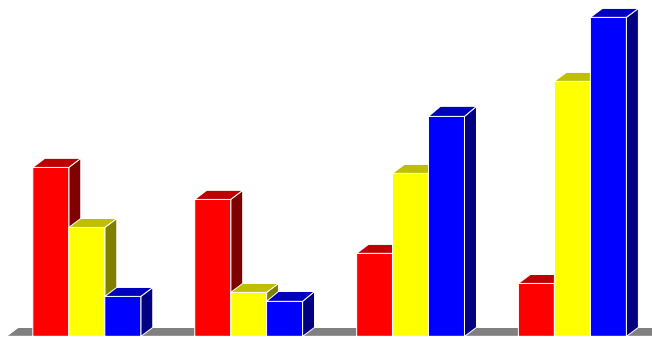


# International Corporate Governance

Professor B. Espen Eckbo

2010

Stock market evolution, 1913-2000  
(number of listed firms per million capita)



Red: 1913 Yellow: 1980 Blue: 2000

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## Agency and control: Adam Smith (1776)

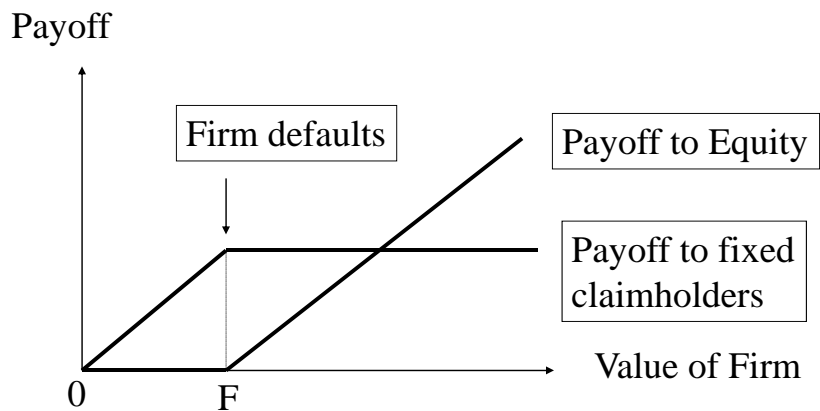
“..being managers rather of other people’s money than of their own, it cannot be well expected, that they should watch over [the firm] with the same anxious vigilance [as owners]...”

- Problem of conflicts of interest and wealth expropriation
- How does the modern corporation deal with this problem?

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## Why shareholder = “owner”?



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## The minority report

- Outside minority shareholders emerged as a consequence of the invention of limited liability
  - Allows equity-holders to diversify risk
  - Dramatically reduces cost of capital
  - Results in ownership dispersion
- Problem: ownership dispersion transfers power to management

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## Management as de facto owner

- Dispersed shareholders rationally do not exercise control rights
- Unexercised control rights are appropriated by management
- Ineffective boards
- Agents protecting agents
- Politicians protecting agents

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## Why focus on outside investor protection?

- Outside investors, in particular minority shareholders, represent a “remote” corporate constituency
- They are “useful” to management only the few times it decides to raise external capital
- Other constituencies (employees, suppliers, creditors) are continually useful and protected by strong contractual rights
- Controlling shareholder’s interest may conflict with minority’s

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## Protection against what?

- Asset transfers and stripping
- Dilution via new equity issues
- Diversion of corporate opportunities
- Hiring under-qualified family members
- Overpaying executives
- Perquisites consumption
- Bribes
- etc...

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## Direct evidence on expropriation

- US savings and loans crisis
- Currency crises in Asia and Mexico
- Case studies of asset tunneling in Western Europe
- State privatizations in Russia
- Japanese banking crisis
- Target defenses in hostile takeovers
- Some cases of executive compensation

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## The 97-98 Asian crisis

- Governance problems most evident in times of crisis
- Research: Exchange rate and stock market declines greatest in countries with weakest investor protection
- Research: Weak investor protection a stronger explanatory factor for market declines than all the usual macroeconomic arguments

