

PASSIVE INVESTORS: IMPLICATIONS FOR CORPORATE GOVERNANCE

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Abstract

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The key research question of this paper is to explore the major implications for corporate governance from the emergence and perspective of passive investors. Passive investors care more about long-term governance practices than short-term financial metrics. They do not trade shares when accounting balances or stock prices fluctuate since they have a long-term perspective. They desire a new investor relations approach, based upon independent directors discussing key corporate governance topics of board refreshment, sustainability, and compensation with the stewardship officers of passive investors. Thus, financial accounting is moving back to a stewardship purpose of accounting versus an investment valuation model. The corporate governance literature relating to investors has only focused on active, not passive, investors. The emergence and perspective of passive investors are relevant for updating the theory and practice of corporate governance as follows. Passive investors have a long-term sustainability perspective, not a short-term focus to make financial analysts' quarterly predictions. Passive investors focus upon three board of directors' committees: nominating, audit, and compensation, with emphasis on a stewardship officer, a lead director, board refreshment, an indefinite investment horizon, and sustainability risks.

Keywords: Passive Investors, Corporate Governance, Strategic Assets

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1. INTRODUCTION

A passive investor is one who does not participate in the day-to-day decisions of running a company. The passive investor assumes the market is efficient and that stocks are correctly priced to reflect the risk involved in buying the stock. A passive investor relies on the controlling stakeholders and the management to conduct the business of the corporation in such a way as both to maximize its value and to share the upside potential with the passive investor. Passive investing is an investment strategy to maximize returns by minimizing buying and selling. Index investing is one common passive investment strategy whereby investors purchase a representative benchmark, such as the S&P 500

index, and hold it for a long-time horizon (Passive investor, n.d.). BlackRock and Vanguard are the two largest money managers and passive investors in the world. In 2019, they each brought in about one billion dollars of new money each day. Passive investors now control and vote 30% of all U.S. common shares and this paper explores the U.S. experiences of passive investors.

Passive investors care more about long-term governance practices than short-term financial metrics. They do not trade shares when accounting balances or stock prices fluctuate since they have a long-term perspective. They do not want the traditional investor relations approach in which CFOs and other corporate executives offer revenue and earnings guidance for the upcoming quarter

or year. They desire a new investor relations approach, based upon independent directors discussing key corporate governance topics of board refreshment, sustainability, and compensation with the stewardship officers of such passive investors. Listed companies will have to modify their reporting and investor relations practices if they want to meet the needs of these increasingly important passive investors (King 2019, 2018).

The key research question of this paper is to explore the implications for corporate governance from the emergence and perspective of passive investors. Accordingly, the major sections of this paper are as follows: literature review, short-term focus of traditional financial accounting, long-term focus of emerging financial accounting on strategic assets, data as a strategic asset, 2021 crossover point for passive investing, the importance of corporate governance for a long-term sustainability focus, three key board committees for passive investors, emerging corporate governance focus, and conclusions.

2. LITERATURE REVIEW

Current corporate governance research has focused just on activist, not passive, investors. For example, Raja and Kostyuk (2015) outlined shareholder activism development in common law (the USA and the UK) countries and civil law (Germany and Ukraine) countries. They concluded that the type of legal system was not the chief determinant of shareholder activism. They found that the system of domestic corporate regulation, development of the stock market, companies' capitalization, and corporate governance influenced the development of shareholder activism in equal measure. Belcredi, Bozzi, Ciavarella, and Novembre (2017) found that specific classes of institutional investors actively monitored investee firms under concentrated ownership. Carrothers (2017) found that leverage, executive compensation, pay for performance, and CEO turnover increase after the arrival of activist hedge funds. Van der Elst (2011) assessed trends in shareholder activists, how shareholders responded to the fall in profits, and how they exercised influence in the turbulent times between 2007 and 2010 after the 2008 global economic crisis. He concluded that shareholder activism depended on the identity of large individual shareholders in contrast to the effectiveness of one size fits all (mandatory) corporate governance measures.

