



## **SHAREHOLDER ACTIVISM AND SHORT-TERMISM**

**Bartosz Balewski**

LLM (Catolica Global School of Law)

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# SHAREHOLDER ACTIVISM AND SHORT-TERMISM

**Bartosz Balewski**

[bartosz.balewski@gmail.com](mailto:bartosz.balewski@gmail.com)

## Abstract

### Executive Summary

This present paper seeks to investigate and compare shareholder activism in the United States and in Poland. It gives an overview of the shareholders activism by presentation of its main premises and understanding of it nowadays.

Shareholder activism is an exercise of a non-financial rights by shareholders. The three main types of it being basic information rights (disclosure), co-decision rights (voice) and withdrawal rights (exit).

Paper draws conclusions from the status and impact of the shareholders activism in two very different economies, with fundamentally different evolution of corporate governance over the years. These two countries despite of a different history of publicly listed companies and their shareholders involvement produce similar outcome from activities perceived as shareholders' activism.

In a latter part, paper addresses short-termism understood as an excessive focus of corporate managers, asset managers, investors and analysts on short-term results of a company. Short-termism being a part of a wider term encapsulated in shareholder activism is an example an activity negatively perceived and harmful in a long run for a company.

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# **1. INTRODUCTION**

System of the corporate governance is continuously evolving. We observe all over the world that the regulations and the whole system that governs companies is dynamic. Some important events, such as a financial crisis, have a significant impact on the whole corporate regime. Change that one may observe in the world-wide scale, is the position and relevance of the shareholder in the corporate governance.

The evolution of shareholder's situation is evident in legislation. On the European grounds we have European Directive of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJEU L 184/17. New provisions that comes along with the directive are aimed at the solution of the situation present at the markets after the financial crisis. Bigger shareholders' control and activity in the overlooking of companies has, ideally, results in the better corporate governance.

Shareholders engagement mentioned above is a distinguish, specific rights of shareholders that are not connected with the financial remuneration. The three main types of non-financial shareholders rights are basic information rights (disclosure), co-decision rights (voice) and withdrawal rights (exit)<sup>1</sup>.

These mentioned rights altogether constitute the shareholder activism. It is the situation where the shareholder is using its rights in order to influence the company in some regards, for example by putting certain pressure on the Board by submitting a proposal for annual meeting, requesting information or by takeover.

In this paper the shareholder activism in the United States and in Poland will be compared. In the United States we can observe the effects and evolution of the shareholders activism over many years. Moreover, the importance and the number of shares in the companies owned by the institutional investors has been dominant there for a very long time. The situation in Poland is much different, considering the fact of short time of existence of the stock exchange there and quite recent change in the position of the institutional investors in terms of shares volume under their control. Based on these big differences in circumstances, the comparison of the outcome in shareholder activism will be explored in order to give an answer how different circumstances affect it.

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<sup>1</sup> Hopt, Klaus J., Comparative Corporate Governance: The State of the Art and International Regulation, 2011. American Journal of Comparative Law, Vol. 59, p. 53, January 2011; ECGI - Law Working Paper No. 170/2011. Available at SSRN: <http://ssrn.com/abstract=1713750>

Shareholder activism in its primary form is seen as undoubtedly positive. It is concerned with the good of the company and aims at performance improvement. Nonetheless, the rise of institutional investors has coincided with the rise of short-termism: the practice of short-term investing by shareholders and short-term business decisions by directors and managers at the expense of long-term corporate sustainability<sup>2</sup>. Therefore we have to distinguish different types of voice and exit rights used by the shareholders. The issue of the short-termism as the way of exercising shareholder activism, is to be explored and examined more deeply in a separate chapter, as distinguished from the main, initial stream of activism.

## **2. SHAREHOLDERS ACTIVISM IN THE US**

Shareholder activism in the US has a particular importance when we are dealing with institutional investors, as mutual or pension funds. Before, when the shareholding was vastly dispersed and held in the private hands, it was not that easy and that feasible to exercise the influence over the company. Now, these institutions due to the fact of possession of a number of shares and having capabilities to attend annual meetings of shareholders and follow the daily business of the companies they have a real influence and can truly exercise their shareholder rights.