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## The Asian crisis

- Thailand: Money moved offshore
- China: Hong Kong liquidators unable to recover assets of bankrupt Chinese firms
- Indonesia: Hard to force liquidation
- Korea: Transfer of funds out of large firms
- Russia: Creditors and minority shareholders get virtually nothing

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## The Asian crisis

- China:
  - Frequent transfers from listed firms to controlling shareholders
  - No efficient internal audit
  - Lack of accounting standards:
    - The China National Audit Office stated 12/98 that “cooked books”, fraud and irregularities in financial management are widespread

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## Japan's ongoing debt crisis

- A firm's outstanding, distressed debt blocks new capital infusion
- Lack of new capital blocks new productive investments by the firm
- Lack of corporate investments leads to economic contraction
- Only solution: Restructure firms with non-performing loans (NPLs)

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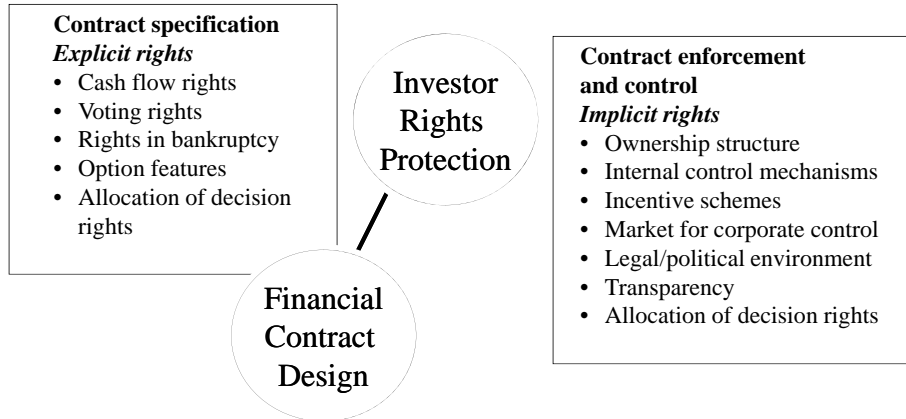
## Long Term Capital Bank of Japan

- 2000: Ripplewood (Chris Flowers ) bought Long Term Capital Bank (now Shinsei Bank)
- Government sold Ripplewood a put on bank's NPLs as part of the deal
- 2001: Government appears to renege on part of its obligation to absorb NPL's

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## Security design and investor rights protection



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## Legal families

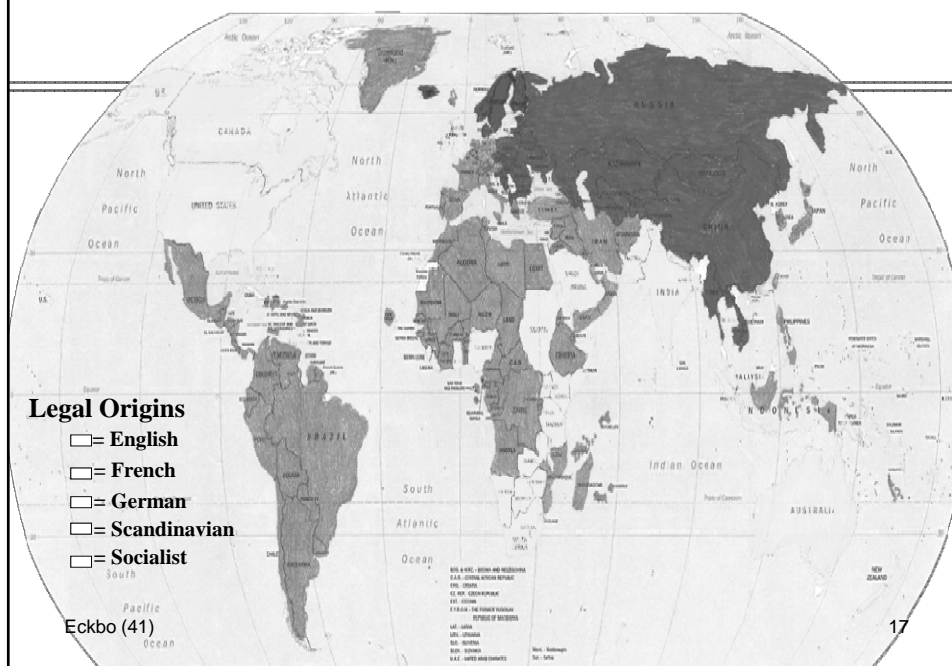
- Common law (British, case-based)
- French civil law (Roman/Napoleonic)
- German civil law (derivative of French)
- Scandinavian law (derivative of French)
- Socialist law (weak individual property rights)

