set the stage for the 2018 relaxation of independence requirements. Fast forward to 2023 and the authors report the remarkable statistic that there was not a single independent director in any of Indonesia's 20 largest listed companies.

The premise behind this change is not to abandon the idea of independent oversight. Rather, it reflects sentiment, not fully shared by the authors, that the independent commissioner system in Indonesia in its current form serves as an adequate substitute for independent board directors given its two-tier tradition. I know that investors have looked sceptically at similar structures in other markets, such as the Statutory Auditor in Japan and the Fiscal Counsel in Brazil.

In these cases, as in Indonesia, the authors rightly identify factors such as the limited legal authority of the commissioners to appoint and remove board directors, which may inhibit their practical effectiveness as compared with independent board directors.

While the authors acknowledge these potential deficiencies their focus is not to revert Indonesia back to an Anglo centric governance framework. They conclude their paper by working within the Indonesian context to propose a range of reforms in the independent commissioner system that would give it more teeth and create more incentives for true independent oversight. Their final thought is that there is a nuanced interplay between global standards and local contexts, and that the Indonesia case is an example of an 'autochtonous' solution to governance challenges that are internationally credible and domestically effective.

Looking at this more broadly, this precedent in Indonesia presents an interesting thought experiment: would companies in other jurisdictions still appoint independent directors if there was no regulatory or listing rule requirement to do so? The investor in me would certainly hope so. But there is no sure fix to realising independence. True board independence is an aspirational goal, an aspiration we abandon at our peril. But it cannot be achieved simply as a matter of board design.

Read the paper: https://www.ecgi.global/publications/working-papers/the-abolition-of-independent-directors-in-indonesia-rationally

Codetermination

Paper: **Codetermination's Moment of Truth: Overseas Workers**
Author: **Jens Dammann** (University of Texas at Austin and ECGI)
ECGI Working paper Law series #809/2024

Codetermination — an approach to company governance involving the election of governing board representation by the company's workforce — is most typically regarded as a European construction, with Germany as its posterchild. But in his paper Codetermination's Moment of Truth: Overseas Workers Jens Dammann aims his attention at the US, exploring the important issue of how overseas workers fit into the codetermination model. This is a question that has global relevance for any company working with a codetermination structure and is not limited to the US.

Dammann's paper begins with a legal overview of codetermination, including both corporate law and employment law perspectives, concluding that there are no legal constraints in the US that would prohibit overseas employees a voice in electing directors of US companies. On the other hand, nor is there a requirement that a US company must grant overseas workers a vote on directors if that right is granted to US workers. This has the potential to be a substantive issue, as major US multinationals such as Coca Cola, Procter & Gamble and General Electric have predominantly a non-US workforce.

Dammann then takes a closer look at European codetermination and how that relates to overseas workers. He notes that no European country requires a co-determined company to extend the right to vote to foreign employees. It was surprising (to me at least) to learn that Germany itself (unlike Denmark and France) explicitly bans foreign workers the right to vote for employee directors or be elected to the board. Cast in this way there can be a clear political economy dimension to codetermination, pitting the industrial logic of the individual company against broader social issues of job security and employment in the home country.

Dammann then does a nice job of taking us through the pros and cons of the codetermination system, in a way that is relevant across jurisdictions. This includes the positives of potentially greater social cohesion with the workforce pitted against concerns relating to diverging interests, including risk aversion, removing corporate directors, board bureaucracy and inhibiting the market for corporate control. In the end the paper is an interesting examination of codetermination in two ways: both the focus on codetermination in the US and the focus on the role of overseas workers in any jurisdiction. Dammann is not advocating a grand solution or generalisable outcomes. His main purpose is to outline the costs, benefits and potential trade-offs faced by companies, boards, employees and directors.

Having said that, I think Dammann could have pressed harder on the issue of directors' fiduciary duties, regardless of whether they are employee- or shareholder-elected. The first order of loyalty and care of any director is to the company itself and not the proprietary interests of the employees or shareholders. But human nature suggests that this may be an aspirational objective — and that as a practical matter employee-elected directors will act not only as advocates for the workforce, but more specifically for the workforce in their own jurisdiction.

