SHAREHOLDER ACTIVISM AND SHORT-TERMISM

Fostering Long-Term Engagement in the European Union

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SHAREHOLDER ACTIVISM AND SHORT-TERMISM

Fostering Long-Term Engagement in the European Union[1]

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Abstract

Executive Summary

Shareholder activism is a central issue in modern corporate governance and the importance of effective shareholder engagement has been put in evidence in the years leading up to the financial crisis of 2008. Indeed, in the last decades, there has been a tendency for corporate investors to disregard due exercise of their rights by focusing exclusively on short-term results.

This paper addresses the issue of shareholder short-termism and considers different alternatives to promote long-term engagement in the European Union setting. In Section I we briefly pose the problem. Subsequently, Section II sets the conceptual framework of short-termism and analyses its economic impacts and the role it has played in the financial collapse of 2008. In section III, we discuss possible regulatory approaches to this issue at the European Union level. In particular, we examine the recently proposed amendments to Directive 2007/36/EC, and pinpoint possible alternatives to the stewardship approach.

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[1] This short paper was written as part of the European Corporate Governance Seminar of the LL.M Law in a European and Global Context, taught by Professor Paulo Câmara, at Católica Global School of Law.

"What is wrong with the British and American system is that far too many shareholders, both individual and institutional, do not behave like owners."

The Economist, 5 May 1990

I – INTRODUCTION

The *quid pro quo* for shareholder primacy in corporate governance is the prospect that shareholders will closely monitor the activities of the company and intervene when they have concerns about the performance and motivations of the board of directors, making use of voting and other rights provided by law.[2] However, in the last decades, there appears to have been a widespread tendency for investors to overlook due exercise of their rights as corporate shareholders, either by being absent or by focusing solely on short-term results.

In these lines, shareholder activism is a central issue in modern corporate governance and it has been put in evidence in the years following the financial crisis of 2008. Indeed, its origins are often attributed, not only to the malfunction of regulation, but also to shareholder short-term activism, arguably stimulating companies to incur unnecessary risks, with potential systemic effects on financial markets.[3]

This paper briefly considers the phenomenon and the adverse impacts of short-termism and the balancing alternative of long-term engagement. Drawing particular focus to the setting of the European Union (EU), the paper discusses different possible regulatory approaches in tackling the problem, namely the recent proposed amendment to Directive 2007/36/EC[4] much inspired by the United Kingdom's (UK) Stewardship Code.

II – THE PHENOMENON AND THE IMPACTS OF SHORT-TERMISM

Short-termism denotes the phenomenon by which investors and corporate managers advert their attention to achieving short-term profitability, without due

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[2] Roger Baker, *Ownership Structure and Shareholder Engagement: Reflections on the Role of Institutional Shareholders in the Financial Crisis,* in Corporate Governance and the Global Financial Crisis – International Perspectives (Sun, Stewart and Pollard Ed.), Cambridge University Press, 2012, at 144.

[3] Lynne Dallas, *Short-Termism, The Financial Crisis and Corporate Governance*, 37 J. Corp. L. 265 2011-2012. See also Martin Lipton, *Empiricism and Experience: Activism and Short-Termism. The Real World of Business*, The Harvard Law School Forum on Corporate Governance and Financial Regulation, available http://blogs.law.harvard.edu/corpgov/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/.

[4] Hereinafter, the Shareholder's Rights Directive (SRD).

consideration of long term consequences.[5] Indeed, the CFA Institute has described it as the "*excessive focus of some corporate leaders and investors on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals and conventional approaches to long-term value creation*." [6]

Shareholder short-termism can manifest in two main ways, often regarded as "pressure" and "walk".[7] Indeed, while some shareholders demonstrate their penchant for rapid returns on their investments, placing pressure on corporate managers to favour short-term results, even if at the expense of long-run performance,[8] others may have the tendency to "exit" rather than to "voice," selling their stock if dissatisfied with corporate management, in good Wall Street Rule fashion.[9] Although it is not limited to any particular class of investors, short-termism is mostly associated with institutional shareholders and gains particular importance with hedge fund investments, as their investment strategy, including speculation, naturally comports buying and holding stock for short periods of time.[10] Indeed, in the words of Kahan & Bock "*short–termism presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism.*"[11] However, the hedge fund industry is not alone in this practice: speculation can also be found in a large population of high-turnover funds portfolio managers ready to jump in and out of the market.[12] Because many of these institutions engage in quarterly evaluation of their fund managers' performance, the managers are left with little option other than to focus their efforts in delivering short-term results.[13]