Kokkinis (2014) assessed the potential impact of short-term shareholder pressure on corporate governance considering available empirical evidence on the effects of institutional shareholder ownership on corporate performance. He concluded that it is expedient to robustly reform the structure of executive remuneration, facilitate a dialogue between companies and long-term investors, and reform shareholder voting rights to deter short-term behavior and reward long-term investors. Jansson (2014) examined the issue of what motivates shareholder activism. He found that significant expropriation risk can antecede a defensive type of shareholder activism characterized by intensified monitoring and reactive intervention to fend off expropriation attempts. Habbash (2012) analyzed the largest 350 UK firms for three years from 2005

to 2007 and found that firms with effective audit committees had less earnings management. The study also found that the monitoring effectiveness of audit committees was moderated in firms with high block holder ownership which suggested that audit committees were ineffective in mitigating the major-minority conflict compared to their effectiveness in reducing owners-managers conflicts.

De Falco, Cucari, and Sorrentino (2016) compared the role of say on pay activism with 120 firms in three different contexts (Italy, the USA, and Australia). In the insider system (Italy), say on pay dissent was positively correlated to the concentration of ownership. In the outsider system (USA), the variable of remuneration was positively correlated to the dissent. In the mixed Australian context, various variables were significant. Diez Esteban and Lopez-de-Foronda (2008) examined the relationship between dividend policy and institutional investors activism by analyzing an international sample of the US, the UK, Irish, and EU companies. In the US, the UK, and Irish firms with the Anglo-Saxon tradition, the relation between dividends and institutional investors was positive but in EU firms with the civil law tradition, the relation was negative.

None of these corporate governance research studies investigated the ways passive investors could influence both the financial and corporate governance performances of a public company. This paper goes beyond these profiles of activist investors and traditional financial accounting analysis in the current literature.

3. SHORT-TERM FOCUS OF TRADITIONAL FINANCIAL ACCOUNTING

The short-term focus upon traditional financial accounting by both financial analysts and corporate executives to "make the numbers", i.e., quarterly, predetermined (analysts' consensus) numbers, has damaged firms' competitiveness (Coburn, 2018). Such damages include postponing or cutting advertising, research and development, employee training, and maintenance expenses to "make the numbers." Research has shown that detected misreporting by firms distorted reported profits on average by only 3% of sales (Terry, Whited, & Zakolyukina, 2019). Similar research has shown that such earnings management techniques are almost meaningless to the stock market since a consensus earnings miss by a company generally produces an insignificant 1.5% to 2% share price drop on average (Lev & Gu, 2016).

However, corporate executives may be focused on "making the numbers" to achieve their short-term, earnings bonus targets. Since traditional financial accounting deficiencies make it hard for executives to report the real performance of the company, they often resort to earnings based upon non-generally accepted accounting principles (non-GAAP). Such non-GAAP numbers have created suspicion and even derision. Lynn Turner, the former Chief Accountant of the Securities and Exchange Commission (SEC), has called such reporting: "Earnings before bad stuff" (Grove, Clouse, & Malan, 2019).

Investors are poorly served by arcane accounting methods and new ways to measure companies' performance are needed (Lev & Gu, 2016).

In the 1970's, 85% of a company's assets were tangible with only 15% being intangibles. By the 2000's, those percentages had reversed. Accordingly, traditionally reported earnings and financial statements no longer reflect the realities of businesses but instead follow an outdated set of accounting rules and regulations, established for "old economy" companies, such as energy, steel, autos, and other traditional manufacturing. New metrics are needed for "new economy" companies, such as technology, software, biotech, and internet operators. Also, with the advent of artificial intelligence and digital technologies, new metrics are needed for both "old" and "new economy" companies in this rapidly changing technological age (Grove, Clouse, & Schaffner, 2018).

The short-term focus of traditional financial accounting fails to highlight essential factors that make an enterprise value rise or fall. For example, the most important, value-creating investments in patents, brands, information technology, and other intangibles must be expensed, just like salaries and rent, instead of reflecting future value or benefits. Reported earnings include both long-term sustainable growth and one-time, transitory gains and losses. All such reporting results in backward-looking accounting statements that say little about an enterprise's future growth and ability to compete with an increasing gap between reporting earnings and share prices (Frigo, 2019; Lev, 2019). This gap is even broader for the "new economy" technology and science-based companies (Grove & Clouse, 2019a). Earnings have lost their ability to predict future corporate performance which is their main use by traditional investors (Lev & Gu, 2016). Furthermore, earnings predictability is not the main use for passive investors who are focused on long-term sustainability for corporate governance.

