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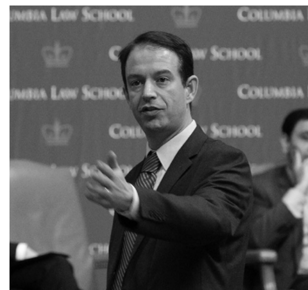
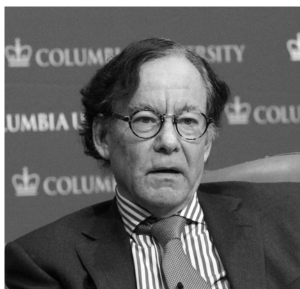
Columbia Business School

# Columbia Law School Roundtable on A Governance Research Agenda for the Academy

**2016 Millstein Governance Forum | Columbia Law School | December 7, 2016**





**Marcel Bucsescu:** Good morning, and welcome to this discussion of academic research on corporate governance. I'm Marcel Bucsescu, Executive Director of the Millstein Center here at Columbia Law School, and I'm going to serve as moderator.

In some ways, the study of corporate governance as an academic discipline is relatively new. Many governance scholars view Berle and Means' much-cited 1932 book, *The Modern Corporation and Private Property*, as the foundational corporate governance study. And by far the most cited successor to Berle and Means is Jensen and Meckling's 1976 article that set out the principles and implications of the theory of "agency costs" that has played such a central role in the corporate finance and governance literature.

The field experienced a new burst of energy following the Enron and WorldCom financial reporting scandals in the early 2000s. And here we are, nearly two decades later, and corporate governance research has matured significantly. Yet many practitioners continue to comment on the disconnect between theory and practice, between the questions researched and the questions that need to be answered. Academic work in the governance arena has come to rely heavily on empirical studies. But if these studies have provided useful insights into past events, practitioners have generally found them lacking in the practical judgment and experience that is required to help inform real world decision-making. And so academic work is often discounted as lacking relevance or applicability.

But the environment that public companies and the capital markets now face may be making the demand for robust academic research greater than ever. The complexity of the world and the challenges that confront investors, boards, management, regulators, and policy makers on a daily basis mean that their decisions need to be informed by rigorous data, judgment, and breadth of experience and perspective.

At this 2016 Millstein Governance Forum, we are celebrating ten years of the Millstein Center. In that spirit, we are looking forward to the next ten years. In this panel, we will be exploring the current thinking and emerging lines of research of three leading law and economics scholars with the hope of generating a dialogue about a corporate governance research agenda for the academy going forward.

So, with that as prologue, let me briefly introduce each of our three distinguished panelists in the order they will be speaking:

**Martijn Cremers** is the Professor of Finance at Mendoza College of Business at the University of Notre Dame and has a long and rich history with the Millstein Center. Professor Cremer's recent work has focused on staggered boards, and he is also known for his work on "Active Share," which measures the percentage of fund holdings that is different from the benchmark holdings.

**Vik Khanna** is the William W. Cook Professor of Law at the University of Michigan Law School. Professor Khanna's scholarship looks at corporate law, securities law and white collar crime in the US and law and legal issues in India. He serves as co-director of the Joint Centre for Global Corporate and Financial Law & Policy, a collaboration between Michigan Law and India's Jindal Global Law School.

And **Jeff Gordon** is the Richard Paul Richman Professor of Law, Faculty Director, Millstein Center, at the Law School, and Co-Director, Richman Center for Business, Law & Public Policy. Professor Gordon teaches and writes extensively on corporate governance, mergers and acquisitions, comparative corporate governance, and, more recently, the regulation of finance institutions. He is the co-author of *Principles of Financial Regulation* and co-editor of the forthcoming *Oxford Handbook on Corporate Law and Governance*.

With that, let's move to the substantive discussion. Martijn, you have the floor first.

## Some New Evidence Against Shareholder Activists—Staggered Boards

**Martijn Cremers:** Thank you, Marcel. And let me start by also thanking the Millstein Center and the other organizers of this event for this great opportunity to share with you my thinking about the future academic research agenda. Before I joined Notre Dame about four years ago, I spent ten years at the Yale School of Management. The Millstein Center was founded at Yale in 2006 while I was there, and that association has been a blessing to me. I have fond memories of long conversations with Ira in which he would respond to my many—and sometimes not well thought-out—questions with unfailing courtesy and insight.

