Project outline junior research project: "Short-termism in corporate governance: a continental European perspective"

Rationale and positioning with regard to the state-of-the-art

Short-termism as a societal problem. *"Short-termism […] is one of the greatest threats to America's enduring prosperity"*, Joe Biden wrote in a 2016 op-ed for the Wall Street Journal. Short-termism can be defined as the phenomenon whereby "*corporate directors and managers […] favor immediate but lower-value results over more profitable long-term results"* (Roe, 2013). Such short-termism could harm the profitability of companies and therefore negatively impact the wider economy. In addition, policy makers worry that corporations that do not invest in the long term will fail to create jobs and will fail to adapt to important societal challenges, such as the shift to a net zero economy. In this regard, the 2020 EY study for the European Commission on "directors' duties and sustainable corporate governance" (hereinafter the "EY Report") concluded that "*[s]hort-term time horizons […] could amount to overwhelming environmental, social and economic consequences for companies, shareholders, investors, and society at large"*. In a statement for the 2017 World Economic Forum, Sasja Beslik (then head of sustainable finance at Nordea Group) put it even more bluntly: *"[t]he finance world's short-termism will destroy our communities, economies and the planet"*. Clearly, short-termist behavior by corporations is seen as a large societal problem.

Scope. The question that this project seeks to answer is to what extent corporate governance in continental Europe encourages or discourages short-termist behavior by corporations. For this purpose, corporate governance can be defined as "*a set of relationships between a company's management, its board, its shareholders and other stakeholders*" (OECD/G20, 2015). Currently, the short-termism debate focuses almost exclusively on the US and the UK, which is why the state of the art starts with a review of this literature. This project outline then continues by analyzing how European corporate governance differs from corporate governance in the US and the UK, concluding that a continental European perspective is missing from the debate.

Evidence on shareholder pay-outs and investment. Several studies, both in the US (e.g., Lazonick, 2014) and in Europe (e.g., EY Report, 2020) have argued that a short-termism problem exists. They point to an increase in shareholder pay-outs (dividends and share buybacks) and a decrease in long-term investments in listed companies in recent years. The idea is that short-term oriented shareholders are demanding pay-outs, leaving corporations with insufficient capital to invest for the long term. However, these studies attracted considerable academic criticism because of several methodological problems. For example, the empirical evidence collected by these studies relied on a skewed sample and did not consider capital inflows through the issuances of additional shares (see for an overview of the criticism: Roe, Spamann, Fried and Wang, 2021; Edmans, 2020). Contrary to the results of these studies, Fried and Wang (2019, 2021) find no evidence that shareholder pay-outs are limiting long-term investment, and actually find an increase in investment in R&D in recent years, both in the US and in Europe. In addition, Roe (2018) argues that even if shareholder pay-outs by firms listed on the stock exchange were increasing, it is possible that this money is being reinvested into non-listed firms with more investment opportunities.

Short-termist investors. More convincing evidence of a short-termism problem may be found in the studies that analyze the impact of short-termist investors specifically, rather than analyzing shareholder pay-outs by all listed firms. For example, Bushee (1998) finds that ownership by "short-termist" institutional investors (i.e., investors that have high portfolio turnover and engage in momentum trading) in the US is positively associated with R&D cuts to boost earnings. Cremers, Pareek and Sautner (2020) confirm these results with a more sophisticated "difference-in-difference" methodology, which makes a causal effect more credible. They find that firms with a large increase in short-termist investors are more likely to decrease investments in R&D and that this increases earnings and firm value in the short term, but harms firm value in the long term. These findings suggest that some (but not necessarily all) institutional investors are excessively focused on short-term results.

Transmission of short-termism to managers. Such short-termism of investors also seems to be transmitted to the management of the corporation. In a survey of 401 CFOs in the US, 80% reported that they would decrease discretionary spending on R&D and advertising to meet a quarterly earnings target, supposedly because of pressure by investors and stock analysts (Graham, Harvey and Rajgopal, 2005). The academic literature discusses two main channels through which the short-termism of certain investors is transmitted to the management of the corporation: executive compensation and shareholder activism (Willey, 2019).