4. LONG-TERM FOCUS OF EMERGING FINANCIAL ACCOUNTING ON STRATEGIC ASSETS

A long-term sustainability focus of emerging financial accounting on strategic assets was developed by Lev and Gu (2016). It was based on the detailed examination of the transcripts of hundreds of quarterly earnings calls by U.S. public companies in order to gauge the information sought by investors. Most financial analysts' questions concerned the strategy of the company and the strategic assets: those value-creating, unique, and hard to imitate corporate resources. Thus, Lev and Gu created a *Strategic Resources and Consequences Report* based on the information they learned from the questions and answers in these earnings calls.

This new focus on strategic assets is also consistent with the interests of passive investors. A company should start by identifying its major strategic assets, such as patents, brands, customer franchise, and unique business processes, like Amazon's and Netflix's customer recommendation algorithms. Then, the company should proceed with identifying the investments in creating and maintaining the strategic assets, such as research and development and customer acquisition costs. Next, the company should delineate the major threats to these assets from competitors' infringement and technological disruptions. Then, the company should articulate the deployment of

strategic assets, such as how many patents are under development, licensed out, or abandoned. Finally, the company should compute the intrinsic value created by its strategic and other assets (Frigo, 2019). The importance of, and focus on, intrinsic value has been advocated for the evolution of corporate governance (Grove & Lockhart, 2019).

Strategic resources share the following three attributes: 1) They are valuable and create or contribute to the creation of a stream of benefits which exceed costs, such as patents underlying profitable products or services; 2) They are rare as a limited amount of these assets is generally available, like wireless spectrums or airlines' landing rights and 3) They are difficult to imitate as competitors cannot easily acquire or produce these resources, like the valuable brands of Google and Amazon.

Enterprises owning and efficiently operating such strategic assets can consistently implement value-creating strategies that their present or potential competitors cannot put into effect and, thereby, gain a sustained competitive advantage. Using this theory of strategic assets as a foundation, Lev and Gu (2016) built a *Strategic Resources and Consequences Report* which has five aspects:

1) *resource development*, such as the number of patents in a company's portfolio, patents supporting products/services, number of patents licensed out, patent quality, and protection mechanisms against infringement;

2) *strategic resources*, such as customer acquisition costs for telecom and internet companies;

3) *resource preservation* concerning the major risks to the company's strategic assets from infringement by competitors, disruptions by new technologies, and regulatory moves, as well as the measures taken by management to mitigate these risks;

4) *resources deployment* concerning the specific deployment or uses of the firms' strategic assets;

5) *value created* by quantifying and reporting the value creation from managers' activities in creating, preserving, and deploying strategic assets.

5. DATA AS A STRATEGIC ASSET

Although technology companies are among the most valuable public companies, the strategic asset of data cannot be found in their financial statements. This insufficient treatment of data as a company asset has been yearly challenged in studies such as the *GIFT report* (Brand Finance, 2017). This report stated that in accounting terms, an asset is defined as a resource that is controlled by the entity in question and is expected to provide future economic benefits. The International Accounting Standards Board's (IASB) definition of an intangible asset requires it to be non-monetary, without physical substance and 'identifiable'. In order to be 'identifiable', it must either be separable (capable of being separated from the entity and sold, transferred or licensed) or it must arise from contractual or legal rights (irrespective of whether those rights are themselves "separable". Therefore, intangible assets that may be recognized on a balance sheet under IASB rules are only a fraction of what are often considered to be intangible assets' in a broader sense.

A broader view of intangible assets argues that data should be considered a strategic asset as the surge of corporate intangible investments is the hallmark of developed economies, radically transforming the business models, strategies, and performance of business enterprises (Lev, 2019). Emphasizing the importance of data and other intangibles as strategic assets, Lev and Gu (2016) argued for the end of traditional accounting and created a financial reporting path forward for investors and managers. Concurring with the importance of intangibles as strategic assets and improved financial reporting, the current chairman of the U.S. Securities & Exchange Commission, Jay Clayton, told a U.S. Senate committee that “we can do a better job around disclosure. In this economy, we should be driving disclosure toward human capital, intellectual property, supply chain management, and relationships with vendors” (Barlas, 2019).

