

# Swiss Finance Institute Roundups

## Corporate Governance at the Crossroads

### Editorial



Fifty years ago, Nobel Laureate Milton Friedman stated that the *social responsibility of the corporation is to maximize profits*. Until recently this doctrine reigned supreme in the corporate and investment worlds, and the principle that companies should maximize shareholder value was widely accepted. Today this consensus has broken. In academia, in the corporate world, and in societies, the primacy of shareholder value is being questioned as ESG concerns increasingly take pride of place. In this SFI Roundup experts from academia and industry discuss "Corporate Governance at the Crossroads." If companies should not seek to maximize shareholder value, what objectives should they pursue in its place? How should companies navigate the tradeoffs between competing objectives? And what would a move away from an exclusive focus on shareholder value imply for company reporting, the role of boards, and the way companies interact with society?

We wish you an enjoyable read.

A handwritten signature in blue ink, appearing to read 'F. Degeorge', with a horizontal line underneath.

**Prof. François Degeorge**  
Managing Director

# Contributors

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François Degeorge is the SFI Managing Director, an SFI Senior Chair, and Professor of Finance at the Università della Svizzera italiana (USI). He is a former dean of the Faculty of Economics at USI and a former president of the European Finance Association. He has taught at HEC Paris, where he also served as Associate Dean for Research. He has been a visiting professor at the Tuck School of Business, at Université Paris-Dauphine, and at the Saïd Business School. He holds a PhD in Political Economy and Government from Harvard University.

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Fiona Frick is Chief Executive Officer of Unigestion and has more than 30 years' experience in the asset management industry. During more than a decade in this role she has developed a high profile in the international asset management industry and in academic circles as a respected speaker on economics, financial markets, and the rise of sustainable finance. She serves on the boards of Swiss Sustainable Finance and Sustainable Finance Geneva, and is also a member of the EMEA committee of the Standards Board for Alternative Investments. She holds an MBA from the ISG International Business School in Paris.

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Romeo Lacher is Chair of the Board of Directors of Julius Baer Group and Bank Julius Baer. In addition, he is also Vice-Chair of the Bank Council at the Swiss National Bank, Vice-Chair of the Foundation Board of the Swiss Finance Institute, and a member of the Foundation Board of Avenir Suisse. In the recent past, he served, among others, as Chair of the Board of Directors at SIX Group and Chief Operating Officer, International Wealth Management, at Credit Suisse Group. He holds a PhD in Economics from the University of St. Gallen.

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# A Bird's-Eye View of Corporate Governance

## Who defines good corporate governance?

► **R. Lacher:** The corporate governance framework has historically been defined by the law and by the firm's shareholders. Interestingly, over recent decades political parties, large institutional investors, proxy advisors, NGOs, and stock exchanges have all increasingly been having their say.

► **A. F. Wagner:** There can be no standardized "best practices" when it comes to corporate governance: good corporate governance addresses the specific needs of a specific firm at a specific time.

► **F. Frick:** Defining good corporate governance is ultimately up to the stakeholders—in particular, to a firm's clients and its employees. From a causal perspective, good corporate governance leads to an increase in stakeholder value, which in turn leads to an increase in shareholder value.

## What are the benefits of good corporate governance?

► **M. Mächler:** Good corporate governance provides a set of checks and balances which drive an institution forward toward fulfilling its purpose. But there is clearly asymmetry at play here. Poor corporate governance has hefty and tangible negative consequences, while the benefits of good corporate governance are difficult to assess. In a nutshell, good corporate governance is the "*fil rouge*" which defines the way things are conducted within a firm. Its benefits are indirectly shown by the success of the firm's various processes, e.g., in business, strategy, and risk management.

► **A. F. Wagner:** Its capacity to make better decisions and to avoid fraud ensures the well-governed firm's long-term success. Moreover, it will attract capital, in the form of both talented workers and investors, at relatively low cost.

## How would you then define corporate governance?

► **F. Degeorge:** Twenty-five years ago, academics defined corporate governance as "the ways in which suppliers of capital assure themselves of getting a return on their investment."<sup>1)</sup> The focus was on the control of managers by shareholders. Since then the academic focus has shifted toward defining the appropriate balance of power between shareholders and various stakeholders.

► **R. Lacher:** Corporate governance is built on multiple factors. First, the law, in particular corporate law, provides the general framework for the structure and supervision of a firm. Second, there are informal and unwritten elements related to cultural norms and codes. The final nuances are specific for each firm and depend on its industry, size, and listed or unlisted status.

## How did we arrive at today's model of a corporation?

► **J.-C. Rochet:** The corporation—formally, a body of people—has existed for thousands of years. Initially created through a charter issued by a local authority, this legal body aimed to allow multiple individuals to work together pursuing a given goal, and to provide a structure for their work which could technically live forever. In the middle of the 19th century, British law was amended to allow "any" person to incorporate. And in the early 20th century a split occurred between the traditional "partnership" model, in which corporations were, at least very largely, owned by the stakeholders (or the state), and the publicly listed companies we know today, in which the shareholders are typically plentiful, external, and anonymous.