Executive compensation as a transmission channel. Executive compensation can incentivize managers to act in the short-term if their bonus targets are based on short-term results. In addition, if executives can sell the shares and stock options that they have been awarded as part of their compensation, they can benefit from a short-term bump to the stock price, while avoiding the long-term stock price reversal by selling their equity. There is some empirical evidence in the US that short-term focused executive compensation, in particular in the form of shares and stock options that can be sold in the short-term, indeed leads to short-term focused corporate behavior, such as investment cuts (Edmans, Fang and Lewelle, 2017; Ladika and Sautner, 2020; Edmans, Fang and Huang, 2021). Flammer and Bansal (2017) also show that shareholder proposals that encourage long-term executive pay lead to increases in long-term investment and firm performance. Taken together, these studies suggest that executive compensation in the US sometimes incentivizes short-termist behavior, and that these incentives matter for long-term performance.

Shareholder activism as a transmission channel. The second potential mechanism for transmitting short-termism of investors to managers is shareholder activism, especially by hedge funds. Several authors have argued that shareholder activists are excessively focused on the short term and pressure the management of a corporation to take short-termist actions (e.g., Strine, 2010; Lipton, 2013). On the other hand, several studies have found empirical evidence that hedge fund activism leads to a boost to the stock price that does not reverse over a period of several years (see for the US: Bebchuk, Brav and Jiang, 2015; Brav, Jiang and Li, 2021; see for Europe: Becht et al., 2017). In addition, the evidence also suggests that hedge fund activism increases long-term operating performance (Bebchuk, Brav and Jiang, 2015) and innovation output (Brav, Jiang, Ma and Tian, 2018). However, another study finds that hedge fund activism negatively affects the social and environmental performance of firms (e.g., DesJardine and Durand, 2020), which may harm the firm in the longer term.

The need for a continental European perspective. This brief overview of the literature shows that the topic of short-termism in corporate governance has already been debated at length. However, what is still missing from the debate is a (continental) European perspective, as many of the studies focus on the US and, to a lesser extent, the UK. This is important, because corporate governance in continental Europe differs in important respects from Anglo-Saxon corporate governance, with potentially profound implications for the short-termism debate.

The role of controlling shareholders in continental Europe. A first important difference is that corporations in continental European countries more often have a controlling shareholder than corporations in the US and the UK. For example, the percentage of shares held by the largest shareholder in the corporation is much higher in France (46.4%), Germany (45.3%), Belgium (38.6%) and the Netherlands (34.6%), than in the US (21.4%) and the UK (19.5%) (Aminadav and Papaioannou, 2020). Corporations with a controlling shareholder will face less pressure from shareholder activists, as it is unlikely that activists will win a vote in the general meeting against a controlling shareholder. In addition, due to their large financial stake, controlling shareholders typically have stronger incentives to monitor management (Gilson, 2006), which makes it less likely that executive compensation incentivizes managers to act in the short term. Controlling shareholders are also considered to have a longer time horizon, because they derive private benefits from remaining in control of the corporation (Choi, 2018). This may be especially true for family ownership, due to a desire to transfer the family business to the next generation (e.g., James, 1999). On the other hand, controlling shareholders may also act in a short-termist manner. For example, controlling shareholders may have liquidity constraints that prevent them from investing more capital in the corporation. This may hamper the corporation's long-term growth if a controlling shareholder also blocks additional share issuances to prevent their control from being diluted. In addition, controlling shareholders may focus excessively on the extraction of private benefits, instead of creating long-term value (Gilson and Gordon, 2003). Which of these effects dominates remains unclear, which means that whether controlling shareholders encourage or discourage long-term corporate behavior is an unanswered question.

