Venturing into the Belly of the Beast: The Ontological Question

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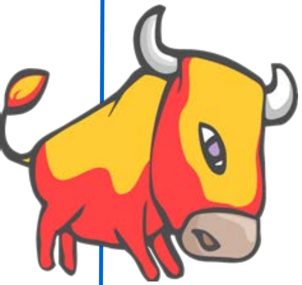

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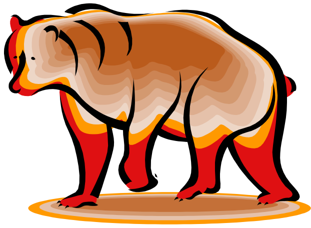


Back to the Future:

The Current and Former Status of the Great Corporate Governance Debate

Back to the Future: Post-Crisis Corporate Governance Regulatory and Legislative Landscape

- *"The current economic crisis has led many investors to raise serious concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders, and has resulted in a loss of investor confidence."* ***– SEC Chair Mary Schapiro, Proposed Rules on Proxy Access***

- *"During this recession, the leadership at some of the nation's most renowned companies took too many risks and too much in salary, while their shareholders had too little say. This legislation will give stockholders the ability to apply the emergency brakes the next time the company management appears to be heading off a cliff."* ***– Senator Charles Schumer, introducing the Shareholder Bill of Rights Act of 2009***

- *"…among the central causes of the financial and economic crisis that the United States faces today has been a widespread failure of corporate governance."* ***– Shareholder Bill of Rights Act of 2009***

- *"By creating a large public demand for reforms, the current crisis offers another opportunity to improve governance arrangements. This opportunity should not be missed."* ***– Prof. Lucian Bebchuk***

Causes and Cures

- Lack of "accountability" of boards/management – to shareholders?
- Compensation levels and incentives?
- Risk management controls?
- "Short-termism" pressures?
- Stated goal of the Shareholder Bill of Rights Act of 2009:
  - "to prioritize the <u>long-term</u> health of firms and their shareholders"
  - to create "more <u>long-term</u> stability and profitability within the corporations that are so vital to the health, well-being, and prosperity of the American people and our economy"

- Is there a disconnect between the stated goals of current legislative/regulatory initiatives and the reality of what they represent – a wish list for governance "reformers" (aka "***GOVERNISTAS***") that is being opportunistically pressed by hijacking a financial crisis?

Causes and Cures *(cont'd.)*

- *"Excessive stockholder power is precisely what caused the short-term fixation that led to the current financial crisis. …The real investors are mostly professional money managers who are focused on the short term. "It is these shareholders who pushed companies to generate returns at levels that were not sustainable. …The pressure to produce unrealistic profit fueled increased risk-taking. And as the government relaxed checks on excessive risk-taking (or, at a minimum, didn't respond with increased prudential regulation), stockholder demands for ever higher returns grew still further. It was a vicious cycle. "Thoughtful observers of corporate governance have recognized the direct causal relationship between the financial meltdown and the short-term focus that drove reckless risk-taking."*

  – Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis, Schumer's Shareholder Bill Misses the Mark, Wall St. Journal, May 12, 2009.

Causes and Cures *(cont'd.)*

- *"It is true that <u>shareholders</u> sometimes encourage companies, including investment banks, to ramp up short-term returns through leverage." "<u>Institutional shareholders should recognize their responsibility</u> to generate long term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working."*

  – International Corporate Governance Network (ICGN), <u>Statement on the Global Financial Crisis</u> (Nov. 10, 2008).

Causes and Cures *(cont'd.)*

- *"Shareholders, boards and [management] and those involved in legislative and regulatory reform initiatives should give special consideration to the <u>long-term</u> nature of corporate wealth-generating activity and strive to avoid undue <u>short-term</u> focus and pressures that may impede the capacity of the corporation for long-term investments and decisions necessary for sustainable wealth creation."*

  – <u>ABA Task Force Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities</u>, Aug. 1, 2009.

- Recommends that <u>boards</u>: "Acknowledge that at times, the company's long-term goals and objectives may not conform to the desires of some shareholders....