When exploring the situation of shareholders activism in the US we can encounter a strong claim of Bernard Black: “the evidence to date suggests that activism, American style, has a little effect on firm performance”<sup>3</sup>. That puts us already on track in terms of evaluation of the situation in the States.

Shareholders voice in the US comes along with the possibility of submitting the proposal for annual shareholder meeting under Securities and Exchange Commission Rule 14a-8. Even though there are other legal provisions that would allow submission of a proposal, they are rarely used.

Analysis of shareholders proposals delivered by institutional investors, gives as a result the information that most of them come from state and local government pension

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<sup>2</sup> Leo E. Strine, Jr., One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, 66 BUS. LAW. 1, 2 (2010)

<sup>3</sup> Black, Bernard S., Shareholder Activism and Corporate Governance in the United States. As published in The New Palgrave Dictionary of Economics and the Law, vol. 3, pp. 459-465, 1998. Available at SSRN: <http://ssrn.com/abstract=45100> or <http://dx.doi.org/10.2139/ssrn.45100>

funds<sup>4</sup>. The reason why these funds are the ones submitting proposals is connected with the conflict of interest, which is less present in their situation than in case of other institutions<sup>5</sup>. It is also observed that the cause for which the funds are submitting proposals is more associated with political dimension of it than aimed at the maximisation of the profits coming from the company<sup>6</sup>.

Taking into account the extended period of the possibility of shareholder activism in the US the most important conclusion can be seek, namely, is the shareholders activism effective and beneficial for the companies? Black summarise that by stating: “the general absence of convincing evidence of a relationship between activism and firm performance suggests that activism has, at most, a minor impact on firm performance.”<sup>7</sup>

These type of the shareholder activism is used to be called a defensive activism. As studies show, it does not lead to a significant increase in stock price. At the same time, it is not said that it does not influence a work of the company in a manner where it sustain good, long-term results. Nonetheless, taking into account the expectation put before activism of shareholder, the actual situation shall be consider as a failure of the idea.

### **3. SHAREHOLDER ACTIVISM IN POLAND**

In Poland situation of the institutional investors was very different than in the US. When in the States, at the beginning of nineties of twentieth century, the 76% of shares of listed companies were in hands of institutional investors, as late as in 2002, for the first time more than 50% of shares of listed companies were in the possession of institution investors in Poland. That shows the great gap between the two economies and situations in a respective stock exchange.

Soon after institution investors got a greater influence, Poland joined the UE and as a Members State had to follow and adopt a respective European law. Polish corporate law is a subject to the European Directive, introduced at the beginning of this paper. Implementation of that directive on the national grounds of Poland brought changes to the Polish Commercial Code.

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<sup>4</sup> Gillan, S.L. and Starks, L.T., 1997, Relationship investing and shareholders activism by institutional investors. Working paper. University of Texas at Austin, Department of Finance.

<sup>5</sup> Brickley, J.A., Lease, R.C. and Smith, C.W., 1988, Ownership structure and voting on antitakeover amendments, *Journal of Financial Economics* 20: 267-291.

<sup>6</sup> Romano, R., 1993, Public pension fund activism in corporate governance reconsidered. *Columbia Law Review* 93: 795-853.

<sup>7</sup> Black, Bernard S, *supra note*.

Following the changes to the Commercial Code and the report of OECD on rules of corporate governance, Polish chambers of pension and mutual funds, produced in 2006 the Code of Good Practices, related to institutional investors and their role in the corporate governance. Vast majority of Polish institutional investors adopted the Code. According to it, they are devoting themselves to:

- participate in the annual meetings of shareholders of companies when they have the right to exercise at least 5% of votes,
- exchange their views before annual shareholders meetings,
- public presentation of candidates for advisory board when proposed by institutional investor or majority shareholder,
- making public their rules of voting on the annual shareholder meetings.

