Creating an Incentive for Investor Intermediaries to Improve Corporate Governance

by

Todd M. Gershkowitz

B.S. Industrial and Labor Relations, Cornell University, 1986

Submitted to the MIT Sloan School of Management in Partial Fulfillment of the Requirements for the Degree of

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Signature of Author: ____________________________
MIT Sloan School of Management
May 18, 2006

Certified by: ____________________________
William F. Pounds
Professor Emeritus of Management and Dean Emeritus
MIT Sloan School of Management
Thesis Advisor

Accepted by: ____________________________
Stephen J. Sacca
Director
MIT Sloan Fellows Program in Innovation and Global Leadership
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Abstract

At the end of the 1980s, there was some speculation that leveraged buyouts (LBOs) would lead to the demise of the public company in favor of privately owned companies after a decade of the market for corporate control serving as a check against agency costs and management inefficiency. Of course, this didn’t happen, and throughout the 1990s, in addition to the market for corporate control, the use of stock-based managerial incentives served a similar purpose. But the failure of these measures to prevent the next cycle of corporate governance crises that occurred in the last five years (e.g., WorldCom, Enron) ushered in an era of hard governance whereby market mechanisms and incentives have given way to Sarbanes-Oxley legislation and stock exchange rules designed to ensure proper stewardship of companies by their boards of directors. A central theme of this thesis is that, although this new era of hard governance might have decreased the degree of information asymmetry between investors and their agents, and thus improved the state of corporate governance, it may be that this has simply lulled us into a false sense of security until the next cycle of corporate governance crises. Companies might adopt symbolic mechanisms that are decoupled from actual practice to evidence compliance with increasing rules and regulations. Some research suggests that a different course—soft governance—is necessary to foster a constructive relationship between companies and their investors, through investor intermediaries such as hedge funds. Soft governance refers to the exercise of voice by investor intermediaries instead of exit (i.e., trading out of a company’s stock). It is believed that not only is soft governance necessary to supplement hard governance, but that the lack of it might also be a significant lost opportunity that could contribute to an erosion of U.S. business competitiveness. This thesis is devoted to an assessment of a specific mechanism for instituting soft governance, referred to as Ownership Shares, a concept introduced by the founder of Institutional Shareholder Services (ISS), Robert A. G. Monks, in 2004.
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Cambridge, MA
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Chapter 1: Introduction

The inspiration to write a master’s thesis on corporate governance came to me after attending the MIT Sloan Convocation in October 2005, during which I observed a panel discussion that was conducted by two legends of the Sloan School—Stewart Myers, the Gordon Y. Billiard Professor of Finance, and William Pounds, MIT Sloan Dean Emeritus and student of corporate governance. I was even fortunate enough to be successful in persuading Dean Pounds to serve as my thesis advisor. I was particularly struck by the tone of the panel discussion, which was refreshingly focused on the future of corporate governance rather than on an extensive examination of the scandals of the recent past, as had been the focus of almost every speech, presentation or article on corporate governance I had come across since the collapse of Enron in late 2001. During the panel discussion, Professor Myers and Dean Pounds speculated on the growing significance of hedge funds and the potential implications of this trend for corporate governance. They also discussed the possibility that we might be about to witness a wave of management buyouts as companies might seek to avoid the onerous cost and effort required to comply with the requirements of the U.S. Sarbanes-Oxley law of 2002 by converting their publicly traded equity into privately held equity. And so began my personal quest to explore the link among three topics as the basis of my master’s thesis: corporate governance, the emerging power of institutional investors—hedge funds in particular—and the benefits of private equity ownership.

As I began thinking, researching and reading to develop a definitive and focused topic for my thesis, I came upon a “debate” that occurred between two venerable Harvard
Business School professors—Michael Jensen, a leading authority on agency theory as applied in corporate finance, and Alfred Rappaport—across two issues of the Harvard Business Review from late 1989 to early 1990. This debate centered on their speculation about the future of the publicly traded corporation, a debate which this thesis resurrects in pursuit of a mechanism to improve the governance of publicly traded companies by embodying some of the positive aspects of corporate governance associated with private equity ownership. As will be examined in detail, the mechanism that would reside at the center of this new system of equity ownership, which might be considered a hybrid of the public and private equity systems of ownership, might exist in the form of Ownership Shares, a concept advanced by the founder of Institutional Shareholder Services, Robert Monks. According to Monks, Ownership Shares are intended to encourage long-term share ownership by institutions in exchange for providing active governance and receiving certain economic benefits.

Chapter 2 of this thesis is devoted to an analysis and presentation of the theoretical underpinnings of the Ownership Shares concept, drawing principally upon classic theories and research in corporate governance, as well as economics and sociology. This introductory chapter serves to establish the premise upon which the Ownership Shares concept is based and confirms it as a legitimate potential mechanism for improving corporate governance.

In Chapter 3, the evidence concerning the tangible benefits of good governance practices to investors—in terms of excess returns and evidence on the effectiveness of institutional investors in implementing good corporate governance practices at their
portfolio companies—are reviewed. In short, Chapter 3 seeks to confirm that the pursuit of a mechanism such as Ownership Shares is a worthwhile investment of time and risk.

Chapter 4 then considers the recent history of corporate governance developments in the United States up to and including the present state of corporate governance. In short, Chapter 4 seeks to describe the context in which Ownership Shares would be introduced, if the concept were proven viable.

Building on the conclusions drawn in Chapter 4, Chapter 5 addresses the direction that the corporate governance environment might need to move—toward soft governance—and posits that Ownership Shares could be a viable mechanism for doing so.

Chapter 6 will review Robert Monks’ Ownership Shares concept in detail, critique it from legal, economic and behavioral perspectives, and offer the specifics of an Ownership Shares policy proposal for evaluation and possible implementation.

Chapter 7 will describe an original research methodology that was designed to test the potential effectiveness of the Ownership Shares policy proposal in a laboratory setting, review the results of data collected and analyzed in this regard, and assess their implications.

Finally, Chapter 8 will summarize the key findings and conclusions of this thesis, and offer recommendations for future research.
Chapter 2: Theoretical Underpinnings

In “Eclipse of the Public Corporation,” an essay written at the conclusion of a decade of unprecedented corporate raiding and restructuring, Michael Jensen, a leading authority on agency theory as applied in corporate finance, speculated that the end of the public corporation was near, as it would fall prey to the leveraged buyout, or LBO. 1 Jensen argued that the LBO, perfected as a corporate control mechanism in the 1980s, essentially resolved the basic conflict of interest between owners and managers concerning the appropriate use of a firm’s resources, sometimes referred to as the agency cost of free cash flow. The accumulation of debt—the leverage in the leveraged buyout structure—serves as a mechanism for forcing the firm to disgorge cash as a substitute for a policy of paying dividends, which emanates from a management decision and is therefore subject to change. Jensen also noted that the impetus for the LBO boom in the 1980s came from large institutional shareholders, who at the time controlled approximately 40% of publicly traded equity. Referring to the prior 10 to 20 years of corporate performance, Jensen wrote:

“The absence of effective monitoring led to such large inefficiencies that the new generation of active investors arose to recapture lost value. These investors overcome the costs of the outmoded legal constraints by purchasing entire companies—and using debt and high equity ownership to force effective self-monitoring.” 2

Jensen concluded that the LBO represented a new model of management and governance under which the returns from the deployment of the firm’s assets must, by

2. Ibid.
virtue of a binding contract, be distributed to its owners (i.e., limited partners). As Jensen put it:

"In effect, the LBO sponsor must ask the institutional investors for permission to reinvest funds, a striking difference from the power of public-company managers to freely shift resources among business units." 3

Being a realist, Jensen acknowledged that there will still be public companies, particularly in growth vs. mature industries, and admonished them to undertake significant changes in their structure and approach to corporate governance, calling for a "coordinated attack on the status quo." Among his recommendations were that public companies change their bylaws to "encourage large investors or experiment with alliances with active investors." 4

In his rebuttal essay entitled "The Staying Power of the Public Corporation," published in January 1990, Alfred Rappaport makes the counter-argument that, as flawed as they may be, public corporations are capable of self-correction, and that while LBOs might have some interesting characteristics, they are "transitory" structures with a limited life and are destined to become, rather than replace, public companies. 5 Rappaport also claims that a firm’s daily stock price is a critical indicator of its long-term viability and that the removal of this indicator under an LBO structure would eliminate a key aspect of how investors measure the performance of their holdings. Rappaport concludes that by institutionalizing the preeminence of shareholder value through value-based asset

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4. Ibid.
deployment, value-based investment decisions, the return of excess cash to shareholders when value-creating investments don’t exist, and value-based incentives for managers, public companies can take on some of the positive characteristics of an LBO as described by Jensen. Rappaport also agrees with Jensen that the emergence of institutional shareholders represents an opportunity to positively influence corporate governance. He writes:

“Large institutions face a choice: they can become directly involved in governance by insisting on the nomination of pension fund trustees or money managers to corporate boards, or they can use their collective influence to promote a governance process that holds managers and directors to a higher standard of accountability. I prefer the latter.” 6

I think it is clear that Rappaport won this debate; in the 16 years since Jensen and Rappaport published their articles, public corporations have thrived. However, it also seems that we learned very little from the last wave of corporate governance crises that sparked the Jensen-Rappaport debate, as an entirely new and more serious wave of corruption began sometime in the 1990s, culminating in 2001 with the collapse of Enron, followed in 2002 with the collapse of WorldCom, then the near demise of Tyco. Even with the passage of the Sarbanes-Oxley law in 2002, which many regard as a particularly onerous remedy, a 2004 McKinsey survey of investors and directors reveals that deeper reforms are still believed to be required to address the underlying governance issues that have persisted since the original Jensen-Rappaport debate. 7 Although the survey acknowledges substantial progress, including a record number of shareholder proposals

being passed supporting the elimination of staggered boards and the introduction of annual director elections, among the deeper reforms the survey points to are improving the independence and accountability of directors. The survey also warns of an impending shortage of capable and talented directors brought on by the gradually increasing time and effort required of directors who become more independent and accountable. It specifically highlights the possibility of a vicious cycle of poorly performing directors causing perceived and actual declines in corporate performance, which will in turn make the recruitment of top-tier directors even more difficult.  

Michael Jensen appears to be getting the last word on the issue of how to further reform corporate governance, 16 years after his original debate with Alfred Rappaport. In a 2005 paper entitled “Agency Costs of Overvalued Equity,” Jensen argues that today’s securities markets, which emphasize short-term financial results, have exacerbated conflicts of interest between a firm’s managers and owners. Jensen claims that the steady run-up in equity valuations over time has created a situation in which firms cannot hope to deliver the performance that fulfils the expectations embedded in their overvalued stock prices, and will inevitably resort to earnings management and manipulation to artificially sustain short-run performance at the expense of long-term value. Although there might be some celebrated scandals associated with this phenomenon, the WorldCom scandal, for example, what is most disturbing is evidence Jensen offers that demonstrates that this is fairly routine corporate behavior. Jensen cites

a 2005 survey of CFOs conducted by Graham, Harvey and Rajgopal, in which 80% stated they were willing to delay discretionary spending and 55% stated they would sacrifice value by delaying the start of small projects. He cites a second study by Glater, also published in 2005, which reported that a record number of companies—253—restated their audited financial statements in 2004, representing a 23% increase over 2003. A third distressing statistic reported by Jensen comes from a 2005 study of acquisition premiums conducted by Moeller, Schlingemann and Stulz, in which they provide evidence that acquiring firms between 1998 and 2001 lost $240 billion in equity value in the three days surrounding acquisition announcements, as compared to $4.2 billion for the entire decade of the 1980s. These authors also document a synergy loss (i.e., equity value losses to acquiring firms exceeded gains to target firms) of $134 billion during the same time period of 1998 — 2001. 

Toward the end of the paper, Jensen writes:

“Overvalued equity is but one example of problems that cannot be solved by compensation/incentive systems alone. Good control systems and monitoring by intelligent people of integrity in a well-designed governance system are always necessary for effective control of corporate agency problems. But the problem here is that we do not now know how to create such well-functioning governance systems. More research on the design of governance systems is required, and it must go forth in the next five years or so taking clear account of the agency costs of overvalued equity as well as traditional agency problems associated with rational conflicts between managers and equity and debt holders, as well as agency problems involving information asymmetries, managerial self-control problems, managerial biases such as systematic optimism, and market pricing mistakes.”

11. Ibid.
12. Ibid.
One of the governance system innovations Jensen proposes is for the board of directors of a company to establish an ongoing dialogue with short-sellers of its stock as a means of learning what is driving their negative sentiment. Jensen acknowledges that taking this kind of action would require most boards to change their belief systems, but argues that dramatic changes of this kind are necessary.

So, what can be made of all of this? Plus ca change, c’est plus la meme chose. As the old French proverb goes, “the more things change, the more they stay the same.” Notwithstanding the wrenching financial losses, ruined reputations and criminal convictions associated with the latest wave of corporate governance crises, and the passage of the first federal corporate governance regulation since the Securities and Exchange Act of 1934, investors, directors and governance experts are still pondering the same questions they did at the end of the 1980s, and which the fathers of the modern corporation, Adolph Berle and Gardiner Means, also asked 70 years ago. The reason for this seems to be that the underlying conflict between owners—whom I will refer to as investors to emphasize the purpose behind their becoming owners of a public company—and managers remains alive and well despite waves of corporate governance crises over many decades, the last five years of deep soul searching in the corporate world, strongly held convictions among many CEOs and directors that Enron, WorldCom, Tyco and other scandals were aberrations not likely to be repeated, and the passage of Sarbanes-Oxley. A key reason for the persistence of the investor-manager conflict could be the ever-growing presence of intermediaries, such as hedge funds, mutual funds and pension funds, which add an additional layer to the relationship. Also, the challenge of engaging
these investor intermediaries in new forms of dialogue and interaction has gone largely unanswered.