With respect to today's subject of academic research into corporate governance, let me start by saying that I think we have to change the way that we have been answering the main question: What's the biggest challenge for the board and the shareholders? Almost all academic work on corporate governance for the past 30

or 40 years has been based on the assumption that the most important corporate governance problem is the one identified by Jensen and Meckling in their seminal 1976 paper that Marcel just mentioned. And that problem, or challenge, is how to minimize the so-called "agency costs" that shareholders bear in monitoring and providing effective incentives for corporate executives to maximize the long-run value of the firm. Chief among these costs are excessive compensation—at least given the performance of the firm—and the loss of value associated with empire building, managerial entrenchment, and other forms of self-dealing.

The basic insight underlying this model is that markets don't work well within corporations, presumably because shareholders don't have enough information and influence on corporate boards to ensure that those boards do a good job of representing their interests. And the conventional solution to this agency cost problem is to try to make market discipline work better, by encouraging active takeover markets and improving the design of incentive pay.

So, again, this is the traditional corporate governance challenge that is addressed by most academic research—limiting the costs associated with the moral hazards facing self-interested and entrenched top executives and directors. But, consistent with all the concern that has been expressed by Ira and many others about corporate "short-termism," I'm going to argue that there may be another major corporate governance challenge, one that may well be both more difficult and more important than limiting agency costs—and that is what I refer to as "inadequate shareholder commitment to long-term cooperation."

Getting all of a company's major stakeholders, including its shareholders, to commit to cooperate in creating long-term value is a difficult collective action problem. It cannot be managed entirely through explicit contracting, for various reasons. One challenge is asymmetric information. Another is that many stakeholders, particularly corporate managers and employees, have to make firm-specific investments that are much more valuable when their ongoing relationship with the firm can be assumed to be long-lasting than when that relationship is subject to change or disruption by, say, a hostile takeover. There are important mutual dependencies in these long-term relationships; to cooperate over the long-term, a company's stakeholders need to be able to trust each other.

And the crux of the problem, as many observers of U.S. markets and governance see it, is that many shareholders may actually have the weakest commitments to long-term cooperation with other stakeholders because they can so easily exit the relationship—in fact, just by selling their shares. In this sense, today's typical institutional shareholder has the least commitment to cooperate in creating long-term value among all the major corporate stakeholders. So, we need to think about developing or making greater use of commitment devices or mechanisms that help ensure that corporate managements and boards feel more confident when taking what they believe to be the long-term value-maximizing courses of action.

Two such commitment devices are the use of staggered boards and super majority shareholder voting requirements to approve major changes in the firm. My co-authors and I recently published two papers, one in the Stanford Law Review and one in the *Journal of Financial Economics*, that look at these commitment devices in great detail.[1]

The consensus among academics has been that staggered boards are bad for shareholders—a consensus that has been supported by research using data from 1990 to 2005, a period when board structure was very stable. But we have found a lot more data to reexamine this view. With very generous support from the Millstein Center and some other sponsors, we went back all the way to the 1970s when staggered boards were very uncommon. Most U.S. company "staggered" up during the mid-1980s; and then many of them "staggered" down during the mid-2000s in response to shareholder activism of various kinds. And when we looked at the stock performance of these companies during these two different periods, we found—somewhat to our surprise—that their performance actually improved after the companies staggered up, and their performance suffered after they staggered down.

These findings provide support for two observations that Ira made earlier today. First, based on his experience, most directors want to do the right thing by their companies and their shareholders. But that, of course, is precisely the opposite of the working premise of most academic research about directors, which assumes that they need strong incentives and market deterrents to restrain them from pursuing their own self-interest. Second, Ira believes that directors need "elbow room" to perform their jobs well; that is, they need to have more discretion, as well as more courage, when making difficult decisions to resist shortsighted share-

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Martijn Cremers

holder proposals as well as shortsighted management strategies designed to satisfy short-term investors. The hypothesis underlying my recent studies is that perhaps the staggering of boards can help lengthen the decision-making horizon of boards and the managers they oversee. Staggering the board has the potential to free the typical director from excessive concern about being forced to step down by shareholders who are too focused on the next quarter's earnings.