A different executive compensation structure in continental Europe. A second notable difference in the corporate governance of European jurisdictions is the structure of executive compensation. Share grants and stock options make up a smaller portion of executive compensation in continental Europe than in the US and the UK (16% in France and 10% in Belgium, compared with 42% in the US and 26% in the UK) (Edmans, Gabaix and Jenter, 2017). In addition, a higher portion of total pay is fixed instead of variable in Europe (63% in France and 60% in Belgium, compared to 22% in the US and 48% in the UK). What executive compensation structure is optimal can be debated (see for an overview: Edmans, Gabaix and Jenter, 2017). However, the existing US evidence on executive compensation suggests that the short-termism problem mainly originates through short-term oriented equity-based compensation or short-term focused bonus targets (see above), which are less important in continental Europe. However, the academic literature has largely ignored whether executive compensation in continental Europe contributes to short-termism.

Less shareholder activism in continental Europe. Third, continental European corporate governance is also different from the UK and especially the US because shareholder activism plays a much smaller role. For example, one study reports the average number of activist engagements per 1000 listed firms during the period between 2000 and 2010: 19.6 in the US, 4.1 in the UK, and 1.2 in both France and Belgium (Becht et al., 2017). This implies that the argument that shareholder activists are the cause of short-termism carries much less weight for continental European jurisdictions. However, this conclusion may soon change, as European shareholder activism seems to be on the rise recently (Activist Insight, 2019).

Loyalty voting rights in continental Europe. European legislators have also already adopted governance reforms to combat short-termism. The most popular reform has been to allow corporations to grant loyalty voting rights to shareholders: these are multiple voting rights for "loyal" shareholders who have held their shares for more than a specified time period. Such loyalty voting rights are allowed in Belgium, France, the Netherlands, Italy and Spain (among other jurisdictions). In France, loyalty voting rights have even become the default rule (Becht et al., 2020). The idea behind allowing loyalty voting rights is that it encourages shareholders (and therefore indirectly corporations) to think in the long term (Berger et al., 2017). Empirical evidence shows, however, that loyalty voting rights are in practice mostly used by controlling (Becht et al., 2020; Bajo et al., 2020). Practical barriers make loyalty voting rights de facto unavailable for long-term institutional investors (Roe and Venezze, 2021). The fact that loyalty voting rights are mainly used by controlling shareholders is not necessarily a problem if these controlling shareholders are also more focused on the long term (as suggested above). Nevertheless, it does create a risk that loyalty voting rights are abused to favor controlling shareholders, especially given the fact that the incentive to extract private benefits increases as the wedge between voting rights and cash flow rights increases. The empirical impact of loyalty voting rights on long-term investment has not yet been researched, although an Italian study has found a decrease in earnings management, a type of accounting manipulation (Mio et al., 2020).

Conclusion about the gap in the literature. In conclusion, the literature has clearly established a difference in corporate governance between continental Europe, on the one hand, and the US and the UK, on the other hand, including on topics like shareholder structures, executive compensation, shareholder activism and loyalty voting rights. However, no studies have explored the implications of these differences for the short-termism debate in continental Europe. The EY Report could have been filled this gap, but it fell short. In addition to the flaws in its empirical methodology (see above) and the one-sided approach in its literature review (Roe, Spamann, Fried and Wang, 2021; Edmans, 2020), it also failed to discuss how short-termism originates and is transmitted to managers in jurisdictions dominated by controlling shareholders and with low levels of shareholder activism and equity-based executive compensation. Because of these deficiencies in the EY Report and the importance of the topic, a group of research members of the European Corporate Governance Institute has issued a "call for reflection" to the European Commission (Edmans et al., 2021). So far, this has not yet led to the necessary research on short-termism in continental Europe. For example, Roe has recently (2022) published a book on short-termism, but it focuses on the US. In addition, Willey (2019) notes in her book that short-termism *"may be more or less pronounced depending on […] the presence of a dominant shareholder"*, but then largely ignores the impact of a controlling shareholders. The conclusion is that there is still a gap in the literature with regards to how corporate governance in continental Europe encourages or discourages short-termism.

