

<b>Institution:</b> LONDON BUSINESS SCHOOL		
<b>Unit of Assessment:</b> 17 – Business and Management studies		
<b>Title of case study:</b> Long Term Investing		
<b>Period when the underpinning research was undertaken:</b> 2015-2019		
<b>Details of staff conducting the underpinning research from the submitting unit:</b>		
<b>Name(s):</b> Alex Edmans	<b>Role(s) (e.g. job title):</b> Professor of Finance; Academic Director, Centre for Corporate Governance	<b>Period(s) employed by submitting HEI:</b> From 20/05/2013
<b>Period when the claimed impact occurred:</b> 2016 onwards		
<b>Is this case study continued from a case study submitted in 2014?</b> N		
<b>1. Summary of the impact</b>		
<p>The UK <b>changed its corporate governance code</b> in 2018, to recommend the usual three-year period before company executives can sell shares should be <b>extended to five years</b>. Several firms have <b>adopted this policy</b>, including the Weir Group, Pets at Home and RBS.</p> <p>This policy change was triggered after research described in this case study was <b>highlighted</b> in a November 2016 Green Paper on corporate governance from the Department for Business, Energy and Industrial Strategy.</p> <p>Quoting Edmans' research, it said: "There is <b>growing evidence</b> that the usual one to three year holding period for shares provided in executive remuneration packages is <b>too short and can incentivise short-term behaviour</b>." The Green Paper suggested a solution in line with the research findings: to extend the time before a CEO can cash in equity.</p>		
<b>2. Underpinning research</b>		
<p>The research evaluated a new policy possibility: to encourage companies and regulators to <b>shift the way CEOs are rewarded</b>.</p> <p>Starting in 2015 Edmans carried out and published research studies that (1) offered some of the <b>first empirical evidence</b> that CEO behaviour was driven by short-term personal financial incentives and (2) provided a <b>possible solution</b> to encourage executives to run firms for the greater good.</p> <p>The research programme focused on how equity (shares and share options), a common part of executive pay, alters the behaviour of CEOs. Company bosses must typically wait a set period of time before they can sell these shares. This creates a <b>perverse incentive</b>: to artificially drive up the share price immediately before they can sell their stock. It also gives researchers an <b>empirical way to measure</b> this behaviour, by studying the amount of equity that vests (becomes saleable) in a particular period. As usual in economics research, the published papers emerged several years after the studies were completed and the findings disseminated and acted upon. Early results were circulated as working papers in 2013.</p> <p>The first study [published as 3.1] looked at data for more than 2000 firms between 2006 and 2010. It found that, the more equity that is vesting (becoming saleable) in a given three-month period, the more the CEO <b>reduced investments</b> to boost earnings and the share price in the short-term. For example, they were less likely to invest in capital equipment or research and</p>		

development. Specifically, a one-standard-deviation increase in vesting equity is associated with an annualized **0.2% decline in growth in R&D**, corresponding to a cut of \$2 million per year. It was published as a lead article in *The Review of Financial Studies*, one of the most highly-regarded journals in the world. It also **won prizes** including the Wharton School-WRDS Award for Best Empirical Finance Paper at the 2014 Western Finance Association (the most prestigious large finance conference in the profession) and the Investor Responsibility Research Center Institute Research Award, 2017. It later was recognised as one of the five-most cited articles out of all papers published in the 2017 volume of *The Review of Financial Studies*.

The second study [3.2] showed CEOs release more positive news **in months in which equity is vesting**, compared with the month prior and afterwards. The research checked the timing of almost 340,000 corporate press releases issued between 1994 and 2011 against when the relevant CEO was entitled to sell stock. They found **bosses preparing to sell announced 20% more news** in those months and cashed out shortly after announcing news. This paper was also published as a **lead article** in *The Review of Financial Studies*.

A third [3.3] showed that CEOs selling their equity was associated with companies undertaking share buybacks and announcing mergers and acquisitions (M&A) — using data on more than 6,000 companies and 9,000 CEOs between 2006 and 2015. In this case a one-standard-deviation increase in vesting equity is associated with a **1.2% increase in a firm's likelihood of conducting a share repurchase** and a **0.6% increase in a firm's likelihood of announcing an M&A**, in a given quarter.