► **M. Mächler:** This historical split of what a corporation is and what its concerns are is still very visible today. For example, in the context of ESG, firms in common law countries, such as the United Kingdom and the United States, are far more attentive to diversity than are firms in civil law countries, such as Germany and Switzerland, for whom environmental considerations are given more attention.

## When was the idea of corporate governance born?

► **J.-C. Rochet:** Back in 1602, the Dutch East India Company (VOC) became the first publicly listed company, with an initial group of several hundred shareholders and the possibility for capital providers to trade the VOC's shares and bonds on an open secondary market—changing capitalism forever. A few years later, in 1609, one shareholder filed a petition against the VOC, making this the first recorded corporate governance dispute and the beginning of shareholder activism.

1) Shleifer, A., & Vishny, R. W. (1997). A survey of corporate governance. *The Journal of Finance*, 52(2), 737-783. <https://doi.org/10.1111/j.1540-6261.1997.tb04820.x>

# ESG Metrics and Reporting— Pros, Cons, and Caveats

## Governance is typically measured alongside environmental and social criteria. Why is that?

▶ **A. F. Wagner:** A look into the past may help. In the 19th and early 20th centuries, investment decisions were predominantly based on soft qualitative factors. Then in 1934 Graham and Dodd, two American economists, laid the foundation for investing based on hard quantitative factors, such as earnings and cash flows. A revolution in investing followed. But eventually investors and researchers realized that other softer factors could be essential for a company's success or failure. The key soft factors were environmental, social, and governance criteria, and thus they ended up being considered together.

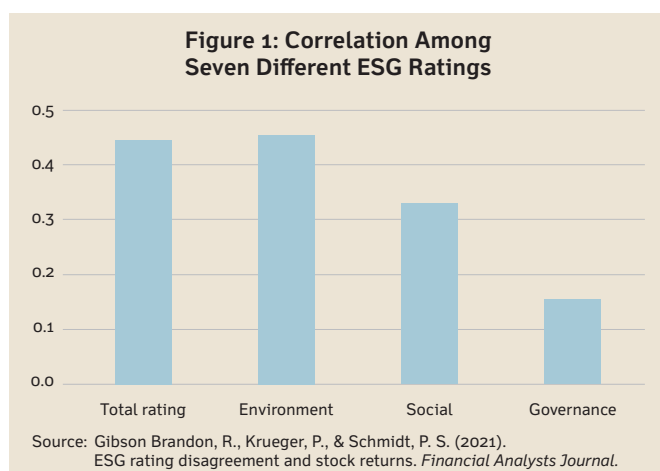
▶ **F. Frick:** The common denominator of these three criteria is how taking appropriate actions today can minimize the damage done to the world of tomorrow. Well-thought-out ESG criteria are the key to developing long-term intergenerational investment strategies.

## How many different dimensions of corporate governance are there?

▶ **F. Frick:** The number of dimensions required for good corporate governance is large; further, it varies in proportion to the distance between managers and shareholders, and with the size of the firm. But the basics of any respectable corporate governance environment are risk management, transparency, and appropriate incentive measures.

▶ **M. Mächler:** There are innumerable dimensions to consider. The answer here equals the number of different standards which currently exist to assess corporate governance, multiplied by the number of methods that firms themselves have developed. We must also remember that the dimensions of corporate governance evolve with time, as firms, markets, and society also evolve. That said, the key element is to have a coherent concept which lets all the firm's stakeholders understand where they stand and where they are heading.

▶ **J.-C. Rochet:** Research by some of my colleagues indeed confirms that corporate governance is not only multidimensional, but also that its metrics are highly heterogeneous.<sup>2)</sup> For example, some data providers rate firms on a best-in-class approach, while others use an absolute rating system, and still others are disclosure oriented.



## Why are the disagreements among governance metrics so large?

▶ **F. Frick:** We need to distinguish ratings from data. Ratings reflect opinions; disagreements in ratings are valuable, as they help to trigger constructive discussions among different stakeholders. Collecting data on ESG dimensions is relatively recent and will likely improve with time.

▶ **J.-C. Rochet:** Empirical work on this question has shown that the correlation for overall ESG ratings, among several large data providers, is relatively low—about 0.45. Detailed calculations reveal that the correlation for "E" is the highest and the one for "G" is the lowest, showing that the level of disagreement when assessing governance is unusually high. This result is of particular interest, given the widely held belief that a strong and common understanding exists on how to measure and quantify corporate governance.