Scientific research objectives

Research objective. The objective of this research project is to analyze the implications for the short-termism debate of the differences between corporate governance in continental Europe, on the one hand, and the US and the UK, on the other hand. The study of continental European corporate governance could lead to a more contextualized understanding of the short-termism problem in general, also in other jurisdictions with a similar corporate governance structure to continental Europe. This research project could therefore also inspire new research avenues that depart from the typical Anglo-Saxon focus in corporate governance research.

The results of the research project will also inform legislators, both at the national and EU level, in shaping policy proposals to combat short-termism in corporate governance. Such governance reforms are currently already being adopted or considered, as illustrated, for example, by the adoption of loyalty voting rights in many EU member states and by the discussion of the short-termism problem in the Sustainable Finance Action Plan of the European Commission (2018). So far, the European Commission has not taken any legislative actions specifically relating to corporate governance and short-termism, perhaps due to the deficiencies of the research conducted in the EY report. Instead, it has decided to focus focused on proposals for corporate sustainability disclosures and corporate sustainability due diligence. This lack of implementation of the Action Plan makes the current research project all the more relevant, to determine whether additional European corporate governance reforms are needed to combat short-termism.

Finally, this research project will also help corporations design an optimal corporate governance regime to reduce excessive short-termism, as corporations already enjoy many possibilities to reorient their governance towards long-term value creation.

Central research question. This research objective is translated into the following central research question: *"to what extent can corporate governance in continental European jurisdictions (such as France and Belgium) discourage short-termism?"* The research project studies both corporate governance as it currently exists, as well as potential corporate governance reforms. France and Belgium are used as case studies of corporate governance in continental Europe. This choice of jurisdictions is motivated in the methodology section. The focus of the research project is on listed corporations, as short-termism is thought to originate from the pressures of public capital markets.

Sub questions. The central research question consists of several sub questions.

1. What does the existing literature identify as the origins and transmission channels of short-termism in corporate governance? (explanatory) **(Work Package 1)**
2. How does corporate governance in Belgium and France differ from corporate governance in the US and the UK, specifically regarding shareholder structure, executive compensation, shareholder activism and loyalty voting rights? (comparative) **(Work Package 2)**
3. To what extent is the presence of controlling shareholders, loyalty voting rights and long-term oriented executive compensation associated with more long-term investments in Belgium and France? (empirical) **(Work Package 3)**
4. If a short-termism problem is present in Belgium and France, what corporate governance reforms are possible to combat this problem? (normative) **(Work Package 4)**

Research hypothesis. The research hypothesis that will be tested is that the absence of shareholder activism and of short-term equity-based executive compensation, and the presence of controlling shareholders and loyalty voting rights reduce short-termism.

Research methodology and work plan

General methodology. The methodology used in the research project to test the research hypothesis will be interdisciplinary in nature, relying on the method of law and economics. WP 1 (literature review) and WP 3 (empirical research) will be more economic in nature, while WP 2 (legal description and comparison) and WP 4 (analysis of potential legislative reforms) will be more legal. The research project is supervised by a team of researchers that is well-versed in these methodologies, as described in this application in the section on "the positioning and embedding of the project in the research group". The goal is to hire a PhD student who is trained in both law and economics for this research project, although the PhD student will be able to remedy any potential gaps in their knowledge and skills during the PhD education.

Work package 1 (explanatory). In WP 1, a literature review is conducted on the origins and transmission channels of short-termism in corporate governance. This literature can be mainly found in the fields of financial economics and law and economics. The focus of the literature review will be to determine what we (do not) know about short-termism in European corporate governance, which is a novel approach to systemizing the literature. The literature review will also be helpful in identifying those elements of corporate governance that are thought to impact short-termist behavior by corporations. These elements of corporate governance can then be further studied from a legal perspective in WP 2. WP 1 also prepares the groundwork for WP 3, by analyzing existing studies (mainly in the US and the UK) on the impact of corporate governance on long-term investments, which can then be translated to France and Belgium in WP 3.