The persistence of the investor-manager conflict is the province of agency theory, a notion in economics and finance first developed by Berle and Means in their landmark book *The Modern Corporation and Private Property*, published in 1932, and further developed and formalized by Michael Jensen and William Meckling in their seminal article “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership structure,” published in the *Journal of Financial Economics* in 1976. As noted in a recently published article on corporate governance written by sociologist Gerald Davis, Berle and Means wrote about the rise of managerialism, under which the separation of the management and control of organizations rendered the shareowners of a corporation relatively powerless compared to the managers and directors they employed to run the day-to-day operations of the firms the shareowners owned through their investment in the firm’s shares. These managers would therefore deliver the minimum results necessary to satisfy shareowners and instead pursue, as Berle and Means put it, “prestige, power or the gratification of professional zeal.”

In a recently published review of agency theory, sociologist Susan Shapiro refers to Jensen and Meckling’s characterization of agency relationships as contracts that incorporate social control mechanisms, in the form of incentives and other monitoring devices, as conditions or clauses. Shapiro then notes that in the specific context of corporate governance, these conditions might include forms of “capitalization” such as a firm paying out dividends to reduce the amount of discretionary

funds available to managers and, at the same time, invoking the monitoring capacity of the financial markets and institutions from which the firm must solicit funds it requires for growth. 14

This recent focus on agency theory and corporate governance by sociologists who examine these issues through the lens of social structure and relationships, is a significant and positive development. This perspective on corporate governance might offer some insight into why the investor-manager conflict persists and what can be done to address it. Shapiro invokes the writings of venerable sociologist Harrison White when casting agency theory as an opportunity rather than a problem, which, as Shapiro notes, is best summarized in the words of White himself:

“Although economists may speak of ‘the agency problem’ it is in fact a solution, a neat kind of social plumbing. The problem is the ancient and ineluctable one of how to attain and maintain control in order to carry out definite, yet varying purposes.” 15

Shapiro then invokes the writings of political scientist Barry Mitnick, who describes agency theory as “a general theory of social relationships of ‘acting for’ or control in complex systems” with “the activities and problems of identifying and providing services of ‘acting for’ (the agent side), and the activities and problems of guiding and correcting agent actions (the principal side).” 16 Applying this context of social relationships and social structure, Shapiro makes the observation that the principal is assumed to have power over the agent, using the contract between them to shape and manage behavior, and that when this power differential is widest or most asymmetric, contracts cannot be

15. Ibid.
16. Ibid.
properly constructed (i.e., with specified preferences, incentives, monitoring devices, sanctions) and the principal-agent relationship becomes almost pointless. This sounds a little like the principal-agent relationship between dispersed individual investors and their agents, either in the form of the boards of directors of the firms in which they invest or the intermediaries through which they invest indirectly and become agents watching other agents. These are agency relationships that Shapiro describes as those that “demand that commitment be conferred far in advance of payoff without any necessary confirmation during the interim that the return on investment will ever be honored.” In a final and critical point of her sociological perspective on agency theory, Shapiro notes that in the process of constructing contracts to manage the power differential in principal-agent relationships, we often force the agent to become so disinterested as to eliminate the prospect of self-dealing, that the agent might sever ties to a valuable network of relationships and information that might have benefited the principal in the long run.

Sociologist Gerald Davis’s recent article, “New Directions in Corporate Governance,” further sharpens the view of corporate governance through the lens of social relationships and social structure. In the article, Davis calls for an examination of corporate governance from the perspective of the social dynamics of the institutions—or the players and participants and the rules and norms of their interactions—that comprise the infrastructure of corporate governance. To support his approach, Davis references considerable evidence that boards of directors, for example, are very much social institutions rather than “antiseptic monitoring devices contemplated by theorists,” prone

to decisions and actions that are influenced by behavioral, structural and cultural factors above and beyond economic factors. This evidence, Davis argues, challenges boards of directors’ independent status, notwithstanding considerable strides in recent years to ensure a larger number of externally sourced and shareholder-elected directors. Davis’ definition of corporate governance, drawn from the writings of Margaret Mendenhall Blair of the Brookings Institution in 1995, is as follows:

“The whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risk and returns from the activities they undertake are allocated.”

Building on this notion, Davis offers his own novel interpretation of corporate governance as “a sort of financial global positioning system, a set of devices that mesh to guide corporate executives toward the North Star of shareholder value.” Davis goes on to elaborate that by viewing the institutions and infrastructures of corporate governance as a response to the activities and events that occur within financial markets, the need to attract financing from investors (who in turn need to realize returns commensurate with the risk their investment entails) can provide a powerful mechanism for driving change in corporate governance. However, Davis also offers an important cautionary point, which will be addressed in more detail in a subsequent chapter. He writes that “compliance with external demands often takes the form of cynical adoption of token structures decoupled

19. Ibid.
from actual practice; moreover when structures are not decoupled, they can often produce unintended consequences that are worse than the problem being addressed." 20

Based on this sociological perspective of the investor-manager conflict, it seems that a remedy must somehow transform the relationship between the two parties to make it one that is less asymmetric and more fruitful, yet which also preserves and builds upon some of the established institutions within, and parties to, the corporate governance process that has evolved over time. There are calls for new forms of investor-manager engagement and interaction alongside claims that investors are represented better than ever by increasingly more independent and accountable boards of directors amidst the sweeping requirements of Sarbanes-Oxley, requirements that have generated more disclosure and transparency of management behavior than ever before. Therefore, the premise from which we must proceed is that the board of directors is a legitimate and appropriate entity for representing the interests of investors, but currently lacks some of the tools it needs to realize its full potential as a true engine of the best possible corporate governance. Along with improvements in information about how the firm is managed via more disclosure and transparency, and an increased presence of independent members, the board of directors might benefit from ongoing and productive interaction and engagement with the intermediaries (e.g., hedge funds, other investment funds) that represent its dispersed individual investors. A more active role for these investor intermediaries in engaging with the board will empower it relative to management, and shift the power asymmetry between the board and management in the direction of the

former by being a source of information about market and investor behavior that is not available to management, and becoming a more prominent monitor of board decisions and actions on behalf of dispersed individual investors.

This idea could be characterized as relational investing, which is probably best exemplified by legendary investor Warren Buffett, and which is quite distinct from its more short-term oriented and confrontational cousin, shareholder activism (i.e., “quiet, steady ownership” vs. “noisy activist ownership”). Relational investing is focused on the potential benefits a company might receive if it had long-term investors with significant ownership stakes and who actively monitor company performance as well as engage in corporate policymaking. The theory behind relational investing is that it should ameliorate many of the problems embedded in the investor-manager principal-agent relationship (e.g., by emphasizing long-term results rather than short-term gain, providing an alternative to the threat of acquisition as a source of management discipline, and better aligning the interests of investors and managers). The focus of this thesis is not to prove the efficacy of relational investing, which will be addressed a bit further in a subsequent chapter, but instead to accept it as a positive trend and to try to identify a mechanism for implementing it effectively. In other words, to identify or develop a specific mechanism or device to cause relational investing to occur and to work, a mechanism or device for making investors, or owners, care, and helping to create value.

Three senior officials of the California Public Employees’ Retirement System (CALPERS), in a recent article on corporate governance, quoted the famous volume

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Security Analysis, published in 1934 and again in 1940 by Benjamin Graham and David Dodd, arguably the forefathers of relational investing:

“The choice of common stock is a single act; its ownership is a continuous practice. Certainly there is just as much reason to exercise care and judgment in being a shareholder as in becoming one.” 22

In the process of conducting research to learn more about what was known or needed to be known about relational investing, I uncovered a speech given by Robert Monks, the founder of Institutional Shareholder Services, at the Harvard Law School in October 2004 in which he proposed several ideas for improving the future of corporate governance. Among Monks’ ideas was a new system of equity ownership that lies somewhere between private equity and public equity and which is directed at giving institutional investors such as hedge funds, an incentive to improve the governance of their portfolio companies rather than trade in and out of them based on short-term performance results. In his speech and a subsequent article, 23 Monks proposes splitting a company’s existing equity into Ownership vs. Trading shares as the mechanism for creating this new system of equity ownership. Ownership Shares would be restricted from sale during a specified period and the owners of these shares would be required to engage in interaction and information exchange with the company in which the shares confer ownership. In return, shareowners would be entitled to a premium priority dividend that is greater than, and paid in priority order to, the dividend payable to the owners of the company’s Trading Shares. Although he devotes only a paragraph to this

proposal, it seems intriguing and worthy of further investigation. As such, the subject of this thesis is to elaborate on and evaluate the potential of the concept of Ownership Shares as a mechanism for improving corporate governance.

Any consideration of Ownership Shares as a potentially viable remedy to the age-old investor-manager conflict rests on two premises: investor intermediaries have a legitimate claim to a more active role on behalf of the principals they represent, and that there is reason to believe that through a more interactive relationship with a company’s board of directors, they can add value to the corporate governance process and enhance value creation for themselves and other investors, or owners of the company’s shares.

The first premise requires revisiting a canon of corporate law and conventional wisdom that has prevailed for over 70 years. Based on Berle and Means’ original conception, the premise assumes that widely dispersed shareholders have relinquished their ability to exercise property rights in favor of rights to the economic value generated by the property under the control of professional managers and directors, which is the essence of the separation of ownership and control. In other words, shareholders gave up their right to control the manner in which a firm deploys its assets and irrevocably delegated this role to a board of directors. In return, they have a right to receive dividends, if declared by the board of directors, which reflect the value generated by those assets. However, as over 60% of shares are now controlled by institutional investors, share ownership is re-concentrating, contrary to Berle and Means’ original conception, and resembling more the circumstances that predated the formation of their

ideas. These institutional investors are already beginning to assert their property rights as legitimate stakeholders in the firms in which they invest, with the help of curbs on management discretion required by the Sarbanes-Oxley law in the U.S., and through filing record-setting numbers of proxy proposals, increasing behind-the-scenes negotiations with portfolio firms, and forming activist and long-term shareholder associations. In a recent review of the increasing power of institutional investors, corporate governance experts Lori Ryan and Marguerite Schneider also point out that the increasing power of institutional investors is derived in part from their ability to impact equity prices temporarily by selling rather than remaining an investor and attempting to influence management to improve value creation. In other words, demand curves do shift in the absence of a truly efficient market for equities in which no one seller can impact the price of an equity; as a result “‘exit’ may have thus become a costly strategy as the current concentration of ownership may lead to financial losses for the seller.”

To further clarify this point about institutional investor power, distinctions should also be made among different types of institutional shareholders. Ryan and Schneider refer to differences in salience of different types of institutional investors based on their degree of relative power (i.e., along three classic dimensions such as the ability to control rewards, reputations and enforce legal remedies), legitimacy (i.e., the amount of risk they absorb on behalf of the principals for which they are agents) and urgency (i.e., active vs. passive trading style), and conclude that public pensions and private multi-employer

26. Ibid.
pension plans have the most salience due to their size, tendency to offer defined-benefit pension plans and interest in broader social agendas.\textsuperscript{27} The argument is that the more salient an institution is, the more likely it will be to exercise its property rights claim. In a critical review of this theory, which he terms the “political model” of corporate finance, legal scholar Thomas Smith draws a sharper distinction between institutional investors, whom he argues have customers who “purchase” risk management services from them (e.g., pension funds), and “entrepreneurs”, who are leveraging their expertise and access to deliberately take on uncertain risk so as to achieve significant excess investment returns (e.g., hedge funds). \textsuperscript{28}

Smith invokes the legendary economist Frank Knight’s writings on the concept of the entrepreneur to argue that institutional investors are in the business of managing and minimizing risk for their customers and as such, will not be interested in increasing risk by concentrating their ownership of a particular company for a long period of time (which might also have implications for legal liability). Rather, this is the role of the entrepreneurial investor to seek to acquire firm-specific risk in the hopes of extracting residual profits from their positions (i.e., whatever is left over after fixed claims have been paid out). By diversifying their holdings, institutional investors, Smith invoking Knight argues, relinquish their rights to firm-specific risks in exchange for more predictable returns.

Entrepreneurial investors, on the other hand, are more predisposed to “bear uncertainty and exercise control” to improve the management of the companies in which they have positions as they deliberately seek out firm-specific risk. Smith’s purpose in making these highly relevant economic arguments is to argue for reforms that encourage active management by entrepreneurial investors who will therein engage, and upon which institutional investors can get a somewhat free-ride. Similar points were made in a more recent article published in 2003 that responded to the issuance of the Hampel Report in the United Kingdom, a report that extolled the virtues of activist institutional shareholders. Nevertheless, Frank Knight’s entrepreneurial investors—including over 8,000 hedge funds that control approximately $1 trillion in invested assets—shall be the focus of this thesis and referred to as investor intermediaries.

To confirm the second premise, one must look at the private equity industry as a nearly perfect simulation of the Ownership Shares concept in action, the exception being that no observable price or public market for the shares exists. Private equity firms concentrate their attention and concentrate their risk on a relatively small number of portfolio companies as compared to fund managers that invest in publicly traded equities. In a recently published review of the benefits of governance under a private equity system of ownership, one private equity industry expert describes the risk orientation of a private equity investor as follows: “It’s OK to put all your eggs in one basket, just watch

the basket very carefully.” The article goes on to quote legendary private equity industry leader Henry Kravis of Kohlberg, Kravis, Roberts & Co. (KKR) as attributing the private equity industry’s lack of involvement in any major corporate scandal over the past two decades to their dedication as owners and consequent pursuit and protection of shareholder value above all else. The article also quotes a 2005 McKinsey study that concludes the critical success factors for private equity firms are:

“...creating value through active ownership, management, and governance by 1) encouraging management ownership through proactive principal-agent relationships, 2) developing dynamic value creation plans and executing them aggressively, 3) managing the performance of the venture and the resources to establish strategic priorities, 4) focusing on performance incentives for talent and requiring CEOs to invest personally in the venture, 5) supporting shareholder activism, 6) insisting on transparency in management, accounting and operational information formulation, and 7) being resilient in risk-taking and striving for sound governance.”