## Would better corporate disclosure help reduce ratings disagreements?

▶ **F. Degeorge:** You might think that more disclosure would reduce ESG ratings disagreements, but research shows otherwise.<sup>3)</sup> It turns out that more information leads to more disagreements—perhaps because ESG ratings are somewhat subjective, and more

2) Gibson Brandon, R., Krueger, P., & Schmidt, P. S. (2021). ESG rating disagreement and stock returns. *Financial Analysts Journal*. <https://doi.org/10.1080/0015198X.2021.1963186>

3) Christensen, D. M., Serafeim, G., & Sikochi, A. (2021) Why is corporate virtue in the eye of the beholder? The case of ESG ratings. *The Accounting Review*. <https://doi.org/10.2308/TAR-2019-0506>

4) Krueger, P., & Pasche, C. (2021). *Sustainable finance metrics*. Swiss Finance Institute Public Discussion Note. <https://www.sfi.ch/en/publications/pdn-sfm>



information leads to more diverse interpretations. In the recent *SFI Public Discussion Note* "Sustainable Finance Metrics," my colleagues analyze in detail the subtle topic of sustainable finance metrics.<sup>4)</sup>

### How is corporate governance currently reported? How might it evolve?

► **R. Lacher:** While corporate law lays the foundation for reporting on corporate governance, further reporting is usually the outcome of discussions with shareholders and stakeholders, in particular financial analysts. One caveat I would like to mention is that there exists a fine line in qualitative corporate reporting, as it is not always easy to distinguish what a firm has achieved, from where it currently stands, from what it intends to achieve.

► **F. Frick:** Reporting on corporate governance is by no means as mature as reporting on environmental criteria or on financial performance, but there are many metrics already in use, such as within-firm salary ratios, board diversity, or the cost of court cases. All of these have been proved to be effective governance metrics.

### Value reporting has been shown to improve firm performance. Why is that?

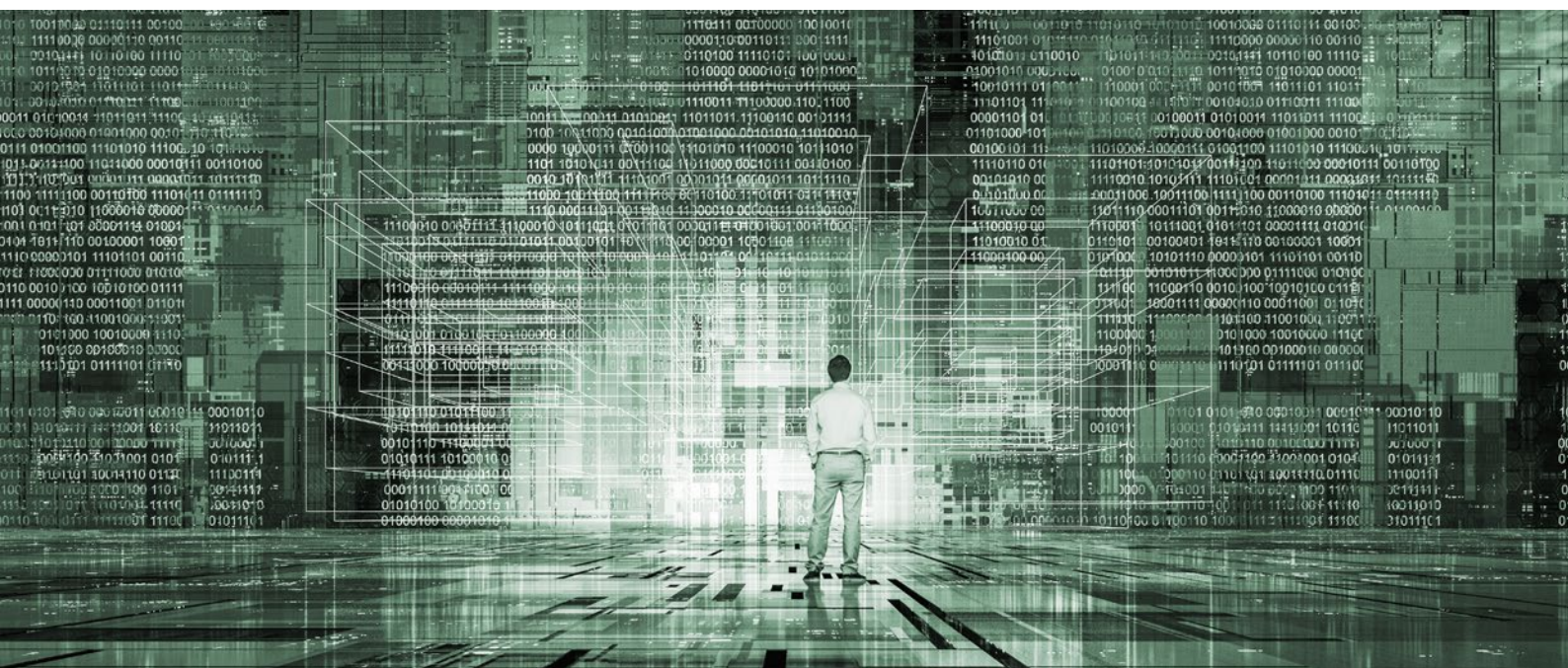
► **A. F. Wagner:** Some people believe that corporate reporting is simply a matter of disclosure—a dry, numbers-driven, compliance-oriented exercise. The key part of value reporting is explaining the story—the why—behind the numbers and connecting

the dots which lead to the bottom line. This story also includes the role of non-financial factors. Empirical research has shown that companies which undertake such an endeavor end up doing better.<sup>5)</sup> Intuitively, you can only explain something well once you have understood it. Thus, value reporting requires managers to have clarity on what their goals are and how efficient they are in reaching them. This clarity, in turn, helps them run their businesses better. Moreover, value reporting facilitates a virtuous circle of trust between the shareholders, the board, the management, and the employees. Higher trust leads to a decrease in the cost of capital and an increase in firm value.