I was jumping out of my seat waiting for the reference (that did not come) to Volkswagen's current dilemma in Germany relating to its announced plans to shut factories in Germany as a matter of operational rationalisation given strains on the company's finances, especially given that VW is a high cost producer in a cost-competitive industry. Yet this restructuring is opposed by the company's all-German employee elected directors (mostly trade union representatives) and by the German state of Lower Saxony, where VW is a major part of its economy — and arguably more interested in VW's ability to provide employment and generate tax revenues in the state than by receiving dividends and capital appreciation on its shares. While these two groups jointly control over 50% of Supervisory Board seats, the Piech/Porsche family control over 50% of VW's voting shares. From the outside this looks to be a train wreck playing out before our eyes in slow motion and is a live example of how divergent interests in a codetermination system can have potentially dysfunctional operational and financial impacts on the company.

Regarding the applicability of codetermination in the US, it is interesting to see Dammann link the interest in codetermination in part to the US concepts of workplace democracy as advocated by the likes of Elizabeth Warren and Bernie Sanders. Yet in the current political climate in the US, I wonder if this seems like more of an academic than a practical question. While Dammann argues that codetermination is 'legal' in the US, I do question its cultural fit; the US is not Germany.

Particularly given the outcome of the recent US presidential election, one may legitimately wonder if the workplace democracy train has left the station in the US — at least for now —along with all other things regarded as 'woke'.

Read the paper: https://www.ecgi.global/publications/working-papers/codeterminations-moment-of-truth-overseas-workers

Private Credit

Paper: **The Credit Markets Go Dark**
Authors: **Jared A. Ellias** (Harvard Law School); **Elisabeth de Fontenay** (Duke University School of Law and ECGI)
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My long experience at S&P rating corporate debt has no doubt embedded in my psyche a creditor's view of the world, as well as some degree of frustration that governance questions as to the role of the creditor and debt capital remain far less explored than in the case of shareholders and equity capital. So I welcomed with great interest the paper The Credit Markets Go Dark by Jared A. Ellias and Elisabeth de Fontenay.

The growth of private equity has been well-documented, but in this paper Ellias and de Fontenay focus on the growing investment strategy of 'private credit' in the US, which they define as commercial loans that are arranged and originated not by banks, but primarily by private investment funds. From a level of $400 million in 2000, private credit grew to roughly $1.6 trillion in 2023 and potentially $3.5 trillion in 2028. Notwithstanding this rapid growth, the authors note that legal scholarship on private credit is 'surprisingly sparse', even though it represents a new form of shadow banking, outside the direct scrutiny of bank regulation.

The relative advantages of private debt are similar to those of private equity, particularly from the perspective of the company as borrower. Some of this reflects the traditional benefits of relationship banking, including factors such as speed, flexibility, confidentiality and easier renegotiation. There are similar benefits to other key players in the private credit ecosystem, namely debt investors themselves (higher returns given lesser liquidity as well as stronger covenants) and asset managers (attractive management fees without banking law limitations and compliance constraints). So, is this win-win-win? What's not to like?

Taking a step back, the authors identify potential concerns relating to the growth of private credit, starting with the growing concentration of significant amounts of both corporate debt and equity in the hands of private investment funds. Compared with the banking sector, investment funds are lightly regulated, and the authors refer to limited public disclosure and a 'shroud of secrecy' in which a significant, and growing, segment of the US economy may simply 'go dark' under the control of private funds with potentially significant power.

They also cite potential consequences including privately prioritising financial returns at the expense of ignoring the needs of non-financial stakeholders or possibly imposing negative social externalities.

The authors' greatest concern is the lack of disclosure that comes with companies financed by private credit and equity. If this growth trajectory continues, they note that 'we may eventually have little or no information at all about the company itself, including its assets, size, governance, and valuation.' This raises scope for misleading valuations, less liquidity in private debt and equity and a greater incidence of fraud. In some ways this seems to be a clear step backwards from the benefits that public markets bring. Ellias and de Fontenay also focus on the question of bankruptcy and observe that private capital providers may possess 'outsized power' that has the potential for inequitable opportunism in the cases of insolvency.

Does private credit represent a systemic risk to the financial system? At present, probably not, but its trajectory warrants attention. This paper shines a thought-provoking spotlight on the growing private credit sector. It is a useful heads up, and the authors identify legitimate concerns, particularly regarding opacity, that will need to be addressed as the private credit market continues to grow.