Work package 2 (comparative). WP 2 will then analyze and compare those elements of corporate governance in continental Europe which the literature review found to be relevant for the transmission of short-termism to corporations. On the basis of the analysis of the literature so far (see above), the following elements of corporate governance will be analyzed: the shareholder structure of corporations, executive compensation, shareholder activism and loyalty voting rights. If other elements of corporate governance are identified by the literature review in WP 1 as relevant to the transmission of short-termism, they may be added to this list. For each of these elements of corporate governance, both the law in the books (using the doctrinal legal method) and the law in practice (using existing empirical evidence) will be considered. The law and practice in Belgium and France will then be compared to the law and practice in the US and the UK.

Motivation of the choice of jurisdictions. As most academic evidence on short-termism focuses on the US and the UK, a comparison with those jurisdictions can teach us to what extent short-termism may be present in continental Europe and under what conditions. Belgium and France were selected as case studies for continental Europe for several reasons. Firstly, Belgium and France have relatively similar corporate governance systems, which keeps the comparative research tractable and the empirical analysis of the different jurisdictions reliable. Other continental European jurisdictions, such as the Netherlands and Germany, differ more from Belgium and France because they give other stakeholders than shareholders a greater role in corporate governance. While the debate on the involvement of stakeholders in corporate governance has clear links with the short-termism debate, these debates can and should be analyzed separately (Roe, Spamann, Fried and Wang, 2021; Edmans, 2020). Analyzing both debates in a single research project would also be infeasible. Therefore, a comparison with corporate governance in stakeholder-oriented jurisdictions such as Germany and the Netherlands is left for a future research project. The downside of this methodological choice is that the results cannot be generalized to the whole of continental Europe, but to some extent this is inevitable, considering the differences that still exist within European corporate governance. Secondly, France and Belgium are also easily accessible to the supervisors of the research project, due to language reasons and familiarity with these legal systems in previous research, which makes them preferable over other jurisdictions in continental Europe, such as Italy or Spain. Thirdly, analyzing two continental European jurisdictions ensures that sufficient data is available for the empirical research. The fact that these jurisdictions have similar corporate governance systems also ensures that the empirical results are comparable.

Work package 3 (empirical). WP 3 then takes an empirical approach to whether short-termism could be present in a sample of listed corporations in France and Belgium. It does so by analyzing the association between long-term investments and several elements of corporate governance, including the presence of controlling shareholders, loyalty voting rights and long-term oriented executive compensation. Shareholder activism cannot be included in the empirical analysis, as it is so rare in Europe. R&D investment is used as a proxy for long-term investments, either scaled by total assets (as in Cremers, Pareek and Sautner, 2020) or by net income (with R&D expenses added back to net income, as in Fried and Wang, 2019 and 2021). Data on these variables can be collected from public sources, such as annual reports and articles of association, and from private databases, such as Compustat or Orbis Global. Several control variables will also be added to the econometric model, for example market capitalization, leverage, industry, institutional ownership, … (see for example the controls in Bushee, 1998; Cremers, Pareek and Sautner, 2020). While adding control variables reduces the risk of omitted variable bias, it cannot be fully eliminated with this research design. Therefore, the empirical research will not allow causal inferences, but will simply establish correlations. Nevertheless, such evidence can be a useful starting point for future research with more sophisticated strategies for identifying a causal link, and it can provide some context to the arguments whether corporate governance in continental Europe is likely to cause short-termism.

Work package 4 (normative). Finally, WP 4 brings together the findings of the literature review (WP 1), the legal comparison (WP 2) and the empirical research (WP 3). After the literature review has identified the possible origins and transmission channels of short-termism, and the legal comparison and empirical research have assessed to what extend the findings of the literature review are relevant for the Belgian and French context, WP 4 then analyzes the possible normative implications of these findings. WP 4 will evaluate the desirability of certain governance reforms in the continental European context, such as strengthening the power of certain long-term shareholders, insulating the board from short-termist shareholders, or recommending or even mandating certain long-term focused executive compensation structures (see Willey (2019) for an overview of potential governance reforms to combat short-termism).

Such governance reforms can be implemented through changes to legislation or to the corporate governance codes.