► **M. Mächler:** I agree that value reporting has large benefits. What is less clear, though, is what parts of such reporting should be made public, as there are often multiple and loosely interlinked explanations for successes and failures, and it does not necessarily always make sense to try to summarize everything in a brief, concise, and structured public statement.

► **R. Lacher:** In my experience, the reporting exercise is an important and beneficial one for both the board and the management, as defining and updating the firm's set of values is the responsibility of the board and part of the corporate DNA.

5) Eugster, F., & Wagner, A. F. (2020). Value reporting and firm performance. *Journal of International Accounting, Auditing and Taxation*, 40. <https://doi.org/10.1016/j.intaccudtax.2020.100319>



Where I am somewhat hesitant is regarding the metrics behind such reporting. These metrics are typically subject to loopholes and window dressing—similar to what we observe regarding the so-called "green washing" of reports on environmental matters.

**Such "green washing" is familiar. Does "good-governance washing" also exist?**

▶ **F. Degeorge:** Certainly. Enron, which went bankrupt in 2001 after an infamous accounting scandal, ticked all the standard boxes of the so-called corporate governance best practices. Yet, it was a corporate governance disaster. In its annual report, Enron trumpeted its "values": "communication, respect, integrity, and excellence." Eat your heart out, George Orwell!

▶ **A. F. Wagner:** Firms naturally seek to depict themselves in the most favorable manner possible. My professional experience shows that when it comes to executive compensation, for example, reality is somewhat different from the structured methodology showcased to shareholders in compensation reports. Then again, over time truth will out.

▶ **F. Frick:** Widespread and generalized data on good-governance washing is limited. What is important here, from an investor's perspective, is for a firm to have time-consistent corporate governance indicators and to track their evolution over time—ensuring the firm goes beyond an expression of good intentions and ultimately reaches its long-term goals.





# Shareholders and Beyond

**Milton Friedman once said, "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud." How do you react to this statement?**

► **M. Mächler:** Our understanding of the world has changed considerably since this statement was made in the early 1960s. The interlinkages between businesses, economies, and societies have tightened considerably since then, just as our awareness of ESG criteria has increased. An interesting debate nowadays is on stakeholder capitalism and the embeddedness of firms within their environment.

► **J.-C. Rochet:** Such a view is appropriate only in a world where all externalities are internalized. And this world does not exist due to regulatory loopholes, imperfect property rights, and court-related inefficiencies. The combination of these factors leads us to live in a world where firms typically under-invest in the prevention of risks, which impacts workers and consumers alike. One way to solve this problem would be for firms to maximize stakeholder value rather than shareholder value.<sup>6)</sup> But such a bold move would require the extension of property rights to employees and consumers. Attempts to partially materialize such rights do exist in the form of memberships for clients and customers, as is the case of Costco Wholesale (which is also a publicly listed company), and also cooperatives, such as Migros or Coop. But because of the general absence of secondary markets for trading such rights, it is not currently possible to quantify the price evolution of these initiatives.

► **F. Degeorge:** Milton Friedman argued that managers should focus on making profits for shareholders and leave it to each shareholder to decide how to act ethically. This separation has the big advantage of giving managers a measurable goal. If a manager is expected to make profits and, in addition, pursue societal goals (e.g., preserve employment and fight climate change), how is she supposed to trade off one goal vs. another when these goals conflict, and how can we assess her performance? And what if different shareholders disagree on the relative importance of various societal goals? It is very hard to answer these questions—perhaps even harder today than in Friedman's time, in view of the increased political polarization in many countries. Therefore, Friedman's argument retains much force even today.

**How can we bridge the gap between what shareholders and stakeholders seek? Has this gap been widening?**

► **J.-C. Rochet:** The true goal of a firm is not solely to maximize the profits of its shareholders, but also to provide valuable goods and services to its customers, while creating a satisfying and productive work environment for its employees. Interestingly, the legal form of a company does not determine its ability to succeed: a stakeholder-oriented firm can operate just as well as a shareholder-oriented one. For example, Credit Agricole, considered one of the world's largest cooperatives, is also one of the world's ten largest banks in terms of total assets. I believe it is ultimately up to the customers and employees to reveal their preferences and to buy from and work for the firms they value.

► **F. Degeorge:** Societal aspirations evolve over time and, as a result, the priorities of stakeholders also change. Today there is a much greater interest in ESG than there was 20 years ago. This shift feeds the perception of a widening gap between shareholder and stakeholder goals, but we should not overstate the size of this gap. In the interest of their bottom-line, the best companies quickly adapt to the new priorities of their stakeholders. For example, profit-seeking food companies have been quick to respond to the growing consumer demand for plant-based foods. Employers known to offer a diverse and flexible work environment are better able to attract talent. Out of pure self-interest, asset managers care deeply about climate change: they do not want to own assets that are at risk of becoming worthless due to the transition to a decarbonized economy. In this sense competitive forces tend to align shareholder and stakeholder goals.