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## Legal Origin Distribution



## Financial market systems across legal families

### Contractarian system

#### Market based

- Common law
- Outsider-controlled
- Dispersed ownership
- Banks play minor role
- Hostile takeovers
- US, UK, Canada

### Communitarian system

#### Bank based

- Civil law
- Insider-controlled
- Corporate cross-holdings
- Concentrated ownership
- Banks play major role
- Japan, Germany

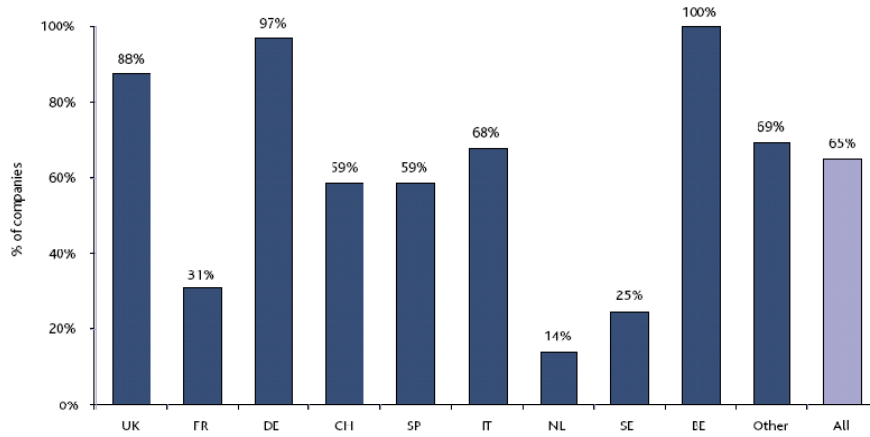
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## Voting impediments in Europe

1/3 of companies have one-share-one-vote deviations

Graph 1: Companies applying the 'one share - one vote' principle

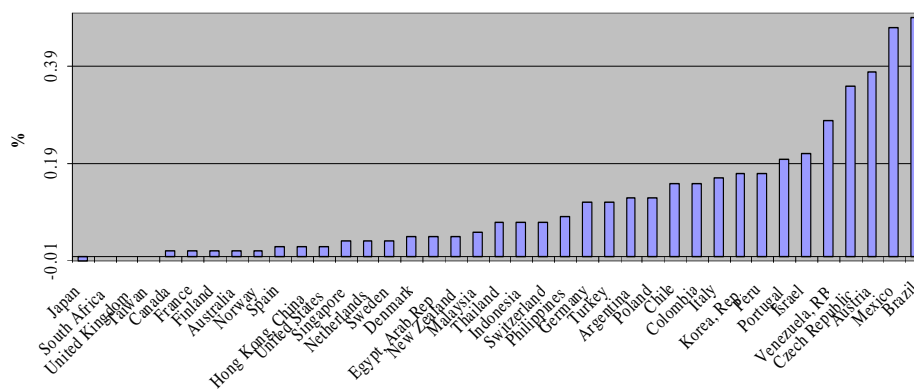


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Source: Deminor 2005

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## Control is valuable: Block Premium in Control Block Transactions

Block Premium (%)

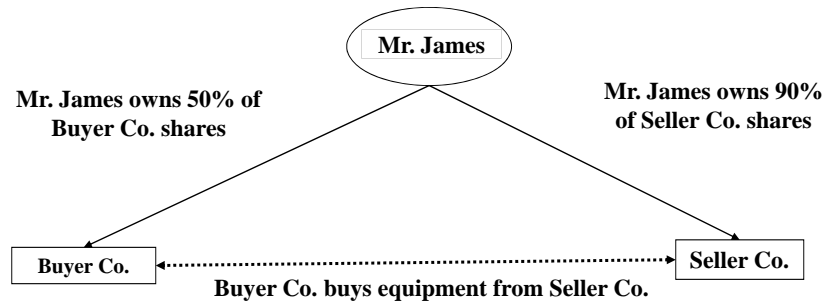


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## Potential for self-dealing in LEGAL (garden variety) transactions between firms

- Buyer and Seller both controlled by same shareholder (Mr. James)



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## How to regulate garden-variety self-dealing?