In its conclusion, the article calls for public companies to follow and learn from this model of corporate governance so as to achieve a balance between “healthy risk-taking” and compliance with new governance regulations such as Sarbanes-Oxley.

In theoretical terms then, it would seem that investor intermediaries have a reasonable property rights claim with regard to their equity holdings. Also, in the private equity industry there is an appropriate analog from which to draw conclusions about the likelihood of adding value and generating excess returns in exchange for the increased risk of exercising this property rights claim. The remainder of this thesis is devoted to a

33. Ibid.
34. Ibid.
thorough exploration of a particular mechanism to start this engine of good corporate governance—Robert Monks’ Ownership Shares concept.
Chapter 3: Does Good Corporate Governance Matter?

To write a thesis devoted to the promotion of good corporate governance presupposes that good corporate governance is a desirable and positive pursuit. To be sure, it is hard to disagree with such a notion in principle. However, if the mechanisms that might be required to instill and maintain good corporate governance entail costs, for example the lack of liquidity that is contemplated in the Ownership Shares concept, then, to make a valid economic determination of the viability of such mechanisms, it is necessary to ascertain the specific benefits that will accrue from good governance practices. In short, this chapter seeks to answer the simple question “Does good corporate governance matter?” as a basis for moving forward with an examination of the Ownership Shares concept as a compass to guide companies and investors along the governance roadmap.

To answer this question, one must begin by establishing what is known about the relationship between governance systems at the national or societal level and how they relate to the type of corporate activity within a nation or society, before conducting an analysis at the level of the corporate entity itself. Next, evidence will be considered concerning the relationship between the presence of institutional investors and certain corporate characteristics related to positive economic benefits, such as innovation, growth, international expansion and even long-term social responsibility. Finally, a body of recent research that attempts to quantify the excess economic returns that are associated with companies engaging in or characterized by good governance practices will be reviewed. The purpose here is not to conduct an exhaustive study of the relationship
between good governance and company performance, which could easily be the subject of an entire thesis itself. The purpose of this chapter is to qualify the subsequent discussion of a mechanism that instills good governance and to make sure it is grounded in economic reality and not merely responding to what some might regard as a management fad or business buzzword. If there are tangible economic reasons to pursue good corporate governance, then it is both prudent and necessary to identify, analyze and promote the valid mechanisms that can help companies and their investors, as well as shareowners, realize their full promise.

In a recent article that builds on their own prior work, as well as the work of famous strategy expert Michael Porter and corporate law expert Mark Roe, Hoskisson, Yiu and Kim describe two systems of corporate governance at the national or societal level as well as the principal economic institutions that embody each system and examine the effect each system has had on innovation and high technology development as markers of economic success. The “market-based system” on the one hand, typified by U.S. companies, is characterized by “transactional” capital markets—in which ownership is widely dispersed, boards of directors are dominated by outside directors, executives are motivated via equity-based incentives and there is a robust market for corporate control, as well as external labor markets with free flows of talent across companies, market-based pay levels, monitoring via external reputation, and generally applicable skills being acquired and developed. On the other hand is the “relationship-based system,” typified by Japanese and some European companies and characterized by “relational” capital markets in which ownership is more heavily concentrated with families and financial institutions,
boards of directors are dominated by inside directors, executives are motivated based on seniority, and in which there is a reasonable expectation of bailout by dominating shareowners in the event of financial distress. Labor markets are largely internal with management-determined pay levels, with monitoring by company management and internal reputation, and company-specific skills being acquired and developed.35

Hoskisson, et. al., go on to conclude that market-based systems are characterized by start-up companies that challenge established companies by pursuing disruptive innovations and taking advantage of labor market dynamism, whereas in relationship-based systems, established companies are insulated from start-ups, and instead compete among themselves and tend to pioneer new products later. One example offered to support this argument is from the semiconductor industry. Japanese firms became dominant in the memory chip sector, which requires manufacturing and process expertise, whereas the United States became dominant in the logic chip or microprocessor sector in which product design is critical. A similar parallel exists in the software industry, which is largely composed of start-up companies in the United States and established companies in Japan, where software and hardware are typically bundled together. The principal message of this analysis is that the nature of a national or societal governance system is a function of its capital and labor markets and, in turn, is a key driver of that nation’s or society’s level of innovation, entrepreneurship and global competitiveness. Somewhat ironically, the market-based system found in the U.S. is also characterized by a short-
term orientation not typically associated with the long-term payoff periods that disruptive innovations often require and that generate certain governance implications.  

Moving a level deeper to the company itself, there are a series of studies that further bolster the hypothesis that governance affects corporate performance. One recent study conducted by Tihanyi, Johnson, Hoskisson and Hitt examines the relationship among a company's institutional investors, the composition of its board of directors, and the company's appetite for international diversification. Building on prior research that identified distinctions among three types of institutional investment styles in terms of their responsiveness to potential pressure from their portfolio companies—"pressure resistant" investors include professional investment funds with no business ties to their portfolio companies—this study explores the notion that such investors are interested in significant company strategies such as international diversification. Studying a sample of 197 large U.S. companies, the authors conclude that two types of pressure resistant investors, professional investment funds and pension funds, pursued companies with international diversification strategies for similar reasons (i.e., an expectation of excess returns) albeit over different time frames. The distinction that is being made among different types of institutional shareholders, concerns the fact that some have customers who purchase risk management services from them (e.g., pension funds) and others represent investors who are leveraging their expertise and access (e.g., professional investment funds such as hedge funds). The authors further note that the composition of

the board of directors further affected the significance of the positive relationship between institutional investors and the international diversification strategies of their portfolio companies. Professional investment funds preferred higher representation of outside directors, and pension funds preferred higher representation of inside directors, both preferences clearly a function of the differences in their respective investment time horizons. 37

A similar study by Hoskisson, Hitt, Johnson and Grossman examines the relationship between institutional investors and the innovation strategies of portfolio companies. Using survey data collected from over 200 companies with at least $30 million in assets, the authors examine the relationship between reported indicators of innovation (e.g., spending on R&D) and the level and type of institutional investor ownership to test whether institutional investors encouraged taking risks on innovation strategies that might take several years to pay off, or instead encouraged other investments that produced gains more realizable in the short-term. The study concludes that the behavior of different types of institutional investors was a significant factor, with professional investment fund managers favoring the acquisition of innovation externally, and pension fund managers favoring the development of innovation internally; in both cases consistent with the respective time horizons of each investor type. Also, companies with boards of directors largely staffed with inside directors favored internally developed

innovation, whereas companies with a high degree of external directors focused more on acquiring externally developed innovation.\textsuperscript{38}

A recent study that appears to be directly motivated by some of the more notable governance scandals, such as Enron and WorldCom, examined data collected on 129 Fortune 500 companies. The goal of the study was to ascertain the relationship between institutional ownership and portfolio companies’ corporate social performance (CSP) as measured by a rating system developed by Kinder, Lyndberg and Domini, which is widely regarded as a valid measure of CSP over a three-year period. The authors of the study refer to CSP as:

“... a company’s policies, programs, and actions intended to improve the quality of life in society (Wood, 1991) as well as a company’s efforts to foster positive relationships with key stakeholders, such as employees, customers, and communities (Hillaman & Keim, 2001). \textsuperscript{39}

The theory behind examining the relationship of institutional investors to their portfolio companies’ demonstration of CSP is that by fostering a closer relationship between a company and its key stakeholders, the company is taking affirmative steps to improve its positioning and sources of future growth and, ultimately, its ability to create value for its investors and owners. The study’s findings indicate that long-term institutional investment, as contrasted with short-term institutional investment, is positively related to portfolio companies’ CSP; this suggests that the expectations of these investors become part of their portfolio companies’ consciousness, and that these

investors will remain engaged long enough to monitor outcomes. The study’s authors also note that the level of institutional investor activism and coordination strengthens the positive nature of the relationship to CSP, and argue that companies should consider pursuing active engagement with their long-term institutional investors about their CSP agendas, noting:

“This dialogue can foster a greater appreciation of firms’ CSP agenda and make it possible to use inputs from different institutional owners in developing or revising this agenda. This process can also deepen long-term institutional owners’ understanding of firms’ CSP plans and reduce the need for activism.” 40

The three studies previously cited refer to the influence that long-term institutional investors have on their portfolio companies’ degree of international diversification, appetite for innovation, and corporate social performance (CSP). Although all three studies suggest that the structure and process of corporate governance can and does create value if designed and executed properly, the notion of relational investing per se has not yet been discussed. Only one comprehensive study has been performed that examines the issue of relational investing specifically as it pertains to corporate performance and value creation, and it produced mixed results.

In a 2004 study of more than 1,500 large U.S. corporations over a thirteen year period from 1983 to 1995, Bhagat, Black and Blair found that companies that had relational investors—which they defined to be institutional investors owning 10% or more of the company for four years or longer—outperformed their peers from 1983-1986, but they could not find a similar pattern in the early 1980s or in the early 1990s. They

account for this finding by arguing that the success of relational investing seems to have
been a function of a robust market for corporate control coinciding with the period of
investment, which then translated into enhanced corporate earnings and stock price
growth. 41 The authors acknowledge that one of the limitations of their study was a lack
of distinction of shareholder type—including “quiet steady, ownership” relative to “noisy
activist ownership”—a variable that was generally accounted for and found to be relevant
in the other studies. The authors also speculated that the size dimensions they used to
categorize investors as relational (i.e., 10% or greater ownership level) could also have an
impact on the results in that a larger number of smaller relational investors (i.e., less than
10% ownership) would not only serve to monitor their portfolio companies but also each
other. As they noted, “…relational investing might produce benefits up to one ownership
level, and costs above that level.” 42

Building further on the idea that a company’s financial and stock performance is
at least to a degree a function of its governance practices, researchers have endeavored to
quantify the effects of this relationship as a governance premium. Although we cannot
be convinced that the mere act of engaging in relational investing will generate this
premium with 100% certainty, we can at least ascertain whether the good governance
practices that relational investing would promote would be worth the investment of
capital, time and risk. This might serve to motivate both a new approach and a new
generation of relational investors, who, in time, could constitute a challenge to the Bhagat,

41. Bhagat, Sanjai, Bernard Black and Margaret Blair. “Relational Investing and Firm Performance.” The
42. Ibid.
et. al. study. Unless there is more measurable relational investing we will never know, which is why an understanding of the nature and validity of a governance premium is so critical. Such an understanding could become a significant factor in motivating investors to pursue relational investments, perhaps executed through a mechanism such as Robert Monks’ Ownership Shares.

In this vein, a report issued in October 2005 by Hermes Pension Management Limited in the UK, which specializes in the active promotion of good corporate governance among its portfolio companies, provides a comprehensive framework through which to consider and evaluate the available evidence concerning a governance premium in the U.S., UK and other global equity markets. The framework groups research on the governance premium into three categories: (1) opinion-based research, (2) focus-list research, referring to prominent investment fund managers placing portfolio companies on a special list to highlight their governance weaknesses, and (3) governance ranking research.

The two most recent and prominent opinion-based research studies on the importance of corporate governance to corporate performance were completed by McKinsey in 2000 and 2002. The data from the 2000 survey, collected from over 200 institutional investors, demonstrated that over 80% of respondents would pay a premium for shares of a company considered to be well-governed, as evidenced by a majority of independent, outside directors, a formal director evaluation process, responsiveness to

44. Ibid.
investor requests for information on governance matters, etc. The premium for U.S. and UK domiciled companies is 18%, but increases to 27% in countries such as Indonesia and Colombia, and even higher in countries with less developed regulatory structures and governance infrastructure and therefore more room to improve and a greater requirement for a premium. The updated 2002 survey surveyed 188 companies in six emerging markets to determine if there was a significant difference in price-to-book ratios for those companies that achieved high governance ratings on ten governance dimensions in the areas of accountability, independence, disclosure and transparency, and shareholder equality. The results demonstrated a 10-12% premium moving from the worst to the best scoring companies in the sample.

Focus-list research attempts to ascertain the increase in value that accrues to companies placed in an investment fund's focus list. A company’s placement on an investment fund focus list indicates that it has governance issues but, more importantly, that the investment fund intends to engage the company’s management to resolve the issues to its satisfaction. Probably the most well-known and carefully considered focus list is produced by the California Public Employees’ Retirement System or CALPERS. In their most recent update, published in 2004, they reported an 8% sustained market premium for focus list companies that were reported five years earlier. These findings indicated a steady decline from 23% in 1997, and from 14% in 1991, and indicated that two-thirds of the companies were underperforming the overall market. This is most

likely explained by the fact that appearing on the list does not suggest that a company is capable of reform, which could contribute to premium erosion as investors learn more about the company and its potential to reform. The returns of those companies that first appeared on the CALPERS focus list in 2004 exceeded the overall market, on average, by 13.9% three months after the list was published, 19.5% six months afterward, and 46% one year afterward. The sustainability of this premium reflects not only the disclosure of the governance issue, but the market’s expectation that CALPERS will actively engage the companies on the focus list to improve their performance.

A stream of findings related to focus list research concerns focus funds, sometimes referred to as engagement funds, which invest in underperforming companies suffering from governance problems, and apply active engagement with company managements to improve performance. Since their dates of inception in 1998 and 2002, respectively, the Hermes UK Focus Fund and the Hermes European Focus Fund have both sustained an annualized market premium of 3.5 to 4.0% net of fees. Since its inception in 1997, the U.S.-based Relational Investors LLC sustained an annualized premium of almost 8% net of fees.