Causes and Cures *(cont'd.)*

- *"[I]n recent years, boards, managers, shareholders with varying agendas, and regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation. . . .Restoring that faith [in corporations being the foundation of the American free enterprise system] critically requires restoring a long-term focus for boards, managers, and most particularly, shareholders—if not voluntarily, then by appropriate regulation."*

- *"Encouraging investors and intermediaries representing investors to adopt a long-term perspective will ultimately encourage and empower boards of directors to adopt long-term strategies for growth and sustainable earnings, and to rely on long-term, forward-looking metrics in the consideration of compensation and performance incentives."*

- *"The trend toward greater shareholder power as encapsulated in legislative proposals under consideration in the 2009 legislative session should be accompanied by greater investor and intermediary responsibility."*

  - Aspen Institute, Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management, Sept. 9, 2009.

Myth v. Reality—Did "Poor" Corporate Governance Cause the Financial Crisis?

- Of the 15 S&P 500 companies with the worst-performing stocks in 2008:
  - 80% did not have staggered boards
  - 80% did not have a poison pill in place
  - 73% had majority voting or a director resignation policy
- The biggest decliners were *less* likely to have staggered boards than the average S&P 500 company (20% v. 33%) and no more likely to have a poison pill
- "[T]he case is not made for fundamental reform of current corporate governance arrangements."
  — Professor Brian R. Cheffins (Cambridge), <u>Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500</u>, Business Lawyer, Nov. 2009.