Organizations have become aware that data may also become a cost and a liability. Although costs for data storage have been decreasing rapidly over the last decades, costs for analyzing ever bigger amounts of data, costs for transporting ever-larger amounts of data, and pressure to use higher encryption standards have been increasing (Georg, 2016). With the enactment and enforcement of the General Data Protection Regulation (European Commission, 2018), the European Union (EU) has made it clear that organizations can possess too much personal data and that possession can result in expensive fines, up to 4% of the organizations worldwide profit. EU citizens have the right to data privacy and may demand that their personal data be deleted from all systems. Also, attempts to tax companies on the collection and usage of personal information of EU citizens are being discussed. (European Commission, 2018).

Data has become the key strategic asset for a growing number of companies due to the emergence of disruptive technologies that are driving value creation across industries. The board of directors has a key role in ensuring that management fully captures and safeguards the future value coming from the data-driven business. The focus is on two key strategic assets: data and the ability of the company to create, amplify, protect, and solidify value from data. A key driver is “datafication”, the process of making processes, business models, and products fully data-driven. Michael Hilb created this term for his research article, “Unlocking the board’s data-value challenge” (Hilb, 2019). Hilb is vice president of group strategy, and digital business at DKSH, a Zurich international market expansion services company, and the titular professor at the University of Fribourg, Switzerland. Emphasizing that data are key strategic, intangible assets for company valuations, seven out of the ten most valuable publicly traded companies as of April 2019 were digital platforms whose main assets are data (Hilb, 2019). In another article, Hilb offered guidance for the key dimensions of digitalization, governing, enabling, amplifying, and realizing digital value creation (Hilb, 2017).

Concerning implications for corporate governance, boards of directors, and passive investors usually face four common challenges in having a strategic dialog with top management on the role of the strategic data asset (Hilb, 2019):

1. *Awareness.* A shared understanding of the nature and value of data across an organization is needed to create real value out of data.

2. *Bimodality.* The value of data is two-fold as data can provide a unique opportunity for business value creation. However, the mishandling of data can pose an existential risk.

3. *Ambiguity.* As data-driven technologies still must unfold their full potential, many of the opportunities and risks remain unclear.

4. *Execution.* The economic value of any data strategy will only manifest itself if the organization can apply new tools and technology, especially how to make the best, the combined use of human and data-driven intelligence.

Addressing these four challenges should be a joint effort by the board, management, and passive investors to ensure that the company has access to the right data and is not overwhelmed by data overload. These four joint steps can provide an approach to encourage, enable, and ensure that an organization embraces data-driven strategies (Hilb, 2019):

1. Create awareness by promoting a data culture. The first step is to establish a common data language in the organization which allows everyone to analyze the benefits and risks related to datafication of the organization.

2. Embrace bimodal thinking by aligning data strategy with the business strategy. A comprehensive strategy consists of clear, concrete actions related to data technology, data assets, and data partnership management.

3. Minimize ambiguity by requesting an agile “datafication” road map from management. It is critical that the board and management have a shared understanding of the business strategy and data which allows for regular modification and short-term action plans.

4. Assess the readiness of the organization to execute a data strategy. The board is well advised to ensure that the optimal conditions for the sustainable success of strategies are present, namely the right capabilities, skills, and processes.

For strong corporate governance, the board must consider the impact of new data-driven technology on strategy and ultimately on long-term value creation. Ensuring that the company exploits the full potential of the data revolution will not only lead to better outcomes but also send a clear signal to the organization. Data is the key strategic asset and how well the organization embraces the risks and opportunities of datafication will determine its future (Hilb, 2019).

Emphasizing “datafication” in 2018, the new CEO of the Swiss company Novartis, one of the world’s largest pharmaceutical companies, declared that Novartis has become a data company. This new business strategy demonstrates the importance of data and digital information for a major global public company. Conversely, the insufficient quantification of data as a strategic asset not only bears financial risk for active and passive investors but also may impact risk management related to the protection and investment in the security of data assets. A study among non-executive board members showed that only 10% of board members know the value of information in their companies and, consequently, cannot tell what strategic data assets their companies possess or how much they

are willing to approve for investment and protection of data (Georg, 2016).