The third category of research in the Hermes framework concerns governance rankings. The results of a recent research study by Paul Gompers, Andrew Metrick and

Joy Ishii applied the results of a 24-factor governance-ranking tool to a sample of 1,500 U.S. companies and then constructed two model portfolios with inception dates in 1990. Companies with the best governance scores were grouped in a “democracy portfolio” and companies with the lowest governance scores were grouped in a “dictatorship portfolio.” Simulated average annual growth in asset values was over 23% for the democracy portfolio and only 14% for the dictatorship portfolio. Other findings in this study included a differential in the price-to-book ratio for democracy portfolio companies relative to dictatorship portfolio companies of 56% for 1999 and 34% for the period 1990-1999. Similar studies with similar findings in terms of market premiums related to good governance rankings have also been conducted in the UK and Japanese markets. Also, a recent study by Bebchuk, et. al. validated the findings of the Gompers et. al. study by isolating the six statistically significant governance predictors of value creation, as measured by market-to-book ratios, of the 24 governance evaluation factors analyzed in the Gompers study, and determined that these six factors accounted fully for the correlation between governance performance and financial performance uncovered in the Gompers study.

Viewed collectively, the findings concerning a relationship between performance and the quality of governance—including the studies that demonstrated a positive impact associated with the presence of active institutional investors on company characteristics

52. Ibid.
that should contribute to good performance, as well as the studies that proved an observable and measurable link between the quality of governance and the premium performance and value of a company's equity relative to the overall market (i.e., measured by abnormal returns, high market-to-book ratios relative to market averages) — make very clear that good corporate governance should matter to investors. Moreover, in addition to the quality and substance of governance practices, the process of active engagement between investors and managers, regardless of the direct outcome in terms of governance quality, is likely to create value or avert disaster over time.  

This chapter established that becoming an active long-term investor or relational investor perhaps, should be well worth the investment of time and risk as there is likely to be a substantial market premium realized in exchange for an infusion of good governance practices and process. The next chapter explores the current state of corporate governance in the U.S. The question to be answered in this next chapter therefore is not why institutional investors or investor intermediaries should pursue the infusion of good governance practices and processes in their portfolio companies, but rather what is the current corporate governance environment or context that a new mechanism might be introduced to and what will be the likely implications.

Chapter 4: Hard Governance: Where We’ve Been and Still Are

This chapter is devoted to describing the corporate governance environment or context in which a new governance mechanism—whether it be a new policy introducing the concept of Ownership Shares, a new code of best practice, a new regulation or law—might be introduced. The unit of analysis here is the overall effectiveness of the corporate governance mechanisms that have come into existence over the last twenty years or so as a basis for understanding if there is room for one more, should it be deemed necessary.

In a recent review of the state of U.S. corporate governance, economists Bengt Holmstrom and Steven Kaplan traced the evolution of U.S. corporate governance developments over the last two decades or so, culminating with the passage of Sarbanes-Oxley in 2002. The central argument of this review seems to be that the practices of corporate governance in the U.S. that coincided with the worst corporate governance scandals in the country’s history (e.g., Enron, WorldCom), do not constitute a poor system of corporate governance. Holmstrom and Kaplan offer as evidence to support their argument the fact that the U.S. stock market and economic system continued to outperform others around the world even during the time periods that witnessed these heinous corporate governance scandals. These authors present evidence that convincingly argues that the financial markets have developed methods over the last two decades to systematically constrain or impose restrictions on management behavior through the market for corporate control and the leveraged buyout wave in the 1980s, followed by less leveraged restructurings in the 1990s. The authors also cite the
increasing prominence of institutional investors who drive shareholder value orientation among company managements, the increasing use of equity-based incentive compensation, and the enhanced independence of boards of directors, as evidenced by increased involuntary terminations of company CEOs. 54 The authors go on to discuss the impact of the Sarbanes-Oxley law, which requires executives to surrender compensation received as a result of misconduct that is only determined at a later date; increases insider trading restrictions and reporting; strengthens the independence and monitoring role of the board of directors (i.e., via the audit committee of the board); and institutes criminal penalties for fraudulent reporting. The authors also cite additional regulations instituted by the New York Stock Exchange and the NASDAQ, which address the same issues, some more directly such as director independence and shareholder approval of compensation plans.55

Holmstrom and Kaplan conclude their comprehensive review by cautioning that the trend in U.S. corporate governance toward increased regulation at the federal or national level can entail certain risks, including increased litigation and, perhaps more importantly, a decrease in the innovation and experimentation critical to long-term value creation by U.S. companies. These risks notwithstanding, they express hope that the

55. Ibid.
regulations will help boards of directors perform their difficult dual roles as monitors and advisors of company managements.  

In their recently published book on executive compensation, Pay Without Performance: The Unfulfilled Promise of Executive Compensation, legal scholars and corporate governance experts Lucian Bebchuk and Jesse Fried, 57 provide a contrarian perspective on this issue through an analysis of the evolution of power relationships between the board of directors and company management. They argue that no matter how independent the board members may be in accordance with the requirements of the Sarbanes-Oxley law or the NYSE regulations, for example, this independence reduces their incentives to side with company managements, but does not adequately motivate them to affirmatively pursue the interests of investors who own the company’s shares. In turn, they argue that although director appointments now depend on independent nominating committees, as long as the preferences of investors are not taken into account, all that can be certain is that the nominee seeks election or reelection to the board and not value creation for the company’s investors. In short, they believe that the economic and social nature of board membership still compromises the independence of board members who may be technically independent due to a lack of business ties with the company. 58 Their solution to this problem is, of course, legal reform that will empower investors and owners to become more involved in the creation of corporate governance ground rules

58. Ibid.
that determine such things as election procedures, compensation plan approvals, etc.

Bebchuk and Fried write:

“Giving shareholders the power to initiate and approve by vote a proposal to reincorporate or to adopt a charter amendment could produce, in one bold stroke, a substantial improvement in the quality of corporate governance. Shareholder power to change governance arrangements would reduce the need for intervention from outside the firm by regulators, exchanges, or legislators.

Indeed, if shareholders had the power to set the ground rules of corporate governance, they could use it to address some of the problems we have discussed. They could establish rules that dismantle staggered boards or invigorate director elections. Shareholders could also adopt charter amendments that improve the process by which executive pay is set or place whatever limits they deem desirable on pay arrangements.” 59

Upon closer analysis, the views of these two sets of authors are not as contrary as they originally seemed. Both sets of authors are concerned about the effects of increased governance regulation. Holmstrom and Kaplan believe that it will stifle innovation and experimentation; Bebchuck and Fried believe it will have no real impact at all and instead argue for a wholesale reform of the legal rights of investors. This could be considered a more extreme form of regulation, where new legal rights accorded to investors give them the power to establish governance “regulations” at the company level, effectively. Both approaches entail a degree of risk that they will trigger symbolic responses that on the surface indicate compliance and support for good governance, but which are in fact decoupled from actual governance practices, as noted earlier.

In two studies conducted by James Westphal and Edward Zajac—the first focusing on the implementation of long-term incentive plans, and the second focusing on the implementation of share repurchase plans—the authors found that among the samples of companies they studied there was a significant positive market reaction to the announcement of the adoption of both corporate governance practices, even if they failed to be subsequently implemented. Moreover, the market reaction was stronger if the rhetoric used to garner support for the adoption incorporated a rationale of agency cost mitigation.  

60, 61 The findings of these studies indicate that the nature of the corporate governance mechanism is critical in determining its effectiveness, and casts considerable doubt on the power of rule-oriented and regulation-based mechanisms. The authors go on to describe a theory of policy institutionalization that emanates from market participants relying upon prior market reactions to policy proposals in the absence of sufficient currently available information. In other words, in the absence of new information, people make assumptions about the future using information from the past. As uncertainty about the nature of the prior or past reactions decreases with an increasing number of investors subscribing to them, the value of the policy increases until it becomes institutionalized.  

62 The same response can also be triggered by social relationships if the nature of the relationship is highly formal and structured. In a chapter that appears in a new book on

62. Ibid.
the sociology of financial markets, Zorn, et. al, trace the impact of external constituents of publicly traded companies on their strategy and structure. They note that with the increasing prominence of institutional investors came increased scrutiny and analysis of company activities by stock analysts, increased volatility in stock process based on quarterly results relative to analysts expectations, increased sensitivity of executive pay packages to stock performance, increased obsession on the part of company managements with meeting stock analyst expectations, and ultimately manipulation of earnings to do so, as in the case of companies like Enron and WorldCom. The authors note that these external parties were causing companies to change because these parties themselves were focused on stock price. This is not a rule, regulation or law, but rather a network of social relationships that exerted considerable control over companies’ activities and in certain cases provoked symbolic responses that ultimately had tragic consequences. The authors cite the following memorable quotation from New York Times reporter Daniel Altman who wrote the following in April 2002:

“In the 1990s, men like Mr. Fastow (CFO at Enron) and Mr. Swartz (CFO at Tyco) were paragons of corporate ingenuity for meeting and beating ever higher revenue forecasts, but those values have backfired. That model made it hard for investors to figure out how much companies are really worth. Now, even many scrupulous companies see earnings statements parsed for accounting gimmicks. In the last decade, as Wall Street demanded more frequent reports of results and more guidance about companies’ prospects, chief financial officers became spokesmen and even salesmen, conducting conference calls with analysts and often delegating to others the mundane task of watching the numbers. Companies began recruiting lawyers, investment bankers and consultants

as chief financial officers, more for their deal-making talents than for technical expertise or fiduciary integrity.\textsuperscript{64}

There is even evidence that this phenomenon occurs within investment funds, or investor intermediaries, as they struggle to defeat reputational herding, which causes institutional investors to avoid what they might consider to be valid but unconventional investment objectives (e.g., engagement with portfolio companies and incorporating long-term responsible investing principles into the investment decision-making process), so as to safeguard their reputations. Instead, institutional investors tend to become focused on generating short-term results that are easily defensible to colleagues and clients, compare favorably to benchmarks against which quarterly investment performance is measured, and which in turn might also drive their own compensation.\textsuperscript{65}

A recent article on this issue (Guyatt, 2005) based its findings on year-long case studies of three institutional investor organizations and confirmed the tendency within these organizations to decouple intent and practice for reasons of, or related to, reputational herding behavior. The author also speculated on the missed opportunity to export “conventions” of long-term responsible investing to portfolio companies and other investors as an unintended but potentially beneficial ripple effect of reputational herding.\textsuperscript{66}

\textsuperscript{66} Ibid.
It could even be argued that the entire history of the survival of the multinational corporation is a result of this ability to decouple action from intent. Geoffrey Jones, in his recently published book titled *Multinationals and Global Capitalism from the Nineteenth to the Twenty-First Century*, traces the detailed history of the resilience of the multinational enterprise over the last two hundred years. Most interestingly, however, Jones describes how successful multinational enterprises survived a period of extensive regulation and restrictions, from 1914 to 1970, by adapting their strategies and structures as necessary. For example, during and after World War II, multinational enterprises stressed the importance of local divisional autonomy and, as a result, were able to protect operations and investments in potentially hostile environments such as Nazi Germany. Perhaps even more importantly, Jones goes on to claim that the adaptability of multinational enterprises allowed them to grow and globalize to such a degree that they could not be controlled or constrained by any single regulatory jurisdiction. This resilience on the part of multinational enterprises, coupled with the desire of many host economies to realize the potential knowledge and capabilities transfer that multinational enterprises offer, has, according to Jones, driven the gradual diminishment of restrictions and regulations and ushered in a new era of openness and fluidity in the global economy.\(^67\) While it is unlikely that many multinationals supported the politics of the Nazi regime, they found ways to remain in business within it, notwithstanding the legal requirements not do so, and as a result the multinational enterprise survived and thrived.

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In response to regulations and restrictions, action was decoupled from intent, and this ultimately contributed to the dissolution of many regulations and restrictions on multinational enterprises in general.

It seems clear that the evolution of corporate governance in the U.S. over the last twenty years has been a steady migration in the direction of hard governance focused on rules, regulations and other formal mechanisms. In addition, parties in the financial markets exerted social control over companies, and were themselves the subject of social controls that shaped their policies and actions. The evolution from control via market forces to constructed hard governance entails risks; this is highlighted by some recent research that shows actions in response to hard governance could be symbolic and decoupled from intent. While Sarbanes Oxley—an example of the ultimate in hard governance—makes it a crime not to comply with its provisions, and there is no suggestion that companies are developing purely symbolic responses to it, it might be the case that responses are intended to comply with the law’s requirements rather than to alter the underlying behavior of company managements and employees. One hint of this is the creation of the Senior Vice President of Corporate Governance position at companies such as Tyco, which has reemerged from its scandalous past. Such a position could genuinely help promote better corporate governance activities through training and consulting, monitor the company’s evolution and develop better capabilities in this area, or it could simply serve as a safety mechanism to ensure every Sarbanes-Oxley requirement is met, and every necessary signature obtained before quarterly report

filing. The former role should cause management behavior to develop and the company to genuinely change its character; the latter might lead to an even worse situation where the public views the position as evidence of genuine change, but its very existence prevents this change from happening.

The fate of the former CEO of Boeing, Harry Stonecipher, is perhaps the most shocking example of this phenomenon having actually occurred. After helping to rescue the company from some embarrassing corporate scandals involving conflicts of interest, and publishing a stern corporate policy on ethics, Stonecipher was discovered to have been engaged in an affair with a subordinate whose performance evaluations and pay decisions he ultimately controlled. Although it might be presumptuous to argue that he implemented the ethics policy with the goal of ensuring he would never be accused of any such behavior (how could he be in violation of his own signature policy?), at the very least, knowledge within the organization that he had done so would have sent the message that a symbolic but effective cover for unethical behavior is acceptable, rather than the message that the unethical behavior itself is unacceptable.