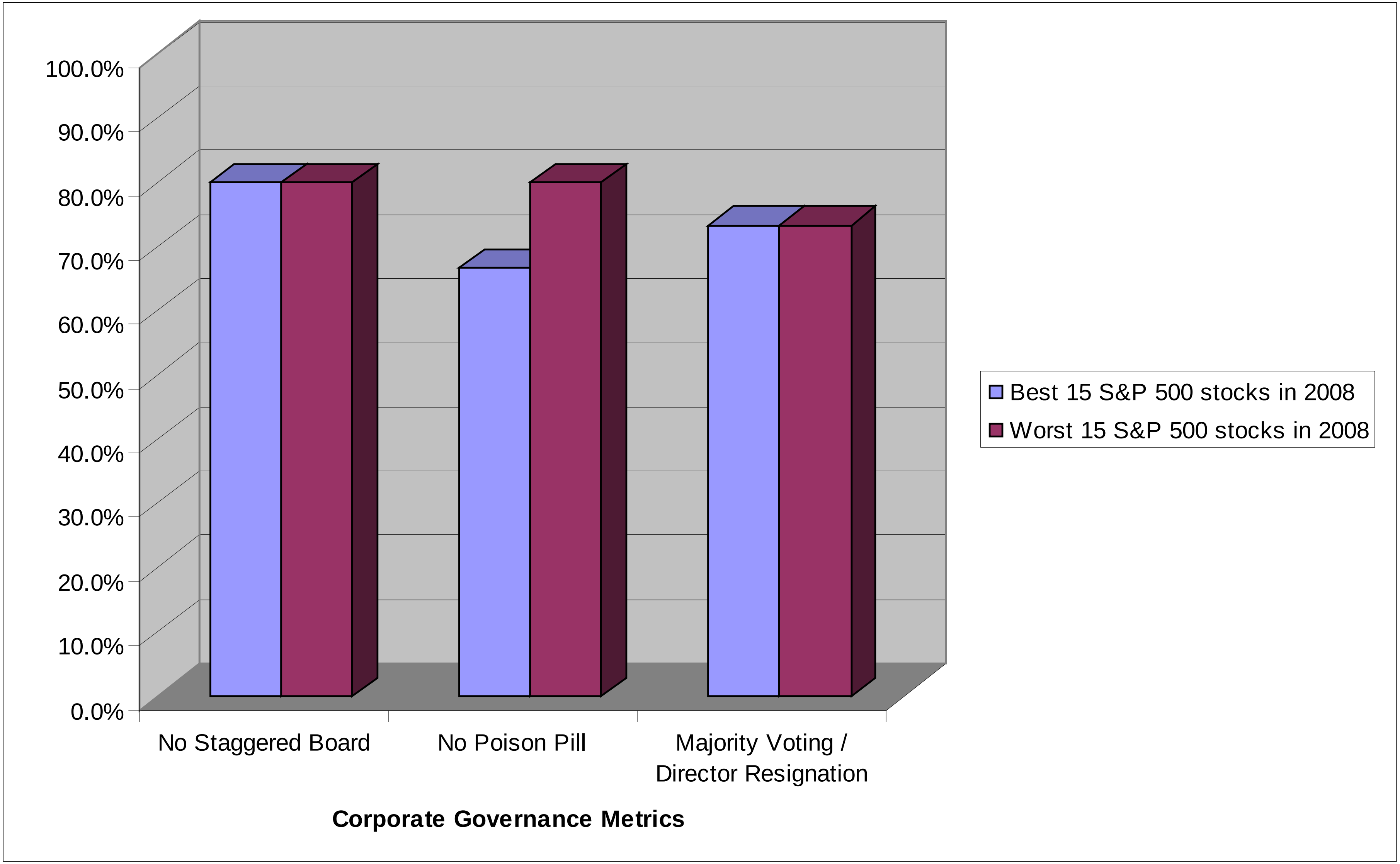
S&P 500 Worst Performing Stocks: 2008

Name	Current Ticker	% Change
Lehman Brothers	*Delisted*	-99.96
Washington Mutual	*Delisted*	-99.84
Fannie Mae	FNM	-98.10
Freddie Mac	FRE	-97.86
AIG	AIG	-97.31
Circuit City	*Delisted*	-96.90
General Growth Properties	GGP	-96.87
EW Scripps	SSP	-95.09
Ambac Financial	ABK	-94.96
XL Capital	XL	-92.65
American Capital	ACAS	-90.17
Bear Stearns	*Merger*	-89.43
National City	NCC	-89.00
Genworth Financial	GNW	-88.88
Developers Diversified	DDR	-87.26

S&P 500 Best Performing Stocks: 2008

Name	Current Ticker	% Change
Wrigley	*Acquired*	36.58
Family Dollar	FDO	35.57
Anheuser-Busch	*Acquired*	31.03
UST	UST	26.61
Amgen	AMGN	24.35
Barr Pharma.	*Acquired*	23.92
Safeco	*Acquired*	22.50
H&R Block	HRB	22.35
Electronic Data	*Acquired*	20.41
Celgene	CELG	19.63
Wal-Mart	WMT	17.95
Rohm and Haas	ROH	16.43
Autozone	AZO	16.31
Hasbro	HAS	14.03
Gilead Sciences	GILD	11.15

Myth v. Reality—Did "Poor" Corporate Governance Cause the Financial Crisis? *(cont'd.)*



“*One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*” Leo E. Strine, Nov. 2010

- “[T]his central problem: why should we expect corporations to chart a sound long-term course of economic growth, if the so-called investors who determine the fate of their managers do not themselves act or think with the long term in mind?” *(pp. 1-2)*

- “Stockholders are not granted the protections of the corporate shield as a societal end in itself. Rather, limited liability encourages stockholders to entrust their capital to corporations, which will engage in risky, but potentially profitable, endeavors. The hoped-for outcome of this risk taking, in the aggregate, is an increase in societal wealth, and not simply through the generation of profits. Rather, to generate profits, corporations have an incentive to employ workers and develop innovative products and services, and to engage in other activities that increase societal wealth.” *(p.2)*

"*One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*" Leo E. Strine, Nov. 2010 (*cont'd.*)

- "The ability of central management to innovate and pursue risky strategies has been protected by corporate law's adoption of a republican, rather than direct, model of corporate democracy. Although stockholders have a regular opportunity to elect a new board, during the board's term, the board has the power, subject to its fiduciary duties, to pursue its vision of what is best for the corporation and its stockholders." *(pp. 3-4)*

“*One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*” **Leo E. Strine, Nov. 2010** (*cont'd.*)

- “If adopted, these corporate governance changes (e.g., changes to the corporation’s board structure or election system) and business strategies (e.g., the reduction of capital expenditures in order to fund a stock buyback program) will often have a long-term effect on the corporation’s performance. Yet, many activist investors hold their stock for a very short period of time and may have the potential to reap profits based on short-term trading strategies that arbitrage corporate policies. Indeed, it is possible for stockholders to engage in activism while holding a net short position, in which they stand to profit if the corporation’s profits decline.