Read the paper: https://www.ecgi.global/publications/working-papers/the-credit-markets-go-dark

ESG engagement in Asia

Paper: **Contextualising ESG Funds' Engagement Strategies in Asia**
Authors: **Luh Luh Lan** (National University of Singapore and ECGI); **Ernest Lim** (National University of Singapore)
ECGI Working paper Law series #807/2024

It is both interesting and important to think about how differing corporate governance regimes around the world can call for different strategies for investors regarding engagement and stewardship more broadly. In their paper Contextualising ESG Funds' Engagement Strategies in Asia, Luh Luh Lan and Ernest Lim address this issue directly, taking into consideration how distinctive features of ownership structures and corporate governance mechanisms in a range of Asian jurisdictions can affect practical stewardship outcomes. They make use of a conceptual model of stewardship to address the obstacles to stewardship in Asia, particularly with regard to investment funds that take consideration of ESG factors in their investment strategy. The authors conclude by identifying the types of investor engagement strategies that may be most effective in an Asian context.

The challenge of this task relates in part to the heterogeneity of Asia itself, reflecting divergent economies, stages of economic development, market structures, legal traditions, ownership patterns and attitudes regarding ESG and sustainability factors.

This can make it challenging, especially for Western investors, to know how to engage effectively in Asia. But the authors do find common denominators that characterise the engagement challenges in Asian markets, including shareholding restrictions, concentrated shareholdings, political concerns and poor ESG data. While these are certainly relevant themes for Asia, they really are not all that much different from other emerging markets, or markets with strong traditions of concentrated ownership.

To help us navigate these complexities the authors present an ESG Funds Engagement Pyramid that they have adapted from the work of Gideon Rosenblatt, presenting how differing levels of stewardship relate to differing levels of engagement: observing, follow up, participating, contributing, owning and controlling. I was not sold on the particular merits of adapting the Rosenblatt approach to engagement in this way and have seen clearer schematics of the stages of engagement and processes of escalation. I found the authors' attempts to adapt it to be a bit forced relative to the actual engagement process. But they did make use of good case examples of North American and European investors and their engagement approaches to specific Asian companies. I thought the authors' discussion of distinctive issues in Asia, such as RPTs, differing shareholder voting mechanisms, 'symbolic' companies, conflicts of interest and investor collaboration with the State was particularly interesting and rich in insight.

China in particular comes to mind here, and one of my favourite parts of the paper was its consideration of how investor engagement fits within the authoritarian Chinese system, particularly given the strong influence of the state. They speak of state openness to overseas 'strategic investors', but that seems more suited for industrial companies' foreign direct investment in China, not diversified asset managers. It was interesting to read about the China Asset Management Company (CMAC) and its role as a state-backed institutional investor. But the authors seem to suggest that overseas investors on their own is close to futile, without working in collaboration with a domestic Chinese investor. This reminds me of the recent paper by Zhou, Zhang, and Puchniak which spoke to the role that domestic Chinese investors play in engagement, and the greater challenges faced by overseas institutional investors.

Notwithstanding my lack of enthusiasm for the Rosenblatt-inspired pyramid (at least in this application), I do think the authors use its underlying concepts sensibly. My take from this is that Western investors will have greater engagement success in Asia if they are seen to be supporting the aims of the company and its controlling owner through acting constructively in strategies such as 'participating' and 'contributing': trying to work in harmony with the system rather that directly challenge it. And while this might come across as a flimsy martial arts metaphor, there does seem to be sense in this conclusion. Though in situations where overseas investors have more fundamental issues or conflicts with the company or its controlling owners, chances of engagement success may be significantly lower.

Read the paper: https://www.ecgi.global/publications/working-papers/contextualising-esg-funds-engagement-strategies-in-asia

Private Credit

Paper: **Common Investors Across the Capital Structure: Private Debt Funds as Dual Holders**

Authors: **Tetiana Davydiuk** (Johns Hopkins University); **Isil Erel** (Ohio State University, NBER, and ECGI); **Wei Jiang** (Emory University, NBER, and ECGI); **Tatyana Marchuk** (Nova School of Business and Economics and CEPR)

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In last month's Debrief we looked at the growing role of private credit, which expressed concern about the potential market opacity that might result as private equity and debt finance build in volume. We continue with the theme of private credit in the working paper Common Investors Across the Capital Structure: Private Debt Funds as Dual Holders by Davydiuk, Erel, Jiang, and Marchuk. In this case the authors consider a different, and arguably more positive, take on private credit, considering in particular the role of Business Development Companies (BDCs) as private providers of equity and debt finance, mainly to small and medium sized companies.