To help remedy this ignorance of data as a strategic asset, a discipline called *infonomics* should be relevant. Infonomics represents the economics of information and describes the data that permeate the economy. There are five ways to calculate the value of data or information using infonomics (Laney, 2017):

1. *Intrinsic value of information* is based on the quality of the data an organization possesses.

2. *Business value of information* is based on how the data can be used to optimize internal processes.

3. *Loss value of information* is based on the calculation of how much it would cost to recover lost data.

4. *Performance value of information* is based on the calculation of how far data can help the organization achieve its key performance indicator targets.

5. *Economic value of information* is the performance or benefit value minus the costs to manage the data.

Calculating the economic value of data with these five steps would help facilitate the management of “datafication” by corporate executives, boards of directors, and passive investors. Also, infonomics could create new measurement systems that would increase the understanding of the strategic asset of data. For example, data security is usually perceived only as a cost that never generates a return on investment. This emergence of data as a strategic asset should help emphasize the value of data and help create returns on investments for both active and passive investors.

6. 2021 CROSSOVER POINT FOR PASSIVE INVESTING

According to Moody’s Investor Service, 37% of all money invested in U.S. mutual funds and exchange-traded funds (ETFs) is passively invested as of 2018. Moody’s predicts that 2021 will be the crossover point where the market share of passive investors increases to over 50%. It says the trend of active versus passive investment is like the spread of technology. Passive investing is viewed as a cheaper and more efficient technology for investors. As more people learn about passive investing, it will spread over time (Butera, 2019). For example, Warren Buffett, CEO of Berkshire Hathaway, has recommended that investors just invest in index funds, like the Vanguard S&P 500 index fund.

The two largest money managers and passive investors in the world are now BlackRock, the leader in ETFs, and Vanguard, the leader in index mutual funds. Such ETFs and index mutual funds hold portfolios of securities designed to mimic the financial return of a market index, such as the S&P 500, the Dow Jones Industrial Average of 30 companies, or the Russell 2000, or a particular sector, such as healthcare, technology, or gold. If the median investor earns the same return as the market index, passive investing should outperform half of all active money managers, due to its low operating costs.

Money managers are classified as beneficial owners since they use client money to pay for

security purchases. Any beneficial ownership greater than 5% in U.S. listed stocks must be disclosed per a U.S. Securities & Exchange Commission requirement. The Dow Jones Industrial Average of the 30 companies can be used to show the growth of passive investors using a market index. In December 2007, BlackRock and Vanguard owned none of these 30 companies but by December 2017, they each owned an average of 6.7% and 5.9%, respectively, of all 30 companies. Index investors seek to deliver investment returns that reflect market indices. If common stock is in a benchmark index, passive investors have an incentive to buy and hold that stock. Failure to hold onto the stock in an index generates unwanted tracking errors, where the passive portfolio results diverge from the underlying index. A passive money manager’s investment horizon lasts as long as security is part of a broader index. Trading decisions are not based on the disclosure of traditional financial accounting information, such as short-term revenues or earnings (King, 2019, 2018).

7. THE IMPORTANCE OF CORPORATE GOVERNANCE FOR A LONG-TERM SUSTAINABILITY FOCUS

Accordingly, passive investors have a much different focus than other investors. They do not buy shares following value or growth investment strategies. They do not sell shares following short-sellers’ strategies. As long as a company’s common stock is part of an index, they must hold those shares regardless of recent financial performance or general stock market bad news or volatility. A former Vanguard CEO has said that index investors are permanent shareholders who hold onto a stock whether active investors pile in or run out. This inability to sell reduces the usefulness of accounting information since passive index investors use such information to assess the corporate governance practices of companies in their portfolios. The critical concern for passive investors, as well as many activist investors, like private equity funds and hedge funds, is the quality of the board of directors. Skilled directors can mentor executives and replace weak CEOs (King, 2019; Grove & Clouse, 2019b).

Corporate governance for these types of investors is focused on a long-term implementation and sustainability horizon. If owners elect skilled directors, then a company should be positioned for long-term success. Skilled directors hire effective CEOs who recruit strong executives who adjust operations as customers and tastes change, patents expire, laws evolve, innovations emerge, technology risks and opportunities appear, and competitive advantages fade. Such adjustments allow a company’s executives to consistently deliver sustainable results (King, 2019).