One contributor to this concern is the recent shareholder rights project at Harvard Law School, which has mounted an aggressive campaign to de-stagger boards. That campaign alone has been largely responsible for a significant increase in board declassifications in recent years. In our new study that we have provisionally called "Boards Declassification Activism," we have done a kind of post-mortem on what actually happened to those companies that declassified their boards after being targeted by the shareholder rights project.[2] And much as we found in our study of earlier destaggerings, the companies targeted by the Harvard Law Shareholder Rights project underperformed after their declassifications.

Before I close, let me also mention two other questions addressed in my recent research. First, how long do institutions hold their positions? In another paper forthcoming in the *Journal of Financial Economics*, I looked at data from form 13Fs, which U.S. institutional investors have to file with the U.S. Securities and Exchange Commission, going back to the 1980s. I reached the conclusion that the holding periods of the large institutional investors in the United States have been fairly stable over the last 40 years.[3] What this tells us is that the huge increases in trading in recent years have not been attributable to these institutional investors who now own about 80% of U.S. stocks. Rather, it has been the high-frequency traders, not the large institutions like investment advisors and pension funds, which have generated the high trading volumes. Institutional investors' holding periods have, as I said, remained fairly stable, and may even have increased a bit.

But that said, it is still very uncommon for institutions to hold stocks, on average, for longer than two years or three years. It was uncommon in the 1980s, and it is still very uncommon now. So if by "long-term holder" you mean an investor who holds more than three years, then not many investors qualify. There has also been a huge trend towards indexing, but my research shows that that trend has been going on for quite some time.

What's more, many institutional investors who are not explicit index funds have been "closet" index funds for a long time, meaning that they have substantial overlapping holdings with the benchmark indices. For example, if both the institution and the market have a 3% stake in Apple, then whatever happens to Apple's share price will affect the fund and the market identically. So the fund, in a relative sense, has what amounts to an indexed position—and thus little motive to become an active monitor of performance. And I think this may be important because when you aggregate all the institutional holdings by institution—so let's say all Fidelity funds represent one portfolio, all of Vanguard makes up another, and all of BlackRock is a third, and so forth—you find that the percentage of assets in the hands of what I think of as largely passive investors has increased from about 50% in 1985 to as much as 80% today.

So, viewed in this way, then, passive index investing is not something new. It's an old issue for corporate governance. If institutional investors have relatively little economic stake in the decisions made by a particular company, it is difficult for them to make a commitment to long-term value creation.

**Bucsescu:** Thank you, Martijn. There was a lot in there, and so I'm going to move along quickly to invite Vik to present his work.

## The Case for Mandating CSR: The Indian Experiment

**Vik Khanna:** Thank you, Marcel. And I also want to express my gratitude to the organizers for inviting me and to Mr. Millstein and the center for your generous support. I'm going to be talking about areas of scholarship that, although they have generated tremendous debate inside business schools and economics departments, are only now beginning to attract the interest of law faculties. And I'm going to use an interesting example of a law that was designed and implemented in India as a way to test some propositions about why companies have corporate social responsibility (CSR) campaigns and what might be the best way for governments to encourage such programs.

As we all know, there has been a great deal of discussion about income inequality and efforts to remediate such inequality through various kinds of gain sharing. It turns out that India has adopted a novel approach in trying to address this issue. India's 2013 Companies Act mandates that all companies that meet certain thresholds spend at least 2% of their after-tax profit on corporate social responsibility initiatives or explain why they did not. This law was the first of its kind, and it continues to be the only such law in the world.

You are probably wondering, "Why did India do this?" It turns out that the primary reason was to address concern about political backlash against the economic liberalization that had been carried out since the early 1990s—and I'll tell you more about this later.

But despite the policy makers' pro-business intentions, what my colleague and I have found in our recent study[4] is, perhaps not surprisingly, a reduction in corporate market values upon the announcement of this rule mandating CSR spending. And the reduction has been quite large, on the order of 3% on average. Our other main finding is that, although the general level of spending on CSR in India has increased dramatically across the board, those companies that were doing the lion's share of CSR spending before the law came into effect have actually reduced their CSR spending, which of course was far from the effect intended by policymakers.

Now, one question that arises is this: in what sense does this particular mandate in India amount to a corporate tax, even though the government neither collects nor redistributes any revenue? And how is it different from, and possibly more socially constructive than, a tax?