While it must be the case that corporate scandals on the order of Enron, WorldCom and Tyco account for a substantial part of this evolution, and that even in hindsight it is difficult to imagine any less of a response, the other reason may be that we don't have a viable alternative. It might simply be that, borne of long history and
experience, we have "strong theories of hard governance but weak theories of soft governance," particularly when it comes to the mechanics of execution. 69

This sets the stage for a consideration of Ownership Shares as a mechanism for implementing a viable alternative or complement to hard governance: soft governance, The next chapter describes what soft governance is and how it performs relative to hard governance.

Chapter 5: Soft Governance: Where We Need To Go

Before directly tackling the issue of soft governance, perhaps a recap of the developing argument is appropriate at this stage. First, I posited that the persistent conflict between investors and managers might be assuaged if a more interactive and productive relationship existed between the investors’ intermediaries (i.e., institutional investors) and their portfolio companies’ boards of directors. Second, I demonstrated that good governance practices such as this kind of engagement might garner a premium return relative to the overall market. Third, I ascertained that the prevalent form of governance practiced is hard governance, which carries a degree of risk in that managers might take symbolic actions rather than change their assumptions and behavior, and, thus, ultimately undermine any good governance practices that have been implemented. The next question to answer then is, if not hard governance, what kind of governance?

The obvious answer to this loaded question would seem to be the opposite of hard governance — soft governance. It is not. A balance of hard and soft governance is needed. In response to the corporate scandals that began in 2001, the recent trend has been toward hard governance. Thus, an increase in the prominence of soft governance is needed to achieve this balance. Lampel (2004) defines soft governance as governance based on “loyalty, trust and informal obligations” which he contrasts with hard governance, which is based on “rules, formal mechanisms, and stringent legal enforcement.” Lampel further argues that soft governance based on trust serves an economic purpose in that it

provides organizations with the ability to embody structure and process flexibility, and actually allows one form of flexibility (process) to facilitate the other (structure). Structural flexibility allows for managerial autonomy and discretion, which leads to a reduction in the number of rules and regulations, but also requires a high degree of process flexibility; specifically, more open channels of communication, a flow of resources and informal coordination of activities. When performance declines in an organization there is a tendency to reduce structural flexibility and, in turn, process flexibility. Lampel argues that the preservation of process flexibility is therefore crucial to organizational performance and that there are, for lack of a better word, “structures” for achieving this objective. These structures are “focal points” that facilitate the social interaction necessary to sustain process flexibility and trust-based organizations; they comprise, in essence, the architecture of soft governance.

Lampel goes on to describe the development of “conventions” that reinforce trust in organizations by imposing social sanctions that govern interactions between parties. He also states that these conventions can become institutionalized over time and evolve into “norms” and “shadow norms”, which take into account patterns of previous behavior. Perhaps most importantly, there are “meta norms” that organizational “bystanders” invoke to impose sanctions on those parties inside an organization who do not respond to norm violations or engage in norm enforcement, provided these bystanders are accorded the legitimacy to act (i.e., are both allowed and encouraged to do so). Lampel notes that there are four types of organizations in terms of their embodiment of norms. At the one end is the “bureaucratic regime”, in which there is no trust-basis to an organization and a
complete lack of bystanders to invoke meta norms. In such organizations, norm violations can increase unchecked. At the other end of the spectrum is the “puritanical regime” in which there is a “highly institutionalized culture.” In such organizations, the trust-basis of the organization is pervasive, shadow norms are prevalent, and bystanders have complete legitimacy to impose sanctions in response to norm violations. 71

Lampel’s work has interesting implications for investor intermediaries trying to improve corporate governance. Investor intermediaries should serve as organizational bystanders enforcing norm violations within the organization. The norm violations in question could pertain to interactions between the board of directors of a company and its management. For example, if investor intermediaries had observed that when she was the CEO of Hewlett Packard (HP), Carly Fiorina was engaging in a public relations campaign to ensure the consummation of the acquisition by HP of Compaq, in an attempt to force HP’s board into agreeing to the acquisition (which then in turn might have prompted some board members to make inappropriate public statements), shouldn’t they have sought to impose sanctions on both parties for norm violations that were contrary to the interests of HP’s investors? An even more interesting example might have been when the board of GE approved, but did not disclose, certain details concerning perquisites being provided to its former CEO, Jack Welch. Given the perennial concerns with executive compensation levels even among the CEOs of high-performing companies, shouldn’t investor intermediaries have asked if all details of Jack Welch’s contract were

disclosed by the board of directors when they were approved? This is where the notion of legitimacy is critical. In order for soft governance to be effective, bystanders such as investor intermediaries must be seen as legitimate monitors of norm compliance and legitimate enforcers of norm violation. In addition, a greater breadth and depth of interaction between investor intermediaries and the boards of directors of their portfolio companies is needed, especially considering that investors are assumed to have relinquished their rights to engage in such processes by delegating all decisions about the companies in which they invest to their boards of directors.

At the beginning of this thesis, I defined corporate governance as “a set of legal, cultural and institutional arrangements” that constitute a “sort of global positioning system for corporate executives.” In order to transform the relationship between investor intermediaries and boards of directors, perhaps a new, more cynical definition of corporate governance is needed: “a mechanism for curbing potentially damaging opportunistic behavior.” As a construct for analyzing corporate governance through this lens, Lindenberg (2004) invokes the cognitive process of “framing”, in which a goal causes a certain party to cognitively bring certain aspects of the situation to the foreground and push others to the background. He argues in favor of using framing to curb short-term opportunistic behavior that can unintentionally accumulate to cause larger problems as opposed to “strategic opportunism” that embodies long-term planned efforts to deliberately deceive and defraud, and which probably typifies most corporate

governance issues and even some of the major scandals that started out small but accumulated. This refers back to the unintended side effects of hard governance, that is, control mechanisms that can trigger defensive or protective responses, which then lead to additional controls and a vicious cycle of control and opportunistic behavior.

According to Lindenberg, this means turning agency theory upside down and transforming the relationship between investors (through investor intermediaries) and managers from one that assumes a conflict of interest to one of “joint production” where the goal is sustaining an economically beneficial relationship rather than strictly extracting economic surplus. In other words, “relational” goals are not sacrificed in order to achieve financial goals. An example in the context of investor intermediaries and managers might be the determination of dividend policy. If managers are intent upon keeping cash within the company to use purely at their discretion (i.e. a purely financial goal), they will seek to avoid or limit dividend payments. This in turn might transmit certain signals to investors, causing investor intermediaries to exit the stock and the stock price to fall (i.e., also a purely financial goal). However, if there were also a relational goal in the background, then alternative approaches might develop within the frame, such as management engaging in discussions with investor intermediaries to explain the rationale for its proposed dividend policy including the nature of internal projects or external acquisitions that will generate an appropriate degree of value.

Interestingly, Lindenberg is not advocating granting additional rights to investor intermediaries to make decisions such as dividend policy, as this would not contribute to an atmosphere of joint production. Rather he argues that:
“...periodic opportunities for face-to-face meetings would offer the social basis for creating and maintaining an orientation of joint production of corporate governance. These meetings would not be used for voting because that again would punish minority investors who are too dispersed to attend.” 73

To establish and foster this environment of joint production, Lindenberg concludes his argument by pointing out the need for “relational signals” that transmit evidence of relational concern and evolve into norms of behavior that serve as a check on short-term opportunism. These signals include “direct signals,” such as dialogue, openness and transparency; “granted rights,” such as signaling a commitment to abide by agreed-upon processes for engagement; and “care,” evidenced through some protection of weaker parties in a relationship (e.g., dispersed investors).

Any serious discussion of a concept such as soft governance requires that careful attention be paid to the economic arguments supporting such an approach so as to avoid invoking any “why can’t we just all get along” arguments. Although soft governance involves assumptions about behavior and different approaches for modifying it, the intended objective is an economic one – driving the performance of companies and their ability to create value for their investors and owners. As such, this chapter began by arguing that there is an economic benefit to having a flexible, trust-based organization, able to respond to internal and external stimuli and change. Second, the notion of developing soft governance in the form of an atmosphere of joint production — wherein investor intermediaries and managers develop a relationship in which relational concerns

are balanced with financial concerns—was evaluated as a mechanism for checking the potential negative consequences associated with short-term opportunistic behavior that managers can exhibit in response to hard governance measures. Now it is time to consider more directly the issue of the inevitable decline in corporate performance, and the criticality of soft governance to facilitating recovery. In this regard, the writings of legendary economist Albert O. Hirschman—father of the economic concepts of “exit”, or voting with one’s feet, and “voice”—form what is arguably the most powerful support for soft governance and will serve as a significant influence on the design of the Ownership Shares mechanism that will be positioned as the foundation of a corporate governance system that appropriately balances hard and soft governance.

In his book titled Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations and States, Hirschman argues that decline in corporate performance is an unavoidable event, and that the prevailing economic wisdom provides no “mechanism for recuperation”, in that a performance lapse is assumed to trigger other companies taking up the slack to restore equilibrium. He goes on to state that those experiencing negative consequences due to a company’s deteriorating performance (e.g., customers, employees, investors, etc.), have two possible reactions: an economic choice which would be to leave or exit, and a political or social choice to stay and exercise their power of voice. Voice is defined to be any attempt to change, rather than to escape, a state of affairs and can be viewed as the residual of exit. The opportunity for exit will “atrophy the development of

the art of voice” by offering a lower cost, yet equally effective, alternative. In this vein, the high degree of liquidity afforded investors in most global stock markets makes an opportunity for exit readily available.

One of the best illustrations of Hirschman’s concepts of voice and exit, still relevant after 35 years, is the debate over school vouchers originated by another legendary economist, Milton Friedman. Friedman proposed offering the parents of children who attend public schools the opportunity to receive a voucher for their share of the cost of providing public education in exchange for opting out of the public system and using the voucher, supplemented with personal income or savings, to pay for private education. Friedman argued that this school voucher system not only created a market for education that provided choice but also an incentive for public schools to improve their quality in order to compete effectively against private schools. School vouchers therefore provide the ability to exit. Voice would have required participation in local school boards, which Friedman referred to as “cumbersome political channels.” 75

Some additional observations that Hirschman makes concerning the use of voice instead of exit have particular significance for investor intermediaries who are in a position to exercise either the exit or voice option but typically use exit, or a threat of exit, when responding to some kind of company performance lapse. The use of voice will depend on the readiness to explicitly complain and the availability of mechanisms to channel complaints to the appropriate party who can engage in further discussion or take

action, as appropriate. Also, for voice to be successful requires some interested parties to be “alert” (i.e., willing and able to provide feedback) and some to be “inert” (i.e., willing to provide time and resources as a cushion while recovery based on feedback ensues). Finally, those who care the most (i.e., have the most economic surplus associated with the organization in question) have the most to lose and will be more likely to exit first, even though this could prove to be a costly response.

Next, Hirschman introduces the concept of loyalty which is the point from which a virtual roadmap for the implementation of soft governance emerges—conditions must exist for a proper balance between exit and voice (and if the weights are tipped they should favor voice) and efforts must be made to build a trust-based organization and foster joint-production oriented investor-manager relationships. Loyalty refers to a special attachment to an organization and has the effect of increasing the likelihood that voice will prevail over exit in the case of a performance lapse. Loyalty raises the cost of exit and increases the value of voice by preventing the cost of deterioration from becoming cumulative. To facilitate the use of voice, the decision-maker must be willing to trade the certainty of exit for the potential uncertainty of the success of voice, and there must be a reasonable expectation that voice will have some impact.

It should be the case that investor intermediaries demonstrate loyalty only to the investors for whom they act as agents, but it could also be argued that to fulfill this mission they must take whatever action is necessary to ensure they create optimal value for their investors (i.e., in proportion to the risk profile of the investors). Therefore, if investor intermediaries assess the risk of cumulative company performance deterioration
and the likelihood that voice can be effective in arresting the problem to both be high, then they would be serving their investors well by exercising voice instead of exit. Moreover, to the degree that this causes investor intermediaries to invest in companies with trust-based cultures and that are open to a joint-production approach to engagement with them, then investor intermediaries would be serving their investors’ interests by pursuing investment opportunities that engender loyalty.

Hirschman argues that voice often will lose out to exit because of a lack of mechanisms to channel voice and influence recovery. He goes on to make the most important point about exit and voice, which is that they are symbiotic and cannot exist without each other. Voice becomes most effective when there is a possibility of exit, although it can’t be a very attractive or easily exercisable option. A small possibility of exit will raise the value of voice by making it easier and more viable, but if the possibility of exit is too remote, this will instead increase the cost of voice relative to exit. Hirschman calls for an increase in the rewards for voice so as to make it the generally preferred alternative that will overtake exit.

Following Hirschman almost directly, the concept of Ownership Shares represents a vehicle for exercising voice, in contrast to its counterpart—Trading Shares—which is the embodiment of exit. The existence of both types of shares provides the “alert” (Ownership Shares) and “inert” (Trading Shares that facilitate a permanent source of capital), offers access to a communication channel and process that should increase the likelihood that voice will have an impact, and provides rewards for voice in the form of premium priority dividend rights, all of which will be discussed in detail in the next
chapter. The conditions that favor loyalty and the likelihood of voice prevailing over exit, such as an atmosphere of trust and joint-production, constitute the architecture of soft governance. The foundation upon which this architecture stands and is held together will be Ownership Shares.