1. *Replicate conditions in an arm's-length transaction*
  - Laws requiring prior approval before—and immediate disclosure after—the decision to enter the transactions has been made
2. *Empower shareholders to seek remedy ex post*
  - Laws that lowers shareholders' litigation costs even if disclosure and approval requirements are met
  - Factors that affect the odds that the plaintiff prevails in court include liability standards and the right to compel evidence.
3. *Fines and criminal sanctions to expropriators*
  - Strength of *public enforcement* with fines and sanctions applicable to Mr. James and those in charge of approving the transaction.

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## Key to minority shareholder protection

- Disclosure
  - “Sunshine is the best disinfectant”
- Prior approval by disinterested parties
- Low cost of suing for restitution
  - class action
  - derivative suits

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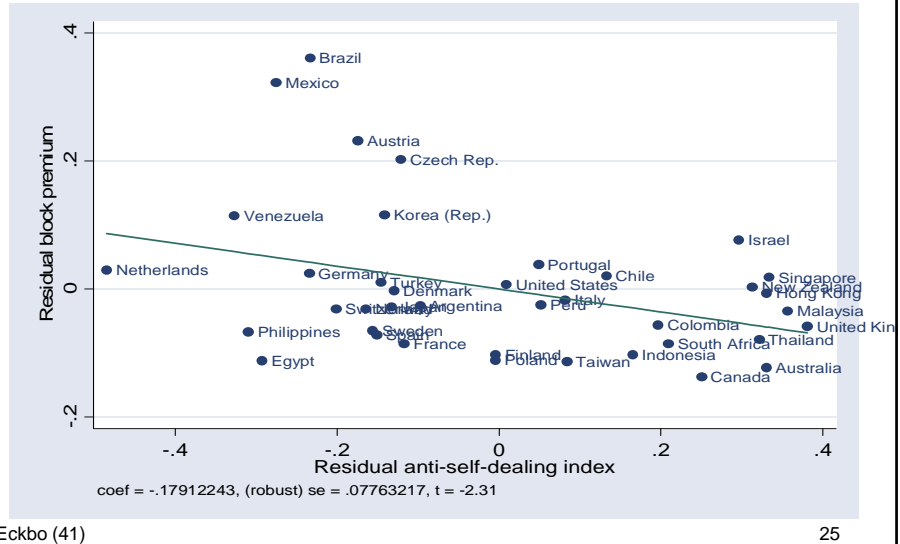
## La Porta et al. (2006)

- Suppose a controlling shareholder wants to enrich himself but also follow the law
  - All legal approvals and required disclosures are met
- How difficult is it for minority shareholders to thwart the deal before it goes through and to recover damages if it is carried out?
- Creates an anti-self-dealing index for each of 108 countries representing 99.3% of total world market capitalization