Statements by the policy makers suggest that they are relying on private executives' incentives and information to do what is normally the government's job—namely, to direct spending on public goods, which I find to be an extremely interesting and potentially effective approach to dealing with this issue. And it raises the last question I'm going to address here: Is something like this worth considering in the United States? And when I say that, I don't necessarily mean mandating CSR spending, but at least finding ways to encourage more of it on a voluntary basis.

As I mentioned earlier, India is the first country to require firms above certain thresholds to spend some amount of their profits on CSR—though what I didn't mention is that, instead of spending 2% of their profits on CSR, the companies also have the option of issuing a statement that explains why they have decided not to comply with the rule. It is, in this sense, a kind of a "soft" mandate, and the comply-or-explain provision provides companies with an out if they really think that such spending would hurt the company.

How many companies does the rule actually affect? There are roughly 2,000 listed companies in India with net profits above the threshold, which is roughly $750,000. And that is about half of the listed companies. If the company has profits above the $750,000 threshold, they have to form a CSR committee with at least one independent director whose task is to formulate and monitor a CSR policy to spend 2% of profits on CSR; or if they choose not to spend 2% of profits on CSR, they must explain why they have chosen not to.

Now, the Indian government has laid out an exceptionally broad array of activities that it considers to fall under the rubric of legitimate CSR—basically anything that can be considered to help alleviate poverty. Since there are about half a billion poor people in India, there are many kinds of spending that would have some kind of effect on alleviating poverty. The main exception disallowed by the government is spending that is considered to benefit firm employees or political parties.

Why did this CSR spending mandate develop? It was a relatively late addition to the drafting of India's Companies Act. In 2009 the government put forward a voluntary guidance on CSR. The government was encouraging Indian companies to spend money on CSR because the country had started liberalizing its economy in 1991. And although there's no doubt that the economy and many people in

To test the possibility that such private-sector spending on public goods could be more cost-effective than government spending, we took a closer look at the actual CSR spending of Indian companies. And what we found is that the companies are basically spending on social initiatives with a short- to medium-term payoff, which we defined as producing some deliverable after one to three years.

Vik Khanna

it had benefited greatly from the growth that came from that liberalization, there remained a perception that some sectors of the economy benefited by a lot more than others. Many believed, and with some justification, that income inequality was getting much worse. And the government was very concerned that a political backlash would either slow or even reverse the liberalization agenda started 20 years earlier.

To prevent that from happening, they pushed companies to voluntarily spend money on CSR instead of taxing them directly. When governments liberalize their economies, they would rather it appear that companies are choosing to spend money on CSR rather than being coerced into doing it. But after about eight months of unsuccessful cajoling, the government became frustrated with the Indian business sector; and in August of 2010 proposed making CSR spending mandatory for companies above a certain profit threshold.

What have been the effects of this measure? India has fairly good data on financial statements of firms and stock prices; and using this data, we found, first of all, that companies with profits right at the threshold at which the law applies experienced a big drop in value on the announcement of this new rule. But companies well above this threshold did not see much of a decline. And, as one would expect, the values of companies well below the threshold were largely unaffected.

So, again, it was mainly just companies at the threshold that saw a large drop in their values in response to the announcement that they were now going to have to spend 2% of their profits on CSR. And as I mentioned earlier, the market reaction was a negative 3%.

We also found that this negative effect was strongest for companies that do not do much advertising. But for those Indian companies that spend heavily on advertising, the mandate had almost no negative effect. Our explanation for this difference is that the companies that advertise were expected to be able to reduce their advertising budget while increasing their CSR and so largely maintain their level of operating cash flow. But companies that do no advertising were seen to be likely to have more difficulty in offsetting their increased CSR spending.

We also found an interesting effect on overall CSR spending. We found, first of all, a very large uptick in spending on CSR in 2014 when the law came into effect. Now keep in mind that since this is a "comply or explain" rule, Indian companies don't have to spend on CSR but just issue a statement justifying their decision. Before the law was passed in 2010, only 5 or 6% of Indian companies reported CSR spending. In the first year after the law went into effect in 2014, 33% of the companies were spending on CSR. That is an incredible increase in a country where law enforcement is generally not very good, and where you have an option to explain rather than comply. This result suggests to me that the social norms are developing to support CSR.