Nonetheless, after several years since adoption of the Code, most of the funds that accepted it, did not implement its provisions fully. Initial will of engaging in the active approach towards portfolio companies, resulted in a rather little outcome.

Situation in Poland that comes from the reports analysis, presents itself as the one of small shareholders activism. Reasons which are given for this situation concerns the fact that there is a limited number of the listed companies with the dispersed shareholding. Another ground that is given in the report, is the fact that pension, insurance and mutual funds are having the high percentage of shares<sup>8</sup>. These funds are seen in Poland as passive or even inactive by their nature. There are only few cases of shareholder activism done by these funds, and the general perception is that they should be encourage to engage more in the corporate governance.

The shareholders activism is seen as something really positive in Poland. The empiric studies show that the shareholders activism, when occurs, in Poland leads to improvement in corporate governance and annual results of the companies that belong to portfolio of institutional investors<sup>9</sup>. Some analysis show that role of the institutional investors and their influence on corporate governance is becoming evident in case of companies that are starting to produce poor economic results<sup>10</sup>. But still, it does not happen too often, and yet the overall outcome is similar to the one in the US.

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<sup>8</sup> Iwanicki J. Nowacki A., 2007, Report from Poland, European Company Law, Issue 2, pp. 90–92.

<sup>9</sup> Słomka-Gołębiowska, A., 2003, Aktywizm inwestorów instytucjonalnych – dobra praktyka w Polsce? *Master of Business Administration* 3/2010 (104): p. 49–64, ISSN 1231-0328.

<sup>10</sup> Karpoff, J.M., Malatesta, P.H., Walking, R.A., 1996, Corporate governance and shareholder initiatives: empirical evidence. *Journal of Financial Economics*, 42(3), p. 365–395.

## **4. SHORT-TERMISM**

As L. Dallas stated, “Short-termism, which is also referred to as earnings management (or, alternatively, managerial myopia), consists of the excessive focus of corporate managers, asset managers, investors and analysts on short-term results, whether quarterly earnings or short-term portfolio returns, and a repudiation of concern for long-term value creation and the fundamental value of firms”<sup>11</sup>.

As we can easily conclude base on the definition given, short-termism is a type of shareholder activism, but yet the one which is not seen as bringing a positive value. Based on the regulations enacted with the goal of improving companies’ performance in the long-run, some shareholders are using them for purposes of immediate result, often harmful for the corporations.

Short-termism in the approach to corporate governance is observed mostly in cases of institutional investors. Different reasons for this situation are examined in case of different entities. Starting with mutual funds, they are connected with this short horizon due to their genuine interest in showing strong short-run results in order to attract new investors to their funds<sup>12</sup>. Pension funds are looking for significant short-term results for reason of renewing of management contracts by its managers and with the expectation of obtaining new ones<sup>13</sup>. In case of hedge funds, managers are simply most often compensated on the base of their immediate results, therefore incentive for achieving them on all costs is already there<sup>14</sup>.

When short-termism occurs is “causing boards and senior managers to forgo long-term value maximization for short-term results, often managing and sometimes manipulating earnings, all toward the end of pleasing the stock market”<sup>15</sup>.

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<sup>11</sup> Dallas, Lynne, Short-Termism, the Financial Crisis, and Corporate Governance (February 16, 2012). *Journal of Corporation Law*, Vol. 37, p. 264, 2011; San Diego Legal Studies Paper No. 12-078.

<sup>12</sup> Aspen Inst., *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management*, 2009, available at [http://www.aspeninstitute.org/sites/default/files/content/docs/bsp/overcome\\_short\\_state0909.pdf](http://www.aspeninstitute.org/sites/default/files/content/docs/bsp/overcome_short_state0909.pdf)

<sup>13</sup> Jenny Anderson, Pension Funds Still Waiting for Big Payoff from Private Equity, *N.Y. TIMES*, Apr. 10, 2010.