Many passive investment firms appoint a stewardship officer or team to coordinate this overview of corporate governance at firms in their portfolio. As one stewardship officer said:

“We are neither interested in nor capable of micromanaging the affairs of any company in our portfolio. When things go awry, one of the things we fall back on as investors are the ability to effect change at the board level. It’s not about getting into the weeds of the company at all. We do not do that here. We are not expert enough to do it. The

management and the board ought to know a whole hell of a lot more about a company than we would ever know. When you get the right people on the board, experienced, engaged, well-informed people in the boardroom who appoint management who are equally engaged and skilled, then the governance process will deal with any concerns. We are very unlikely to need to talk to those companies” (BlackRock, Inc.).

To go awry is not missing the quarterly revenue and earnings projections but consistently reporting results that are below performance numbers of peer companies. Stewardship officers or teams from passive investors then ask to speak to directors to understand how that company’s board functions. These discussions are not deep dives into how companies are run but instead focus on how boards facilitate corporate renewal, including getting good directors (King, 2019).

8. THREE KEY BOARD COMMITTEES FOR PASSIVE INVESTORS

If stewardship discussions with board directors imply that weak governance contributed to poor competitive performance, then passive investors, who hold sizable equity positions may use their influence to vote against established directors or to vote for newly nominated directors. The goal is to bring change to the three key board committees: nominating, audit, and compensation (King, 2019, 2018).

Nominating Committee

Since the nominating committee recruits new directors, good governance depends on attracting directors who can provide effective oversight as companies and markets evolve. A corporate governance red flag is a board composed of long-tenured directors with similar backgrounds. This red flag was pointed out by the activist investor, Barington Capital Group, for L Brands which was outperformed by its industry group peers over the last five years by about 100%. L Brands total market capitalization loss over that period was \$20 billion while both its industry peer group, which could be an ETF, and the S&P 500, which could be an index fund, went up 72% and 68%, respectively (Grove & Clouse, 2019b). For another example, international banks’ poor performance during the 2007-2009 global financial crisis showed how their boards failed to attract engaged directors with derivatives and risk management expertise.

Strong board members with relevant industry experience can evaluate company performance and assess long-term threats. They can offer productive suggestions for long-term renewal. Such directors can protect investors by replacing the CEO or selling the company at a fair price. To help assess board strength, stewardship officers can seek information on how nominated directors will be expected to contribute, especially when foreseeable problems arise, such as the increased risk from rapid technological change for most companies. They can also determine how a nominating committee refreshes the board of directors. Refreshment means attracting qualified new directors, managing the performance of current directors, and ensuring that

tenured directors leave at appropriate times (King, 2019). Such refreshment helps avoid “male, pale, and stale” problems.

For example, the Constellation Software CEO has argued that the board’s real mission is to build long-term intrinsic value and that it takes several years for a new board member to learn enough about a company to add real value as a director, especially in mentoring company executives. In the last five years, Constellation’s stock price has quadrupled, and its market cap has increased \$11 billion. It has been the top-performing stock on the Toronto Stock Exchange over the last eight years (Grove & Lockhart, 2019).

Audit Committee

The audit committee seeks to keep a company’s financial reports free of material misstatements. It selects the independent auditor and reviews critical accounting policies. The most notorious breakdowns in such oversight were WorldCom (capitalizing, instead of expensing, over \$1 billion of operating costs) and Exxon (ignoring illiquid investment write-downs and hiding debt off the balance sheet). Both companies were audited by Arthur Andersen, which consequently went out of business.

Accounting policy selections are only a minor concern to passive investors since such choices will reverse out over their long-term investment horizon. A key concern for passive investors is the identification, measurement, and disclosure of long-term risks facing the company. Accordingly, one passive investor commented: “I want to make sure that a company has a plan which incorporates sustainability in the long-term strategy” (BlackRock, Inc.). For passive investors, sustainability means a company can pursue business goals indefinitely. Operating activities with harmful social consequences, such as emitting pollutants, paying unfair wages, selling unhealthy products, or bribing government officials, threaten the long-term earnings power of a company. Passive investors see sustainability issues as strategic financial risks to be mitigated. For example, they want to know how a company is dealing with the risks and opportunities from technological change. If a company depends on the quality of its human capital, then stewardship officers want to know how the company assesses efforts to attract, motivate, and retain talented employees (King, 2019).