But that said, I don't want to paint too rosy a picture of CSR in India. Let's take a quick look at the CSR spending of the top 100 companies in India, for which we actually have very good data. What we basically find is that before the law, in 2013, the firms can be divided among those doing less than 2% CSR spending and those doing more. The ones that

were doing less than 2% increased their spending dramatically after the law. But the ones that were doing more than 2%—the "high-quality" firms, so to speak—all dropped their spending to 2%; not one of them retained their pre-law levels of CSR.

So, there appears to be some substitution between CSR spending and advertising. As soon as the law came into effect and made 2% spending mandatory, companies that previously spent as much as 5% on CSR all dropped to 2%. That is a very puzzling, and presumably unintended, effect, one that suggests that charity that had been considered a good thing wasn't so good once the law required it. Prior to passage of the law, spending 5% of your profits on CSR was a viewed as a very effective signal that you were a socially responsible company. Now, to maintain such a reputation, you might have to spend as much as 10% of profits because the baseline has gone from zero to two. And in the interviews we did with CSR and other executives at these firms, that is exactly what they told us. The finance people said, "We're going to have to spend much more to get the old effect, but we don't want to do that. We think we have better uses for that money."

India is a country where people are accustomed to various taxes where the government decides how to spend the money. But in this case, the government simply said, "You must spend it. How you spend it is up to you." That suggests that this is not a pure tax because they are allowing corporate executives to decide how to do the spending. It seems quite plausible to me that corporate executives are better able to spend the money than the government because they have better information or maybe better incentives. And their companies get goodwill from their investors—perhaps even a lower cost of capital, and thus higher valuations—from such spending. And that, of course, would be a real benefit.

To test the possibility that such private-sector spending on public goods could be more cost-effective than government spending, we took a closer look at the actual CSR spending of Indian companies. And what we found is that the companies are basically spending on social initiatives with a short- to medium-term payoff, which we defined as producing some deliverable after one to three years. And they are targeting relatively young people. India has roughly 800 million people, just a massive number, under the age of 40. Indian companies are investing most of their CSR dollars in education and healthcare, but mainly in short-run fixes. Instead of building hospitals, they buy antibiotics, and mosquito net beds to prevent malaria. And they don't invest in K through 12, but rather in one-year degree or certificate programs.

Now having told you all this, should the U.S. consider enacting something like this law? I think a mandatory rule in the U.S. might be a bit of a stretch, but a voluntary push might actually not meet much resistance. Fortune 1,000 companies in the U.S. already do a substantial amount of CSR, and a voluntary push might be used effectively to address concerns that the private sector is not giving back to society—which, of course, is one of the key undercurrents in the ongoing inequality debate. I'll stop there.

**Bucsescu:** Thanks, Vik. We're going to conclude with Jeff Gordon, who will look at public company boards in relation to some other board governance models, notably that of private equity.

## The Private Equity Model for Public Companies

**Jeff Gordon:** Thanks, Marcel, it is a pleasure to be here, and it has been great fun to work with Ira Millstein on these issues and hear the debates. I want to respond to Martijn's observation that the academy has focused too heavily on managerial moral hazard, or "agency costs," and not enough on shareholder commitment and the long term.

Martijn looked at these questions through the lens of structural solutions such as staggered boards, special voting requirements, and maybe even dual-class common stock. Although all of these structural solutions may have some benefits in extending the time horizons of managements and boards, they all face a fundamental problem that I call the "lock-in" issue. Dual-class stock may seem to work well now, when companies have lots of value-adding growth opportunities. But as their founders age and their growth opportunities begin to dry up, shareholders will want to have ways of influencing companies to return capital and, in some cases, perhaps even replace the founders.

So, my main focus is on a corporate governance system's ability to bring about changes of direction and control when they become necessary—and not on addressing Martijn's long-term, short-term problem. The monitoring board model that was developed by academics nearly 50 years ago assumed that directors would be "outside" directors—people who, inevitably, get most of their information by looking at the firm's stock prices, year against year and relative to their peers'. These people might be described as "thinly informed" directors. And I'm going to argue that this model of the board is really at the core of both the tra-

We can look at these questions through the lens of structural solutions such as staggered boards, special voting requirements, and maybe even dual-class common stock. Although all of these structural solutions may have some benefits in extending the time horizons of managements and boards, they all face a fundamental problem that I call the "lock-in" issue…What I focus on is a corporate governance system's ability to bring about changes of direction and control when they become necessary—and not on addressing [the] long-term, short-term problem.