**How can stakeholders assess and influence the governance of firms?**

► **J.-C. Rochet:** History is plagued with cases where governments were unable, or unwilling, to take the necessary measures to maximize social welfare. Here, I believe NGO activism plays a crucial role. A theoretical model I recently developed shows that public regulation becomes vulnerable to industrial stakes when the cost of influence declines and economic activity grows.<sup>7)</sup> And that when NGOs are efficient and well informed, they can substitute for the government and help reach a social welfare optimum.

6) Magill, M., Quinzii, M., & Rochet, J.-C. (2015). A theory of the stakeholder corporation. *Econometrica*, 83(5), 1685-1725. <https://doi.org/10.3982/ECTA11455>  
7) Daubanes, J., & Rochet, J.-C. (2019). The rise of NGO activism. *American Economic Journal: Economic Policy*, 11(4), 183-212. <https://doi.org/10.1257/pol.20180027>

► **R. Lacher:** There are multiple routes for stakeholders to express their views, ranging from general assemblies to lobbies to political votes to NGO activism. The "*Abzocker-Initiative*" ("Anti-Rip-off Initiative" or "Executive Pays Initiative of 2013") is a clear example of how stakeholders, in this case the Swiss people, expressed their views on corporate compensation and transparency, as well as on vote transparency for pension funds. Other stakeholder routes which should not be forgotten are public opinion and the stock market sentiment, which can have a strong impact on all publicly listed companies.

► **M. Mächler:** At Zurich Insurance Group, interactions with stakeholders over the past 150 years have been key in shaping the company the way it is today. The circle has widened over time from internal stakeholders to a range of external stakeholders, such as regulators, capital markets, and the public at large. External stakeholders who play an increasing role in corporate governance in general include proxy advisors and academics, who have a global vision regarding the general direction the industry is taking.

► **F. Degeorge:** Today technology offers many more ways to access information and to express views than in the past. Tech-savvy stakeholders can easily obtain granular information about firms, to a degree of detail that was inconceivable 20 years ago. Thanks to social media, they can also express their views forcefully. Well-orchestrated campaigns can steer firms to change their ways.

### Finally, does current corporate law sufficiently recognize the stakeholder principle? What changes should be made? And by whom?

► **A. F. Wagner:** From an international perspective Switzerland stands out as an exception, as boards here are explicitly responsible for the overall welfare of their firm—including its stakeholders, such as employees, and not solely its shareholders. A very practical implication here is that the board can, at least temporarily, decide to be unpopular with respect to the wishes and desires of the shareholders, which allows it to steer away from excessive short-termism. While giving shareholders more power sounds like a good idea, from the perspective of standard corporate governance teachings, such power shifts can induce less regard for other stakeholders.

► **F. Degeorge:** By and large, corporate law gives primacy to shareholder value. In some countries there have been attempts to widen corporations' priorities. It will be interesting to see how such experiments work out. For example, France recently introduced the legal form of "*entreprise à mission*" ("purpose-based company"). So far, the results are not encouraging. The French food conglomerate Danone adopted this corporate form, but under pressure from some shareholders the board of directors recently fired the CEO. This example illustrates the challenge of widening the goals of corporations beyond shareholder value.

There is a deeper problem with some recent proposals for legal reforms. While ostensibly addressing the shortcomings of shareholder value, these reforms actually stem from other motives. In the United States, in particular, political polarization has led finance academics to push for corporate governance reforms to achieve societal goals that seem out of reach through the regular political process. In effect, this push to widen corporate goals beyond shareholder value is an attempt to bypass democracy. Fortunately, the Swiss political process does not face the same roadblocks, making many of the corporate governance proposals currently being discussed in the United States not pertinent for Switzerland.



# The Role of Corporate Boards

## In the old days, the standard was "management acts and boards oversee." What is the standard today?

► **R. Lacher:** I believe this standard remains largely true, as it is important to distinguish the mandate of a board from the mandate of management—otherwise why have two different bodies if they have the same function? That said, the situation is not black and white, but depends on cultural codes and norms and on the firm itself. I believe it is still best when the board defines the organization and its broad strategy, and management implements that strategy, with frequent interactions between the two bodies.

► **A. F. Wagner:** The answer here depends largely on where the firm is based and also how large it is. The Swiss setting is again somewhat unique, as the board ("Verwaltungsrat") here, in principle, does play an important role in setting the firm's strategy. By contrast in Germany, say, the board ("Aufsichtsrat") mostly has a supervisory role. Over time, shareholders have certainly become more demanding of boards. While historically expertise in the actual business was not necessarily a requirement for board members, nowadays the members of large global companies' boards especially come under intense scrutiny from investors regarding their competencies and time availability.