The phenomenon of short-termism has been under discussion between academics, corporate lawyers and the investment community for over three decades. While the first concerns about short-termism were easily dismissed as associated with ideological considerations,[14] the issue has gained renovated relevance, cutting across the ideological

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5 Alison Atherton et al., Inst. for Sustainable Futures, *Causes of Short–termism in the Finance Sector* (2007).

6 Dean Krehmeyer et al., *CFA Centre for Fin. Market Integrity & Bus. Roundtable Inst. for Corp. Ethics, Breaking the Short–Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts can Refocus on Long–Term Value* 3 (2006).

7 Emeka Duruigbo, *Tackling Shareholder Short–Termism and Managerial Myopia,* Kentucky Law Journal vol.100, 536

8 Louis Lowenstein, *What's Wrong with Wall Street: Short–Term Gain and the Absentee Shareholder* 91–92 (1988); see also J.H.H. Weiler, *The Transformation of Europe*, 100 Yale L.J. 2403, 2411 (1991)

9 The exit–voice formulation was initially made by the economist Albert Hirschman. Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms*, Organizations, and States 30 (1970).

10 Hirschman, *Ibid*, at 46.

11 Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev (2007), at 1087

12 Matteo Tonello, *The Conference Bd., Revisiting Stock Market Short–Termism* (2006)

13 Duruigbo, *Ibid,* at 539.

14 Tonello, *Ibid*, at 13.

divide, since the financial scandals of the early 2000's, such as the collapse of giant energy company Enron. Particularly, consternation about short-termism intensified with the financial crisis of 2008, and the threat it posed to the stock markets and global economy.[15] Indeed, empirical evidence has shown that, in the years leading to the financial collapse, there has been a widespread acquiescence by institutional shareholders in respect of rapidly rising levels of leverage in banks and other financial institutions.[16] A 2008 survey by the CFA Institute Centre for Financial Market Integrity,[17] shows that there has been a significant "*over-emphasis on the short-term perspective*", fostered not only by the profit-oriented motivations of shareholders, but also by the very preferences and methodologies of analysts and asset managers. Similarly, a 2009 UK study by Manifest has shown little evidence of shareholder long-term engagement in relation to the activities of banks prior to 2008.[18]

In face of these developments, it has become clear that the excesses of short-termism need to be curbed and that long-term engagement should be encouraged. Indeed, in a 2009 paper, Warren Buffet and 27 other highly regarded businesspeople, expressed their concerns about the issue, stating that "*the focus of some investors on quarterly earnings and other short-term metrics can harm the interests of shareholders seeking long-term growth and sustainable earnings, if managements and boards pursue strategies simply to satisfy those short-term investors., which may put a corporation's future at risk.*"[19] While some commentators argue that short-term thinking is not a real problem, claiming that it can lead to positive results,[20] the most prominent side of the debate is which strongly views as "*the culprit and as a continuing threat to the economy.*"[21]

While we admit that a short-term outlook is not intrinsically wrong,[22] as it may be a way to counterbalance the risks of long-term policies, and that investors who trade on the short-term may actually provide for liquidity in the stock markets, we believe, in line

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15 See. e.g, Lawrence Mitchell, *Protect Industry from Predatory Speculators*, Financial Times (London), July 8, 2009, http://www.ft.com/intl/cms/s/0/fac881b6–6be5–11de–9320–00144feabdc0

16 Roger Baker, *Ibid,* at 114.

17 CFA Institute, *Short-Termism Survey Practices and Preferences of Investment Professionals Earnings & Other Guidance*, *Communications & Incentive, Report*, 28 May 2008.

18 Manifest, *Treasury Select Committee Inquiry into the Banking Crisis: Memorandum by Manifest Information Services Ltd*, 2009.