The paper draws from a sample of 69 BDCs in the US that provided funding to over 9000 portfolio firms from 2004-2017, a period in which the number of BDCs grew rapidly in absolute terms. The authors conducted a range of econometric tests, focusing specifically on BDCs that hold debt and equity investments in the same portfolio. They conclude that BDCs are more effective monitors than sole lenders, which enables them to charge higher loan spreads while reducing credit risk at the same time.

While this might sound like alchemy or something that defies 'credit physics', there is an intriguing logic to this that the authors express primarily as a result of what they call 'delegated monitoring', namely that dual holders can exercise both creditor rights through covenants and reorganization and shareholder rights via voting and board representation. But they also identify the critical role that capital structure plays as a mechanism. As dual holders, BDCs also have better access to firm information than sole lenders, and this blend of capital facilitates closer and more robust monitoring. The premium earned by BDCs in this way can be interpreted as a sort of 'service fee' by adding value to the portfolio by close monitoring and the alignment of interest between creditors and shareholders— as they are one and the same.

As a former credit and fixed income professional I found the paper's findings to be interesting, intuitively right, and an important perspective on corporate finance and investment. In particular I like the blended perspective of the dual holder, something that is missing in credit-only or equity-only funds, and possibly underplayed in investment analysis more generally. While creditors and shareholders are sometimes pitted against one another, their relationship is ultimately symbiotic: they need one another and are united by their common interest in the success of the company they are both funding.

An enlightened creditor realises the need for equity capital, and that the shareholder requires a fair return on risk adjusted equity capital; an enlightened shareholder understands the importance of the company to have access to cost effective debt, which requires it to maintain a prudent capital structure to protect against credit risk. The process of enlightenment can be facilitated through dual holdings of debt and equity, and from a capital allocation perspective it can also serve as a mechanism for a company to develop an appropriate balance of debt and equity at the individual company level.

While it may be right to flag concerns about the growth of private credit, including opacity and impacts on public markets— and particularly given their rapid growth— there also may be a lesson to be learned here in taking a holistic approach to corporate finance through the blended lens of debt and equity. In a more general way, the paper speaks to, and in some ways quantifies, the value that investors can provide through 'delegated monitoring' — or what others might call stewardship.

Read the paper: https://www.ecgi.global/publications/working-papers/common-investors-across-the-capital-structure-private-debt-funds-as

Comparative Executive Remuneration

Paper: **Executive Remuneration: A Comparative Overview II**
Authors: **Guido Ferrarini** (University of Genoa, ECLE, EUSFiL and ECGI); **Maria Cristina Ungureanu** (Genoa Centre for Law and Finance)
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Executive pay is one of those evergreen corporate governance topics that never really goes away. But it is certainly not static, and changes in the nature of executive remuneration are often reflective of changes in corporate governance more generally. In their paper Executive Remuneration: A Comparative Overview II, Ferrarini and Ungureanu bring both a scholarly and a practitioner's approach to executive remuneration, updating a study that they had published over 10 years ago.

While the paper focuses on recent trends in executive pay, it also serves nicely as a primer on remuneration from a governance perspective, focusing on Europe and the US and how these markets differ in approach. The authors begin by grounding us with a theoretical economic framework for executive pay: shareholder value, rent extraction and institutional factors such as regulation, tax and accounting. The paper is rich with content, structured around factors including financial stability, incentive design, environmental and social sustainability governance mechanisms (boards, shareholders disclosure) regulations, and financial institutions.

The wide scope of this paper makes it a challenge to draw overarching conclusions. But to highlight a couple of items, the paper does show contrasts in approach to executive pay in continental Europe on the one hand and the US and UK on the other.

For example, while the US and UK use mandated disclosures, such as pay ratios, to deter (not always successfully!) excessive pay, on the European continent more prescriptive regulation is on the rise, including a 75% 'super tax' pay by employers on compensation over €1 million. While investors historically have been reluctant to consider the raw quantum of pay, that is now gaining greater attention, particularly given broader social concerns about inequality and unfair distribution of wealth.