## What are your views on proper executive compensation, incentives, and risk-taking?

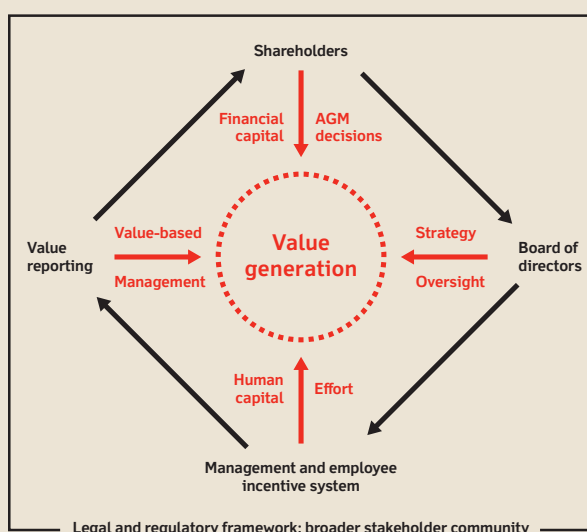
► **A. F. Wagner:** This is a very challenging question. The basic principle is that the compensation system should fit the concrete needs of the business: transplanting a compensation system from one company to another is a recipe for problems. But it strikes me that the workings of complex, multi-layered compensation plans are sometimes not fully understood, in particular their effect on incentives to take risk. Risk incentives need to be actively managed.<sup>8)</sup> I think companies in general do well when they use the power of simple share ownership effectively, both at the executive level and also for the broader employee base.

► **F. Degeorge:** Research shows that incentives work: they change the behavior of managers and companies. The problem is that sometimes they work too well. If incentives are poorly designed, they reward value-destroying behavior. For example, target-based incentives encourage gaming, leading to excessive risk if the target is far off and to excessive caution if the target has already been met. Another key aspect of incentives is their horizon: short-term incentives promote short-term behavior, while incentives that reward management for taking a longer view lead to long-term value creation.

► **F. Frick:** Providing the appropriate incentive system is by no means easy, as the decisions of managers and employees in any given sector of a firm bear potential consequences for the entire firm. What we increasingly see in the financial industry are compensation schemes paid in cash and equity, so as to align the employees' incentives with those of the firm's owners, but also compensation schemes in which part of the cash is invested, for a given number of years, in funds managed by the firm, so as to align the employees' incentives with those of the firm's clients and, ultimately, of the firm itself.

► **M. Mächler:** What I find encouraging is that more and more employees are acting as capital providers to their firms through equity ownership. This trend shows that these incentive systems not only reward workers, but also allow workers to engage in and show their commitment to their firms.

**Figure 2: Corporate Governance within the Legal Framework**



Source: Wagner, A. F., & Wenk, C. (2016). *Corporate governance: Beyond best practice*. Swiss Finance Institute White Paper.

8) Chesney, M., Stromberg, J., Wagner, A. F., & Wolff, V. (2020). Managerial incentives to take asset risk. *Journal of Corporate Finance*, 65, 101758. <https://doi.org/10.1016/j.jcorpfin.2020.101758>

**What should the "ideal" board look like?**

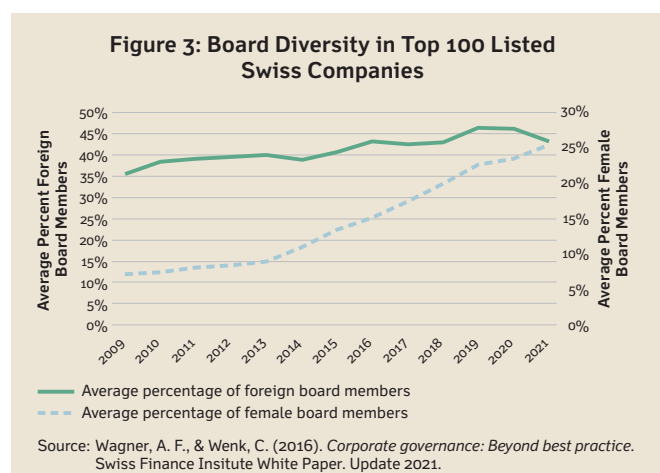
▶ **M. Mächler:** There is no one-size-fits-all solution when it comes to corporate governance, but boards should reflect the values of the company and its stakeholders. Because corporate governance is multi-dimensional, it is good to ensure that the board is diverse and multi-minded.

▶ **F. Frick:** My experience shows that the major risk is over-boarding. Board members, no matter how experienced they are, need to do their homework—a considerable amount of reading and research—before each and every meeting to understand the firm's current context and the general industry environment. Board members need to challenge, support, and encourage management, as well as agreeing to disagree with the other board members.

▶ **R. Lacher:** Diversity and size are both key. I strongly believe in competency gridding, which means having a broad set of abilities, values, and experiences represented on the board. For example, we always try to have a non-banker with CEO industry experience on the board I chair to provide an alternative and novel view on how to tackle financial questions. Another important requirement is time commitment: having a board with big names who give limited time provides very limited benefits. Also, the board members need to understand the roles and qualities of their peers

to ensure a constructive work environment. Finally, the board must be open to having early interactions with the CEO, when it comes to handling a crisis.

▶ **J.-C. Rochet:** With respect to seeking a stakeholder society, representatives of workers and consumers alike, as in the case of co-operatives, should also be included on the boards of firms.