Before proceeding with a detailed analysis of the Ownership Shares concept, it is perhaps worth noting that soft governance can also have positive implications for boards of directors regardless of their interactions with investor intermediaries. For example, if the trend toward the separation of the chairman and CEO roles picks up steam in U.S. boardrooms, coupled with the trend toward the appointment of a lead director, new conflicts could be created in the boardroom. The principles and benefits of soft governance apply in these cases as well.

Chapter 6: Ownership Shares – A Foundation for Instituting Soft Governance

The logic of pursuing a balance of hard and soft governance to mitigate the persistent investor-manager conflict seems compelling, and fortunately Robert Monks’ Ownership Shares concept seems to be a viable mechanism for implementing and sustaining soft governance through its facilitation of voice as a viable alternative to exit. This chapter will examine the detailed design of Ownership Shares more closely and assess their technical viability from economic, legal and behavioral perspectives. It will also evaluate the likelihood that the chosen mechanism will succeed from functional and technical perspectives, and suggest changes or enhancements before testing or simulating the mechanism in action.

As the founder of Institutional Shareholder Services (ISS), former chairman of investment firm The Boston Company, and co-founder of the activist investment firm Lens Investment Management, Robert Monks is someone who has thought a great deal about the relationship between corporate governance and investment returns. As such, his views and ideas on how to transform corporate governance should be noted and studied. Monks first introduced the concept of Ownership Shares (and, by extension, Trading Shares) in a speech he delivered at the Harvard Law School in October 2004 as a guest of Professor Lucian Bebchuk; he subsequently wrote about the concept in an article published in March 2005. The entire package of reform ideas emanates from Monks’ core belief that good corporate governance is critical to the creation of wealth because it maintains the “health of the equity culture” that thrives in the U.S. and other global markets. Monks claims that governance is what creates the celebrated equity premium, or
the return earned by equities over and above the return earned on bonds over long periods of time; he estimates this premium to be 4% over an average bond return of 2% for an overall average equity return of 6%. In other words, Monks contends that poor governance practices will negatively affect equity prices and could therefore, over time, have a sustained negative impact on investors' confidence in the U.S. equity market and, potentially, other global equity markets.

Monks' package is composed of five proposed reforms: (1) a tax penalty on institutional investors that dispose of shares less than six months after acquisition, which scales down to zero after five years; (2) direct shareowner nomination of candidates for election to the board of directors; (3) mandatory periodic change of auditing firms subject to a bidding process; (4) a mandatory comprehensive disclosure policy and a cap on executive pay expressed as a multiple of pay to lowest organizational level; and (5) the mandatory separation of a company's equity into Ownership Shares and Trading Shares.

Two critical assumptions underscore this set of reforms. First, Monks believes that economic incentives are necessary to cause reforms to be taken seriously and to effect sustained change in behavior. Second, he believes there is an inherent bias incorporated into all governance reforms implemented to date in that responsible ownership has been sacrificed in the name of liquidity; Monks refers to this bias as the "brokerage ethic," which assumes maximum freedom and ability to trade shares. Both of these assumptions,

particularly the latter one, have profound implications for determining how to proceed with further reforms to corporate governance. Departing from the brokerage ethic means increasing the rewards for those who exercise voice and increasing the costs of exit—in other words, tilting in the direction of soft governance. However, Monks believes that hard governance—in the form of incentives, specifically—might be needed to some degree to produce a significant amount of fruitful soft governance.

Of Monks’ five proposed reforms, four could easily be classified as hard governance in the narrowest sense—a tax penalty, a voting rule, a requirement to change auditors and a pay cap. The separation of a company’s equity into Ownership Shares and Trading Shares is also a requirement, but its intent is to transform the brokerage ethic into an ownership ethic. In this regard, the other four reforms, all notable and worthy of further consideration, would likely be more actionable in an atmosphere characterized by trust and mutually beneficial relationships, both essential features of soft governance. The creation of Ownership Shares (and, by extension, Trading Shares) may provide a basis for a transformation in the relationship between investors/owners and managers, and will either pave the way for further governance reforms or obviate their necessity altogether. For this reason, a detailed analysis and assessment of this reform in particular is appropriate.

The design of Ownership Shares put forward by Monks features three central requirements: (1) that companies’ existing equity be split into Ownership Shares and Trading Shares, with existing shareowners being able to choose between the two classes; (2) that Ownership Shares carry the right to a priority payment, or ownership dividend,
before dividends are paid to owners of Trading Shares; and (3) that shareowners who hold Ownership Shares would be obligated, under threat of audit, to actively engage with company managements to resolve problems; non-compliance by either the owner of the shares or the company would result in sanctions and penalties. If this design were implemented, it can be assumed that, as fiduciaries, investor intermediaries would have no choice but to convert to or acquire Ownership Shares; in other words, a prudent person would likely accept the additional dividend rights in exchange for additional obligations.

To establish the viability of the Ownership Shares design, it is then necessary to examine its economic, behavioral and legal implications and either accept or reject its ability to instill soft governance or suggest possible modifications to arrive at a more functional and effective policy.

From an economic perspective, there are two main questions to consider. First, do Ownership Shares and Trading Shares entail the same requirements as, and therefore generate concerns similar to those associated with, dual-class equity? And, second, does the right to a priority dividend ensure appropriate compensation for the obligations (i.e., time and efforts to monitor and engage with management) and risk of being in non-compliance with those requirements? The principal concern associated with dual-class equity is that a disproportionate relationship between cash flow and control rights held by one or more investors can cause management to make decisions that favor one class of investor/owner over another. In a dual-class equity company, management typically holds the class of equity that confers a greater proportion of control to cash flow rights, with proportional control and cash flow rights represented by one share = one vote.
Dual-class equity might confer control rights equivalent to one share = two votes to the holders of the favored class of equity, and two shares = one vote to the holders of the other class of equity.

In a recent study of dual-class companies by Gompers, Ishii and Metrick (2004), the authors documented the decision-making effects of dual-class equity using a sample of 100 to 225 companies, taken each year from 1994 to 2001. They found that in dual-class equity companies the management and directors possess 26.7% of cash flow rights and 50.7% of voting rights (i.e., roughly one share = two votes) and tend to be more reliant on debt financing and less willing to access the capital markets for equity financing as prospective investors will likely not be interested in equity with inferior voting rights. Otherwise, management would have to relinquish the control that dual-class equity affords them. According to the authors, the result of these management practices is that dual-class companies tend to experience less growth and lower market valuations.\footnote{Gompers, Paul, Joy Ishii and Andrew Metrick. "Incentives vs. Control: An Analysis of U.S. Dual-Class Companies." National Bureau of Economic Research. Working Paper 10240, January 2004.} Ownership Shares do not alter the voting rights of a single share of stock held, and as such maintain a proportionality between cash flow and control rights (i.e., one Ownership Share = one vote, one Trading Share = one vote). Although they do confer additional rights, such as a priority dividend, this right, which is given to shareowners in exchange for agreeing to engage in a dialogue with management, does not allow shareowners to decide whether to distribute dividends or the value of any dividends issued.
The second economic issue that must be considered is whether the priority dividend is adequate compensation for the obligation to expend time and effort engaging with management. It is difficult to consider this requirement to be significant, especially as there are no frequency and time requirements, and since preferential access to management is an opportunity to convey interests, preferences and concerns that could translate into management actions that could ensure a dividend is paid and ultimately increase the value of both Ownership and Trading Shares. As such, the right to a priority dividend is more than adequate compensation for any obligations borne by investors with Ownership Shares. Furthermore, Monks’ original concept does not specify a holding requirement or sale restriction period pertaining to the shares owned, so an investor with Ownership Shares could sell them; presumably these sold Ownership Shares would be converted into Trading Shares automatically. The primary benefit associated with a priority dividend is that investors with Ownership Shares have first access to the available and potentially distributable cash flow that management doesn’t need to re-invest. As it is reasonably accepted that management avoids reducing dividend levels at almost any cost, including taking on debt in order to pay them, and that Ownership Shares impose no requirement to increase dividends relative to investors with Trading Shares, they might not have any impact, positively or negatively, on the probability or magnitude of dividends being paid to investors with either Ownership or Trading Shares.

If structured differently, specifically as a premium priority dividend with both a greater magnitude and in priority order to investors with Trading Shares, dividends payable to investors with Ownership Shares could represent an opportunity to discipline management into disgorging free cash flow that is not justifiably required to be reinvested in the business. This is the classic function of dividends—reducing the degree of information asymmetry between management and investors/owners by accurately signaling the financial condition of the company, and ensuring that management does not subjugate the interests of equity holders to those of debt holders (i.e., dividends help to enforce “incomplete contracts” between management and investors/owners). However, such a structure would be inappropriate given the original Monks’ Ownership Shares design and would cause it to take on some of the negative attributes of dual-class equity.

In economic terms, Ownership Shares as conceived by Monks seem to have no apparent problems, and offer the possibility of reducing information asymmetry between managements and investors/owners through dialogue. However, it is not clear if this possibility creates a distinct advantage, as there are minimal incentives for ensuring this dialogue not only take place, but is actually meaningful. An analysis of the behavioral implications of Ownership Shares as conceived by Monks yields a similarly lukewarm assessment. Although Ownership Shares offer shareowners a distinct opportunity to exercise the voice option, they do nothing to increase the costs or reduce the relative value of the exit option, which remains readily available. Therefore it is difficult to

predict the likelihood that voice will be exercised instead of exit, or that it will be perceived as more productive than exit. In addition, it is not clear that Ownership Shares will truly foster a trust-based atmosphere or create a genuine sense of joint-production between managements and investors/owners. Because Monks conceived of no requirement concerning the relative or absolute magnitude of an investment in Ownership Shares, it cannot be assumed that investors with said shares will own a large enough part of a company or have invested enough of their own capital to truly care about the outcome of dialogue with management; they could simply use the opportunity to make demands or threats rather than to engage in substantive and constructive discussions.

A final consideration in an assessment of the feasibility of Monks’ Ownership Shares concept is its legal viability. This legal assessment is not intended to be definitive but rather to identify the key legal issues that could determine the viability of the Ownership Shares concept and provide an indication as to the likelihood that each issue could pose an obstacle to its implementation. The first issue refers to insider trading restrictions under SEC Section 16(b) that could be triggered by the exchange of information between managements and investors/owners. The second issue refers to limitations on the disclosure of confidential information by management to some, but not all, investors (i.e., those with Ownership Shares) under SEC Regulation FD (Fair Disclosure). The third and final issue concerns the administration of the requirement to implement Ownership Shares; could it exist in the form of a ruling issued by the SEC or must the U.S. Congress pass it into law?
Section 16(b) of the Securities Exchange Act of 1934 is designed to prevent securities trading and profit making based on insider information not available to the general public. For this section to be applicable, the purchase and sale of a company’s securities must have occurred within six months. Therefore, if the subsequent sale of a security purchased occurs in less than six months, then the prohibition and potential penalties provided for in Section 16(b) are applicable. If the sale occurs after six months from purchase, the section is not applicable. \(^82\) In the context of Ownership Shares, if there is an exchange of inside information in the course of the required dialogue between management and investors with Ownership Shares, then as long as the investor does not sell the shares and realize gains from the sale less than six months after they were acquired, then the investor need not be concerned about violating the provisions of Section 16(b). Although this constrains the investor, and the exchange of inside information may be beneficial to the dialogue between management and investors, it is not a requirement of the Ownership Shares concept as conceived by Monks and thus would need to be a condition to which both the management and the investor must agree.

Related to these insider trading prohibitions is a concern about the provision of inside information to some investors or interested parties (e.g., stock analysts) and not others. In August 2000, the U.S. Securities and Exchange Commission (SEC) adopted Regulation FD to address this and other related issues. Regulation FD does provide for the exchange of material nonpublic information with some but not all investors, provided an expressed agreement to maintain the information in confidence until it is made public.

is entered into by both parties. Therefore, should management and investors with Ownership Shares decide to exchange inside information, they would have to comply with Section 16 (b) and formalize and abide by a confidentiality agreement as required under regulation FD.

A final legal issue concerns the administration of Ownership Shares. The U.S. SEC was created to monitor the securities industry with the goal of protecting investors; specifically, it is charged with interpreting and enforcing the relevant laws passed by Congress as well as developing and implementing rules to address changing market conditions. On this basis, it seems possible that the SEC could develop and implement a ruling that provides for the mandatory splitting of companies’ equity into Ownership Shares and Trading shares. However, it might also be the case that a law could be passed by the U.S. Congress mandating the creation of Ownership Shares. It should be noted that this would constitute only the second time in seventy-two years that such a federal law concerning corporate governance was passed, the first time being the Securities Exchange Act of 1934, and the second time being the Sarbanes-Oxley Act of 2002. The salient point is that at least one way to implement a federal requirement to split a company’s equity into Ownership and Trading Shares exists. It is important to note as well that if the goal behind the Ownership Shares concept truly is to shift the nature of investing from a brokerage ethic to an ownership ethic, then the creation of Ownership Shares

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84. Ibid.
Shares must be a requirement at the federal level. If the requirement were to be voluntary, or left to individual states, no sustainable societal change would occur.

Based on the economic, behavioral and legal analysis of the Ownership Shares concept as conceived and presented by Robert Monks, one can conclude that the concept might be feasible but very limited in its likely effectiveness. However, this analysis also recommends potential modifications to Monks’ original concept—modifications that might improve its ability to develop an ownership ethic and foster an atmosphere characterized by a combination of hard and soft governance, the emphasis on the latter. The first necessary modification is to increase the economic incentive both for management and the investor who has Ownership Shares to engage in substantive and meaningful dialogue that genuinely reduces the degree of information asymmetry. To complement an increase in economic incentives, which could be characterized as hard governance, it is necessary to increase the cost of exit and the rewards of voice (i.e., duty to care). This modified version of Monks’ original Ownership Shares concept would, in other words, allow for a small amount of hard governance in the hopes that it would generate a large amount of soft governance.