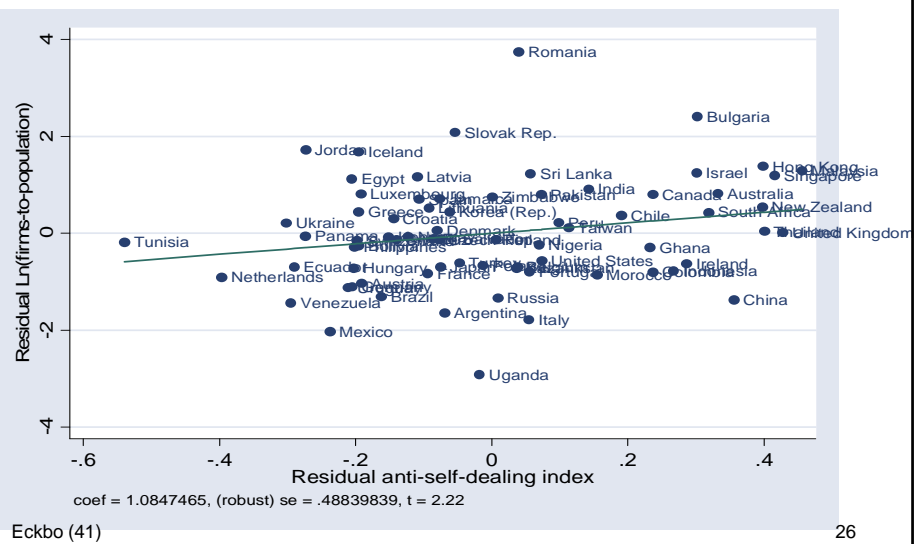
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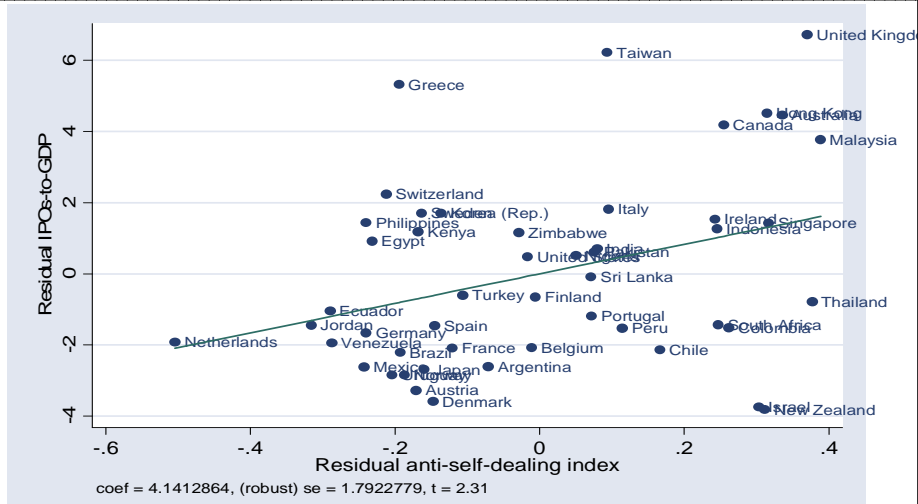
# Anti-Self-Dealing Index and Block Premium



# Anti-Self-Dealing Index and Ln Firms / Pop



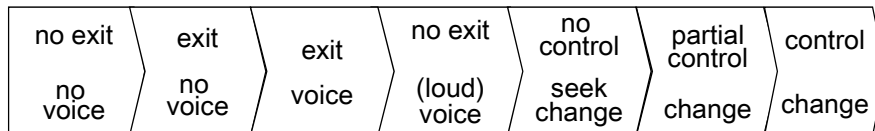
## Anti-Self-Dealing Index and IPOs/GDP



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## Shareholder Activism – A Continuum



passive index tracker	passive stock picker	active stock picker	active index tracker	focus fund hedge fund	raider hedge fund	raider (buyout fund)
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## Role of market expectations

- Today's stock price reflects the market's valuation of a firm's current and expected future governance characteristics
- Since inexpensive governance changes are anticipated, they produce no excess return (no free lunch)
- Costly governance changes (unanticipated) may produce risk-adjusted excess stock returns

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## Returns to shareholder activism

- Plenty of evidence that costly governance changes produce large excess returns
  - Hostile takeovers; LBOs; debt restructurings; etc.
- Much less evidence that "voice" strategies produce excess stock returns
  - Governance principles; shareholder resolutions; etc.

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## Return to passive stock picker ("no exit, no voice")

- Gompers, Ishi, Metric (2003): Data on corporate governance provisions for 1,350 NYSE/Amex firms
- Governance Index (GI) = sum of the number of governance provisions for a given firm
- Short a portfolio of firms with weakest shareholder rights (lowest GI decile), and going long in firms with strongest shareholder rights (highest GI decile)

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## Portfolio returns, 1990-2000

- Use a four-factor model to adjust for portfolio systematic risk:  
$$E(R) = \alpha + aRM + bSMB + cHML + dMOM$$
- The long-short strategy produces an "alpha" of 71 bp per month, i.e., an abnormal stock return of 9% per year
- What are alternative interpretations?