# Investor Behavior and Proxy Advisors

## What can we say about the relationship between firms and their investors?

► **R. Lacher:** This question deserves a dual answer; the relationship depends a lot on the firm's shareholder structure. For companies with hundreds of shareholders who each owns a fraction of a percentage of the overall firm, the decision-making ultimately boils down to the proxy advisors and institutional investors; this case calls for a loose relationship between managers, board, and shareholders. For companies with only a handful of shareholders who each owns a significant portion of the firm, there is room for intense discussions between these shareholders and the CEO, CFO, and board. Finally, we need to remember that activist shareholders can be very vocal. Managing the shareholder base can be challenging, as was shown with the recently solved multi-year dispute between Sika and Saint-Gobain.

► **A. F. Wagner:** Conversations about shareholders often treat them as a homogenous group. But they are very heterogeneous, in terms of their horizons and other preferences. This variety shows in their behavior. For example, research on the COVID-19 crisis reveals that firms suffered particularly steep drops in their share prices when their institutional investors had strong exposure to *other* companies with weak financials; these investors were inclined to engage in fire sales when the crisis hit its first peak in spring 2020.<sup>9)</sup> This episode shows that "know your investor" may be as important as the "know your customer" mantra.

► **F. Frick:** Due to the increase in shareholder activism, firms have become more in touch with their shareholders. There have actually been cases of the management of a firm reaching out to the shareholders and trying to influence their voting decisions, which is clearly borderline ...

## Proxy advisory firms have become increasingly common. What was their initial role, and how has it evolved?

► **A. F. Wagner:** Proxy advising has been gaining traction over the last 20 years. In principle, the idea has value: since many investors need to form opinions on the same issues, it makes sense to have specialists provide information on these issues. Over time, many institutional investors decided to basically copy-and-paste the proxy advisors' recommendations. We have observed, however, that while many shareholders follow proxy advisors' negative recommendations, they frequently deviate from their positive recommendations and instead vote more critically.

► **M. Mächler:** Proxy advisors need to be cautious regarding their ability to influence public opinion. I believe they should morph away from the current pre-conceptualized approach toward a listening one. They should avoid box-ticking approaches.

## Do proxy advisors improve corporate decisions and corporate governance?

► **A. F. Wagner:** It is difficult to provide an overall answer here. One concern is the potential conflict of interest of some proxy advisors, another is that they induce shareholders to spend too little effort doing their own research. On that second point, however, new research suggests that proxy advising can play a positive role by highlighting critical issues and allowing shareholders to forge their own opinions on those issues, which ultimately improves overall corporate governance.<sup>10)</sup> The key issue here is that the time between when firms send out their voting material and when the general meeting is held needs to be sufficiently long.

► **F. Frick:** Proxy advising firms have clearly helped facilitate the voting process, as the number of firms one person can invest in is very large and forming a considered opinion on each vote would require far too many resources. That said, I prefer to rely on a hybrid approach: to follow the recommendations of proxy advisors for mainstream questions, but also to dive into niche questions and not hesitate to vote against the advisors' recommendations.

► **R. Lacher:** In general, proxy advising has clearly improved the efficiency of the voting process for institutional investors and pension funds. Where I am hesitant about its value is indeed the box-ticking approach and also the underlying conflict of interest, given their need to serve their own interests as a business and not only the interests of their clients. Regarding their future, I would keep an eye on the increase in divergence among their recommendations, which I believe may ultimately cause more confusion than value.

9) Glossner, S., Matos, P., Ramelli, S., & Wagner, A. F. (2021). Do institutional investors stabilize equity markets in crisis periods? Evidence from COVID-19. *Working paper*. <https://doi.org/10.2139/ssrn.3655271>

10) Buechel, B., Mechtenberg, L., & Wagner, A. F. (2021). When do proxy advisors improve corporate decisions? *Working paper*.



**Do proxy advisors actually relieve investors from doing their homework, in the way that risk ratings do?**

▶ **A. F. Wagner:** They should not. In fact, proxy advisors are increasingly becoming data providers, with the most sophisticated shareholders developing their own opinions based on this data. By contrast, small institutional investors, such as a significant portion of Swiss pension funds, are likely to continue to follow the recommendations of proxy advisors very closely.

▶ **F. Degeorge:** In principle, the outsourcing of voting decisions by investors to proxy advisors should indeed make sense if the proxy advisors have special expertise. However, academic research suggests that the voting recommendations issued by proxy advisors are too often one-size-fits-all. There is also some evidence that the conflict of interests biases the recommendations: proxy advisors help firms put together proposals, then advise investors on how to vote on these same proposals. This mixing of roles is hardly conducive to objectivity.





# The Eminence of Regulators and Society

## Governments typically carry the force of the law, while firms are more dynamic and innovative. What are the pros and cons of regulatory measures versus market-based initiatives?

► **M. Mächler:** A balancing of interests should be at the heart of the decision-making process here. Governments and regulators fulfill their mandate of defining what is best for society, in the broadest sense, as well as setting the milestones required to reach these goals, if there is a broad and functioning democratic process in place and an intensive cooperation with the private sector. Unfortunately, government decisions are too often one-sided and politically driven, with short-term views. Furthermore, when a glitch occurs in the financial sector, for example, regulators are very reactive. While it is, in theory, appropriate for them to try to avoid the repeat of such a glitch, their solution is typically not always analyzed well enough and does not rationally maximize welfare. The increase in political polarization that many countries are currently experiencing is not helping to keep the fair balancing of interests in perspective.