A significant example of the importance of sustainability was provided by Larry Fink, the BlackRock CEO, the world’s largest asset management company and passive investor with over \$6 trillion under management in 30 countries and clients in over 100 countries. In January 2018, he sent a letter to all CEOs of public companies across the world telling them to start accounting for the societal impact of their companies and to focus upon economic growth that is sustainable. Currently, a majority of S&P 500 companies have publicly disclosed their sustainability performances with Environmental, Social and Governance (ESG) metrics. These ESG reporting companies have higher financial returns than their non-ESG reporting competitors as investors are becoming responsive to sustainability (Grove & Clouse, 2018).

Compensation Committee

The compensation committee oversees incentives given to a company's senior executives. Passive investors look for clear links between company goals, performance measures showing goal achievement, and rewards based on reported performance measures. High compensation should be associated with evidence of meaningful long-term value creation, not the short-term goal of making the quarterly or annual revenue and earnings numbers. Stewardship officers look for board directors to take ownership of the design and oversight of incentive programs. A red flag is delegating this authority to management or compensation consultants who never find that company executives are overpaid as they want to be rehired next year. One passive investor commented: "When the chair of the compensation committee can't articulate the most basic tents of the company's compensation policy and has to rely exclusively on the compensation consultant, that's a concern" (King, 2019).

For example, the Constellation Software CEO instills a culture of ownership by requiring senior managers and directors to hold substantial equity in this publicly listed company. Long-term oriented incentive programs rewarding profitability and growth, as well as director fees, must be invested

substantially in Constellation common stock and held in escrow for an average of four years. Thus, Constellation has a company-wide commitment to near-perpetual ownership, resulting in a long-term horizon for the creation of intrinsic value, like Berkshire Hathaway's compensation program for both executives and board directors (Grove & Lockhart, 2019).

9. EMERGING CORPORATE GOVERNANCE FOCUS

The traditional short-term investment focus is on making (or missing) the quarterly and annual numbers for security analysts to make buy (or sell) recommendations. However, passive investors have a long-term focus with limited discretion over security selections. These almost permanent investors seek to understand how decisions are made in boardrooms. Thus, publicly listed companies must allow independent directors to answer open-ended questions posed by stewardship officers of passive investors. A stewardship officer performs careful and responsible management of the assets that investors have entrusted to the care of a passive investor. Table 1 compares the old versus the new approach for investor relations (King, 2019).

Table 1. Traditional versus new investor relations approach

	<i>Old approach</i>	<i>New approach</i>
Shareholder representative	Security analyst	Stewardship officer
Company representative	Chief financial officer	Lead director
Typical discussion topic	Competitor threats	Board refreshment
Investment horizon	Two years	Indefinite
Performance measures	Revenues & earnings	Sustainability risks

When a company reports lagging performances or shows some other corporate governance concerns, stewardship officers will want to meet directors separately from company executives to learn more about how a board operates. If a company declines such a meeting or engagement request, it may indicate that company executives either believe directors don't know enough about their company or may say something that they do not want investors to hear. Evolving financial reporting to passive investors requires that company management prepares and allows independent directors to meet privately with investors. Such engagement meetings want to determine if a board has the ability and willingness to hold management accountable. As one passive investor commented: "Talking to the management team about the board isn't terribly instructive for us because I can't think of a management team that has said we have a crappy board and you are really lucky that things haven't gone off the rails. Occasionally, we leave an engagement meeting with a sense that either the directors are clueless or so under management's thumb that we're concerned" (King, 2019).

Directors can reduce the need for such engagement discussions with stewardship officers by focusing upon the following corporate governance guidelines of passive investors (King 2019):

Declassified boards: Corporate boards should require all directors to stand for election annually. Classified boards, typically with three cohorts of

directors serving staggered three-year teams, slow shareholders' ability to vote against unwanted directors.

Majority voting: Any director who secures fewer than half of all votes cast in an uncontested election should offer to resign. The board should either accept the resignation or explain in writing to shareholders the reason for not accepting the resignation.

Proxy access: Shareholders who own a meaningful stake in the company for a sufficiently long period of time should have the ability to nominate directors either in proxy statements or at shareholder meetings.

Say on pay: Shareholders should have the right to vote on compensation plans for a company's senior executives, especially for a majority blend of long-term goals over short-term goals.