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## Active index trackers (“no exit (loud) voice”)

- Total global pension fund assets estimated to 15 trillion USD
  - Hold 40% of US equities
  - Hold 30-50% of the European equities
- Growth of global pension fund assets in 2005 was around 17 % in 2005
  - Have doubled in size during the past ten years
- Global ownership is major and growing
  - 30% in the US held by foreign investors
  - 30-40% in Europe held by foreign investors

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## More recent activism in the US and Europe

- Focus Funds
- Hedge Funds
- Opportunity Funds
- ...

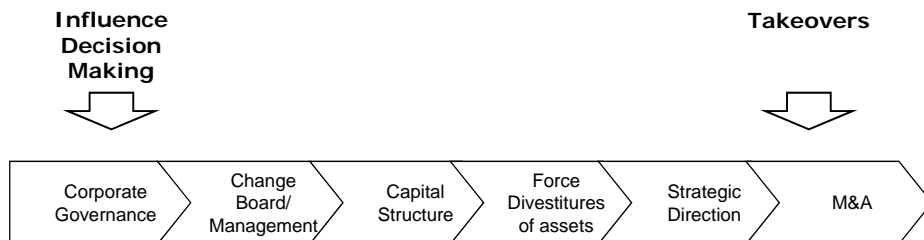
Engaging in

- “active ownership”
- “activist arbitrage”
- “raiding”

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## Spectrum of Hedge Fund Activism



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## Recent studies of Hedge fund activism

- Brav, Alon, Wei Jiang, Frank Partnoy, and Randall Thomas (2006), "Hedge Fund Activism, Corporate Governance, and Firm Performance"  
[http://www.fdic.gov/bank/analytical/cfr/2006/oct/hedge\\_fund.pdf](http://www.fdic.gov/bank/analytical/cfr/2006/oct/hedge_fund.pdf)
- Klein, April and Zur, Emanuel (2006), "Hedge Fund Activism" <http://ssrn.com/abstract=913362>
- Bratton, William (2006), "Hedge Funds and Governance Targets"  
<http://ssrn.com/abstract=928689>
- Becht, Marco, Julian Franks and Jeremy Grant (2007), "Active Ownership in Europe". [work in progress].

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## Becht, Franks, Mayer, Rossi (2006)

### Clinical Study of the Hermes U.K. Focus Fund

- Majority owned by BT Pension Scheme
- Trustees have fiduciary duty to beneficiaries, not BT management
- Trustees set up the Focus Fund to reduce free riding problem leading to passivity
- High-powered incentives for managing partners linked to fund returns
- Focus fund acts independently of fund promoter

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## HUKFF Investment Strategy

Focus fund applies triple investment criterion

1. Is the company under-performing?
2. Can the fund engage the company successfully?
3. Does the fund expect it can get at least 20% more value over current share-price?

If triple “yes”

- Invest
- Engage (bring about governance/real change)
- Divest

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## Engagement Objectives

- Board Changes
  - CEO
  - Chairman
  - introduction of > independence
- Financial Policies
  - payout policy
  - rights issues
- Restructuring
  - refocusing / asset sales
  - narrowing discount on investment funds

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## HUKFF Excess Returns against Benchmark

	Raw Return (net of fees)	FTSE All (raw return)	Relative to Benchmark
			Arithmetic mean
Since Inception Oct 98 – Dec 2004	63.7%	22.4%	41.3%
Annual	8.2%	3.3%	4.9%

Source : Hermes Focus Asset Management

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## Weak boards

- Director voting rules favor incumbents
- Lack of director independence
  - CEO chairmanship
  - Mandatory employee representation
  - Legal/accounting consultants
- Lack of financial literacy
- Lack of accounting transparency
- Largely misunderstood emphasis on constituencies other than shareholders