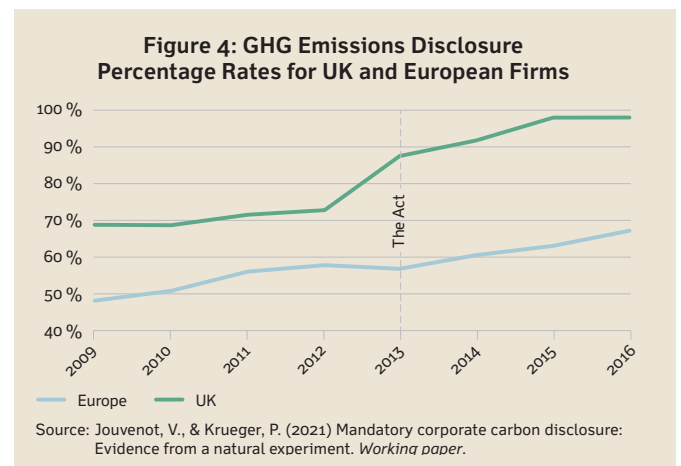
► **F. Frick:** State-imposed regulation is indeed important, with respect to setting the rules of the game, but along with large corporations, market players such as IFRS and ISO could also endorse the key role of spreading out standardized metrics and methodologies.

► **J.-C. Rochet:** We also need to acknowledge that large corporations, due to their international span, are able to interact with more stakeholder groups than can the government of any single country. This puts corporations in a prime position to take us collectively out of the "prisoners dilemma," in which nations are trapped when it comes to ESG improvements. Obviously, society—whether in the form of a consumer, an investor, or a worker—needs to further expose its ESG preferences and to support stakeholder-targeted firms.

## Mandatory ESG disclosure is becoming increasingly widespread. How do firms and investors react to such regulatory measures?

► **J.-C. Rochet:** Mandatory ESG disclosure has still to become mainstream. That said, in 2013 firms listed on the Main Market of the London Stock Exchange were required to disclose their greenhouse gas emissions—a significant component of any environmental criteria. Empirical results show that the firms most heavily affected by the regulation, in particular the oil and gas sector, experienced significant positive valuation effects, and that

UK firms have since been decarbonizing significantly faster than their European counterparts. You could speculate that mandatory governance disclosure could have a similar effect on firm valuation and good corporate governance.<sup>11)</sup>



► **R. Lacher:** I believe we are still at the beginning of the process, with too many stakeholders having created too many ESG standards. This situation has led to what is now referred to dismissively as "ESG alphabet soup." But from a corporate perspective, the message has been heard and virtually all firms have embarked on the journey of making improvements based on ESG criteria.

## What are some recent initiatives in market-based corporate governance?

► **F. Frick:** The fiduciary duty of investors has been shifting, particularly in Europe, from being solely a measure of risk-adjusted performance, to one which also includes the overall impact of investments on society. As a direct consequence, performance fees are now increasingly being distributed to those asset managers who perform well in terms of ESG criteria—showing that market-based initiatives are working.

11) Jouvenot, V., & Krueger, P. (2021) Mandatory corporate carbon disclosure: Evidence from a natural experiment. *Working paper*. <https://doi.org/10.2139/ssrn.3434490>

► **M. Mächler:** The Swiss code of best practices for corporate governance has shown an overall positive evolution over the past decades. What is very interesting in this respect is to observe how the changes in the United States' and the United Kingdom's codes gradually made their way into the Swiss one, showing that large multinational firms have an overarching indirect market-based influence.

**Who is best positioned to push forward with respect to corporate governance? Legislators? Regulators? Shareholders? Firms? Or someone else?**

► **A. F. Wagner:** As there is no one-size-fits-all setting when it comes to corporate governance, in-depth regulatory and legal measures will often fail. Market-based solutions and market discipline are, in my view, our most effective tools. However, a clear and well-enforced legal framework targeted toward avoiding potentially systemic risks remains essential.

► **M. Mächler:** The different players have different sets of tools at their disposal, each with its specific strengths and weaknesses,

which they can use to influence the shape of tomorrow's definition of good corporate governance. In the Swiss case, we should be aware that financial regulations can change far more quickly and efficiently than can general corporate law, meaning that ESG requirements may be applied to financial firms well before they impact the general economy. While the benefit of targeting one specific industry bears questioning, financial actors need to be ready.

► **R. Lacher:** The current ESG disclosure landscape is a misty—and a costly—one. What I hope for is that the standards will consolidate rapidly, as we experienced in accounting with the IFRS and US-GAAP principles, and that just a couple of reporting norms will remain. Whether these standards are set by a government, an NGO, or the industry ultimately does not matter.

► **J.-C. Rochet:** For an efficient transition, society—whether by voting, consuming, investing, or working—needs to manifest its ESG preferences to firms, governments, and lawmakers alike. The push is therefore likely to come simultaneously from many different directions.



## Swiss Finance Institute

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