Exhibit 1 represents a modified and augmented version of Monks’ original concept. Key additions include: (1) a minimum investment requirement to trigger the splitting of equity into Ownership and Trading Shares; (2) a sale restriction period for Ownership Shares; and (3) an Ownership Share dividend premium, in addition to priority status, over dividends to Trading Shares.
Provided an investment fund acquires at least 1% of the outstanding shares of a company’s common stock on the open market and the value of the stock equates to at least 5% of the net asset value of the fund at all times, the following provisions automatically apply:

1. **Dialogue with Board of Directors:** The Board of Directors of the company is obligated to conduct quarterly meetings with the fund’s managers to engage in substantive and detailed discussions about the company’s governance, strategy and performance, and any other issues related to the company or industry, which may include inside information. A minimum of one two-hour meeting is to be held each quarter, subject to external audit certification and disclosure.

2. **Long-Term Holding Requirement:** The shares in the company acquired by the fund are subject to a three-year lock-up period during which they are restricted from sale and must be held in an escrow account, and may not be pledged or encumbered in any way. If quarterly meetings include the exchange of inside information, then the sale restriction may extend for six months after the lock-up period expires to comply with SEC “short swing profit” prohibitions (i.e., requirement to refund profits earned from securities purchases or sales within six months of having access to inside information).

3. **Priority Premium Dividend Rights:** The fund’s managers have the right to receive a priority premium dividend (i.e., greater in magnitude and in priority order to the dividends paid to other shareholders) in exchange for their enhanced role in corporate governance and monitoring the company’s Board of Directors. The specific dividend determination and/or terms must be agreed upon by the fund’s managers and the company’s Board of Directors and disclosed to all shareholders by the end of the quarter following the initial investment.

The following additional points should be noted:

- The proposed ruling does **not** provide for the fund’s managers to have a seat on the company’s Board of Directors, which would require the fund to conduct a proxy solicitation and win a majority shareholder vote.

- The proposed ruling does **not** entitle the fund’s managers to any different voting rights from other shareholders. One share equals one vote.

- The disclosed agreed premium dividend terms **must** be judged by other shareholders to be reasonable and commensurate with value added by the investment fund(s) entitled to receive them. If not, the company’s other shareholders will sell their stock in the company, and the investment fund(s) will suffer long-term unrealized losses due to the 3-year lock-up period.
The minimum investment requirement requires that for the separation of a company's equity into Ownership and Trading Shares to be triggered, an investor intermediary (i.e., an investment fund) must acquire at least 1% of the company’s shares that also equates to at least 5% of the net asset value of the fund during the period of time the shares (i.e., Ownership Shares) are held. This, coupled with a three-year sale restriction period, will ensure two things—that the cost of exit is quite high, and that the likelihood of voice being not only exercised but highly valuable is very high. Although it could be argued that this design makes exit virtually impossible—which is undesirable as it will deter investors completely—this is not the case. The possibility of exit is remote but exists to a sufficient degree to motivate the exercise of voice. First, the dialogue between the board of directors representing the company and the investor/owner will be documented, audited and disclosed to all shareholders, excluding the details of any inside information that might be exchanged pursuant to a formal confidentiality agreement between the parties. Nevertheless, if the substance of this dialogue is not productive, there will probably be clues in the reports that will be disclosed by the company's external auditors that could trigger exit by investors with Trading Shares. Although this will also penalize investors with Ownership Shares, the three-year sale restriction period should also afford these investors sufficient time to use the decline in the stock price precipitated by the exit of investors with Trading Shares to call for dramatic changes and a restoration of the stock's performance trajectory before the sale restriction on their Ownership Shares lapses. Another possibility is the opportunity to exit should the board
of directors fail to honor its obligations in a more blatant manner, which would also be
detected and disclosed by the company’s auditors.

The three-year sales restriction period is intended to provide sufficient time to
develop a productive dialogue between the board of directors and investors who have
Ownership Shares, and to provide sufficient time for recovery to occur in the event of a
business performance lapse. This restriction period could be renewable at its completion,
which would serve as an incentive for the board of directors to engage investors who are
approaching renewal in retention discussions. This might help to retain Ownership
Investors who might otherwise sell their shares and cause a decline in the company’s
stock price. However, some investors who have Ownership Shares might need to sell to
diversify their portfolios, or due to other external issues that need to be ascertained and
understood. Another possibility might be to have every Ownership Share correspond to a
rolling three-year sale restriction period unless the investor holding the share requests to
opt out at the beginning of each period. It should also be noted that the sale restriction
might automatically apply for an additional six months after each three-year period
elapses if the dialogue between the board of directors and investors included the
exchange of inside information.

The dimensions of 1% of shares that corresponds to 5% of the investment fund
were chosen to reflect meaningful levels of investment, and to encourage multiple
investors who can assist in monitoring not only the company but also each other (e.g.,
via auditor’s reporting and disclosure concerning investor meetings). Requiring greater
levels of investment might have discouraged the participation of both smaller investors
concerned about concentrating too much risk and other parties averse to the possibility of going through the SEC-mandated reporting procedures that are often triggered by ownership stakes of 10% or greater.

The premium priority dividend provides a stronger incentive for a board of directors to engage in serious dialogue with investors that have Ownership Shares. Specifically, boards would have the incentive to explain the company’s investment needs, and to justify why free cash flow is being used to fund these needs instead of being distributed to investors in both Ownership Shares and Trading Shares, or used to implement a buyback of Trading Shares. In this regard, the premium dividend should fulfill the classic mission of dividends mentioned earlier—to disgorge cash from the business unless it is absolutely necessary to fund growth opportunities that can earn a higher return than investors can achieve on their own. The dividend determination process is typically done in an atmosphere of great information asymmetry, as noted earlier; using the design under discussion, this asymmetry would be corrected or at least mitigated by one of the hallmarks of soft governance—an atmosphere of trust that allows for meaningful dialogue between the board and investors with Ownership Shares.

The premium dividend also serves to compensate investors with Ownership Shares for taking on the illiquidity risk associated with the sale restriction and for making the effort to engage in the exercise of voice. Although there is much speculation about the value of a premium for illiquidity risk, one classic study by Amihud and Mendelson found that the difference in returns between the least liquid and most liquid stocks (i.e., based on bid-ask spreads as a percentage of overall stock price) traded on the New York
Stock Exchange between 1961 and 1980 averaged approximately 8.5% per year. The premium earned by private equity investments over broad public markets between 1985 and 2005 is approximately 5% on average, although it is greater at the upper quartile of private equity performance. Anecdotally, an illiquidity premium can be as high as 20-30%, especially in light of the extreme liquidity that investors have come to expect in a society characterized by a brokerage ethic. As noted on the description of Ownership Shares in Exhibit 1, the magnitude of the premium dividend needs to be set at a level that will be viewed as reasonable by investors with Trading Shares; otherwise, they will either sell their stock, which will cause the price to decline, or be deterred from buying the stock in the first place.

The modified and augmented Ownership Shares design expands on Robert Monks’ original design to improve the likelihood that Ownership Shares can help to institute soft governance. Ownership Shares might be a form of hard governance, but as noted earlier and described above, their purpose is to facilitate the development of soft governance and to initiate the transformation of our investment system’s brokerage ethic into something closer to an ownership ethic.

Chapter 7: Ownership Shares – A Simulation

In the last chapter, a modified Ownership Shares design emerged that could facilitate the exercise of voice over exit by investor intermediaries, and therefore help to instill soft governance into their relationships with their portfolio companies. This chapter is devoted to an assessment of a simulation of this design to determine if it could be effective as a public policy, either in the form of a law or SEC ruling. It would have been ideal to conduct a simulation with actual investor intermediaries, particularly with hedge funds as they are playing an increasingly significant role in the securities and investment industry. However, it became clear that, in this environment, the range of experience participants had would be too varied; better would be a more controlled simulation that required participants to have similar backgrounds and capabilities. So instead, a simulation was conducted using samples of MBA students taking a finance class that would have familiarized them enough with the issues to represent what could become a next generation of investors or investor intermediaries such as a hedge fund.

Before delving further into the simulation process and its results, I will speculate on the likely reaction of investor intermediaries, hedge funds in particular, to a mechanism such as Ownership Shares based on reports of their activities that have appeared in the press, and then compare this impression with the outcome of the simulation. For example, the celebrated downfall of Morgan Stanley’s Chairman and CEO Philip Purcell in mid-2005 has been credited by many to eight former senior executives and current investors who used their collective power as a voting block to apply public pressure on Purcell to either sell Morgan Stanley’s credit card and retail
brokerage businesses or resign. Actually, the process began to gain real momentum when hedge fund manager Scott Sipprelle of Copper Arch Capital, and a former Morgan Stanley executive, wrote a letter to the Morgan Stanley Board urging the sale of certain businesses, and other hedge funds began trading in the stock in the hopes that the Board would move fast to replace Purcell, which of course it promptly did. Three years earlier, Guy Adams had been operating a $50 million hedge fund called GWA Capital that targeted poorly governed companies with depressed stock prices and then agitated for change to improve valuations. Adams used a relatively small stake of 1,100 shares in Lone Star Steakhouse to successfully argue for the ousting of its CEO and other governance and management changes. Also in 1995, U.S.- and UK-based hedge funds forced the senior management of Germany’s Deutsche Borse, including Rolf Breuer, the former Chairman and CEO of Deutsche Bank, to resign and withdraw its bid for the London Stock Exchange. In two other high-profile cases, hedge funds initiated full-blown takeovers of failing companies, taking on a role traditionally performed by private equity firms: Highfields Capital Management attempted to acquire Circuit City but was unsuccessful, and ESL Investments successfully took control of Kmart and merged it with Sears.

In a 2005 Wall Street Journal article titled “Hedge Funds Are New Sheriffs of Boardroom,” Alan Murray offers the following argument to explain this phenomenon:

“While Sarbanes-Oxley forced companies to play defense, hedge funds force them to play offense. Any risk-averse company that wants to sit on a big pile of cash waiting for a rainy day is likely to find itself under quick attack from these fast-moving pools of money that will come in, buy up stock, and agitate for change. The hedge funds have become the new sheriffs of the boardroom. But they are less concerned with legal processes and accounting procedures and more with returns to shareholders.” 90

The process that ensues is probably the most interesting aspect of this phenomenon. It often involves public complaints about company performance or nasty letters to boards of directors as opening salvos in what can become protracted wars, rather than a single battle at an annual shareholders meeting. One example is Pershing Square Capital Management, which was trying to force McDonald’s, of which it owned just below 5%, to restructure by giving an open presentation at a New York Hotel to other investors about its harsh views of the company’s problems and its recommended solutions. McDonald’s came under immediate pressure to implement the recommendations, which included selling 1,500 restaurants, repurchasing $1 billion of stock and increasing financial disclosure; a week later they began to do so. 91 Another more famous example is Icahn Partners’ attempt to reform Time Warner, a war that began with the following open letter from Carl Icahn to Time Warner shareholders in October 2005:

“Unless the legacy of poor decision-making is fully recognized and the board is held accountable, the dismal record of mistakes and inaction will continue to the detriment of shareholders.” 92

92. Ibid.
Hedge fund managers claim that these tactics have noble objectives—cleaning up badly managed companies and creating value for those who invest in their funds. One of the most aggressive fund managers claiming to be of this ilk is Third Point LLC, which has a fund of almost $4 billion. Routinely, Third Point sends blunt and pointed letters to the CEOs of the companies it invests in and shares the contents with the public in the same manner as Icahn Partners did with Time Warner. This has prompted some to argue that in the true spirit of independent directors perhaps corporate boards of directors should recruit hedge fund experts to help them navigate their own terrain. Cerebus Capital Management’s presence on the MCI Board of Directors helped MCI to deal with other hedge funds as it was in the process of accepting a bid to be acquired by Verizon that was less than a competing but lower quality bid from Quest.  

In a more recent Wall Street Journal article published earlier this year titled “Hedge-Fund Lessons from the Icahn Affair,” Alan Murray makes the following critical observation about the motives and objectives of hedge funds as investor intermediaries:

“Companies can’t sit on cash without risking a hedge-fund attack. Private-equity firms make much of their money these days by adding debt to the company balance sheet, enabling investors to get “leveraged” returns. Why shouldn’t public-company investors be entitled to the same? Mr. Icahn didn’t succeed in breaking up Time Warner, but he did succeed in forcing the company to buy back more stock, paying out cash and increasing its debt.”

‘Shareholder democracy’ has never proven itself to be very potent at holding corporate leaders accountable. Maybe hedge-fund democracy has more promise.”

This observation has been endorsed by prominent economists as well. Steven Kaplan of the University of Chicago, in a recent article on shareholder democracy in *The Economist*, says that, unlike some hedge fund managers who push a company in which they own an interest to be acquired, while simultaneously hedging their downward exposure, others who are in the activist mold are demonstrating a genuine interest in increasing the value of the companies in which they have invested. 95

The impression one can take from all of this activity is that the latest breed of investor intermediary (i.e., hedge fund managers) have the capabilities and knowledge to add value to the companies in which they invest, but either enjoy the adrenaline rush of battling to channel this value or do not believe a viable, more constructive alternative route exists. In short, they are fully exercising the voice option. The results of a study just released in March 2006 of the Hermes UK Focus Fund in the UK, conducted by Professors Marco Becht, Julian Franks, Colin Mayer and Stefano Rossi, shed some light on this issue and suggested that the latter explanation might be the more valid one. The study focused on the private interactions between the Fund’s managers and forty-one companies in which it had investments of 1% or more (up to 15%) and an average holding period of almost two years (691 days). Of the forty-one companies, the fund’s managers had regular, private and behind-the-scenes engagement with the boards of directors and occasionally the managements of thirty, and the engagement was considered “collaborative” in ten, “confrontational” in ten, “very confrontational” in two

and unclear in the remaining eight. The study found that the fund succeeded in securing
the objectives it conveyed in the course of these private interactions primarily in the areas
of core business focus, board changes and "financial policies" such as dividend payouts.
The study also measured changes in the prices of these stocks around the public
announcements pertaining to these issues and documented "economically large out-
performance", which has, in turn, contributed to performance by the fund. Of course
this is only one study, but it indicates an alternative route to creating value that investor
intermediaries may take. Ownership Shares, as modified and augmented, are a
mechanism intended to foster the institutionalization of this alternative route—one of soft
governance, characterized by the exercise of voice in an atmosphere of trust and mutually
beneficial relationships. Two key questions to be answered include whether investor
intermediaries in the U.S. would be willing embrace this approach and venture away
from the brokerage ethic, and whether any mechanism such as Ownership Shares is really
necessary.