  “The rights given to stockholders to make proposals and vote on corporate business are premised on the theory that stockholders have an interest in increasing the sustainable profitability of the firm. But in corporate polities, unlike nation-states, the citizenry can easily depart and not “eat their own cooking.” As a result, there is a danger that activist stockholders will make proposals motivated by interests other than maximizing the long-term, sustainable profitability of the corporation.” *(pp. 7-8)*

"*One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*" Leo E. Strine, Nov. 2010 (*cont'd.*)

- "For a variety of reasons, these institutional investors often have a myopic concern for short-term performance. Responsible commentators estimate hedge fund turnover 29 at around 300 percent annually. What is even more disturbing than hedge fund turnover is the gerbil-like trading activity of the mutual fund industry which is the primary investor of Americans' 401(k) contributions. The average portfolio turnover at actively managed mutual funds, for example, is approximately 100 percent a year. Median turnover is in the 65 percent range. Sadly, there appears to be a basis to believe that pension funds also engage in turnover of their equity investments at a similar rate. Given that institutions dominate ownership, these trends now consistently result in annualized turnover of stocks traded on the New York Stock Exchange of well over 100 percent, with turnover approaching 138 percent in 2008.

  "And, a rough calculation using transaction activity and market capitalization data from the U.S. Statistical Abstract reveals that turnover across all U.S. exchanges reached approximately 311 percent in 2008.

  "***This kind of churning renders the institutions more short-term speculators than committed, long-term investors***." *(pp. 10-11)*

“*One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*” **Leo E. Strine, Nov. 2010** (*cont'd.*)

- “ The focus of many of these institutions on quarterly earnings and other short-term metrics is fundamentally inconsistent with the objectives of most of their end-user investors, people saving primarily for two purposes, to put their kids through college and to fund their own retirements. These end-user investors do not care about quarterly earnings or short-term gimmicks. These end-user investors want corporations to produce sustainable wealth that will be there when they need it.

  “Indeed, it is increasingly the case that the agenda setters in corporate policy discussions are highly leveraged hedge funds, with no long-term commitment to the corporations in which they invest.” *(p. 12)*

“*Does Changing Corporate Governance Alone Result in Better Firm Performance?*” N. K. Chidambaran, Darius Palia, and Yudan Zheng (2010)

- “An important public policy issue actively debated in the financial economics literature is whether firms can increase their value *solely* by changing one or more corporate governance mechanisms. In this paper, we directly examine whether changing governance leads to future firm performance. Specifically, we analyze a sample of firms that instituted governance changes and sort them based on the direction of their governance change for thirteen different governance measures. We focus on firms that make large governance changes to enhance the power of our tests. We find no significant difference in future performance between firms that have a large increase in governance measures and firms that have a large decrease in governance measures. We also find that the governance changes are driven by movement towards mean industry governance levels, merger pressures, as well as to changes in the firm’s observable characteristics.” (*Abstract*)

“*Does Changing Corporate Governance Alone Result in Better Firm Performance?*” N. K. Chidambaran, Darius Palia, and Yudan Zheng (2010)*(cont’d.)*

- “We interpret our results to imply that firms optimize on a Coasian envelope across various governance measures. Our results are also consistent with prior work that has found each of the governance mechanisms to be endogenously related to firm characteristics (see, for example, Demsetz and Lehn 1985, Smith and Watts 1992, Himmelberg, Hubbard, and Palia 1999, and Wintoki, Linck, and Netter 2010). We add to this literature in that our findings *directly* show that simply prescribing a particular change in any governance measure cannot generate value-increasing effects for all the firms. Our results also offer evidence in favor of firms being in equilibrium with respect to their governance structure. In addition, we note that our study is over an 11-year period (1992-2002) that is significantly larger than most previous studies. Further, we have concurrently examined a broad set of governance measures rather than focusing on just one or two governance measures as in the prior literature.” *(p. 3)*

“*Does Changing Corporate Governance Alone Result in Better Firm Performance?*” **N. K. Chidambaran, Darius Palia, and Yudan Zheng (2010)** *(cont'd.)*

- “Very dissimilar changes in governance can lead to similar performance results, suggesting that unobservable firm characteristics such as corporate culture and management philosophy play a role in determining the impact of governance reform. While these results indicate that firms should, and do, try to optimize their governance structure, it is best perhaps to encourage firms to audit their governance choices rather than use one-size-fits all externally imposed mandates that can prove to be ineffective.” *(p. 29)*

“‘*Activist’ hedge funds: creators of lasting wealth? What do the empirical studies really say?*” Yvan Allaire and François Dauphin, July, 2014