**Jeff Gordon**

ditional agency problem and Martijn's short-term horizon and underinvestment problem—and for both of these reasons, I think the model needs to change. We need a model that incorporates what Ira Millstein and Bill McCracken have called "activist" directors. The rise and success of activist hedge funds can be viewed as the market's reaction to the shortcomings of the monitoring board model that has been the central governing model of the board since the 1970s.

As we heard on the earlier panel, we know that the burdens of being a director have increased sharply—maybe exponentially—while the capacity of directors has increased in only a linear way. We now have committees and outside advisors to committees. But these extensions of the traditional board model have clearly proved to be inadequate. We know they are inadequate because the activists are succeeding by getting institutional investors to vote in their favor. Even BlackRock and other asset managers who profess to value "stewardship" and long-termism are voting for the activists 30 to 40% of the time.

So what is going on? Well, let's start with the fact that the institutional investors who vote with the activists are at the same time committing substantial amounts of money to PE firms in blind-pool investments with lock-up periods for essentially a decade—which is very much the epitome of long-term investing. Are the institutional investors being inconsistent? Or could it be that such institutional investors have come to appreciate that the public firm governance model is deeply flawed—and that the PE governance model has proven to be quite effective?

To see the failings of the public company model more clearly, let's take a look at what activists actually do. The activists show up with a thick slide deck, claiming that the firm's business strategy is awry. Management, of course, is going to resist this claim, but in many cases for reasons that may not necessarily serve the long-run interests of their shareholders. And the institutional investors, who collectively are the majority owners of most large U.S. companies, understand management's position and incentives. Such investors also recognize that board members are "thinly informed" and therefore cannot be relied upon to evaluate the activist's alternative strategy proposal with deep understanding or much objectivity.

And that's the principle reason why activists with a good reputation tend to get quite a good hearing from the institutions and win their support a fair amount of the time. Again, the underlying reason for the success of activists is that the boards of public companies lack the capacity to offer a better-informed choice than the one offered by the activist.

What's more, I would even suggest that

thinly informed directors are also at the root of the long-run coordination problem that Martijn mentioned. For to the extent that outside investors recognize that a company's directors have neither the information—nor the incentives—to engage in genuine strategic review or operational oversight, they will be rationally skeptical about the payoffs from the company's strategic investments and will react sharply to evidence of managerial underperformance such as missed earnings estimates. Managements will be on a "short leash" because of the governance shortfalls.

In short, I disagree with Martijn's characterization of the governance problem as a matter of time horizon: short-term versus long-term. Sure, there is some of that going on. But I think the more fundamental problem is with the governance capacity of the public firm. Therefore, I'm trying to look more closely at the governance model of the PE firm.

How do PE firms run the their portfolio companies? What you see is that portfolio companies have small boards that consist mostly of PE firm partners who are highly focused on the business at hand, which is intensive monitoring of the performance of their portfolio companies. I have been doing interviews of these PE firm partners. And as one of the directors told me, I spend my time meeting with the CEO and the CEO's reports, not to tell him or her how to run the business, but really to gather information so that when we have a board meeting, the board focuses on the four or five things that the board needs to focus on.

And the board doesn't meet just quarterly, as in public companies, but every two weeks or more frequently if necessary. When you have boards like that—and I think that Ira would agree with me that these are truly "activist" boards—then the institutions are probably willing to defer to the judgment of that board. Those are thickly informed, and deeply engaged, boards.

And I also think that these findings have implications for how we recruit directors of public companies. Some of the PE folks I've spoken to think that the common practice of our public companies of recruiting CEOs of other companies to be a director is completely wrong. Directors who are currently CEOs of other companies do not have the time to do an adequate job. And retired CEOs do not have any clear financial incentive. Such former CEOs are likely to think to themselves, "I'm now being asked to serve on boards because I've made it; I'm retired, and I'm trading off leisure against involvement in this firm. The thing I really don't want is downside harm. I don't want anything embarrassing to happen on my watch." And that kind of thinking leads to a focus on compliance and not value creation.

By contrast, the directors that PE firms put on their boards are mid-career people whose personal wealth and future depend on how effective they are as directors, how much value they deliver, how involved they are with the firm, and what capacities they bring to make the firm function better. And notice that the PE model also solves some of the diversity issues we discussed today just because of the demography of the people who are today in these middle ranks, given the way business schools have changed.