<sup>14</sup> Carl Ackermann, Richard McEnally & David Ravenscraft, 1999. *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 *J. FIN.* 833, 834.

<sup>15</sup> Roe, Mark J., 2014, *Corporate Short-Termism – In the Boardroom and in the Courtroom*. *Business Lawyer*; Vol 68, August 2013; ECGI - Law Working Paper No. 210; Harvard Public Law Working Paper No. 13-18. Available at SSRN: <http://ssrn.com/abstract=2239132> or <http://dx.doi.org/10.2139/ssrn.2239132>

Short-termism is a most evident example of a bad use and application of the shareholder activity. It brings results opposite to the intentions of the legislators introducing ways of control and intervention done by the shareholder.

## **5. CONCLUSIONS**

Some studies confirm that legal framework of the countries and evolution of it in perspective of tens of years, is the main reason for lack of incentives for corporate governance done by institutional investors<sup>16</sup>. This conclusion perfectly applies to the present situation in the US. Corporate governance has been evolving in this country longer than in any other, and yet at the end, involvement of the institutional investors, which represents majority of shareholders, does not bring a considerable positive effect. Analysis of the polarized situation of US and of Poland, shows that regardless of massive differences in circumstances, results are quite alike.

Even though the stock exchange in Poland is very young and idea of shareholders activity arrives so recently and came as a solution to many problems in corporate governance, institutional investors, already mostly give up on exercising it. A completely new system and possibilities, that came without the burden of old bad habits or bad experiences, does not change the situation in field of corporate governance. As in both jurisdiction shareholder activism is seen as undoubtedly positive, after the implementation in so different grounds, its favourable effects are in the sphere of wishful thinking equally here and there.

Ultimately some differences in the approach of the investors still can be perceived, but they rather base on the general legal traditions and did not affect the outcome of the shareholders activism as such. This dissimilarity can be seen when in Poland “the major institutional investors engage in a limited spectrum of shareholder activities. Most often they seek to contact the company's management board members as well as supervisory board members if they are dissatisfied with a portfolio company. None of the funds even considers public criticism or litigation”<sup>17</sup>. Apparently the situation in the US is really alike concerning the first phase. Institutional investors also use the way of seeking the quite

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<sup>16</sup> Black, B., Coffee J., 1994, Hail Britannia?: Institutional Investor Behavior Under Limited Regulation. Michigan Law Review, 92, p. 1997–2087

<sup>17</sup> Slomka-Golebiowska, Agnieszka, 2013. Great Expectations from Pension Fund Activism: Insights from an Emerging Market. Corporate Governance and Corporate Social Responsibility: Emerging Markets Focus, Forthcoming.

agreement regarding governance changes with the company board in first place<sup>18</sup>. When this succeeds, proposals for annual meeting or any other actions are not taken. When it does not result in the consensus, some formal operation may take place. In the US we see the litigation as a considerably often chosen attempt on problem solution between board and shareholders. This comparison proves that shareholders in the US are willing to go a step further than in Poland in some matters, but yet these small distinctions do not alter the final result.

The outcome of introduced possibilities of shareholders activism has not reached satisfactory level neither in the US nor in Poland. Dissatisfaction is increased by, present in some of shareholders activities - short-termism. Described under chapter 4, unfortunately solely undermines the anyway small results and positive impact which were aimed to be achieved by shareholder activism. Harmful interventions to the companies done by the shareholders that are directed by immediate results, only increases reluctance towards the idea.

Before mentioned problems and the outcome of the analysis will not remain unanswered. As it was mentioned at the beginning of the paper, the system is still evolving, thus we can anticipate the progressive solutions, which will address problems of corporate governance, also in relation to shareholders activism.

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<sup>18</sup> Carleton, W.T., Nelson, J.M. and Weisbach, M.S., 1997, The influence of institutions on corporate governance through private negotiations: Evidence from TIAA-CREF. Working paper. University of Arizona, Department of Finance.