As noted earlier, a simulation of the effects of Ownership Shares was conducted
on two samples of MIT Sloan students, primarily graduate students seeking their MBA
degrees. The two samples corresponded to two sections of a course in Entrepreneurial
Finance (15.431) taught by Professor Antoinette Schoar, in which the governance aspects
of private equity and the nature of private equity funds and investors are key topics
covered. Prerequisites for the course generally include two semesters of finance theory.

96. Becht, Marco, Julian Franks, Colin Mayer, and Stefano Rossi, "Shareholder Activism in the United
Kingdom", presentation at the London Business School Centre for Corporate Governance, London, UK,
February 9, 2006.
The students in the class were considered qualified to place themselves in the position of a future investment fund manager. The students in each section were given approximately ten minutes to read the modified and augmented Ownership Shares description in Exhibit 1, answer two questions, which differed slightly for each section, and provide some background demographic information.

The questions that were posed to each section of students are shown in Exhibit 2. Understanding that they were to act as investment fund managers, the students in Section A were asked to determine if they would be willing to become investors owning Ownership Shares, and then to also indicate the magnitude of the premium dividend they believed would be appropriate and reasonable, regardless of whether they answered positively or negatively. This allowed for an analysis of the dividend premium that might be required to institute Ownership Shares, even if the questionnaire respondents demonstrated a negative sentiment toward the idea. Somewhat differently, the students in Section B were asked to indicate if they would be more or less inclined to become investors owning Trading Shares of a company that already had one or more Ownership Share investors. Section B students were also asked to indicate the level of premium dividend they believed was fair and reasonable, even if they expressed a negative sentiment toward becoming investors in Trading Shares.

It should be noted that, for every question, the respondent was asked for both a direct answer and a brief rationale behind the answer. The rationale responses were used to ensure that the respondent thought about the question, and were audited to ensure that
respondents understood the question when developing a response. Reported rationales were not used for any additional analytic purposes.

**Exhibit 2: Simulation Questions**

**Section A Questions:**

1. As a fund manager, would you proceed with acquiring enough shares in one or more companies you are considering to trigger the SEC ruling provisions described on the previous page? Please check “YES” or “NO” and briefly explain your rationale.
   
   YES _______ NO _______
   
   Rationale:

2. Assume your answer to Question #1 is “YES” even if it wasn’t. What dividend premium relative to regular shareholders (i.e., X% greater than the regular shareholder dividend) do you think would be reasonable and, in the eyes of other shareholders, commensurate with the value you would be adding to corporate governance? Please indicate a percentage and briefly explain your rationale.
   
   ____%  
   
   Rationale:

**Section B Questions:**

1. As a fund manager, assume you aren’t interested in acquiring enough shares in one or more companies to become subject to the SEC ruling provisions, due to potential over-concentration of risk. Would you be more or less inclined to make a smaller investment in a company that had one or more shareholders subject to the SEC ruling provisions described on the previous page? Please check “MORE” or “LESS” and briefly explain your rationale.
   
   MORE _______ LESS _______
   
   Rationale:

2. Assume your answer to Question #1 is “MORE” even if it wasn’t. What dividend premium (i.e., X% greater than the regular shareholder dividend) do you think would be reasonable for the investors subject to the SEC ruling provisions and, in your eyes as a regular shareholder, commensurate with the value you would be expecting these investors to add to corporate governance? Please indicate a percentage and briefly explain your rationale.
   
   ____%  
   
   Rationale:
Exhibit 3 summarizes the demographic breakdown of the sample population by educational program and years of investment experience. As noted in the exhibits, a significant majority of the population included in both samples are 2\textsuperscript{nd} year MBA students without any prior investment experience. Actual sample sizes surveyed were sixty-nine students in Section A, and sixty-four students in Section B. However, responses that were not complete (e.g., did not answer both Questions 1 and 2) were discarded, which brought the sample size down slightly to sixty-three for Section A and sixty for Section B. In situations where respondents provided a range as the suggested dividend premium in Question #2, an average of the endpoints of the range was used.

**Exhibit 3: Sample Demographics**

<table>
<thead>
<tr>
<th>Educational Program</th>
<th>Section A</th>
<th>Section B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>#</td>
<td>Percent</td>
</tr>
<tr>
<td>MBA 1\textsuperscript{st} Year</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>MBA 2\textsuperscript{nd} Year</td>
<td>50</td>
<td>79%</td>
</tr>
<tr>
<td>Sloan Fellow</td>
<td>5</td>
<td>8%</td>
</tr>
<tr>
<td>Other</td>
<td>8</td>
<td>13%</td>
</tr>
<tr>
<td><strong>Sample Total Population</strong></td>
<td>63</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investment Experience</th>
<th>Section A</th>
<th>Section B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>#</td>
<td>Percent</td>
</tr>
<tr>
<td>None</td>
<td>52</td>
<td>83%</td>
</tr>
<tr>
<td>1 – 5 years</td>
<td>10</td>
<td>16%</td>
</tr>
<tr>
<td>6 – 10 years</td>
<td>1</td>
<td>2%</td>
</tr>
<tr>
<td>&gt; 10 years</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Sample Total Population</strong></td>
<td>63</td>
<td>100%</td>
</tr>
</tbody>
</table>
Exhibit 4 shows a summary of the responses to Question 1 and Question 2 from Exhibit 2. In response to Question 1, not surprisingly, only 29% of respondents in Section A stated they would be willing to acquire Ownership Shares, given their conditions and stipulations, with the remaining 71% favoring Trading Shares instead. However, both the positive and negative respondents to Question 1 from Section A provided almost identical dividend premium recommendations as appropriate and reasonable for those who become investors holding Ownership Shares (i.e., average of around 18%, median of 10%). Also, not surprisingly, a majority, 58%, of respondents in Section B indicated they would be more inclined to acquire Trading Shares in a company that has one or more investors with Ownership Shares, with the remaining 42% less inclined to do so. The dividend premium recommendations from Section B respondents are approximately half the magnitude of those recommended by Section A, and both the positive and negative respondents to Question 1 from Section B recommend similar dividend premiums, after accounting for the outlier data points.

**Exhibit 4: Simulation Summary**

<table>
<thead>
<tr>
<th>Question</th>
<th>Type of Data</th>
<th>Section A</th>
<th>Section B</th>
</tr>
</thead>
<tbody>
<tr>
<td>#1</td>
<td>Number in Sample</td>
<td>18 45</td>
<td>35 25</td>
</tr>
<tr>
<td>#1</td>
<td>Proportion of Sample</td>
<td>29% 71%</td>
<td>58% 42%</td>
</tr>
<tr>
<td>#2</td>
<td>Average Dividend Premium</td>
<td>17.6% 19.1%</td>
<td>9.6% 14.7%</td>
</tr>
<tr>
<td>#2</td>
<td>Median Dividend Premium</td>
<td>10.0% 10.0%</td>
<td>5.0% 5.0%</td>
</tr>
<tr>
<td>#2</td>
<td>Mode Dividend Premium</td>
<td>20.0% 5.0%</td>
<td>10.0% 5.0%</td>
</tr>
<tr>
<td>#2</td>
<td>Standard Deviation</td>
<td>22.6% 27.8%</td>
<td>11.7% 39.6%</td>
</tr>
<tr>
<td>#2</td>
<td>75th %ile Dividend Premium</td>
<td>20.0% 20.0%</td>
<td>10.0% 8.0%</td>
</tr>
<tr>
<td>#2</td>
<td>Maximum Dividend Premium</td>
<td>100.0% 100.0%</td>
<td>50.0% 200.0%</td>
</tr>
</tbody>
</table>
These results indicate that although a significant proportion of the sample respondents responded negatively to the concept of Ownership Shares in some manner — primarily to the sale restriction in the case of Section A, but also possibly due to a perception of inferior rights such as with dual-class equity in the case of Section B — they were uniform within each Section in their recommendation for an appropriate dividend premium. This could suggest that there is an emotional response to the notion of a sale restriction, or anything that resembles dual-class equity, which subsequently dissipates when having to decide the premium that would appropriately compensate for the illiquidity associated with Ownership Shares. The concern on the part of investors with Trading Shares that investors with Ownership Shares could try to extract excessive economic benefits is reflected in the difference in the recommended premium magnitude.

Given the nature of the population sample (i.e., inexperienced students albeit with financial training), the results of this simulation should be interpreted as nothing more than an indication that the concept of Ownership Shares might make some sense. A more sophisticated study of the decision making and behavior of practicing investor intermediaries, including those that are already actively engaging in the exercise of the voice option as described earlier, would be required to truly understand if Ownership Shares are necessary and could be effective. The results of the study are interesting to the degree that they were more positive than anticipated (i.e., the null hypothesis being 0% interest in Ownership Shares, and a required dividend premium of infinite value), but should not be over-interpreted or mistakenly applied.
Chapter 8: Conclusions

This thesis is about shaping the future of corporate governance in the United States and possibly on a global basis. The history of the publicly-owned corporation, particularly in the U.S., is steeped in a tradition of hard governance, which is governance based on rules, regulations and the enforcement of laws, that continues to evolve. The risk is that in our attempt to improve how companies are governed by continuing to introduce new rules, regulations and requirements, we cause companies to rely upon symbols of compliance rather than change their behavior. The inevitable result of a sole reliance on hard governance could be a vicious cycle of governance lapses and crises followed by regulation, followed by more lapses and crises, etc. Given the rising power and influence of investor intermediaries such as hedge funds, and their developing interest in improving the performance of their portfolio companies rather than capitalizing on both their performance successes and problems, the time seems right to introduce a mechanism that would balance hard governance with some soft governance. Soft governance is defined as the existence of an atmosphere of trust and concern for the relationship between investor intermediaries and the boards of directors of the companies in which they invest, such that the exercise of voice in the form of regular engagement and dialogue between parties becomes preferable to exit in the form of an investor selling stock in a company, or shorting it, at the first sign of performance problems.

The proposed mechanism for achieving this is a modified and augmented version of the Ownership Shares concept developed originally by Robert Monks. The design of the Ownership Shares mechanism is intended to create incentives for investor
intermediaries and boards of directors to transform their relationship, and to emulate many of the governance aspects of the private equity ownership to the extent possible. It seems that investor intermediaries are ready for the opportunity to exercise voice in a more productive and fruitful manner than a proxy fight or open letter to investors. A simulation of the Ownership Shares concept with samples of financially trained MBA students indicates that a modified and augmented version of Robert Monks' original concept might be a viable vehicle for facilitating this, although much more study of the potential effectiveness and implications of Ownership Shares is required first. For example, while it might seem obvious that, if Ownership Shares became a reality they would improve the long-term nature of equity compensation programs, this is not entirely clear and would need to be modeled and studied further.

The nagging issue concerning the potential implementation of a requirement for companies to split their equity into Ownership Shares and Trading Shares, provided there are investors who qualify for and wish to acquire Ownership Shares, is that such a policy must take the form of hard governance at the federal level—either as an SEC ruling or as a law passed by the U.S. Congress—if it is to have any genuine impact on creating a better balance between hard and soft governance. The question then is, are we ready for another—albeit much milder—Sarbanes-Oxley Act?

In a recent book titled Societal Learning and Change, author Steve Waddell refers to two dimensions of change, one being breadth, referring to who is affected and needs to be engaged in the change process, and the other being depth. Waddell refers to

the writings of organizational learning and change theorist Chris Argyris and others to explain that the depth of change occurs at different levels—first-, second-, and third-order—with each order corresponding to deeper and more significant change. To determine if a policy change such as mandating the introduction of Ownership Shares is feasible, diagnosing where we are as a society in terms of the depth of change and learning we have experienced and are ready to experience in the realm of corporate governance is a necessary first step.

"First-order" change in corporate governance occurred in the 1980s and 1990s. This level of change refers to changes in the "rules of the game," but no fundamental changes in the game itself. During the 1980s, institutional shareholders began to grow impatient with corporate earnings disappointments and evidence of excessive agency costs in the expansionist behavior of many corporate managements, and played the game of using the market for corporate control to effect change. In the 1990s, institutional shareholders grew in size and importance, and started using other levers of change that were available, such as equity compensation and proxy battles.

"Second-order" change occurred in the last five years. The structure and process of the game fundamentally changed. The passage of the Sarbanes-Oxley Act in 2002—the first piece of federal corporate governance legislation in the U.S. since the Securities Exchange Act of 1934—codified the responsibilities and accountabilities of boards of directors and managements that had heretofore been simply expectations.

Now, "third-order" change is upon us. The entire game must change to prevent a vicious cycle of hard governance from occurring. Although the need for change on the
order of mandating the creation of Ownership Shares in some form might be apparent, the process required to create and implement new SEC rulings or federal laws is a governance issue well beyond the scope of this thesis.
Bibliography


