Research Assessment Exercise 2020
Impact Case Study

University: The Hong Kong University of Science and Technology
Unit of Assessment (UoA): 21-Economics and Finance
Title of case study: Corporate Governance Regulation

(1) Summary of the impact

Business research by Kasper Meisner Nielsen has demonstrated how sound corporate governance provides an incentive structure that benefits all shareholders. His research evaluates: 1) executives' compensation; 2) whether independent directors contribute to shareholder value; and 3) the effect of dual class shares on firm value. The research has directly informed policy discussion among stakeholders in financial markets, such as Blackrock, the world's largest asset manager, that have referred to Nielsen's research in public consultation submissions on government regulatory corporate governance policy proposals. It has also achieved impact through contributions to professional practice through direct engagement with business communities across Asia, and public discourse on company performance and governance through extensive media dissemination, including named references in leading publications, such as *The Economist* and *Financial Times*.

(2) Underpinning research

Nielsen (HKUST Associate Professor since 2010; on leave since 2018), and co-authors Bennedsen (INSEAD) and Nguyen (University of Cambridge Judge Business School), have conducted studies from 2010 onward throwing light on how good corporate governance practices can convincingly assist companies and policymakers in mitigating agency problems and creating shareholder value.

Prior research had shown that measures of good corporate governance practices (e.g. independent directors or shareholder democracy) might *correlate* with firm performance but found it difficult to show that good corporate governance practices *caused* firm performance, rather than well-performing firms choosing to follow good corporate governance practices.

Given that causal evidence is highly important to ensure policy recommendations are aligned with intended outcomes, Nielsen addressed this issue by introducing shock-based natural experiments as a way to evaluate the effect of corporate governance on firm performance. A natural experiment is an empirical study in which the experimental and control variables are influenced by nature or factors outside the researcher's control, allowing for a comparison that makes the case for a causal relationship.

In this research, Nielsen used natural experiments that exploited random variation due to sudden deaths of executives and directors. Nielsen's research evaluated the following key corporate governance questions: i) executive compensation [**R1**]; ii) the value of independent directors [**R2**]; and iii) the consequences of using dual class shares [**R3**], the subject of much debate in Europe, and more recently in Hong Kong and Singapore where, in 2018, their respective stock exchanges lifted their ban on dual class shares to cater to large Chinese technology companies considering an initial public offering. Key findings were:

i) <u>Executive compensation</u>: Attempts to regulate the level of executive pay are ill-advised [**R1**] because executives are paid according to their contribution to shareholder value. Regulators should instead focus on making executive compensation transparent and consider subjecting it to shareholder approval.

ii) <u>Mandating independent directors on corporate boards</u>: Independent directors do contribute to shareholder value, but the marginal effect is declining, suggesting that a well-functioning board should strike a balance between having inside and independent directors [**R2**].

iii) (<u>De-)regulation of the use of dual class shares</u>: Firms with dual class shares have lower firm value, and this cost is internalized by shareholders when firms offer new shares to the public [**R3**].

The practical implication of this research is that governments should take unintended consequences into account when they regulate corporate governance to improve firm performance and economic growth.

(3) References to the research

[**R1**] Nguyen BD and Nielsen KM. "What death can tell: Are executives paid for their contributions to firm value?". Management Science 60 (12), 2994-3010. December 2014.
[**R2**] Nguyen, BD and Nielsen KM. "The value of independent directors: evidence from sudden deaths". Journal of Financial Economics 98 (3), 550-567. December 2010.
[**R3**] Bennedsen M and Nielsen KM. "Incentive and entrenchment effects in European ownership". Journal of Banking and Finance 34 (9), 2212-2229. September 2010.

(4) Details of the impact

Nielsen's research has informed and contributed to a) *policy discussion* through citations in submissions by major international financial stakeholders on consultations by regulators over the introduction of dual class shares, b) *professional practice* through workshops delivered across Asia, and c) *public awareness-raising* through extensive media citations and coverage in news articles related to analysis of good corporate governance. Beneficiaries have included financial analysts and government regulators, finance executives and professionals, corporate monitoring organizations, and the investing public, locally and globally.

Nielsen's research has impacted *policy discussion* by shaping recommendations on corporate governance principles, specifically on the regulation of dual class shares. The European Commission and OECD have long been concerned with the lack of proportionality between ownership of votes and cash flow rights, allowing controlling owners to hold a majority of the votes, but a relative fraction of the cash flow (i.e. dividend) rights. Dual class shares are one of the control-enhancing mechanisms allowing controlling owners to concentrate their ownership of votes, while holding a small economic claim on dividends. The discussion intensified between Spring 2017 and Spring 2018 with the decision by the Hong Kong and the Singapore Stock Exchanges to lift the ban on the use of dual class shares to cater to Chinese technology companies considering an initial public offering. During the public consultation on these proposed changes, Blackrock Inc. argued against lifting the ban on dual class shares while referring to Nielsen's research findings [**Section 5, S1**] in their response to questions posed by Singapore Stock Exchange in its policy memo "Possible Listing Framework for Dual Class Shares Structure". Specifically, Blackrock argued:

"*The results of a 2010 research conducted by Bennedsen and Nielsen on 4,000 European issuers draw a similar conclusion. They found that companies with dual class shares have higher discount in firm values (as measured by the market-to-book ratio). These companies also showed "a lower takeover frequency, operating performance, payout ratio, and growth in assets". Firm value of an average European firm with dual class shares is around 19% lower than the average firm with a proportional ownership structure. Therefore, the misalignment between the voting power and the cash flow rights of the controlling shareholders should serve as a deterrent to minority shareholders."*

Recommendations on corporate governance from organizations such as the European Commission, OECD, and World Bank (see **S2-S3** for examples) serve as inspiration for regulation around the world. Many corporate governance codes suggest, or mandate, a minimum number of independent directors, consistent with the findings in Nielsen's research **[R2)**]. Indeed, the G20/OECD has highlighted this: "*National principles, and in some cases laws, lay down specific duties for board members who can be regarded as independent and recommend that a significant part, in some instances a majority, of the board should be independent*" **[S2, p40]**.

In most developed economies, committees consisting of academics and business professionals have discussed implementing principles of corporate governance in the form of such codes, as either soft or hard regulation. Nielsen's research has informed such policy discussion. One example is provided by the Spanish National Securities Market Commission (CNMV), the body responsible for the supervision and inspection of Spanish securities markets [**S4, p55**], which stated in a bulletin:

"Finally, we highlight the work of Nguyen and Nielsen (2010), who analysed the impact of unexpected deaths of independent directors on companies' share price. They found that in such cases shares lose value, losing more if the deceased director's role was more significant and less if the board has many independent directors (consistent with an optimal independence level) or where doubts subsist as to the deceased director's actual independence (such as independent directors who have spent too many years in post). A noteworthy observation from this study is that it shows that it is not just the fact of being external or the firm's classification of a director as independent that counts: markets value the genuine independence of each director."

Nielsen's research has been widely disseminated through extensive coverage in local and international financial media, helping to raise awareness among investors and other members of the public of the findings and their relevance to governance issues. This coverage includes reports in the *Financial Times*, *The Economist*, *Times of India*, *South China Morning Post*, Bloomberg, *Business Week*, *Harvard Business Review*, *International Herald Tribune*, *Le Mondé*, and *Wall Street Journal* [**S5-S7** for examples]. Collectively, these outlets have global circulation of at least 10 million copies.

Nielsen has also informed practice through public talks for finance sector professional organizations across Asia, including India, Hong Kong, Singapore, the Philippines, and Myanmar. For example, research on independent directors was shared in talks to leading business groups, such as the American Chamber of Commerce in Hong Kong (9 March 2016); Indian Association of Investment Professionals (Bengalaru, 7 September, 2016; Mumbai, 4 September 2015) and CFA Society Philippines (Manila, 28 March 2017) [**S8**]. As noted by the program director of the CFA Society Philippines in email testimony, 100% of participants at the Nielsen presentation on "Do Independent Directors Provide a Valuable Service to Shareholders" said the content was very useful or useful in their work. She also looked forward to continuing the partnership on presentations with HKUST **[S9]**.

(5) Sources to corroborate the impact

[S1] Blackrock Inc. Response to "Possible Listing Framework for Dual Class Structures" consultation paper, issued by Singapore Exchange Limited.
https://docplayer.net/docview/65/54253903/#file=/storage/65/54253903/54253903.pdf

[S2] OECD (2015). G20/OECD Principles of Corporate Governance, OECD Publishing, Paris.
http://dx.doi.org/10.1787/9789264236882-en

[S3] International Finance Corporation, World Bank Group (2018). "Governance and Performance in Emerging Markets - Empirical Study on the Link Between Performance and Corporate Governance of IFC Investment Clients". World Bank.

[S4] CNMV. "CNMV BULLETIN", March 2016.

[S5] Financial Times. "Market reaction to a CEO's death can reveal attitudes to pay". 27 August 2014.
https://www.ft.com/content/b3a369dc-2e03-11e4-b330-00144feabdc0

[S6] The Economist. "Executive pay. The final reckoning". 6 September 2014.
https://www.economist.com/business/2014/09/06/the-final-reckoning

[**S7**] Times of India. "Are CEOs underpaid?" 22 September, 2014.
https://www.educationtimes.com/article/65780180/69517011/Are-CEOs-underpaid.html

[S8] Talks: Kasper Meisner Nielsen website http://www.kaspermeisnernielsen.com/talks.html

[S9] Email: R Sampang-Manaog, Program Director, CFA Society Philippines.