Both strategies lead to short-term boosts in share price. Normally, share buybacks are also associated with long-term price increases. But, the research showed, when associated with CEOs selling stock, they led to the companies showing **poorer financial performance** in subsequent years. A one-standard-deviation increase in vesting equity is associated with an **annualised 0.61% higher return** over the two quarters surrounding a repurchase, but a **1.11% lower return the year after**. For M&A, the **negative association with long-run returns persists** for longer. A one-standard-deviation increase in vesting equity is associated with an annualised 1.47% higher return over the two quarters surrounding an M&A announcement, but a 0.81%, 0.35%, 0.72%, and 0.62% **lower return in the first, second, and third, and fourth** subsequent years. This paper **won** the Investor Responsibility Research Center Institute Research Award, 2017 and the International Centre for Pension Management Research Award, 2018. It has a revise-and-resubmit at the *Journal of Accounting Research*, a top accounting journal.

Taken together, this research suggests a **simple and effective way** to encourage CEOs to run companies for more than their personal gain: encourage them to lead the firm for more years **before they can cash in** their equity.

Building on this idea, in 2020 Edmans **published a critically acclaimed book** called *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*, which was named to the *Financial Times* Business Books of the Year for 2020. The book shows how companies can create **profit for investors and value for society**, using a “pie-growing mentality” that stresses the size of the pie is not fixed. His research on CEO pay is a cornerstone of the book, showing that the structure of pay (which grows the pie) is more important than the level of pay (which merely redistributes the pie). [3.4]

### 3. References to the research

[3.1] **Alex Edmans**, Vivian W. Fang and Katharina A. Lewellen, Equity Vesting and Investment, *Review of Financial Studies*, Volume 30, Issue 7, July 2017, Pages 2229-2271, <https://doi.org/10.1093/rfs/hhx018>

[3.2] **Alex Edmans**, Luis Goncalves-Pinto, Moqi Groen-Xu and Yanbo Wang, Strategic News Releases in Equity Vesting Months, *Review of Financial Studies*, Volume 31, Issue 11,

November 2018, Pages 4099–4141, <https://doi.org/10.1093/rfs/hhy070>

[3.3] **Edmans, Alex** and Fang, Vivian W. and Huang, Allen, The Long-Term Consequences of Short-Term Incentives (last revised: June 19, 2020). European Corporate Governance Institute (ECGI) - Finance Working Paper No. 527/2017, Available at SSRN: <https://ssrn.com/abstract=3037354> or <http://dx.doi.org/10.2139/ssrn.3037354>.

[3.4] **Alex Edmans** *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*. Cambridge University Press. March 2020. ISBN: 9781108494854

#### 4. Details of the impact

There is **growing demand** among the public and policy makers for **action to tackle short-term thinking** in the corporate world. So, the research was timely, found a receptive audience and had direct impact on **policy makers, business regulations** and **corporate practice**.

##### Policy makers:

Impact on policy makers came after Edmans invested **substantial effort to disseminate** the findings beyond academia. He wrote an FT op-ed in 2017, an HBR article in 2018, and gave a Gresham public lecture series in 2018-9 which included a lecture dedicated to executive pay. He was the guest columnist for *Economia*, the magazine of the Institute for Chartered Accountants in England and Wales, in 2018 and wrote a column on executive pay reform. In 2017 he wrote and published on his own website a non-technical guide on how to reform pay that has been **viewed over 10,000 times**. He has also spoken at many industry conferences on pay design, for example hosted by the Investment Association, the Institute of Chartered Secretaries and Administrators, and the Westminster Business Forum. The research findings received widespread media coverage in high profile publications. For example, they were featured in a *Financial Times* front page article and highlighted in both the *Wall Street Journal* and *The Economist's* prestigious Buttonwood column.

As a result of this outreach effort, Edmans was invited to **testify to the House of Commons Corporate Governance Inquiry** in 2016. The subsequent select committee report, in April 2017, **endorsed the findings of his research** and called for equity to be cashed in “over a genuinely “long-term” period, normally at least five years”. [5.1]

The research findings were also **highlighted** in a November 2016 Green Paper on corporate governance from the Department for Business, Energy and Industrial Strategy (BEIS) [5.2]. Quoting [3.1] it said: “There is **growing evidence** that the usual one to three year holding period for shares provided in executive remuneration packages is **too short and can incentivise short-term behaviour**.” The Green Paper suggested a solution in line with the research findings: to extend the time before a CEO can cash in equity from three to five years.