So anyway, no conclusions yet, but I hope that I'll be able to report more at next year's forum.

## Governance Problems with Passive Investors—and the Possibility of "Stewardship"?

**Bucsescu:** We covered a lot of ground there and have a few minutes left. I'm going to take a question or two from the floor.

**Alicia Ogawa:** Hi, I'm Alicia Ogawa with the Center on Japanese Economy and Business at the Columbia Business School. I'd like to hear the panel's view on something that Mr. Millstein touched on, which is the tension between exercising effective stewardship and the rise of passive funds. In Japan, as you may know, the public pension fund is the biggest in the world. They control the market, and they are invested almost entirely in passive vehicles.

So the issue is, how do you get "active" passive management, if you will? How do you get engagement when most of the money is managed passively? The previous panel talked about engagement with shareholders. But my sense is it's a very specific group of shareholders. What are the views about the possible effect of the growing passive fund interest in active stewardship?

**Cremers:** Although passive funds have grown a lot, Fidelity and many of the other large institutional investors still make corporate governance decisions at the aggregate level, the family level. They have been relatively passive for a long time already. My own view is that those passive funds and institutional investors have little at stake. If a fund has 3% of its assets invested in Apple and the S&P 500 has a 3% weight in Apple and we live in a world of relative performance, what does the fund have at stake?

**Gordon:** I think the stewardship concept—the idea that one size fits all—is a bad idea. The last thing we need is more uniformity in the way companies are governed. The nice thing that the activists bring to the party is their own view, their divergent view. And maybe they're crazy, but the point is that it's an alternative view about how this firm ought to be run, presented by somebody with a sufficient economic stake to be treated seriously. We ought to have a governance model in which these alternative opinions can be reflected upon with respect to this or that specific firm. But the claim that companies in general are likely to be governed more effectively by a set of uniform governance standards formulated and imposed by large passive institutional investors, each with very small ownership stakes in a given company, is to me highly implausible.

As I said earlier, a better alternative may be the PE model, which involves relational investing. You need a party with a very significant economic stake in the company's success, and greater information flow between directors and line management. That seems to me to be a more promising way to improve corporate performance than forcing some 6,000 different U.S. companies into a uniform, one-size-fits-all model of governance.

## CSR Spending as a Substitute for Advertising and a Strategic Investment

**Audience:** Hi, I'm from Shearman and Sterling, London. I have a question for Vik about the substitution effect that he described in connection with the law mandating CSR spending by Indian companies. Vik, you said that one of the negative effects of CSR spending is less spending on advertising. But isn't CSR spending likely a form of advertising? And do you think that this kind of advertising may be especially effective for companies operating in the Third World?

**Khanna:** My initial reaction to both of your questions is yes. I think for a lot of firms CSR is simply advertising. But I also that think that a lot of the executives, especially in the U.S., are increasingly thinking of CSR as not just advertising but as something that might be part of their strategy. People who have studied CSR spending by U.S. companies tell me that when such companies started adopting it voluntarily in the 1990s, the stock market had a negative reaction. But over the last five years, the market reactions to voluntary CSR in the U.S. have become increasingly positive. And this suggests to me that, if you are a Fortune 1,000 company, having no CSR policy suggests that you're not really thinking through your full strategic arsenal.

Now, to answer your broader question about how this might benefit companies in the Third World, I would say that, rather than imposing a pure corporate tax on CSR, a better approach would probably be the voluntary approach that they first tried in India—that is, to try to cajole the companies into doing it. And I can imagine other kinds of policy interventions that might be more like "nudges" rather than "hard shoves." But part of the reason for framing the question as I did at the end, "Should the U.S. consider this?" is that there are already a large number of companies doing CSR in the U.S., much more than in India. Even in the U.S., you have similar concerns about income inequality and the possibility of more gain sharing. In the U.S., to be sure, the discussion is likely to proceed from a much different perspective, and be informed much more by the strategic discussions that we're seeing from U.S. companies. But this Indian experiment I have just described represents a first step in that direction, one that might provide useful insights for even U.S. policymakers and companies.

**Bucsescu:** With that, I am afraid we have to bring this session to a close. At the Millstein Center, we see great value in bringing together business leaders and scholars to focus on the right questions and to think together through the solutions to the issues at hand. That is our purpose with the Forum and sessions like those we just had. Please join me in thanking our speakers and please keep the dialogue going.

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