19 Aspen Institute, *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management,* 2009.

20 See, for instance Joe Nocera, *A Defense of Short-Termism*, N.Y. Times, July 29, 2006; George W. Dent Jr., *The Essencial Unity of Shareholders and The Myth of Investor Short-Termism,* 35 Del. J. Corp. L. 97 2010; Kuang-Wei Chueh, *Is Hedge Fund Activism New Hope for the Market?,* 2008 Colum. Bus. L. Rev. 724 2008. Fried, Jesse M., *The Uneasy Case for Favoring Long-Term Shareholders* (February 26, 2014). Forthcoming, Yale Law Journal (2014); ECGI - Law Working Paper No. 200

21 Duruigbo, *Ibid,* at 540.

22 Kuang-Wei Chueh, Ibid, at 743

with the evidence brought to sight by the recent financial crisis, that short-term approaches can, indeed, be harmful[23] when they detrimentally conflict with companies' long-term interests and when they hamper appropriate proxy voting and corporate governance policies that are beneficial and sustainable in the long run.

III – FOSTERING SHAREHOLDER LONG-TERM ENGAGEMENT IN THE EU

Against this framework, it appears to be clear that long-term shareholder engagement plays a decisive role in ensuring the sustained development of companies and the stabilization of financial markets. Most importantly, there is a need for meaningful and effective engagement on the part of corporate investors. In the words of John Kay,[24] there is a growing call for investment relationships which are "*based on trust and respect, rooted in analysis and engagement which is positive and supportive, and not merely critical*." This kind of mutual understanding is likely to be of benefit to companies in difficult times. By improving the quality of communication with institutional shareholders, a good basis of confidence and trust can be embedded and, as a result, situations involving tension and potentially strong differences between boards and stakeholders can be more easily solved at an earlier stage. But more than that, a potential benefit of a trust-based relationship is precisely to reduce the focus of investors on earnings announcements and other short-term performance metrics, allowing the company to adopt a long-term strategic orientation.[25]

The ideas presented by John Kay and earlier by Sir David Walker,[26] were very influential in the UK and ultimately lead to the adoption, in 2010, of the Stewardship Code[27] by the Financial Reporting Council, the UK's independent corporate governance regulator. Consisting of a set of seven principles and guidelines, the Stewardship Code, which has been growingly adopted by firms, aims at fostering shareholder engagement by institutional investors. It encourages institutional stakeholders to publicly disclose their engagement policy and to clarify how they plan to discharge their stewardship

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[23] Some commentators even link it with higher levels of corruption. See Salter, Malcolm S., *Short-Termism at Its Worst: How Short-Termism Invites Corruption… and What to Do About It* (April 11, 2013). Edmond J. Safra Working Papers, No. 5.

[24] John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, Final Report, July 2012.

[25] Roger Baker, *Ibid*, at 146.

[26] David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Institutions*, 24 November, United Kingdom HM Treasure (2009)

[27] Stewardship Code, Financial Reporting Council 2012, available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf

responsibilities, amongst other obligations, adopting the "comply or explain" approach used in the UK Corporate Governance Code. Over 250 corporate groups, mainly asset management firms, have agreed to the code since it was launched.

Certainly influenced by the popularity of the Stewardship Code in the UK, the European Commission has recently proposed a review of the so-called Shareholder's Rights Directive, drawing inspiration from the seven stewardship principles and guidelines, as part of the Commission's Action Plan: European Company Law and Corporate Governance – A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies.[28] Taking the hard law approach - unlike the UK alternative - the proposed amendment suggests that institutional investors and asset managers should in principle adopt an engagement policy, disclosing it to the public and informing how it is implemented and what results it accomplishes. Besides, it provides that, where they decide not to develop and/or disclose such engagement policies, institutional investors and asset managers should present a clear and reasoned explanation for their lack of compliance.