##### Business regulations:

Following the publication of the 2016 Green Paper, in July 2018 the UK's Financial Reporting Council revised its Corporate Governance Code, which sets **principles and standards for 2,600 firms** listed on the London Stock Exchange. It said firms should lengthen the time horizon for shareholdings by executives to five years, and that they should hold shares for two years after retirement. [5.3] The Financial Reporting Council invited Edmans to speak at the launch event for the new Corporate Governance Code.

##### Corporate practice:

Several high-profile firms including RBS and Pets at Home have **switched their practices**. In 2018, the multinational engineering company The Weir Group said it would **make executives wait up to seven years before they could sell stock**. Writing in the company's annual report, Clare Chapman, chair of its remuneration committee, said the reform was **based on academic**

**research** that indicated “pay packages with less reliance on short-term performance conditions and requiring large shareholdings, have a positive impact on investment, innovation, long-term decision making and long-term value creation.” [5.4] As Chapman explained in the Harvard Business School case study on The Weir Group’s pay reform, “Professor Alex Edmans from London Business School ... assembled the **strongest possible academic evidence** on pay design and the link with long-term value. ... This provided a **strong rationale for proposals** and gave the RemCo confidence in discussions with both executives and investors that our proposals had a **robust underpinning**.” [5.5]

Beyond the UK, in 2016 Edmans was appointed in-house corporate governance advisor to the \$910bn Norwegian Sovereign Wealth Fund, which on average owns **1.3 per cent of every listed company** in the world. In April 2017, the fund released guidelines that said CEOs should be made long-term shareholders because short-term incentives encouraged them to make poor decisions. [5.6] Explaining its decision, it said: “While many CEOs resist such temptations, **academic research supports the notion** that such behaviours exist.”

Yngve Slyngstad, head of the fund, told the Financial Times it would start pressing companies to force chief executives to own substantial stakes in their companies for at least five and preferably 10 years. [5.7]

Attributing change in the complex business world to specific academic findings should be done with caution. But Tom Gosling, then a senior partner at PwC and an expert in executive compensation who advises the BEIS and others on policy, says **Edmans’ research has been instrumental** in driving a rethink on short term incentives in corporate pay. “Prior to Professor Edmans’ work, these concerns had not been documented by rigorous evidence,” he says. This evidence was “**highly influential**” in encouraging the BEIS to recommend the changes in the UK Corporate Code, he says. And it was “**directly influential**” in the development of the Norwegian Fund’s pay guidelines. [5.8]

The 2020 book *Grow the Pie won plaudits* from reviewers. Andy Haldane, Chief Economist of the Bank of England, said “Alex Edmans’ superb book makes the case, compellingly and comprehensively, for a radical rethink of how companies operate and indeed why they exist. It is a tour de force”. Dame Helena Morrissey, former CEO of Newton Investment Management, wrote “This is a brilliant and timely book, taking the business case for responsible capitalism to a whole new level.” It has been presented at Talks at Google and is currently being translated into Chinese and Korean.

## 5. Sources to corroborate the impact

[5.1] House of Commons Corporate Governance Inquiry in 2016; Conclusions and recommendations, 4 April, 2017;

[https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/70211.htm#\\_idTextAnchor108](https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/70211.htm#_idTextAnchor108)

[5.2] BEIS Green Paper: Corporate Governance Reform (November 2016)

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/584013/corporate-governance-reform-green-paper.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf)

[5.3] FRC website -Advice to Directors on revised UK Corporate Governance Code,

<https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code>

[5.4] The Weir Group Annual Report 2017: Directors' Remuneration Report; from

<https://www.annualreport2017.weir/documents/Remuneration%20Report.pdf>

[5.5] The Weir Group: Reforming Executive Pay by Lynn Sharp Paine and Federica Gabrieli. 7 November, 2018. Harvard Business School

<https://store.hbr.org/product/the-weir-group-reforming-executive-pay-b/319047>

[5.6] NBIM: Remuneration of CEO.

<https://www.nbim.no/contentassets/bc85c448e6b24ff5a31088883695a344/ceo-remuneration---amp-1-17---norges-bank-investment-management.pdf>

[5.7] FT article: 'Norway's oil fund wants CEO incentive plans scrapped',

<https://www.ft.com/content/f04af412-1ace-11e7-bcac-6d03d067f81f>

[5.8] Tom Gosling, PwC - beneficiary letter