One share, one vote: Voting power should be proportional to a shareholder's investment at risk in a company. Different classes of common stock with uneven voting rights disadvantage certain owners, especially when company founders own a majority of the voting shares, like Facebook and Alphabet (Google).

These five key corporate governance guidelines or views held by passive investors are all included into the eight major corporate governance principles developed by major corporate leaders and investors. In 2015, the CEO of JPMorgan Chase, Jamie Dimon, called the CEO of Berkshire Hathaway, Warren Buffett, and suggested that they get together and

come up with general principles for corporate governance that would become a pathway for the future. 13 prominent U.S. business leaders came from industry, including IBM, Coca-Cola, General Motors, Johnson & Johnson, and Bank of America, one activist investment firm, and several asset management firms, including the passive investors, BlackRock and Vanguard, State Street Global Advisors, T Rowe Price, and the Capital Group (Grove & Clouse, 2017).

These 13 leaders secretly worked for one year and created a report named Commonsense Corporate Governance Principles (Governance Principles, 2016). They wanted to provide such guidance at a time when fewer entrepreneurs are deciding to sell shares on U.S. public markets (Mathews, 2016). These authors said that the resulting document was detailed and tough-minded with commonsense recommendations and guidelines about the roles and responsibilities of boards, companies, and shareholders (Thakker, 2016). One commentator said that these principles may set a new standard in American corporate governance and that the stakes couldn't be higher as over 90 million Americans own U.S. public companies through their investments in mutual funds, ETFs, retirement plans, and pensions (Gara, 2016). A corporate governance expert commented on these principles: "I think it shifts the burden of proof onto any corporation that doesn't comply, and I am delighted the signatories are such influential people" (McGregor, 2016).

For an update in October 2018, CEOs of 21 leading public companies, pension funds, and investment firms, including the original 13 sponsors, signed Version 2.0 of the Commonsense Corporate Governance Principles and committed to using these principles to develop corporate governance practices within their own organizations. The same eight corporate governance principles are intended to provide a basic framework for sound, long-term-oriented governance. Given differences among public companies, not every principle will be applied in the same fashion by every company, board of directors, shareholder, or stakeholder (Business Wire, 2018).

10. CONCLUSION

The key research question of this paper is to explore the major implications for corporate governance from the emergence and perspective of passive investors. Since passive investors care more about long-term holding and long-term performance, they usually do not trade shares when accounting balances or stock prices fluctuate. This long-term focus is consistent with the 2018 Commonsense

Corporate Governance Principles which are intended to provide a basic framework for sound, long-term-oriented governance. A major implication for corporate governance from passive investors is to focus upon their desire for a new investor relations approach. To accommodate this new focus, corporate governance should emphasize the role of directors discussing the relevant topics of board refreshment, sustainability, and compensation with the stewardship officers of passive investors.

In summary, the emergence and perspective of passive investors are relevant for updating the theory and practice of corporate governance as follows. Passive investors have a long-term sustainability perspective, not a short-term focus to make financial analysts' quarterly predictions. Passive investors focus upon three board of directors' committees: nominating, audit, and compensation, with emphasis on a stewardship officer, a lead director, board refreshment, an indefinite investment horizon, and sustainability risks. Building on the analysis and suggestions in this paper, corporate governance theory and practice will need to be updated by focusing on the changes required to adapt to the needs and desires of the growing population of passive investors which are also consistent with the emerging Commonsense Corporate Governance Principles.

The major limitations of this study are that there is a dearth of both theoretical and empirical academic research, as well as practice applications, due to the relatively recent emergence of significant or material passive investing. Thus, all the following suggestions for future research represent the limitations of this study. Future theoretical and empirical research could explore passive investing as it becomes more widespread. For example, the following topics could be investigated with case studies of major public companies tracked in various indexes used by passive investors. The increase in passive investing should require such companies to improve their investor relations practices in order to maintain good working relationships with these almost permanent investors who are not influenced by the latest quarterly releases. Improved company communications should include engagement meetings with stewardship officers of passive investors, discussing how boardrooms are filled with skilled directors who oversee effective CEOs and the effectiveness of the three key board committees for passive investors: nominating, audit, and compensation. Such communications should require active involvement from independent directors and should focus company efforts to manage for the long-term.

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