Although it undoubtedly represents a worthwhile step for corporate governance in the EU, we understand that the proposed stewardship mechanism faces an uphill battle in order to exert a meaningful effect on board-shareholder engagement. On the one hand, the flexibility inherent to the "comply or explain" enforcement model is prone to create the risk that those under the obligation will fail to treat compliance as a priority and will offer little or inadequate explanation to justify non-compliance.[29] Indeed, especially considering that the proposed revision entails a hard law obligation, there is greater risk of it crystallizing in a merely formal procedure, voided of significant effectiveness. On the other, the proposed approach is to some extent incapable of dislodging certain intrinsic deterrents of long-term shareholder engagement: institutional investors, as custodians of others' funds, typically prefer not to be "locked in" by a policy of intervention and instead want there to be ample scope to off-load underperforming assets when appropriate.[30] Likewise, the asset managers who invest on behalf of institutional investors are geared up to focus on trading decisions and are neither incentivized nor resourced to act as an "owner."[31] Moreover, the growing trend towards the fragmentation of corporate

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28 COM(2012) 740 Final

29 Andrew Keay, *Comply or Explain: In Need of Greater Regulatory Oversight?* (September 10, 2012)

30 A. Hill, *Preacher Myners is Right to Raise Hell With Investors*, Fin. Times, 22 April 2009, 18.

31 P. Skypala, *Expert in How to be a Good Owner Looks Forward to New UK Codes*, Fin. Times, 7 June 2010, FT fm,4.

ownership, prominent, for instance, in the UK,[32] poses greater challenges to stewardship-based regulatory approaches.[33]

In this sense, the approach taken by the European Commission may prove to be ineffective or insufficient in the long run. Stewardship measures should be conciliated with other types of regulatory approaches capable of encouraging long-term shareholder engagement.

On the one hand, the principle of effective engagement should also be embraced at the Member-State level. Governments should recognize that creating an effective shareholder presence in all companies is of national interest and that it is in the nation's policy to foster effective shareholder involvement in the governance of both publicly and privately owned companies. One possibility would be, for instance, to create national councils, with supervision at the EU level, so as to ensure the effective involvement of agencies, stock exchanges and other relevant entities.

On the other, EU regulation and enforcement should create a mechanism to ensure that shareholders are made accountable for exercising their rights in an insensible manner, without hindering their rights and freedoms. This could be achieved through more or less intrusive measures. One possibility would be to impose a sort of "pigouvian tax" on securities transactions especially designed to impose an extra weight on fast moving capital, in order to reduce short-term speculation without damaging the long-term benefits of exchange. The idea of deploying a securities transaction tax to address perceived problems in the financial world is not new. John Maynard Keynes proposed a stock transfer tax many decades ago to "*mitigate the predominance of speculation over enterprise in the United States*."[34] This taxation mechanism would automatically penalize short–horizon activism, while negligibly affecting the incentives for long–term capital investments. A less restrictive alternative, much inspired by Richard Posner's concept of "reputation costs",[35] would be, for instance, to adopt a system of publicly held statistics at the EU level, disclosing evidence of insensible short-term engagement policies by identified institution investors and fund managers.

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32 See Office of National Statistics, Ownership of UK Quoted Shares, 2012, available at http://www.ons.gov.uk/ons/rel/pnfc1/share-ownership---share-register-survey-report/2012/stb-share-ownership-2012.html

33 Cheffins, Brian R., *The Stewardship Code's Achilles' Heel* (July 2, 2010). University of Cambridge Faculty of Law Research Paper No. 28/2011.

34 John Maynard Keynes, *The General Theory of Employment, Interest, and Money* 160 (Harcourt, Brace & World 1964) (1936).

35 Richard Posner, *Privacy, Secrecy and Reputation*, 28 Buffalo Law Review 1 (1979).

IV – CONCLUSION

The financial crisis of 2008 has exposed the shortcomings of stakeholder activism based on short-term approaches. Indeed, shareholder short-termism has proved to stimulate companies to incur unnecessary risks, and to overlook long-term consequences, with potential systemic effects on financial markets.

Shareholder short-termism and lack of effective and serious engagement are transversal concerns to most European countries. In this sense, there is a growing need to encourage meaningful long-term engagement of stakeholders in the EU. Although the recently proposed revision of the Shareholder's Rights Directive represents an unquestionable step forward, effective combat of insensible shareholder engagement can benefit from complementary measures both at the Member State and ate the EU level.

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