Normative framework. The normative framework that will be used in the normative analysis of this research project consists of the tradeoff between "agency costs" and "principal costs". Agency costs arise in corporate governance due to the separation of ownership and control: an agent (the management or a controlling shareholder) can take decisions that influence the welfare of the principals (the shareholders), who have less information about the agent's performance (information asymmetry) (Armour et al., 2017). In such a case, the agent has an incentive to act opportunistically and pursue their own interests, which leads to agency costs. However, shifting power back to the principals to reduce agency costs also creates certain costs, because shareholders are generally less informed and competent than the agent (the management) and because shareholders may have conflicting interests among each other. Goshen and Squire (2017) have referred to these costs as "principal costs". The problem that certain investors have a shorter time horizon than other investors can be considered one example of a principal cost. In the normative analysis of this research project, the trade-off between agency costs and principal costs will be analyzed for the current governance regime in Belgium and France, and for the potential governance reforms. This analysis will be informed by empirical research where possible, although an exact quantification of all costs remains impossible. This implies that reasonable minds can differ about the final conclusion of the trade-off, although the systematical analysis of the trade-offs in corporate governance reforms will present a useful contribution to the literature.

Risks and contingency plans. The research project comes with certain risks, especially relating to the interdisciplinary nature of the project. A first risk is that no PhD student can be recruited who possesses sufficient knowledge about law and economics or the willingness to acquire such a knowledge during the PhD. This risk will be reduced by circulating a potential call for applications among the e-mail list of the European Association of Law and Economics and among universities that offer a master's degree in law and economics (for example the master's degree in law, economics and business studies offered by the KU Leuven or the European Master in Law and Economics offered by a cooperation of several universities). A second risk is that the empirical part of the research project will take more time to complete than estimated, for example because some data is unavailable from financial databases. To address this risk, an extra buffer of three months is allotted for the empirical project, if some of the data needs to be hand-collected.

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Work package	Intermediate results	Timetable
WP 0 ***Preliminary research***	☒ Project outline ☒ Series of workshops organized by Jean-Pierre Blumberg Chair on "short-termism in Belgian corporate governance"	**Already completed**
WP 1 ***Literature review***	☒ Map and summarize the main papers on short-termism ☐ Draft literature review on short-termism in corporate governance, with a focus on continental Europe ☐ Publish literature review in a (law and) economics journal ☐ Organize a kick-off conference to solicit feedback from stakeholders and other academics on the research project	**9 months remaining**
WP 2 ***Legal description and comparison***	☐ Research differences in corporate governance between the UK, the US, France and Belgium with regard to short-termism ☐ Research stay (6 months) in the US, for example with Mark Roe at Harvard (contact already established) ☐ Research stay (3 months) in the UK, for example with John Armour at Oxford (contact already established) ☐ Publish paper on "loyalty voting rights in Belgium: law and practice" for a Belgian law review (e.g., TRV/RPS or TBH/RDC) ☐ Publish paper on "the differences in executive compensation between the US, the UK and continental Europe" for a European law review (e.g., European Company and Financial Law Review) ☐ Present results in national and international conferences	**15 months remaining**
WP 3 ***Empirical research***	☐ Follow courses in (advanced) econometrics and corporate finance to further develop empirical skills, if necessary ☐ Construct database of corporate governance in France and Belgium and analyze impact on long-term investments ☐ Publish empirical results in a law and economics journal (e.g., Journal of Law & Economics, Review of Law and Economics, …) ☐ Present results at a law & economics conference, such as the European Association of Law and Economics (EALE) Conference	**12 months remaining (+ 3 in reserve)**
WP 4 ***Normative analysis of possible reforms***	☐ Analyze proposals to amend legislation and corporate governance codes to combat short-termism ☐ Organize conference to present the results of the research projects and solicit feedback from stakeholders and academics ☐ Publish research results in a monograph ☐ Publish summary of results in Belgian and European law review ☐ Disseminate research results to legislators through policy memos ☐ Disseminate research results to the general public through op-eds in (financial) newspapers	**9 months remaining**

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