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A Personal Reflection on Corporate Governance: Is 2015, like 1985, an Inflection Year?

In an October 2015 paper, I posed the question: *Will a New Paradigm for Corporate Governance Bring Peace to the Thirty Years' War?* As we approach the end of 2015, I thought it would be useful to note some of the most cogent recent developments on which the need, and hope, for a new paradigm is based. These developments include, among other things, the accumulation of a critical mass of academic research that discredits the notion that short-termism, activist attacks and shareholder-centric corporate governance tend to create rather than destroy long-term value.

In January a *Report of the Commission on Inclusive Prosperity*, co-chaired by Lawrence Summers and Ed Balls, identified activism and short-termism as being a threat to the American economy and society. The report noted that reforming corporate governance and moving away from quarterly reporting are critical:

> "An additional reason for the absence of inclusive prosperity [inequality] is the changing nature of corporate behavior. Business leaders, government officials, and academics have pointed out that corporations have shifted their traditional focus on long-term profit maximization to maximizing short-term stock-market valuations.
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> The effects of short-termism are damaging to the economy as a whole. A firm that invests for the long term will make more investments in future productivity, whether that's developing lifesaving medicine; building or buying newer, more efficient machinery; or paying for training for its workforce. All of these investments show up immediately as expenses on the balance sheet and reduce profits in the current quarter but raise future productivity of the firm. Incentivizing a continuing short-term focus lowers future output, reduces long-term competitiveness, and diminishes future worker productivity and the higher wages that it can bring.
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> To provide greater macroeconomic and financial stability and to raise productivity, it is essential that markets work in the public interest and for the long term rather than focusing only on short-term returns."

At various times during the year, BlackRock, State Street and Vanguard (the major managers of index funds that together hold, on average, about 15% of the shares of most significant U.S. public companies) issued statements that they would support the long-term plans of companies against activist attacks and they would withhold support of activists who primarily seek to force companies into share buybacks and extraordinary distributions. In May, these three institutional investors supported DuPont in its proxy fight with Trian. See Winning a Proxy Fight – Lessons from the DuPont-Trian Vote and Some Lessons from BlackRock, Vanguard and DuPont—A New Paradigm for Governance.

During 2015, five important papers were published by prominent economists, law professors, a renowned jurist and The Conference Board, each of which points out serious flaws in the so-called empirical evidence and policy arguments being put forth to justify short-termism, attacks by activist hedge funds and shareholder-centric corporate governance.

> Emiliano Catan and Marcel Kahan, *The Law and Finance of Anti-Takeover Statutes*,
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> Yvan Allaire and François Dauphin, *The Game of 'Activist' Hedge Funds: Cui bono?*
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> John C. Coffee, Jr. and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance,*
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> The Conference Board, *Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?*
>
> Leo Strine, Jr., Chief Justice of the Supreme Court of Delaware, *Securing Our Nation's Economic Future: A Sensible, Nonpartisan Agenda To Increase Long-Term Investment And Job Creation In The United States*

For an earlier critique of the defects in the so-called empirical evidence, see *The Bebchuk Syllogism*.

In addition, last month, K.J. Martijn Cremers, Erasmo Giambona, Simone M. Sepe, and Ye Wang published the results of an impressive econometric study, *Hedge Fund Activism and Long-Term Firm Value*, that indicates that hedge fund activism more likely destroys long-term value rather than creates it. Their results show that prior studies—of the type Harvard Law School Professor Lucian Bebchuk relies on to validate his policy arguments in favor of unfettered attacks by activist hedge funds—do not warrant the credibility claimed for them.

The aforementioned studies and papers build on the growing body of academic and policy research focused on this critical issue, including many other insightful studies that seriously undermine the credibility of shareholder-centric governance and its concomitant short-termism and hedge fund activism.

In a paper I presented at an August meeting of the World Economic Forum, *Is Activism Moving In-House*, I quoted Laurence Fink, Chairman and CEO of BlackRock:

> "It is critical, however, to understand that corporate leaders' duty of care and loyalty is not to every investor or trader who owns their companies' shares at any moment in time, but to the company and its long-term owners. Successfully fulfilling that duty requires that corporate leaders engage with a company's long-term providers of capital; that they resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, that they clearly and effectively articulate their strategy for sus-

> tainable long-term growth. Corporate leaders and their companies who follow this model can expect our support."

I concluded by expressing hope that activism would continue to move in-house at the major institutional investors and, as this new paradigm for corporate governance becomes pervasive, the influence of hedge fund activists and ISS and Glass Lewis will shrink and be replaced by the policies, evaluations and decisions of the major institutions. While this will be a welcome relief from the short-termism imposed by hedge fund activists, it raises a new fundamental question—how will the institutions use their power? In an article in Fortune discussing the ramifications of the outcome of the DuPont-Trian proxy fight, Ram Charan posed the following question:

> "As the biggest asset managers gain more power and exercise it more freely, they bear a heavy responsibility. They may influence employment, national competiveness, and economic policy for better or for worse. They can ensure a balance between short-term and long-term corporate goals, and between value creation and societal needs. They can keep succession planning near the top of every company's agenda. How they will discharge their responsibility remains to be seen…."

I believe that the influence of the major institutional investors will be more favorable to the Nation's economy and society than the current hedge fund activism and pressure for quarterly performance. Hopefully, the institutional investors will follow through on what they are saying about encouraging long-term investment and implement fully the new paradigm.

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