This leads nicely to the other main trend over the past 10-15 years: the growing focus on sustainability and integrating ESG metrics into executive pay structures. ESG linked incentives are on the rise, even though it can be a challenge to define meaningful and material ESG metrics, and the authors remind us that there is scepticism that ESG pay metrics can represent a 'woke' way of sandbagging executive incentive awards. The paper concludes with interesting discussions of comparative pay regulation between Europe and the US and the relevance of remuneration incentives for systemically important financial institutions.

The paper serves as a useful update and is a very good and readable introduction to remuneration for those less familiar with it as a corporate governance topic. Yet I'm wondering if this is already a bit out of date. Given the recent US political election and the emboldened 'anti woke' culture, one wonders if we are possibly entering a phase of ESG backlash, which might have the effect of reducing the use of ESG factors in executive pay. That chapter may have to wait for the third edition.

Read the paper: https://www.ecgi.global/publications/working-papers/executive-remuneration-a-comparative-overview-ii

ESG and Executive Pay

Paper: **Executive Remuneration: A Comparative Overview II**
Authors: **Nickolay Gantchev** (University of Warwick, CEPR and ECGI); **Mariassunta Giannetti** (Stockholm School of Economics, CEPR, SHoF and ECGI); **Marcus Hober** (Stockholm School of Economics)
ECGI Working paper Finance series #1020/2024

The paper Beyond ESG: Executive Pay Metrics and Shareholder Support by Gantchev, Giannetti, and Hober continues on the theme of executive pay, drilling down specifically on ESG factors in executive pay. Like Ferrarini and Ungureanu, the authors document the 'explosive' growth of E&S metrics in executive incentives, in this case based on a manual classification of the compensation targets in the executive contracts of 10,636 listed companies around the world from 2011 to 2022. This is the data foundation on which the authors conduct a wide range of statistical tests on the use of E&S and other operating metrics as part of executive pay practices.

The paper's econometric model classifies pay metrics into four categories: earnings, market performance, operating and ESG.

The analysis contains many interesting insights, drawing from statistically significant correlations (without claiming causality). To pick just one, the authors suggest that companies employ specific ESG metrics on which they have outperformed during the previous year—regardless of whether such metrics are material for the company's performance or not. This suggests a possibly cynical approach that points to the use of ESG factors effectively as a gaming device or 'sandbagging' mechanism, as discussed in the Ferrarini and Ungureanu paper above. The authors don't go quite that far, but they do conclude that ESG factors play 'a crucial role in reducing shareholder dissent on compensation and other managerial proposals'.

I can see why the authors separated what they call operational metrics from E&S metrics, as this allows for a statistical comparison as to how they may differ in executive pay packages. But I am slightly troubled by the labelling of E&S metrics as 'non-pecuniary', almost suggesting that E&S sits at the children's table, away from the grown-ups of earnings, market performance and traditional operational metrics. It is certainly the case that some, if not many, E&S metrics may be empty of financial relevance. In such cases, those metrics should not be used, even if the company may be 'good at it'. But the whole idea of using the SASB materiality matrix is aimed towards identifying those sustainability factors that do have a pecuniary impact and financial materiality. In these cases, material E&S factors should be considered just as another form of operational risk, and not in a standalone silo for 'non-pecuniary' stuff. This lies behind the concept of so-called 'enlightened shareholder value'.

One of the paper's main conclusions is that the rise in ESG metrics in pay reflects a more general rise in the use of operating metrics. This seems sensible, as operating metrics are often employed in balanced scorecards by company management, and can form a legitimate basis for executive pay, specifically in short term (one year) incentive plans. But they also make a broader point about ESG metrics building investor consensus around overall corporate strategy that did not entirely resonate with my professional experience in asset management. No doubt, there is (or at least should be) a clear linkage of performance metrics linked to strategic goals. Maybe it is a semantics point, but I don't think investors interpret executive pay as an endorsement of corporate strategy per se — though in cases where they are not happy with strategy it is more likely that this would be reflected in say on pay votes. The authors also used the term 'signaling role' that the use of compensation metrics communicates to shareholders. To me that is a better way of putting it, though for investors the key is to ensure that the company's 'signals' are material and have relevance to the company's long-term strategy, financial performance and resilience.

Read the paper: https://www.ecgi.global/publications/working-papers/beyond-esg-executive-pay-metrics-and-shareholder-support

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