- “We carefully reviewed Bebchuk et al.’s paper and reached the following conclusions:
  - First, the authors have not demonstrated that activist hedge funds, per se, create lasting, long term value and bring a long-term perspective to their ‘activism’…. The weight of experience still trumps the results presented in Bebchuk et al.
  - Secondly, the most generous conclusion one may reach from these empirical studies has to be that ‘activist’ hedge funds create some short-term wealth for some shareholders as a result of investors who believe hedge fund propaganda (and some academic studies), jumping in the stock of targeted companies. In a minority of cases, activist hedge funds may bring some lasting value for shareholders but largely at the expense of workers and bond holders; thus, the impact of activist hedge funds seems to take the form of wealth transfer rather than wealth creation. *(cont’d.)*

“*‘Activist’ hedge funds: creators of lasting wealth? What do the empirical studies really say?*” Yvan Allaire and François Dauphin, July, 2014 *(cont’d.)*

- Thirdly, “activist” hedge funds operate in a world without any other stakeholder than shareholders. That is indeed a myopic concept of the corporation bound to create social and economic problems, were that to become the norm for publicly listed corporations.
- Finally, the Bebchuk et al. paper illustrates the limits of the econometric tool kit, its weak ability to cope with complex phenomena; and when it does try to cope, it sinks quickly into opaque computations, remote from the observations on which these computations are supposedly based.” *(p. 2)*

ACTIVIST HEDGE FUND: LONG-TERM OR SHORT-TERM INVESTOR?

- "The results reproduced in the Table 4 below show that half of the interventions, from the first Schedule 13D filing to divestment, had duration of 266 days or less (not even 9 months). Claiming that these are long-term "investors" seems a bit of a stretch. It is even more of a stretch to credit these activist funds for a favourable, enduring effect on the performance of a firm 3 to 4 years after their departure." *(p. 15)*

Table 4

Length of Holding Period (Days) for Completed Spells

Percentile	Hostile (Initial)	Non-hostile (Initial)	All Events
5%	11	23	22
25%	96	141	126
50%	229	285	266
75%	439	504	487
95%	840	1,273	1,235

Source: Brav, Jiang & Kim (2010), in *Hedge Fund Activism: A Review*

“*Hedge Fund Activism and their Long-Term Consequences: Unanswered Questions to Bebchuk, Brav and Jiang*” Yvan Allaire and François Dauphin, Aug., 14 2014

- “In our paper ‘Activist’ hedge funds: creators of lasting wealth? What do the empirical studies really say,’ we asked Lucian Bebchuk, Alon Brav and Wei Jiang questions of the sort that any referee/reviewer for a professional journal would raise about their paper The Long-Term Effects of Hedge Fund Activism….
- The reply we got from Professor Bebchuk was essentially that he had already answered all our questions in his reply to Wachtell Lipton ‘Don’t run away from the evidence’ and that our paper was not academically rigorous because ‘it expresses an opposition to relying on empirical evidence’. He is wrong on both counts.” *(p. 1)*

"*The Impact of Hedge Fund Activism: Evidence and Implications*" John C. Coffee, Jr. and Darius Palia, Sept. 15, 2014

- "Our concern with public policy stems from the possibility that hedge fund activism may exacerbate an important externality: namely, it may encourage corporate boards and managements to forego long-term investments (particularly in research and development) in favor of a short-term policy of maximizing dividend payouts and stock buybacks. Such a shift towards shorter-term profit maximization might ultimately prove costly to the American economy, but those costs would not necessarily be observable within the time periods examined in the existing studies.... Worse yet, if such a short-term investment horizon were to be imposed (or at least encouraged) by hedge fund activism..., then on the macro level the American economy would suffer an injury without any compensating benefit."*(p. 7)*

- "More generally, some management scholars have reported empirical evidence showing a strong correlation between 'short-termism' within firms and a high ownership level on the part of 'activist' hedge funds and certain other institutional investors. In particular, Wharton Professor Brian Bushee has found that 'predominant ownership by transient institutions—which have high portfolio turnover and use momentum trading strategies…significantly increases the likelihood that managers cut R&D to manage earnings.' In a later study, he reports that 'high levels of ownership by transient institutions are associated with overweighting of the near-term earnings component and underweighting of the long-term earnings component.'"*(p. 40)*

“*The Impact of Hedge Fund Activism: Evidence and Implications*” John C. Coffee, Jr. and Darius Palia, Sept. 15, 2014 *(cont’d.)*

- “Overall, the evidence is clearest that there is a short-term positive stock price reaction to a Schedule 13D’s filing, less clear that there is any statistically significant positive long-term price reaction, and very unclear that operating performance improves after the intervention.” *(p. 64)*